FINANCIAL SERVICES COUNCIL

15 October 2015

House of Representatives Standing Committee on Tax and Revenue
Parliament House
PO Box 6021
Canberra ACT 2600

Email: taxrev.reps@aph.gov.au

Dear Sir/Madam

RE: INQUIRY INTO TAX EXPENDITURES STATEMENT

The Financial Services Council (FSC) has over 115 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The industry is responsible for investing more than $2.6 trillion on behalf of 11.5 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world. The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The Tax Expenditure Statement (TES) is a source of concern for the financial services industry. Whilst we understand and support its purpose of providing costings of government policy initiatives that result in a notional decrease in tax collected, we are concerned that figures are inaccurate and send a confusing message to the public.

Simply identifying items from the TES and claiming that a policy results in an "X dollar decrease to government revenue" does not take into account the complexity of the taxation system as a whole, nor taxpayer behaviour. It also fails to take into account the relevant benchmark against which an expenditure item should be measured.

If tax expenditure items in the TES were reversed the government would not receive the relevant foregone income. Instead other second round behaviour would occur as a result of the removal of any tax concession. Second round effects are not modelled in the TES and whilst we understand the difficulties associated with modelling these in many cases, it is unrealistic to assume them away.

We believe there would be significant benefit in releasing more detailed information in relation to costing assumptions. This would allow industry to provide greater input into the process and to provide additional information when policies are designed. It would also provide Australians with greater certainty regarding the reliability of the TES.

Further, we believe it is essential that items costed in the TES are measured and reported against 'actuals' to the extent possible.

In Appendix A we outline issues with the TES in relation to the calculation of superannuation tax concessions and in Appendix B we outline issues in relation to exporting funds management. These examples are provided as case studies to highlight the practical limitations of the current TES process.

Should you wish to discuss this submission further please do not hesitate to contact me on [redacted]

Yours sincerely

[redacted]

ANDREW BRAGG
Director of Policy & Global Markets

Appendix A

SUPERANNUATION

Debate around the taxation of superannuation has been undermined by misuse of the Tax Expenditures Statement (TES).

Misuse of the TES threatens the capacity for meaningful and informed debate around the tax treatment of superannuation and the capacity for publicly supported reforms that improve the effectiveness of the superannuation system.

The impact of behavioural change

The methodology underpinning the TES ensures that it is not a reliable basis for interpreting the cost to the Commonwealth of the superannuation system. In particular, claims that the earnings tax 'cost' the taxpayer $16 billion per annum are incorrect.

Treasury itself has conceded the flaw in classifying the current earnings tax arrangement as a 'concession':

> 'The revenue foregone approach - this approach measures the difference in tax paid by taxpayers who receive a particular concession relative to similar taxpayers who do not receive that concession. It compares the current/prospective treatment to the benchmark treatment, assuming taxpayer behaviour is unchanged. Accordingly, revenue foregone tax expenditures measure the impact of a concession in terms of the benefit taxpayers derive from the concession given their behaviour once it is in place.[1]
>
> …Care should be taken when interpreting the tax expenditure estimates presented in this document. The estimates of reported tax expenditures are not necessarily reliable indicators of the budgetary impact of removing particular tax concessions.'[2]

Superannuation provides a pool of national savings that would not exist in the same quantum if the superannuation system did not exist. It is wrong to assume that superannuation savings could be taxed at the full rate in the absence of mandatory savings as there would be behavioural change and the money would be saved or consumed elsewhere, such as further investment in housing.

Superannuation savings, like other forms of savings, should be lightly taxed, if at all. Research from the Reserve Bank of Australia (RBA) indicates that compulsory superannuation contributions are not offset by reductions in other forms of saving.[3] An extra dollar in

---

[1] Tax Expenditures Statement 2012 at 16
[2] Ibid at 19
[3] Connolly, E., The Effect of the Australian SG on Household Saving Behaviour, Reserve Bank of Australia Research Discussion Paper 2007-08.

superannuation is estimated to add between 70 and 90 cents to household wealth. The increase in household wealth is highest for lower income households.

There is a strong evidentiary basis, articulated in the Australia's Future Tax System (AFTS) report, for lightly taxing savings that are preserved for retirement incomes.

The AFTS Review argued:

> 'There is a general case for providing concessions under income tax arrangements for all forms of savings to reduce distortions in the relative treatment of current and deferred consumption... Beyond this, reasons for favouring additional tax assistance for superannuation include the social benefits of overcoming life cycle myopia and compensating for compulsion and preservation.'[4]

The 2012-13 Budget also detailed the importance and benefits of a higher rate of national savings[5]:

- it moderates price pressures, providing scope for monetary policy to respond to economic developments;
- it is prudent for a portion of national income, which is temporarily elevated by the mining boom, to be saved for the future;
- borrowing less and saving more makes Australian companies more resilient to external shocks by having access to a pool of domestic capital; and
- the ageing of Australia's population means that more should be saved now in order to support a progressively older population.

