FINANCIAL SERVICES COUNCIL

2019–20 Federal Budget

Submission to Treasury

Contents

1. About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 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 fourth largest pool of managed funds in the world.

2. List of recommendations

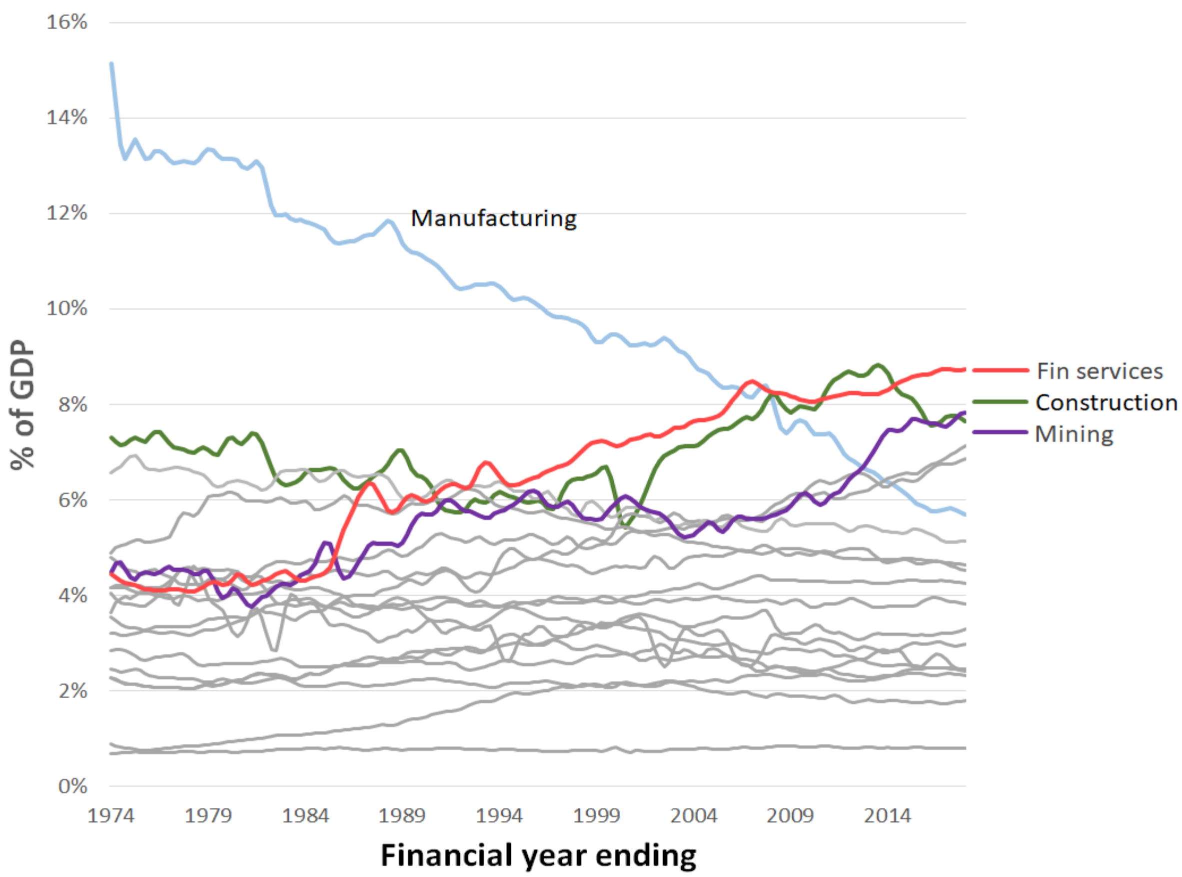
The FSC recommends:

- The Government deliver on its commitment to facilitate the rationalisation of legacy products in financial services. This should involve a consumer interest test applied at a collective level; roll over of all tax attributes to the new vehicle; and no tax implications of the rollover itself.
- The Government implement a zero rate of Non-resident withholding tax on Passport payments, excluding both direct and indirect income from Australian real property.
- The Government should prioritise meeting existing commitments to address outstanding Investment Manager Regime (IMR) issues, extend the attribution regime to Investor Directed Portfolio Services, and fix outstanding issues with the Taxation of Financial Arrangements.
- The Government's proposal to remove the CGT discount at fund level not proceed, and instead be replaced with a measure targeted at corporates and non-residents that are accessing the CGT discount through MITs and AMITs.
- If unfavourable changes occur to the Offshore Banking Unit (OBU) regime, then the Government should not proceed with proposed changes to AMIT penalties and the CGT discount at fund level to offset the industry-wide adverse effects of the OBU changes.
- The Government place a priority on negotiating a tax treaty with Luxembourg and Hong Kong and addressing financial services issues in existing tax treaties. We also encourage the Government to ensure that any new Free Trade Agreements are accompanied by a tax treaty.
- The Government pursues a reduction in the overall corporate tax rate to 25%, preferably lower

3. Introduction – importance of financial services

The financial services industry is the largest industry in the Australian economy, and has grown to contribute about 9% of Australia's GDP as shown in Figure 1 below. The sector is larger than the mining, manufacturing, education and construction industries.

Figure 1 – Industry share of GDP



Source: ABS Australian National Accounts: National Income, Expenditure and Product, Table 6.

The industry employs over 440,000 people,[1] and has one of the best productivity performances — multifactor productivity growth in the financial services industry since 1996 is the third highest of any industry,[2] as shown in Figure 2 below.

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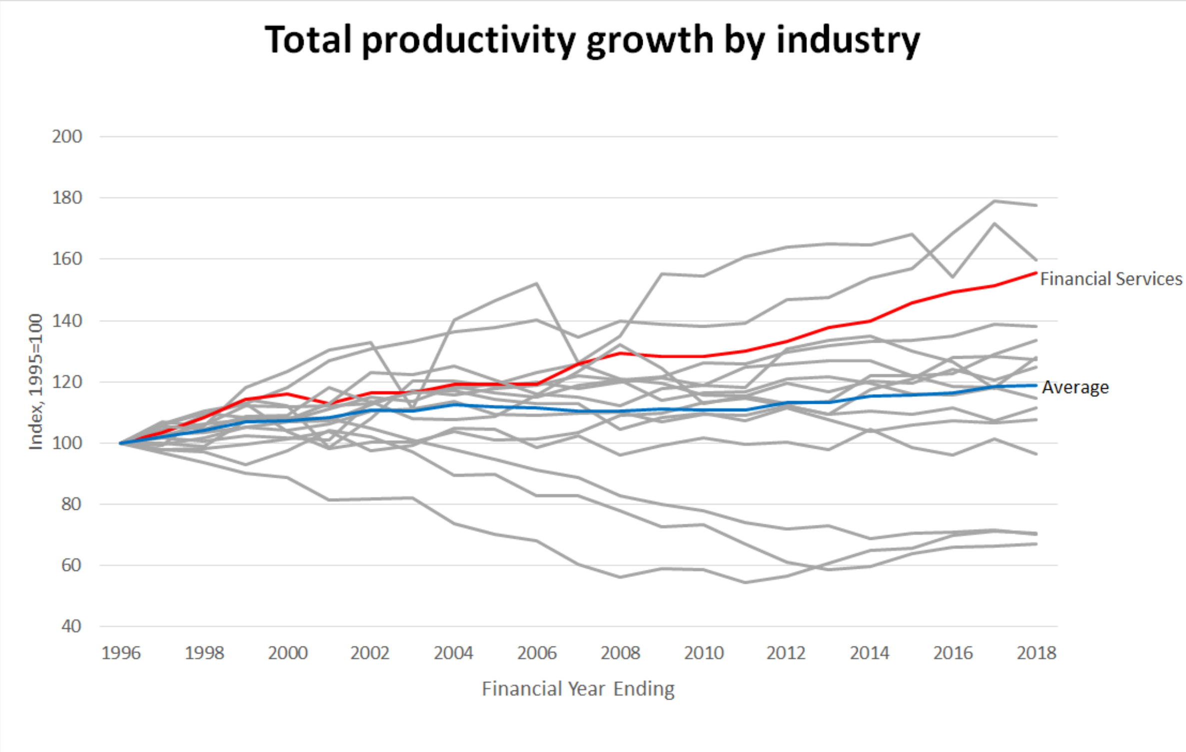
[1] ABS Labour Force, Australia, Detailed, Quarterly, Nov 2018
[2] The best performer is wholesale trade and the second best is agriculture.

Figure 2 - Total productivity growth since 1996

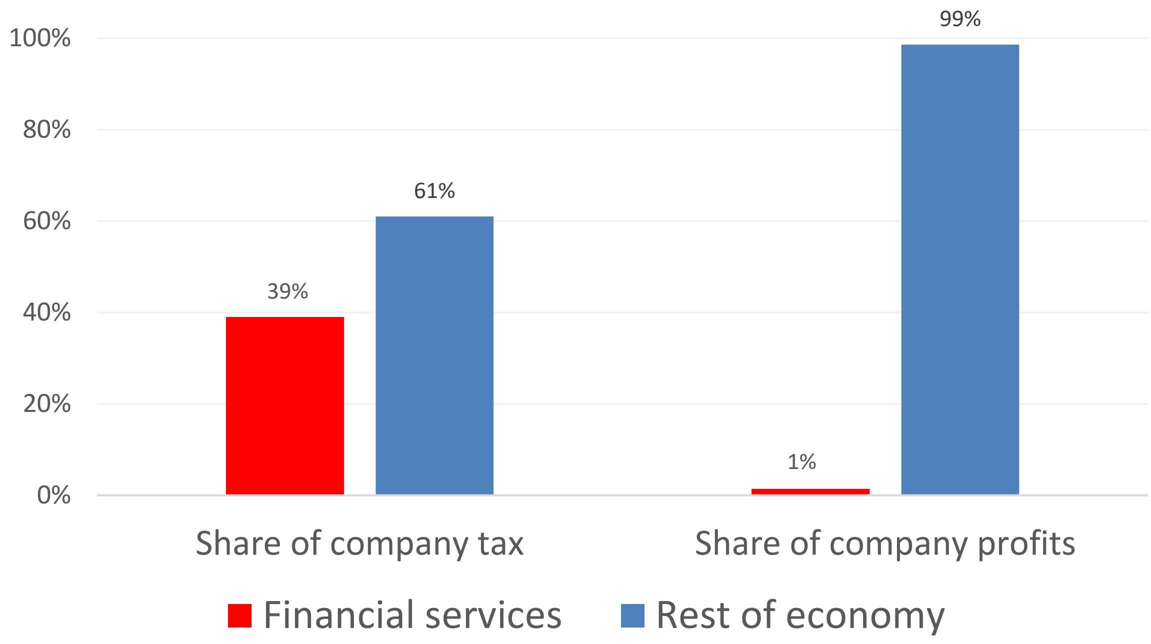


Source: ABS Estimates of Industry Multifactor Productivity, 2017-18. Figures are for multifactor productivity growth. Financial services industry also performs strongly on labour productivity growth.

The financial services industry pays a disproportionate share of company tax — see Figure 3 below showing financial services as a share of total company profits and as a share of corporate tax paid. This confirms earlier more detailed analysis by Treasury.[3]

[3] Chart 1 of John Clark, Peter Greagg and Amy Leaver (2011) "Average rates of company tax across industries revisited", *Economic Roundup* Issue 2.

Figure 3 – Financial services share of tax vs share of company profits (2015–16)



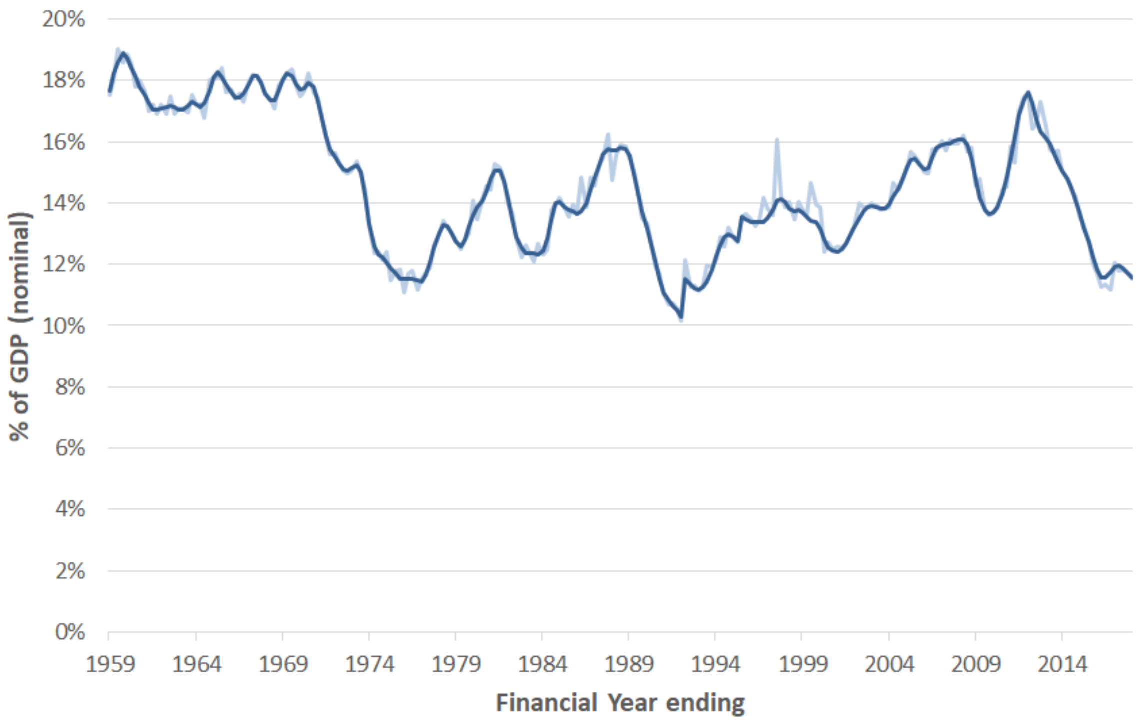
Sources: ATO Taxation Statistics 2015–16 and ABS 5676.0 - Business Indicators, Australia, Table 11.

More data on the financial services industry is in Section 6 below (funds management exports and competitiveness).

4. Australia's investment problem & savings gap

Business investment in Australia is at very low levels, well below the levels from before the mining boom, as shown in Figure 4 below.

Figure 4 – Business investment as % of GDP



Source: ABS Australian National Accounts: National Income, Expenditure and Product, Table 3. Light line is seasonally adjusted figures; dark line is trend.

This is linked to weakness in domestic saving and foreign capital inflows.[4] Australia needs to boost both domestic saving and foreign capital inflows to allow more funds for investment. Domestic savings will be boosted by the ongoing increase in the superannuation guarantee to 12%,[5] while foreign capital will be boosted by reductions in the tax on foreign capital – which can particularly be achieved by reducing the company tax rate (see section 7.6 below).

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[4] The weakness in domestic saving is shown in ABS Australian National Accounts: National Income, Expenditure and Product, Table 11, and in foreign capital flows into Australia is shown in ABS Balance of Payments and International Investment Position, Table 1.

[5] One study suggests an increase in Australian saving by $1 causes an increase in investment of 50–60c, see Saten Kumar, Scott Fargher and Don Webber (2009) "Testing the Validity of the Feldstein-Horioka Puzzle for Australia", *Applied Economics*, 44 (5), pp599–605.

5. Product rationalisation

Product rationalisation was a recommendation of the Government's Financial Services Inquiry (FSI) in 2014, and in 2015 the Government announced it accepted this recommendation.

