BARCLAYS
GLOBAL INVESTORS

Telephone +61 2 9272 2274
Facsimile +61 2 9278 5274
mark.oh@barclaysglobal.com

Barclays Global Investors Australia Limited
ABN 33 001 804 566
AFS Licence No. 225398
Level 43, Grosvenor Place
225 George St, Sydney
NSW 2000

19 December 2008

Mr Dick Warburton AO
Managed Investments Trust Review
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Facsimile: (02) 6263 4471
Email: taxboard@treasury.gov.au

Dear Mr Warburton

Re: Barclays Global Investors
Submission on the Review of the Tax Arrangements Applying to Managed Investment Trusts

Thank you for the opportunity to provide our comments in relation to the review of the tax arrangements for managed investment trusts ('MITs').

By way of background, Barclays Global Investors ('BGI') is one of the world's largest investment managers, with over A$2 trillion in assets under management[1] and serves over 3,000 clients worldwide. BGI is one of the world's largest providers of structured investment strategies, including indexing, market strategies and risk-controlled active products, running more than 3,000 funds globally. BGI is majority owned by Barclays PLC – one of the UK's largest companies and one of the world's foremost providers of financial services with operations in over 60 countries.

Our submission addresses three key issues. Firstly, we believe the capital versus revenue distinction needs to be resolved, and our proposal is to recommend a statutory rule be adopted to deem all gains and losses made by MITs to be on capital account.

Secondly, with respect to the international considerations of MITs, we address the determination of source. We submit that a statutory rule of source be adopted, along with an exemption for non-resident investment managers. This will greatly encourage inbound investment and further enhance the Government's commitment to make Australia the financial services hub of the Asia-Pacific region.

Thirdly, we submit that the capital gains tax treatment for MITs should be amended to eliminate the double taxation that occurs with these products. This amendment will also resolve the uncertainties of a MIT satisfying the fixed trust definition where the MIT transfers underlying assets to satisfy a redemption of its units. Currently, the absence of such a rule is

---

[1] as at October 2008.

hindering the growth of certain MITs like Exchange Traded Funds ('ETFs') in Australia. Should our proposals be accepted, we would expect that the MIT structure will be globally competitive and will translate to an Australian ETF market that will grow strongly and is able to compete on the world stage.

If you would like to discuss any aspect of our submission, please do not hesitate to contact us.

Yours sincerely

Mark Oh
Head of Taxation

Justin Wood
Head of Strategic Solutions and Client Advisory Group

1. The Capital versus Revenue Distinction

Perhaps the most important piece in the Board of Taxation recommendation to the Government will be the capital versus revenue distinction. If the Board of Taxation recommends an outcome that is inconsistent with the commercial and economic realities of MITs, the modern MIT will cease to be viable going forward for a wide range of commonly used investment strategies involving growth assets for the superannuation market. In uncertain economic and financial times, this will not just be destructive to the funds management industry, but will have adverse effects on the economy.

The capital versus revenue distinction for investments in the funds management industry is an example of the uncertainty and complexity referred to in the Henry Review Panel.[2] There is no statutory directive that allows the industry to operate with efficiency and simplicity. The case law provides some guidance, however most of the cases were decided in a pre-capital gains tax ('CGT') era, and before the growth and innovation of the modern MIT.

Further, it is widely understood that the Australian Taxation Office ('ATO') is attempting to apply certain cases on a universal basis to investments and in doing so, is disregarding the core purpose for which MITs are established. If the Board of Taxation aligns itself with this view, the serious risk is that MITs will cease being used and the industry will fragment and become increasingly costly.

From a BGI perspective, approximately 90% of clients are superannuation fund entities and other long-term retirement focused institutions. Superannuation funds currently are allowed the benefit of a statutory rule with respect to their investments. That is, they are allowed capital treatment of their investments.[3] Should the recommendation to the Government be that investments in managed funds be on revenue account, there is a disincentive for superannuation funds to continue to hold units in managed funds. That is, the gains derived that pass through the managed fund would be revenue gains to superannuation funds, and would not have the benefit of CGT treatment (in effect, the CGT discount on those assets held for longer than twelve months).

This would result in a costly exercise to superannuation funds. Should revenue treatment of a MIT's investment assets be recommended, and as a consequence superannuation funds request their own investment mandates, funds managers will have no choice but to on-charge the additional fees and costs for more costly direct investment mandates (e.g.

---

[2] *Australia's future tax system*, Henry Review Panel, December 2008, page 8. "The tax-transfer system is very complex. To a degree, this refects the reality of the modern world.... However, complexity adds cost and risk to day-to-day business and personal activities. It affects the choices individuals make to work, save and consume. The time and resources individuals and businesses spend understanding and complying with the tax-transfer system could be devoted to more productive or satisfying activities."

[3] Section 295-85, *Income Tax Assessment Act ('ITAA') 1997*

custody movement charges, brokerage and administration costs). At a time when superannuation funds are experiencing record low performances driven by the financial crisis, this would be another negative impact on investors and the superannuation industry.

