Parliamentary Inquiry into Diversifying Australia's Trade and Investment Profile

FSC Submission

August 2020

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1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advice licensees and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2. Introduction & Summary

The Financial Services Council (**FSC**) welcomes the opportunity to provide a submission to the Joint Standing Committee on Trade and Investment Growth in response to the Committee's Inquiry into Diversifying Australia's Trade and Investment Profile (**the Inquiry**). The terms of reference for this Inquiry are in <u>Attachment A</u>.

The key points raised in this submission are:

- There are in-principle benefits from Australia diversifying export destinations.
- This could be achieved if the Government addresses the barriers that have meant Australia is ranked equal last for tax and regulation of managed funds.
- In particular, the Government should:
    - Prioritise the delivery of an existing commitment to a Corporate Collective Investment Vehicle (CCIV) to create a globally competitive investment management vehicle;
    - Facilitate the rationalisation of current investment products into the CCIV to promote the uptake of the CCIV regime as an effective means of accessing global markets;
    - Deliver on existing commitments to fix tax problems for managed funds;
    - Simplify the current withholding tax system that applies to managed funds to deal with the unnecessary complexity;
    - Examine the unintended tax impediments which currently exist in the Australian system to prevent the global mobility of existing Australian investment management vehicles;
    - Abandon proposals to remove the Capital Gains Tax (**CGT**) discount for managed funds which will overtax investors in managed funds, and will cut the superannuation savings of many Australians; and
    - Develop Double Tax Agreements with major financial hubs

- The Asia-Region Funds Passport has the potential to dramatically reduce barriers to trade in funds management services in our region but the Passport has so far failed to reach its potential.
- Australia has been reliant on foreign investment for much of its history – but this reliance has declined recently, to such an extent that we are now running a Current Account Surplus.
- This is largely, if not exclusively, because of a decline in Australian investment, rather than an increase in Australian savings.
    - This indicates Australia does not have an issue with excessive reliance on foreign investment compared to much of our history. If anything, we need to be doing more to promote foreign investment.
- Australian investment levels need to be boosted if Australia wishes to return to growth. This can occur by Australia:
    - increasing Australian savings levels, such as through a more efficient superannuation system;
    - reducing excessive regulation on foreign investment; and
    - reducing taxes on foreign investment, including by lowering the company tax rate which evidence indicates will boost foreign investment.

3. Exports (terms of reference 1, 2, 5–8)

There are benefits in principle from Australia diversifying its export destinations – in particular it will make our economy more resilient to downturns or shocks that are country-specific or region-specific. Note the FSC does not have a view about whether Australia is too reliant on any one country for exports (terms of reference 1).

The FSC has recently noted that Australia has a once in a generation opportunity to make Australia an international financial services hub.[1] This has long been a priority of the FSC.

Promoting Australia as a financial services hub will clearly help in diversifying exports, as an international hub, almost by definition, is diversified in its exposure to export markets.

3.1. Policy proposals – prioritise existing Government policies

There are several important policy changes the Government should make that will enable Australia to export financial services to a more diverse range of countries and potentially become a financial services hub. The need for these changes is clear. The most recent international comparison of managed funds by Morningstar concluded that Australia ranked ***equal last*** for tax and regulation, inferior to 20 other markets including the UK, much of Europe, Hong Kong, Singapore, Thailand, Taiwan and Korea.[2] There are also significant

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[1] See FSC press release: https://fsc.org.au/resources/2038-fsc-media-release-fsc-backs-policies-to-promote-australia-as-a-financial-services-hub/file

[2] See FSC press release: https://fsc.org.au/resources/2007-fsc-media-release-australia-managed-funds-world-leading-despite-inferior-tax-and-regulation/file

opportunities, with some financial service businesses currently located in Hong Kong potentially looking to relocate.

The Government has already adopted many of these measures as policy, so the FSC is largely arguing the Government should be implementing its own policies.

These changes will lower a number of the barriers that are currently discouraging investors, particularly in the Asian region, from purchasing Australian financial service exports.

- **Implement a Corporate Collective Investment Vehicle** (CCIV). Australia is currently at a disadvantage compared to other countries that have a corporate vehicle for managed funds, because of the much more widespread overseas knowledge and acceptance of corporate vehicles.
    - It is important that there is an ability of the industry to adopt a CCIV through rollover from existing investment vehicles. This is important in ensuring that there is critical mass in funds which are to be distributed regionally. It is also important element of the creation of a more efficient industry through product modernisation.
    - CCIVs will substantially increase the global competitiveness of Australia's funds management industry, and therefore diversify our fund management exports, as long as the CCIVs have similar tax treatment to existing funds management vehicles and the important tax problems with funds management vehicles, discussed below, are addressed.
    - The introduction of the CCIV is Government policy, announced in 2016.[3]
- Address **outstanding issues with the Investment Manager Regime (IMR).** The IMR should mean that a foreign managed fund that engages an Australian fund manager doesn't therefore become an Australian taxpayer. The IMR allows Australian fund managers to be competitive in exporting funds management services to other countries, particularly in our region. The Government has committed to consulting on the need for legislation to ensure the IMR works correctly but this has not yet occurred.
    - This is a Government commitment from 2017.[4]
- **Expand the functional currency election to certain trusts and partnerships**. This reform will enable managed funds to use a more relevant currency for tax purposes, with the fund not being subject to inappropriate taxation solely because of movements in the Australian dollar that are irrelevant to the fund's operations. This reform will also assist in diversifying Australia's fund management exports as it will be significantly easier for Australian funds to be established using foreign currencies and marketed in relevant countries, particularly in Asia.

