INVESTMENT AND FINANCIAL SERVICES ASSOCIATION

A RESPONSE TO THE CONSULTATION PAPER, A REVIEW OF INTERNATIONAL TAX ARRANGEMENTS

October 2002
TABLE OF CONTENTS

ABOUT THIS SUBMISSION ...............................................................................................................4

ABOUT IFSA .................................................................................................................................10

PART 1  THE TAXATION OF AUSTRALIAN TRUSTS.......................................................... 11
  SUMMARY ...............................................................................................................................11
  CAPITAL GAINS DERIVED BY NON-RESIDENT INVESTORS - THE PROBLEM TO BE
  SOLVED ..................................................................................................................................12
  CAPITAL GAINS DERIVED BY NON-RESIDENT INVESTORS - THE SOLUTION ...... 14
  WITHHOLDING TAX ON NON-RESIDENT INVESTORS – THE PROBLEM TO BE
  SOLVED ..................................................................................................................................14
  WITHHOLDING TAX ON NON-RESIDENT INVESTORS – THE SOLUTION ............... 16
  TAXATION TREATMENT OF HEDGE GAINS - THE PROBLEM TO BE SOLVED ...... 17
  TAXATION TREATMENT OF HEDGE GAINS - THE SOLUTION .................................. 18

PART 2  ATTRIBUTION FOR CONTROLLED ENTITIES .................................................... 19
  SUMMARY ...............................................................................................................................19
  THE PROBLEM TO BE SOLVED ..........................................................................................20
  THE PREFERRED SOLUTION .................................................................................................21
  INTERIM SOLUTION ..............................................................................................................21

PART 3  ATTRIBUTION FOR PORTFOLIO INVESTMENTS .............................................. 33
  SUMMARY ...............................................................................................................................33
  THE PROBLEM TO BE SOLVED ..........................................................................................33
  THE PREFERRED SOLUTION .................................................................................................34
  A CARVE OUT ......................................................................................................................38
  SOME ANOMALIES .............................................................................................................41

PART 4  IMPUTATION AND ITS EFFECT ON ONSHORE INVESTMENT ............................. 46
  THE THRESHOLD POLICY QUESTION ..............................................................................46
  ANALYSIS OF REFORM OPTIONS ..................................................................................48
  REVENUE CONSIDERATIONS OF REFORM OPTIONS ..................................................50

PART 5  TAX TREATIES ........................................................................................................... 51
  CURRENT LEGISLATION .......................................................................................................51
  THE PROBLEMS AND ISSUES .........................................................................................51
  POSSIBLE SOLUTIONS .......................................................................................................51
  RELATIONSHIP TO OTHER OPTIONS ..............................................................................53

PART 6  FOREIGN NON-PORTFOLIO DIVIDENDS ............................................................ 54
  THE CURRENT LAW ............................................................................................................54
  ISSUES ASSOCIATED WITH THE CURRENT LAW ............................................................55
  RECOMMENDATION/SOLUTION ......................................................................................55

PART 7  THE TAXATION OF BRANCHES ............................................................................ 56

PART 8  EXPATRIATE AND IMPATRIATE EMPLOYEES ................................................... 57
ABOUT THIS SUBMISSION

This submission is a response to the Treasury’s Consultation Paper ‘Review of International Tax Arrangements’ (‘the Consultation Paper’).

The need to build a more efficient system of international tax for funds management is underpinned by a number of community-wide considerations. Australia as a key global player in visible exports and imports needs a sophisticated financial system to facilitate these transactions, and funds management is an integral component of a developed financial system. In addition, as a net importer of capital, Australia needs to have an international tax regime that gives better access to international markets to reduce the cost of capital. Retirees and long-term savers also need access to international capital markets to gain optimal risk and return outcomes, and diversification.

Additional inflows of funds management dollars assist the Australian community in two key ways – by allowing Australian investors to benefit from lower-cost funds services arising from economies of scale, and by generating additional GDP which benefits the community at large. To this end, IFSA supports the Government’s policy to review and reform Australia’s international tax arrangements and is dedicated to making a contribution to enhance Australia’s international tax system to achieve positive outcomes for the nation, customers, investors and the financial services industry.

This submission draws on econometric evidence clearly indicating the community benefits that would flow from certain reforms by way of increased GDP. We also provide anecdotal evidence identifying the lost opportunities as a consequence of the somewhat uncompetitive current regime that has erected barriers to offshore flows into the Australian funds management industry. With the right system Australia could become an even more potent force in the global financial services community.

It is useful to explore some the practical implications of attracting additional funds into the Australian financial services industry. Fund managers interested in attracting such funds need to establish a business development unit of marketing professionals to develop prospectus and marketing information. These teams, based in one of the Australian capital cities, would need accommodation, communications equipment and from time to time would travel offshore to meet with prospective clients.

Australian based funds managers offering services to offshore clients would need to employ currency risk minimisation and hedging professionals.

The same companies would need access to accounting, legal and taxation services to ensure compliance with Australian and offshore regulatory requirements. Call centres would be needed to service new clients – this would entail the industry employing individuals trained in foreign languages.

Importantly, these new positions would require high levels of training, in most cases tertiary education, and would have above average remuneration packages.

Establishing linkages with off shore investors would have ‘spillover’ benefits to other financial houses. For example, a good and proven relationship with an Australian based funds manager
could lead to a level of confidence in our economy such that an overseas investor would take advantage of the new venture capital IPO or, indeed, invest in a private equity arrangement in one of Australia’s regional centres.

**The Structure of this Submission**

This submission discusses the issues in international tax reform topic by topic beginning with the areas of the taxation of Australian trusts and the attribution rules. These are the topics of most interest to us.

Due to time constraints not all issues raised by the Consultation Paper are dealt with in this submission.

This table summarises our responses to the various options raised by the Consultation Paper and indicates where the discussion of these responses can be found.

<table>
<thead>
<tr>
<th>Option for Consultation</th>
<th>Page</th>
<th>Summary of our Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1 : after further considering the effect on Australian companies of the dividend imputation bias at the shareholder level, to consider three alternative options :</td>
<td>46</td>
<td>The view proposed by the Business Council for Tax Reform is supported.</td>
</tr>
<tr>
<td>A. Providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income;</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Allowing dividend streaming of foreign source income; and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Providing franking credits for foreign dividend withholding taxes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.1 : to consider options to expand roll-over relief under the controlled foreign company rules while maintaining the integrity of those rules</td>
<td>27</td>
<td>Roll-over relief be extended to all CFCs in wholly-owned groups irrespective of the jurisdiction of the CFC</td>
</tr>
<tr>
<td>3.2 : to consider options to appropriately target the tainted services income rules while maintaining the integrity of the controlled foreign company rules</td>
<td>24</td>
<td>Services on an arm’s length basis and services that do not have a direct connection with Australia to be excluded</td>
</tr>
<tr>
<td>3.3 : to consider whether additional countries should be included on the</td>
<td>28</td>
<td>Other countries should be included</td>
</tr>
<tr>
<td>Option for Consultation</td>
<td>Page</td>
<td>Summary of our Responses</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------------------</td>
<td>------</td>
<td>-----------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>broad exemption country list and to clarify the criteria for inclusion or exclusion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.4 : to identify technical and other remaining policy issues regarding the controlled</td>
<td>29</td>
<td>A number of issues are identified.</td>
</tr>
<tr>
<td>foreign company rules and consider options to resolve them either on a case-by-case</td>
<td></td>
<td></td>
</tr>
<tr>
<td>basis or as part of a major rewrite of the provisions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.5 : to consider whether the recently negotiated protocol to the Australia-United</td>
<td>52</td>
<td>The United States treaty is a starting point but the model needs to be modified</td>
</tr>
<tr>
<td>States tax treaty provides an appropriate basis for future treaty negotiations or</td>
<td></td>
<td></td>
</tr>
<tr>
<td>whether alternative approaches are preferable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.6 : to consider whether or not to proceed with the Review of Business Taxation</td>
<td>65</td>
<td>The proposal is impractical.</td>
</tr>
<tr>
<td>proposal to apply CGT to the sale by non-residents of non-resident interposed entities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>with underlying Australian assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.7 : to consider which countries should be given priority for tax treaty negotiations,</td>
<td>52</td>
<td>Current negotiations with the United Kingdom to be halted until a new approach is settled.</td>
</tr>
<tr>
<td>taking into account negotiations under way with the United Kingdom and Germany, the</td>
<td></td>
<td></td>
</tr>
<tr>
<td>need to update pre-CGT treaties, and countries that Australia may be obliged to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>approach because of most favoured nation clauses in existing treaties</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.8 : to consider options to improve consultation processes on negotiating tax treaties</td>
<td>53</td>
<td>Wider consultation is supported.</td>
</tr>
<tr>
<td>3.9 : to consider abolishing the limited exemption country list and provide general</td>
<td>27</td>
<td>This is supported.</td>
</tr>
<tr>
<td>exemption for foreign non-portfolio dividends Australian companies receive and, subject</td>
<td></td>
<td></td>
</tr>
<tr>
<td>to some existing exceptions, branch profits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option for Consultation</td>
<td>Page</td>
<td>Summary of our Responses</td>
</tr>
<tr>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------</td>
<td>---------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>3.10 : to consider options to provide conduit relief for Australian regional holding and joint venture companies, including considering the benefits and costs of introducing a general conduit holding company regime, providing an exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business and providing conduit restructure relief.</td>
<td>-</td>
<td>No comments are made.</td>
</tr>
<tr>
<td>3.11 : to consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation and whether to allow the tax free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1</td>
<td>66</td>
<td>The current foreign dividend accounts do not work in practice.</td>
</tr>
<tr>
<td>3.12 : to consider options to clarify the test of company residency so that exercising management and control alone does not constitute the carrying on of a business</td>
<td>-</td>
<td>No comments are made.</td>
</tr>
<tr>
<td>3.13 : to consider whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law as an alternative to the current dual resident company provisions</td>
<td>-</td>
<td>No comments are made.</td>
</tr>
<tr>
<td>4.1 : to give longer term consideration to a replacement of the current FIF rules to provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers.</td>
<td>36</td>
<td>A replacement regime is recommended.</td>
</tr>
<tr>
<td>4.2 : to consider, including undertaking detailed case studies in conjunction with industry, increasing the 5% balanced portfolio exemption threshold.</td>
<td>37, 41</td>
<td>This would not remove the compliance costs imposed by the classification system.</td>
</tr>
<tr>
<td>4.3 : to consider exempting Australian managed funds that follow widely</td>
<td>35, 39,</td>
<td>To be covered by an improved</td>
</tr>
<tr>
<td>Option for Consultation</td>
<td>Page</td>
<td>Summary of our Responses</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------------------</td>
<td>------</td>
<td>-----------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>recognised indices.</td>
<td>42</td>
<td>balanced portfolio exemption</td>
</tr>
<tr>
<td></td>
<td></td>
<td>It is difficult to identify an index fund.</td>
</tr>
<tr>
<td>4.4 : to consider exempting complying superannuation funds.</td>
<td>35, 39, 42</td>
<td>This is an appropriate minor rule but it does not go far enough.</td>
</tr>
<tr>
<td>4.5 : to consider amending the foreign investment fund rules to allow fund management services to be an eligible activity.</td>
<td>42</td>
<td>This is supported.</td>
</tr>
<tr>
<td>4.6 : to consider exempting from CGT, gains to which non-resident beneficiaries are presently entitled that relate to assets without the necessary connection with Australia. Whether an asset has the necessary connection with Australia could be determined as if the trustee of the resident trust was a non-resident.</td>
<td>11</td>
<td>This is supported. It is a very high priority.</td>
</tr>
<tr>
<td>4.7 : to consider the feasibility of exempting from CGT, gains on the disposal of a non-portfolio interest in a unit trust that relate to unrealised gains on assets that do not have the necessary connection with Australia.</td>
<td>11</td>
<td>This is supported. It is a very high priority.</td>
</tr>
<tr>
<td>4.8 : to consider amending the CGT rules so that a distribution of income to which a non-resident is presently entitled but which is not assessable because the income has a foreign source or because of Option 4.6 does not reduce the cost base.</td>
<td>11</td>
<td>This is supported. It is a very high priority.</td>
</tr>
<tr>
<td>4.9 : to consider proceeding with the recommendations of the Review of Business Taxation rationalising the application of the current rules to foreign trusts.</td>
<td>64</td>
<td>This is supported.</td>
</tr>
<tr>
<td>4.10 : to consider proceeding with the recommendations of the Review of Business Taxation in relation to transferor trusts.</td>
<td>-</td>
<td>No comments are made.</td>
</tr>
<tr>
<td>Option for Consultation</td>
<td>Page</td>
<td>Summary of our Responses</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------------------</td>
<td>------</td>
<td>-------------------------------------------------------------------</td>
</tr>
<tr>
<td>4.11 : to consider specific tax issues outside the Government’s tax reform programme</td>
<td>56</td>
<td>Branches to be taxed on a separate entity basis</td>
</tr>
<tr>
<td>where the lack of separate entity treatment inappropriately impedes the use of branch</td>
<td></td>
<td></td>
</tr>
<tr>
<td>structures.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.1 : to consider whether to proceed with the Review of Business Taxation</td>
<td>57</td>
<td>The recommendation would add to the current complexity and should not proceed.</td>
</tr>
<tr>
<td>recommendation that residents departing Australia provide security for deferred CGT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>liability.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.2 : to consider addressing the double taxation of employee share options through</td>
<td>58</td>
<td>Other countries should be proactively engaged to enter negotiations whether we currently have a treaty or not.</td>
</tr>
<tr>
<td>bilateral tax treaty negotiations and possible consequential changes to Australia’s</td>
<td></td>
<td></td>
</tr>
<tr>
<td>domestic tax law treatment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.3 : to consider whether to proceed with the Review of Business Taxation</td>
<td>59</td>
<td>The recommendation should not be introduced</td>
</tr>
<tr>
<td>recommendation to treat ceasing to be an Australian resident as a cessation event</td>
<td></td>
<td></td>
</tr>
<tr>
<td>for the purposes of Division 13A.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.4 : to consider the Australian Taxation Office establishing a specialist cell to</td>
<td>59</td>
<td>This is supported.</td>
</tr>
<tr>
<td>work with employees to deal with the tax administration concerns of foreign expatriate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>employees.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
ABOUT IFSA

The Investment and Financial Services Association (‘IFSA’) is the representative body for the life insurance, public offer superannuation and funds management industry, which represents members who are significant investors in the Australian economy. Currently, IFSA member companies manage more than $650 billion on behalf of nine million Australians. IFSA members hold about 23 per cent of the current market capitalisation of the Australian Stock Exchange.
PART 1    THE TAXATION OF AUSTRALIAN TRUSTS

SUMMARY

In summary our recommendations in relation to the taxation of non-residents in Australian managed funds are as follows:

   • That non-resident investors in managed funds receive the same taxation treatment as if they held an underlying investment directly regardless of whether the non-resident holds a portfolio or non-portfolio interest in a managed fund;

   • That the Board consider the possibility of an exemption for certain Australian unit trusts from withholding obligations other than interest and dividend withholding obligations; and

   • That the taxation treatment of hedge gains is reviewed to ensure that non-residents are not subject to tax in Australia on hedges over foreign assets.

The Options presented in Chapter 4 of the Consultation Paper in the section titled “Improving the treatment of international investors in Australian managed funds” are welcomed by IFSA. They recognise that biases exist within the existing rules and that these biases present a significant barrier to attracting global capital to Australia via the funds management industry.

Options 4.6 to 4.8 are concerned with removing the anomalous treatment of non-residents investing in unit trusts compared to direct investment, specifically exempting the following from Australian tax:

4.6. Distributions by a unit trust of capital gains from disposals of assets without the necessary connection to Australia;
4.7. Disposals of non-portfolio interests in a unit trust relating to assets without the necessary connection with Australia; and
4.8. Distributions by a unit trust of foreign sourced income (exemption from cost base reductions).

These Options are welcome and supported by IFSA. In particular, the capital gains tax provisions contained in Division 136 of the ITAA 1997 create further bias against foreign investors investing via Australian managed funds, forcing non-residents into inefficient mirror structures, or out of the Australian funds management market altogether. Option 4.7 addresses this issue.

However, these options do not go far enough. IFSA recommends that the fundamental taxation policy should be to treat non-resident investors in Australian unit trusts on the same basis as if they held the underlying investment directly. This would mean that the following gains would not be subject to Australian tax:

   • gains on disposal of foreign assets held by Australian unit trusts;
• gains on disposal of non-portfolio interests in Australian public companies held by Australian unit trusts.

This policy should apply regardless of whether the non-resident investor holds a portfolio or non-portfolio interest in the Australian unit trust.

A related issue is the withholding requirements on Australian unit trusts on distributions to non-resident investors. IFSA submits that there should be a total exemption from the withholding requirements for certain unit trusts. This exemption should be granted as the amounts collected are small and the compliance costs and negative impact on non-residents desire to invest in Australia are high.

A further related issue is the treatment of hedge gains. IFSA submits that regardless of the outcome of the withholding issue referred to above, hedge gains over foreign assets should be treated as foreign income. This would mean that non-residents would not be subject to tax on such gains.

**CAPITAL GAINS DERIVED BY NON-RESIDENT INVESTORS - THE PROBLEM TO BE SOLVED**

Notwithstanding that a foreign investor may hold less than a 10 per cent interest in Australian public companies via an Australian managed fund, they may still incur a capital gains tax liability on the disposal of their units in the managed fund. This will occur where the foreign investor (together with associates) beneficially owns at least ten per cent of units issued at any time within five years of the actual date of disposal. Clearly, the prospect of incurring an Australian CGT liability in such circumstances creates a powerful disincentive for foreign investors to invest in an Australian managed fund, particularly a fund that is newly established or in the process of developing a critical mass, or when the underlying fund assets do not have the necessary connection with Australia (such as funds holding foreign assets). We have gathered the following case studies from our members to illustrate this problem:

**Case Study : An Australian fund manager cannot offer best solution**

The prospect was a major institution in Singapore. Potential mandate was for AS$1billion in indexed International Equities, offered through a pooled investment vehicle (unit trust) managed by an Australian based fund manager. The prospects’ investment requirements matched the investment strategy offered by the unit trust, and the prospect preferred this solution to a separately managed account. Due to the size of the mandate relative to the fund size, the fund manager was unable to offer the fund to the investor as the client would have exceeded 10% of the units in the fund, and thus incurred a CGT liability on disposal, even though the underlying assets of the unit trust had no connection with Australia. The opportunity was lost.
Case Study: Mandate lost to foreign fund manager

The prospect was a semi-Government corporation in New Zealand. Potential mandate was for **A$500 million** in indexed International Equities, offered through a pooled investment vehicle (unit trust) managed by an Australian fund manager. Having dealt with the specific problems posed in offering Australian funds by New Zealand tax laws, the fund manager was still unable to offer the fund, due to the size of the mandate relative to the fund size. Once again, the investor would have fallen foul of the 10% holding limit, and thus incurred a CGT liability on disposal, even though the underlying assets of the unit trust had no connection with Australia. The opportunity was lost.

Case Study: Tax inefficiencies create higher costs for investors

In addition to the above examples, some other specific instances of tax related inefficiencies encountered by IFSA members include the use of separately managed accounts by New Zealand investors in order to avoid breaching 10% holding limit, particularly in the early stages of a fund – adding duplication of administration, reducing the benefits of scale and potentially creating higher cost structures for Australian investors.

Case Study: A fund manager loses a contract to its European parent

A New Zealand fund manager won a contract to manage an international portfolio of approximately **A$500 million** for a large institution. The obvious choice to perform the asset management role was its Australian associate where there is significant capability. However for various tax reasons it was decided that the services were better performed out of Europe. As a consequence Australia lost out on significant amount of management fees that could have been generated. The key tax issues were:

- the 10% threshold would have been exceeded giving rise to CGT consequences that the client was not willing to accept; and
- there was a significant risk that given the presence of the asset manager in Australia, the gains arising on the sale of the international assets would give rise to an Australian sourced gain which would be subject to 98(3) and (4) withholding.
Case Study: A fund manager loses New Zealand clients due to tax

An IFSA member is currently in the process of transferring NZD$50 million for a NZ client from an Australian domiciled Fund to a Dublin domiciled Fund. In addition, the fund manager has had to divert NZD$100 million for two other NZ clients to the Dublin Funds due to the 10% rule. In addition the rule prevents the IFSA member from offering a "complete investment solution" to a far broader range of New Zealand clients. As you see, this rule continues to be a problem for existing and potential non-resident investors in Australasia.