The FSI argued:[6]

> ***Recommendation 43: Legacy products***
>
> *Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors.*

In response, the Government made the following commitment:[7]

> *The Government agrees to facilitate the rationalisation of legacy products, in light of consumer, constitutional and fiscal issues.*
>
> *It is important that consumers should not be worse off due to any transition to a newer product. Under the existing framework there are possible tax implications of facilitating the transition away from legacy products, which will be explored in the context of the Government's Taxation White Paper process.*

The need for rationalisation of legacy products was also highlighted in the Royal Commission into the Banking, Insurance and Financial Services Industry, and the Productivity Commission inquiry into superannuation.

No major progress has been made on a regime for product rationalisation, so this remains as unfinished work from the FSI and a long-standing concern of the FSC remains unaddressed. In particular, the FSC first put forward a proposal for product rationalisation to the Government in July 2005 and in other forums since then.[8]

5.1. Background

Many FSC members have legacy products in managed investment schemes, life insurance, superannuation, and other related products or structures. Our members have updated and modernised their product offerings over time, but customers who have purchased earlier products cannot easily be transferred into the newer products.

As a result, the number of legacy products has increased and we estimate there are over 600 legacy structures amongst FSC members, each of which may contain multiple products, affecting an estimated 2.44 million consumers.

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[6] http://fsi.gov.au/publications/final-report/executive-summary/#recommendations
[7] https://static.treasury.gov.au/uploads/sites/1/2017/06/Government_response_to_FSI_2015.pdf
[8] For example: Phase Two submission to FSI; and Product Rationalisation — Managed Investment Schemes and Life Insurance Products Proposals Paper, 26 February 2010.

The FSC has surveyed members to develop conservative estimates of the benefits that an effective product rationalisation regime would deliver:

- 38 individual IT systems could be closed, of 79 legacy IT systems across the sample;
- 286 life insurance products and 77 managed investment schemes could be closed; and
- $22.6 billion in funds under management could be transferred to contemporary products.

FSC members forecast that through these changes they could reduce costs to consumers by $94 million over the near term through a staged rationalisation program.

However, the current mechanism for rationalising products is too difficult and expensive. As a result, consumers remain in higher cost financial products.

A legacy financial product may be closed and have few members, but regardless it still needs a broad range of behind the scene support services similar to those provided to an on-sale product, including technology, accounting, audit, disclosure, legal, actuarial, product and tax services as well as being supported by an administration team and front line call centre staff who need to be trained on the particular product. Legacy products have caused some absurd problems for FSC members, including:

- One life insurer needed to hire a computer programmer fluent in FORTRAN — a largely defunct programming language developed in the 1950s — to implement a regulatory system change.
- Another has customer records stored on microfiche.
- A super fund had to buy a spare part on eBay for one of its legacy systems because the manufacturer does not make or supply it anymore.

Addressing product rationalisation will substantially reduce costs to consumers, as noted above, and move consumers into up-to-date products with better customer benefits and improved ease of use. Other benefits include:

- Allowing use of updated technology, to make systems more resilient and more productive.
- Increased product innovation, as the costs of innovation will decline. Innovation creates legacy products; and if legacy products cannot be rationalised this increases the costs of innovation.
- Reduced complexity and compliance costs

Conversely, continuing to manage bespoke financial products that are highly aged and predate most employees is a significant challenge for most financial services companies. This causes many problems including:

- increased risk of failure, with consequent major costs to consumers — failures of aged systems are more likely because they are less resilient and harder to restore.
- reduced resources for activities that add customer value
- problems maintaining aged systems that are typically less agile or economical to run and keep updated (including for regulatory change)
- greater challenges to locate appropriately skilled support staff

- increased difficulties caused by the need to ensure customer requirements are kept
- barriers to organisational change

If the problem is not fixed, providers will not be able to rationalise products in the overall interests of consumers. It will become increasingly risky and expensive to administer products. Consumers will be worse off due to increasing costs and reduced service, and also run the risk of being trapped in out of date products — products which may have become obsolete as a result of changing tax, legal and social security regimes and also shifts in consumer sentiment and demand.

Furthermore, it is hard for product issuers to justify investment in legacy products to provide new tools and other enhancements beyond what is legally required. Because of this, consumers of legacy products lose out on that benefit. For example, a legacy product will not typically offer online access and other digital features that are being built into new products.

5.2. Product Rationalisation in Superannuation

The current rationalisation regime in superannuation has worked to reduce legacy products, providing significant benefits to consumers. However, more needs to be done, with the Productivity Commission arguing that about 10% of superannuation assets and 12% of accounts were in legacy products in 2017.[9]

The current super rationalisation regime permits a consumer to be transferred to another product, or have their existing product changed, broadly if the Trustee determines it to be in the interests of those consumers. The precise test is determined by whether the customer is moving:

- between different super funds (called a successor fund transfer or SFT); or
- to another product within the same super fund (known as an intra-fund transfer or IFT).

In both cases, if the bundle of rights consumers enjoy in the current product can be met by an alternative product that passes the consumer interest test, the trustee may approve the transfer without consumer consent. For a SFT, the test is undertaken at an individual consumer level, whereas the test is taken as a group of consumers for an IFT. In both cases, if the bundle of rights consumers enjoy in the current product is equivalent (for SFTs) or better (for IFTs) in the new product, the trustee may approve the transfer without consumer consent.

Our view is that the regulatory aspects of the rationalisation regime for other product types should be modelled on the regime for super, with the exception that the relevant test be undertaken at the collective consumer level in all cases.

[9] See Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91, page 115.

5.3. Superannuation taxation issues

While the regulatory settings for superannuation rationalisation are beneficial, work still needs to be done in relation to tax, with the tax liability from product rationalisation still a substantial problem. Some super funds may not undertake a product rationalisation because of a large tax liability that may result from the rationalisation – in this situation, undertaking a rationalisation may not meet the funds' best interests duty.

There is currently Capital Gains Tax (CGT) rollover relief for merging superannuation funds (SFT) – but this relief is due to expire in 2020. The Productivity Commission has recommended this relief be made permanent (Recommendation 21 of final report), a recommendation the FSC strongly supports.

However, product rationalisation is also important for rationalisation *within* existing funds (IFT). CGT relief is often not available for rationalisation within funds – so a financial services business that runs only one super fund (generally) does not have tax relief options to deal with legacy products.

- The FSC has previously raised this issue in the context of rollover from legacy default super products into MySuper products (see submission at **Attachment A**), and in response the Government allowed tax rollover relief for IFTs into MySuper products;[10] however rollover relief is not available for IFTs relating to legacy products today.

In addition, relief from State stamp duty may not be available for product rationalisations, either SFTs or IFTs.

These tax issues are potentially why rationalisation of legacy products in superannuation is still being raised as an issue, even though the regulatory regime is beneficial (see above).

5.4. FSC proposed rationalisation regime

The FSC's proposed product rationalisation mechanism leverages that of superannuation and is focused on consumer protection and industry efficiency. The proposal would result in improved disclosure, lower operational risk and access to more relevant and modern product solutions for consumers. It would also promote competition and productivity within the industry and reduce costs for industry participants.

The FSC proposes a common rationalisation regime that can be applied to any financial product including following product types or structures:

- Life insurance products (risk and investment)
- Managed Investment Schemes and Investor Directed Portfolio Services.
- Underlying investment structures, including deferred annuities
- Superannuation products (noting the only changes proposed by the FSC relate to tax)

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[10] See: http://jaf.ministers.treasury.gov.au/media-release/035-2015/

The rationalisation scheme would have several components discussed below.

Consumer interest test

Rationalisation should remove economically inefficient or outdated products while providing a fair outcome for consumers. To achieve that outcome for consumers, the FSC proposes that a consumer interest test apply at group or class level to assess whether a financial product or group of products can be rationalised.

It is proposed that the test be applied at the collective level, rather than the individual level, to enable the maximum number of consumers and other stakeholders to benefit. To do otherwise could prevent some rationalisations that are in the interests of the majority from going ahead because of a minority impact.

The FSC also proposes ASIC should play a role in this process to ensure that, on balance, customers are better off as a result of the rationalisation. There would be a requirement that the provider initially conducts the assessment with oversight from ASIC.

As in Part 9 of the *Life Insurance Act* 1995 and successor fund transfer processes of Part 18 of the *Superannuation Industry (Supervision) Act* 1993, the consumer interest test should be:

- Based on the monetary benefits and rights enjoyed by the consumer as at the transition date (rather than intangible product features, unless these represent a monetary benefit or right);
- Determined as the accrued value of those benefits;
- Calculated by an independent expert or the Appointed Actuary; and
- Based on the overall bundle of rights consumers have and not at the individual feature level.

Tax implications and relief requirements

To deal with the tax implications that hamper the rationalisation of legacy products, the tax attributes of an original vehicle should be able to roll over to the destination vehicle, and there should be no tax implications of the rollover itself. In particular, CGT and State stamp duties should not be levied when rationalisation occurs.

Attachment B to this submission outlines more details of the FSC's financial product rationalisation proposal.

Recommendation: The Government deliver on its commitment to facilitate the rationalisation of legacy products in financial services. This should involve a consumer interest test applied at a collective level; roll over of all tax attributes to the new vehicle; and no tax implications of the rollover itself.

6. Funds management exports

Australia has one of the largest pools of managed fund assets in the world, and is the largest in the Asian region.[11] However, our financial services exports are significantly smaller and do not reflect the relative contribution of our industry.

In particular, Australia only sources about 3.5% of total funds under management from offshore,[12] so we are only capturing a small share of global funds under management. By comparison, many other countries with large funds management industries have much larger proportions of funds sourced from offshore. This includes the United Kingdom (31 per cent sourced from offshore), Hong Kong (68.5 per cent), Singapore (80 per cent) and Luxembourg (99 per cent).

The FSC has therefore for some time been arguing that more needs to be done to remove barriers to Australia as an exporter of financial services.

The Asia Region Funds Passport (**the Passport**) will significantly lower the barriers to trade in funds management within the participating economies. Australian fund managers will find it much easier to export funds offshore; and foreign fund managers will find it much easier to import funds into Australia. This presents both opportunities and risks for the Australian industry – while Australian funds could increase exports to Asia, conversely foreign funds could enter Australia and undercut the Australian industry.

Australian fund managers can compete with foreign funds on a level playing field. The concern is when the playing field is not level – when Australian fund managers face a more restrictive tax and regulatory regime, then these settings give an inappropriate advantage to foreign managers and they can outcompete Australia purely on the basis of government policy settings.

Funds management is one of the most globally mobile, and globally competitive, industries and competition can occur over just a few basis points (hundredths of a percent) of return.

In the case of the Passport, if Australian policy settings are not right, fund managers might prefer to service Australian investors from offshore (particularly from Singapore if they join the Passport) rather than locally.

6.1. Competitiveness of funds management

There are some recent policy developments that have improved the competitiveness of the Australian financial services industry, including the introduction of the attribution (or AMIT) regime and the development of the Corporate Collective Investment Vehicle (CCIV).

[11] Austrade (2017) Australia's managed funds 2017 update, April
[12] Sources: total funds: ABS Managed Funds, Australia, Sep 2018, Table 1; overseas sourced funds: ABS Managed Funds, Australia, Sep 2018, Table 9.

However, there are also a number of issues that are having an adverse impact on the competitiveness of the industry, including:

- The recently increased withholding tax rates on managed funds investing in residential property and agricultural land.
- Potential changes to the Offshore Banking Unit regime, which (despite the name) is used by a number of fund managers to provide a competitive tax rate for Australian fund managers servicing foreign funds. Some possible changes to the regime could have a large adverse effect on a number of local fund managers and further reduce the ability of the industry to export its services (see section 7.4 below on the OBU regime).
- The proposed removal of the Capital Gains Tax (CGT) discount at fund level for managed funds (see section 7.3 below).
- The proposed tightening of the attribution penalty regime. The FSC's concerns with this proposal are contained in a previous submission on the CCIV draft legislation.[13]
- Ongoing uncertainty about tax changes relating to stapled structures, not yet resolved as legislation has not yet passed Parliament.
- Ongoing tax uncertainty about certain foreign funds that may unexpectedly be treated as an Australian taxpayer because they engage an Australian fund manager.
- Substantial delays in important technical changes to the AMIT regime and the IMR regime (see Section 7.2 below).
- A lack of solutions to the withholding tax treatment of foreign exchange hedging and bond profits which result in inappropriate taxation (see Section 7.2 below).
- An inability of Parliament to reduce Australia's globally uncompetitive corporate tax rate (see Section 7.6 below).
- The lack of Double Tax Agreements (DTAs) with Hong Kong and Luxembourg – two of the most important countries that fund managers deal with (see Section 7.5 below).

Given all these issues, other jurisdictions, particularly Singapore if it enters the Passport, could easily outcompete the Australian fund management industry on the basis of policy settings alone. This would slow growth and harm the whole economy.

Conversely, addressing these issues by improving the competitiveness of the financial services industry would have substantial economy-wide benefits if this leads to increased exports. Research by Deloitte for the FSC shows that increasing Australia's funds management exports to the same level as Hong Kong by 2023–24 would have significant flow on effects, including that:

- GDP would increase by $4.2 billion by 2029-30 and around 10,000 additional jobs would be created;
- fees received by fund managers would lead to an increase in income and payroll tax;
- an increase in funds management exports would lead to a net increase in the amount of foreign assets invested in Australia; and

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[13] See Page 9 of: https://fsc.org.au/_entity/annotation/79b98d2e-ae7d-e811-8159-70106fa11a21

- the Government would receive an additional $1.7 billion in tax revenue in 2024-25, stabilising to $1.2 billion in 2029-30.

To address issues that are holding the funds management industry back, the FSC has a number of policy proposals, some of which are of long standing concern, discussed in the rest of this submission.

7. Taxation issues

7.1. Non-resident withholding tax

The FSC considers that Australia's current tax system is not competitive in the Asia Region Funds Passport. In particular, the non-resident withholding tax (NRWT) system is complex compared to other Passport countries, as a result of:

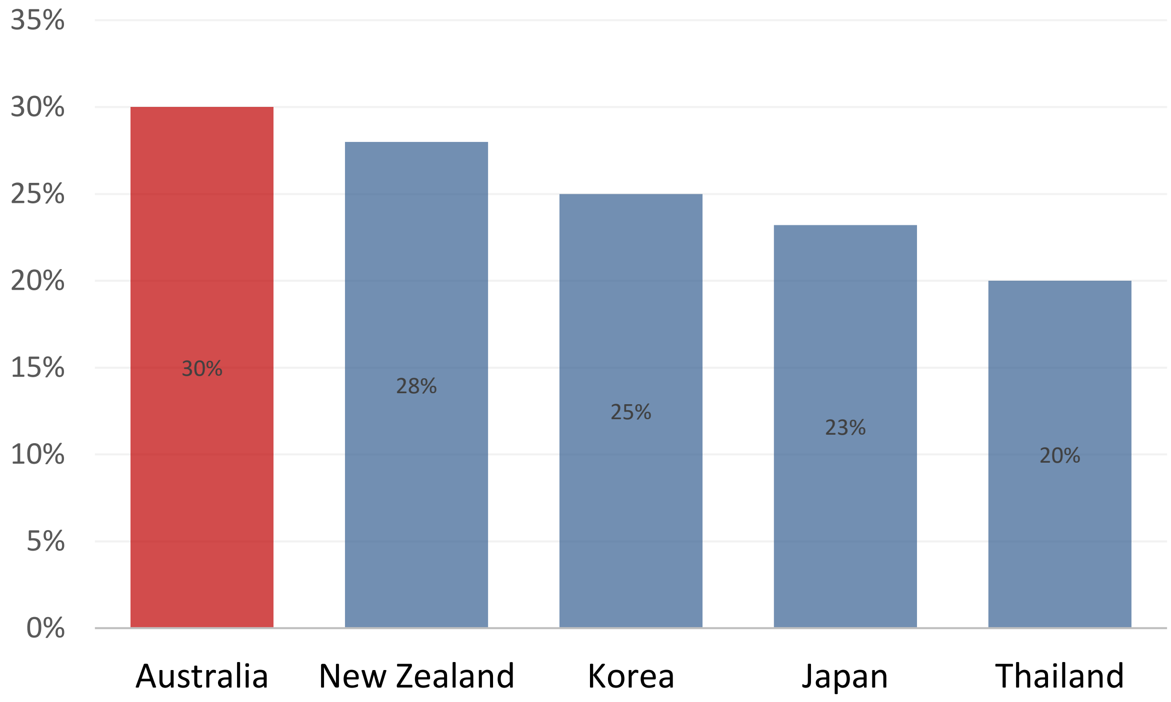
- multiple rates
- complexity and difficulty of determining appropriate rate;
- interactions with tax treaties (including how the treaties deal with trusts);
- no overarching consistent principle of application; and
- relatively simpler approaches in competitor jurisdictions, with Singapore in particular charging a zero withholding tax rate.