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[3] See: https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Corporate-Collective-Investment-Vehicle/
[4] See: https://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/improving-australias-financial-services-taxation-regime

- This is a commitment from 2012, reaffirmed by the current Government in 2013.[5]

- **Fix outstanding issues with the Taxation of Financial Arrangements** particularly the need for appropriate taxation of foreign exchange (forex) hedging. The lack of an appropriate forex hedging regime is discouraging Australian funds from operating across borders.
    - This a Government commitment from 2016.[6]
- **Implement a comprehensive product modernisation scheme for managed funds and life insurance products** which would enable customers to move from out of date financial products to more modern products with equivalent or better features, without a tax penalty. A modernisation scheme would encourage managed fund innovation, including through seeking out new markets in the Asian region.
    - This is a Government commitment from 2015.[7] The FSC argues the commitment should be expanded to cover superannuation products, given the Productivity Commission estimated in 2017 there was $162 billion trapped in out of date (or legacy) super products.[8]
    - The need for a product modernisation scheme has been recognised by ASIC,[9] APRA,[10] Treasury,[11] the Cooper Review (Superannuation System Review),[12] the Financial Systems Inquiry,[13] and the Productivity Commission.[14]

3.2. Asia Region Funds Passport

An ideal vehicle exists to make it easy for Australian managed funds to export to our region: the Asia Region Funds Passport (**The Passport**). The Passport allows managed funds domiciled in any Passport country to be sold easily to retail clients in any other Passport country. The current Passport countries are Australia, New Zealand, Korea, Japan and Thailand.

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[5] See page 4 of: http://ministers.treasury.gov.au/sites/ministers.treasury.gov.au/files/2019-05/MR008-2013.pdf
[6] See: https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Taxation-of-financial-arrangements---regulation-reform/
[7] See: https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry
[8] Page 115 of Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91
[9] See: https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-466-asic-s-work-to-reduce-red-tape/
[10] https://www.apra.gov.au/sites/default/files/APRA-submission-to-Financial-Advice-Life-Insurance-Inquiry_1.pdf
[11] https://financialservices.royalcommission.gov.au/publications/Documents/reforms-to-general-and-life-insurance-background-paper-27.PDF
[12] https://treasury.gov.au/review/super-system-review
[13] https://treasury.gov.au/publication/c2014-fsi-final-report
[14] Rethinking Regulation: Report on the Taskforce on Reducing the Regulatory Burden on Business (January 2006) See: https://www.pc.gov.au/research/supporting/regulation-taskforce/report/regulation-taskforce2.pdf

However, the takeup of the Passport has been minimal – at time of writing we are not aware of any Australian managed funds in the Passport, and very limited funds from any other Passport country.

There are several potential reasons for the Passport failing to take off, including:

- A lack of clarity about tax treatment of investors from Passport countries investing into funds domiciled in other Passport countries.
- Complex tax rules in some member countries, particularly Australia. The tax proposals in this submission should help the issues for Australia.
- Significant limitations on the assets that can be held in Passport funds. It is vital to expand the range of products which may be distributed through the Passport so it is an effective alternative to other passport products distributed throughout Asia.
- Difficulties with how to distribute funds to retail clients in a different Passport country – for example, financial advisers may be unaware of funds domiciled in other countries or reluctant to advise them to clients.

The success of the Passport requires Australia to lead in facilitating better understanding of the cross-border flows between Passport participants, particularly in relation to their tax treatment.

The Committee may wish to explore the issues with the Passport with the ATO, ASIC and Treasury.

3.3. CGT discount for managed funds

The Government has proposed to remove the CGT discount at fund level for Managed Investment Trusts (**MITs**) and Attribution MITs (**AMITs**). The FSC opposes this proposal, which was announced in 2018, because:

a) The change will harm 'mum and dad' investors who invest through a managed fund compared to those who invest in the market directly.
b) The change will harm 'mum and dad' investors who invest through a managed fund compared to those who invest through a discretionary trust.
c) The change will cut the superannuation savings of Australians because it will increase the tax on superannuation investments that occur through a managed fund.
    a. this investment from super funds is around $673 billion for large super funds as at March 2020;[15] and $125 billion for SMSFs as at December 2019.[16]

The proposal would impose an unwarranted tax penalty on investors into MITs and AMITs – a tax penalty that will be passed through to all investors into Australian MITs and AMITs, including foreign investors (even though the policy is not directly harmful to foreign

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[15] APRA Quarterly superannuation statistics, sum of superannuation investment in retail and wholesale trusts.

[16] See: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-quarterly-statistical-report---December-2019/?page=3#Asset_allocation_tables

investors). In addition, the proposal will not help Australia address its poor global ranking for managed funds in the Morningstar study (see Section 3.1 above).

More detailed arguments against the policy proposal are in Attachment B.

The FSC instead considers the Government's proposed measure be replaced with a measure targeted at the small proportion of investors that are inappropriately accessing the CGT discount through MITs and AMITs.

3.4. Simplification of the Australian Withholding tax regime

The existing withholding tax rules applying to foreign investors into Australian collective investment vehicles are unnecessarily complicated and are perceived as being uncompetitive.

We recommend the simplification of the withholding tax rules as they apply to Australian investment vehicles. These changes do not necessarily need to cover investments into Australian real property. Currently, the withholding tax provisions raise very limited revenue as the FSC has argued in previous submissions[17] so a change would come at limited cost.

Given these withholding tax concerns limit the ability to promote the Passport, the FSC recommends the withholding tax on distributions by Passport vehicles be reduced, preferably removed, other than for distributions related to investment in Australian real property.

3.5. Double Tax Agreements (DTAs)

Australia's financial services exports as well as the sources of foreign investment are likely to become more diversified if the Government prioritises the development of Double Tax Agreements (DTAs, also known as tax treaties) with current major financial service hubs.

This submission focusses on the need for a DTA with Luxembourg; other DTA needs are outlined in previous FSC submissions.[18]

Luxembourg has the second largest market for managed funds in the world, after the US, with $US4.5 trillion under management as at March 2020, by far the largest managed funds location in Europe. By contrast, Australia has about $US 1.8 trillion in funds under management. Yet Australia does not have a DTA with Luxembourg.

The lack of effective tax treaties with financial service centres, particularly Luxembourg, means higher taxes on income to and from these jurisdictions, so Australian fund managers

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[17] See particularly the FSC Submission on the 2018–19 Federal Budget and FSC submission to Consultation Paper on Collective investment vehicle non-resident withholding taxes, 2 December 2016.
[18] See FSC 2018-19 Pre-Budget submission, available from: https://www.fsc.org.au/resources/726-2017-12-22-fsc-2019-pre-budget-submission-final-combined/file

are disadvantaged when competing to manage funds flowing from, or through, these locations, compared to other countries that do have DTAs with these countries.[19]

Australia is currently negotiating a free trade agreement with the European Union.[20] The value of FTAs relating to financial services is significantly diminished in the absence of a tax treaty with these two jurisdictions.