Treasury analysis has demonstrated the unreliability in using the revenue foregone approach as a measure of the 'cost' of earnings tax concessions to Australian taxpayers. Treasury modelled alternatives to the comprehensive income tax benchmark as included in Appendix A in the 2013 Tax Expenditures Statement, which demonstrated that the tax expenditure on superannuation entity earnings, previously estimated to be worth $16.1 billion in 2013-14, is revised to negative $5.8 billion.[6]

By adding to the pool of national savings and supporting the stability of the national economy, superannuation earnings, like other forms of savings, should be lightly taxed, if at all. The TES estimates of earnings concessions should be dismissed as an unreliable measure of the costs of the superannuation system as it fails to consider behavioural change, should tax rates change.

---

[4] AFTS at Section 3.5
[5] 2012-13 Commonwealth Budget, Statement 4
[6] Appendix A, Tax Expenditures Statement 2013

Savings derived from superannuation

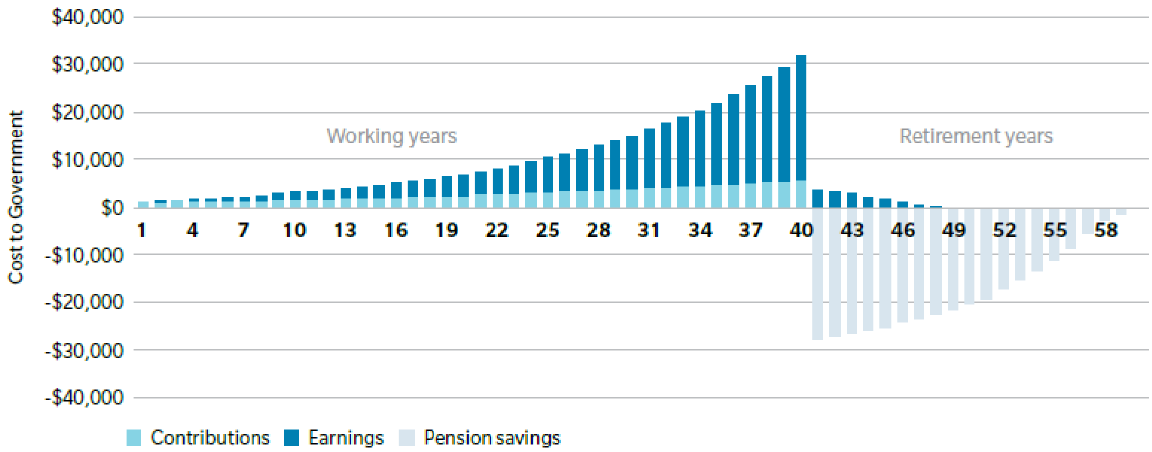
In its comprehensive report *Tax & Superannuation: The Shortcomings of the Superannuation Tax Expenditures* Mercer demonstrated that by ignoring Government savings from reduced age pension costs, the Treasury approach in the TES is fundamentally flawed.

Mercer cautioned that, if used to develop long-term retirement income policy, the TES would be likely to lead to sub-optimal outcomes for individuals, households and the Government.[7]

The TES failed to recognise the savings Government derives from the superannuation system over and individual's life.

Chart 1 below shows the savings to Government of the future age pension payments in respect of an average income earner who works for 40 years and then has a retirement period of 20 years. It is clear the accumulated superannuation benefit reduces future age pension payments at a significant saving to Government.

Chart 1. The costs and savings of an average income earner



The FSC is concerned that these savings are ignored in the TES figures and that persistent misconceptions around the tax treatment of superannuation put at risk the capacity for an informed, evidence-based debate.

[7] *Tax & Superannuation: The Shortcomings of the Superannuation Tax Expenditures*

Appendix B

EXPORTING FUNDS MANAGEMENT

In November 2009 the Johnson Report[8] was delivered to government. It contained a series of recommendations designed to improve Australia's standing as a financial centre and increase financial services exports.

Collective Investment Vehicles

The Johnson Report recommended that the government introduce a wider range of tax flow through vehicles to supplement the existing managed investment trust structure and to ensure that more activity would be located in Australia.[9]

Managed investment trusts are underpinned by a unit trust structure which is quite unique to Australia. The report noted the following in relation to their effectiveness in attracting offshore investors:

> "Many potential non-resident investors in Australian funds, particularly in the Asia-Pacific region, do not come from common law jurisdictions. Neither they nor investment advisers in the region are typically familiar or comfortable with trust structures. They are more familiar with managed funds structured as a corporate vehicle or a limited partnership. The lack of widespread use or recognition of unit trusts in the region contributes to Australian based funds management companies typically using collective investment vehicles that are established and administered offshore, such as in Luxembourg, Dublin or the Cayman Islands, and in some cases also basing their fund managers offshore. This is expensive, time consuming and not in Australia's interests. It results in employment in areas such as fund administration, accounting, legal, custody and other services being lost to offshore centres, with consequent loss of tax revenue in Australia."[10]