The complexity of the application of Australia's NRWT means the possible tax consequences for foreign investors cannot be explained in a simple and easy to understand manner. The Passport is specifically designed for retail investors so the inability to explain tax simply will put Australia at a substantial disadvantage.

Australia's NRWT complexity means comparisons with other jurisdictions are complicated; in general Australia's regime has high headline tax rates, but a variety of exemptions which often means the actual tax paid in Australia is low. As a result, we have a lose-lose situation – a tax system that significantly impedes investment due to its complexity while delivering little revenue (see section on potential budget impact below).

NRWT comparisons are not simple, but generally show Australia is uncompetitive. By contrast, comparisons of company taxes much more clearly show Australia is uncompetitive – Australia has the highest corporate tax rate in the Passport and in some cases the Australian tax disadvantage is large. This is shown in Figure 5 below.

Figure 5 – Corporate tax rate in Passport countries



Source: OECD report on corporate tax, see Section 7.6 below.

The corporate tax comparisons are clear cut in showing Australia is uncompetitive (more details on Australia's company tax rate is in Section 7.6 below). Our uncompetitive tax regime is inconsistent with Australia's aspirations of becoming a global financial centre and exporting fund management services, particularly to Asia.

Other countries are reducing their NRWT and corporate tax rates over time, making our system more uncompetitive as time passes. Therefore, if Australia does not set NRWT and company tax rates at a competitive rate determined in the appropriate international context, funds will not be invested in Australian vehicles and the ATO will receive 100% of nothing, while Australia will miss out on the revenue, jobs and growth of our funds management industry. The benefits are likely to include back end operations as well as higher value added operations such as investment management.

If Australia is unable to reduce its corporate tax rate (see discussion below), this emphasises the need for other tax settings, particularly NRWT, to be more competitive.

Investors will be choosing Passport products from a number of competing jurisdictions and Australia's current tax system will place Australian funds behind funds from other countries. If tax disadvantages are removed for Australian funds, then Australian fund managers will be able to compete. In addition, a globally competitive NRWT would address one of the larger barriers to the success of Australia's funds management export industry.

Recommendation: The Government implement a zero rate of NRWT on Passport payments, excluding both direct and indirect income from Australian real property.

Potential budget impact

The Passport only allows investments into very simple ('vanilla') products such as listed equities and bonds. This means that income generated by non-resident investors will comprise dividends and interest.

Analysis of these income types shows that little government revenue from NRWT (outside of property) will be received as a result of Passport funds under existing policy settings:

- Just over 90% of Australian top 100 company dividends are franked therefore dividend withholding tax collections will be small. A portion of the remaining unfranked dividend also qualifies for conduit foreign income (CFI) exemption. For example, the unfranked component of AMP's dividends has historically been CFI and therefore withholding tax free.
- Interest will be either overseas sourced or substantially subject to an exemption (under section128F); as a result it would not be subject to NRWT.
- Capital gains from Australian assets that are not taxable Australian real property are not subject to a withholding obligation when derived by non-residents. The permitted investment class only allows for listed equities which are all treated as non-taxable Australian real property.
    - Note the FSC is not calling for a reduction in the NRWT applying to any property income that might be received by a Passport fund (even though this income would be limited in a Passport fund).
- Some tax treaties may operate to allocate the taxation of gains to the treaty partner.
- Some of the remaining NRWT is inappropriately applied to bond profits and foreign exchange hedging – see section 7.2 below.

As a result of these points, a removal of NRWT on the Passport will have limited budget impact, however it will have significant impact on the ability of Australian managers to market their funds, as it will allow confident statements to be made about the taxation impact of investing in an Australian fund.

We also understand previous costings of this proposal have used data from the ATO's Annual Investment Income Report (AIIR). However this data is misleading as it combines property income to foreigners and non-property income to foreigners. This means the AIIR data (at least in in its current form) is unlikely to be helpful for this costing.

We expect this change will reduce compliance costs for all funds without property income, as only one rate of withholding tax will apply. A fund with property income might face higher compliance costs from complying with the property-related NRWT, but this will be offset by a reduction in compliance costs from collapsing multiple non-property rates into one rate.

7.2. Unresolved tax issues

There are a number of financial services tax issues that remain unresolved and need to be placed at a higher priority. These issues include:

- Meeting the Government's commitment to address any issues with the Investment Manager Regime (IMR), to ensure that a foreign fund will not be treated as an

Australian taxpayer merely because it engages an independent Australian fund manager. The Government made this commitment on 19 July 2017.[14]

- Meeting the Government's commitment to consult with industry on extending the attribution eligibility rules to platforms, wraps or master trusts. The Government made this commitment on 19 July 2017.[15]

The Government also made a commitment to the simplification of the Taxation of Financial Arrangements (TOFA) rules in December 2017.[16] Two issues relating to the TOFA rules are of particular importance to FSC members – foreign exchange hedging and bond profits. These issues are discussed below. Addressing these issues would go some way towards addressing the competitiveness issues that Australia faces with the Passport.

Foreign exchange hedging gains/profits are normally treated as being on revenue account and therefore potentially bear withholding tax. This has been a source of frustration to the industry for many years as such hedging is normally related to the holding of foreign assets which generate income and gains that are exempt from withholding tax. A key principle is that hedging contracts should be taxed the same as the asset they hedge – if the underlying asset is exempt from tax, then so should the hedge.

One of Korea's largest investment managers has specifically raised the issue of Australia's taxation treatment of foreign exchange hedging being a barrier to offering their Australian asset funds in Korean won. Their Korean investors would prefer to bear the foreign exchange risk themselves, by investing into an Australian dollar fund and undertaking their own hedging back to Korean won, as opposed to having the hedging undertaken in the fund. They noted that this was an Australian-specific problem that they did not have when investing in other jurisdictions.

The FSC has previously suggested that section 230E of the TOFA provisions be clarified to eliminate uncertainty as to its application to passive investment portfolios. In the absence of such clarification it would be appropriate to effectively exempt foreign exchange hedging profits from MIT withholding tax as part of a general NRWT exemption for Passport vehicles (discussed above).

Bond sale profits are economically akin to interest but can be treated as ordinary income for withholding tax purposes and can therefore be subject to NRWT. In particular:

- A bond profit normally reflects an interest rate movement meaning that the gain is really attributable to interest. Interest withholding tax is 10% – yet the bond profit would likely be subject to NRWT at 15% (the rate applying to ordinary income).
- Many bonds are exempt from NRWT under section 128F, but it is unclear if bond profits on these securities are also exempt.

[14] See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/
[15] See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/
[16] See: http://kmo.ministers.treasury.gov.au/media-release/126-2017/

If the foreign exchange hedging and bond sale profits issues are not addressed, this further supports the FSC's arguments for providing an NRWT exemption for Passport vehicles (other than for property income) – see Section 7.1 above.

Recommendation: The Government should prioritise meeting existing commitments to address outstanding Investment Manager Regime (IMR) issues, extend the attribution regime to Investor Directed Portfolio Services, and fix outstanding issues with the Taxation of Financial Arrangements.

7.3. Capital Gains Tax (CGT) at fund level

The 2018–19 Budget announced the Government would remove the CGT at the fund level for Managed Investment Trusts (MITs) and Attribution Managed Investment Trusts (AMITs).[17]

The FSC has major concerns with this proposal.

Most importantly, the policy contradicts its own stated policy goals. The 2018–19 Budget states[18] this proposal is designed to ensure that MITs and AMITs operate as genuine flow through vehicles, so that income is taxed in the hands of investors as if they had invested directly. However, the 2018–19 Budget proposal has the **opposite effect** of this policy goal.

The policy disadvantages indirect investment by individuals through MITs and AMITs compared to direct investment. It removes the current neutral treatment of individuals and replaces it with a non-neutral treatment. Using the terms from the 2018–19 Budget, under the current tax system MITs and AMITs are taxed as genuine flow through vehicles for individual investors, "so that income is taxed in the hands of investors as if they had invested directly". The proposal replaces this approach with a system that **overtaxes** individuals that invest through MITs and AMITs.

This detrimental proposal would be a key contributor to the increasing adverse policy environment for fund managers noted earlier in this submission.

The specific reasons the proposal overtaxes individuals that invest in MITs and AMITs are:

- In allocating deductible expenses against assessable income components, a MIT or AMIT would be required to allocate deductions against gross capital gains instead of only the assessable discount capital gains component; and
- In recouping prior year or current year revenue losses, the MIT or AMIT would be required to recognise as assessable income the gross amount of the capital gain rather than only the discount capital gain.

A briefing from Greenwoods HSF (see Section 2 of **Attachment C**) provides an example where:

- an individual would pay no tax if they invested directly; but

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[17] See Budget Paper 2, page 44.
[18] See Budget Paper 2, page 44.

- the same individual would pay tax on $500 if they invested in exactly the same way, but through a MIT.

This clearly shows the proposal does not meet the principle of *horizontal equity* which it a long-standing tax policy principle accepted by governments. Broadly, the principle is that investors should bear the same tax burden regardless of whether they invest directly or indirectly. The proposed measure runs counter to this principle.

Example

Another example is shown below.

Where a MIT / AMIT derives a $100 discount capital gain, but has expenses of $20 that are to be allocated against the capital gain, the difference in the trust net income would be as follows:

Trust level	Current	Proposed
Discount capital gain	100	100
50% discount	50	-
Net gain	**50**	**100**
Expenses	-20	-20
Net income	***30***	***80***

Once the net income is distributed, the impact on an individuals' investor's taxable income could be illustrated as follows (with direct investment included for comparison):

	Invest through MIT/AMIT		Direct investment
Individual level	Current	Proposed	
Distribution	30	80	100
Gross up	30	-	-
Gross gain	**60**	**80**	**100**
1/2 discount	-30	-40	-50
Individual expenses	**-**	**-**	**-20**
Taxable income	***30***	***40***	***30***

The example above equally applies if fund-level expenses are replaced by carry forward revenue losses.

The examples above and in **Attachment C** show where expenses or carry-forward revenue losses are offset against these discount capital gains at the MIT / AMIT level, the proposed measure will result in members that are entitled to discounting (individuals, complying superannuation funds entities and trusts taxed under Division 6) being worse off under this proposal than if they had invested in assets directly under the same scenario.

Discussion

The current CGT treatment does not always achieve parity between direct investment and investment through a MIT/AMIT; but the proposed change does not achieve this parity either — and for most investors the change moves the treatment further away from parity.

The FSC submits that, across the investment life-cycle of a managed fund, many (perhaps nearly all) AMITs and MITs would allocate expenses, or current year or carry forward revenue losses, against capital gains. This means that the proposed measure will disadvantage many or all AMITs and MITs relative to direct investment by individuals and super funds.

The proposal also introduces another inconsistency: Division 6 trusts would be able to access the CGT discount, while MITs and AMITs will not. The FSC submits this is inconsistent and confusing and further underlines the concern that this proposal is clearly not meeting the policy intent of ensuring direct and indirect investment is treated similarly.

Another issue will emerge if the proposal is implemented. The allocation of expenses against different types of income has not been definitively addressed since the repeal of section 50 of the Income Tax Assessment Act 1936. That section prescribed an order for the allocation of expenses and was particularly relevant in the context of the former Undistributed Profits tax. Since the repeal there have been miscellaneous rulings and statements to the effect that direct expenses should be allocated to the income to which they relate but that general and surplus direct expenses should be allocated pro rata against taxable income. Whether this is correct and whether any gross or discounted capital gains should form part of this allocation base is an issue that until this proposal did not matter. However, the change, as it is proposed, will force the Government to deliberate and prescribe an outcome. Such an outcome will inevitably have consequences beyond MITs and AMITs.

We note the original exposure drafts of the AMIT legislation included this measure, but were removed by Treasury during consultation. We understand this change was made because of the concerns raised above in this paper: disallowing the CGT discount at the trust level reduced tax neutrality compared to direct investment.

Given the increased compliance costs from the measure and the distortion in the tax treatment of direct vs indirect investment, the proposed CGT change would likely actively discourage many investors (individuals and super funds) from investing in MITs and AMITs, adding to the competitiveness issues raised earlier in this submission.

The added burden on MITs and AMITs caused by higher taxation and higher compliance costs from these combined proposals means the benefit of reforming and moving out of Division 6 has been considerably reduced — possibly negated. It also is particularly concerning that this change has been proposed after many fund trustees have made the irrevocable election to adopt the AMIT regime.

We note that this measure is ostensibly meant to prevent beneficiaries that are not entitled to the CGT discount from getting a benefit from the CGT discount being applied at the trust level. This would be non-resident investors and corporate investors.

It is not clear why the Government has proposed a measure targeting all investors in AMITs and MITs rather than a measure specifically targeting resident corporations and non-resident beneficiaries. Instead, the Government proposes a measure that will result in individuals and superannuation funds paying an inappropriate amount of tax compared to direct investment.

Additionally, the beneficiaries of apparent concern represent a small proportion of unitholders. According to the ABS, non-government trading companies represent just 1.85% of total investment into managed funds, and foreign investors represent 5.8% of total investment.[19] Most investment is by individuals, superannuation funds and pension funds. In addition, capital gains are only subject to tax for non-residents when the gains relate to "taxable Australian Real Property" ('TARP'). Other gains are not subject to Australian tax. Hence the supposed mischief relates to a small proportion of the total gains recorded by the fund.

If the Government wishes to address concerns about corporates and non-residents accessing the CGT discount through MITs and AMITs, then we submit there would be value in exploring options that are more targeted at the issue. The FSC has provided a range of options to Treasury and we are willing to discuss these options in more detail. We await further consideration of these options.

Recommendation: The Government's proposal to remove the CGT discount at fund level not proceed, and instead be replaced with a measure targeted at corporates and non-residents that are accessing the CGT discount through MITs and AMITs.

7.4. Offshore Banking Unit regime

We understand that changes may occur to the Offshore Banking Unit (OBU) regime that may mean a significant reduction in the usefulness of this regime to Australian fund managers.

