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

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By email: taxboard@treasury.gov.au

Dear Mr Warburton Richard

MANAGED INVESTMENT TAX REGIME: INTERNATIONAL TAX SUBMISSION

The Investment and Financial Services Association (IFSA) is pleased to lodge this submission which seeks to address the current Board of Tax 'Review of Tax Arrangements Applying to Managed Investment Trusts'. Specifically, this submission is directed at the capacity of Australia's managed funds industry to attract funds under management from other countries.

Historically, the Australian tax system has been a significant barrier to the flow of funds from foreign investors through Australian trusts. Indeed, if Australia is to compete with the other major international fund centres, it is imperative that there is certainty about the operation of Australia's tax laws as they impact upon non-resident investors.

It is also imperative that non-resident investors suffer no additional tax impost by reason of investing through an Australian resident fund than would have been the case had they invested in the underlying assets directly or through one of the other international fund centres.

This submission supplements IFSA's earlier submission to the Board and sets out a range of issues relating to Australia's tax law and the administration of that law which need to be addressed before Australia can seriously compete with the established international fund centres.

Should you have any questions, please do not hesitate to contact either myself or Martin Codina, Senior Policy Manager, Global Markets, on 02 9299 3022.

Yours sincerely

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Investment & Financial Services Association Ltd

BOARD OF TAX SUBMISSION: TAX MEASURES TO DEVELOP AUSTRALIA INTO A REGIONAL FINANCIAL SERVICES CENTRE

1. Capital or Revenue Status of Assets

1.1 Assets held by an Australian unit trust

A major area of uncertainty in terms of the administration of Australian tax law is the issue of whether an Australian unit trust holds its assets on capital account or alternatively on revenue account. The difference in treatment can be quite significant for a non-resident investor.

There are no statutory rules for determining whether assets are held on capital or revenue account. Rather, there is a long history of complex and often conflicting court decisions, many of which do not take in account the practicalities of investing in the modern world.

In its report of July 1999, the Ralph Review of Business Taxation recommended that certain assets such as shares and other membership interests, land and buildings be subject to statutory CGT treatment (refer Recommendation 4.10). However, this recommendation has to date not been acted on by Government.

If the assets of the Australian unit trust are held on capital account then Subdivision 855-A of the Income Tax Assessment Act 1997 may apply to exempt a non-resident investor on its share of capital gains realised by the trust and distributed to the non-resident and also on capital gains realised on disposal of units in the trust. However, Subdivision 855-A does not provide an exemption in relation to revenue gains and if the assets of the trust are held to be on revenue account then a gain distributed to the non-resident would be subject to Australian tax to the extent the gain has a source in Australia.

It can be difficult for a potential non-resident investor to appreciate the technical distinction between "revenue" (e.g. equity futures) and "capital" (e.g. equities) assets as both kinds of assets can be used to provide the same economic or asset class exposure. However, the current distinction in the tax law often compels the potential non-resident investor to address this complex issue when evaluating the attractiveness of an Australian managed fund investment, or else choose an alternative (non-Australian) product where the rules and treatment are clear.

Consequently, it is proposed that the tax law be amended to make the CGT provisions the primary code for calculating gains and losses in respect of shares, property and trust units held by Managed Investment Trusts. This is consistent with recommendation 2.1.8 of IFSA's March 2006 submission on a Managed Investment Tax Regime.

1.2 Units held in an Australian unit trust

Where units in an Australian trust are held on revenue account by a non-resident investor any gain realised on disposal of the units will (assuming it has an Australian source) be subject to Australian tax as ordinary income. Subdivision 855-A which deals only with capital gains will not relieve the gain from Australian tax. In these circumstances, the non-resident may be subject to Australian tax regardless of the underlying assets held by the trust.

As a complementary measure to 1.1 above, it is suggested that the tax law be amended to make the CGT provisions the primary code for taxing non-resident investors on gains and losses arising on disposal of units in Australian Managed Investment Trusts.

2. Lack of Statutory Rules for Determining Source of Income and Gains

The general scheme of the trust provisions in the Australian tax law is that non-resident beneficiaries in an Australian trust will only be subject to tax on income and gains having a source in Australia. However, there are no statutory rules for determining source.

There are two schools of thought in relation to the determination of the source, for tax purposes, of an item of income or a gain. The first and preferred view is known as the "transactions test" which provides that a gain on the disposal of securities will be sourced at the place where the contract giving rise to the acquisition and disposal of the securities is executed. Consequently, if securities are purchased and sold on a foreign stock exchange the source will be taken to be outside Australia.

The alternative view is known as the "operations test" and provides that the source of a gain will be the place where the decision making as to which security to buy and sell takes place. For an Australian resident trust which is managed from Australia this test may give rise to an Australian source notwithstanding that the securities are traded outside Australia.

Whilst it is generally believed that the Australian Taxation office supports the transaction test in determining source on disposal of securities, the position is not beyond doubt and clarification in this area would be welcome.

Other jurisdictions have dealt with similar issues by introducing a 'fund manager exemption' to ensure that non-resident investors do not create a taxable presence in these jurisdictions merely by virtue of having appointed a local fund manager to manage their money. Such an exemption has been introduced in the UK and Hong Kong and is currently proposed in Japan.