Australia already has a tax agreement with many EU countries, as shown in Table 1 below — Luxembourg is the clear gap in terms of the financial sector. For example, Australia has a tax treaty with Romania and Slovakia which have managed funds of less than €9bn each, compared to Luxembourg which has managed funds of €4,279bn. It is anomalous that Australia has a DTA with most countries in Europe, including countries with a tiny funds management sector, but not with Luxembourg.

Table 1 – Australian DTAs with Europe compared with share of managed fund assets

Country	DTA with Australia?	Managed fund assets – share of Europe
Luxembourg	no	26.7%
Ireland	yes	15.8%
Germany	yes	13.1%
France	yes	11.9%
United Kingdom	yes	10.4%
Netherlands	yes	5.5%
Sweden	yes	2.2%
Italy	yes	2.0%
Spain	yes	1.9%
Denmark	yes	1.8%
Austria	yes	1.1%
Belgium	yes	1.0%
Finland	yes	0.7%
Poland	yes	0.4%
Czech Republic	yes	0.1%
Hungary	yes	0.1%
Malta	yes	0.1%
Portugal	no	0.1%
Romania	yes	0.1%
Bulgaria	no	<0.1%
Croatia	no	<0.1%
Cyprus	no	<0.1%
Greece	only Airline Profits Agreement	<0.1%
Slovakia	yes	<0.1%
Slovenia	no	<0.1%
Total		100.0%

[19] Luxembourg's DTAs are listed here (in French): https://impotsdirects.public.lu/fr/conventions/luxembourg.html

[20] https://www.dfat.gov.au/trade/agreements/negotiations/aeufta/Pages/default

Source: DTAs: https://treasury.gov.au/tax-treaties/income-tax-treaties/
Investment Fund Assets: EFMA Quarterly statistical report and World Bank Global Financial Development Database. Total is of all the countries listed in table.

Implementing DTAs with financial service centres, particularly Luxembourg, would be consistent with the Government response to industry's Action Plan to boost Australian services exports, where the Government committed to "assessing Australia's [tax] treaty network to ensure it remains appropriately aligned to our trading relationships, whilst maintaining tax system integrity" (page 25).[21]

Australia does not even provide Luxembourg with Exchange of Information (EOI) country status, which provides for lower Australian withholding tax rates. Australia has provided EOI status to 122 countries as at June 2020.[22]

Other DTA issues

Australia's export of funds management services would be assisted by addressing various issues with existing DTAs. These issues are detailed in previous FSC submissions.[23] In summary:

- The provisions contained in the Australia-Switzerland DTA covering collective investment vehicles and complying superannuation funds should be considered a benchmark that future treaties should meet.
- Complying Superannuation business of life insurance companies ("VPST" business) and pooled superannuation trusts should also be provided coverage in treaties as these businesses operate consistently with standalone superannuation funds.
- The China-Australia DTA be aligned with Chinese DTAs recently negotiated with other governments to provide relief for Australian residents from capital gains on their Chinese portfolio investments.
    - Other DTAs with China concede taxing rights on non-resident capital gains from shareholdings of less than 25% in non "land-rich" Chinese companies, such as the China DTAs with Hong Kong, Singapore and UK.
- Clarify existing Australia-US tax treaty provisions relating to superannuation funds and allow treaty relief in the common circumstances where an Australian resident fund invests into US investments via a Cayman feeder fund.
- Provide trusts, particularly Managed Investment Trusts, with clear access to treaty benefits (UK and India).
- Provide an interest withholding tax exemption for interest paid to and derived by a financial institution (including a non ADI) which is unrelated to and dealing wholly independently with the payer.
- Codify sovereign immunity and at source exemptions for entities wholly owned by Federal or State Governments.

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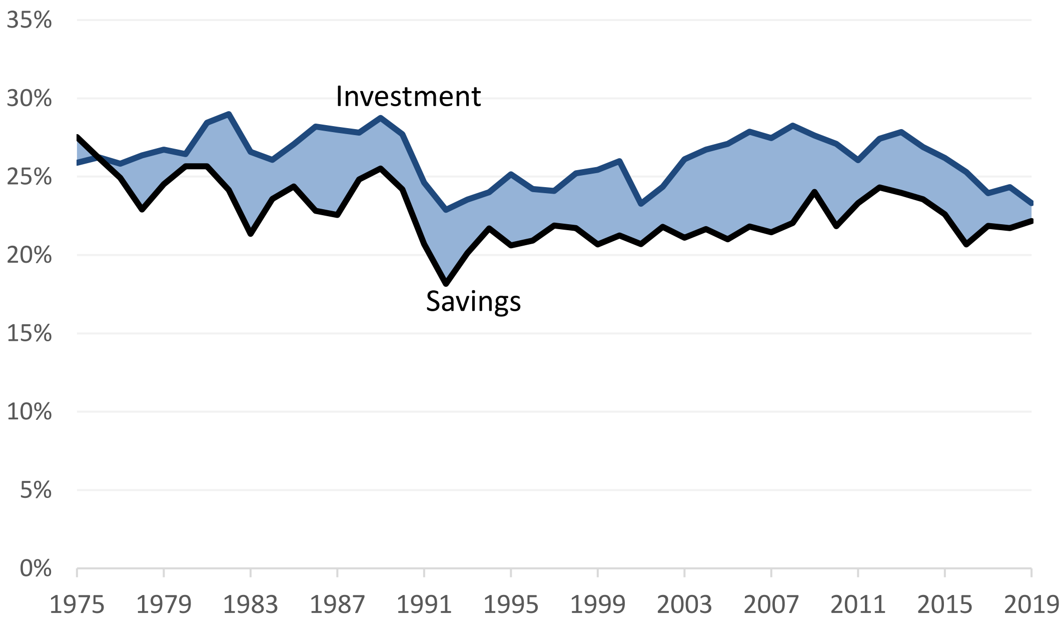
[21] See: https://dfat.gov.au/about-us/publications/Pages/action-plan-to-boost-australian-services-exports.aspx
[22] See: https://www.legislation.gov.au/Details/F2020C00063
[23] See FSC 2018-19 Pre-Budget submission, available from: https://www.fsc.org.au/resources/726-2017-12-22-fsc-2019-pre-budget-submission-final-combined/file

4. Saving and Investment (terms of reference 3–5, 7, 9)

4.1. Australia's call on foreign investment

The available data suggests that Australia has been reliant on foreign investment for much of its history.[24] This is shown in Figure 1 below, which has Australia's gross national savings and gross national investment as a share of GDP. The amount of foreign investment required is the gap between national savings and investment – the shaded area in the graph.