- Even though the name "OBU" implies the regime is only used by banks, in fact this regime is used by a number of local fund managers and life insurers to ensure that Australia is globally competitive in these industries. The OBU regime broadly permits an Australian funds manager to pay a lower rate of tax on activities that relate to offshore managed funds (and similarly for life insurers).

An unfavourable change to the OBU regime would exacerbate the tax-related issues being faced by the funds management industry from the adverse policy climate facing funds managers, particularly from the proposed tightening of the AMIT penalty regime and the proposed removal of the Capital Gains Tax (CGT) discount at fund level (discussed in the Pre-Budget submission). All of these changes put together will cause substantial cost and disruption to the industry for no clear benefit. If the Government is considering changes to other tax policies to offset the problems caused by an adverse change relating to OBUs, then we strongly suggest abandoning the proposed changes to AMIT penalties (see Section 6.1 above) and the CGT discount at fund level (see Section 7.3 above).

[19] ABS Managed Funds, September 2018, table 9.

Recommendation: if unfavourable changes occur to the OBU regime, then the Government should not proceed with proposed changes to AMIT penalties and the CGT discount at fund level to offset the industry-wide adverse effects of the OBU changes.

The FSC has also provided Treasury with a number of proposals relating specifically to the OBU regime.

Differences between the IMR and OBU

There have been questions raised about whether the OBU regime is no longer required for funds management given the start of the Investment Manager Regime (IMR).

The FSC considers both of these regimes are required, as they apply to different taxpayers. The IMR is designed to ensure a foreign managed fund does not become an Australian taxpayer merely because it engages an Australian fund manager. By contrast, the OBU applies a lower tax rate to an Australian fund manager to the extent it manages a foreign managed fund. So the IMR applies to managed funds but not to investment managers; and the OBU applies to investment managers and not managed funds.

Both regimes operate together to ensure that a foreign managed fund is not subject to a tax penalty by engaging an Australian fund manager.

The Johnson Report specifically recommended both an IMR and the updating the OBU concession to become competitive.

7.5. Tax Treaties

The FSC has been for some time concerned that there are some gaps in Australia's tax treaty regime – in particular the lack of a tax treaty with Hong Kong and Luxembourg.

Finalising these tax treaties would help address the competitiveness issues for Australian financial services raised earlier in this submission. The attractiveness of Australia's funds management industry to foreign investors is reduced without relevant tax treaties. Conversely, an effective tax treaty increases the attractiveness of Australia as a destination for capital and it significantly improves the ability of Australian fund managers to compete in managing global capital on behalf of foreign investors.

The broader economic benefits from funds management exports should be an important factor in deciding the approach to tax treaties. Tax treaties may result in an initial loss of revenue, but longer-term 'second round effects' (such as increases in jobs or economic activity) traditionally not accounted for in Treasury estimates have the potential to outweigh these costs.

This is particularly relevant for taxation of international capital flows, which are very sensitive to tax changes. Treasury has repeatedly noted the sensitivity of international capital flows to tax.[20]

Luxembourg and Hong Kong

It has been a long-standing submission of the FSC that the Government should conclude tax treaties with Luxembourg and Hong Kong as a matter of priority. These two jurisdictions are significant global funds management centres. Luxembourg funds have about $US 4.95 trn in net assets under management, by far the largest asset pool in Europe.[21] Hong Kong unit trusts and mutual funds have about $US 1.66 trn under management.[22] These are two of the largest asset pools in the world, but Australia does not have tax treaties with these countries.

The ability of Australian fund managers to provide asset management services to foreign investors has been hampered by uncertain tax outcomes arising from Australia's source and permanent establishment taxation rules. The Investment Manager Regime (IMR) seeks to address these uncertainties and remove barriers for foreign investors wishing to utilise the expertise of Australian managers.

The IMR is only available to foreign investors from jurisdictions with an 'effective exchange of information agreement'. This requirement rules out foreign investors from both Luxembourg and Hong Kong. The lack of effective tax treaties with these two economies means Australian fund managers are at a significant disadvantage when competing to manage funds flowing from, or through, these locations.

The Government has completed a free trade agreement (FTA) with Hong Kong, and is currently working towards a free trade agreement with the European Union. The value of FTAs relating to financial services is significantly diminished in the absence of a tax treaty with these two jurisdictions.

Australia already has a tax agreement with many EU countries, as shown in Table 1 below—Luxembourg is the clear gap in terms of the financial sector. The completion of tax treaties with other EU countries suggests higher priority has been placed on industries other than financial services in the prioritisation of treaties. For example, Australia has a tax treaty with Romania and Slovakia which have managed funds of less than €9bn each, compared to Luxembourg which has managed funds of €4,279bn.

The size of funds domiciled in each EU country is shown in the table below.

[20] See for example Michael Kouparitsas, Dinar Prihardini & Alexander Beames (2016) Analysis of the long term effects of a company tax cut, Treasury Working Paper 2016-02; and The Treasury (2008) Architecture of Australia's Tax and Transfer System, Box 8.8: Taxation and foreign direct investment (FDI).
[21] Investment Company Institute Worldwide Public Tables, 2018 Quarter 3, available from: https://www.ici.org/research/stats/worldwide
[22] Hong Kong Securities and Futures Commission Statistics Table D3 as at December 2017, available from: https://www.sfc.hk/web/EN/files/SOM/MarketStatistics/d03.pdf

Table 1 – DTAs with Australia in Europe compared with share of net investment fund assets

European Country	DTA with Australia?	Investment fund assets – share of EU total
Luxembourg	no	26.7%
Ireland	yes	15.8%
Germany	yes	13.1%
France	yes	11.9%
United Kingdom	yes	10.4%
Netherlands	yes	5.5%
Sweden	yes	2.2%
Italy	yes	2.0%
Spain	yes	1.9%
Denmark	yes	1.8%
Austria	yes	1.1%
Belgium	yes	1.0%
Finland	yes	0.7%
Poland	yes	0.4%
Czech Republic	yes	0.1%
Hungary	yes	0.1%
Malta	yes	0.1%
Portugal	no	0.1%
Romania	yes	0.1%
Bulgaria	no	<0.1%
Croatia	no	<0.1%
Cyprus	no	<0.1%
Greece	only Airline Profits Agreement	<0.1%
Slovakia	yes	<0.1%
Slovenia	no	<0.1%
Total		100.0%

Source: DTAs: https://treasury.gov.au/tax-treaties/income-tax-treaties/
Net Assets: Table 12 of EFMA Quarterly statistical report[23]. Only countries in the EFMA report are listed.

Recommendation: The Government place a priority on negotiating a tax treaty with Luxembourg and Hong Kong and addressing financial services issues in existing tax treaties. We also encourage the Government to ensure that any new Free Trade Agreements are accompanied by a tax treaty.

[23] https://www.efama.org/Publications/Statistics/Quarterly/Quarterly%20Statistical%20Reports/181204_Quarterly%20Statistical%20Release%20Q3%202018.pdf

Other DTA issues

The FSC has a range of other issues with DTAs, detailed in previous submissions.[24] In summary:

- The provisions contained in the Australia-Switzerland DTA covering collective investment vehicles and complying superannuation funds should be considered a benchmark that future treaties should meet.
- Complying Superannuation business of life insurance companies (“VPST” business) and pooled superannuation trusts should also be provided coverage in treaties as these businesses operate consistently with standalone superannuation funds.
- The China-Australia DTA be aligned with Chinese DTAs recently negotiated with other governments to provide relief for Australian residents from capital gains on their Chinese portfolio investments.
    - Other DTAs with China concede taxing rights on non-resident capital gains from shareholdings of less than 25% in non “land-rich” Chinese companies, such as the China DTAs with Hong Kong, Singapore and UK.
- Clarify existing Australia-US tax treaty provisions relating to superannuation funds, and allow treaty relief in the common circumstances where an Australian resident fund invests into US investments via a Cayman feeder fund.
- Provide trusts, particularly Managed Investment Trusts, with clear access to treaty benefits (UK and India).
- Provide an interest withholding tax exemption for interest paid to and derived by a financial institution (including a non ADI) which is unrelated to and dealing wholly independently with the payer.
- Codify sovereign immunity and at source exemptions for entities wholly owned by Federal or State Governments.

7.6. Corporate tax rate

The Government has already legislated for a gradual reduction in company tax for smaller businesses to 25%.[25] However, the headline company tax rate remains at high levels for larger businesses. It is well known this headline tax rate for larger business is uncompetitive when compared to other developed countries, our region, and the whole world. This is clearly shown in a recent report by the OECD.[26] Several graphs from that report are shown below.

Figure 6 below shows corporate tax revenue as a share of GDP – Australia is well above the OECD and developing country averages, and again is one of the highest levels in the OECD.

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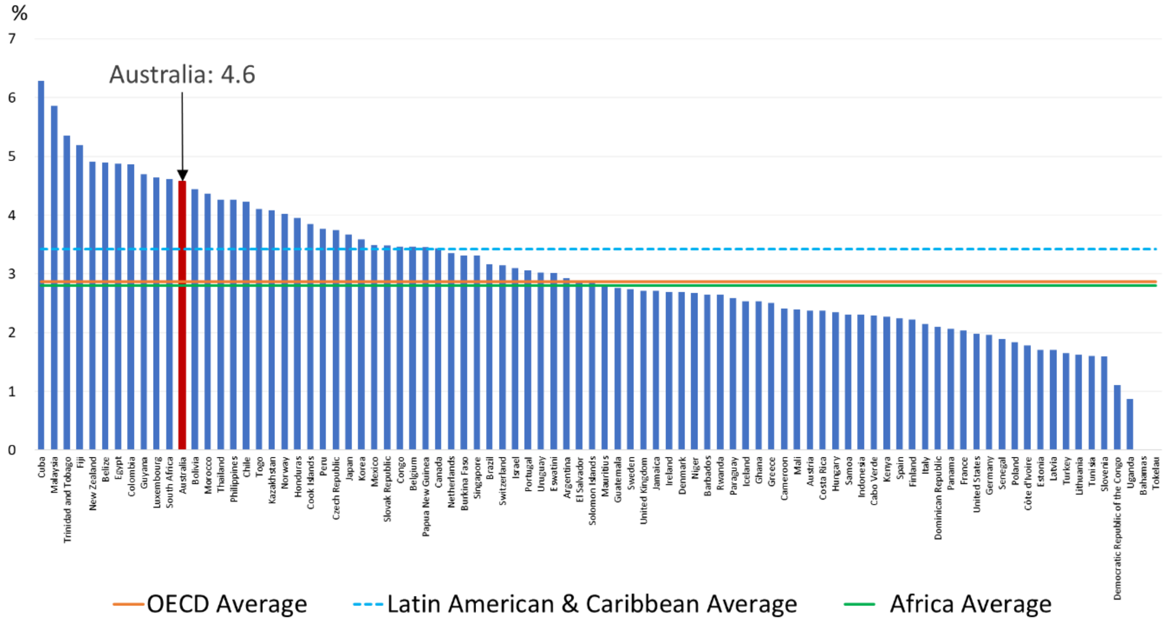
[24] See FSC 2018-19 Pre-Budget submission, available from: https://www.fsc.org.au/resources/resource-detail/?documentid=a584454b-99f9-e711-812d-e0071b686a81

[25] See: https://www.ato.gov.au/Business/Small-business-entity-concessions/Concessions/Income-tax-concessions/Small-business-company-tax-rate/

[26] See: http://www.oecd.org/tax/beps/corporate-tax-statistics-database.htm

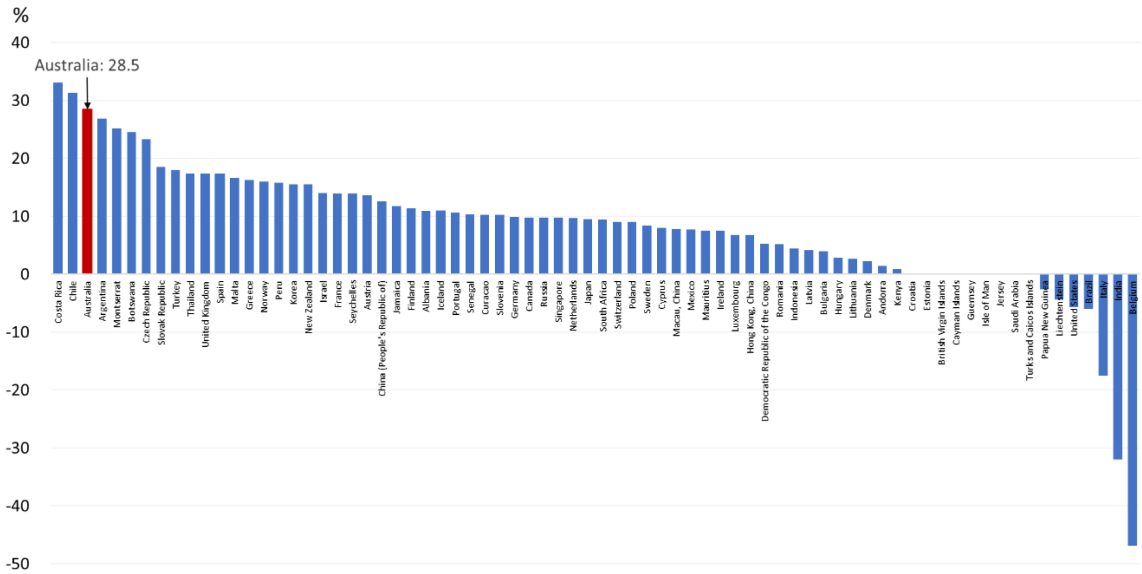
Figure 6 – Corporate tax revenues as percentage of GDP, 2016



This figure shows the **actual** amount of tax revenue received from companies – so includes the effect of any supposed tax avoidance. The actual tax received from companies in Australia is well above averages as shown in these figures, and Australia is not facing an issue, relative to other countries, with corporate tax avoidance.

Another measure of the tax burden on companies is the effective tax rate – which incorporates the effect of tax concessions and deductions. On this measure, the OECD report finds Australia is third highest among the surveyed countries, well above all averages:

Figure 7 – Effective marginal tax rate in OECD, G20 and other jurisdictions, 2017



In response the data above, it is sometimes argued that Australia's imputation system reduces the effective company tax rate. However, imputation has negligible effect on international investors and so should be disregarded for international comparisons.

Other important facts from the OECD report:

- For company tax as a share of total tax revenue, Australia is well above the average for developed countries and developing country groupings, and is one of the highest in the developed world.
- The average headline tax rate declined from 28.6% in 2000 to 21.4% in 2018, a decline of 7.2 percentage points. The Australian rate declined from 34% in 2000 to 30% in 2001, a decline of 4 percentage points and has not changed since then.
- Of the 94 countries in the database, only 8 have a headline company tax rate higher than Australia's rate, and 76 countries have a lower rate (ten have an equal rate).
- Our current headline tax rate is well above the average for all the countries surveyed, for developed countries, and for all the regions surveyed. Australia has been well above all of those averages for some time.[27] This holds even when zero rate jurisdictions are excluded.[28]

[27] See Figure 6 of OECD report.
[28] See Figure 7 of OECD report.

This uncompetitive tax rate on larger business needs to be addressed. Tax expert John Freebairn and others[29] have argued the economic benefit is greater from reducing the corporate rate on larger businesses.

