Federal Budget 2022–23

FSC submission

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FINANCIAL SERVICES COUNCIL

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About the Financial Services Council

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

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. 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 $3 trillion on behalf of more than 15.6 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.

1 Introduction

The FSC welcomes the opportunity to submit its policy recommendations for the 2022–23 Budget.

As the economy continues to recover from the COVID-19 pandemic, it will be vital for the to ensure Budget policy settings are geared towards opening opportunities for business to create even more jobs and better products and services for consumers.

Financial services covering superannuation, life insurance, financial advice and funds management impact the lives of every Australia and have the potential to compliment and drive a prosperous economic recovery, including by driving more investment in infrastructure, removing barries tax or regulatory to better products and services for consumers, and creating new opportunities for industry to service international markets.

Our recommendation focus on these opportunities.

2 Recommendations

Superannuation [Section 3]

- **Leveraging Superannuation to Invest in Infrastructure** by introducing a new approach to facilitate private investment into infrastructure, unlocking up to $1.7 trillion in potential new superannuation investment.

- **Facilitate product modernization in superannuation** triggered by the Your Future, Your Super reforms, by extending the capital gains tax rollover relief for mergers of superannuation funds to additionally include the transfer of superannuation products within a fund.

- **Remove unnecessary cost and complexity created by the transfer balance cap** by streamlining how the indexation rules apply to individuals in the retirement phase.

Life Insurance [Section 4]

- **Support better decision making by Government and the private sector** by funding a new ABS National Survey of Mental Health and Wellbeing as recommended by the Productivity Commission in its Final Inquiry report on Mental Health**.**

- **Allow the life insurance industry to support its clients getting back to work** by removing legislative barriers preventing life insurers funding mental health treatment for customers as recommended by Productivity Commission in its Final Inquiry report on Mental Health.

Financial Advice [Section 5]

- **Increase accessibility to financial advice for all Australian's** by leveraging the tax system to support people to take up financial advice.

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Technology Aligned Regulation [Section 6]

- **Lower costs for consumers** by promoting technology aligned regulation to remove remaining restrictions on the use of electronic communications**.**

- **Lower costs for consumers** by working with the states to introduce an Australia-wide, standardised lost customer/money scheme for financial services.

Funds Management, Global Markets and Taxation [Section 7]

- **Ensure the tax system does not disadvantage (overtax) indirect investment by individuals through managed funds compared to direct investment** by reversing the 2018-19 Budget announced the Government would remove the CGT discount for managed funds.

- **Improve the international competitiveness of Australia's funds management industry through a range of measures:**

    - Extending the Managed Investment Trust start-up treatment to a longer time frame (5 years) while include additional requirements to qualify such that only funds which are intended to be widely held can benefit from the extended start up treatment.

    - Implementing a 5% withholding tax on payments under the Asia Region Funds Passport, excluding income that is already exempt and income from Australian real property.

    - Prioritise tax treaty negotiations with Luxembourg and Hong Kong and address financial services issues in existing tax treaties; ensuring that any new Free Trade Agreements are accompanied by a tax treaty; and amend older tax treaties so they fully deal with superannuation and collective investment vehicles.

    - Address outstanding Investment Manager Regime (IMR) which are undermining its effectiveness, specifically to ensure that the engagement of an Australian independent fund manager will not cause a fund that is legitimately established and controlled offshore to be an Australian resident.

    - Extend the attribution regime to Investor Directed Portfolio Services so the Corporate Collective Investment Vehicle due to commence on 1 July 2022 can effectively implement existing industry products including including platforms, wraps or master trusts from a tax perspective.

    - Widen eligibility for functional currency election to support the introduction of the AMIT regime and the Asia Region Funds Passport in order to permit Australian fund managers to attract overseas investors who may wish to invest and receive accounting and tax reports, distributions and capital returns in their own (non-Australian dollar) currency,

- Fix issues with the Interest Withholding Tax (IWT) exemption, particularly ensuring bond profits are treated as interest for IWT purposes and remove IWT on posted collateral.
- Allow AMITs to access CGT rollover relief that is available to other trusts.
- Ensure the correct Australian taxation of foreign capital gains.
- Provide flowthrough tax treatment for foreign trusts.