To the extent that investment strategies hold assets for less than twelve months, the tax rate applied to short-term capital gains is identical to that applied to revenue gains. Hence there is no net loss of revenue. The discount only applies to growth assets held for longer than twelve months and arguably these assets should be viewed as held on capital account in any event.

It is widely recognised that one of the key objectives of the Government is to make Australia the financial services hub of the Asia-Pacific region. Indeed, the Government introduced legislation which was designed to encourage non-residents to invest in Australian managed funds. Treating asset gains as revenue gains rather than capital gains will broaden the scope of the withholding tax measures for non-residents. This would seriously undermine the opportunity to make Australia the financial services hub of the Asia-Pacific region.

Foreign investors and global institutions look for countries which have a skilled workforce, certain and compliance-friendly regulation, political stability, and no over-taxing and tax uncertainties. Countries such as Ireland, Luxembourg and Singapore have these characteristics. If Australia truly desires to be seen as the financial services hub of the Asia-Pacific region, it cannot follow the revenue treatment option for MITs.

The Proposal

We strongly support a statutory rule to treat gains and losses made on growth assets held by MITs to be on capital account.

The impact on the funds management industry would be favourable on many levels. A statutory rule treating asset gains and losses on capital account would eliminate the uncertainties in the current system, prevent superannuation funds deserting MITs and encourage non-resident investment in the Australian funds management sector. Further, the rule would significantly reduce compliance costs and prevent further industry fragmentation which will add to transaction and administration costs.

2. A Statutory Rule to Determine Source of Income

The determination of source is another vital and long awaited issue for MITs. Currently, the ambiguous and uncertain source rules (or lack of) have created significant impediments to deter non-resident investors from choosing MITs for investment. To strengthen Australia's position as the financial services hub, we propose that a new statutory source regime, supplemented with an exemption for non-resident investment managers, is urgently required.

Australia taxes on two bases: residency and source of income.[4] Australian residents are subject to tax with respect to both Australian and foreign sourced income. Non- residents are subject to tax with respect to Australian sourced income only.

This chapter of our submission predominantly focuses on how source of income is determined and the numerous impediments and disincentives they create for non-resident investors.

Current source rules

There is no definition of, or clear concept of source in the legislation. Legislative reference to source applies to those beneficially entitled to income by deeming the source of that income to be the same as the MIT.[5] Recently, the issue of source in relation to assets held by non-residents on capital account is prescribed by the CGT provisions.[6]

Case law indicates that the source of income may be determined in two ways:

1. Operations test – source is determined by examining the essence of the business. For MITs, that is by examining such factors as where the majority of the research and investment management services are physically performed. The place where the contract is executed is generally not conclusive or determinative of source. Accordingly, this test seeks to examine the economic substance of a transaction, which is essential given the complexities of contemporary financial instruments and transactions. Its substance over form approach means tax outcomes are closely aligned to the economic objectives of transactions.

2. Transactions test – source is determined merely by reference to the geographic location of where the contract giving rise to the gain or loss is executed. It fails to take into account the true economic objectives and substance of most, if not all, transactions.

---

[4] Sections 6-5, 6-10, *ITAA 1997*.
[5] Section 6B, *ITAA 1936*
[6] Division 855, *ITAA 1997*.

We understand the ATO prefers the transactions test. There is a danger that non-resident investors will avoid the transactions test by prohibiting any dealings with Australian counterparties.

Ambiguous source rules will mean that rational non-resident investors or investment managers will prefer to not use Australian investment managers because they fear they might be subject to tax in Australia (unreasonably). Additionally, countries like Hong Kong and Singapore have similar exemptions that allow non-resident investment managers to trade securities without being subject to tax in the respective countries. These countries also have equally skilled and competent workforce, certain and compliance-friendly regulation, and political stability. Compared to these countries, Australia is anti-competitive in the international playing field and considerably less attractive to non-resident investors.

It would be contrary to the Government's objective to make Australia the financial services hub if determinations of source remain ambiguous and particularly if the ATO continues to follow the transactions test.

Our proposals

We propose a statutory rule to determine the source of income held by MITs. This way, uncertainties with existing rules can be eliminated and support Australia's position as the financial services hub.

We further propose an exemption for non-resident investors from Australian tax on gains from trading Australian securities.

3. Capital gains tax exemption for *in specie* redemptions in MITs

Our submission is for MITs to be provided with a concession such that capital gains and losses triggered by *in specie* redemptions are disregarded for Australian tax purposes. We support the retention of taxation when an investor sells or redeems their units in the MIT, or where capital gains are triggered by a cash redemption.

Without such a rule, the probability that Exchange Traded Funds ('ETFs') will develop in the Australian market to the extent seen in other developed countries is low. ETFs have numerous commercial features which make them desirable from both an investor and a regulator perspective. ETFs can bolster the Australian financial market and support Australia as a financial services hub of the Asia-Pacific region.

What is an ETF?