Recommendation: The Government pursues a reduction in the overall corporate tax rate to 25%, preferably lower.[30]

[29] John Freebairn (2017) Comparative Effects of a Lower Corporate Tax Rate on Small Versus Large Companies, paper presented to ANU Tax & Transfer Policy Institute; Michael Potter (2017) "Penalising big companies means a bonsai economy" *Australian Financial Review*, 5 April.
[30] The FSC argued in its submission to the Tax White Paper that there should be a medium term objective to reduce the corporate tax rate to 22% to better align with the average tax rate in the Asian region.

MYSUPER ROLLOVER RELIEF

INTRA-FUND TRANSFERS

1. Issue

The objective of the Government's MySuper reforms is to provide a low cost and simple superannuation product to replace existing "default" funds. From 1 January 2014, employers must make default contributions to a MySuper product. Further, any amounts in a "default" product as at 31 December 2013 (an "accrued default amount") must be transferred to a MySuper product no later than 1 July 2017 (a "mandatory transfer").

It was recognised that a mandatory transfer may have adverse financial consequences for members due to the incurrence of capital gains tax (CGT) or the loss of the benefit of the unused revenue and capital losses. Accordingly, Division 311 of the Income Tax Assessment Act 1997 ("ITAA") was introduced to allow for CGT rollover relief and for the transfer of losses on the transfer of accrued default amounts (ADA's) to a MySuper product. However, Division 311 only operates when there is a transfer of an ADA from an original fund to another complying superannuation fund (sub-section 311-10(3) of the ITAA).

We submit that a "mandatory transfer" involving the transfer of a member from a default product to a MySuper compliant product **within the same superannuation fund** may result in the derivation of capital gains, the result of which is to detrimentally affect the account balances of members so transferred. In order to obviate this unintended detrimental impact, the rollover relief currently provided under Division 311 of the ITAA should be extended to also encompass all "mandatory transfers", and specifically mandatory transfers to a MySuper compliant product within the same superannuation fund.

2. "Mandatory Transfers"

2.1 Legislative Framework

Schedule 6 of the *Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012* (the "Act") contains provisions relating to the movement of ADAs to a complying MySuper product. These are the requirements under which ADAs for members who have not given a direction with respect to their superannuation fund and investment option must be transferred to MySuper (providing the members do not 'opt-out' during the notice period). These transfers are due to occur by 2017.

The Act contains provisions for the Trustee of a fund that intends to obtain a licence from APRA and offer a MySuper product, to make an election to transfer members to that MySuper product, hence recognising that in many cases a transfer to MySuper will involve a move between products within the same fund.

The wording of the section clearly refers to 'product' rather than 'fund'. The relevant section (with emphasis added) reads as follows:

29SAA Election to transfer accrued default amounts

(1) An RSE licensee that applies for authority to offer a class of beneficial interest in a regulated superannuation fund as a MySuper product makes an election in accordance with this section if:

(a) the RSE licensee elects that, if authority to offer the class of beneficial interest in the fund as a MySuper product is given, the RSE licensee will:

> (i) attribute to the MySuper **product** each amount that is an accrued default amount for a member of the fund who is eligible to hold the MySuper **product**, unless the member directs the RSE licensee in writing to attribute the amount to another MySuper **product or an investment option within a choice product in the fund; and**
>
> (ii) do so before the end of a period of 30 days beginning on the day on which notice of authority to offer the class of beneficial interest in the fund as a MySuper product is given to the RSE licensee under section 29TD;

2.2 Regulatory Framework

The majority of the requirements with respect to the transfer of ADAs are dealt with in APRA's Superannuation Prudential Standard SPS 410 - MySuper Transition ("SPS 410"). This also uses the phrase 'product' throughout and does not differentiate between transitions that involve a move between products within a single fund, and those that require a transfer between funds (because the fund currently holding the ADAs will not offer a MySuper product).

The core definition within SPS 410 of a suitable MySuper product to which ADAs can be transferred recognises that the product could be an existing product, a different product within the same fund, or a product in a different fund.

Paragraph 11 of SPS 410 defines a suitable MySuper product as:

11. A MySuper product will be suitable for the purposes of paragraph 10 if it is a MySuper product:

(a) that:

> (i) the RSE licensee is authorised to offer in the RSE in which the accrued default amount is held; or
> (ii) the RSE licensee is authorised to offer in another RSE within its business operations; or
> (iii) is in any other RSE; and

(b) into which the member or class of members is eligible under the governing rules to make contributions; and

(c) to which the RSE licensee is legally able to attribute the member's accrued default amount and the RSE licensee has formed the view that attribution of the member’s accrued default amount to that MySuper product promotes the financial interests of the member or class of members.

2.3 Intention to treat product and fund transfers equally

It is clear from both legislative drafting and the drafting of APRA prudential standards that the policy parameters for the transfer of ADAs to the MySuper regime treats transfers between products, and transfers between funds equally; no distinction or differentiation is made in this regard.

A superannuation Trustee that holds ADAs on behalf of a member is required to transfer those amounts to a suitable MySuper product. This is a mandatory transfer.

The MySuper regime does not, however mandate that the member’s ADAs must be transferred between funds, it clearly recognises that the MySuper product may be the same product in which the member’s monies reside, a different product within the same fund, or a product within a different fund. If the Trustee selects a suitable MySuper product within the same fund as the appropriate MySuper product, the transfer to this product is ‘mandatory’ in the same way as a transfer to a product in a different fund would be, had that been the appropriate product selected by the Trustee.

We therefore submit that the structure of the CGT relief being provided to facilitate the transition to MySuper should equally support transfers between products within a single superannuation entity.

3. Capital Gains Tax Implications

3.1 Typical Life Backed Superannuation Model

Division 311 of the ITAA was introduced to ensure that members were not detrimentally affected through the crystallisation of capital gains on the transfer of assets pursuant to a mandatory transfer. However, the relief as currently written does not apply in relation to capital gains crystallised as a result of the transfer of members from a default option to a MySuper compliant option within a single superannuation entity. In particular, this is so in the case of “life-backed” superannuation products (i.e. products where investments are made via an investment policy in a life insurance company).Such an outcome is inconsistent with the purpose of Division 311. We note that paragraph 1.22 of the Explanatory Memorandum to Superannuation Laws Amendment (MySuper Capital Gains Tax and Other Measures) Bill 2013 (which introduced Division 311) specifically acknowledges the commercial reality that a significant amount of superannuation is invested through life insurance companies.

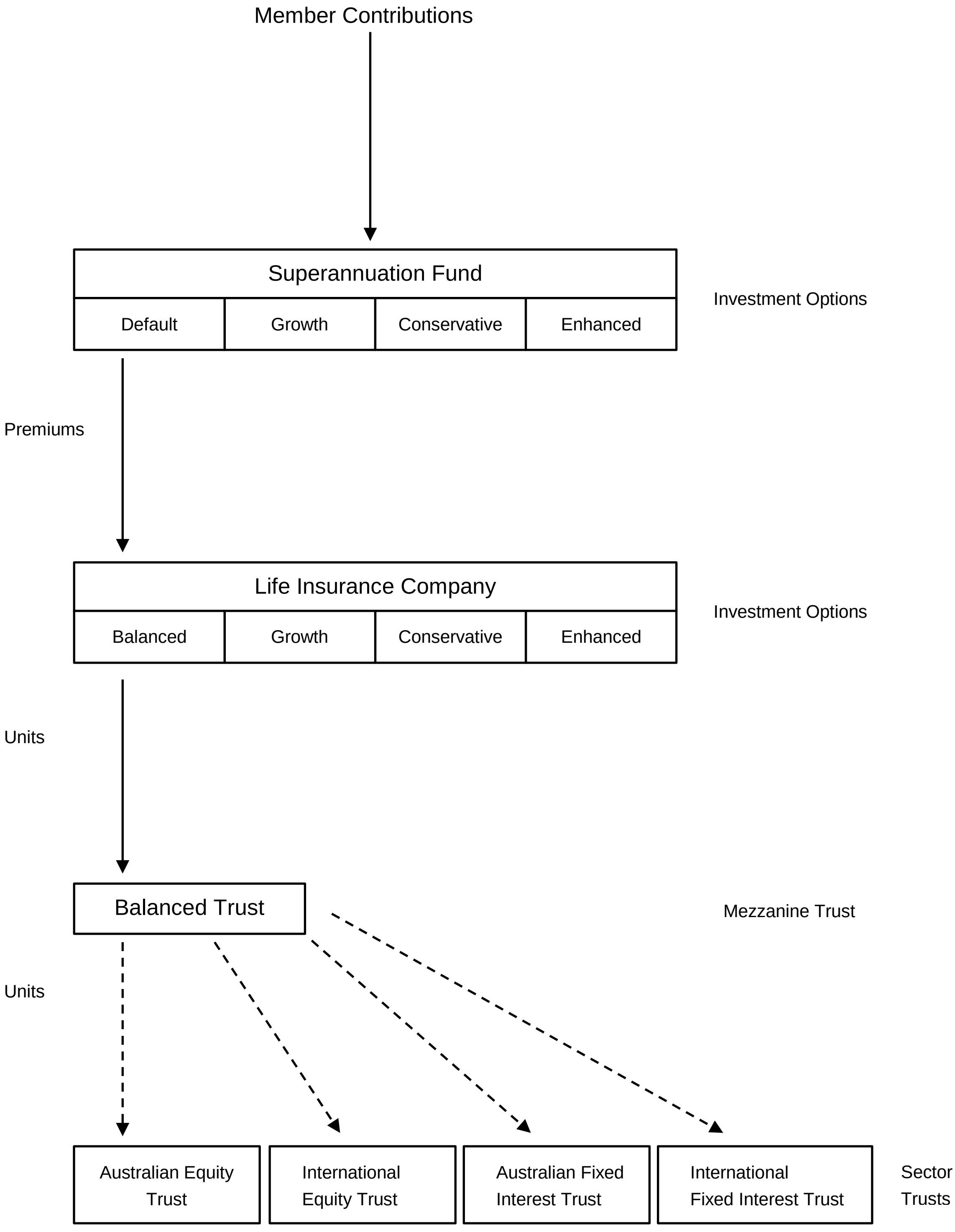
Typically, a life-backed superannuation arrangement (prior to MySuper) would be structured as follows:

- The superannuation fund offers investment options. If a member does not choose an investment option, that member will be attributed to the “default” option.

- The superannuation fund will “acquire” an investment policy from a life insurance company. The life insurance company will offer investment options similar to those offered by the superannuation fund. The life insurance company will invest the moneys "assigned" to those options under a mandate which supports the investment aims of that option (e.g. growth option, conservative option etc). Default funds of a superannuation fund would normally be invested in a balanced investment option.

- Normally, the life insurance company will invest their balanced option in a Balanced Trust. The life company will own units in that Balance Trust and the Balanced Trust will in turn invest in specific investment sectors in accordance with the trust's "balanced" mandate.

This typical structure is shown in the following diagram:

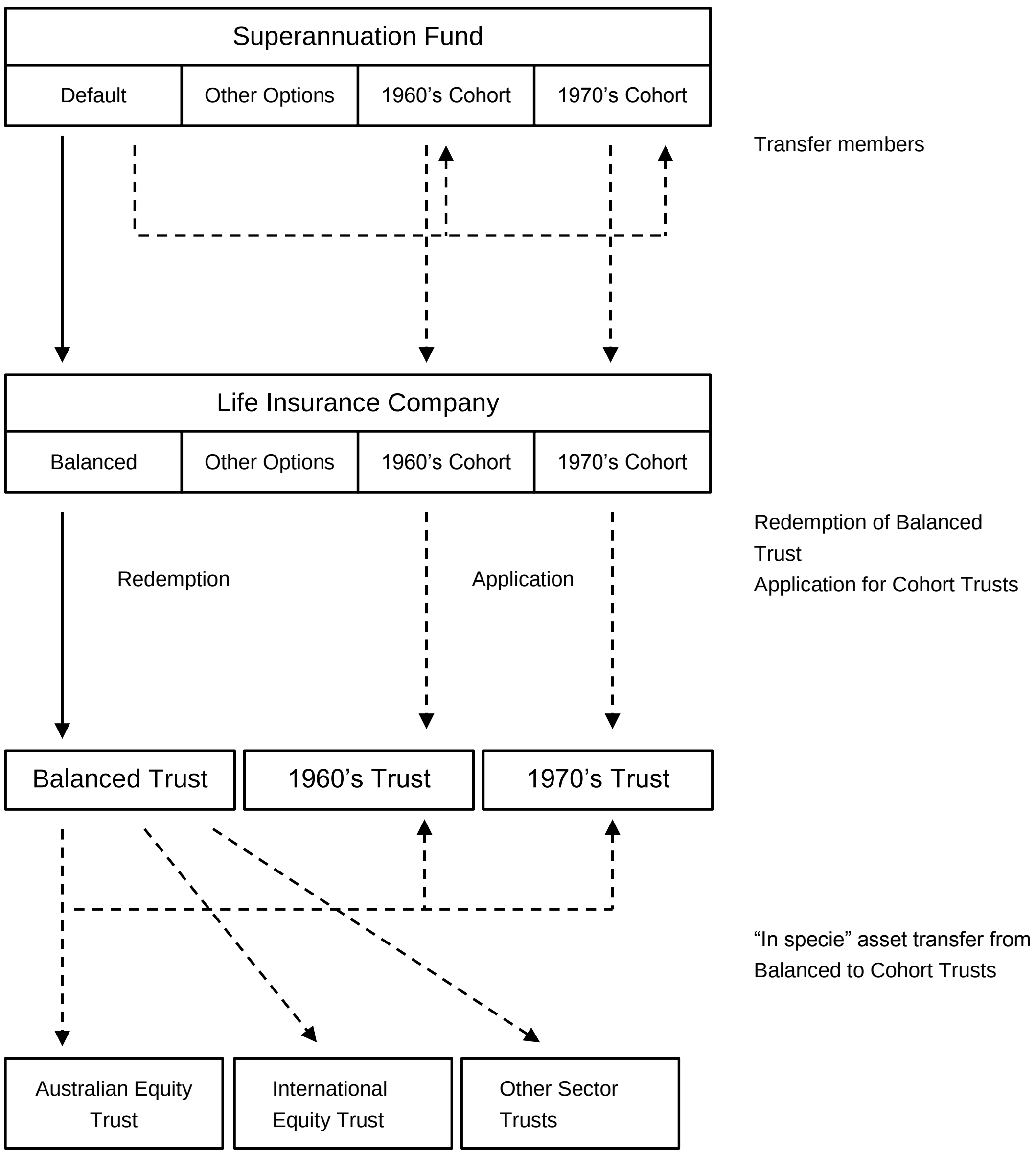


3.2 Mandatory Transfers Pursuant to a Life Backed Superannuation Model

A MySuper product can either have a single diversified investment strategy (similar to the balanced option above) or can adopt a lifecycle strategy. Given the variances in appropriate investment strategies across an individual's working life, we understand that the vast majority of funds are providing their MySuper compliant products with a lifecycle strategy. Accordingly, in the case of typical life-backed superannuation arrangements:

- MySuper products offered by the superannuation fund would be based on the respective age cohort of members (e.g. someone born in the 1960's would be a member of the "1960's Cohort" MySuper product).
- The life insurance company will offer an investment option that corresponds to the respective age cohort product in the superannuation fund (i.e. the moneys referable to the 1960's age cohort product in the superannuation fund will be invested in the "1960's Option")
- The respective age cohort investment option of the life company will invest in a cohort-specific trust (e.g. the "1960's Cohort" MySuper product will invest in the "1960's Trust" which in turn would invest in relevant investment sectors dependant on the mandate of that age cohort.
- Under MySuper arrangements, members in current default options (the Balanced Option in the diagram above) would be required to be mandatorily transferred to the new MySuper compliant age cohort product. This will ordinarily involve the following steps:
    - Members will be switched from the Balanced Option to their respective Age Cohort Product. This will simply be transferring between products offered by the same superannuation fund.
    - The life company will redeem units in the Balanced Trust;
    - The life company will apply for units in the Age Cohort Trusts (corresponding to the value of member balances attributable to each cohort option)
    - As consideration for redemption of units in the Balanced Trust, assets of the Balanced Trust will be transferred "in-specie" to the Age Cohort Trusts (ordinarily, this will be a pro-rata transfer of each asset held by the balanced trust referable to the value of member balances in each age cohort).