3 Superannuation

3.1 Leveraging Superannuation to Invest in Nation Building Infrastructure

The FSC calls for the Government to design and implement an improved approach to private sector investment in infrastructure.

Australia has substantial infrastructure investment needs, Governments have an incentive to crowd in private sector investment, and there are substantial funds in collective investments, including superannuation, looking for assets to invest in.

Superannuation funds are already investing into infrastructure, but much more could be done to facilitate the meeting of infrastructure investment needs with the large supply of potentially investible funds.

The FSC has been calling for a new structure to be introduced called an Australian Superannuation and Infrastructure Investment Vehicle (or **ASIIV**) to help bridge this divide.

The strength of ASIIVs is that they will enable governments to more effectively tap into categories of investors seeking the steady income stream that infrastructure can often provide, including the almost $700 billion SMSF sector and the $1 trillion invested by ‘choice’ customers.

The ASIIV will differ from existing infrastructure vehicles by being:

- Tradeable on secondary markets, supporting liquidity and facilitating price discovery;
- Available to retail investors through existing platforms; and
- Unitised and regularly valued by independent consultants.

The FSC’s proposal for an ASIIV is designed to:

- Accelerate the financing of new infrastructure projects by providing governments access to additional sources of capital; and
- Expand access to existing asset recycling programs to all categories of superannuation investors.

The strength of ASIIVs is that they will enable governments to more effectively tap into categories of investors seeking the steady income stream that infrastructure can often

provide, including the almost $700 billion SMSF sector and the $1 trillion invested by 'choice' customers.

The FSC recommends the creation of two categories of ASIIVs:

- Single-asset ASIIVs to finance new infrastructure developments, for investors seeking exposure to a specific asset; and
- Multi-asset ASIIVs that 'bundle' existing infrastructure assets, collectively producing a predictable and stable yield, and allowing different levels of Governments to contribute assets into the vehicle.

ASIIVs will encourage asset recycling by creating collective vehicles that governments can participate in, freeing up capital to allow investment in new infrastructure projects.

ASIIVs also overcome the current reliance on institutional investors for ownership of infrastructure. Recent experience has shown direct ownership of infrastructure by a narrow field of investors generates perceptions of liquidity risk that undermines public confidence in the superannuation system.

To maximise the attractiveness of ASIIVs to investors tax issues with funds owning infrastructure should be resolved, including the double taxation of funds owning depreciating assets and the 'trapping' of tax losses in the fund.

3.2 Rollover relief for superannuation product rationalisation

The Government has announced a limited product modernisation scheme for superannuation, which is to cover market-linked, life-expectancy and lifetime pension and annuity products, and has recently introduced permanent CGT rollover relief for merging superannuation funds. While the FSC welcomes these measures, we consider that further reform is needed to adequately support simplification and rationalisation of superannuation products.

The FSC considers that these policies should be extended to cover the rationalisation of investment structures and individual superannuation products.

Currently, there is tax rollover relief for the merger of an entire fund with another fund. However, there is no relief available for the transfer of assets to simplify and rationalise the underlying investment structure nor for the transfer of only the assets of an identifiable product within a fund. Introducing this tax relief will assist in consolidating the number of investment vehicles and individual products in superannuation funds, and will dramatically assist funds in dealing with any underperformance in individual products.

Superannuation trustees unable to improve performance of a particular product identified as underperforming based on the *Your Future Your Super* performance test will need to consider options for moving members to better performing products. While tax relief is available if an entire fund is merged with another fund, there is currently no such relief where performance could be improved by transferring members and underlying assets to another product within the same fund. In the absence of relief, there will be tax penalties (which may be substantial) if members of an underperforming product are transferred to other products.