Figure 1 – National saving and investment as % of GDP



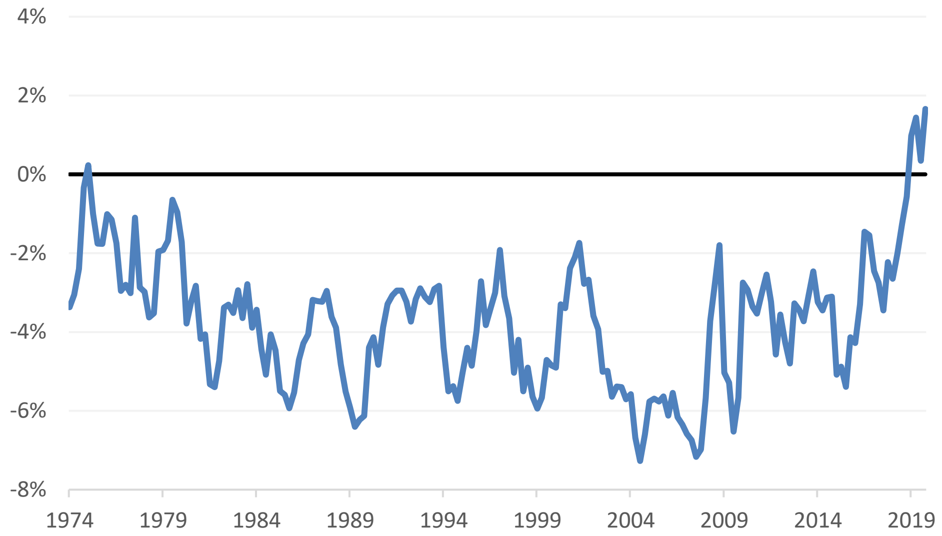
Source: ABS Australian System of National Accounts. Figures are gross national saving (net saving plus depreciation) and gross national investment.

The graph above shows that in the past few years, Australia's call on foreign investment has declined substantially – and this is largely or entirely because of a decline in national investment (the upper blue line), rather than an increase in national savings (the lower black line).

As a result of the declining call on foreign investment, Australia has been running a Current Account Surplus for the most recent four quarters, as shown in Figure 2 below. This means that Australia is a net investor into the rest of the world.

[24] See in particular

Figure 2 – Current Account Balance as % of GDP



Source: ABS. Figures are seasonally adjusted. Negative is a current account deficit, positive a surplus

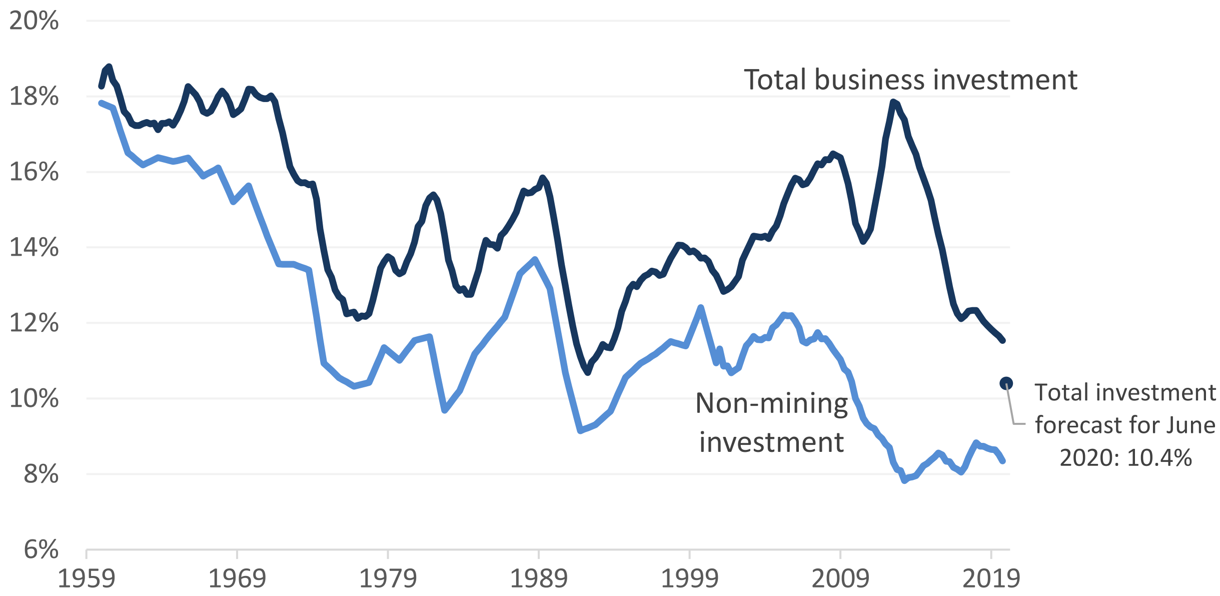
There are forecasts that Australia is going to run ongoing current account surpluses, particularly caused by the compulsory savings through our superannuation system.[25] If this eventuates, over time Australia's net foreign debt position will be eliminated and Australia will become much more resilient to financial market shocks.

Investment

Figure 1 above makes it clear that Australia currently has an issue with inadequate levels of national investment. This is shown even more clearly in the graph of business investment in Figure 3 below, with the Government's forecast for June 2020 shown in the dot. The forecast is for business investment as a share of the economy to be at record low levels, lower than the levels that prevailed in the 1990 recession.