These mandatory transfer steps are shown in the diagram below (note that for simplicity, only the Default product and Balanced Option from Diagram 1 is included, as it is that option that will be impacted by the MySuper mandatory transfer, and only 2 age cohorts are shown):


Superannuation Fund
Default
Other Options
1960's Cohort
1970's Cohort
Transfer members
Life Insurance Company
Balanced
Other Options
1960's Cohort
1970's Cohort
Redemption
Application
Redemption of Balanced Trust
Application for Cohort Trusts
Balanced Trust
1960's Trust
1970's Trust
"In specie" asset transfer from Balanced to Cohort Trusts
Australian Equity Trust
International Equity Trust
Other Sector Trusts

3.3 CGT Events and Rollover Extension

The following CGT events occur as a result of the above steps:

- The redemption by the life company of its units in the Balanced Fund is a CGT event to the life company, potentially giving rise to realisation of capital gains; and

- The transfer of assets from the Balanced Trust to the Age Cohort Trusts is a CGT event, potentially giving rise to a capital gain that will be "distributed" to the life company.

In the event that a capital gain is realised as above, crystallisation of this liability will detrimentally impact member account balances. **We contend that such detriment to members is unintended and that therefore the CGT rollover relief currently provided in Division 311 of the ITAA be extended to provide relief in such circumstances.** Such relief could take the following form:

1. Roll over by the life insurance company of the cost base of units in the Balanced Trust to units in the respective age cohort trusts. This can be simply achieved by extending the second condition contained in sub-section 311-10(3) of the ITAA to include the circumstances whereby member 'accrued default amounts' are mandatorily transferred to a MySuper product offered by the original fund. If the "original fund" were then defined to be both the "transferring entity" and the "receiving entity" for the purposes of the Division, then the operative provisions of Subdivision 311-D of the ITAA should provide the requisite rollover without the need for additional amendments.

2. Roll over by the Balanced Trust of the cost base of the units it holds in the sector trusts to the age cohort trusts.

3.4 Mandatory Transfers Pursuant to Other Superannuation Investment Models

Notably the diagram above only depicts a life-backed investment model. However some of our members may also have their Super Funds directly invested in other flow through and taxed vehicles. Some of these include Unit Trusts and Pooled Superannuation Trusts (PST) instead of an investment policy with the life insurance company. Furthermore with the use of Unit Trusts, our members vary in terms of the number of layers of these interposed entities required to construct their MySuper/cohort options.

Alternatively, their Super Funds could invest directly in the underlying asset classes, instead of holding them through any investment vehicles.

Regardless of the investment structure adopted, each equally need to be afforded the option and flexibility of CGT rollover relief when it comes to an Intra Fund Transfer.

PRODUCT RATIONALISATION WORKING GROUP PROPOSAL
PROPOSED PRODUCT RATIONALISATION MECHANISM

1. FINANCIAL PRODUCT RATIONALISATION SCENARIOS

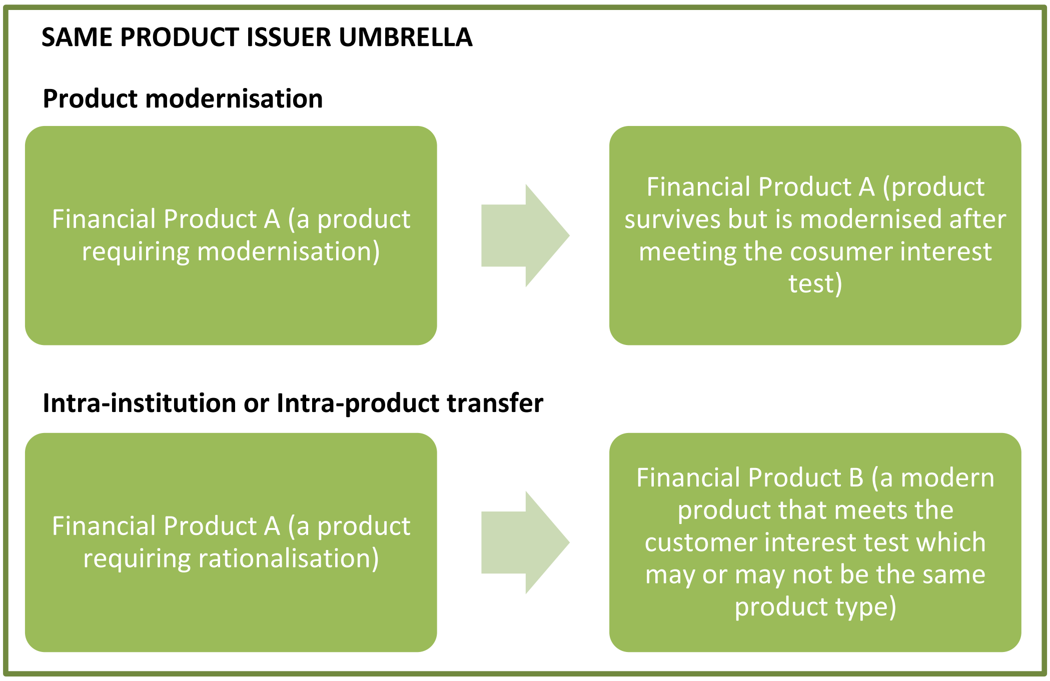
Under Part 9 of the Life Insurance Act 1995 (Cth) and the Financial Sector (Business Transfer and Group Restructure) Act 1999 (Cth), there is a process for the merger of the statutory funds of two life companies or the transfer of part of the life insurance business between them however this is too complex and expensive for wide scale use.

Enabling consumers to move into a more competitive, efficient and modern product will improve competition and efficiency in the industry. In practice, achieving this outcome may involve the transfer or simplification of a financial product under a range of different scenarios. The FSC has captured these scenarios below and believes all can be achieved by leveraging the common framework proposed above. We would be pleased to provide more detailed information and also to elaborate further on being able to transfer consumers between product types which would provide positive consumer and industry outcomes.

a. Internal simplification

This scenario involves:

- Transferring a consumer from one product to another issued by the same product issuer; or
- Leaving the consumer in the product they are currently in and changing it, or an underlying structure which supports the product, such as an investment structure.

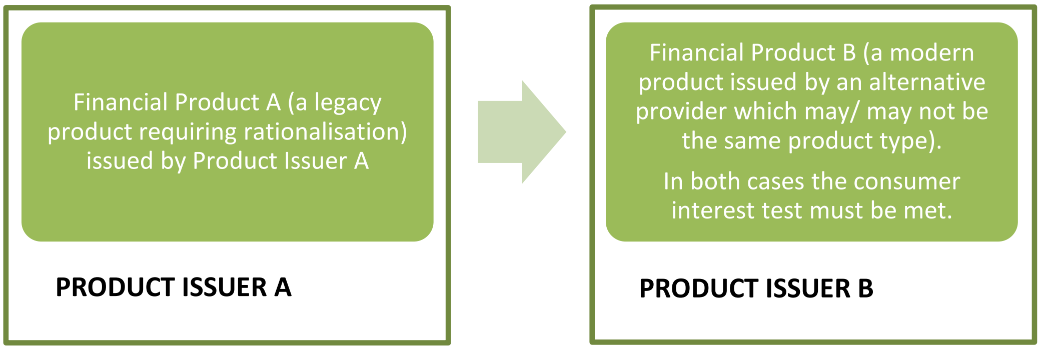


b. External simplification

This scenario involves:

- Transferring a consumer from one product to another issued by a different product issuer, whether that product is of the same kind or a different financial product. In practical terms this could be a life product to life product transfer or the transfer from one financial product to another financial product; or
- Substituting the current product issuer for another product issuer.

Inter-institution transfer or Inter-product transfer



c. Termination of product

When a product is no longer economically viable and has a very small number of remaining customers, a product provider can either terminate a product on the basis of the interests of consumers (returning their monies) or transfer the client(s) to a substitute product.

This mechanism would obviate the need to increase fees to in order to pass on the high costs of operating legacy products and the continuing cross-subsidisation of legacy products by the majority of consumers who are invested in contemporary products. This termination mechanism should be able to be exercised unilaterally by the product issuer and override any individual arrangements between the product issuer and the client.

2. APPLICATION OF TEST UNDER DIFFERENT PRODUCT TYPES

a. Life Insurance

Life Insurers cannot rationalise products under the current legislation, which requires the life insurer to ensure each individual policyholder is no worse off under any individual policy condition, despite such change being:

- In the **interest of the majority** of consumers.
- **As an overall package** of benefits and services, in the interests of an individual consumer, despite an individual condition being less advantageous.

While in theory consumer consent could be obtained to upgrade consumers, this is impractical. Under Part 9 of the Life Insurance Act 1995 (Cth) there is a process for the merger of the statutory funds of two life insurance companies. However, this provides limited practical benefit even in a merger (as only minor changes can be made) and does not assist a life insurer rationalise its own portfolio.

Over time and to meet prevailing market needs, a life insurer may have issued hundreds of individual products, which may also have been further customised for individual customers. Given the significant variation between policy terms, life insurers are effectively locked out from upgrading consumers to modern products as the current exercise of ensuring all consumers are no worse off is too arduous and unsustainable for life insurers to participate in.

The lack of a product rationalisation framework for life insurance is a significant barrier to product innovation in life insurance because life insurers don't want to be left with small portfolios of policies from innovation initiatives which are costly to administer. This stifles product innovation and in fact makes innovation very difficult. Ultimately the consumer loses as a result

Reinsurers also play an important role in the viability of any future rationalisation framework as should they reinsure the policy, they would need to consent to changes. Reinsurers should provide consent on the basis of independent actuarial advice confirming that they are not materially impacted.

Recommendation:

1. Amend the Insurance Contracts Act to allow life companies to unilaterally amend policy terms where a consumer interest test is satisfied when comparing the overall bundle of benefits the consumer currently has versus the proposed changes.
2. If a reinsurer is involved, independent actuarial advice should be sought prior to the action that confirms reinsurers are not materially impacted by product rationalisation and if so, they should provide consent to the change.

b. Managed Investment Schemes and IDPS

Many organisations operate managed investment schemes (registered or unregistered) which, due to their size or numbers of members are no longer efficient to operate. This may arise because a scheme is closed to new members and over time redemptions have reduced the size of the scheme (but the cost base has stayed the same or increased) or because mergers have resulted in duplication in the investment strategies of funds in the group.

For example, post merger a group may operate two emerging markets funds and it would be more efficient (and cost savings could be passed on to investors) if the funds could be merged.

It is difficult under the current legal framework to transfer investors from inefficient schemes to more modern or more sufficient schemes. For registered and unregistered schemes generally a 'trust scheme' is needed which requires meetings to be convened and generally requires applications to court for judicial advice, the outcomes of which are uncertain and the costs of which can be significant.

If transfers are not viable the only other real alternative is termination. Again, the outcome may be uncertain and the costs may be significant as a meeting may be required to amend the trust deed or seek member approval (a meeting is mandated by the Corporations Act for a registered scheme) and judicial advice may be needed. The termination of the fund may also crystallise any capital gains for the investor.

As these managed investment scheme problems arise in relation to all types of schemes the FSC proposes that the solution be made available to all categories of managed investment scheme, including:

- IDPSs, which are generally classified as unregistered managed investment schemes (because investors have the expectation of cost savings or access to investments that would not otherwise be available to them and are exempted from registration where they meet certain conditions); and
- IDPS-like schemes which operate similarly to IDPSs but are registered managed investment schemes.

Recommendation:

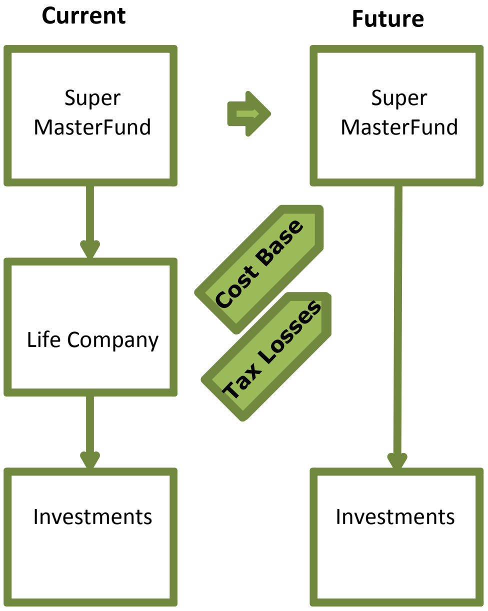
3. Permit the transfer of all the members from a legacy scheme (e.g. a scheme that is economically inefficient or out-dated) to another fund where the responsible entity or trustee considers on reasonable grounds that those transfers are in the interests of those members as a whole.
4. Introduce a more streamlined regulatory regime for the transfer of REs within a corporate group.

c. Underlying Structures

Facilitation of transfers between investment portfolios applicable to a financial product should apply to both life-backed investment portfolios as well as investment portfolios structured as managed investment schemes or pooled superannuation trusts. Such facilitation would allow for a transfer between portfolios without consent of affected investor(s) but subject to the consumer interest test.

For example, "life-backed superannuation product" is a commercial term that describes a superannuation fund offering super products with investment options invested through an investment policy from a life insurance company. The investment policy comprises of investment options similar to those offered by the superannuation fund.

The life insurance company invests the moneys "assigned" to those investment options under the investment policy under a mandate which supports the investment aims of the corresponding option offered by the super fund (e.g. growth option, conservative option, or in the case of the default fund, the life company would commonly invest the moneys assigned to either a balanced investment option or the appropriate life cycle options).



For many providers, the investment structure of life-backed superannuation products is a legacy of retail funds seeking to utilise benefits associated with the life insurance structure which were of greater benefit historically than today. For many providers, these benefits have now been eroded however the trustee and consumers remain "trapped" in the life policy structure which now results in an unnecessary impost of inefficiency, additional cost and red tape. Importantly, our proposal mirrors that of the existing rollover relief for the merger of superannuation funds, so is building on an already established framework.

Recommendation:

5. Having met the consumer interest test, the transfer of investment portfolios including life backed superannuation products to a modernised regime should involve:

   a. Members are switched from an investment option under a life policy to which they are invested into a corresponding investment option that is offered in the new directly investing product in the same superannuation fund.
   b. The manager of the investment option (in the case of life policy, the life company) disposes of the assets (the units in investment trusts)
   c. The superannuation MasterFund will withdraw its investment policy with the Life Company.
   d. The Superannuation MasterFund will acquire the same units in investment trusts, as disposed of by the manager of the investment option.
   e. The rationalisation mechanism should operate without tax consequences.

