Department of Treasury

International Tax Review

A Submission by the

Australian Custodial Services Association

Foreign Income Funds

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International Tax Review

Foreign Income Funds

1. A Consultative Approach

The Australian Custodial Services Association ("ACSA") welcomes the review of the international tax arrangements and the opportunity to contribute a view. The following submission reviews the current arrangements and makes suggestions for change.

Importantly, we also see the submission as a catalyst for potential further dialogue between ACSA and Treasury on the range of institutional investment issues.

2. Executive Summary

The current FIF regime is complex and generates significant compliance costs for investors. A detailed analysis of FIF issues is contained in Section 4 of the submission.

In summary, some of the key issues include:

- The current FIF exemption rules for non-US entities are difficult and expensive to apply in practice and catch more than investments that are used to accumulate income offshore in low tax or untaxed jurisdictions. Consequently, application of the exemption rules may unnecessarily impact upon investment decision.

- The rules can be seen as unfair in that losses are quarantined whereas profits are brought to account.

- Amounts calculated under the FIF rules are not treated as capital gains. As such, superannuation funds and individuals do not obtain the CGT concessions on such investments.

- The calculation method of determining nominal income specified in the FIF rules is almost impossible to apply in practice and the conditions for using the market value method are unnecessarily restrictive.

- The alternative of using the deemed rate of return method can produce extremely unfair results if the deemed return ultimately proves to be greater than the actual return.

- The majority of ACSA members provide taxation reporting services to clients and are therefore responsible for producing FIF reports. The complexity of the regime, stringent control process, general need for external audit, and lack of certainty in classifying securities adds considerable cost to compliance.

Recommended alternatives to the current arrangements are outlined in Section 6 of the submission. A major step forward could be to prima facie *exclude wholesale investors* from the regime and then specifying investments that should be included rather than the current approach of prima facie including all foreign investments and then excluding some.

More generally, a similar exemption to that adopted for US investments should be available for investments in the UK, New Zealand, Canada, Germany, Japan and France.

Finally, the submission includes a raft of suggestions where the current rules can be simplified and made fairer.

3. Introduction

The press release by the Department of Treasury dated 2 May 2002 announced a review of international taxation and indicated that a particular focus would be placed on foreign source income rules (consisting principally of the controlled foreign company, foreign investment fund and foreign tax credit/exemption rules).

The press release states that "the review will examine claims that the rules are complex and impose significant compliance costs on business, are out of step with modern business practice, and negatively affect decisions to locate in Australia vis a vis countries with less stringent or no such rules".

As outlined in this submission, ACSA believes that these claims are justified. We also outline alternatives that should satisfy the objectives of the FIF rules but at the same time achieve greater equity for investors, lower compliance costs and greater efficiency.

4. Impact of current rules on investors and custodians

The FIF rules originate from the Government's tax reform agenda in the early 1990's to develop a comprehensive system for taxing foreign sourced income. The rules were introduced in 1992 to address a tax deferral problem where foreign entities were used to shelter income from Australian taxation by accumulating income in low tax or tax-free jurisdictions.

The rules basically require Australian taxpayers to pay tax on notional amounts if investments are made in non-resident companies, limited partnerships and trusts that do not satisfy one of the specified exemptions.

The notional amounts are intended to roughly equate to unrealised gains made on the investments, but due to the prescriptive nature of the rules this is not usually achieved. *As such, the rules can impose significant timing disadvantages and even permanent disadvantages with investing offshore compared to investing in similar investments in Australia.*

To the extent that the Australian taxpayer is required to pay tax on the notional amounts, extensive records must then be kept to claim relief from future taxation on the actual profits made (that is, on distributions or realised gains) on the relevant investments.

More specifically, the rules apply as follows:

Specified exemptions

Prima facie all investments in a foreign company, trust or limited partnership are caught by the FIF rules unless they are specifically exempted.

To determine whether an investment is exempt the Australian tax payer has to either:

- determine that the entity is eligible for the US investment exemption;
- obtain a stock exchange or sectorial classification (from a recognised market source, for example, Bloombergs) that the company carries on activities that are not banking, insurance, property or financial services related; or
- use the balance sheet of the entity to determine whether more than 50% of the assets are engaged in eligible activities.

Stock exchange or other recognised market classifications are sometimes *miscellaneous* or contain various descriptions including financial services activities and are thus not always useful in for these purposes.

However, the balance sheet method is extremely difficult to apply in practice (that is, financial information including balance sheets must be obtained in English with enough detail to determine the use of the assets. This may require judgement and skill in financial analysis).