[25] See: https://www.afr.com/policy/economy/australia-headed-for-super-surplus-exante-20190715-p527f4

Figure 3 – Business investment as % of GDP



Source: ABS National Accounts, Table 24 from 2000 onwards and ABS Australian System of National Accounts, table 52 before 2000. Forecast: Frydenburg (2020) Ministerial Statement on the Economy, 12 May. Figures are smoothed.

Inadequate investment is an important risk to Australia's economy. To boost this investment, Australia can increase local funding sources (ie increase national savings), or make increased use of foreign funding sources (ie increase foreign investment). These options are explored below.

4.2. Increasing national saving

To increase local sources of investment, the Government should:

- Increase the efficiency of the superannuation industry, including by introducing a 'default once' system that removes inefficient duplicate accounts from the system, and introduce a product rationalisation system (as discussed earlier). These reforms to increase the super system's productivity and efficiency will mean more funds available for domestic investment.
- Implement a new investment vehicle, the Australian Superannuation and Infrastructure Investment Vehicle (ASIIV), which would enable a much wider range of superannuation funds, particularly SMSFs, to invest in infrastructure. The ASIIVs would be tradable, available to retail investors through existing platforms, dramatically reducing the barriers to investment in a wide array of infrastructure investment. As a result, an asset pool of around $1.7 trillion would be opened up to investment in infrastructure.
  - The ASIIVs would help address issues with foreign investment into infrastructure, by opening investment to many more Australian investors, reducing the need to seek foreign investment, and allowing foreign investors to contribute capital in smaller allotments than currently – so the foreign

investors still obtain exposure to Australian infrastructure but without obtaining any control or influence over the infrastructure asset.
    - Further details on the ASIIV proposal are in the FSC's paper on Accelerating Australia's Economic Recovery 2020.[26]
- Continue to increase the Superannuation Guarantee (SG) to 12% once the reforms to the superannuation system have been implemented. Research shows that a substantial portion of the SG increase leads to increased national saving.[27] Treasury has estimated the addition to national savings due to the superannuation system to be just under 0.7% of GDP when the system is fully mature.[28]

4.3. Foreign investment

The terms of reference for this inquiry request examination of whether Australia is overly reliant on foreign investment. However, Figure 1 and 2 above show that Australia currently does not have an issue with excessive reliance on foreign investment compared to much of our history. If anything we need to be doing more to promote foreign investment into Australia, if we wish to promote Australian economic growth.

A recent study by the Productivity Commission[29] concludes that the relevant studies (both modelling and empirical studies) *unambiguously* show that foreign investment is positive for the Australian economy (page 55). In particular, two studies specifically examined the direction of causation (does foreign investment cause GDP growth, or does GDP cause foreign investment?):

- A study from 2009 found higher foreign direct investment into Australia causes changes in GDP (not the other way around). It estimated that a 10% increase in FDI would increase GDP by nearly 0.5%.[30]
- A study form 2006 found increases in FDI inflows into Australia are associated with increases in investment growth and GDP growth.[31]

Two important ways an increase in foreign investment could be achieved is by reducing the company tax rate and removing unnecessary red tape in the foreign investment review rules, discussed in turn below.

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[26] See: https://fsc.org.au/resources/2026-fsc-report-accelerating-australia-s-economic-recovery/file
[27] A paper by the RBA suggests a dollar saved due to the SG results in retirement savings increasing by 70 to 90 cents, see Connolly (2007) The Effect of the Australian Superannuation Guarantee on Household Saving Behaviour, RBA Research Discussion Paper 2007-08
[28] See Figure 3 of David Gruen and Leigh Soding (2012) Compulsory superannuation and national saving, available from: https://treasury.gov.au/publication/economic-roundup-issue-3-2011/economic-roundup-issue-3-2011/compulsory-superannuation-and-national-saving
[29] Productivity Commission (2020) *Foreign Investment in Australia*, Commission Research Paper.
[30] Iyer, Rambaldi, and Tang (2009) 'How trade and foreign investment affect the growth of a small but not so open economy: Australia?', *Applied Economics*, 41(12), pp1525–1532.
[31] Faeth (2006) *Consequences of FDI in Australia - Casual Links Between FDI, Domestic Investment, Economic Growth and Trade*, Working Paper, December, University of Melbourne.

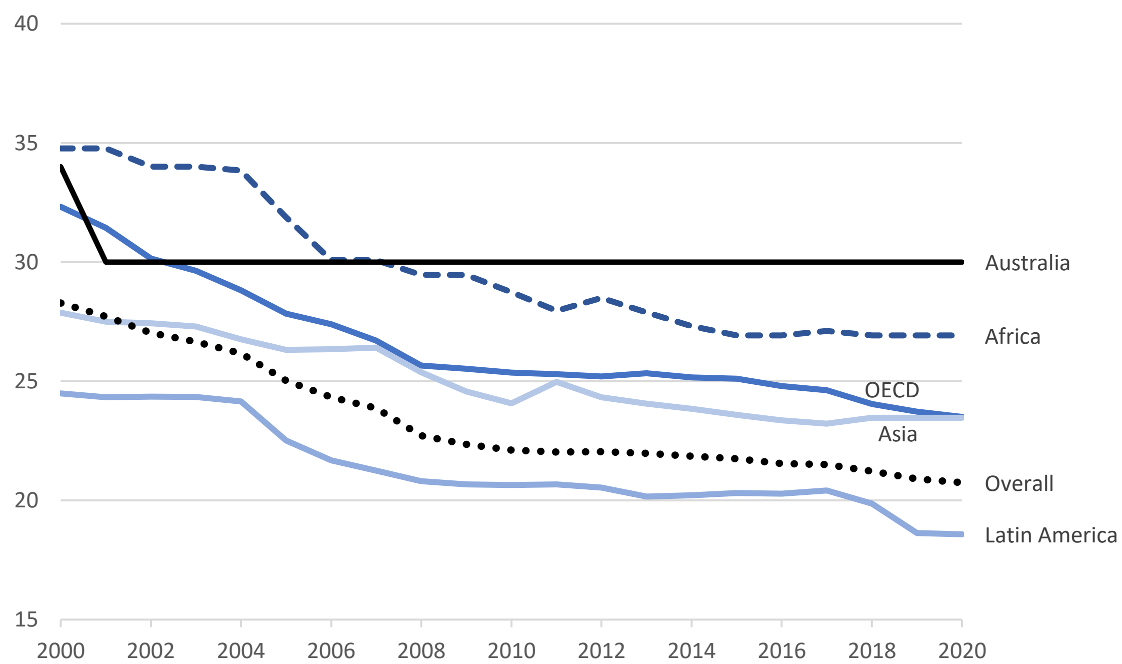
To address concerns about foreign investment, a more relevant target for policy is probably to diversify our sources of foreign investment, particularly for sensitive sectors. Several of the FSC's policy proposals should assist in this goal of diversifying foreign investment sources, including:

- Addressing the tax issues facing managed funds, highlighted in Section o above. Promoting managed funds exports is likely to lead to increased foreign investment into Australia through managed funds, which would involve portfolio investment (ie investment that does not involve control or influence of assets).
    - In particular, implementing DTAs with financial service hubs such as Luxembourg would encourage more managed fund investments to occur through these jurisdictions into Australia.
- Implementing the ASIIVs would enable infrastructure investment to occur with much smaller minimum investments, so a more diverse collection of foreign investors could participate in investment, each with a small share of the total investment.
- Streamlining foreign investment review processes for fund managers (see below) would also facilitate greater portfolio investment from foreign investors.

Company tax rate

The climate for business investment in Australia would be substantially improved by reducing Australia's company tax rate on all businesses. The headline company tax rate in Australia is well above regional and global averages, as shown in the graph below from the OECD company tax database (which has the tax rates for 109 countries).

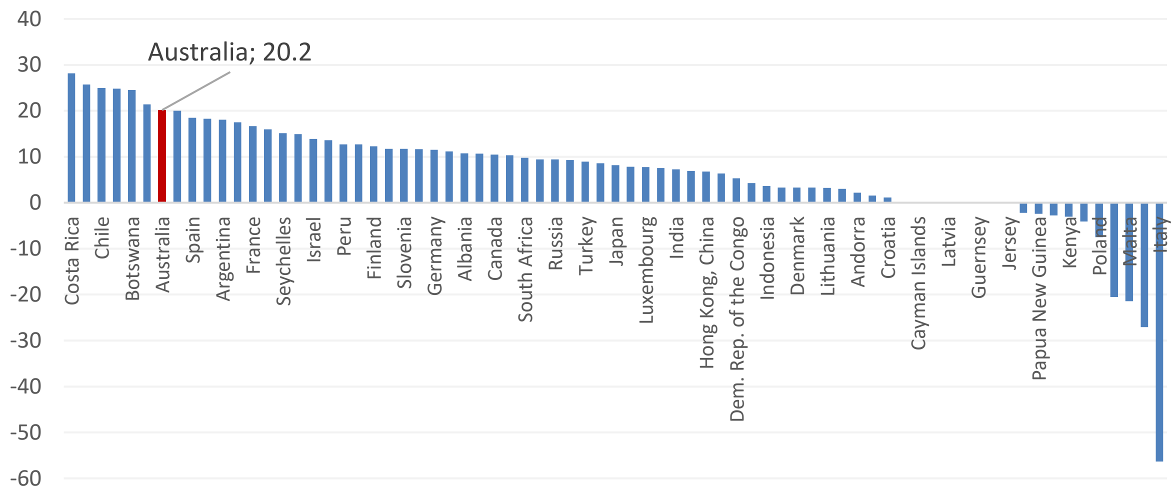
Figure 4 – Statutory company tax rates



Source: OECD Corporate Income Tax Database. Averages are unweighted. The Overall average includes 109 countries.

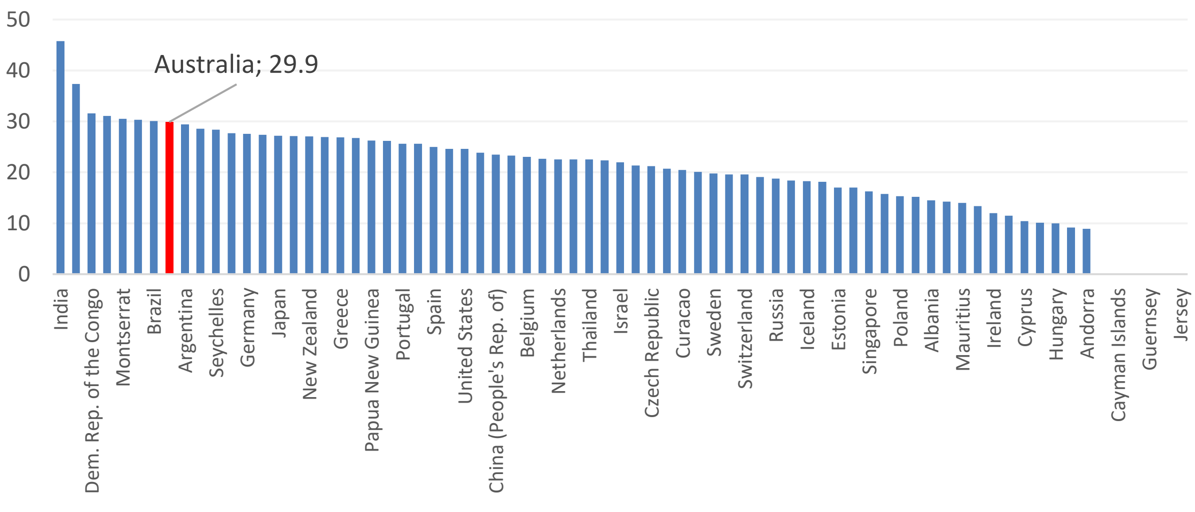
Australia also has very high effective tax rates on companies, as shown in research from the OECD released in 2019 and shown in the graphs below.

Figure 5 – Effective Marginal Tax Rate, 2019



Source: OECD Corporate Tax Database

Figure 6 – Effective Average Tax Rate, 2019



Source: OECD Corporate Tax Database

Cutting the company tax rate would make Australia internationally competitive and promote business investment, economic growth and higher employment. Australia's recent cut in the company tax rate for small business has had a positive effect on employment and investment[32] and in the current environment it is important to extend the same incentives to invest to larger companies.