The Johnson Report also suggested that the issue be put to the Board of Taxation for consideration[11] and the then Assistant Treasurer and Minister for Financial Services instructed the Board on 11 May 2010.[12]

---

[8] Report delivered by the Australian Financial Centre Taskforce 'Australia as a Financial Centre – Building on our Strengths' November 2009 (the 'Johnson Report') <http://afcf.treasury.gov.au/content/final_report%5Cdownloads%5CAFCF_Building_on_Our_Strengths_Report.pdf>

[9] Ibid, p 64 "Recommendation 3.3 Funds management vehicles".

[10] Ibid, p 62.

[11] Ibid, p 63.

[12] Bowen, C. and Sherry, N. 'Government Response to Australia as a Financial Services Centre Report' Press Release 11 May 2010. <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/050.htm&pageID=003&min=ceba&Year=&DocType=0>

The Board reported to government in December 2011 but the Report was not released publically until June 2015 as a part of the government's Tax White Paper discussion paper process.[13]

The FSC understands that the delay in releasing this paper was in part due to the costing produced by Treasury when examining the recommendations. We understand this was due to tax expenditure forecasts having to be made for the perceived 'tax concession' that the new vehicles would receive. The result was that the regime was thought to have a significant cost to revenue.

From the perspective of industry it is unfathomable that collective investment vehicles which are common place in successful global funds management centres, such as London and Luxembourg, could provide such a large potential for revenue loss. In reality no revenue is lost from the introduction of a wider range of CIVs as the activity which would occur through new vehicles is either:

- already being undertaken through existing vehicles, such as managed investment trusts, and thereby already receiving tax flow through treatment; or
- is not being undertaken at all, and therefore does not contribute to government revenue or GDP.

It is our view that Treasury advice relating to the cost of the CIV regime is likely to have been a significant factor in the then government's delay in releasing the Board of Taxation report in a timely manner. As a result this Johnson recommendation from six years ago has still not yet been formally committed to by government.

This is a regime which could easily have been legislated within a year of the recommendation being handed down. Existing regimes for a corporate CIV in the United Kingdom (the open-ended investment company - OEIC) or in Luxembourg (Société d'investissement à capital variable – SICAV) offer tried and tested examples which could be incorporated into Australia's legislative framework, without the need to reinvent the wheel.

For limited partnership CIV structures, examples abound in the United States and United Kingdom that could again be adopted and adapted to the Australian framework.

The current predicament is that Australia has signed on to the Asia Region Funds Passport, due to commence in 2016, but lacks the necessary domestic CIV framework to be able to effectively compete. The suite of Johnson reforms, which were intended to work together, have become fragmented and we are now at risk of opening up the Australian market without first having our own house in order.

Withholding Taxes applying to Managed Investment Trusts

There are four kinds of withholding tax which can apply to distributions made by managed investment trusts (MITs). Because MITs are tax flow through vehicles, the character of any

[13] Board of Taxation Website 'Taxation Treatment of Collective Investment Vehicles' <http://taxboard.gov.au/consultation/taxation-treatment-of-collective-investment-vehicles/>

income derived from underlying investments is maintained as that income is passed through them to the beneficial owner.

This means that investors into MITs must be cognisant of the taxation implications of the withholding taxes charged on dividends, interest and royalties, but they are also subject to withholding on any components of a distribution considered a 'fund payment'.

A fund payment is a component of a payment made by the trustee of a MIT that, in effect, represents a distribution of its net income of the MIT, but exclude:

- dividend, interest or royalty income (as defined in Division 11A of the Income Tax Assessment Act 1936 subject to (or exempted from) a requirement to withhold under Subdivision 12-F of Schedule 1 of the Tax Administration Act 1953;
- capital gains and losses from a capital gains tax asset that is not taxable Australian property;
- amounts that are not from an Australian source; and / or
- deductions relating to any of the above amounts.[14]

The rates applicable for withholding of dividends, interest and royalties are determined by the relevant tax treaty between Australia and the investor's country of origin. The rate of withholding applicable to fund payment components is determined by whether the investor's country of origin is considered to have an 'effective exchange of information' agreement with Australia.

The result is that foreign investors are subject to complex withholding tax arrangements that require considerable administration and compliance procedures to manage.

It is imperative that in such a complex and administratively burdensome regime, there is accurate costing of changes to taxation rates. In addition it is essential that actual numbers reported to the ATO by MITs are publically disclosed so that the actual consequences of policy changes can be measured.