Consequently, it is sometimes very difficult to determine whether a foreign investment is exempt creating uncertainty and compliance risk.

Banking, life insurance, general insurance or active property business

Under the current rules, investments in companies that predominantly conduct banking, life insurance, general insurance or active property businesses are only exempt if the shares in the company are listed, widely held and actively traded on a regular basis.

These additional requirements can be difficult to establish and would not always be relevant to satisfying the objectives of the provisions to prevent the accumulation of funds in low taxed jurisdictions.

Further, entities undertaking such activities are becoming more and more multi purposed and as such are increasingly being classified as financial services businesses rather than simply banking, life insurance etc. This trend can be seen by through the activities in acquisition and business diversification of many of Australia's leading financial institutions non of which remain as single function companies.

As such, singling banking, life insurance, general insurance or active property businesses for special treatment no longer serves a useful purpose.

Entities engaging in financial services

Entities that undertake non-banking financial services such as Nomura and the Singapore Stock Exchange (and until the US exemption was introduced, American Express, Bloombergs etc) are not considered exempt even if they are carrying on active business that are fully taxed in jurisdictions comparably taxed to Australia.

This point can be illustrated if we were to look at Australian securities to see whether they would be exempt if they were, say, resident and paying tax in the UK.

We would find that investments in Perpetual Trustees, Permanent Trustees, and ASX would *not* be exempt notwithstanding these companies carry on legitimate active businesses and are paying appropriate levels of corporate tax on their profits.

Consequently, there would be a different income tax treatment if an Australian resident were to invest in these companies (ie taxation would be on a realisation basis) compared to the Australian resident investing in identical companies in the UK (ie taxation would be on a complicated psuedo unrealised basis with onerous record keeping requirements). Such an income tax impact on ordinary investment decision making is unnecessary.

Dichotomy between FIF and CFC rules

We note that companies that would pass the active income test if they were controlled foreign companies (ie CFCs) such that no income need to be attributed to the Australian investors would nevertheless be caught by the FIF rules if they were not controlled companies, because of the nature of their businesses.

For example if an Australian taxpayer had a controlling interest in Nomura, no amount would be attributed under the CFC rules as the company would pass the active income test. However, an amount would be attributed under the FIF rules if the Australian taxpayer did not have a controlling interest. Clearly such anomalies should be addressed.

Investments that change classifications

It is possible that the classification of some investments change over time. For example, (before the US exemption) the General Electric company was originally set up to manufacture white goods, but more recently its financial arm has became more predominant.

It would seem to be anomalous that an investment that was exempt when first made could become non-exempt later despite there being nothing done by the Australian taxpayer.

Balanced portfolio exemption

The balanced portfolio exemption excludes entities from the FIF rules if less than 5% of their foreign portfolio is held in exempt funds. The balanced portfolio exemption does not take into account investments in Australian securities.

As such, even if the overseas investments reflect only a small per centage of the overall portfolio, and if more than 5% of the international investments are in non-exempt funds, the fund either needs to undertake the additional costly administrative measures (such as sell down etc) or would need to unbalance the portfolio and invest in more exempt investments.

Such interference by the Australian tax regime on investment strategies is clearly not desirable.

Emerging markets

Where investments are not listed, the classification of the FIF needs to be done by using the balance sheet method, which (as noted above) can be difficult to apply in practice. As such, there are additional costs associated with investing in emerging markets. Perhaps it was not intended that the Australian tax regime should have an impact on investment strategies.

Conclusion

In summary, the current exemption rules for non-US entities are difficult and expensive to apply in practice and catch more than investments that are used to accumulate income offshore in low tax or untaxed jurisdictions.

Consequently, the rules may unnecessarily impact upon investment decision, and certainly add costs and uncertainty in compliance.

Calculation of the notional amounts

Where the market value method is available

If the relevant investment has a listed price or has a listed buy-back price, the Australian taxpayer has a choice of methods to calculate the taxpayer's share of the actual profit made by the entity ("calculation method") or to calculate the unrealised gain made on the investment during the year ("market value method").

It is important to note that if the investment has other investments in other non-Australian securities (including subsidiaries), the calculation method is either practically impossible to apply or nearly always provides a worse result compared to the market value method.

The rules are practically impossible to apply because a separate FIF calculation needs to be made under the FIF rules for each of the investments and the information is usually not available.