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[32] AlphaBeta (2018) Do company tax cuts boost jobs, wages and investment?

The economic benefit of a competitive tax rate is well established:

- A 2017 study[33] found a one per cent cut in company tax will increase employment by between 0.2 and 0.4 per cent. Applying this to Australia, this implies that a cut in the company tax rate from 30 per cent to 25 per cent for all business would increase employment by between 3.3 per cent and 6.6 per cent.
- A 2018 US study[34] of a sample of businesses operating in multiple states between 1977 and 2011 found that a one per cent increase in the corporate tax rate corresponds to a 0.4 per cent decline in employment.
- An OECD study[35] in 2017 found company tax reductions boosted economic growth as well as the incomes of the poor, while having no significant impact on income distribution; and the results were the same whether or not a country had an imputation system, such as in Australia.
- A 2019 study in Canada[36] found a 1 per cent reduction in the tax rate led to an increase in real per capita GDP by 1.2 per cent in the long run.
- A 2013 study for the US[37] found a 1 per cent reduction in the tax rate results in an increase in GDP of 0.6 percent after one year.
- A study involving 70 countries[38] found that cutting the corporate tax rate by 10 per cent increased annual growth in GDP by up to 2 per cent.
- The OECD in 2012 surveyed the evidence[39] and concluded that company tax has "sizable adverse effects on labour use, productivity and capital accumulation [i.e. investment]."
- A US study from 2018[40] found higher company taxes are associated with lower quality, and quantity of, innovation.
- A 2017 study found 'star' scientists were discouraged from moving to US states with high company tax rates.[41]
- A 2010 study of the impact of corporate income tax on mid-sized companies in 85 countries[42] found a large adverse effect on business investment, foreign direct investment, and entrepreneurial activity arising from corporate taxes.

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33 Hanson and Brannon (2017) "Corporate Income Taxes and Labor: An Investigation of Empirical Evidence" *Tax Notes*, July 24.
34 Giroud and Rauh (2018) "State Taxation and the Reallocation of Business Activity: Evidence from Establishment-Level Data." *Journal of Political Economy* 127(3).
35 Akgun, Cournède and Fournier (2017) The effects of the tax mix on inequality and growth, OECD Economics Department Working Paper 1447.
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Foreign investment review processes

A recent review by the Productivity Commission has demonstrated that foreign investment rules have a substantial impact on foreign investment.[43] In particular the Commission found tightening Australia's restrictions on foreign investment to a similar level of restrictiveness as New Zealand would likely reduce national income by between $0.8 and $7.1 billion per year (or $82–$731 per household per year), due to a loss of $19–$182 billion of net foreign capital.

While the FSC understands there is a need to review foreign investment for national security reasons, we recommend a reduction in unnecessary red tape that hinders investment into Australia, particularly by managed funds which pose no security risk.

In particular, the FSC recommends fund managers be able to apply for an exemption certificate that removes the need for fund managers to apply individually for investment in hundreds of Australian companies. This would recognise that fund managers are portfolio investors and do not seek to control the day to day management of the company. Rather fund managers include Australian companies in diversified portfolios of assets seeking to deliver investment returns to their underlying investors.

This is particularly the case for managed funds with foreign managers and a diverse client base, often including numerous Australian investors.

The FSC also supports reforms to foreign investment review fees to make the fees fairer and simpler, while ensuring they cover the administration costs of the scheme. We note a recent paper by the Productivity Commission[44] demonstrates that current fees are much higher than costs. On this basis, the FSC recommends moving to a cost recovery approach which would mean a substantial reduction in fees for many applicants.

[43] Productivity Commission (2020) *Foreign Investment in Australia*, Commission Research Paper
[44] Productivity Commission (2020) *Foreign Investment in Australia*, Commission Research Paper.

5. Attachment A – terms of reference

Pursuant to the Committee's resolution of appointment, the Joint Standing Committee on Trade and Investment Growth resolved to inquire into the 2018-19 annual reports of the Department of Foreign Affairs and Trade (DFAT) and the Australian Trade and Investment Commission (Austrade). DFAT's and Austrade's annual reports stand referred to the Committee under the Schedule presented by the Speaker. The focus of the Committee's inquiry will be to understand whether there is a need for Australia to diversify its trade markets and foreign investment profile including;

1. Consider if Australia is too reliant on any one market for exports. If so, what factors are contributing to this dominance;
2. The advantages and disadvantages, including in relation to the national interest and national economic risk, to an over reliance on any one market;
3. Consider if Australia is too reliant on foreign investment. If so, what factors are contributing to this dominance;
4. The advantages and disadvantages, including in relation to the national interest and national economic risk, to an over reliance on foreign investment, especially foreign investment by state-owned enterprises;
5. The impact of global crises including trade disputes and political disputes on Australia's relationship with countries we are reliant upon for trade and investment purposes;
6. The impact of bilateral trade agreements on Australia's exports and whether they contribute to concentrated export markets;
7. The impact of bilateral trade agreements on Australia's domestic market and whether they contribute to an over reliance on foreign investment;
8. Analysis of industry and government preparations to diversify its trading partners and secure new markets for Australia's exports, including through further free trade agreements; and
9. Analysis of industry and government preparations to ensure the Australian economy is not overly reliant on foreign investment.

6. Attachment B – proposed removal of CGT discount at fund level

The 2018–19 Budget announced the Government would remove the CGT at the fund level for Managed Investment Trusts (MITs) and Attribution Managed Investment Trusts (AMITs).[45]

The FSC has major concerns with this proposal.

Most importantly, the policy contradicts the Government's own stated policy goals. The 2018–19 Budget states[46] this proposal is designed to ensure that MITs and AMITs operate as genuine flow through vehicles, so that income is taxed in the hands of investors as if they had invested directly. However, the 2018–19 Budget proposal has the **opposite effect** of this policy goal.