6. Having met the consumer interest test, the transfer of life company superannuation annuities to a modernised regime (a regulated superannuation fund) should involve:

   a. Policyholders switched from an investment option under the superannuation policy to which they are invested into a corresponding investment option that is offered in the superannuation fund.
   b. The life company transfers the assets to the trustee of the superannuation fund.
   c. The policyholder's rights under the superannuation annuity are extinguished and replaced by an interest in the superannuation fund.
   d. The superannuation fund will acquire the same units in the investment trust as disposed by the life company or acquire an investment-only policy with the life company relating to the same investment options.

3. OTHER CONSIDERATIONS

Overall the super mechanism works well from a consumer and product issuer perspective and has been used considerably by the industry in recent years to the benefit of all industry stakeholders.

Although it is outside of the scope of the FSI Panel's recommendation, which deals exclusively with life insurance and managed investment scheme legacy books and underlying structure rationalisation, there is scope to revisit one element of the current superannuation rationalisation mechanism.

Allowing holders of a term allocated pensions (TAPs) and other exempt pensions to easily commute their benefits into an account-based pension where they no longer receive any social security benefit from maintaining the pension would be a valuable improvement to the existing regime.

This would provide existing TAP and other pension holders with greater flexibility and choice in relation to how they can manage their retirement benefits.

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TAX BRIEF

8 May 2018

Budget 2018-19

The Budget has become like Christmas – it is a season, not an event. This year's Budget Season began in mid-April with the regular and strategic placement of good news stories (and definitely no bad news stories): no increase to the Medicare levy, personal income tax cuts for low income earners, tax reductions for higher income earners but spread over a longer time frame, incentives for the film industry (and yet another attempt to tweak the R&D tax incentive), changing the excise system to benefit brewers of craft beer, a Taskforce to crack down on illegal tobacco sales, big spending on infrastructure (including more money for hospitals in WA), new drugs added to the Pharmaceutical Benefits Scheme, more spending on the aged, and so on. Budget Season will continue for a few weeks yet as the Government tries to impress upon us the messages it wants us to remember. This Tax Brief outlines the tax components of the Budget, both the good news and the bad.

1. Corporate tax

In April, the Treasurer revealed that tax receipts from July to December 2017 were $4.8bn higher than expected, and of that, almost $3bn was due to higher than expected company tax collections. Notwithstanding that surprise, the Government has announced a series of measures which will increase corporate tax revenue.

1.1 Digital economy

Towards the end of his speech the Treasurer alluded, ever so briefly, to his earlier statements to make sure companies in the digital economy pay 'their fair share of tax,' if necessary by unilateral action pending a multilateral resolution. He indicated that a Discussion Paper on options for taxing the digital economy will be released 'in a few weeks' time.'

This is likely to include the options that the EU announced in March 2018 of developing in the longer term rules to be incorporated in tax treaties for a 'virtual permanent establishment' in the countries of the users of digital platforms and attributing some of the platform owner's profits to those countries. In the interim, the EU proposed an interim digital tax of 3% on revenues of large companies involved in (i) selling online advertising space (such as Google and Facebook); (ii) digital intermediary services (which allow users to interact with other users to facilitate the sale of goods and services between them (such as Uber or Airbnb); or (iii) the sale of data generated from user-provided information (such as Palantir).

In March the OECD said its work on these issues would be completed in 2020 but more recently the OECD has shifted the date to 2019.

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1.2 Valuation of assets for thin capitalisation purposes

The thin capitalisation rules will be amended to require entities to align the value of their assets for thin capitalisation purposes to the values used in their financial statements. There is currently some flexibility in the thin capitalisation rules to use asset values that are not contained in an entity's financial statements. In this regard, the ATO has been actively reviewing taxpayers who revalued their assets after the 2014 changes to the thin capitalisation rules (which reduced the safe harbour debt threshold to a 1.5 to 1 debt to equity ratio). The Government must consider that the robust review that comes with the preparation of financial statements affords additional integrity in this area. This measure will apply to income years commencing on or after 1 July 2019.

1.3 Classification of consolidated entities for thin capitalisation purposes

Foreign controlled Australian consolidated entities and multiple entry consolidated groups that control a foreign entity will now be treated as both outward and inward investment vehicles for thin capitalisation purposes. This will overcome a curiosity under the current thin capitalisation rules where these consolidated entities are deemed to be outward investment vehicles and different tests therefore apply. This change will apply for income years commencing on or after 1 July 2019.

1.4 'Significant global entity' definition

The definition of a 'significant global entity' ('**SGE**') will be broadened 'to ensure that Australia's multinational tax integrity rules operate as intended.'

SGEs are subject to the Diverted Profits Tax rules, the Multinational Anti-Avoidance Law and the Country by Country reporting obligations. While not mentioned in the Budget measures, any amendment to the SGE definition will presumably also have an impact on the increased penalty regime applicable to SGEs and the General Purpose Financial Statements lodgement obligations.

Under the current rules, an entity is regarded as a SGE for a particular income year if it satisfies one of the following:

- the entity is a 'global parent entity' ('**GPE**') with 'annual global income' of AUD$1bn or more; or
- the entity is a member of a group of entities consolidated for accounting purposes and the GPE of the consolidated group has annual global income of AUD$1bn or more.

The Government's proposal is to broaden the current definition to include members of large multinational groups headed by private companies, trusts and partnerships. It will also include members of groups headed by investment entities that may not otherwise be currently captured as they are not permitted to consolidate for accounting purposes.

For example, the new definition may have an impact on global funds including real property and private equity funds that currently may not be required to consolidate their Australian investments for accounting purposes.

The new measure will apply to income years commencing on or after 1 July 2018.

1.5 Tax consolidation

Budget Paper No 2 re-announced two changes already enacted by the *Treasury Laws Amendment (Income Tax Consolidation Integrity) Act 2018* which received Royal Assent in March this year. That is, the announcement reflects current law, not proposed changes. This is somewhat odd. The Budget will often recap announced but unenacted measures, but these measures have already been enacted.

The 'churning measure' ensures the consolidation tax cost setting rules will not apply to reset the tax cost of assets held by a non-land rich entity that joins a consolidated group or MEC group after being transferred from a non-resident entity who is not taxed on the transfer. This measure was clarified as requiring 50% common ownership within the previous 12 months based on an associate-inclusive test.

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However, this clarification was amended so that it only took effect from introduction of the Bill on 15 February 2018. For the period from 14 May 2013, the test is not associate-inclusive.

The highly convoluted (and unworkable) transitional rule initially proposed for the removal of deferred tax liabilities ('**DTLs**') from an entity's exit tax cost setting calculation was removed. The enacted measure removed DTLs from both entry and exit amounts from the date of introduction of the Bill on 15 February 2018.

1.6 Denying deductions for costs of holding vacant land

The Government will deny deductions for expenses associated with holding vacant land, whether the land is for residential or commercial purposes. Deductions which have been denied will not be able to be carried forward for use in later income years but will be included in the CGT cost base of the asset.

The measure will not apply to expenses associated with holding land:

- that are incurred after any property constructed on the land is complete and available for rent; or
- where the land is being used by an owner to carry on a business.

The Budget Paper says somewhat cryptically, that '*the carrying on a business test will generally exclude land held for commercial development*.' It is not clear whether the Budget Paper is trying to say:

- '*the carrying on a business test will generally exclude* [from this measure] *land held for commercial development*' and sale; or
- '*the carrying on a business test will* [not extend to] *land held for commercial development*,' even if the land is being developed for sale.

On the other hand, it may be trying to say, if the land is being developed for retention and lease, then '*the carrying on a business test'* will not be met and so the measure would apply.

Further clarification will be required about the scope of the measure given its potential impact. The measure will take effect from 1 July 2019.

2. Managed investment trusts and AMITs

2.1 CGT discount

The Government proposes to prevent Managed Investment Trusts ('**MITs**') and Attribution MITs ('**AMITs**') from applying the 50% capital gains tax discount at the trust level. This measure will apply to payments made from 1 July 2019.

The measure is directed at Australian resident companies that are beneficiaries of MITs and AMITs. They can, at present, effectively access the CGT discount where deductions (such as interest) are offset against capital gains, even though companies are not meant to enjoy CGT discount. For example, if a trust has a gross, discountable capital gain of $1,000 and interest deductions of $500 it will have net income of nil:

Gross capital gain	1,000
CGT discount	(500)
Interest deductions	(500)
Net income	0

This means that an Australian resident corporate beneficiary would have no taxable income despite the fact that, if it had derived and incurred those amounts directly, it would have had taxable income of 500. Further, at least in the case of a MIT, the trust could distribute $500 as a CGT concession amount with no cost base adjustment for the corporate or non-resident beneficiary.

While the proposed measure may be considered an appropriate outcome for Australian resident corporate beneficiaries, this represents the classic 'sledgehammer to crack a nut' response. The proposed position will put all *other* Australian resident beneficiaries in a worse position than they would have been if they had made a direct investment. Using the example above, an Australian resident individual would have no taxable income if they made the relevant investment and borrowed themselves. However, if that person invests through a MIT, the position of the MIT will now be:

Gross capital gain	1,000
Interest deductions	(500)
Net income	500

The Australian resident individual will now include $500 in their assessable income. While that $500 may qualify for the CGT discount, some tax will be payable in circumstances where no tax would be payable if a direct investment would be made.

This negative outcome will also apply for complying superannuation funds. Again, using the example above a direct investment would produce the following result:

Gross capital gain	1,000
CGT discount	(333)
Interest deductions	(500)
Net income	167

Under the proposed change, the complying superannuation fund would have net income of $500, reduced to $333 after the CGT discount. In effect, the rate of taxation has been doubled on a complying superannuation fund in this example.

These examples show that the Government's statement that, '*this integrity measure will ensure that MITs and AMITs operate as genuine flow-through tax vehicles, so that income is taxed in the hands of investors, as if they had invested directly*,' is simply not correct for Australian resident beneficiaries.

In the case of non-resident beneficiaries of MITs and AMITs, the effect of the CGT discount is already reversed in calculating the amount of income to which MIT withholding tax applies. Thus, even under current law a non-resident beneficiary would be subject to withholding tax on its share of the gross $500 income in the example set out above.

Given that Australian resident corporations make up a tiny proportion of the overall investment in MITs and AMITs, it must be wondered whether Australian resident individuals and complying superannuation funds should have to pay an inappropriate amount of tax to address the perceived windfall for Australian resident corporations. It is not clear why the Government has avoided specifically targeting Australian resident corporations and instead used the blunt instrument of changing the calculation of net income at the trust level.

Aside from the substance of the proposed change, the application date of the measure is also problematic. The Government has stated that the 'measure will apply to payments made from 1 July 2019.' Just what this means is unclear since:

- beneficiaries of AMITs are subject to tax on an attribution basis, which is unrelated to whether there are any payments made by the AMIT; and
- beneficiaries of MITs are subject to tax on their share of the net income of the trust for the year as a whole, regardless of when distributions are made. It is not clear how the Government considers

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that resident beneficiaries of MITs will be taxed for the year ending 30 June 2019 where some distributions are made before and some after 30 June 2019.

It is to be hoped that, at a minimum, the proposed measure will not apply to payments that relate to an income year that commences before 1 July 2019.

2.2 Expanded list of countries for reduced MIT withholding tax

A concessional rate of withholding tax (15%), currently applies to 'fund payment amounts' made to unitholders in a MIT that are resident in an 'information exchange country' listed in the regulations. There are currently 60 countries on this list but it has not been updated since 2012.

The Government announced that it will update the list of countries to include 56 additional jurisdictions that have entered into information sharing agreements since 2012. This updated list will be effective from 1 January 2019.

The announcement does not include the list of countries and it is not entirely clear what criterion the Government is using to identify the selected countries:

- if the requirement is that the other country *automatically* exchanges information with Australia, then it should extend to countries with which Australia has a comprehensive bilateral income tax treaty plus other countries which have signed the multilateral *Convention on Mutual Administrative Assistance in Tax Matters*, and in either case have signed the multilateral Competent Authority Agreement or a bilateral Competent Authority Agreement for Automatic Exchange of Information);
- if the requirement is the other country only exchanges information *on request* (which seems currently to be the case) then this would include any countries with which Australia has a comprehensive tax treaty or a Taxation Information Exchange Agreement, or that have signed the multilateral *Convention* but only exchange information on request.

Whatever the answer to that question, it is worth noting that Luxembourg will now be added to the list and Hong Kong remains a notable omission from the list.

2.3 Stapled structures

The Budget repeats the media release by the Treasurer on 27 March 2018 that the Government will introduce a package of measures to address the perceived integrity risks posed by 'stapled structures.' Broadly speaking, the following measures are being proposed:

- applying a 30% MIT withholding tax rate to distributions derived from trading income that has been converted to passive income (usually rent) using a MIT. Certain exemptions will apply for nationally significant infrastructure projects and for third party rents;
- thin capitalisation amendments to prevent double gearing structures. This will be achieved by lowering the associate entity threshold from 50% to 10%;
- limiting the foreign pension fund and sovereign immunity exemptions from withholding tax to portfolio investments only (that is, interests in the entity of less than 10%); and
- preventing agricultural MITs from accessing the 15% concessional MIT rate.

The thin capitalisation changes will apply from 1 July 2018. All other changes will apply from 1 July 2019 with a transitional period of at least seven years.

Our Tax Brief available **here** provides further details regarding these measures.

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3. Small business measures

3.1 Extending the $20,000 instant asset write-off for small business

In the 2015-16 Budget the Government introduced a small business depreciation concession for assets costing less than $20,000. The measure was due to expire on 30 June 2017 but was extended in last year's Budget to expire on 30 June 2018. This year's Budget announces that it will be extended again to expire in 30 June 2019 at a cost to revenue of $550m. Small businesses with aggregated annual turnover of less than $10m can immediately deduct the cost of assets costing less than $20,000 which are first used or installed ready for use by 30 June 2019. From 1 July 2019, the immediate deductibility threshold will revert to $1,000.

Assets costing more than $20,000 can be put into a pool and depreciated at 15% in the year first included and 30% in subsequent years. If the pool balance falls below $20,000 before 30 June 2019, the balance can be immediately deducted. From 1 July 2019, the pool balance threshold will revert to $1,000.

The rules which prevent small businesses from re-entering the simplified depreciation regime for five years if they opt out will continue to be suspended until 30 June 2019.

3.2 Amendments to Division 7A – unpaid trust entitlements

It has long been the view of the ATO that an amount to which a company that is a beneficiary of a trust is presently entitled, but which has not been paid to the company (an unpaid present entitlement or '**UPE**') should attract the application of Division 7A. The theory is that the amount represents a loan by a private company to the trustee of the trust (usually, an associate of a shareholder of the company) but a loan which is typically not appropriately documented and so not immune from challenge under Div 7A.

While the Commissioner had applied concessional treatment in some circumstances, from 1 July 2019, a new measure will 'clarify' that a UPE to a company beneficiary will be treated as a dividend under Div 7A unless a complying loan agreement has been entered into.

3.3 Delayed Div 7A amendments

In addition, the Government announced a deferred start date of 1 July 2019 for compliance-focused amendments to Div 7A that were announced in the 2016-17 Budget. Some of the main elements of the proposal include:

- a mechanism to amend without penalty arrangements which 'inadvertently' trigger the application of Div 7A;
- amended documentation requirements for Div 7A loans; and
- new safe harbour rules aimed at preventing the application of Div 7A in circumstances where an asset is provided for use by a company to a shareholder or associate.

A single package which combines all the Div 7A amendments will be enacted.