CAPITAL GAINS DERIVED BY NON-RESIDENT INVESTORS - THE SOLUTION

It is submitted that the same income tax treatment should apply to the disposal of units in Australian managed funds as would apply if the foreign investor had held the underlying investments of the fund directly. The suggested amendments in Options 4.6 and 4.7, correctly implemented, should achieve this aim. It is IFSA’s belief that the modifications to the taxation of non-residents as presented will have a number of important flow-on benefits to the Australian economy, and Australian investors in particular. These benefits include increased scale, by reducing the inefficiencies created by mirror funds, which will drive down costs for Australian investors. The options as presented can be implemented by fund managers with very little change to existing systems – IFSA members tend to have sophisticated accounting systems, so tracking and classifying the underlying fund assets is a simple exercise. In addition, many products offered are straight International funds, with no underlying Australian assets. For these funds, implementation will be straightforward.

Many managed funds use an underlying unit trust to achieve exposure to investment markets. For example, a unit trust offered to retail or superannuation investors may invest in a wholesale unit trust in order to achieve its investment objectives – the wholesale trust then pools these funds with other wholesale investors and invests in physical markets. For trusts with this structure, the application of the suggested tests regarding the necessary connection with Australia may yield an anomalous result. To avoid this result, we recommend that the test incorporates a look through to the underlying assets of the unit trust at the “waters’ edge” in such structures.

Implementation of the suggested reforms coupled with the above recommendations will help to level the playing field in many respects for Australian funds. However, implementation of these measures alone still leaves a significant barrier in place for the managed funds industry in attracting foreign capital, and we urge the Board to consider extending the scope of these Options to facilitate removal of this barrier.

WITHHOLDING TAX ON NON-RESIDENT INVESTORS – THE PROBLEM TO BE SOLVED

The introduction to Chapter 4 of the Consultation Paper identifies Australia as “a highly attractive location within the Asia-Pacific region for financial services providers”, but recognises impediments within the existing tax system to the Government’s stated policy of developing Australia as a global financial services centre. The existing FIF regime and Capital
Gains Tax anomalies are explicitly identified in the paper. A further impediment to this aim is the imposition of withholding tax on distributions of income to non-residents.

Currently, where a resident trust in the funds management industry makes a distribution to a non-resident it is required to withhold tax at a minimum of 29% from those taxable components that are not subject to interest, royalty or dividend withholding tax, under sections 98(3) and (4) of the *Income Tax Assessment Act 1936*. As far as most non-resident investors are concerned this is a punitive rate. Consequently, they seek to invest through other jurisdictions. The experience of IFSA members is that non-resident capital is particularly sensitive to this tax. By way of example a significant portion of the international investments of the New Zealand managed investment industry is undertaken through the use of open-ended investment companies (“OEICs”) in the United Kingdom rather than through Australia (despite the obvious time zone / proximity benefits in investing through Australia). These investors are often exempt from tax in their jurisdictions (pension funds and foundations) or do not wish to become involved in ‘chasing’ tax credits.

**Case Study : Australia loses out to the United Kingdom**

A fund manager’s New Zealand operation was being restructured and A$1 billion needed to be invested. Due to the imposition of 98(3) and (4) withholdings on earnings it was decided to invest the funds through OEICs [Open Ended Investment Companies] in the United Kingdom rather than through Australian trusts. The net result was that the management fee revenue of approximately $10 million pa went to the United Kingdom rather than Australia. The tax revenue on those fees will be derived by the Inland Revenue in the United Kingdom rather than the Australian Taxation Office.

**Case Study : A fund manager cannot bring business onshore**

A fund manager has some assets of a trust being managed by a non-related United States asset manager. They have been trying to bring the management of these assets back to Australia for some time. The main impediment is the 98(3) and (4) risks as there is a view that the gains may take on an Australian source if the asset management was performed in Australia. Accordingly the fund manager is currently paying fees to external asset managers when the necessary capability exists within the Australian Group itself. In this instance both the fund manager and the Australian Revenue are missing out!

The problem posed by the withholding obligations is particularly acute for funds which utilise foreign exchange hedging in respect of their foreign assets. Under current rules any gain or loss on that hedge is considered to be of an Australian source and of a revenue nature. Thus, on distribution of a hedge gain to a non-resident investor, tax is withheld at a minimum of 29%, even though the underlying assets which are being hedged are foreign in nature, the income from which is foreign sourced and therefore not subject to withholding obligations. This apparent anomaly can be solved by allowing foreign exchange hedges to take on the same character and source as the underlying assets in portfolio investment situations. For further
evidence of this problem, please refer to point 4 of the section “Other FIF anomalies” on page 35 of this submission.

WITHHOLDING TAX ON NON-RESIDENT INVESTORS – THE SOLUTION

Option 4.6 does not explicitly refer to the imposition of withholding tax at the point of distribution of a capital gain, but implies an exemption from the withholding provisions for such distributions. IFSA recommends that this exemption be extended, to specifically exclude unit trusts which satisfy the definition of a fixed trust (refer Appendix 1) from the withholding obligations imposed on Australian trusts under sections 98(3) and (4) of the Income Tax Assessment Act 1936.

The consultation paper canvasses the possibility of exempting just capital gains from sections 98(3) and (4). The difficulty with this is that there are usually small amounts of other income that are also caught by these provisions. Examples of such amounts are foreign exchange gains, gains on traditional securities such as bonds, and sub-underwriting income. Such amounts are not capital gains and therefore would still be subject to withholding tax under the proposed exemption. IFSA has surveyed its members and believe that for non-property trusts such amounts give rise to less than 3% of total section 98(3) and (4) withholding payments they make annually. Upon total annual collections of $14 million this translates to $420,000 per annum. For such trifling sums it would be imprudent to continue the application of the provisions.

IFSA acknowledges that different policy considerations apply to real property income derived by property trusts. Property trusts are generally widely held collective investment vehicles. Their investors are either retail investors or institutional investors, such as superannuation funds or managed funds, on behalf of retail investors. An investment in a property trust is more akin to an investment in a managed fund than a direct investment in real property.

If this proposition is accepted then different rules can apply to the taxation of direct property investments and investments in property trusts. To ensure property trusts are internationally competitive in obtaining international capital the taxation of property trust income must be internationally competitive. The main international comparable is the US REITs. To match the position for US REITs Australia should adopt a 15% withholding tax on the taxable component of property trust distributions where the non-resident investor holds a portfolio investment in the property trust. The US accepts the different treatment of direct property investment and investment in REITs (which have the same flow through characteristics as Australian property trusts). This is reflected in the recently negotiated protocol to the Australia-United States tax treaty.

An amendment to the tax law to exclude Australian managed funds from the withholding obligations would result in additional employment opportunities for highly skilled workers and would strengthen the Australian equity and bond markets together with associated infrastructure. Further, these additional funds would provide for economies of scale to drive down costs for Australian investors.

Economic research conducted for IFSA by Econtech estimates that at a very small cost to revenue this change will eliminate a highly inefficient tax, but add substantially to GDP.
Having regard to long-run approach to the modelling exercise and the fact that investments in our industry are for between five and ten years, the research indicates that the additional GDP is sustainable.

Due to system issues within the Australian Taxation Office the Government is unlikely to be aware of how little revenue it actually receives from MIA trusts pursuant to s. 98(3) and (4) withholding tax provisions for non-residents. IFSA has surveyed its more substantial members and extrapolated the result across the industry. It was found that for the years ended 30 June 2000 and 2001 estimated annual collections from MIA trusts was only $14 million.

In contrast, industry analysts believe that, conservatively, an additional $10 billion of funds under management (“FUM”) would arise from the change. The Econtech research found that the change to the withholding tax regime would:

- reduce the cost of capital for portfolio investment in Australia;
- boost annual GDP by $64 million;
- boost net exports by $19 million;
- boost investment by $35 million;
- raise living standards by about $10 million annually;
- cost annual budget revenue of $6 million, with a direct cost of $15 million partly offset by indirect savings of $9 million; and
- eliminate an inefficient tax with a high excess burden of about 65 cents in the dollar compared with efficient taxes such as GST and income tax on wages and salaries that have low excess burdens of 10 to 20 cents in the dollar.

In relation to the conclusion that the cost to revenue would be $6 million annually, it is important to point out that IFSA believes this is a ‘worst case’ scenario. The long-run model used by Econtech generates ‘sustainable outcomes’ under which it is assumed that employment is fixed, so that increased employment in one sector must be exactly offset by reduced employment in other sectors. Having regard to remuneration in the financial sector, it would appear that this element of the model produces a somewhat ‘pessimistic’ result. The Econtech research is provided in Appendix 2 to this submission.

In summary, a targeted amendment restricted to fixed trusts would boost the economy and further enhance the strength of the Australian financial sector. Moreover, the change would eliminate an inequitable and inefficient tax.

**TAXATION TREATMENT OF HEDGE GAINS - THE PROBLEM TO BE SOLVED**

As outlined above, under current law hedging gains derived by Australian unit trusts will generally have an Australian source and accordingly non-resident investors will be subject to Australian tax on the gain. This applies despite the fact that the non-resident investor is not
subject to Australian tax on the underlying foreign income and despite the fact that any hedge loss is applied against the foreign source income and is not an Australian deduction.

**TAXATION TREATMENT OF HEDGE GAINS - THE SOLUTION**

The solution is to treat the hedge gain as having the same character as the underlying income. Australian resident investors would still be subject to tax on the hedge gain as they are taxed on their world wide income. However, non-resident investors would not be subject to Australian tax on such gains.

An alternative non tax solution is for the Australian unit trusts to enter into arrangements with foreign counterparties such that the hedge gains would be foreign source income. IFSA submits that is a nonsense for Australia to discourage Australians from contracting with each other.

While this issue is part of the general review of the taxation treatment of foreign exchange gains and losses, IFSA feels that the issue is significant enough to warrant separate consideration.
PART 2  ATTRIBUTION FOR CONTROLLED ENTITIES

SUMMARY

In summary our recommendations in relation to the reform of the CFC rules are as follows:

- The operation of the present CFC rules are a significant departure from the taxation policy objectives that the rules were designed to achieve, at their inception. This is partly attributable to the changed business environment and partly due to inadequacies in drafting of the current rules. Compliance and administration costs are also significant issues.

- Our preferred position is that the CFC rules need to be rewritten with revised taxation policy objectives. The revised rules need to be more targeted to counter genuine deferral of income and ensure active business activities are not inadvertently captured, as is presently the case.

- In the more immediate/shorter term, we recommend that the following be adopted:
  - to ease compliance, some outright exemptions from the CFC rules need to be provided. Such exemptions could include an exemption for CFCs resident in countries accepted to have a highly comparable tax system, having an active business exemption and a motive/purpose exemption
  - the tainted services income rules are particularly problematic as they capture active business income, contrary to the policy objective of the CFC rules. In addition, these rules need to be amended to exclude services provided between CFCs which are on an arms length basis.
  - the various anomalies with treatment of capital gains need to be removed. This includes issues associated with character of attributed capital gains, capital gains and losses resulting from foreign exchange movements and anomalous outcome which exists in relation to share sales of active businesses.
  - S.47A is problematic and draconian in its operation. Value shifts which are reversed should not be double taxed as is presently the case. Section 47A should be removed upon introduction of a general exemption for all foreign non-portfolio dividends.
  - CGT roll-over relief in CFC context should extend to all roll-overs provided by tax laws of foreign jurisdictions, particularly where the CFCs are all wholly-owned. Roll-over reliefs granted under foreign tax laws should not be clawed back.
  - countries presently on the limited exemption list need to be reconsidered for possible inclusion on the broad exemption list. Criteria that may be used for this purpose is discussed.
- given the regulatory environment in which they operate, CFCs that are life insurance companies and their wholly owned subsidiaries should be excluded from the CFC rules.

- attributable income should be able to be offset against attributed losses

- the present CFC rules result in income being attributed and taxed in Australia notwithstanding that the CFCs are in a loss position. This is not appropriate and is contrary to the policy objective of the CFC rules.

- the foreign tax credit regime associated with the CFC rules is extremely complex and needs much simplification.

THE PROBLEM TO BE SOLVED

The Government’s Consultative document on Taxation of Foreign Source Income released in 1988, stated the key element of the reform package is “New rules governing the taxation on an accruals basis of the income of non-resident entities in which Australian residents have interests, where the income has been derived in a low-tax country or has benefited from a designated tax concession in another country”. The Treasurer narrowed this purpose in April 1989. In the Taxation of Foreign Source Income - An Information Paper he stated that under the rules “most income sheltered in low-tax countries through foreign companies controlled by Australian Residents and through trusts will be taxed in Australia on an accrual basis”.

In December 1989, the Treasurer stated that the purpose was “to attribute to Australian residents income derived by a non-resident company that is controlled by Australian Residents, unless the company is subject to a tax system comparable to Australia’s or is predominantly engaged in active business”. 1 Simon Crean, the then Minister Assisting the Treasurer, in the Second Reading Speech announced that the Bill will “….introduce an accrual system of taxing foreign source income that had been derived in low tax countries by Australian controlled entities and has been accumulated offshore, avoiding Australian tax” but later in the speech adopts the wording used in December 1989.

The types of designated tax concessions intended to be clawed back were specifically identified in the 1988 Consultative Document (refer p17). Notably, however it was contemplated that “genuine foreign investment in active business [would] be exempt” from attribution under the proposed rules, and this was reiterated more strongly in later statements.

This taxation policy objective is echoed in the Consultation Paper which at page 33 confirms:

“The purpose of the Australian CFC rules is to prevent residents accumulating “tainted income” taxed at low or zero rates in foreign entities. The rules target tainted income as it is highly mobile between countries and poses a greater revenue risk than less mobile income. Active income from

---

1 Treasurer Taxation of Foreign Source Income – Draft Legislation; Explanatory notes (December 1989) AGPS at 3. The same words were used at pages 3 and 5 of Treasurer Taxation of Foreign Source Income – Draft Explanatory Memorandum and Draft Regulations (June 1990) AGPS and in Explanatory Memorandum to Taxation Laws Amendment (Foreign Income) Bill 1990.
running a business is generally exempted to ensure the competitiveness of Australian companies”

IFSA broadly agrees with such taxation policy. The CFC rules should be principally focused on targeting low taxed income in tax haven jurisdictions.

However, the controlled foreign companies rules as enacted in 1991, together with the subsequent further refinements and amendments, particularly the 1997 amendments have resulted in legislative rules the practical scope of which, clearly transgress boundaries contemplated by the original taxation policy. In particular the practical application of the current CFC rules:

- creates economic distortions in business behaviour because business arrangements are implemented/not implemented cognisant of these rules
- create competitive disadvantages for business, in breach of capital import neutrality. For example, business concessions available to competitors in foreign jurisdictions are clawed back under these rules, resulting in extra cost for Australian owned foreign businesses.
- are extremely complex and unwieldily in application. There are many instances where the application of the CFC rules is uncertain and/or anomalous.
- create substantial compliance and administration costs often for little tax payable. Record keeping requirements associated with the active income test and attribution accounting is particularly onerous.

Furthermore the economic and business environment since the CFC rules were enacted in 1991 has changed. By way of example of this, we note that the services industries have matured substantially in the last decade and are active businesses in their own right yet the CFC rules still operate to treat income derived from provision of services, as passive income.

THE PREFERRED SOLUTION

In light of the above, we recommend that the most appropriate solution would to a wholesale comprehensive rewrite of the CFC rules with substantially revised policy taxation policy objectives. Given the significant amount of discussion required between relevant parties, before such policy can fully developed, we have not commented in this submission on the what the scope of the revised CFC rules should be.

IFSA would be interested in working with the Board of Taxation and/or Treasury (as appropriate) in developing suitable policy guidelines for the scope of the new CFC rules.

INTERIM SOLUTION

We anticipate that the above solution would be seen as the longer term objective. Accordingly, we have also considered more immediate/shorter term solutions to address various
inadequacies and inconsistencies in the CFC rules and suggested ways that the CFC rules can be modernised.

All these recommendations should be considered to be of the highest priority.

1. **Clean Exemptions From the CFC Rules [ Option for Consultation 3.4 ]**

*The Current Law*

As discussed above the current CFC regime is extremely complex, difficult and costly to administer and apply in practice and often (from experience of our members) results in fairly insubstantial amount of Australian tax being payable, especially in the context of an active business. Accordingly, in this context and to ease associated compliance the CFC regime should be amended to ensure that there are appropriate outright exemptions, for CFCs which are not established abroad for any tax deferral objective, are engaged in an active business or are resident in a country which is considered to have a highly comparable taxation system with Australia (ie an extended broad exemption listed country list).

In this regard, we note that the UK CFC rules contain numerous clean outright exemptions. The benefits of having such exemptions include:

- simplification of the CFC rules
- ease of administration and compliance from a taxpayer perspective
- minimising inefficient distortions in business behaviour eg many business structures are set up to minimise the adverse impacts of the CFC rules.

Clean exemptions which could be incorporated into the CFC rules include the following.

**Recommendation/Solution**

(a) **CFCs Resident in Broad Exemption Listed Countries Should Be Excluded.**

We recommend that all CFCs resident in broad exemption listed countries (“BELC’s”) be completely excluded on the basis these countries are considered, by the Legislature’s own admission, to have a highly comparable tax systems which are likely to reduce any tax deferral advantage that could be obtained.

In broad terms, in a BELC context the current CFC rules purport to tax “eligible designated concession income” derived by a CFC resident in these countries. This is not appropriate given the acknowledged highly comparable nature of the tax system of the BELC. It would appear to be counter intuitive to treat countries as having a highly comparable tax system on the one hand and then simultaneously clawback features of that system (in substance treating the system as not highly comparable).

Accordingly, an exemption for CFCs resident in BELCs is reasonable given:
• the low levels of CFC tax actually collected in these jurisdiction. (this leaves compliance as the big issue)

• the relative importance of these countries as destinations for foreign investment

• their highly comparable tax system; and

• the competitive disadvantages that Australian owned businesses suffers, as a result of the present system, when competing with local players.

As a complimentary integrity measure, to avoid BELC CFCs being used as conduits for non-BELC investments, the exemption could be structured such that the relevant CFC would be required to meet specified criteria which could include the following.

The CFC must:

• be a resident (or created) under the tax laws of that BELC

• derive majority or substantially all of its income from operation conducted in a BELC.

In this regard, we note the UK equivalent exemption (referred to as the Excluded Countries Exemption) requires the CFC to be resident in the particular (comparably taxed) country and the CFC must not derive the greater of 50K or 10% of “commercially quantified income” of the CFC from non-local sources.

To the extent the conduit income was not subject to tax it could then be attributed.

For equity considerations, the exemption should equally extend to branch operations in BELCs. This is broadly the intention in relation to s.23AH and the current CFC rules.

(b) Active business exemption

The present active income exemption included in the CFC rules, whilst designed to exempt active businesses from attribution is not fully effective in achieving that objective. For example, the current CFC rules can result in passive income earned by an active business in early years of operation to be attributed, presenting a major issue for many start-up companies. In addition, the active income exemption is transactional based and carries a significant amount of compliance obligations eg record keeping and annual tainted income ratio calculations.

IFSA would endorse an entity based active business exemption. Such an exemption could parallel the active business exemption contained in Div 3 of the Part X1 dealing with the FIF rules by requiring that a specified percentage of the assets of the CFC must be engaged in an active business. We also note that concepts associated with an active business are used in various other parts of the tax legislation, for example “active asset” in subdivision 152, trading business in Div 6C and more recently the active income test in the new (amended) s.44, in the context of the demerger legislation.

Integrity could be developed around an active business exemption by mandating criteria such as the following – by requiring that the :
- the CFC be a resident of that country
- the CFC must have a business establishment in its territory of residence
- the CFC must be effectively managed in that territory of residence through-out the relevant period
- the business of the CFC must be an active business (or conversely must not be an excluded (inactive) business).

For holding companies we would recommend that the above exemption be applied on a look-through basis, such that if the assets of the underlying subsidiaries are involved in an active business then the income of the CFC should be exempted from attribution.

If over-capitalisation of subsidiaries in low-taxed countries is a concern, then limiting the exemption to CFCs of listed public companies may be an appropriate option, given the significant pressure on these companies to maintain capital efficiency both from a regulatory and cost of capital perspective.

(c) Motive exemption

In addition to the above, we would recommend that as third full exemption, a CFC be exempted from attribution if on basis of the motive exemption, the CFC was not engaged in transactions to minimise Australian tax. We note that a motive exemption is contained in the UK CFC rules as well as the recently introduced Italian CFC regime. This test could focus on the underlying rationale for why the CFC was established in the particular jurisdiction in the first instance.

2. Appropriate Targeting of the Tainted Services Income Rules [ Option for Consultation 3.2 ]

The Current Law

The current CFC rules treat services income derived by a CFC from provision of services to related or associated parties as passive income notwithstanding that an arms length consideration may have been charged for those services or that the services are provided in an active business context (refer s.448).