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There is also no rollover relief to simplify and rationalise underlying investment structures where a product or an entire fund is merged with another fund. Without this relief, any merger/transfer of a superannuation fund or product will mean the cost and inefficiency issues could easily perpetuate in the successor fund, limiting further potential improvements in performance.

We note that tax relief was provided when fund members were moved from 'old' default superannuation products to MySuper products – the relief we are proposing would mirror this relief, also covering underlying investment structures. The case for this proposal is similar to the case for the relief provided for MySuper.

Introducing these rationalisation schemes will provide additional avenues for the underperformance of individual products to be addressed, including by simplifying and rationalising the investment structure of the existing fund, rather than needing to transfer that structural complexity and attendant costs to the successor fund.

We specifically recommend that:

- Rollover relief would be available for assets supporting a superannuation product where the member interests in that product are identifiable.
- Any transfer would need to be in the best financial interests of members – similar to the current rule required for a super fund merger (successor fund transfer).
- The transfer of assets relating to the product would not be a taxing point. The original cost base of the assets would be retained.
- The fund members would not have any tax or social security impact from the transfer of the assets of the product.
- Rollover relief would be available for the consolidation of Managed Investment Schemes where there is no change in ultimate beneficial entitlement to distributions of income and capital.

These changes can be most easily and quickly implemented by copying the expired sections 311-12 and 311-42 into Division 310 (with only the smallest of drafting changes). Those two sections were to enable implementation of My Super investment structures without CGT cost.

The need for more policy responses to legacy superannuation products was shown by the Productivity Commission in a report into the superannuation industry, which found in 2017:[1]

- there was $162 billion invested in legacy superannuation products, which was 10% of the total assets held in APRA-regulated funds at that time.
- there were 3.2 million legacy member accounts, which was 12% of the total for APRA-regulated funds.

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[1] Productivity Commission (2018), *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91, Page 115 except where stated.

  - This implied around 2 million individuals were trapped in legacy superannuation products with poor returns, based on the number of duplicate accounts in 2017.[2]
- Legacy products made up 46% of the assets in the high fee tail of products, with about 2 million member accounts; and almost all legacy products have high fees. The average fee in this tail was 2.2%, which is more than three times the most prevalent (i.e. modal) fee of 0.7% (see page 180 of the report).
- The number of products in the high fee tail has remained steady over time (see page 180 of the report). This implies that it cannot just be assumed that the issue of legacy products will gradually disappear over time.

Earlier FSC estimates of the extent of legacy products in superannuation are contained in previous FSC submissions.[3]

3.3 Remove inefficiency and complexity due to the transfer balance cap

The superannuation system now has several caps on contributions and a cap on the maximum amount that can be transferred into retirement phase accounts (the Transfer Balance Cap or **TBC**). These caps add substantial complexities to the superannuation system. The upcoming indexation of the TBC is a case in point.

The general TBC is indexed by increments of $100k, but the actual value of the cap will be a different amount below $100k for all individuals who have some money in retirement phase already. Specifically:

- A superannuation fund member who only has $160k in retirement phase has only used up 10% of the $1.6m of the general TBC. So they have 90% leftover of the general TBC. Under the legislation, they have 90% or $90k added to their own personal TBC (taking it up to $1.69m) at that point in time.
- A member who has $1.44m in retirement phase has used up 90% of the $1.6m general TBC. So they have 10% leftover of the general TBC. Under the legislation, then they only get 10% or $10k added to their own personal TBC (taking it up to $1.61m) as at that point in time.

As a result, every person who has entered into retirement phase will have a different and personal TBC.

The superannuation industry has not in its recent history experienced any caps that vary between individuals in such a way.

[2] There were about 1.6 accounts per person in 2017, see: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Multiple-super-accounts-data/

[3] For example see FSC Pre-Budget submission for 2018–19, available from: https://consult.treasury.gov.au/budget-policy-division/2018-19-pre-budget-submissions/consultation/download_public_attachment?sqId=question.2017-09-12.3768452384-publishablefilesubquestion&uuId=596571344

The ATO now has to calculate every taxpayer's personal TBC. However:

- The calculation of the TBC is complicated, and complexity will increase over time with each indexation of unused caps;
- The situation is difficult to explain to members; and
- The individualised TBC is hard for trustees or financial planners to advise on if they are unaware of a customer's total super balances (e.g. if the customer has accounts with several providers).