3.4 Removing small business CGT concession for partnership assignments

Partners who alienate their income by creating, assigning or otherwise dealing in rights to the future income of a partnership (including so-called *Everett* assignments) will no longer be able to access the small business capital gains tax concessions in relation to these transactions.

The Government has become convinced that some taxpayers, including large partnerships, are able to access these concessions inappropriately in relation to the assignment to an entity of a right to the future income of a partnership, without giving that entity any role in the partnership.

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In recent times the ATO has withdrawn its guidelines in relation to income splitting in professional firms (including *Everett* assignments) due to concerns regarding 'high risk' arrangements. The ATO is still formulating revised guidelines.

4. Personal income tax measures

4.1 Staggered reductions to personal income tax rates

The centrepiece of the Budget, so far as the Government is concerned, is the personal income tax cuts. While there is a modest tax cut scheduled to start on 1 July 2018, the most significant cuts are staggered over the period until 2024 – that is, after both the 2019 election and the election after that! The Treasurer promised that these measures would be legislated immediately (one can hear the faint echo of Paul Keating prior to the 1993 election declaring that his tax cuts were 'L-A-W'), but clearly these measures are subject to the vicissitudes of the election cycle.

The new rates and thresholds would be:

	Current rates 2017-18	**Stage 1 2018-19 to 2021-22**	**Stage 2 2022-23 to 2023-24**	**Stage 3 2024-25**
Tax-free amount	$18,200	$18,200	$18,200	$18,200
First rate, income between	19% $18,201 to $37,000	19% $18,201 to $37,000	19% $18,201 to $41,000	19% $18,201 to $41,000
Second rate, income between	32.5% $37,001 to $87,000	32.5% $37,001 to $90,000	32.5% $41,001 to $120,000	32.5% $41,001 to $200,000
Third rate, income between	37% $87,001 to $180,000	37% $90,001 to $180,000	37% $120,001 to $180,000	45% $200,001 and above
Fourth rate, income between	45% $180,001 and above	45% $180,001 and above	45% $180,001 and above	

These tax cuts come at a cost of over $13bn over the four year forward estimates.

Increased Medicare levy threshold. The Budget repeats the Government's decision to increase the various Medicare levy thresholds for the 2017-18 income year.

Extra ATO funding. The Budget also announces that the Government will give the ATO an extra $130m 'to increase compliance activities' focussed on individuals. The ATO is clearly concerned about the increasing cost of employee deductions and appears to have formed the view that tax agents are not an effective bulwark against incorrect claims. Part of the money will be devoted to continuing some of the ATO's income matching programs and other measures such as '*improving real time messaging to tax agents and individual taxpayers to deter over-claiming of entitlements …*'

The Budget estimates that for an outlay of $130m, the ATO will generate additional revenue of $1.1 billion.

4.2 Increase to the LITO

The Government's decision that the Budget would offer tax cuts to low income earners was leaked some time ago; over the weekend, it was revealed the mechanism for doing this would involve something similar to the Low Income Tax Offset ('**LITO**').

The Government has decided to supplement the LITO with another tax offset, the 'Low and Middle Income Tax Offset' ('**L&MITO**'), which will operate for four years, from 2018-19 to 2021-22.

LITO. The current LITO is valued at $445. It is payable in full until the taxpayer's taxable income reaches $37,000 at which point it is withdrawn at the rate of 1.5c for every extra dollar of taxable income and ceases entirely by $66,667.

From 1 July 2022, the government is proposing:

- taxpayers with taxable income up to $37,000: the LITO would increase to $645;
- taxpayers with taxable income between $37,001 and $41,000: the $645 tax offset is withdrawn at the rate of 6.5c for every extra dollar of taxable income;
- taxpayers with taxable income above $41,000: the tax offset is withdrawn at the slower rate of 1.5c for every extra dollar of taxable income and ceases entirely by $66,667.

L&MITO. This tax offset works in these stages:

- taxpayers with taxable income up to $37,000: they will receive an additional tax offset of $200;
- taxpayers with taxable income above $37,000 but less than $48,000: the $200 tax offset will *increase* at the rate of 3c per dollar of extra taxable income up to a maximum of $530. (Presumably this counters the *reduction* to the LITO occurring over part of this income range);
- taxpayers with taxable income between $48,001 and $90,000: these taxpayers will receive the maximum tax offset of $530;
- taxpayers with taxable income above $90,000: the $530 tax offset is withdrawn at the rate of 1.5c for every extra dollar of taxable income and ceases entirely by $125,333.

From the Government's point of view, there would seem to be several benefits from delivering the tax cut in this way: unlike an increase to the tax-free threshold or a reduction in the bottom rates, the benefit is delivered only to people whose taxable income is low, it does not affect PAYG collections, it can only be accessed by people who go to the trouble of filing an income tax return, and there is a lot of wastage (the LITO is not refundable, can't be transferred and can't be carried forward, and one assumes the L&MITO will follow the same pattern).

On the other hand, a tax cut delivered by the LITO and L&MITO is all but invisible to most voters. No-one will see the impact of this tax cut in their pay slip once it begins.

4.3 Increase to Medicare levy cancelled

The biggest single revenue-raising measure in the 2017-18 Budget was the announcement of an increase to the rate of the Medicare levy from 2% to 2.5% from 1 July 2019, a measure which was expected to raise more than $8bn over the forward estimates. And in a break from Treasury tradition, this revenue was actually to be ear-marked to fund the National Disability Insurance Scheme with the Government promising to credit the funds 'to the NDIS Savings Fund Special Account when it is established.'

The Labor party supported the increase to the Medicare levy rate but only for individuals with taxable income above $87,000. The Government was unwilling to compromise and so the package of 11 Bills has been stalled in the Senate for the last 6 months.

It was not surprising when the Treasurer announced in late April that this measure would be scrapped. Not only was the proposal unachievable in the current political climate, it would undermine the Government's preferred message – people should focus on the personal income tax cuts being offered in the Budget, not the tax increase planned for 2019.

5. Superannuation

The Budget announces that the Government will:

- ban exit fees, cap fees for low balance accounts under $6,000, require low balance inactive accounts to be transferred to the ATO and make insurance optional for low balance accounts, inactive accounts and accounts for members aged under 25 years (members will have to 'opt-in' to any insurance component);
- allow new retirees aged 65 to 74 with less than $300,000 in superannuation to make voluntary contributions in the year after they fail the 40 hours in 30 days 'work test';
- require superannuation funds to formulate and offer a comprehensive income in retirement product for members and provide favourable Age Pension means testing for pooled lifetime income stream products;
- allow high paid employees with more than one job that causes mandated contributions to exceed the $25,000 concessional contributions cap to partly opt out of superannuation guarantee;
- adopt compliance procedures to reduce the incidence of employees claiming tax deductions for personal contributions where they have not advised the fund by submitting a valid and acknowledged 'notice of deduction' form (so that the fund is unaware that it has to pay 15% tax on the contribution); and
- increase supervisory levies to pay for increased ATO compliance.

6. Indirect taxes

6.1 Online hotel accommodation providers

Offshore sellers of hotel accommodation such as Wotif, Expedia and Bookings.com that provide Australian hotel accommodation will be required to calculate their GST turnover in the same way as local accommodation providers from 1 July 2019.

As a result, online providers that make sales of hotel accommodation in Australia of over $75,000 per annum will be required to register for GST and charge GST on the sales, capturing GST on their mark-up on the accommodation. The additional GST should only be on the margin as they will also be entitled to claim input tax credits on GST incurred on their acquisitions.

This measure comes after extensive ATO audit activity in the sector which recognised the 'uneven playing field' and also aligns with the move to tax digital supplies from offshore.

The Government estimates that this will raise $15m over the forward estimates period. It will only apply to sales made after 1 July 2019 and so should exclude a hotel stay after 1 July 2019 that was paid for prior to that date. Initially this cost falls on the offshore sellers but will likely be passed on to consumers or back to hotel operators.

6.2 Other online accommodation providers

In addition, the Government has noted a recommendation in the *Black Economy Taskforce Final Report* which suggested it examine how GST should apply to accommodation provided through Airbnb and similar platforms. The Government response was merely to note that such providers may need to account for GST on those sales where they reach the turnover of $75,000 per annum.

6.3 GST and ABN aspects of phoenix activity

The Government has announced measures directed to combating illegal phoenix activity including extending the Director Penalty Regime to GST, luxury car tax and wine equalisation tax. This measure will make directors personally liable for the company's debts for these taxes.

The Director Penalty Regime currently makes directors personally responsible for PAYG and superannuation guarantee charge, which only has an impact on companies with employees. Extending this regime to GST will affect thousands more companies, and thus many thousand more directors than the current regime. The Australian Institute of Company Directors raised multiple concerns in its response to the Treasury Consultation, noting 'to impose personal liability for corporate breaches occurring at a time when the new director had no actual or legal ability to influence the conduct of the corporation offends a fundamental tenet of the rule of law.'

No details of how these measures will apply has yet been provided but presumably all company directors will now take a keener interest in the GST compliance of all entities for which they have a fiduciary responsibility. This regime will put pressure on in-house tax teams to reassure the Boards of every company in the group that GST has been correctly paid.

The Government also indicates its intention to overhaul the ABN system (including possible renewal of ABNs), a review of the business register and verifying ABNs in electronic payment processing.

7. Tax administration – the Black Economy

The final report of the *Black Economy Taskforce* and the Government's response to 'tackle the black economy' were released together with the Budget papers. The *Black Economy Package* in the Budget contains a number of announcements, mainly directed at tax administration and compliance to assist in revenue recovery, and which follow on from the *Tax Integrity Package* in last year's Budget. The *Black Economy Package* includes the following measures.

7.1 Taxable payments reporting system

The taxable payments reporting system ('**TPRS**') is a transparency measure that requires businesses to report to the ATO all payments they make to certain contractors. From 1 July 2019, the TPRS will be further extended to cover the following industries:

- security providers and investigation services;
- road freight transport; and
- computer system design and related services.

7.2 Cash payment limit

In order to tackle tax evasion and money laundering, a limit of $10,000 for cash payments made to businesses for supplies of goods and services will be introduced from 1 July 2019. An electronic payment method or cheque will be required instead.

Carve outs from this measure are anticipated for consumer to consumer (non-business) transactions, and for transactions with financial institutions (which would still be subject to existing anti-money laundering and counter-terrorism financing reporting requirements).

7.3 Removal of tax deductibility for non-compliant payments

A business that has not withheld PAYG from a payment of employee remuneration, or to a contractor that has not quoted an ABN when required, will not be entitled to claim an income tax deduction for the payment. This measure will apply from 1 July 2019.

This appears intended as a financial deterrent in addition to the existing regime, that already imposes an administrative penalty for failure to withhold when required under the PAYG system. However, as acknowledged by the *Black Economy Taskforce Report*, it requires the non-withholding to be detected, and also for phoenix type activity to be thwarted in order to recover tax shortfalls.

7.4 Government enforcement

Additional funding of approximately $300m over four years will be provided to the ATO 'to implement new strategies to combat the black economy' and 'to support the new multi-agency Black Economy Standing Taskforce', in order to ensure a more coordinated approach to combatting the black economy. This will include increased ATO audit activity, use of improved data analytics and information sharing between Government agencies.

A significant return is forecast to be delivered from this new funding (a gain to revenue of $3bn, and to cash receipts of $2.5bn, over the four year forward estimate period).

7.5 Further action to combat phoenix companies

In December 2015, the Productivity Commission released the *Final Report* from its inquiry into *Business Set-up, Transfer and Closure*.

The first measure announced following the *Report* was the proposed introduction of Director Identification Numbers. This was the subject of a Press Release from the Minister for Revenue and Financial Services on 12 September 2017. In that Press Release, the Minister also referred to 11 other measures to 'deter and disrupt the core behaviours of phoenix operators, including non-directors such as facilitators and advisors' upon which consultation would be sought.

The Budget announcement seeks to implement 6 of those measures (albeit with tweaks). Measures specifically referred to in the Budget Papers are:

1 the introduction of new phoenix offences to target those who conduct or facilitate illegal phoenix activity;

2 prohibiting entities related to the phoenix operator from appointing a liquidator – the Budget announcement differs in that related creditors will be restricted in their ability to vote on the appointment, removal or replacement of an external administrator;

3 preventing directors from backdating their resignations to avoid liability or prosecution;

4 limiting the ability of directors from resigning and leaving a company with no directors; and

5 expanding the ATO's power to retain tax refunds where there are outstanding tax lodgements.

There is still some unfinished business from the 12 September 2017 Press Release and we wait to learn the fate of the remaining measures:

1 the establishment of a dedicated phoenix hotline – the Government refers to a 'new hotline' to report illegal activity in the black economy in its response to the *Black Economy Taskforce Final Report* (both the *Report* and the response were released along with the Budget papers);

2 the extension of the promoter penalty regime to capture advisers who assist phoenix operators – the Government agreed with this measure in principle, and refers to implementing 'a comprehensive package of reforms which focus on deterring, disrupting and penalising those who

engage in illegal phoenixing activity.' This is likely to be part of the new phoenix offences to be introduced as noted above;

3 stronger powers for the ATO to recover security deposits from suspected phoenix operators – perhaps the GST withholding regime on property developers is seen as a 'toe in the water' for this measure;

4 a 'next-cab-off-the-rank' system for appointing liquidators; and

5 allowing the ATO to commence immediate recovery action following the issuance of a Director Penalty Notice.

8. Other measures

TOFA. The Budget confirms the Government's decision, announced in December last year, to defer the start date of measure arising from the project to reform various aspects of the TOFA regime. The project will apparently try to improve the design and functioning of the basic accruals and realisation system, the forex regime in TOFA and the hedging regime in TOFA.

R&D. The Government is trying yet another design for the R&D tax incentive 'to better target the program and improve its integrity and fiscal affordability.' The proposed changes will implement recommendations made in the 2016 *Review of the R&D Tax Incentive*. The changes will apply for income years starting on or after 1 July 2018.

Treatment of concessional loans in entities that become taxable. When a tax exempt entity becomes a taxable entity (eg, a privatisation occurs), the rules in Division 57 operate to deem liabilities held by the entity to have been assumed for a payment equal to the 'adjusted market value' of the corresponding asset in the hands of the person to whom the liability was owed. In the case of a concessional loan, this would likely lead to a market value below the face value of the loan. When the loan is repaid, Division 230 treats the difference between the face value repaid and the market value at the time the entity became taxable as a loss and therefore the entity obtains a deduction for a portion of the principal.

For entities that become taxable after 8 May 2018, a tax deduction will not be allowed for that principal amount by requiring the liability to be valued as if it were on commercial terms.

Revolving trust distributions. The Budget announces that the Government will apply 'a specific anti-avoidance rule that applies to … closely held trusts that engage in circular trust distributions' to family trusts. Just which particular provision the drafters have in mind is not spelt out but the most likely candidate is Div 6D ITAA 1936 – a regime which requires the disclosure of the ultimate beneficiaries of a trust which has as one of its beneficiaries the trustee of another trust. The measure does not start until 1 July 2019 so there is clearly no great urgency to the measure.

Income of minors from testamentary trusts. The Government has announced it will change the taxation of the unearned income of minors received from testamentary trusts. Income from testamentary trusts is currently subject to tax at ordinary rates; that is, the income is not subject to the punitive rates that apply to other types of unearned income of minors. From 1 July 2019, marginal rates will only apply to 'income … from assets that are transferred from the deceased estate or the proceeds of the disposal or investment of those assets …'

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