The above treatment is particularly problematic in the context of a centralised shared services centres used in many Corporate Groups. For example, it is not uncommon for a back office processing function be carried on by one particular company (which could be a CFC) for all other companies in the Group. As the rules are presently drafted, even if that CFC is charging an arms length consideration for those services the income earned can be attributed and be taxable in Australia.

This treatment creates competitive disadvantages for businesses owned and controlled by Australian investors by increasing the cost structure attributable to that investment. Also, the
present rules create economic distortions in business behaviour, for example the rules implicitly discourage use of in-house services or conversely encourage the use of externally acquired services.

The current rules are not appropriate in modern business environment where many services are provided in-house. Further these rules require a significant degree of compliance effort in our members’ overseas operations. For example, we have found it involves the equivalent of one to two weeks (sometimes more) of analysis in each jurisdiction for each entity.

**Recommendation/Solution**

As a potential solution to the above, we would recommend the following:

- services provided between CFCs on an arms length basis should be outside the scope of the CFC rules
- consistent with the tainted sales income rules, provision of services that do not have a direct connection with Australia (ie they are not provided directly to or from an Australian resident entity) should also be excluded.

From an integrity perspective, we note that the transfer pricing rules have become an important element in targeting any potential profit shifting that could occur by under or overpricing for goods and services between CFCs, particularly more so since the introduction of the CFC rules in 1991. This is also reflected globally in many jurisdiction which have implemented or improved their own transfer pricing rules (eg India) to counter any profit shifting arrangements.

**3. Exclude capital gains from the CFC regime [Option for Consultation 3.4]**

**The Current Law**

The current CFC rules are inadequate in number of ways in their treatment of capital gains. By way of example:

- attribution can occur where an active business is disposed of through a sale of shares yet no attribution occurs if the same sale is effected through a sale of the underlying assets
- any capital gains that are attributed under the CFC rules lose their character as capital gains because it is treated as other statutory income. This prevents Australian capital losses from being offset against those capital gains.

In addition under the current CFC rules capital gains and losses can be crystallised due to foreign exchange movements, even though economically there may not have been any capital gain or loss. For example, assume a CFC buys an asset for US$100 (forex rate $1AUD = $0.55 US$) and later disposes of the asset for US$100 (forex $1AUD=$0.50US$). For Australian CGT purposes, the CFC will have made a capital gain, on which the Australian entity will be taxed yet the CFC has made no economic gain.
Recommendation/Solution

Given the significant number of issues associated with treatment of capital gains in a CFC context and the complexity of possible solutions, the simplest option may be to exclude capital gains from the CFC rules altogether. In this regard, we note that this is the approach adopted under the UK CFC regime.

If outright removal of capital gains is not acceptable, then the above issues may be addressed as follows:

- In relation to share sales of active business – this anomaly could be removed by granting a CGT exemption if the majority of the underlying assets are not “tainted assets”.

- In relation to the alteration of the character of attributed capital gains – the policy justifications for this is not clear. Clearly, the treatment of attributed capital gains derived by CFCs is much more onerous than domestic capital gains. Our recommendation is that attributed capital gains should retain their nature. Whilst this may add some complexity in relation to identifying portion of attributed income that is capital gains, the ability to use Australian capital losses against such income would be a significant advantage.

- In relation to the functional currency issue, provisions need to be introduced to ensure that capital gains are calculated in the local currency and then converted subsequently. We understand that this issue is also being progressed via separate consultation.

4. Section 47A Needs To Be Substantially Revised [Option for Consultation 3.4]

The Current Law

Section 47A of the 1936 Act deems value shifts out of an unlisted country CFC to be deemed dividends which are fully taxable to the Australian attributable taxpayers under s.459. In part s.47A is intended to prevent the abuse of the s.23AJ exemption. Whilst s.47A is acknowledged as an anti avoidance provision, its practical application can result in double taxation. This is particularly problematic given the enormous breadth of the s.47A.

By way of example:

- a CFC operating a successful business in Hong Kong needs to ensure that any lending arrangements to CFCs in listed countries do not breach s.47A. Section 47A can however be easily breached where the funding is through inter-company accounts (such financial arrangements could be considered to be non-arms length). If s.47A is breached in this situation, then even if the relevant funds were repaid the subsequent repatriation of them (through a dividend) to a listed country resident Parent can give rise to a further taxing point resulting in clear double taxation.

- Section 47A can cause issues where a listed country resident Parent company and a CFC which itself is resident in an unlisted country enters into a incorporated joint
venture arrangements and the JV Co is established in a listed country. Equity funding of the JV Co by the unlisted country CFC can give rise to s.47A issues.

**Recommendation/Solution**

IFSA supports Option 3.9 of the Consultation Paper which relates to abolishing the limited exemption list and providing a general exemption for all non-portfolio dividends received by Australian companies. Adoption of this option will remove the need for s.47A altogether. This is our preferred approach. The present drafting of s.47A is nearly incomprehensible.

If s.47A is to be retained then the appropriate amendments need to be made to ensure that any value shifts which are restored are not taxed as dividends eg a non-arms length loan is repaid.

In addition the specific structural impediment identified above needs to be addressed. Current drafting of s.47A limits choice of investment vehicles available to Australian businesses.

5. Roll-overs recognised by the CFC rules should be broadened [Option for Consultation 3.1]

**The Current Law**

Certain roll-overs available to CFCs in overseas jurisdictions are not recognised by the CFC rules, and may be undone. This is problematic because lack of appropriate recognition of those roll-over can effectively “lock” Australian businesses into a particular structure because of the tax costs that may be incurred in restructuring the operations, notwithstanding that such restructuring could enhance the business efficiency of a particular business. Accordingly, broadening the scope of roll-over relief available (and the consequent removal of the tax cost) would enhance opportunity to utilise the best business structures.

In addition there are many technical deficiencies with the current drafting of the CFC rules in relation to roll-overs. In many instances, the CFC rules and the associated regulations make references to repealed legislation (eg reference to s.160ZZO in Regulation 152G(3) in the Income Tax Regulations).

**Recommendation/Solution**

Given our endorsement of Option 3.9 to adopt a general exemption for all non-portfolio dividends, we would recommend that roll over relief be extended to all CFCs in wholly-owned groups irrespective of the jurisdiction of the CFC. The current limitations contained in s.419, which for example prevents roll-over of assets from a limited exempted listed country (LELC) resident CFC to a BELC CFC are not appropriate.

Especially, in the context of active businesses all roll-overs permitted locally in foreign jurisdictions should not be clawed back under the Australian CFC rules. This is competitively disadvantageous.

Furthermore, roll-overs that do not give rise to a disposal outside of a related group should be respected where they remain within the tax net. Such asset transfers should only be subjected
to tax as J1 events under the CGT rules once an asset is disposed of in a context where they will fall outside the jurisdiction of the Australian taxing rules.

6. Additional Countries that should be included in the broad exemption category list
[Option for Consultation 3.3]

The Current Law

Under the current law, the effect of countries being on the broad exemption list is that relatively a much smaller category of passive income (namely eligible designated concession income) is attributed under the CFC rules, in comparison to treatment of non-BELC resident CFCs.

The number of companies on the broad exemption list were substantially narrowed after the 1997 amendments to the CFC rules. Prior to this amendment some sixty countries were treated in effect, similar to the countries now present on the broad exemption list (namely US, UK, New Zealand, Japan, Canada, Germany and France).

For attribution purposes, most European countries are treated in the same manner as tax havens such as Bermuda. This is clearly deficient policy.

Recommendation/Solution

We note our recommendation above that all CFCs resident in a country on the current BELC list should be excluded from the CFC rules. Consideration also needs to be given to including other countries on the BELC list. Example of criteria that could be used includes:

- comparable rates of tax – the higher the rate of taxes, the more unlikely that Australian tax deferral was not an objective in setting up in that country.

- existence of a double tax agreement – substantial knowledge is likely to have been obtained as to comparability of the tax system of the DTA country, as part of the DTA negotiation process.

- existence of anti-deferral rules – the existence of these rules shows a level of sophistication in the tax system (alternatively if the rules render the relevant income subject to tax, the existence of anti-deferral rules isn’t a necessary criteria).

- extent of any substantive structural tax concessions /objectionable features of the country’s tax system.

Consistent with the pre 1997 approach countries which are presently on limited exemption country list (refer Schedule 10 of the Income Tax Regulations) should all be reconsidered for inclusion.

To the extent that any of the countries are not included on the revised BELC list, our preference would be for the legislation to specify any objectionable features of that tax system that are to be clawed back under CFC rules (ie through attribution). This is consistent with the
pre 1997 approach. Such an approach would ease compliance with the CFC rules and simultaneously achieve the integrity concerns of the revenue.

7. **CFCs that are life insurance companies [Option 3.4]**

**The Current Law**

Section 446(2) of the CFC rules operates to reduce the prima facie attributable income of a CFC to the extent that the assets of the life company are used to back third party policyholder liabilities. The intention being to exclude from the attributable income of a CFC, income which is referable to policyholder assets. This calculation is complex and requires actuarial input before it can calculated. This causes significant compliance issues.

Secondly, as presently drafted s.446(2) only applies to the life assurance company itself and not to wholly owned subsidiaries of the life insurance company, even if those companies are fully backed by policyholder assets. This is clearly anomalous. CFC attribution can occur at the subsidiary level yet if the investment had been held at the life insurance company, this would not have been the case.

**Recommendation/Solution**

Life insurance companies are highly regulated entities. Given the substantive regulatory environment in which life insurance companies operate they are unlikely to be used as tax deferral vehicles. For example, significance regulatory requirements have to met before a company can be registered, under the relevant foreign legislation as a life company. Given this regulatory context, our recommendation is that life insurance companies be exempted from the CFC rules.

We note, that if there were integrity concerns in granting such an exemption (eg because of a perceived (albeit remote) possibility that life companies could be used to avoid attribution) then the general anti-avoidance provisions in Part IVA could be applied.

Furthermore, the exclusion should be extended to subsidiaries of life insurance companies.

8. **Allowing offset of attributable income against attributable losses [Option for Consultation 3.4]**

**The Current Law**

The current CFC rules do not allow attribution losses from one CFC to be offset against attributable income from another CFC. Especially, in the context of wholly owned companies, this is relatively harsher tax treatment than that applicable under the domestic law.

Additional tax costs are incurred, where overall at the corporate group level no profit was made. In a sense, the rules penalise Australian companies for making investments which ultimately turn into losses by failing to provide suitable relief (limited relief is available re carry forward of the losses). Also, non-groupability of the losses would appear to be inconsistent with domestic context.
Recommendation/Solution

The CFC rules should be amended to allow attributable income from one CFC to be able to be grouped with an attributable loss from another CFC. This treatment would be consistent with the present domestic law.

9. Inappropriate Attribution Where a CFC is in Loss Position [Option for Consultation 3.4]

The Current Law

The current rules can result in attribution of income to Australian attributable taxpayers, notwithstanding that the particular CFC is in a loss making position.

This result arises for 2 reasons:

- the active income test, which focuses on gross turnover can still be failed (the active income test does not focus on the net position ie expenses are ignored)
- only limited range of deductions (notional allowable deductions) are able to be offset against passive income. (in some instances, no deductions relate to passive income because all of them are attributable to the active business)

The above is clearly problematic because additional Australian tax is payable in circumstances where the particular CFC is otherwise in a loss position. This puts Australian owned businesses at a further comparative disadvantage. The above treatment is also relatively more onerous than the domestic tax law treatment applicable to resident companies.

Recommendation/Solution

Consistent with the policy objective of the CFC rules, there should not be any attribution of income, where in fact a CFC is in a loss position. This could be implemented in number of ways. A simple solution would be look at the accounting profit or loss as calculated under generally accepted accounting principles. A more complex solution would be to require that the income/loss of the CFC be recalculated in accordance with the Australian tax rules. Obviously, the former is the easier approach from tax compliance perspective.

10. FIF Interests held by CFCs [Option for Consultation 3.4]

The Current Law

Under the current CFC rules the attributable income of a CFC includes income derived and deemed to be derived in respect of foreign investment fund (“FIF”) interests held by a CFC (akin to FIF attribution for resident taxpayers).

There are number of aspects of the FIF rules which requires reconsideration from a taxation policy perspective. We have addressed these in Part 3 of this submission.
Recommendation/Solution

Our recommendations in Part 3 of this Submission in relation to FIFs equally applies to FIF interests held by CFCs.

11. Foreign Tax Credits and CFCs [ Option for Consultation 3.4 ]

The Current Law

The legislative provisions associated with calculating foreign tax credits related to attributable income are extremely complex and need much simplification (for example refer s.458/s.160AFCC and s.23AI/s.160AFCD). In many instances the provisions are so complex, that informed professionals can differ profoundly about the correct outcome.

Recommendation/Solution

The rules in respect of calculating foreign tax credits in a CFC context need to be greatly simplified. However, given the close connection between CFC reform and reform of the FTC rules, recommendations accepted in respect of the former will clearly depend on what is accepted in respect of the latter. Given this context, IFSA will be interested in making further submissions in relation to the reform of the FTC rules when the CFC reform proposals have been developed further.

12. Treatment of LLPs and LLCs issues [ Option for Consultation 3.4 ]

The Current Law

Whilst this aspect is currently being addressed in separate consultation it is included here for completeness. The Australian Taxation Office view as expressed in TR 2000/D14 results in significant adverse tax effects. In broad terms the ATO view is that a US or UK Limited Liability Company (“LLC”) or Limited Liability Partnership (“LLP”) is not a resident of any particular country. The consequences being inter alia that:

- the passive income of the LLP/LLC is attributed
- the active income exemption is not available for such an LLP/LLC. (This acts to exacerbate the attributable income)
- potentially no foreign tax credits are available in respect of that attributed income

Recommendation/Solution

IFSA supports allowing flow through taxation of such LLP/LLC. That is by deeming the LLPs/LLCs not to be companies for purposes of calculating the attributable income under the CFC rules. Such an approach will ensure that the underlying partners are potentially taxable on their pro-rata share of the income of the LLP/LLC. Furthermore, adopting flow through
treatment will ensure that active income is not attributed contrary to the clear objective of the CFC rules.

However, where an LLP/LLC is established and carries on its activities in a BELC and the Australian resident investor’s share of the income of the LLP/LLC is subject to tax in a BELC, there should be an election to treat the LLP/LLC as a CFC resident in the BELC.

13. Bare Trusts Should Be Ignored Under the CFC Rules [Option for Consultation 3.4]

The Current Law

There is presently an inconsistency between the treatment of bare trusts under the CFC rules as compared to the FIF rules. Under s.484 of the FIF rules, interests held by the bare trustee are attributed to the underlying beneficiary/ies i.e. the bare trustee is effectively ignored.

However, for CFC rules, the position is potentially more complex because a bare trust could be seen to be a controlled foreign trust with a separate identity from the underlying owner (which would be a CFC). This causes various tax compliance issues.

It should be noted that bare trusts are also ignored in Division 6 of the current tax legislation.

Recommendation/Solution

Consistent with the policy under the FIF rules, bare trusts should be ignored for CFC purposes.
PART 3 ATTRIBUTION FOR PORTFOLIO INVESTMENTS

SUMMARY

The current FIF regime has been designed too broadly catches innocent overseas investment. It imposes huge compliance costs on investors and in the case of the funds management industry results in very little or no additional revenue collection.

IFSA suggests that the ideal solution is to replace the regime completely. Alternatively, the Board should investigate a complete carve out for genuine public offer vehicles.

If either of these is not possible a number of changes to the regime are suggested to make it less costly to comply with.

THE PROBLEM TO BE SOLVED

The comments contained within Chapter 4 of the Consultation Paper in respect of the FIF regime are welcomed. They acknowledge that the rules catch investments beyond those at which they are targeted and that they impose a high compliance burden on our industry.

The rules are required to prevent investors directing their money into entities that accumulate their income in low tax rate jurisdictions rather than distributing that income and subjecting it to Australian tax. Our submission refers to these as “offshore accumulation entities” adopting a term used in the Consultation Paper.

Measured against this policy objective the rules can be seen to be poorly targeted. Instances of this poor targeting include treating the following as though they are offshore accumulation entities:

- entities that are not carrying on business activities whether they accumulate or not;
- entities that are listed on an exchange other than one listed in legislation;
- entities in respect of which the stock exchange classification or international sectoral classification is inappropriate;
- entities whose published balance sheet is not timely or not sufficiently descriptive;
- banks where the investment is in a form other than shares;
- entities whose principal business activities are financial intermediation without being a bank;
- entities whose business activities are diversified financial services without being a bank;
entities whose principal business activities are the management of real estate;

The approach the legislation takes is to treat as offshore accumulation entities any entity where there is a perceived risk that it could be used as such. While the Government may have considered this to be an appropriate approach back when the legislation was introduced, it is no longer acceptable.

IFSA suggests that the best approach is to completely repeal the FIF regime and replace it with a more targeted regime. If this is not possible consideration should be given to a “carve out” for the funds management industry (unit trusts, life companies, PSTs & superannuation funds). If such a carve out is not possible the minimum change required is to address the various anomalies in the current legislation. The third component of this part of the submission lists some of these anomalies and suggests changes.

THE PREFERRED SOLUTION

It has been a focus of the Government’s tax reform, beginning with the Review of Business Taxation’s discussion paper, ‘A Strong Foundation’, to improve the system through better legislative design. Legislation that has been introduced since then has generally, but not always, met a much higher standard of only affecting transactions that are subject to the policy objective of the legislation.

Two significant problems arise from the existing FIF regime. One is that investors have to attribute income from entities that are not offshore accumulation entities. This is an inappropriate acceleration of the tax liability in respect of these investments.

This problem is at its worst when it prevents a fund manager achieving economies of scale by preventing them from investing money raised in Australia in existing offshore pools.

---

**Case Study: A large European fund manager offers an international equities fund in Australia**

A large fund manager has a 10 billion euro fund of international equities operating in Europe into which money from various countries is invested. The investors receive regular distributions of the income and realised capital gains derived by the fund. The size of the fund means that the fixed and operating costs are quite small per investor.

The fund manager now wishes to offer the same investment style to Australian customers through an Australian unit trust. If the Australian unit trust invests into the European fund there will be FIF attribution each year of all of the increase in the value of the fund. This would be uncompetitive against the existing international equity products in the Australian market so this is not viable. The Australian trust instead contracts with the fund manager to run a separate pool for it.

The product is successful in the Australian market and raises $A100 million in the first year. The cost per investor is significantly higher than it would have been if the trust invested into the European fund. There are also additional costs being borne by the fund manager.
The second significant problem is that the legislation creates a complex classification system. Any offshore investment has to be analysed against a range of criteria using information that would not otherwise be collected or collated. This information is often not available or is only available in an unreliable form after much investigation.

A custodian acting on behalf of fund managers and similar investors keeps a database of several thousand offshore investments, whether they are exempt from attribution and, if so, the grounds of that exemption. The criteria are such that for many of these investments the classification could change from year to year as the companies evolve.

**Case Study: Is ING exempt from FIF attribution?**

ING Groep NV is one of the world’s largest and most successful financial services groups. It’s financial accounts for the 2002 year show a tax expense of 1.8 billion Euros so it is not an offshore accumulation entity.

How long does it take you to determine whether an investment in ING is exempt from attribution or not? What workpapers can you create to record and justify this decision? How long would it take you to do this for all the financial services groups that someone may invest in?

Hint: A few of the questions required to be answered in the analysis in respect of the particular ING group company in which the interest is held are:

- What assets on the company’s balance sheet, as distinct from the consolidated balance sheet of the group, are used for business activities other than those listed in the legislation?
- What assets on the company’s subsidiaries’ balance sheets are used for business activities other than those listed in the legislation?
- What percentage of each of those subsidiaries does the company own?
- Are the balance sheet values in accordance with commercially accepted accounting principles giving a true and fair view of the company’s financial position?
- Is the company itself a ‘bank’? What is a ‘bank’?
- What is the place of residence of each wholly-owned subsidiary? Are any of them authorised under the law of that place to carry on banking business or life insurance business or general insurance business?
The FIF regime will continue to be an impediment to Australia being a global financial services centre as long as this classification system continues. There are no modifications that can be made to it to make it acceptable. It has to be overhauled.

In Chapter 4 it is suggested that as a long term measure the regime should be replaced.

While we acknowledge the difficulty of devising a test to identify offshore accumulation entities, if replacing the regime is the only way of getting away from the classification system then there is an urgent need to do so. There is no reason to delay working on a replacement regime. There is very little chance that overseas jurisdictions are going to come up with something better suited to the Australian economy than we can come up with ourselves.