There is a particular issue of concern to FSC members if fund members act on a personal TBC calculation if this is based on incorrect data. In some cases, the fund member could be subject to a penalty for an error outside their control. The issue is exacerbated if a customer has interests in an SMSF (in addition to an APRA regulated fund) which do not need to report as quickly as APRA regulated funds. Some degree of leniency in administration is warranted.

The FSC recommends the Government consider methods for reducing this complexity, for example:

- There could be one indexed TBC for everyone, regardless of when individuals transferred into a retirement phase account, or how much is in the retirement phase.
- As an alternative, the proportionate reduction for unused caps could only apply at the higher end (i.e. those close to the TBC in the previous year), as opposed to the entire retiree population.
- The TBC could be replaced by taxation of income from retirement phase accounts above a high tax free threshold that mirrors the effect of the TBC.

A large majority of retirees will never get close to $1.6m for the proportional reduction calculation to matter, so the current approach is costly and inefficient to administer and calculate for the majority.

4 Life Insurance

4.1 Fund a new ABS National Survey of Mental Health and Wellbeing

The Productivity Commission in its Final Inquiry report on Mental Health recommended:

> The Australian Government should support the Australian Bureau of Statistics to conduct a National Survey of Mental Health and Wellbeing no less than every 10 years (Action 24.2).

We recommend the Government act on this PC recommendation. The latest population wide survey data on mental health is over a decade old4 and has not kept pace with emerging societal trends.

[4] Australian Bureau of Statistics, The 2007 National Survey of Mental Health and Wellbeing, 2008

More up-to-date data is collected in respect to individual funding systems for mental health, such as funding from life insurance, social security and workers' compensation. However, considering these data sources in piecemeal fashion does not account for the complex nature in which these different funding sources often interact with one another. Importantly, they do not cover the whole Australian population. The FSC would also welcome consultation from Government and other sectors in relation to possible cross-industry data utilisation and sharing.

4.2 Make permanent the temporarily increased limits on subsidised psychological therapy sessions

In the 2020–21 budget, the Government announced $100.8 million in funding over two years to provide up to 10 additional psychological therapy sessions under the Better Access scheme each calendar year nationally due to the impact of COVID-19 on mental health.

This will not only increase access to mental health care for all Australians who are experiencing more severe or enduring mental health impacts from the COVID-19 pandemic but also benefit those Australians with more complex mental health conditions who need to access more counselling sessions on a permanent basis.

It has also been raised that the out-of-pocket expenses can be unaffordable for people in lower socio-economic groups.[5] The FSC recommends these changes be made permanent, subject to proper monitoring and evaluation on whether this temporary measure has proven effective in addressing these concerns.

4.3 Remove legislative barriers preventing life insurers funding mental health treatment for customers

The Productivity Commission's Inquiry into Mental Health recommended:

> The Australian Government should review the regulations that prevent private health insurers from funding community-based mental healthcare activities, and permit life insurers to fund mental health treatments for their insurance clients on a discretionary basis (Actions 23.9, 23.10).

Despite the important role that life insurers can play in supporting people with mental health conditions, life insurers are generally prohibited by existing regulatory frameworks from providing funding for psychological or psychiatric counselling for our customers. The FSC has long advocated for the legislative constraints be reformed so that life insurers can fund the provision of health services to consumers[6], and facilitate consumers returning to wellness. For a system where services are already stretched, especially in regional and

[5] Graham N Meadows, Joanne C Enticott, Brett Inder, Grant M Russell and Roger Gurr, Better access to mental health care and the failure of the Medicare principle of universality, Medical Journal of Australia, 2015

[6] For example, Financial Services Council, Submission to the Parliamentary Joint Committee on Corporations and Financial Services 2018

remote Australia, therefore allowing life insurers to fund mental health treatments may remove one of the barriers to seeking regular treatment.