The rules nearly always provides a worse result because losses are quarantined whereas profits are brought to account (see below) and because there is no relief for amounts attributed in relation to foreign investments of a FIF (see below).

Where the market value method is not available

Where the relevant investment is not listed or does not have a listed buy-back price the market value method is not available notwithstanding there might be rigorous opening and closing market values available (ie by qualified valuers etc), which are used in statutory accounts etc.

Instead, the Australian taxpayer has a choice of adopting the calculation method or of applying the deemed rate of return method.

However, the deemed rate of return method can produce extremely unfair results if the deemed return ultimately proves to be greater than the actual return.

This is because the mechanism for providing relief for amounts that have previously been taxed under the FIF rules is to first reduce the taxability of distributions and then, if these are insufficient, reduce the capital gain (or increase the capital loss) made upon disposal of the relevant foreign investment.

However, capital losses are quarantined against future capital gains. Consequently, a taxpayer may be in a position of paying tax even though there were no economic gains. That is, a taxpayer may pay tax on the deemed income, but have to carry forward a capital loss indefinitely (or in the case of a trust or company – lose it upon winding up).

Quarantining unrealised losses

The amounts that are brought to account or attributed to Australian taxpayers are calculated separately for each foreign investment. However, losses made on an investment in one FIF cannot be offset against gains made on an investment in another FIF.

Consequently, Australian taxpayers can be attributed amounts even when there are in fact no economic gains. This is clearly an anomalous result.

No relief for disposal of second tier FIF where amounts have previously been attributed

As noted above, where an Australian trust holds an investment in a FIF ("first tier FIF") which in turn holds interests in other FIFs ("second tier FIF") notional amounts are attributed to the Australian taxpayer in relation to the second tier FIF.

However, there is no mechanism for reducing a gain or loss made by the first tier FIF on a disposal of a second tier FIF for amounts previously brought to account in relation to the second tier FIF.

Unavailability of CGT concession

It is important to note that the amounts calculated under the FIF rules are not treated as capital gains. As such, superannuation funds and individuals do not obtain the CGT concessions on such investments. Consequently, they are in a worse position compared to investing in similar Australian investments. For a more detailed explanation of this issue, please refer to the attached appendix.

Tracking the notional amounts

The rules require trusts to track the amounts that are taxable under the FIF rules at both the fund level and at the beneficiary level. As you would appreciate, this is practically impossible in large fund situations.

5. Other practical implications

Sell down

Due to the cost of administering the FIF regime and other concerns, many clients instruct their custodians to sell down investments in non-exempt FIFs at the end of the year to ensure that they satisfy the balanced portfolio exemption. Such a practice imposes unnecessary costs (including brokerage, stamp duty and potential market impact) for no economic benefit.

Use of unnecessary structures

In an effort to reduce the reach of the FIF rules to customers, additional Australian entities are sometimes interposed between the customers and the overseas entities. Such a practice imposes unnecessary costs (including legal expenses) for no economic benefit.

Unnecessary costs

As custodians, our members are responsible for producing FIF reports for external Master Custody clients. Accordingly, ACSA members have first hand experience with the FIF reporting process and regard it as both complex and stringent. On top of our internal checks, most of our members also seek an external audit sign-off on FIF reports and process to provide additional compliance comfort (a costly process).

Unnecessary risk

Some of our members have enlisted external assistance to help classify the more difficult securities. However, even then there is the occasional error, which can have some quite drastic consequences. That is, considerable expense needs to be incurred to retrospectively calculate the FIF amounts and penalties and interest can accrue.

We request that the rules be clarified to ensure that our members are not penalised for an incorrect classification (eg if this pushes it above the 5% threshold) if the necessary care has been taken based on the information available.

6. Suggested alternatives

Responsible public policy requires control over Australian taxpayers parking money offshore in tax havens. But it should be possible to achieve this outcome without the administrative complexity and compliance risk inherent in the current system, and without impacting upon investment decisions.

Wholesale Investors

Reformulate the rules to prima facie exclude wholesale investors (that is, wholesale and retail unit trusts, widely held complying superannuation funds and life insurance companies) other than in specific circumstances. This applies to the tax paying entity, not the investments.

This is preferable to the current approach that prima facie includes all foreign investments (regardless of entity) and then provides for (complex) investment level exclusions.

Specific instances of entities where the FIF rules should not provide exclusion should include:

- life insurance companies and complying superannuation funds investing in tax haven life insurance policies (ie where otherwise the profits could be repatriated back to Australia tax free after 10 years); and

- life companies taking more than a 10% interest in investment companies resident in non-broad exemption listed countries such as Luxembourg, Ireland and Singapore such that low taxed profits can be repatriated back to Australia tax free.