Based on the discussion in the paper and the existing legislation, the parameters for the regime to meet the policy objective are as follows:

- There is attribution in respect of investments in offshore accumulation entities.
- The regime only applies where the Controlled Foreign Corporation regime does not. This includes both near-control situations and pure portfolio investments.
- If the investor has a diversified portfolio of investments listed on stock exchanges then there is no need for attribution. This is the current balanced portfolio exemption and it is the exemption for index funds proposed in option 4.3 in the Consultation Paper.
- Superannuation entities, superannuation monies of life companies and the like are exempted because their continuing low tax rate means that the benefit from deferral is low. This is option 4.4 in the paper.
- There is a de minimus exemption for small investors.
- There are exemptions for certain visitors to Australia, interests in employer-sponsored superannuation funds, trading stock and certain interests of underwriting members of Lloyd’s.
- There are alternative methods of calculating the attributed amount allowing for the different characteristics of investments that are caught by this regime.
- There is attribution accounting to avoid double taxation.

We recommend the following replacement regime:

- The method of identifying an offshore accumulation entity is it does not carry on a trading business, pays tax on its worldwide income at a rate less than 20% and distributes less than 50% of income and realised gains over a three year period.
- It is made clear that the regime only applies where the entity invested into is not a company where the control tests in the Controlled Foreign Corporation regime are met. The regime does not apply just because there is zero attribution under the
Controlled Foreign Corporation regime. This is current policy but it is often argued that the legislation is not clear.

- The balanced portfolio exemption is rewritten so that a taxpayer who deserves to be excluded from the regime on this ground is not punished by the enormous compliance costs of the classification system. The effect of the balanced portfolio exemption is to overcome the need for certain taxpayers to have to deal with the identification of offshore accumulation entities.

If the investor has a portfolio of more than, say, 20 different investments, at least, say, 75% of which are listed on approved stock exchanges then they are taken to have a diversified portfolio. This measurement includes their Australian investments as well as their foreign investments. If the taxpayer has a diversified portfolio then all investments in the portfolio, other than those that fail a concentration test, are exempted from attribution. The concentration test means that if the portfolio is too weighted to a particular investment then that investment does not get the benefit of this exemption. The concentration threshold could be, say, 10% of the total value of the portfolio.

This would incorporate the exemption for index funds proposed in Option 4.3 in the Consultation Paper and can be justified by the reasoning given for that proposal. The amount of actual deferral available under our proposal may be slightly greater than that available to index funds but it would still be very minor.

We acknowledge that Option 4.2 in the Consultation Paper to investigate increasing the 5% threshold in the current balanced portfolio exemption was a submission that we made ourselves to the Review of Business Taxation. Our thinking has moved on since that time and we now believe that the above is a better solution. Merely increasing the threshold in the current exemption would not remove the compliance costs imposed by the classification system.

- Superannuation entities and the like are exempted because their continuing low tax rate means that the benefit from deferral is low. This is Option 4.4 in the Consultation Paper. This is an appropriate minor rule but on its own it does not go far enough to reduce the compliance burden borne by the Australian industry. Most Australian fund managers adopt a pooling approach whereby they invest superannuation monies and private investment monies jointly through a sector specific wholesale trust. Sometimes two or more superannuation funds will invest into that sector specific trust in order to obtain scale. Consequently the “waters’ edge entity” investing offshore is not a superannuation fund but a trust, thus making the proposed exemption academic. Similarly non resident monies invested through Australian managers will not be through superannuation vehicles and hence are impeded by the FIF rules. New Zealand investors would be a particular example of this.

- There is no attribution in respect of investments into ‘Broad Exemption Listed Countries’. Consistent with our proposals for the Controlled Foreign Corporation regime, as these countries have comparable tax rates, a comparable tax base and their own attribution regimes there is little scope for an offshore accumulation entity to be resident there. There would be an exception to this exemption where the entity invested into is exempt from tax in the Broad Listed Exemption Country
and does not have a requirement to distribute its income and realised gains. This is an extension of the current exemption for investments in certain United States entities.

This exemption would allow some fund managers with a large global fund in a ‘Broad Exemption Listed Country’ to access that fund rather than having to set up a new fund in Australia. If the foreign fund is distributing its income and realised gains then it is not an offshore accumulation entity and there is no deferral benefit from investing in it rather than in Australian funds.

- Similarly there is no attribution in respect of an investment in an entity where that entity is bound to distribute its income and realised gains by its constitution, its offer documents, and the laws of any country or any other means.

This is similar to the previous exemption in that it allows fund managers to access foreign funds where, because of the nature of the fund itself, it is not an offshore accumulation entity.

- The de minimus exemption is retained but the threshold is increased to a more modern number.

- The current exemptions for certain visitors to Australia, interests in employer-sponsored superannuation funds, trading stock and certain interests of underwriting members of Lloyd’s are retained.

- The current methods of calculating the attributed amount and of keeping attribution accounts are retained except for widely held trusts. In the case of such trusts the attribution accounts should be kept only at the trust level.

- The regime needs to recognise the difference between deferred income and unrealised capital gains. The latter should not be subject to attribution.

- To the extent that a capital gain must be attributed it should be given the tax treatment applicable to capital gains rather than that applicable to ordinary income.

**A CARVE OUT**

The second approach in Chapter 4, rather than replacing the regime, suggests various modifications to reduce the compliance costs. Such modifications include increasing the 5% balanced portfolio exemption and exemptions for indexed funds and complying superannuation funds discussed above. It is IFSA’s view that if the complete replacement of the FIF regime is not likely in the short term then it is necessary that a substantial carve out for the funds management industry is developed. Whilst the modifications are desirable they do not go far enough to reduce the compliance burden borne by the Australian industry.

The difficulties arising from the existing regime have been discussed in the preceding section. However, there are a number of preliminary comments that need to be made in this section.

The comments within Chapter 4 of the Consultation Paper implicitly reject the notion of a complete carve out except for complying superannuation funds and indexed funds. The basis
for this would seem to be a perception that “significant tax advantages are available to a taxpayer using an offshore accumulation entity”. IFSA has two concerns with this. Firstly it completely ignores all of the FIF issues that arise for direct investment. For example investments into non resident entities dual listed on the Australian stock exchange such as Baycorp and GPG. Secondly we question whether there actually are significant tax advantages.

The two advantages referred to are the offshore accumulation of income and secondly attracting the 50% concession. It is suggested that income from overseas investment is quite low. For example dividend yields as measured by three indicators are:

<table>
<thead>
<tr>
<th>Index</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 100</td>
<td>1.75%</td>
</tr>
<tr>
<td>FT</td>
<td>3.90%</td>
</tr>
<tr>
<td>Eurotop</td>
<td>3.20%</td>
</tr>
</tbody>
</table>

[Source Bloomberg]

By comparison the average dividend yield on the ASX is 3.6%.

The benefits of compound yield through accumulation are utterly insignificant for yields this low. Accordingly the second line of Table 4.1 (Conversion of income to capital gain) significantly overstates the tax advantage to be gained as long term dividend yields are considerably less than 10%. It should also be noted that a 15% source country withholding tax rate overstates the position. The bulk of offshore equity investments are made into the United States, United Kingdom and New Zealand where there is either no withholding tax or tax at a much lower rate.

The second concern should be dismissed in the context of the managed fund’s industry. This is because a not insignificant component of any yield on overseas investments is in the form of a capital gain. The paper expresses concern about income being converted to a concessionally taxed capital gain. In reality the FIF regime results in capital gains, both realised and unrealised, being converted into more heavily taxed income. In the ordinary domestic context capital gains retain their character when passing through a trust. However, the FIF regime seeks to override this. Further, the Australian taxation system is grounded upon the principle that only REALISED income and capital gains are taxable. The FIF regime seeks to tax unrealised income and gains. In the context of the managed funds industry the perceived mischief that justifies such an approach does not exist. This is because gains and losses are realised for sound investment reasons. Similarly the deferral of realisation of a gain or loss is made on the basis of a commercial investment decision not a decision to seek tax deferral. In any case most funds achieve a complete turnover on average every 3 to 4 years.

Therefore it is suggested that the two fundamental concerns about accumulation entities are not relevant for the Australian funds management industry.

Option 4.3 suggests a FIF carve out for index funds. Whilst this suggestion appears meritorious closer analysis reveals flaws. What is an index fund? Does it include a fund that uses derivatives to replicate the index, or is it restricted to funds with actual stock holdings? Which indexes are relevant? When one Australian fund manager created a new class of fund they created an index to measure it against. Most funds use the relevant index as a base to judge performance. How much deviation is permitted before a fund is no longer an index fund? If a
fund uses two or more asset managers with different styles in order to minimise risk, and thus produces returns mimicking the index, is it an index fund?

Option 4.4 suggests a FIF carve out for complying superannuation funds. However, as previously explained it is the waters edge entity that matters and considerable superannuation money is invested offshore via wholesale trusts. The position of superannuation monies in Life Companies is also problematic. Hence this option is not sufficient.

Instead IFSA suggests that particular types of Australian investor should be expressly excluded from the FIF regime. Specifically it is suggested that entities, which satisfy all of the following criteria, should be exempt:

1. The taxpayer is a registered managed investment scheme or a Life Company registered by APRA.
2. If the taxpayer is not a Life Company it is a fixed trust as defined in the suggested attachment contained in appendix 1.
3. The entity is a resident of Australia for tax purposes. Further if the entity is a managed investment scheme its Responsible Entity must also be an Australian resident and trust administration must be performed in Australia.
4. If the entity is a trust it is not subject to tax under Division 6B or 6C of the ITAA 1936, and
5. The ATO has not issued a notice to the entity to the effect that the trust / Life Company is not considered to be a genuine public offer vehicle.

[This last item is a “fail safe” to prevent any abuse of the proposed concession.]

It is suggested that this exclusion is necessary in order to eliminate the FIF issues discussed in the consultation paper and in various submissions that have been made to Government. The above carve out would be very simple to legislate and the industry would bear no implementation cost provided a sensible commencement date such as 1 July 2003 was chosen. Specifically it will:

- Eliminate the wastage associated with year end sales.
- Eliminate the classification costs in relation to FIF interests
- Eliminate the custody costs associated with year end checking to ensure the 5% balanced portfolio exemption is not breached.
- Eliminate costs associated with avoiding anomalies such as dual listed entities carrying on financial intermediation.
- Eliminate the enormous costs of attempting to maintain attribution accounts for individual investors.
- Maintain parity between direct and indirect investment into overseas equities.
• Eliminate the unintentional FIF issues that can arise from direct investment into overseas listed entities

• Eliminate the need to maintain costly “mirror” funds.

• Provide a framework for investment into overseas hedge funds. There is a growing demand for investment funds which adopt a “manager of managers” approach for hedge funds. Such an approach cannot be efficiently performed from Australia under the existing FIF rules.

SOME ANOMALIES

Lastly we have some specific comments in respect of the modification contained within Chapter 4. IFSA sees these modifications as desirable but very much a third best alternative.

Option for Consultation 4.2

To consider, undertaking detailed case studies in conjunction with industry, increasing the five per cent balanced portfolio exemption threshold in the foreign investment fund rules.

Whilst increasing the percentage is laudable it will not alleviate all concerns. The current 5% rule is that attribution is not required if less than 5% of all FIFs held fall outside the various exemptions. Exemptions exist for entities that are not trading in the financial sector. Further exemptions are available for some financial sector activities. The difficulties with this proposal are:

1. It is still necessary to do a sectional analysis of the assets held. Typically a custodian will charge at least $3500 per fund for this.

2. Some finance sector participants are so diverse that it is impossible to truly accurately classify them. E.g. American Express, Citigroup, Irish Life, ING Groep.

The percentage applies only to FIFs not to the whole portfolio. For example the Australian Shares offering of one of our members invested in a company called Baycorp Holding Limited. This company is incorporated in New Zealand but listed on both the Australian and New Zealand stock exchanges. It is involved in credit management activities that fall outside the various FIF exemptions. This entity represented less than 1% of the total fund portfolio. However, of the four dual listed entities held it represented 18% of value. Thus attribution was required because the test is 5% of FIF assets not total assets. This is frankly nonsensical. Any balanced portfolio exemption must be based on total assets not just FIFs.

Most managers have diversified fund offerings. “Diversified funds” can usually be divided into four:

- Conservative
- Moderate
- Growth
- High Growth
The international share component of such offerings is typically:

- Conservative - up to 10%
- Moderate - up to 20%
- Growth - up to 30%
- High Growth - up to 50%

On the face of it a 5% threshold will not even be adequate for a conservative style fund let alone a High Growth fund.

What is appropriate is a figure that matches the positioning of that style of fund. Such percentages are readily available on an ongoing basis from consultants such as Mercers.

**Option for Consultation 4.3**

To consider exempting Australian managed funds that follow widely recognised indices from the foreign investment fund rules.

Virtually all funds measure themselves against the relevant index for benchmarking purposes. How much tracking error will result in the loss of availability of this exemption? See our earlier comments.

**Option for Consultation 4.4**

To consider exempting complying superannuation funds from the foreign investment rules.

Such an exemption, whilst welcome, only reduces the FIF difficulties for a relatively small number of superannuation funds. Firstly, many superannuation funds invest via wholesale unit trusts. Hence they are not the “waters’ edge” entity and thus the exemption would not be available. Secondly such an exemption ignores the other repositories of superannuation monies specifically ADFs, PDFs and VPSTs of life companies.

Any exemption for superannuation monies needs to be wider than that proposed.

**Option for Consultation 4.5**

To consider amending the foreign investment fund rules to allow fund management services to be an eligible activity for the purpose of the foreign investment fund rules.

Such a change would make it easier for a number of overseas companies to fall within the FIF exemption particularly the “All Finanz” entities such as ING, Irish Life and Citigroup. However, IFSA believes this proposal stems from an earlier submission it made. That submission was aimed at finding a solution for those companies seeking to offer Hedge fund products in Australia. In particular those seeking to provide a “manager of managers” hedge
fund offering where a portfolio of, say, 20 offshore hedge funds was invested in. The exemption sought was for investment into overseas managed funds not just investment into overseas fund managers.

As the Consultation Paper currently stands the difficulties with offering such hedge fund products still remain. One solution would be to enable such overseas funds to be treated as de facto trading stock. This overcomes Treasury concerns about accumulation funds but eliminates expensive year end practices.

Other FIF anomalies

1. If a fund manager has investments in two or more non exempt FIFs it must treat the attribution on each of those differently. Specifically attributed gains on one cannot be offset against an unrealised loss on another. The FIF rules need to allow a collective position to be determined across the entire portfolio.

2. Under Part XI where attribution arises in respect of an investment by a trust an attribution account needs to be kept for each beneficiary of the trust; s. 605(8). Where the investment is by a public offer trust there may be thousands of unitholders and commercial necessity will mean that the manager must keep the attribution account for each of those unitholders. Further, for each individual FIF there must be a separate attribution account: Division 19. So for fund with, say 2000 unitholders and 20 hedge fund investments offshore, 40,000 attribution accounts would need to be kept. Further, each time a unitholder enters or exits the trust the “attribution account percentage” changes and those 40,000 accounts need to be revised. This is simply not practical.

Registered managed investment schemes should be able to keep one attribution account for all investments. Similarly that account should be at the fund level not the investor level.

3. Section 23AK exempts certain FIF attribution account payments when made to taxpayers. There is a technical risk that this exemption may not apply where a FIF attribution account payment is made through a chain of trusts.

A FIF attribution account payment is defined in 603 (d) (amongst other things) as:

(d) if a beneficiary of a trust is presently entitled to a share of the income of a trust – that share of the net income (within the meaning of section 95) of the trust of a year of income;

23AK (1)(a)(i) and (1)(c)(i) effectively exempts that amount, but only where the payment is made to a taxpayer other than in the capacity of trustee of a trust – see 23AK (1)(a)(i).

Where the taxpayer receives the amount in its capacity of trustee of a trust (eg because it is interposed between the FIF and the beneficiary), there is a technical risk that 23AK will not exempt the amount, and therefore the ultimate beneficiaries would be subject to double taxation. The solution to 2 above would partially redress this problem.
4. Many managers take some form of foreign exchange hedge in respect of their overseas investments. Under current rules any gain or loss on that hedge is considered to be of an Australian source and of a revenue nature. Hence a situation can develop where there is an FX hedge gain but the underlying FIFs have given rise to a realised capital loss. The hedge gain cannot be offset against the capital loss and a tax result follows that is out of kilter with the true economic result.

E.g. Asset bought for US$100 (AU$200). At the end of the year 2 the asset is sold for US$90 (AU$160). A foreign exchange hedge returns, AU$20. However the capital loss cannot be offset against this.

Solution: Allow FX hedges to take on the same character and source as the underlying assets in portfolio investment situations.

5. Currently attribution can arise in respect of active companies carrying on a business in comparably taxed jurisdictions (see the examples described earlier on page X). It is suggested that there should be a complete exemption from the FIF regime for entities carrying on active businesses in comparably taxed jurisdictions. Such jurisdictions as Canada, the US, New Zealand, The United Kingdom, Japan, France, Germany and the Scandinavian countries would form the basis of a BELC exemption.

6. Further complications can arise where a FIF investment is held by a CFC. Under the CFC provisions the overseas entity must calculate its taxable income as if it were an Australian entity. Hence potentially the FIF rules apply to a CFC too. This application should be discontinued.

7. Currently managers who are faced with an attribution problem at year end will often undertake a “Bed & Breakfast” arrangement. Such an arrangement is entered into not to reduce tax exposure but purely to reduce the compliance costs associated with having any attribution under the FIF regime. The ATO has previously indicated that in the context of FIF matters they are comfortable with such arrangements as the relevant revenue / gain is brought into assessable income. They are not concerned with whether it is brought in under ordinary concepts or FIF concepts. However, B&B arrangements are not without cost. Such arrangements involve selling assets immediately before year end and repurchasing immediately after. Invariably there will be some transaction costs such as brokerage.

Given that the ATO is not concerned about revenue loss through such arrangements it would be desirable to seek to eliminate these transaction costs. This could be done by allowing affected entities to elect to make a deemed disposal and purchase at market value. Such a procedure would have no revenue cost and would reduce the implicit FIF compliance costs.

Other matters

It is IFSA’s belief that the recommendations made above have no significant revenue consequences for the Government. Provided a regime of some sort remains in place for undesirable accumulation strategies the three levels of recommendation will merely reduce the compliance burden borne by the industry.
All of the above recommendations will have an insignificant implementation cost for fund managers provided a sensible implementation date, such as 1 July 2003 is chosen.
PART 4 IMPUTATION AND ITS EFFECT ON ONSHORE INVESTMENT

Chapter 2 of the Consultation Paper canvasses the effects of the Australian imputation system on the decision of a company to invest offshore. It acknowledges that there may be a structural disincentive towards offshore investment that is created by the Australian imputation system and is reflected in a higher cost of capital to the company making the investment decision. Before the paper analyses and reviews the 3 suggested reform options, however, it highlights a threshold requirement that an economic analysis needs to be performed that demonstrates conclusively that this structural disincentive does exist (“the threshold policy question”). IFSA will deal firstly with this threshold question and then consider the reform options proposed. IFSA will also consider briefly the cost considerations of those options as IFSA recognises the revenue context of all policy recommendations.

THE THRESHOLD POLICY QUESTION

Appropriately, the process proposed by the Consultation Paper requires that before any reform option is examined, it is necessary to clearly demonstrate that a structural disincentive against offshore investment exists. IFSA supports this approach. The essence of the issue as it is described in the Consultation Paper is that the disincentive will be demonstrated if it can be shown that a company’s cost of capital is increased as a result of the existence of the imputation system.

More specifically, this is seen as a need to prove that the marginal price-setter of stock prices for a company is not a non-resident. This proposition is a result of the view of Treasury that as a non-resident price setter’s investment decisions are unaffected by biases created by the imputation system, then changes to the treatment of foreign source income within the Australian tax system cannot affect the cost of capital. IFSA will deal with this proposition at two levels.

Firstly, it is not considered that the cost of capital is, in isolation, the only aspect of the investment decision where tax system attributes such as imputation have an effect on a company’s decision to invest offshore. In making an investment decision, a company will look beyond the pure investment decision itself (hurdle rates, risk premiums, synergy benefits etc. as well as non-financial aspects such as comparable legal systems) and will also look at the impact the investment decision will have on shareholder value.

It is quite clear from Chapter 2 of the Consultative Paper (refer Table 2.1) that a higher pre-tax hurdle rate is required for investments in comparable or higher taxed countries for an individual or superannuation fund to achieve the same after tax return as a benchmark domestic investment. This fact is not ignored by the firm in making an investment decision. Even if the marginal price setter for a stock is a non-resident, or the cost of capital is found to be lower offshore, the company will necessarily consider the impact of the investment decision on its existing shareholders. Where existing shareholders’ after tax returns cannot be maintained (due to the higher tax cost for foreign investments), the company will consider that shareholder value will likely be destroyed and the investment decision is likely to be adverse. That is, the higher hurdle rates demonstrated in Table 2.1 do affect the investment decision , and accordingly create a bias towards domestic investment. This is particularly the case for a
company with a high dividend yield and a high franking percentage as there is greater potential for loss of existing shareholder value as a result of an offshore investment.