In 2018, the FSC engaged Cadence Economics to undertake research in relation to the economic benefits of allowing life insurers to fund access to health services7, including services for people with mental health conditions. This research showed that approximately 1,400 people on an annual basis could be assisted by life insurers providing funding for targeted early intervention treatments, with consequent productivity and economic benefits for the community and the Government. Adjustment would need to be made to a number of pieces of legislation to achieve these reforms, however, these amendments would not be significant.

The life insurance industry is one of the largest non-Government financial supporters of people with mental health conditions, paying out a total of $1,478 million to their customers for mental health in the 12 months to 30 June 2020.8 It therefore seems incongruous that life insurers can potentially face criminal penalties if they provide funding for health services to support the needs of their customers.

The FSC supports the Government acting on the Productivity Commission's recommendation on this important issue. Any health service that is provided to customers following such reforms would be provided by an appropriate registered health provider, with fully informed patient consent and in consultation with the customer's medical team.

5 Incentives to increase access to professional financial advice

The most recent Intergenerational Report[9] shows a considerable proportion of the population in retirement, with more costly and complex financial needs, underlining the need for professional financial advice. The cost of producing advice is worn by consumers and these costs increase as the compliance burden on advice increases, placing professional advice out of reach for many consumers, particularly those on low to middle incomes.

Advised consumers are better positioned to self-fund their retirement compared to individuals who do not access advice. Maximising retirement incomes reduces a consumer's reliance on the Age Pension and provides a benefit both to the Government's fiscal position and taxpayers. Rice Warner's modelling has shown that the wider provision of advice could result in a one per cent uplift in the investment earnings of Australians, with national savings increasing by approximately $2 trillion over 30 years.[10] The cost of increasing access to

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[7] Cadence Economics, Falling through the Cracks, 2018
[8] FSC/KPMG life insurance data project
[9] 2021 Intergenerational Report. Australian Government. The Treasury. Source: 2021 Intergenerational Report | Treasury.gov.au
[10] Page 19. 'Future of Advice'. Rice Warner. (Source: https://www.ricewarner.com/wp-content/uploads/2020/10/RW-Future-of-Advice-Report.pdf).

advice would be offset by the social benefits of incentivising disengaged cohorts of consumers to engage in financial advice to help meet their financial needs.

The FSC's White Paper on financial advice[11] advocates the Government examine how the tax system could be used to support people to take up financial advice this could be assessed in three ways including:

- A means tested tax rebate
- One-off $500 payment for upfront financial advice
- Tax deductibility at a capped or uncapped rate

6 Technology aligned regulation

The FSC recommends the Government:

- Remove any remaining restrictions on electronic communications, so that businesses are in all cases allowed to communicate by electronic means alone. This includes removing all exemptions from the Electronic Transactions Act for superannuation and life insurance, and ensuring electronic signatures in financial services are permissible.

- Work with the States and Territories to introduce an Australia-wide and standardised lost customer/money regime for financial services outside of superannuation.
  - Currently, most unclaimed money regimes have a minimum amount that can be lodged with the regime[12] – it would be preferable if a new standardised regime should not have a minimum threshold amount, so that financial service businesses are able to lodge very small unclaimed amounts with the regime.

7 Funds management, global markets and taxation

7.1 Reverse decision to remove CGT discount for managed funds

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).[13] As at time of this submission, the proposal has not been legislated, but it still remains Government policy.

The FSC has major concerns with this proposal in that it replaces a tax neutral approach with one that **overtaxes** individuals that invest through MITs and AMITs.

Specifically, the 2018–19 Budget states[14] 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

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[11] See: https://www.fsc.org.au/policy/advice/white-paper-advice
[12] See ASIC Attachment to CP 350 (draft regulatory guide on remediation) at paragraph 203.
[13] See Budget Paper 2, page 44.
[14] See Budget Paper 2, page 44.

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”.