The policy disadvantages indirect investment by individuals through MITs and AMITs compared to direct investment. It removes the current neutral treatment of individuals and replaces it with a non-neutral treatment. Using the terms from the 2018–19 Budget, under the current tax system MITs and AMITs are taxed as genuine flow through vehicles for individual investors, "so that income is taxed in the hands of investors as if they had invested directly". The proposal replaces this approach with a system that **overtaxes** individuals that invest through MITs and AMITs.

This detrimental proposal would be a key contributor to the increasing adverse policy environment for fund managers noted earlier in this submission.

The specific reasons the proposal overtaxes individuals that invest in MITs and AMITs are:

- In allocating deductible expenses against assessable income components, a MIT or AMIT would be required to allocate deductions against gross capital gains instead of only the assessable discount capital gains component; and
- In recouping prior year or current year revenue losses, the MIT or AMIT would be required to recognise as assessable income the gross amount of the capital gain rather than only the discount capital gain.

A briefing from Greenwoods HSF (see at Attachment C) provides an example where:

- an individual would pay no tax if they invested directly; but
- the same individual would pay tax on $500 if they invested in exactly the same way, but through a MIT.

This clearly shows the proposal does not meet the principle of *horizontal equity* which is a long-standing tax policy principle accepted by governments. Broadly, the principle is that investors should bear the same tax burden regardless of whether they invest directly or indirectly. The proposed measure runs counter to this principle.

[45] See Budget Paper 2, page 44.
[46] See Budget Paper 2, page 44.

Example

Another example is shown below.

Where a MIT / AMIT derives a $100 discount capital gain, but has expenses of $20 that are to be allocated against the capital gain, the difference in the trust net income would be as follows:

Trust level	Current	Proposed
Discount capital gain	100	100
50% discount	50	-
Net gain	**50**	**100**
Expenses	-20	-20
Net income	***30***	***80***

Once the net income is distributed, the impact on an individuals' investor's taxable income could be illustrated as follows (with direct investment included for comparison):

	Invest through MIT/AMIT		Direct
Individual level	Current	Proposed	investment
Distribution	30	80	100
Gross up	30	-	-
Gross gain	**60**	**80**	**100**
1/2 discount	-30	-40	-50
Individual expenses	**-**	**-**	**-20**
Taxable income	***30***	***40***	***30***

The example above equally applies if fund-level expenses are replaced by carry forward revenue losses.

The examples above and in Attachment C show where expenses or carry-forward revenue losses are offset against these discount capital gains at the MIT / AMIT level, the proposed measure will result in members that are entitled to discounting (individuals, complying superannuation funds entities and trusts taxed under Division 6) being worse off under this proposal than if they had invested in assets directly under the same scenario.

Discussion

The current CGT treatment does not always achieve parity between direct investment and investment through a MIT/AMIT; but the proposed change does not achieve this parity either — and for most investors the change moves the treatment further away from parity.

The FSC submits that, across the investment life-cycle of a managed fund, many (perhaps nearly all) AMITs and MITs would allocate expenses, or current year or carry forward revenue losses, against capital gains. This means that the proposed measure will disadvantage many or all AMITs and MITs relative to direct investment by individuals and superannuation funds.

The proposal also introduces another inconsistency: Division 6 trusts would be able to access the CGT discount, while MITs and AMITs will not. The FSC submits this is inconsistent and confusing and further underlines the concern that this proposal is clearly not meeting the policy intent of ensuring direct and indirect investment is treated similarly.

Another issue will emerge if the proposal is implemented. The allocation of expenses against different types of income has not been definitively addressed since the repeal of section 50 of the Income Tax Assessment Act 1936. That section prescribed an order for the allocation of expenses and was particularly relevant in the context of the former Undistributed Profits tax. Since the repeal there have been miscellaneous rulings and statements to the effect that direct expenses should be allocated to the income to which they relate but that general and surplus direct expenses should be allocated pro rata against taxable income. Whether this is correct and whether any gross or discounted capital gains should form part of this allocation base is an issue that until this proposal did not matter. However, the change, as it is proposed, will force the Government to deliberate and prescribe an outcome. Such an outcome will inevitably have consequences beyond MITs and AMITs.

We note the original exposure drafts of the AMIT legislation included this measure, but it was removed by Treasury during consultation. We understand this change was made because of the concerns raised above in this paper: disallowing the CGT discount at the trust level reduced tax neutrality compared to direct investment.

Given the increased compliance costs from the measure and the distortion in the tax treatment of direct vs indirect investment, the proposed CGT change would likely actively discourage many investors (individuals and superannuation funds) from investing in MITs and AMITs, adding to the competitiveness issues raised earlier in this submission.

The added burden on MITs and AMITs caused by higher taxation and higher compliance costs from these combined proposals means the benefit of reforming and moving out of Division 6 has been considerably reduced — possibly negated. It also is particularly concerning that this change has been proposed after many fund trustees have made the irrevocable election to adopt the AMIT regime.

We note that this measure is ostensibly meant to prevent beneficiaries that are not entitled to the CGT discount from getting a benefit from the CGT discount being applied at the trust level. This would be non-resident investors and corporate investors.

It is not clear why the Government has proposed a measure targeting all investors in AMITs and MITs rather than a measure specifically targeting resident corporations and non-resident beneficiaries. Instead, the Government proposes a measure that will result in individuals and superannuation funds paying an inappropriate amount of tax compared to direct investment.

Additionally, the beneficiaries of apparent concern represent a small proportion of unitholders. According to the ABS, non-government trading companies represent just 1.85% of total investment into managed funds, and foreign investors represent 5.8% of total investment.[47] Most investment is by individuals, superannuation funds and pension funds. In addition, capital gains are only subject to tax for non-residents when the gains relate to "taxable Australian Real Property" (**TARP**). Other gains are not subject to Australian tax. Hence the supposed mischief relates to a small proportion of the total gains recorded by managed funds.

If the Government wishes to address concerns about corporates and non-residents accessing the CGT discount through MITs and AMITs, then we submit there would be value in exploring options that are more targeted at the issue. The FSC has provided a range of options to Treasury and we are willing to discuss these options in more detail. We await further consideration of these options.

Instead of this measure, the FSC is recommending a measure targeted at corporates and non-residents that are accessing the CGT discount through MITs and AMITs.

[47] ABS Managed Funds, September 2018, table 9.