This effect of the imputation system on investment decisions can be demonstrated by analysing the investment model used by all member companies which includes shareholder value calculations in analysing whether an investment should be made. The shareholder value component of the calculation takes into account after tax returns to shareholders, which includes a value for imputation credits to shareholders.

Secondly, even if the issue was distilled as being a cost of capital/location of marginal stock price setter debate, IFSA considers that in the bulk of capital raising situations involving Australian companies, the marginal price-setter of stock prices in Australia is a domestic investor, who is most likely an institution, but often an individual. Numerous investment situations demonstrate the active involvement of domestic investors in capital raisings as the marginal investor, generally in preference to non-residents-

- Dividend reinvestment plans ("DRPs") are commonly used to tap existing shareholders for equity capital. This method is more likely to attract an investment by an existing resident shareholder rather than from some theoretical price-setting non-resident investor, particularly as DRPs are often not offered to non-resident shareholders.

- Rights issues can be used to fund a company’s larger investment needs. They access existing shareholders proportionately, which obviously includes substantial numbers of resident shareholders. Clearly rights are often in a tradeable form, which means the existing shareholder may not in fact end up as the new shareholder, however, there is nevertheless again likely to be a skew towards investment by existing shareholders (including domestic residents) rather than a price-setting non-resident.

- Domestic index investors will need to participate proportionally in capital raisings by domestic companies (or participate in the secondary market) in order to maintain their relevant index weightings. They are, therefore, likely to be the marginal investor.

- Government privatisations (Commonwealth Bank, Telstra etc) have lead to high levels of domestic shareholders with high levels of domestic share ownership in general throughout the economy. This active participation by large numbers of domestic residents in the capital markets indicates a strong likelihood that the marginal investor would be a resident.

- The inflow of Superannuation Guarantee system funds implies a regular flow of investment capital. The net inflow amount for managed monies for the year ended March 2002 was $15bn and for the year ended March 2001 was $20bn (refer Assirt Market Share reports). It is estimated that approximately 20% of these monies are directed into equities markets. The availability of this money means that domestic investors are extremely likely to be competing with non-resident investors when companies are raising capital from the market.
Whilst difficult to conclusively prove that a marginal investor is not a non-resident, IFSA is of the view that to succeed in this analysis it is only necessary to demonstrate that in many/most situations a resident investor will in fact be the marginal investor. Whilst the above situations ably demonstrate this the likelihood of this conclusion, anecdotal evidence also supports it.

For example, AMP Limited is an IFSA member with a large proportion of assets and earnings offshore. It is likely to be categorised as a large multinational company that can readily access (cheaper) offshore capital markets. Despite this ready assumption, AMP is better known and understood in Australia than offshore (possibly even being seen as an icon by residents) and currently sees Australia as its core source of capital. Indeed, its last 3 capital raisings have been made within the Australian capital market. These were by way of its dividend reinvestment plan (which has recently been underwritten in Australia) and 2 hybrid capital instruments. It is accepted that the hybrids issued were not affected by franking considerations in this case (hybrids are issued primarily to meet regulatory capital requirements), however, AMP considers that they indicate a preference to meet capital needs in most cases from domestic markets. Clearly non-residents can participate in such capital raisings, however, the percentage of domestic participants will always be higher in a domestic capital raising than for a foreign raising. Despite the fact that AMP can access foreign capital markets, it currently considers the marginal price setter of its stock to be a resident.

Also, reset preference shares are a new capital instrument that pays a return analogous to a fixed interest return, but with the addition of franking credits. The calculation of the yield on such shares takes into account and is reduced by 100% of the value of any franking credits attached to the dividend. Clearly the pricing of the equity return on such shares indicates that they are targeted at domestic shareholders who are able to utilise franking credits. Non-residents would not be expected to invest in such instruments. Accordingly, the marginal investor can be expected to be a resident.

ANALYSIS OF REFORM OPTIONS

The various bodies lodging submissions in response to the consultation paper have analysed in depth the reform options provided in Chapter 2 of the Consultation paper. Some have even analysed additional options. IFSA will not restate this analysis.

There is a clear general consensus against Option C (providing a franking credit for foreign dividend withholding taxes), for the reasons stated in the Consultative Paper (that most offshore investment occurs in countries with low or no dividend withholding taxes, and due to integrity concerns) and IFSA supports this conclusion.

There is much debate in relation to the Option A proposal over the relative merits of an exemption system versus a credit system, and the level of the exemption/credit to be provided. Without restating this debate, in this regard IFSA supports the views proposed in the submission by the major listed outbound investing companies. In particular, IFSA supports an approach (such as is recommended in that submission), that would make a significant reduction in the bias against offshore investment by providing domestic shareholders relief for unfranked dividends paid out of foreign source income. The large corporates’ submission and, also IFSA, makes the following integrated recommendations-
1. The foreign dividend account system will be converted into a tax-paid system, which will equate it with the imputation system following the recent revisions to that system.

2. The receipt of a non-portfolio dividend by an Australian company from a foreign company will generate a credit to its foreign dividend account. The credit will be based on the foreign tax payable on the profits from which the dividend was paid, subject to a limit based on the maximum Australian tax payable on that income in a domestic context, being 3/7 of the dividend. For dividends from a BELC, or from a LELC where the dividend is from income sourced in the LELC, the credit will automatically be available at the maximum rate.

3. The Australian company will be able to frank a dividend from its franking account and/or foreign dividend account (at its option).

4. A non-resident shareholder receiving a dividend that is franked from either the franking account or the foreign dividend account will be exempt from withholding tax to that extent.

5. Resident shareholders receiving franking credits attached to their dividends will be taxed as at present on a gross up basis, with a credit to offset their tax liability, with refundability of the credit if the tax liability is less than the credit.

6. Resident shareholders receiving a dividend that is franked from the foreign dividend account will also gross up their income, and offset the credit against their tax liability based on their marginal tax rate, however, the offset will be limited to the actual Australian tax on the dividend income, and there will be no refundability of excess credits.

7. Dividend streaming (Option B) be permitted to enable foreign shareholders of Australian multinationals to receive dividends directly from foreign earnings, without the imposition of Australian franking and foreign dividend account penalties.

**This proposal will not completely remove the bias in the following scenarios:**

- The foreign dividend account tax rate will be limited to the Australian company tax rate. This will lead to lost value where foreign tax rates are greater than the Australian tax rate.

- The credits can only be offset against the dividend sourced from the foreign income, so shareholders on lower tax rates than the corporate rate will not receive full value.

- Excess foreign dividend account credits will not be refundable where the Australian shareholder’s tax rate is lower than the company tax rate.

These situations should reduce the cost of the proposal and are a balance between cost and the need to address the bias issue.

Whilst IFSA also accepts that streaming of dividends (Option B) primarily benefits companies with existing foreign shareholder bases, it nevertheless recommends that it needs to be considered as a way of encouraging other resident companies to attract foreign shareholders. It also likely improves returns to non-resident shareholders and will accordingly attract them.
IFSA, therefore, supports a hybrid solution involving both the proposal detailed above (providing a foreign dividend account credit) and the streaming of dividends.

**REVENUE CONSIDERATIONS OF REFORM OPTIONS**

The costing of reform options is difficult. IFSA has participated in discussions on this issue with other bodies such as ABA, BCA and BCTR. The economy wide analysis required would appear to be beyond IFSA’s capacity, and IFSA is supporting BCA in its attempts to accurately cost the options recommended in its submission.

Clearly, the greater the reduction in tax rate at the shareholder level, the greater cost to the revenue. In the absence of an ability to accurately cost the alternatives, IFSA would merely note that the smaller the change made to reduce the bias against offshore investment, the less likely it is that any behavioural change will result. Whilst appreciating revenue costs, in the context of a meaningful review, token changes to the taxation of foreign income are not supported by IFSA.

Against the cost of the reform options, consideration needs to be taken of synergy benefits and other offsets as a way of mitigating the revenue costs of providing one of the reform options discussed above. Such benefits/offsets include:

- Where foreign income is repatriated as a result of any change in tax system, this will both accelerate and increase tax at the shareholder level.

- Stock price rises can also be expected due to increased demand from residents and non-residents, which will increase CGT revenue once stocks are sold by residents.

- Residence migration of companies beyond the Australian tax system is also likely to end, with consequent favourable revenue implications.

- Eliminating the bias from the foreign investment decision making process will allow more foreign investments to be made on their merits. This is likely to increase investment returns, in turn, enhancing retirement savings and reducing the drain on government funds for pensions.

IFSA supports an analysis by an economics house such as Access Economics (or even Federal Treasury) that costs both the primary proposals above, and the listed offsets (as well as other offsets that may have been omitted).

IFSA also accepts that the imputation system should be retained for the reasons given in the Consultative Paper.
PART 5  TAX TREATIES

CURRENT LEGISLATION

Australia has a network of Double Tax Agreements (DTAs) with a number of other countries including our major trading partners. Through these DTAs Australia (and the corresponding treaty partner) agrees to limit its rights to tax in respect of certain taxpayers or activities. This is achieved by effectively apportioning rights to tax.

As a broad principle, Australia's DTAs generally follow the OECD model. However, there is a fundamental shift in focus whereby Australia prefers a "source" bias to taxing income. Under OECD model based treaties the country of residency has the dominant right to tax unless the transaction is closely associated with the economic activity of the source country.

THE PROBLEMS AND ISSUES

Appendix A of the Consultation Paper points out that since 1980-81, the stock of foreign capital invested in Australia has almost quadrupled from 32 per cent of gross domestic product (GDP) to 121 per cent in 2001-02. While Australia remains a net capital importer, the increase in total capital invested offshore has risen also - from 9 per cent of GDP in 1980-81 to 62 per cent in 2000-01. Direct investment in the United States has also moved in Australia’s favour. Given that the trend appears that Australia is moving from a capital importer to a capital exporter continuing a sourced base treaty model must be questioned. Importantly, the source of the investment into Australia is now 60% from portfolio investment. This has implications for both inbound and outbound investment.

In negotiating a source country right to tax certain kinds of income we also allow the other country that right, this much is reflected in most of our treaties. Having said that, when it comes to franked dividends we have as a feature of our system the giving up of source taxing rights yet allow foreign countries to tax such dividends. The source country tax basis discourages or impedes inbound investment and the effective granting to the other country of rights to tax affects the return to outbound investors.

Because the life of DTAs seems to be 20 or more years it is important to recognise that getting any changes that reflects changing economic or industry dynamics will always be "behind the 8-ball". Similarly, the DTA negotiators have not always consulted in a way that allows the collection of any such data on dynamics that could feed into the negotiating process.

POSSIBLE SOLUTIONS

Fundamentally it is necessary that the government rethink its approach to DTA negotiation. If the problems identified above are to be addressed there is a significant shift in approach required. Until that rethink is undertaken it would be inappropriate to negotiate any further DTAs as they are likely to be in place for some considerable time to come. This is of particular importance in the case of the UK DTA as we understand that a new DTA with the UK is likely to give rise to most favoured nation consequences through out the EU.
**Option for Consultation 3.5**

To consider whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations or whether alternative approaches are preferable.

The USA Protocol is a starting basis, especially given the reduction or elimination of dividend withholding tax. However, the DTA model needs to be modified to:

- Seek to reduce withholding taxes (i.e., dividend interest and royalty);
- remove source taxation from the "Other Income" article;
- eliminate the "Source of Income" Article and enact appropriate rules in the domestic law;
- confirm that s.3(11) and similar articles in DTAs do not apply to managed investment funds;
- provide for equal treatment between portfolio and non-portfolio investments;
- allow the "banking" interest concession to be extended to other institutional investors as well as group finance entities;
- insert the OECD non-discrimination clause as recommended by RBT.
- review approach to capital gains;
- remove the subject to tax provisions from Article 15;
- solve superannuation issues in tax treaties rather than social security agreements; and
- do not adopt US specific clauses such as the “Limitation on Benefits Article” (which dramatically increase the length of treaties and the “fiscally transparent entity” concept in a revised Article 7). These issues can be dealt with under Part IVA.

**Option for Consultation 3.7**

To consider which countries should be given priority for tax treaty negotiations, taking into account negotiations under way with the United Kingdom and Germany, the need to update pre-CGT treaties, and countries that Australia may be obliged to approach because of most favoured nation clauses in existing treaties.

In light of the statements above about formulating policy before pursuing new DTAs, we would recommend halting current negotiation until a new approach is settled. The adoption of OECD approach in respect of the UK would cause a MFN flow on which would be concluded quickly as there would be little argument about words.
**Option for Consultation 3.8**

To consider options to improve consultation processes on negotiating tax treaties

As stated above, wider consultation would be fruitful as Government would benefit from point submissions by groups that may have particular experience with, or knowledge of, the particular country concerned and its business environment. Involvement should be permitted after the first round negotiation (when issues are identified). This will ensure proper input. The current exposure after the second round means input is restricted to interpretation rather than policy. IFSA supports proposals for consultation put forward in the Consultation Paper.

**RELATIONSHIP TO OTHER OPTIONS**

The suggested reforms will have impact on CFC, taxation of capital gains, interest, royalties and interest and changes to domestic law in respect of anti-avoidance legislation and source rules.
PART 6 FOREIGN NON-PORTFOLIO DIVIDENDS

THE CURRENT LAW

Whilst the tax treatment of non-portfolio dividends received from listed countries is relatively straightforward, the issues associated with non-portfolio dividends received from unlisted country CFCs ("unlisted CFCs") are considerably complex. These dividends may be:

- taxable under s.44 of the 1936 Act
- be exempt under s.23AJ to the extent that they are paid from comparably taxed profits (exempting receipts)
- be exempt under s.23AI to the extent that they are paid from previously attributed profits

The treatment therefore clearly depends upon the source of profits out of which the dividend is paid. This results in a tremendous amount of compliance effort and record keeping in having to separately identify and calculate the different sources of profits which comprise a dividend. For unlisted CFCs there are potentially 3 sources of profits:

- previously attributed profits
- comparably taxed profits
- other profits eg low taxed or untaxed income which has escaped attribution because the CFC has passed the active income test

The determination of the relevant source of profits and consequently whether the dividend is exempt or taxable also has relevance to whether foreign tax credits can be claimed in respect of that dividend. Under the current law, foreign tax credits are only able to be claimed in respect of dividends which are taxable under s.44 or exempt under s.23AI. No foreign tax credits can be claimed in respect of dividends which are exempt under s.23AJ. The provisions in relation to foreign tax credit calculations for s.23AI dividends are practically incomprehensible (eg refer s.160AFCD) and often professional opinion can differ as to how the rules should be applied. The compliance is horrendous, often for little Australian tax payable.

The varying treatment of non-portfolio dividends in a CFC context is also problematic. Dividends paid out from unlisted CFCs to listed CFCs give rise to attribution, with foreign tax credit entitlement (s.458 and s.160AFCC). This occurs whether the underlying income results from an active business or is passive (although some relief is provided for previously attributed income). Importantly, in these instances the CFC rules are clearly taxing active income contrary to stated policy objectives (ie CFC rules not taxing active profits).

Another problem, is the treatment of “disguised dividends” from unlisted CFCs to listed CFCs (refer our previous discussion on issues associated with s.47A). As discussed previously in our submission, s.47A treats certain “payments” (called distribution payments) as dividends paid by the unlisted CFC. These deemed dividends are taxed to Australian attributable taxpayers under s.459.
Various transactions that may be deemed to be dividends include:

- waivers of debts
- grants of non-arms length loans
- transfer of property or services for inadequate consideration
- subscription for, and payment of calls in respect of shares etc (there are others)

Given the anti-avoidance nature of s.459, no foreign tax credits can be claimed. Section 47A is draconian in its operation and can lead to multiple layers of taxation.

**ISSUES ASSOCIATED WITH THE CURRENT LAW**

As is evident from the above, the current treatment of non-portfolio dividends received from unlisted CFCs is extremely complex. Furthermore, associated compliance is often difficult and expensive, particularly given the low levels of Australian tax that is actually payable in respect of these dividends.

**RECOMMENDATION/SOLUTION**

Given the above, we would support a full exemption from Australian tax on all non-portfolio dividends. The benefits of having such an exemption include:

- significant simplification of the Australian tax rules governing non-portfolio dividend flows (eg potential removal of s.47A value shift issues as well as the issues associated with foreign tax credit calculations)
- such an exemption could provide an incentive to repatriate cash from overseas operations to Australia.

We note that widening the exemption to all non-portfolio dividends in this manner will impact deductibility of various expenses. Our preference would be that this simplification measure be enacted.

**FLOW THROUGH OF NON-PORTFOLIO DIVIDEND EXEMPTION**

Under current law the exemption in s.23AJ does not apply to a distribution by a trust which is attributable to a non-portfolio dividend received by the trust. In other words the interposition of a trust disentitles a corporate trust beneficiary from the exemption notwithstanding that the corporate beneficiary indirectly holds a non-portfolio interest in the underlying company.

It is submitted that a non-portfolio dividend should retain its character as an exempt dividend (if the other requirements are satisfied) on distribution by an interposed trust.
PART 7  THE TAXATION OF BRANCHES

IFSA supports the move towards the taxation of branches on a separate entity basis.

Branches can be used by outward investors for the same reasons noted in the Consultative Paper in relation to foreign multinationals conducting business in Australia.

In particular, IFSA members may have life insurance or bank subsidiaries that utilise a branch structure offshore. Inter-branch transactions such as the supply of services and funding are best dealt with on the basis that the transactions are between separate legal entities. This is particularly necessary in relation to foreign exchange exposures which can generate real economic gains or losses, but nevertheless fall outside the tax net (refer Max Factor case).

IFSA supports a system of branch taxation that includes all economic gains and losses as falling within the tax net.
PART 8  EXPATRIATE AND IMPATRIATE EMPLOYEES

Option 5.1 for Consultation

To consider whether to proceed with the Review of Business Taxation recommendation that residents departing Australia provide security for deferred CGT liability.

The Current Law

Under the current taxation legislation, individual residents of Australia, including temporary residents who cease to be Australian residents for tax purposes, face a CGT liability on any unrealised gains arising on certain assets via a deemed disposal rule. Broadly, the CGT liability will arise in respect of assets that do not have a necessary connection with Australia, which are principally foreign assets. Individuals can currently elect to defer the CGT liability until physical disposal occurs, however the tax is calculated on the gain arising until the time of disposal which may include post departure gains (if the asset is not sold until many years later).

Clearly the current CGT treatment of departing residents adds to the cost of employing foreign workers in Australia. Retaining them for any period greater than five years is even more expensive. Expatriates staying more than five years in Australia face double taxation on any disposal of assets, inflated gains due to currency movements, and cash-flow difficulties from paying tax in Australia before assets are disposed of.

Exacerbating the above concerns, the Review of Business Taxation Recommendation 22.20 proposed that if departing residents defer the CGT liability as available above, until actual disposal of the assets takes place, then they should provide security against payment of the future liability.

Recommendation/Solution

IFSA are firmly of the view that adopting such an approach would only add to the current problems employers’ face in attracting and retaining foreign workers. Such a measure would only add to the existing unfavourable CGT treatment, involve further compliance and administrative costs for employers, foreign workers and the ATO, as well as prove inconsistent with current ATO thinking.

IFSA therefore strongly support the option of not proceeding with the recommendation previously put forward as part of the Review of Business Taxation, particularly given the potential compliance and enforcement burden that the ATO would face in administering such a system.

IFSA would go further and suggest that additional consideration should be given to reforming the existing provisions to ease the current burden on employers (refer to other options set out below).
Option 5.2 for consultation

To consider addressing the double taxation of employee share options through bilateral tax treaty negotiations and possible consequential changes to Australia’s domestic tax law treatment.

The Current Law

Under current legislation in both Australia and the country of employment, a foreign expatriate is likely to be subject to double taxation on any benefits arising from an employee share/share option plan. The most common scenario is where an employee is issued share options offshore that are conditional on a certain period of service with the employer, but part of it occurs in Australia.

Double taxation occurs since countries adopt different approaches in terms of the time at which benefits arising under such schemes are taxed. Some countries for example, tax the benefit at the time the option is granted, at the time it vests, at the time it is exercised or when the shares acquired under the option are sold. Clearly this lack of uniformity will most certainly give rise to some element of double taxation in even the most straightforward of situations where two jurisdictions are involved.