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 E) provides an example where:

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

7.1.1 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):

Individual level	Invest through MIT/AMIT Current	Invest through MIT/AMIT Proposed	Direct investment
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 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.

7.1.2 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 superannuation 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 it was 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 superannuation 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.[15] 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.

Instead of this measure, the FSC is recommending a measure targeted at corporates and non-residents that are accessing the CGT discount through MITs and AMITs.

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

7.2 Extend the existing Managed Investment Trust start-up treatment

It is important to retail investors for a managed fund to have MIT or Attribution MIT (**AMIT**) status. The benefits most notably include the certainty provided by deemed capital account treatment for covered assets, ability to adjust 'unders and overs' in subsequent years (rather than amending unitholder tax statements) and deemed fixed trust status.

To qualify as a MIT a fund needs to meet widely held/not closely held tests within 1-2 years of set up under the current start up treatment rules (and to elect to be an AMIT, a fund must first qualify as a MIT).

However, in practice, funds generally need a 2 to 3-year track record before starting to gain any sales traction and up to 5 to 6 years to become properly established. Many new funds are 'seeded' by the fund manager, in order to demonstrate the viability of the strategy over an initial period and so attract further investors required to meet the widely held or not closely held requirements. If the fund fails the widely held/not closely held tests at the end of the relatively short start-up treatment period, the loss of MIT/AMIT status then makes the fund unattractive to many retail investors.

The limited timeframe for MIT qualification can be a self-fulfilling exclusion from attaining MIT status. Many investors will not invest unless MIT status can be confirmed and in the start up phase, this can limit the ability of the fund manager to attract clients, because the timeframes may be considered too tight.

While the full 5-year period proposed below may not be utilised, it provides sufficient 'buffer' that provides confidence to potential investors that the fund will qualify as a MIT. Given the implications of not qualifying are material, potential investors will assess the risk as high even if it is probable that MIT status may be achieved in a shorter time frame.

7.2.1 Proposal

Extend the MIT start-up treatment to a longer time frame (5 years) while include additional requirements to qualify such that only funds which are intended to be widely held and not closely held would benefit from the extended start-up treatment.

On that basis, we would propose a targeted extension of the MIT start up treatment for funds intended for retail distribution:

- Extension of start-up period to 5 years
- Election to be made by the fund in year 1 to elect into the extended start up treatment (with a commitment that the additional requirements below will be satisfied)
- To be eligible for the extended start up treatment, the investment in the entity must be actively marketed with the intention that the widely held (and not closely held) requirements be satisfied once fund established. The ATO may provide guidance material on what would evidence bona fide marketing efforts to attract investors – this may include (but is not limited to) roadshows to promote the fund, advertising the fund online or with advisors, seeking consultants rating on the product etc. Further examples are provided below.
- ATO discretion to extend the start-up period beyond 5 years.

Transitional arrangement – for funds which already exist at the time the targeted extension of the MIT start up treatment becomes law; these funds should be able to elect into the new rules and benefit from the extended start up period provided:

- The election is made in the first year the new rules become law; and
- The 3rd bullet point above must be able to be satisfied.

Examples of evidence to demonstrate active marketing:

- Roadshows to promote the fund
- Advertising the fund - online or with advisors
- Seeking consultants rating on the product
- Marketing materials and go-to-market strategy
- Diary of meetings with investors/advisers/platforms
- Budget of marketing costs and promotional events including conference exhibitions and sponsorships
- Identification of target market segments e.g. SMSFs or retail platforms, retirees, high net-worth individuals
- Feasibility studies of focus groups and market research to demonstrate that the fund would get traction within a certain time period
- Recruitment of marketing people and advertising or promotional campaign with external parties

We note that the original MIT start-up/wind down treatment did not allow a trust to qualify as a managed investment trust for two successive income years by utilising the start-up phase in the first year and wind-up phase in the following year. This was because each exception to the widely held requirement is specifically targeted and not intended to be used in conjunction. To allow otherwise would be inconsistent with the broad aim of the new rules, which was to encourage long-term investment by foreign residents.