A similar exemption could be used in Australia, to address situations in which foreign source income flowing through to non-residents is taken to be Australian source income under Australian tax law because the management and control function is performed by an Australian fund manager. So doing would provide a significant boost to the export activities of the funds management industry.

3. Operation of Division 6 and in particular Section 99A of the 1936 Act

There are two generally accepted principles in relation to the taxation of trust income and gains which are relevant from the point of view of a non-resident investor.

The first is that a non-resident beneficiary in a trust should only be subject to Australian tax to the extent that their share of the trust net income comprises income or gains sourced in Australia.

The second is that provided the beneficiaries of a trust are presently entitled to all of the distributable income of the trust, all of the trust net income for tax purposes should be assessed to the beneficiaries as appropriate and no part of the trust net income for tax purposes should be subject to tax in the hands of the Trustee other than effectively as agent for a non-resident.

A recent Interpretative Decision of the ATO in ATO ID 2005/200 was inconsistent with these principles. The ATO found that the trustee of an Australian resident trust should be subject to tax under Subsection 99A(4A) of the 1936 Act in relation to attributed Foreign Investment Fund Income of the trust notwithstanding all of the beneficiaries of the trust were non-residents of Australia and those beneficiaries where presently entitled to all of the distributable income of the trust.

It is understood that the ATO recognises that their decision on the operation of Section 99A is contrary to the policy intent of the provisions. This matter needs to be rectified promptly either by legislative amendment or by withdrawal of the ATO ID and issue of an amended ATO ID.

4. Extension of Foreign Investment Fund Exemption for Fixed Trusts Wholly Owned by Complying Superannuation Entities

Division 11A of Part XI of the 1936 Act provides an exemption from the FIF regime for virtual PST assets, segregated exempt assets and interests held by complying superannuation entities. Under subsection 519B(3) the exemption is also extended to fixed trusts which are wholly owned by such entities.

Given that from a policy perspective Australia does not seek to tax non-residents on ex-Australian income and gains, there would appear to be no reason why non-resident investors should be excluded from the list of eligible investors in trusts enjoying the benefit of the FIF exemption. Similarly, Australian resident investors which are exempt from tax (e.g. charities and government bodies) should also be permitted to invest in such trusts without the exemption being prejudiced.

It is important from the point of view of economies of scale that fund managers be allowed to include non-residents in existing trusts rather than be forced to establish new trusts to accommodate them.

5. Treatment of Foreign Exchange and Other Hedging Gains

Related to the issue of source as outlined at point 2 above, the treatment of foreign exchange (FX) gains and losses can be problematic. FX hedging contracts are typically used by fund managers to offer investments in asset classes denominated in a foreign currency without the concomitant exposure to the currency fluctuations (that is, the investor will always get exposure to both currency movements and the underlying asset class unless the fund manager strips away the FX exposure using hedging contracts).

Often, the non-resident investor does not want the FX exposure (just the pure asset class returns) and will be less likely to invest with the fund manager unless the manager offers FX hedging. The tax law treats FX gains as statutory income rather than capital gains and where those gains have an Australian source an Australian tax liability may arise in respect of a non-resident unit holder's share of the gains. Whereas, currently fund managers may seek to execute hedge contracts offshore in order to ensure that non-resident investors are not disadvantaged, in practise that may be difficult to control and is an unnecessary administrative burden.

Similar issues arise in relation to other hedging contracts such as futures and forwards.

It is proposed that the tax law be amended such that non-resident investors in an Australian trust would not be subject to tax on hedging gains which relate to ex-Australian assets irrespective of where they are sourced. It would also make sense to exempt hedging gains relating to Australian assets which are non Taxable Australian Property as defined in section 855-15 of the Income Tax Assessment Act 1997.

It is considered that such an exemption would not be detrimental to the Australian Revenue given that little tax would currently be collected on such gains and if the measure allowed Australian fund managers to increase their funds under management by attracting more non-resident investors', tax collections from funds managers' fee income would increase.

6. Modification of Eligibility Criteria for Trust Exemption in Offshore Banking Unit (OBU) Provisions

The OBU provisions of Australia's tax law currently provide for an exemption from tax for the income of a trust of which an OBU is a trustee or the central manager and controller, where all of the investors in the trust are non-residents and the investment activities are limited to those prescribed within the OBU provisions (refer section 121EL of the *Income Tax Assessment Act 1936*).

Unfortunately, those investment restrictions are extremely onerous and difficult to comply with in practice. Consequently very few funds qualify for the exemption and the Government's intention of encouraging the management of ex-Australian assets on behalf of non-residents is unfulfilled.

It is suggested that some minor relaxation of the investment restrictions could improve this position. In particular it is suggested that:

(i) the requirement in section 121D(6A)(d) that "the currency in which the investment is made is not Australian currency" be deleted;

(ii) foreign exchange and other hedging contracts be excluded from the definition of "Australian thing" in section 121DA(5) for the purpose of determining the average Australian asset percentage (which must not exceed 10%)

(iii) that the provisions be modified to accommodate the position where the '121EL Trust' has a trustee which is independent of the OBU manager of the trust. This could be achieved by inserting the following words at the end of paragraphs (a) and (b) of subsection 121DA(6): "or the trustee of a trust which satisfies each of subparagraphs 121EL(1)(a), (b) and (c)".