Recommendation/Solution

As a result of the wide range of approaches adopted worldwide, and the need for reciprocity to effectively remove double taxation, it is really necessary to address the double taxation of such benefits arising from such options on a country by country basis through bilateral tax treaty negotiations. However it is not a matter of waiting until the next time a treaty is to be re-negotiated and introducing the amendments at that time. IFSA would prefer to see the Australian taxation authorities, taking a very pro-active stance on this issue. IFSA would like to see this issue raised with all existing countries with which we have a double tax treaty so that amendments can be made as the earliest possible opportunity. IFSA feel the need to make this issue a priority, given the significance of the issue and the costs that Australian employers are currently having to bear as a result of very real double taxation.

Furthermore, the issue also needs to be considered in relation to jurisdictions with whom we have no double tax treaty ie Hong Kong, but which may be a key source of foreign workers for Australian based employers. Whilst the rate of tax may be considered concessional in certain of these jurisdictions there is still double taxation.

In terms of the amendments that need to be introduced into existing tax treaties, one approach put forward in Chapter 5 that could be used is the adoption of the OECD’s preferred methodology. As stated in Chapter 5, this approach allocates full residence taxation to the treaty partner in which the share options are exercised. The other treaty partner’s taxing rights are limited to that proportion of the income or gain on the option which relates to the period between the grant and the exercise of the option during which the individual has worked in the partner country.

IFSA support the introduction of such taxing rights, and we agree that this approach will deal with residence-source issues where share options are subject to tax in more than one country. As noted however it does not cater for all situations such as those where more than two
countries may be involved. In this regard, IFSA would support the necessary changes required to the double tax treaties being expanded to ensure that as many scenarios as possible could be covered. Certainly the OECD preferred solution which would provide for each competent authority to agree to provide relief on the residence-based tax that the other country levied on that part of the benefit relating to employment exercised while the employee was a resident of the partner country, should be seriously considered. Where possible these amendments should be included in the suite of amendments to be made to the double tax treaties.

In addition, IFSA firmly support the view that Australian domestic legislation should be reviewed and amended to ensure that as far as is possible, the tax treatment of share option schemes can be made more flexible. This would facilitate foreign employees and indeed more importantly, Australian residents (who become temporarily non-resident) to manage the consequence of tax arising as a result of moving jurisdictions.

**Option 5.3 for consultation**

To consider whether to proceed with the Review of Business Taxation recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A.

**The Current Law**

As currently provided for under Division 13A, tax on a discount given to an employee for ‘qualifying’ shares or rights acquired under an employee share scheme may be deferred for up to ten years unless a ‘cessation time’ event occurs. The Review of Business Taxation Recommendation 22.19(a) proposed the introduction of a rule that would treat a resident’s departure from Australia as a cessation event.

Clearly given the comments made above with regard to the many double taxation scenarios, which arise already, creating another taxation event in Australia would only add to the issue that currently needs to be addressed. The holder of such an interest would most certainly face similar cash flow and currency valuation issues that taxpayers face with the deemed disposal CGT rules (outlined above). This is particularly an issue if the employee has not left the current employer (which is generally the key cessation test).

Further the introduction of such a rule would be contrary to the Government’s current policy direction in relation to taxing foreign expatriates and departing residents.

**Recommendation/Solution**

Based on the above analysis, IFSA firmly support the option of not introducing Recommendation 22.19(a) from the Review of Business Taxation for the reasons set out above and under Option 5.1.

**Option 5.4 for consultation**

To consider the Australian Taxation Office establishing a specialist cell to work with employers to deal with the tax administration concerns of foreign expatriate employees.
The Current Law

There is currently no official ‘centre of excellence’ within the ATO which has sole responsibility for the taxation issues associated with the employment of foreign expatriates working in Australia or indeed the taxation issues associated with Australian residents working overseas, either temporarily or on a longer term basis.

It is however a reasonable assumption that foreign expatriates working in Australia generally have tax affairs involving a wide range of domestic and international tax issues. Likewise, Australians seconded overseas face similar issues in having to deal with at least two comprehensive tax regimes. As stated in Chapter 5, the requirement to be familiar with a second and very complex tax system, will increase compliance costs, many of which will fall on the employer. Whilst not conclusive in itself, these requirements are further disincentives when considering whether to work in Australia or indeed work overseas.

Recommendation/Solution

As a consequence, IFSA firmly support the establishment of a specialist cell within the ATO which would go a long way to alleviating the concerns set out above. The cell should provide a single contact point for foreign expatriates (and their advisers) to obtain advice and assistance on how the Australian tax law operates in relation to their own particular tax circumstances.

This cell could also maintain close links with employers to address the tax concerns of their foreign expatriate employees so that further developments can be made in this area.

Other Options for consultation:

Other options either previously introduced or discussed in various degrees throughout Chapter 5 include the following:

Four year foreign source investment income exemption for first time temporary residents;

IFSA note that the Government has already made announcements that first time temporary residents will receive a tax exemption for income derived from foreign assets and from interest withholding tax on interest payments for their foreign liabilities.

IFSA support this announcement and note that it should reduce the tax cost for employers bringing skilled employees to Australia. As noted in Chapter 5, as a result of Australia’s relatively high personal tax rates, the foreign source income of temporary residents would otherwise be subject to a higher tax rate than if the temporary residents stayed in their home country.

Similarly having to withhold tax on interest payments relating to foreign liabilities will push up the borrowing costs for temporary residents. Again, IFSA strongly support the exemption announced in relation to interest withholding tax on interest payments for foreign liabilities.

IFSA note that the introduction of the announcement will basically create a new class of taxpayer, the ‘temporary resident’. As discussed in Chapter 5, eligible temporary residents will include individuals from a range of occupations who are granted business visas. IFSA are keen to ensure that careful consideration is given to the range of visas that can be included in this
new class of taxpayer, to ensure that maximum efficiencies are obtained for expatriates and their Australian employers.

As an aside, IFSA are firmly of the view that the personal tax rates applicable in Australia as well as the bands to which they apply should be reviewed as part of the objective of improving Australia’s tax treatment of foreign expatriates. IFSA note that such review would of course, have far reaching consequences. However it should be noted that these factors are in themselves a disincentive for foreign workers to working in Australia.

Amendments to the exemption from the Foreign Investment Fund (FIF) rule for exempt visitors

IFSA support the recent announcement noted in Chapter 5 in relation to the Government’s intention to extend the exemption from the FIF rules for temporary residents. As a result, taxpayers holding a temporary resident visa should be exempted from the FIF rules regardless of the period of the visa.

The previous exemption taxed temporary residents who were in Australia for more than four years on the increase in their accumulated retirement benefits in non-employer sponsored superannuation funds in their home country. Clearly this outcome would result in such taxpayers’ being taxed on an increase in benefits that they would not be entitled to until retirement. Furthermore it is unlikely that the home jurisdiction would provide a credit for Australian tax paid on the accrued increase, hence double taxation would arise.

Again IFSA are keen to ensure that the announcement once implemented, will have maximum impact. As previously stated, IFSA would like to see the Government expand the definition of ‘temporary resident’ as broadly as possible to ensure that the announcement has sufficient impact.

Renegotiation of tax treaties for departing residents

As previously stated, individuals resident in Australia, including temporary residents, who cease to be Australian residents face a CGT liability on the unrealised gains of certain assets via a deemed disposal rule. This treatment is exacerbated if the departing taxpayer was in Australia for more than five years.

In light of the above concerns, IFSA support recent Government announcements that it will move to address these concerns by renegotiating tax treaties. IFSA agree that this is the best approach on the grounds that it addresses the potential double taxation issue and can be tailored to the interaction of the two tax regimes in question.

Similar to the amendments proposed to be made to tax treaties to cater for employee share option plans, IFSA would like the Australian Government to be proactive in raising the amendments required to effect the desired outcomes as soon as possible. If we wait until the next round of treaty negotiations, this could result in various treaties not being changed for many years and hence any benefit would be a long way off.

Relaxation of the Superannuation Preservation Rules for eligible temporary residents permanently departing Australia and other Superannuation related Issues

As set out in Chapter 5, domestic legislation currently requires all employers to make superannuation contributions to a complying superannuation fund on behalf of eligible
employees. This will include foreign expatriates working temporarily in Australia, who may wish to or be required to, continue with their own retirement plan in their home country. Obviously this results in double contributions being required to be made which in turn increases the cost to Australian employers (who will be the party required to meet both contributions) of hiring those foreign skilled workers who wish or are required to remain in their home country retirement plans.

IFSA fully support the current exemptions which apply to foreign workers namely the exemption from the super guarantee charges for senior executives and the exemption provided under Superannuation Double Coverage (SDC) Agreements where they have been entered into.

IFSA are of the opinion however that the exemption from the super guarantee charge is too narrow and is difficult to interpret. As a result, employers tend to be conservative in their application of the exemption and pay SGC in respect of employees even though they are employed in similar roles to those for which an exemption is available. Time and resources is nevertheless spent and hence wasted in determining the extent of the current exemption.

IFSA would therefore like to see the exemption available in relation to SGC more clearly defined so that employers can easily apply the exemption and obtain the benefit of it in a more straightforward manner. Indeed the exemption should be expanded to cover ‘all employees’ required to or who make the choice to, remain in their overseas funds (regardless of whether it would qualify as a complying fund under Australian legislation).

Similarly IFSA agree that the introduction of SDC agreements go along way towards defining for the parties to the agreement the correct pension or superannuation scheme that needs to be contributed to. The number of SDC however in existence, is still relatively small and does not include some of the countries where most of Australia’s foreign workers originate. IFSA would be keen to see these SDC agreements being developed with our major trading partners as soon as possible (which do not appear to be covered on the list of countries involved in current negotiations).

Finally, IFSA are in agreement with recent exemptions announced to the superannuation preservation rules. Basically, individuals holding eligible temporary residence visas and who have or will permanently depart Australia will be able to access their superannuation benefits before reaching preservation age. A withholding tax arrangement will also apply however to recoup the superannuation tax concessions that were provided on the benefits because they were to be used for retirement income purposes.

IFSA again support the introduction of this exemption however IFSA would like to see the expansion of this exemption to include other situations, which should be able to avail of the exemption. For example, a temporary resident visa holder may become a permanent resident for a period of time before moving permanently overseas. There is no reason why these similar scenarios should not be able to take advantage of the exemption.

Foreign Work Days

The concept of ‘foreign work days’ is discussed in Chapter 5 as it applies in foreign jurisdictions such as the UK and Singapore. In broad terms, the concept is described as providing an ongoing tax exemption for income; certain temporary residents earn from employment outside their ‘home’ country (their country of normal residence). If the country of
temporary residence does not tax the income ie, where the employment occurs, then the temporary resident will receive this income tax free.

Under current Australian income tax legislation (section 23AG), the rule will exempt from tax an Australian resident’s foreign earnings arising from at least 91 days of continuous employment in a foreign country. The need however for the days to be continuous unfortunately limits the applicability of the exemption. Furthermore the exemption is not available (even if days are exceeded) if the income is exempt from tax in the foreign country.

IFSA request the Government to seriously consider the usefulness of the current domestic tax legislation and the extent of its operations to Australians temporarily employed overseas. IFSA suggest that further amendments should be made to the provisions to make their operation comparable with similar regimes in overseas jurisdictions. Many employers bringing skilled workers to Australia are global employers and look at expatriate tax issues as a global issue, which covers both foreign expatriates coming to Australia and the issues, associated with Australians being sent overseas.
In Options 4.9 and 4.10 the Consultation Paper presents for consideration the Review of Business Taxation’s recommendations in respect of foreign trusts.

These recommendations cover the Deemed Present Entitlement rules, the Foreign Investment Fund rules and the Transferor Trust rules. They discuss the application of these rules generally and with specific reference to Controlled Foreign Trusts for the purposes of the Controlled Foreign Company rules and to hybrid trusts.

Our industry is not involved with Transferor Trusts, Controlled Foreign Trusts, hybrid trusts or trusts where people benefit even though they do not hold something that amounts to an ‘interest’ for the purposes of the Foreign Investment Fund rules. We are therefore not in a position to offer any opinions on the details of the recommendations that relate to these structures. Our comments below only address the application of the Deemed Present Entitlement rules and the Foreign Investment Fund rules to widely held fixed trusts.

The Deemed Present Entitlement rules are anomalous and ineffective. They overlap with the Foreign Investment Fund rules but lack any of the provisions in those rules that attempt to balance the integrity measures against the compliance costs. For example, there is no balanced portfolio exemption and no de minimis rule.

We strongly recommend that the Foreign Investment Fund rules, rewritten as recommended in Part 3, be the sole regime for taxing interests in widely held foreign fixed trusts.

It is important for the efficient operation of our industry that integrity measures are properly targeted. An integrity measure should only apply to our activities if our actions are those that the measure is aimed at preventing. Properly targeted Foreign Investment Fund rules are the appropriate integrity measure for investments in foreign trusts.

If a line is to be drawn between ‘fixed trusts’ and ‘non-fixed trusts’, we repeat our recommendation that the current definitions in the legislation have to be revised because they do not accurately make the distinction they are aiming for. In this regard we refer to the suggested tests in Appendix 1.
PART 10  CAPITAL GAINS ON NON-RESIDENT INTERPOSED ENTITIES

While we understand the policy behind the Review of Business Taxation’s proposal to apply capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets (that would have been taxed had the non-resident held the asset directly), we consider it impractical.

This is option 3.6 in the Consultation Paper.
PART 11 FOREIGN INCOME ACCOUNTS

CURRENT LEGISLATION

Currently the foreign dividend account allows a withholding tax exemption for unfranked dividends paid out of non-portfolio dividends received from listed countries (and from unlisted countries to the extent that foreign tax credits are available).

THE PROBLEMS AND ISSUES

The requirements for the operation of the accounts make it of limited use. In particular:

- the limitation of credits to the account to non-portfolio dividends
- the payment of the credit is subject to pro-ration across all shareholders, and
- the non recognition of non-dividend forms of foreign income which gives rise to the issues and problems discussed in relation to Option 2.1.

It is noted that the Review of Business Taxation made a number of recommendations in relation to expanding the operation of the foreign dividend account (Recommendations 21.1 to 21.5 inclusive) but especially to provide a withholding tax exemption for all conduit income an Australian company distributes (Recommendation 21.1).

POSSIBLE SOLUTIONS

Option for Consultation 3.11

To consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1

The Consultation Paper concludes that

An in-principle case exists to establish foreign income accounts to provide conduit taxation relief. However, a final decision on the foreign income account, and its design, can only be made as part of final consideration of the imputation options in Chapter 2.

Whether the foreign income account also should be extended to allow effective flow-through of foreign income account amounts along a chain of Australian companies (Figure 3.4) is also interlinked with the Chapter 2 options (page 50).
However, IFSA has concerns with the Foreign Income Accounts if they are structured like the current FDAs which in practice do not work. The wastage of those credits in relation to domestic shareholders is particularly problematic. IFSA would therefore strongly recommend the ability of company's to stream the Foreign Income Account amounts to foreign shareholders. As an adjunct or alternative to this, the impact of the FIA credit could be extended to domestic shareholders. It is noted that similar treatment would need to be afforded to investors in managed funds products to the extent that foreign tax credits do not currently flow through to those investors.

**RELATIONSHIP TO OTHER OPTIONS**

The solution in the paper should be implemented independently of any solution in respect of the Chapter 2 issues (although there may be a need to modify the Foreign Income Account to accommodate the outcome of the Consultative Paper's Chapter 2 Options.)
PART 12 FOREIGN EXCHANGE GAINS AND LOSSES

An important aspect of Australia’s taxation system is the treatment of foreign exchange gains and losses. Following the High Court decision in ERA in 1996 there has been substantial uncertainty as to the taxation treatment of many foreign exchange gains and losses.

The Assistant Treasurer announced in May 2002 that consultation (including release of exposure draft legislation) would be undertaken in relation to this issue with a view to introducing legislation in the Spring Sittings of Parliament (by the end of 2002).

Earlier this year IFSA was involved in consultation with Treasury and the Australian Taxation Office on this issue. Notwithstanding this consultation there have been no further Government announcements on this issue. In our view it is totally unsatisfactory that such an important issue could be left in a state on uncertainty for so long. We strongly urge the Board of Taxation to raise this issue with Treasury and the Government, and request the release of exposure draft legislation for further consultation.
PART 13    DIVISION 16E SECURITIES

Over recent years, custodians have been under increasing pressure from their clients to assist them in identifying securities that are subject to Division 16E of the Income Tax Assessment Act 1936.

Division 16E was introduced to alter the basis or taxing income accruing on discounted and other deferred securities from a realisation basis to an accrual basis. A security to which Division 16E applies is called a ‘qualifying security’.

One of the conditions for a security to be subject to an accrual basis is that it has an ‘eligible return’. Fund managers and custodians find determining eligible returns to be complex and time consuming. This is particularly difficult in respect of securities issued outside Australia because the issuer is not familiar with Australian tax law.

To reduce the compliance costs in this area we recommend a united approach through IFSA and the Australian Taxation Office (‘ATO’) to address the practical application of this legislation, especially in relation to international securities. We recommend that the ATO work with IFSA to create a database of securities that have been identified as being ‘qualifying securities’.
We consider that simplicity and certainty can be achieved if the definition of fixed trust in s95-1(1) read as follows:

"Fixed Trust": a trust is a fixed trust if:

(a) entities have fixed entitlements to all of the income and capital of the trust, or

(b) it is a registered managed investment scheme or an investor directed portfolio service – like product in accordance with ASIC Policy Statement 148 as amended, or

(c) it is a unit trust and at least 25% of the units in the trust are held by one or more trusts that are a registered managed investment scheme or investor directed portfolio service like product in accordance with ASIC Policy Statement 148 as amended; or

(d) it is a trust and at least 75% of the units in the trust are held by two or more non-associated unitholders; or

(e) the trustee has no discretion to distribute income or capital to one unitholder to the exclusion of any other unitholder, except in calculating the amount payable on redemption of a beneficiary’s interest where that amount is calculated as an *arms length price, and the issue or redemption of beneficiary’s interests in the trust is at an *arms length price, or

(f) The Commissioner prescribes within the Income Tax regulations that the trust is a fixed trust.

Arms Length Price: an amount is an arms length price if it is a price that would be calculated between parties who were dealing at arms length.

By adopting an “arms length price” rule for distributions on redemption, and the issue and redemption of units, existing commercial practices that do not derogate from the policy of fixed trusts, can continue to operate. The requirement of offer price for listed trusts or net asset value for unlisted trusts is then not necessary. This addresses the concerns for distribution reinvestment plans and the like which offer new units at a discount. It also addresses the distribution to a redeeming unitholder, where the trustee is afforded the discretion to distribute the outgoing member’s share of income or capital to maintain investor equity.
APPENDIX 2

ECONOMIC ANALYSIS OF EXTENDING THE CGT EXEMPTION ON FOREIGN PORTFOLIO INVESTMENT IN AUSTRALIA

This report was prepared by Econtech Pty Ltd for the Investment and Financial Services Association Ltd (IFSA)

20 March 2002

This report has been produced for IFSA according to strict instructions. Econtech makes no representations to, and accepts no liability for, reliance on this work by any person or organisation other than IFSA. Any person, other than IFSA, who uses this work does so at their own risk and agrees to indemnify Econtech for any loss or damage arising from such use.

CANBERRA OFFICE SYDNEY OFFICE

Econtech Econtech
P.O. Box 4129 Phone: (02) 9518-4283
Kingston ACT 2604 Fax: (02) 9518-4638
Phone: (02) 6295-0527 E-mail: sydney@econtech.com.au
Fax: (02) 6295-8513
E-mail: canberra@econtech.com.au
Web-site: www.econtech.com.au
Contents

EXECUTIVE SUMMARY  \textbf{ERROR! BOOKMARK not defined.}

1. INTRODUCTION  \textbf{ERROR! BOOKMARK not defined.}

2. MODELLING EXTENDING THE CGT EXEMPTION ON FOREIGN PORTFOLIO INVESTMENT  \textbf{ERROR! BOOKMARK not defined.}
   2.1 Economic Model  \textbf{Error! Bookmark not defined.}
   2.2 Model Inputs  \textbf{Error! Bookmark not defined.}

3. MODELLING RESULTS  \textbf{ERROR! BOOKMARK not defined.}
   3.1 Main Results  \textbf{Error! Bookmark not defined.}
   3.2 Sensitivity Analysis  \textbf{Error! Bookmark not defined.}

ATTACHMENT A: TAXATION OF FOREIGN EQUITY INVESTMENT IN AUSTRALIA  \textbf{ERROR! BOOKMARK not defined.}

ATTACHMENT B: THE FOREIGN INVESTMENT MODEL (FIM)  \textbf{ERROR! BOOKMARK not defined.}
Executive Summary

Key Findings

Currently foreign investment in the Australian sharemarket is exempt from Australian CGT if the foreign entity invests directly, but is subject to CGT of 29 per cent if the foreign entity instead invests via an Australian managed fund. It is estimated from economic modelling that removing this anomaly by extending the CGT exemption to foreign investment via an Australian managed fund would:

- reduce the cost of capital for portfolio investment in Australia;
- boost annual GDP by $64 million;
- raise living standards by about $10 million annually;
- cost annual budget revenue of $6 million, with a direct cost of $15 million partly offset by indirect savings of $9 million; and
- eliminate an inefficient tax with a high excess burden of about 65 cents in the dollar compared with efficient taxes such as GST and income tax on wages and salaries that have low excess burdens of 10 to 20 cents in the dollar.