Currently the Tax Expenditures are calculated through a non-transparent process and no actual numbers for withholding taxes (of any kind) are reported for foreign investors. This is despite that information being provided to the ATO through the Annual Investment Income Report.

The implications of incomplete, possibly inaccurate and opaque estimate methods is highlighted by the case of the withholding tax on fund payments from MITs – the Managed Investment Trust Fund Payment withholding tax (or 'fund payment WHT')

[14] Source ATO Website 'Withholding Tax arrangements for managed investment trust fund payments' https://www.ato.gov.au/Business/International-tax-for-business/In-detail/Investing-in-Australia/Withholding-tax-arrangements-for-managed-investment-trust-fund-payments/

History of the Managed Investment Trust fund payment withholding tax

A reduction in the Fund Payment WHT rate was first canvassed in May 2007 by the Hon Kevin Rudd, then leader of the Opposition, where he made an election commitment to halve the rate from 30% to 15%.[15]

On 13 May 2008, Treasurer Wayne Swan announced the 2008-09 Budget and issued a joint press release[16] with then Assistant Treasurer the Hon Chris Bowen announcing that the Fund Payment WHT rate would be substantially reduced from a non-final rate of 30% to a final rate of 7.5% on certain distributions from Australian MITs to foreign resident investors. The Treasurer stated:

> "Residents of jurisdictions with which Australia has effective exchange of information arrangements, to be specified by regulation, be subject to a non-final withholding tax at the rate of 22.5% for the first income year (intended to be 2008-09); a final withholding tax of 15% for the second income year (intended to be 2009-10**);** and a final withholding tax of 7.5% for the third (intended to be 2010-11) and later income years".[17]

Of note was the Government's explicit commitment that the 7.5% rate would carry forward in later income years. This formed the premise for foreign investors to invest into MIT structures in Australia (often in precedence to other less favourable jurisdictions).

The announcement stated the arrangements were intended to make Australia's withholding tax rate:

> "one of the most competitive in the world, and provide a significant boost to Australia's ability to compete globally.
>
> The arrangements will ensure Australian property trusts (which will be primarily affected by the new arrangements) are well placed to attract future foreign investment now and into the future.
>
> This will provide a major boost to Australia's goal of becoming a financial hub in the Asia-Pacific region and goes beyond the commitment made during the election."[18]

Consistent with the 2008-09 Budget announcement, the measure was included in the 2008-09 Budget Papers, where it was reported under the heading 'Election Commitments' that a final withholding tax rate of 7.5% was intended to apply for the "2010-11 and later" income years.[19]

---

[15] Kevin Rudd, Federal Opposition Leader, *Budget Reply Speech,* 10 May 2007
http://australianpolitics.com/2007/05/10/2007-budget-reply-speech-kevin-rudd.html
[16] Wayne Swan, Deputy Prime Minister & Treasurer and Chris Bowen, Assistant Treasurer & Minister for Competition Policy and Consumer Affairs, *Joint Press Release - Establishing Australia as a Regional Financial Hub*
http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/043.htm&pageID=003&min=wms&Year=&DocType=0
[17] Treasurer's Press Release no. 043 of 2008
[18] Ibid

The government subsequently implemented these staged changes in accordance with the announcement.

On 18 October 2010, the then Assistant Treasurer and Minister for Superannuation and Financial Services, the Hon Bill Shorten, released a discussion paper on the new tax system for managed investment trusts which referred to the 7.5% rate.[20]

The discussion paper called for comment on additional measures that were to have effect from 1 July 2011 and stated that:

> "Two major features of the Government's new tax system for MITs have **already been legislated.**
>
> The trustee of a MIT can choose to apply the capital gains and losses (capital gains tax) regime to disposal of eligible assets.
>
> Also**, a reduced rate of final withholding tax (of 7.5 per cent) applies to most foreign investors on fund payments from a MIT**."[21]

As part of the 2012/13 Budget the then Treasurer announced that the Fund Payment WHT would be doubled from 7.5% to 15%.

Recommendations:

1. The Tax Expenditure Statement should include detail on assumptions unpinning the expenditure estimates.

2. Tax expenditures should be report against actual numbers collected by the ATO in the ABS Taxation statistics (particularly for items such as this where there is specific data being reported to the ATO and it is relatively easy to measure).

3. Treasury should adopt a better approach for developing costings for items that are about taking a share of global revenue from other countries – i.e. items that are not based on a domestic immobile taxpayer base.

---

[19] Budget Measures 2008-09, Budget Paper 2, p13, at http://www.budget.gov.au/2008-09/content/bp2/html/revenue-07.htm

[20] Bill Shorten, Assistant Treasurer & Minister for Superannuation and Financial Services, *Press Release - Release of Discussion Paper on Implementation of the New Tax System for Managed Investment Trusts* 18 October 2010 http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/004.htm&pageID=003&min=brs&Year=&DocType=

[21] Ibid