Non-wholesale Investors

In relation to non-wholesale taxpayers we submit that FIF rules be amended as follows:

- A similar exemption to that adopted for US investments should be available for investments in the UK, New Zealand, Canada, Germany, Japan and France (this country list is taken from the Controlled Foreign Company rules).

  However, this exemption should be extended to all entities that are taxed on their world wide income in these countries and not just companies.

- The additional restrictions on exempting FIFs undertaking banking, life insurance, general insurance or active property business should be removed.

- The exempt activities should be extended to include financial services.

- The balanced portfolio exemption should be changed to include the total value of all the taxpayer's investments (ie including property and Australian securities) and not just FIF interests.

- The balanced portfolio exemption should also be drafted to apply where the Australian taxpayer has taken reasonable care when classifying the investments based upon the information available.

All taxpayers/investors

We also submit that the administration of the rules be simplified and made fairer. In particular, we submit that:

- The capital gains tax exemption should be available for superannuation funds and individuals on amounts calculated under the FIF rules.

- The market value method should be available to Australian fund managers notwithstanding the foreign securities are not listed or there is no quoted buy back price.

  That is, values used in published accounts or unit prices should be capable of being used to determine the FIF attributable income.

- All non-exempt FIF unrealised losses should be available to offset all non-exempt FIF unrealised gains when calculating the amount attributable to Australian investors.

- The trust (as opposed to the beneficiaries) should be the entity that is required to keep the attribution accounts.

- Any reversal of the deemed rate of return actually realised should be tax deductible and not a capital loss.

- Any gains or losses made on the sale of second tier FIFs should be reduced by amounts that have previously been attributed in relation to those investments.

Appendix - Foreign Investment Funds and the CGT discount

Presently the FIF regime applies to attribute income to the trust where it holds certain foreign investments. The attributed income is generally distributed to unitholders of the trust as part of the net income of the trust pursuant to section 95 of the 1936 Tax Act.

To avoid the double taxation of income, the FIF provisions reduces the consideration received on disposal of an interest in a FIF by any amount previously attributed. This section worked adequately under the indexation provisions.

However, as the CGT discount measures apply to the capital gain (ie the difference between the consideration and the cost base) a lower amount of consideration will result in a lower capital gain and a lower discount. Under the CGT discount measures a resident individual on the highest tax rate will have an effective tax rate of 24.25% rather than 48.5% (highest marginal tax rate). In the case of a FIF investment the effective tax rate is between 24.25% and 48.5%. This creates an anomaly, as the full discount amount is not available to the investor under the FIF provisions where the consideration is reduced by previously attributed FIF income.

On disposal of units previously attributed FIF income should be allowed as a tax deduction and then the capital gain can be worked out using the full consideration amount.

This can be demonstrated in the example below:

Example:

Trust A acquires an interest in a FIF for a cost of $50 on 1 January 2000. On 30 June 2001 this FIF interest has a market value of $200. On the 29th of June 2002, Trust A disposes of this FIF interest for $250. Trust A does not receive any distribution from this FIF interest during the period 1 January 2000 and 29 June 2002. For convenience the only unitholder of Trust A is a resident individual with a marginal tax rate of 48.5% (with medicare levy). Assume Trust A uses the market value method to attribute income under the FIF provisions.

Trust A – tax position 30 June 2001

The trust will include attributed income of $150 in the net income of the trust in the 30 June 2001 year. This will be distributed to unitholders.

Resident individual unitholder – tax position 30 June 2001

The unitholder would include the income of $150 in assessable income and have a tax liability of $73 ($150 x 48.5%)

Trust A – tax position 30 June 2002

Capital gain on disposal of the FIF interest:

Reduced consideration ($250 - $150)	$100.
Cost	$50
Capital gain	$50
Discounted capital gain	$25

This discounted capital gain will be distributed to unitholders.

Resident individual unitholder – tax position 30 June 2002

If the individual unitholder has no other capital losses the unitholder will be making a tax payment of $12.13 (48.5% of $25).

As demonstrated in the example above the unitholder has paid tax of $85 on the notional capital gain of $200 (an effective tax rate of 42%) when in fact the unitholder should only have paid tax of $48.5 on this investment (($250 - $50) x 50% x 48.5%).

Therefore the unitholder has paid excess tax of $35.50 on the FIF investment.