Equity investment in Australia can be split into four types, namely portfolio, direct, venture, and other private. This report is concerned with the taxation treatment of foreign portfolio investment in Australia.

Foreign portfolio investment in the Australian sharemarket is exempt from Australian CGT, provided the foreign investor holds less than 10 per cent of the shares in the Australian company. However, in an apparent anomaly, if the foreign investor instead invests in the same shares via an Australian managed fund, the CGT exemption is lost. Instead, the managed fund is required to apply CGT of 29 per cent as a withholding tax.

This report, commissioned by the Investment and Financial Services Association (IFSA), analyses the economic effects of extending the CGT exemption on foreign portfolio investment in Australia to cases where such investments are via Australian managed funds.

The existing withholding tax of 29 per cent represents a burden on foreign investors if they are not able to claim tax credits in their home countries to offset this Australian tax. IFSA advise that these foreign investors fall into the following categories:

- tax exempt pension and charitable funds such as foundations; and
- high net worth individuals who either are in tax exempt regimes or are not prepared to become involved in a messy credits retrieval system.

On that basis, Econtech has adopted the modelling assumption that tax credits to offset the withholding tax are not available in the foreign investors home country. This is an important assumption that is discussed further below. It means that, to offset the withholding tax, foreign investors will require a higher pre-tax rate of return on their Australian portfolio investments than on their portfolio investments in other countries that do not apply such a tax. This increases the cost of capital to Australia.

The existing CGT provisions also act as a powerful disincentive for foreign investment in Australian managed funds. While the ABS estimates that investment managers obtain $23 billion from foreign sources, IFSA estimates that foreign investment subject to this CGT

---

2 “Managed Funds”, ABS Cat No. 5655.0, December quarter 2001.
currently amounts to only $2 billion. IFSA believes that the balance of the reported ABS funds is brought into Australia via 'mandates'. Under these mandates the underlying securities are in the names of the offshore owner, as opposed to being held in trust by the funds manager in Australia. These mandates operate under a tax preferential arrangement (not subject to CGT), but are only available to big investors. Therefore the budget revenue estimates in this report are based on the IFSA estimate that foreign investment in Australian managed funds that is subject to CGT amounts to $2 billion.

To obtain a CGT exemption, some foreign entities bypass Australian managed funds and invest directly in the Australian sharemarket. Other foreign entities invest in the Australian sharemarket via fund managers in third countries. Still other foreign entities bypass the Australian sharemarket completely.

The current anomalous situation could be overcome by extending the CGT exemption for foreign portfolio investment in Australia to cases where such investment is via an Australian managed fund. IFSA estimates that this would raise foreign investment in Australian managed funds that are now subject to CGT withholding tax from $2 billion to at least $12 billion. This would mainly reflect changes in the way that foreign investment is channeled to the Australian sharemarket, with Australian management funds playing a more major role. However, it would also reflect some increase in the overall level of foreign investment in the Australian sharemarket, due to the more favourable CGT regime.

The general economic effects of extending the CGT exemption have been analysed using Econtech’s Foreign Investment Model (FIM). The FIM3 is a long-run economy-wide model and so, importantly, it models outcomes that are sustainable.

This model was built in 2001 to specifically analyse the effects of taxation of foreign investment in Australia. The model was originally used to analyse a CGT exemption for foreign venture capital investment, and this report extends the analysis of CGT exemptions to foreign portfolio investment via managed funds. In both cases, the existing CGT exemption for foreign portfolio investment (other than via managed funds) serves as an important precedent.

The economic modelling estimates the long-run effects of extending the existing CGT exemption for foreign portfolio investment to cases where that investment occurs via an Australian managed fund. As noted above, the modelling assumes that tax credits to offset the existing CGT are not available in the foreign investors home country. To the extent that such credits are available in reality, the existing CGT is not a burden on foreign investors and the modelling will overstate the benefits of removing that CGT.

The CGT exemption will lower the pre-tax rate of return that foreign investors require on their Australian portfolio investments made via Australian managed funds, because those returns will no longer be subject to tax on capital gains. This will lower the overall cost of capital to Australia resulting in a modest expansion in the capital stock, as shown in Table A.

This increase in capital will raise annual GDP by an estimated $64 million. This gain in GDP can be divided into gains in consumption, investment and net exports. Consumption, which is a measure of living standards, rises by $10 million. Investment increases by $35 million, consistent with the gain in the capital stock. Net exports rise by $19 million, sufficient to service the increased foreign equity present in Australia.

3 FIM was previously known as the Venture Capital Model or VCM.
Table A
Estimates of Long-run Economic Effects

<table>
<thead>
<tr>
<th></th>
<th>change $m</th>
<th>change %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>250</td>
<td>0.03</td>
</tr>
<tr>
<td>GDP</td>
<td>64</td>
<td>0.01</td>
</tr>
<tr>
<td>- consumption</td>
<td>10</td>
<td>0.002</td>
</tr>
<tr>
<td>- investment</td>
<td>35</td>
<td>0.03</td>
</tr>
<tr>
<td>- net exports</td>
<td>19</td>
<td>0.07</td>
</tr>
<tr>
<td>Income Tax Revenue</td>
<td>-6</td>
<td>-0.004</td>
</tr>
<tr>
<td>- Foreign Portfolio Investment</td>
<td>-15</td>
<td>-0.27</td>
</tr>
<tr>
<td>- Other Foreign Investment</td>
<td>2</td>
<td>0.03</td>
</tr>
<tr>
<td>- Local Investment</td>
<td>-6</td>
<td>-0.03</td>
</tr>
<tr>
<td>- Labour Income Tax</td>
<td>13</td>
<td>0.01</td>
</tr>
<tr>
<td>Excess Burden of Foreign Investment Tax (a)</td>
<td>65</td>
<td></td>
</tr>
</tbody>
</table>

(a) Excess burden for each dollar of revenue raised. Calculated as consumption effect relative to direct tax revenue effect (10/15 = 65%).

The revenue currently being collected from the CGT on foreign portfolio investment via Australian managed funds will be foregone under the IFSA proposal. As shown in the table above, the long-run direct loss in annual revenue is estimated at $15 million, similar to the IFSA estimate of $14 million. The FIM model makes the standard long-run assumption of fixed national employment – where the extra jobs in funds management are offset by fewer jobs in other industries. Thus, any additional tax revenue generated from increased activity in the funds management industry is expected to be offset by reductions in tax revenue from other industries.

Taking indirect effects into account lowers the net cost to the budget to $6 million. Higher capital intensity raises the marginal product of labour and real wages, lifting personal income tax collections from wages and salaries. This partly offsets the direct cost to the budget of $15 million, leaving a net cost of $6 million. Further details are in Table A.

In the FIM model, this revenue loss is assumed to be made up by a tax increase elsewhere that does not distort economic decision making. Thus the total tax take is unchanged. Despite this, as mentioned above, annual GDP increases by $64 million, with consumers receiving an annual gain of $10 million.

This highlights the inefficient nature of raising revenue by applying CGT to foreign portfolio investment in Australia via Australian managed funds. The model results imply a high excess burden from this tax of 65 cents in the dollar of revenue raised (calculated as the consumption effect of $10 million relative to the direct revenue from the CGT of $15 million). This high excess burden is not surprising as it is consistent with other studies that show that taxing international capital flows is highly distortionary. This is because capital is highly mobile internationally so taxes can easily lead to big distortions in flows between countries.

Put simply, the existing CGT on foreign portfolio investment in Australia via Australian managed funds is a poor method of raising revenue. Its excess burden on consumers of about 65 cents in the dollar compares unfavourably with other taxes. For example, broad-based taxes such as the GST or income tax applied to wages and salaries are much more efficient having an excess burden of only 10 to 20 cents in the dollar.
Introduction

Equity investment in Australia can be split into four types, namely portfolio, direct, venture, and other private. This report is concerned with the taxation treatment of foreign portfolio investment in Australia.

Foreign portfolio investment in the Australian sharemarket is exempt from Australian CGT, provided the foreign investor holds less than 10 per cent of the shares in the Australian company. However, in an apparent anomaly, if the foreign investor instead invests in the same shares via an Australian managed fund, the CGT exemption is lost. Instead, the managed fund is required to apply CGT of 29 per cent as a withholding tax.

To obtain a CGT exemption, some foreign entities bypass Australian managed funds and invest directly in the Australian sharemarket. Other foreign entities invest in the Australian sharemarket via fund managers in third countries. Still other foreign entities bypass the Australian sharemarket completely.

The current anomalous situation could be overcome by extending the CGT exemption for foreign portfolio investment in Australia to cases where such investment is via an Australian managed fund. IFSA estimates that this would raise foreign investment in Australian managed funds that are now subject to CGT withholding tax from $2 billion to at least $12 billion. This would mainly reflect changes in the way that foreign investment is channelled to the Australian sharemarket, with Australian management funds playing a more major role. However, it would also reflect some increase in the overall level of foreign investment in the Australian sharemarket, due to the more favourable CGT regime.

This report, commissioned by the Investment and Financial Services Association (IFSA), analyses the economic effects of extending the CGT exemption on foreign portfolio investment in Australia to cases where such investment is via Australian managed funds. This analysis uses Econtech’s Foreign Investment Model (FIM). The FIM is a long-run economy-wide model and so, importantly, it models outcomes that are sustainable.

FIM was originally developed in 2001 to analyse a CGT exemption for foreign venture capital investment, and this report extends the analysis to cover foreign portfolio investment via Australian managed funds. In both cases, the existing CGT exemption for foreign portfolio investment (other than via managed funds) is an important precedent.

This report is structured as follows.

- Section 2 discusses the modelling approach. It details the model used and the significant inputs into the modelling.
- Section 3 presents the results from the modelling. It covers the effects on budget revenue, GDP, living standards and other economic outcomes of extending the CGT exemption on foreign portfolio investment to cases where this investment is via managed funds.
- Attachment A gives background information on the taxation of foreign equity investment in Australia. Attachment B provides detailed information on the FIM.

---

4 FIM was previously known as the Venture Capital Model or VCM.
While all care, skill and consideration has been used in the preparation of this report, the findings are based upon the strict instructions of IFSA and are designed to be used only for the specific purpose set out below. If you believe that your instructions are different from those set out below, or you wish to use this work or information contained within it for another purpose, please contact us.

The specific purpose of this report is to provide IFSA with an economic analysis of extending the CGT exemption on foreign portfolio investment in Australia to cases where such investment is via Australian managed funds.

The findings in this report are subject to unavoidable statistical variation. While all care has been taken to ensure that the statistical variation is kept to a minimum, care should be used whenever using this information. Should you require clarification of any material, please contact us.
Modelling Extending the CGT Exemption on Foreign Portfolio Investment

Analysing the economic effects of extending the CGT exemption on foreign portfolio investment in Australia to cases where such investment is via Australian managed funds requires an appropriate economic model. Econtech’s Foreign Investment Model (FIM) is well suited for this purpose.

FIM distinguishes different types of foreign equity investment in Australia, including portfolio, direct, venture capital and other private, and their respective tax treatments. Also, as a long-run model, FIM models outcomes that are sustainable. Finally, because it is an economy-wide model, it covers the effects on the main variables of interest to policy makers including GDP, living standards and government budget revenue.

FIM was originally developed in 2001 to analyse a CGT exemption for foreign venture capital investment, and this report extends the analysis to cover foreign portfolio investment via Australian managed funds. In both cases, the existing CGT exemption for foreign portfolio investment (other than via managed funds) is an important precedent.

The section provides an overview of the structure of FIM and its inputs. The modelling results are then presented in section three.

2.1 Economic Model

The general effects of the IFSA proposal have been analysed using Econtech’s Foreign Investment Model (FIM). This model was built in 2001 to specifically analyse the taxation of foreign investment in Australia. The FIM is a long-run economy-wide model and so, importantly, it models outcomes that are sustainable.

In all respects, the FIM makes the standard, widely-used long-run assumptions in this type of economic modelling. These standard long-run assumptions are:

- the required after-tax rate of return on each type of capital is determined outside of Australia on world capital markets;
- national employment is fixed;
- businesses maximise profits;
- there is constant returns to scale in production; and
- the level of Australian-owned capital of each type is fixed (national saving assumption).

It is important to analyse economic policies using a long-run model that generates sustainable outcomes. In contrast, short-term models often generate estimates of gains that are not sustainable, leaving an unjustifiably rosy impression of the policy proposal that is being modelled.

For example, short-run models often predict gains in national employment from a wide variety of policies. If eliminating unemployment were that easy, it would have happened a long time ago! The FIM avoids this pitfall by assuming, as noted above, that national employment is fixed, so that increased employment in one sector must be exactly offset by reduced employment in other sectors. This use of long-term assumptions is necessary to
avoid any element of exaggeration in modelling the effects on the Australian economy of the IFSA proposal.

The FIM also has special detail in the areas important for this report:

- four types of capital are recognised, namely portfolio, direct, venture, and other private;
- business tax is modelled taking into account the Australian and foreign treatments of each type of capital;
- the representative business chooses its capital structure (i.e. how it is divided between the four types of capital) based on the relative user cost of each type of capital; and
- businesses choose their capital-labour mix.

Full details of the model, including all inputs, equations and outputs, are in Attachment B, so the results in this report can be fully reproduced and reviewed by others.

2.2 Model Inputs

The baseline solution for the FIM is produced using forecast data for the current financial year of 2001/02 and assumed values for key elasticities.

The forecast data for 2001/02 includes:

- a total business capital stock of $880 billion;
- employment of 9.2 million;
- an average annual wage of $43,800; and
- GDP (net of consumption of housing services) of $627 billion.

The key elasticities include:

- labour-capital elasticity of substitution of 0.75; and
- capital-capital elasticity of substitution of 0.75.

For this report, another key parameter is the amount of foreign portfolio investment in Australia that is made via Australian funds and therefore currently subject to CGT of 29 per cent. IFSA estimates this amount at only $2 billion. This represents only 1.3 per cent of all foreign portfolio investment in Australia, which is estimated to total $174 billion.

On the other hand, the ABS estimates that investment managers obtain $23 billion of their funds from foreign sources (“Managed Funds”, ABS Cat No. 5655.0, December quarter 2001). As mentioned above, IFSA estimates that only $2 billion of this are funds under management that are affected by the CGT on funds operating under a trustee relationship. IFSA believes that the balance of the reported ABS funds is brought into Australia via 'mandates'. Under these mandates the underlying securities are in the names of the offshore owner, as opposed to being held in trust by the funds manager in Australia. These mandates operate under a tax preferential arrangement (not subject to CGT), but are only available to big investors. Therefore the modelling in this report, including of budget impacts, is based on the IFSA estimate that foreign investment in Australian managed funds that is subject to CGT amounts to $2 billion.
The existing withholding tax of 29 per cent represents a burden on foreign investors if they are not able to claim tax credits in their home countries to offset this Australian tax. IFSA advise that these foreign investors fall into the following categories:

- tax exempt pension and charitable funds such as foundations; and
- high net worth individuals who either are in tax exempt regimes or are not prepared to become involved in a messy credits retrieval system.

On that basis, Econtech has adopted the modelling assumption that tax credits to offset the withholding tax are not available in the foreign investors home country. This is an important assumption. It means that, to offset the withholding tax, foreign investors will require a higher pre-tax rate of return on their Australian portfolio investments than on their portfolio investments in other countries that do not apply such a tax. This increases the cost of capital to Australia. To the extent that tax credits are available in reality, the existing CGT is not a burden on foreign investors, and the modelling will overstate the benefits of the IFSA proposal.

Full details of all model inputs are provided in Attachment B.
Modelling Results

This section presents the main modelling results. To take into account that there is some uncertainty around the value of some model parameters, the main results are supplemented by sensitivity analysis that examines the effects on the results of varying a key parameter.

3.1 Main Results

Extending the CGT exemption to foreign portfolio investment in Australia made via Australian fund managers will lower the pre-tax rate of return that the affected foreign investors require, because those returns will no longer be subject to tax on capital gains. However, as explained in section 2, only 1.3 per cent of foreign portfolio investment is subject to CGT at present. So abolishing that CGT leads only to a small reduction in the required pre-tax rate of return for foreign portfolio investment in aggregate, estimated at just under 0.1 percentage point.

This small reduction in the cost of foreign portfolio investment to Australia encourages investment. This results in a modest expansion in the capital stock and a boost to annual GDP, as shown in Table 3.1.

| Table 3.1 |
|---|---|
| **Estimates of Long-run Economic Effects** |
| | change | change |
| | $m | % |
| Capital Stock | 250 | 0.03 |
| GDP | 64 | 0.01 |
| - consumption | 10 | 0.00 |
| - investment | 35 | 0.03 |
| - net exports | 19 | 0.07 |
| Income Tax Revenue | -6 | 0.00 |
| - Foreign Portfolio Investment | -15 | -0.27 |
| - Other Foreign Investment | 2 | 0.03 |
| - Local Investment | -6 | -0.03 |
| - Labour Income Tax | 13 | 0.01 |
| Excess Burden of Foreign Investment Tax (a) | 65 |

(a) Excess burden for each dollar of revenue raised. Calculated as consumption effect relative to direct tax revenue effect (10/15 = 65%).

Gross Domestic Product (GDP) depends on inputs of both labour and capital. By reducing the cost of foreign portfolio investment to Australia, annual GDP is expected to rise. The economic model assumes that employment is fixed at a long-run equilibrium level, so there is no contribution to GDP from increased employment. However, the increase in the capital stock does flow through to produce a gain in annual GDP estimated at $64 million.

This gain in GDP can be divided into gains in consumption, investment and net exports. Consumption, which is a measure of living standards, rises by $10 million. Investment increases by $35 million, consistent with the gain in the capital stock. Net exports rise by $19 million, sufficient to service the increased foreign equity present in Australia.
The revenue currently being collected from the CGT on foreign portfolio investment via Australian managed funds will be foregone under the IFSA proposal. As shown in the table above, the long-run direct loss in annual revenue is estimated at $15 million, similar to the IFSA estimate of $14 million.

As discussed in the previous section, the FIM model makes the standard long-run assumption of fixed national employment – where the extra jobs in funds management are offset by fewer jobs in other industries. Thus, any additional tax revenue generated from increased activity in the funds management industry is expected to be offset by reductions in tax revenue from other industries.

Taking indirect effects into account lowers the net cost to the budget to $6 million. Higher capital intensity raises the marginal product of labour and real wages, lifting personal income tax collections from wages and salaries. This partly offsets the direct cost to the budget of $15 million, leaving a net cost of $6 million. Further details are in Table A.

In the FIM model, this revenue loss is assumed to be made up by a tax increase elsewhere that does not distort economic decision making. Thus the total tax take is unchanged. Despite this, as mentioned above, annual GDP rises by $64 million, with consumers receiving an annual gain of $10 million.

This highlights the inefficient nature of raising revenue by applying CGT to foreign portfolio investment in Australia via Australian managed funds. The model results imply a high excess burden from this tax of 65 cents in the dollar of revenue raised (calculated as the consumption effect of $10 million relative to the direct revenue from the CGT of $15 million). This high excess burden is not surprising as it is consistent with other studies that show that taxing international capital flows is highly distortionary. This is because capital is highly mobile internationally so taxes can easily lead to big distortions in flows between countries.

Put simply, the existing CGT on foreign portfolio investment in Australia via Australian managed funds is a poor method of raising revenue. Its excess burden on consumers of about 65 cents in the dollar compares unfavourably with other taxes. For example, broad-based taxes such as the GST or income tax applied to wages and salaries are much more efficient having an excess burden of only 10 to 20 cents in the dollar.

The model results are provided in more detail in Attachment B.

3.2 Sensitivity Analysis

There is uncertainty around the precise value of the elasticity of substitution between different types of capital, so sensitivity analysis was undertaken to investigate the effect of varying this elasticity. Table 3.2 shows the estimates of the economic effects of the proposal in three cases:

- base – where the capital-capital elasticity of substitution is set to 0.75;
- low – where the capital-capital elasticity of substitution is set to 0.6; and
- high – where the capital-capital elasticity of substitution is set to 0.9.