An ETF is generally a single-class unitised MIT, which has obtained a listing for its units on recognised investment exchanges for secondary market trading (e.g. ASX). It also has a primary market mechanism which effectively regulates supply and demand of its units, ensuring secondary market prices remain very close to the net asset value of the underlying investments. The ETF is a transparent vehicle which leads to an extremely robust pricing process. Applications and redemptions on the primary market are generally made *in specie* and not via the exchange of cash.[7]

An essential mechanism of the ETF is the efficient increase and decrease in ETF units for the underlying ETF holdings. ETFs motivate price competition for fund management strategies, enhance price discovery and increase market liquidity. Units in the ETF trade like any share on the stock exchange.

Growth of ETFs

Since the launch of the first ETF in the USA in 1993, ETFs have emerged as one of the most innovative yet stable financial products in the market. From late 2002, ETFs grew from 280 funds worldwide to 1,502 ETFs with 2,528 listings worldwide, assets under management of US$642.95 billion. These are managed by 85 providers on 43 exchanges as at the end of October 2008.[8] The USA has the largest number by far, 663 ETFs and US$454.38 billion, followed by Europe (587 ETFs and US$125.76 billion) and Japan (61 ETFs and US$23.23 billion).

---

[7] BGI Australia has a suite of these cross-listed ETFs, known as "iShares".

[8] Donald Jay Korn, "ETFs After the Fall", *Financial Planning Magazine*, 1 November 2008

To illustrate the contribution of ETFs to market liquidity, obviously an extremely valuable attribute in the current financial crisis, ETF trading accounted for 43% of all US equity trading in the week ended 21 November 2008. In the US market, 8 out of 10 of the most actively traded securities in the week ended 21 November 2008 were ETFs.

Transparency and liquidity have become significantly attractive features in the recent market turmoil

A core benefit of the ETF is knowing exactly what is owned by the fund at any given point. This has been attractive to those seeking to manage their risks during the recent credit crisis confronting global markets. Furthermore this transparency is combined with an ability to add or reduce ETF positions in large volumes if needed at very short notice. In order to acquire more market exposure, investors can have access to diversified exposure with simple and efficient means of buying at reliable prices.

Rationale

An unit in an ETF has the simplicity and appeal of holding a stock on ASX. Consistent with directly holding the underlying stocks, capital gains should not be triggered and distributed to investors as a consequence of the redemption of other unit holders while the investor continues to hold their units. Capital gains and losses within the ETF should only be realised at the investor level when the investment is sold (via ASX) or the ETF units are redeemed (via primary market). To do otherwise will discourage development of ETFs on the ASX.

Practically, some ETF providers and wholesale MITs may attempt to deal with the current problems of double taxation and externalities by allocating capital gains triggered by a redemption to the redeeming investor. This adds undue complexity to the capital gains calculations of those providers. It also adds uncertainty for the ETF and wholesale MIT providers in respect of whether the ETF or MIT satisfies the legislative definition of fixed trust.

The exemption for capital gains and losses will create simplicity for the MIT and the investor. This contributes to a greater level of certainty for investors about their tax outcomes as well as minimising compliance costs. All of these benefits would encourage the use of ETFs as investment vehicles in Australia.

Revenue neutrality

We submit that the overall impact of the exemption for capital gains triggered by *in specie* redemptions will be small. While the change will potentially reduce capital gains tax revenue through reducing the unfair timing advantage currently enjoyed by the ATO under existing rules, the recent market price declines will mean that this effect is small in the current

environment. In addition, Australia's economy will benefit from the expansion of the ETF market and increased attraction of Australian managed funds for non-residents.

We note that our submission still requires that capital gains are recognised by an investor at the time of sale (via ASX) or redemption (via primary market).

Overseas experience

As previously noted, the overseas experience is that certain countries such as Singapore and Hong Kong have committed to simple and predictable tax regimes with no over taxing and no taxes on capital, particularly due to the actions of other investors in the fund. Most of these countries have strong ETF markets as a result. We submit that the exemption for capital gains and losses triggered by *in specie* redemptions within MITs (and specifically ETFs) would greatly assist in making Australia more competitive in the international arena as well as in the Asia-Pacific region.

The USA, as the largest provider of ETFs in the world, operates from a model where only capital gains from rebalancing activity[9] within the fund are recognised and distributed. That is, capital gains from *in specie* redemptions are disregarded,[10] although investors are also taxed on their capital gains when they sell or redeem their units in the ETF.

Our Proposal

We propose that capital gains and losses which are triggered as a result of *in specie* redemptions from MITs, should be disregarded for tax purposes.

The impact on the funds management industry and ETFs in particular would be favourable on many levels. By disregarding capital gains and losses triggered by *in specie* redemptions in a MIT, double taxation is eliminated and investors are not exposed to any tax consequences from other investors' redemptions. Further, disregarding the capital gains and losses removes the uncertainties regarding fixed trust issues.

---

[9] ETFs are largely index tracking funds and capital gains from rebalancing activity would be minimal.
[10] Internal Revenue Code section 852(b)