The key results are seen to be robust to these variations in the elasticity of substitution between different types of capital.
The key impact on living standards, as measured by annual consumption, only varies in a narrow range of $9 million to $10 million. The impact on budget revenue is $6 million in all scenarios. Similarly, the gain in GDP is $64 million in all scenarios.

Table 3.2
Sensitivity Analysis of Estimates of Long-run Economic Effects ($ million)

<table>
<thead>
<tr>
<th></th>
<th>base ($=0.75)</th>
<th>low ($=0.6$)</th>
<th>high ($=0.9$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>GDP</td>
<td>64</td>
<td>64</td>
<td>64</td>
</tr>
<tr>
<td>- consumption</td>
<td>10</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>- investment</td>
<td>35</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>- net exports</td>
<td>19</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Income Tax Revenue</td>
<td>-6</td>
<td>-6</td>
<td>-6</td>
</tr>
<tr>
<td>- Foreign Portfolio Investment</td>
<td>-15</td>
<td>-15</td>
<td>-14</td>
</tr>
<tr>
<td>- Other Foreign Investment</td>
<td>2</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>- Local Investment</td>
<td>-6</td>
<td>-6</td>
<td>-6</td>
</tr>
<tr>
<td>- Labour Income Tax</td>
<td>13</td>
<td>13</td>
<td>13</td>
</tr>
</tbody>
</table>

Excess Burden of Foreign Investment Tax (a) 65% 64% 67%

(a) Excess burden for each dollar of revenue raised. Calculated as consumption effect relative to direct tax revenue effect (e.g. 10/15 = 65%).
Attachment A: Taxation of Foreign Equity Investment in Australia

There is a high level of foreign equity investment in Australia, so its tax treatment is an important issue. As shown in Table A.1, at 30 June 2000 the ABS estimates that the level of this investment had reached $327 billion.

Most of this equity investment is from the UK and US. Table A.1 implies that these two countries together account for 70 per cent of foreign equity investment in Australia. Thus in considering the tax position for foreign equity investment in Australia, this report focuses on the situation for UK and US investors.

Both direct and portfolio equity foreign investment in Australia are important. The ABS defines direct investment as the case where the foreign investor owns ten per cent or more of the shares in the investee company. Portfolio investment is where the foreign investor owns less than ten per cent. Table A.1 implies that foreign equity investment in Australia is divided almost evenly at 54%/46% between direct and portfolio investment.

Table A.1
Equity Investment in Australia at 30 June 2000
($ billion)

<table>
<thead>
<tr>
<th></th>
<th>Direct</th>
<th>Portfolio</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>49</td>
<td>65</td>
<td>114</td>
</tr>
<tr>
<td>US</td>
<td>62</td>
<td>53</td>
<td>115</td>
</tr>
<tr>
<td>Other</td>
<td>65</td>
<td>33</td>
<td>98</td>
</tr>
<tr>
<td>Total</td>
<td>176</td>
<td>151</td>
<td>327</td>
</tr>
</tbody>
</table>

Source: ABS Cat. No. 5352.0, International Investment Position

Thus in considering the taxation of foreign equity investment in Australia, it is useful to distinguish between three types of investment:

- portfolio — portfolio investment in Australian public companies, about $2 billion of which represents funds under management (FUM);
- direct — direct investment in Australian public companies; and
- private — investment in Australian private companies, part of which is “venture capital”.

The tax position of foreign investors in Australia depends on the nature of the foreign investor. The major foreign equity investors in Australia are:

- companies — these are generally subject to company tax in their home country; and
- tax-exempt investors — pension or superannuation funds and endowment funds are often exempt from company tax in their home country.

Foreign equity investors in Australia may receive business income in different forms, and each form may attract a different tax treatment. For the purposes of this attachment, a distinction is drawn between three forms of income that may be received by foreign equity investors:

- franked dividends — most dividends paid by Australian companies are franked. Australian company tax has already been paid on franked dividends;
- unfranked dividends — Australian company tax has not been paid on unfranked dividends, but they are subject to withholding tax when paid to foreign investors; and...
capital gains — capital gains made when a foreign company investor disposes of equity in an Australian asset may be subject to Australian capital gains tax. However, there is an exemption for non-FUM portfolio investment.

Thus the tax position of income earned from foreign equity investment in Australia depends on at least three considerations — the type of investment, the nature of the foreign investor, and the form of income. Depending on these considerations, income earned on foreign equity investment in Australia may be subject to taxation in Australia or the foreign country or both countries. Further, taxation paid in Australia may or may not be allowed as a tax credit against taxation paid in the foreign country.

Table A.2 summarises how the tax position depends on the nature of the foreign entity, the type of investment and the form of income.

**TABLE A.2**

**POST-TAX RETURNS ON $1 OF AUSTRALIAN-SOURCED EQUITY INVESTMENT INCOME**

<table>
<thead>
<tr>
<th>Return in Australia(1)</th>
<th>Final Return for companies (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Franked Dividends:</strong></td>
<td></td>
</tr>
<tr>
<td>Portfolio: non-FUM</td>
<td>(1-t)</td>
</tr>
<tr>
<td>Portfolio: FUM</td>
<td>(1-t)x(1-f)</td>
</tr>
<tr>
<td>Direct</td>
<td>(1-t)</td>
</tr>
<tr>
<td>Private</td>
<td>(1-f)</td>
</tr>
<tr>
<td></td>
<td>(1-t)x(1-f)</td>
</tr>
<tr>
<td><strong>Unfranked Dividends:</strong></td>
<td></td>
</tr>
<tr>
<td>Portfolio: non-FUM</td>
<td>(1-w)</td>
</tr>
<tr>
<td>Portfolio: FUM</td>
<td>(1-w)</td>
</tr>
<tr>
<td>Direct</td>
<td>(1-w)</td>
</tr>
<tr>
<td>Private</td>
<td>(1-w)</td>
</tr>
<tr>
<td><strong>Capital Gains:</strong></td>
<td></td>
</tr>
<tr>
<td>Portfolio: non-FUM</td>
<td>1</td>
</tr>
<tr>
<td>Portfolio: FUM</td>
<td>(1-g)</td>
</tr>
<tr>
<td>Direct</td>
<td>(1-t)</td>
</tr>
<tr>
<td>Private</td>
<td>(1-t)</td>
</tr>
</tbody>
</table>

Explanatory Notes:
1. Tax-exempt foreign investors receive the amount shown in the “return in Australia” column while foreign company investors are also subject to tax in their home country, as taken into account in the “final return for companies” column.
2. “t” is the Australian company tax rate, currently 30 per cent.
3. “w” is the Australian withholding tax rate on unfranked dividends paid to countries with which Australia has a double taxation agreement. This withholding tax rate is currently 15 per cent for US and UK investors.
4. “f” is the foreign company tax rate. The major sources of foreign equity investment in Australia are the US and UK where the company tax rates are 35 per cent and 30 per cent respectively. The economic modelling described in Attachment B uses the US rate.
5. “g” is the Australian withholding tax rate on capital gains made by foreign investors in Australian managed funds, currently 29 per cent.

Before considering Table A.2, a further issue that needs to be taken into account is whether or not a double taxation agreement exists between Australia and the country of the foreign investor. Double taxation agreements aim to alleviate the double taxation that may arise.
from taxation of foreign investment income by both the host and investing countries. Under
double taxation agreements, reduced rates of withholding tax apply on certain income paid to
foreign investors. Further, the home country of the foreign investor may give credits for
some income taxes paid by the foreign investor in the host country.

Most foreign equity investment in Australia is covered by a double taxation agreement. For
example, Australia has double taxation agreements with both the US and UK. As indicated
above, these two countries alone account for as much as 70 per cent of foreign equity
investment in Australia. Thus the following discussion is based on the situation where a
double taxation agreement is in place.

Table A.2 shows, in different situations, the amount received by a foreign equity investor on
$1 of Australian income after the deduction of taxes in both countries. Calculating this
amount is a two-step process.

The first step is to allow for Australian taxation, as in the column headed “return in
Australia”. This tax is paid by foreign investors irrespective of whether they are companies
or tax-exempt entities such as US pension funds.

For foreign investors that are tax-exempt, by definition tax is not paid in their home country.
Thus they are only subject to Australian taxation and the final return that they receive is the
same as the return in Australia calculated in the first step.

The second step, which applies to foreign investors that are companies, is to allow for
taxation in the foreign investors’ home country, net of any credits that may be allowed on
Australian taxation. The final amount received by foreign company investors is shown in
the column headed “Final Return for Companies”.

The explanation of Table A.2 considers the tax treatment of each form of income in turn,
beginning with franked dividends.

By definition, Australian company tax has been deducted from franked dividends. Thus out
of $1 of income earned by the Australian company, Australian company tax at the rate “t”
has been deducted, where “t” is currently 30 per cent. This leaves a return in Australia of (1-
t). This is the final return that is received by tax-exempt foreign investors on franked
dividends.

Foreign companies may also be subject to company tax in their own country on this amount.
Taking into account both Australian and foreign company tax, this leaves a return of (1-f) x
(1-t). This is the final return received from a franked dividend paid under a portfolio
investment, as shown in Table A.2. However, for a direct investment, both the US and the
UK allow a credit for Australian company tax. Allowing for this credit, the final return for a
direct investment is (1-f), where f is the foreign country company tax rate. Currently the US
company tax rate is 35 per cent while the UK rate is 30 per cent.

The situation is different for unfranked dividends. By definition, Australian company tax
has not been deducted from unfranked dividends. However, they are subject to withholding
tax at the rate “w”, currently 15 per cent where the payment is to the US or UK or 30 per
cent for payments to countries with whom Australia does not have a double taxation
agreement. This leaves a return of (1-w). This is the final return that is received by tax-
exempt foreign investors on unfranked dividends.
Foreign companies may also be subject to company tax in their home country on this amount. However, under double taxation agreements, they can claim a credit for the Australian withholding tax. Allowing for this credit, the final return for foreign companies on unfranked dividends is \((1-f)\), where “\(f\)” is the foreign company tax rate.

A different tax treatment applies to capital gains, which are the final category of foreign equity income. Capital gains may be received by foreign investors on the sale of Australian equity. For direct or private investment, these gains will generally be subject to tax at the Australian company tax rate, “\(t\)”, leaving a return of \((1-t)\).

However, the situation is different for capital gains on portfolio investment. An exemption from CGT applies for capital gains made on the disposal of equity in a listed public company, where the foreign investor owns no more than ten per cent of the equity in that company, and the investment is not made via an Australian managed fund (non-FUM). Reflecting this CGT exemption, the table shows an after-tax return in Australia of $1 for a pre-tax capital gain of $1 made on non-FUM foreign portfolio investment.

However, as highlighted in the main report and in Table A.2, this CGT exemption does not apply where the foreign investment is made through an Australian managed fund (FUM). Instead, the managed fund must deduct withholding tax at the rate “\(g\)” (currently 29 per cent), leaving an after-tax rate of return in Australia of \((1-g)\). The IFSA proposal analysed in the main report aims to bring the CGT treatment of FUM foreign portfolio investment into line with that for non-FUM foreign portfolio investment.

As before, the final return that is received by tax-exempt foreign investors matches the return received in Australia.

Foreign company investors may also be subject to company tax in their home country on Australian capital gains. However, under double taxation agreements, they may be able to claim a credit for Australian CGT. In that case, as shown in Table A.2, their final return on an Australian capital gain will be \((1-f)\), where “\(f\)” is the foreign company tax rate.
Attachment B: The Foreign Investment Model (FIM)

B.1 Equations

**GDP Identity**
\[ Y = C + I + NX \]

**CES Production Function**
\[ Y = [(an*N)^\rho + (ak*K)^\rho]^{1/\rho} \]

**Investment**
\[ I = (\delta + g)\Sigma K(i) \]

**Foreign Investment**
\[ KF(i) = K(i) - KP(i) \quad \text{for all } i \]

**Net Export Requirement for External Balance**
\[ NX = \Sigma \{\theta\ast[(1–t(i))/(1–tf(i))] – g\} \ast KF(i) \]

**Marginal Product of Capital**
\[ K = (MPK/ak)^{-\sigma}\ast(Y/ak) \]

**Marginal Product of Capital Equals User Cost**
\[ MPK = \Sigma PK(i) \ast K(i)/K \]

**User Cost for Capital of Type i**
\[ PK(i) = \delta + \theta/(1–tf(i)) \quad \text{for all } i \]

**Cost-minimising Capital Structure**
\[ K(i)/K = (1/b(i)) \ast \{[PK(i)/b(i)]/MPK\}^{-\gamma} \quad \text{for all } i \]

B.2 Definitions: model outputs

\[ Y = \text{gross domestic product} \]
\[ C = \text{consumption (private plus public)} \]
\[ I = \text{gross investment} \]
\[ NX = \text{net exports} \]
\[ K = \text{aggregate capital stock} \]
\[ K(i) = \text{capital stock of type } i \quad (i=1...4) \]
\[ KF(i) = \text{foreign-owned equity of type } i \quad (i=1...4) \]
\[ MPK = \text{marginal product of capital} \]
\[ PK(i) = \text{user cost of capital of type } i \quad (i=1...4) \]
B.3 Definitions: preset model inputs (2001/02)

\( t(i) \equiv \text{business tax rate paid by foreign investor in Australia} \)
\( tf(i) \equiv \text{business tax rate paid by foreign investor overall} \)
\( N \equiv \text{employment=9.2 million} \)
\( g \equiv \text{growth rate=3.5\%} \)
\( \sigma \equiv \text{labour-capital elasticity of substitution} = \frac{1}{1-\rho} = 0.75 \)
\( \gamma \equiv \text{capital-capital elasticity of substitution} = \frac{1}{1-\phi} = 0.75 \) (0.6 and 0.9 for sensitivity analysis)
\( \delta \equiv \text{depreciation rate = 0.10} \)

B.4 Definitions: calibrated model inputs (2001/02)

\( KP(1) \equiv \text{Australian-owned portfolio equity=$235bn} \)
\( KP(2) \equiv \text{Australian-owned direct equity=$197bn} \)
\( KP(3) \equiv \text{Australian-owned venture capital equity=$4bn} \)
\( KP(4) \equiv \text{Australian-owned other private=$106bn} \)
\( \theta \equiv \text{world required after-tax rate of return on capital=10.8\%} \)
\( an \equiv \text{scale parameters for employment in CES production function=257} \)
\( ak \equiv \text{scale parameters for capital in CES production function=15.6} \)

The above values were calibrated using both the preset model inputs and the following data/assumptions about the baseline position:

- capital stock is $880bn divided 44.5%/43%/0.5%/12% between portfolio, direct, venture and other private;
- 40\% of portfolio, 48\% of direct, 20\% of venture and 0\% of other private are foreign-owned;
- 1.3\% of foreign-owned portfolio is invested in managed funds;
- average annual wage is $43,800; and
- GDP (net of consumption of housing services) is $627bn.

B.5 Capital Inputs

<table>
<thead>
<tr>
<th>Capital inputs</th>
<th>value ($bn)</th>
<th>( t(i) )</th>
<th>( tf(i) )</th>
<th>( b(i) )</th>
</tr>
</thead>
<tbody>
<tr>
<td>- portfolio</td>
<td>391</td>
<td>24.1%/24.0%</td>
<td>24.1%/24.0%</td>
<td>29</td>
</tr>
<tr>
<td>- direct</td>
<td>378</td>
<td>30%</td>
<td>35%</td>
<td>25</td>
</tr>
<tr>
<td>- venture</td>
<td>5</td>
<td>30%</td>
<td>30%</td>
<td>1.26E+9</td>
</tr>
<tr>
<td>- other private</td>
<td>106</td>
<td>30%</td>
<td>30%</td>
<td>4808</td>
</tr>
</tbody>
</table>
Table B.2
Results in Detail

<table>
<thead>
<tr>
<th></th>
<th>baseline ($)bn</th>
<th>proposal ($)bn</th>
<th>change ($)m</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>880.0</td>
<td>880.2</td>
<td>250</td>
<td>0.03%</td>
</tr>
<tr>
<td>GDP</td>
<td>627.0</td>
<td>627.1</td>
<td>64</td>
<td>0.01%</td>
</tr>
<tr>
<td>- consumption</td>
<td>481.8</td>
<td>481.8</td>
<td>10</td>
<td>0.00%</td>
</tr>
<tr>
<td>- investment</td>
<td>118.8</td>
<td>118.8</td>
<td>35</td>
<td>0.03%</td>
</tr>
<tr>
<td>- net exports</td>
<td>26.4</td>
<td>26.4</td>
<td>19</td>
<td>0.07%</td>
</tr>
<tr>
<td>Income Tax Revenue</td>
<td>130.6</td>
<td>130.6</td>
<td>-6</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Foreign Portfolio Investment</td>
<td>5.4</td>
<td>5.4</td>
<td>-15</td>
<td>-0.3%</td>
</tr>
<tr>
<td>- Other Foreign Investment</td>
<td>9.1</td>
<td>9.1</td>
<td>2</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Local Investment</td>
<td>21.4</td>
<td>21.3</td>
<td>-6</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Labour Income Tax</td>
<td>94.7</td>
<td>94.7</td>
<td>13</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Excess Burden of Foreign Investment Tax (a)</strong></td>
<td></td>
<td></td>
<td></td>
<td>65%</td>
</tr>
</tbody>
</table>

Table B.3
Sensitivity Analysis Results in Detail – Low Capital Elasticity Case

<table>
<thead>
<tr>
<th></th>
<th>baseline ($)bn</th>
<th>proposal - low ($)bn</th>
<th>change - low ($)m</th>
<th>% change - low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Stock</td>
<td>880.0</td>
<td>880.2</td>
<td>250</td>
<td>0.03%</td>
</tr>
<tr>
<td>GDP</td>
<td>627.0</td>
<td>627.1</td>
<td>64</td>
<td>0.01%</td>
</tr>
<tr>
<td>- consumption</td>
<td>481.8</td>
<td>481.8</td>
<td>10</td>
<td>0.00%</td>
</tr>
<tr>
<td>- investment</td>
<td>118.8</td>
<td>118.8</td>
<td>35</td>
<td>0.03%</td>
</tr>
<tr>
<td>- net exports</td>
<td>26.4</td>
<td>26.4</td>
<td>19</td>
<td>0.07%</td>
</tr>
<tr>
<td>Income Tax Revenue</td>
<td>130.6</td>
<td>130.6</td>
<td>-6</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Foreign Portfolio Investment</td>
<td>5.4</td>
<td>5.4</td>
<td>-15</td>
<td>-0.3%</td>
</tr>
<tr>
<td>- Other Foreign Investment</td>
<td>9.1</td>
<td>9.1</td>
<td>3</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Local Investment</td>
<td>21.4</td>
<td>21.3</td>
<td>-6</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Labour Income Tax</td>
<td>94.7</td>
<td>94.7</td>
<td>13</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Excess Burden of Foreign Investment Tax (a)</strong></td>
<td></td>
<td></td>
<td></td>
<td>64%</td>
</tr>
</tbody>
</table>
### Table B.4
**Sensitivity Analysis Results in Detail – High Capital Elasticity Case**

<table>
<thead>
<tr>
<th></th>
<th>baseline</th>
<th>proposal - high</th>
<th>change - high</th>
<th>% change - high</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($bn)</td>
<td>($bn)</td>
<td>($m)</td>
<td></td>
</tr>
<tr>
<td>Capital Stock</td>
<td>880.0</td>
<td>880.2</td>
<td>250</td>
<td>0.03%</td>
</tr>
<tr>
<td>GDP</td>
<td>627.0</td>
<td>627.1</td>
<td>64</td>
<td>0.01%</td>
</tr>
<tr>
<td>- consumption</td>
<td>481.8</td>
<td>481.8</td>
<td>9</td>
<td>0.00%</td>
</tr>
<tr>
<td>- investment</td>
<td>118.8</td>
<td>118.8</td>
<td>35</td>
<td>0.03%</td>
</tr>
<tr>
<td>- net exports</td>
<td>26.4</td>
<td>26.4</td>
<td>19</td>
<td>0.07%</td>
</tr>
<tr>
<td>Income Tax Revenue</td>
<td>130.6</td>
<td>130.5</td>
<td>-6</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Foreign Portfolio Investment</td>
<td>5.4</td>
<td>5.4</td>
<td>-14</td>
<td>-0.3%</td>
</tr>
<tr>
<td>- Other Foreign Investment</td>
<td>9.1</td>
<td>9.1</td>
<td>2</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Local Investment</td>
<td>21.4</td>
<td>21.3</td>
<td>-6</td>
<td>0.0%</td>
</tr>
<tr>
<td>- Labour Income Tax</td>
<td>94.7</td>
<td>94.7</td>
<td>13</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Excess Burden of Foreign Investment Tax (a)</strong></td>
<td></td>
<td></td>
<td></td>
<td>67%</td>
</tr>
</tbody>
</table>