We recommend that a similar integrity rule be re-instated to alleviate any concerns about starting and then winding up the fund within the period.

In circumstances where the widely held/not closely held requirements are not met by the end of 5 years, an integrity rule could be introduced whereby the fund will be deemed not to have been an MIT for the relevant years and the trustee would be required to reissue tax statements on that basis.

Further background and arguments are provided in Attachment A.

7.3 Withholding Tax Under the Australian Regions Funds Passport

The FSC considers 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.

To address this we recommend implementing a 5% withholding tax on payments under the Asia Region Funds Passport, excluding income that is already exempt and income from Australian real property.

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.

Our uncompetitive tax regime is inconsistent with Australia's aspirations of becoming a 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, 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.

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, as detailed in previous FSC Budget submissions.[16]

As a result of these points, a reduction in 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.

7.4 Australia's tax treaty network

The FSC welcomed the announcement in the 2020–21 Budget that the Government would "modernise and expand" Australia's tax treaty network, prioritise tax treaties with Luxembourg and Hong Kong, addressing financial services issues in existing tax treaties, and ensuring that any new Free Trade Agreements are accompanied by a tax treaty.

[16] For example see FSC Pre-Budget submission for 2019–20, available from: https://fsc.org.au/resources/1717-2019-20-budget-fsc-submission-combined/file

The FSC considers treaties with Luxembourg and Hong Kong should be a priority, as explained in detail in previous Budget submissions.[17]

This would be consistent with the Government response to industry's Action Plan to boost Australian services exports, where the Government committed to "assessing Australia's [tax] treaty network to ensure it remains appropriately aligned to our trading relationships, whilst maintaining tax system integrity" (page 25).[18]

In the 2020–21 Budget, the Government also indicated it will "prioritise refurbishing Australia's treaties with key strategic partners where necessary to maximise the benefits for Australia's economy" – the FSC considers that older tax treaties should be amended so they fully deal with superannuation funds and collective investment vehicles.[19]

7.5 Address outstanding Investment Manager Regime (IMR) issues

The Government announced it would address existing issues with the Investment Manager Regime (IMR) in July 2017:

> "The Government is committed to implementing an effective IMR whilst maintaining the integrity of our residency rules. The Government will therefore consult on whether a legislative amendment is required to ensure that the engagement of an Australian independent fund manager will not cause a fund that is legitimately established and controlled offshore to be an Australian resident." See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/

Under 94T(2) of the ITAA 1936, the Investment Manager Regime (IMR) offers partial protection for Corporate Limited Partnerships (CLPs) from the residency test – it protects against the conducting business part of the residency test, but it doesn't protect against the CM&C part of the residency test.[20]

The residency and IMR issues for CLPs could be addressed by amending the "or" test in 94T(1)(f) to an "and" test and extending the IMR protection in 94T(2) to cover the CM&C rules.

7.6 Extend the attribution regime to Investor Directed Portfolio Services

The Government announced in 2017:

> "While this amendment [extending AMITs to single unitholder widely held entities] will not extend to including platforms, wraps or master trusts (commonly referred to as Investor Directed Portfolio Services) in the list of deemed widely-held entities, the Government will consult with industry on broadening the eligibility for these widely held entities to access the concessional tracing rules as part of the Corporate Collective

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[17] See FSC Pre-Budget submission for 2019–20 and 2020–21, available from FSC website: https://fsc.org.au/resources?search=budget

[18] See: https://dfat.gov.au/about-us/publications/Pages/action-plan-to-boost-australian-services-exports.aspx

[19] See FSC Pre-Budget submission for 2019–20 and 2020–21.

[20] See: http://classic.austlii.edu.au/au/legis/cth/consol_act/itaa1936240/s94t.html

Investment Vehicle public consultation process" See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/

7.7 Widen eligibility for functional currency election

The 2011–12 Budget announced the then Government would allow "certain trusts and partnerships that keep their accounts solely or predominantly in a particular foreign currency to calculate their net income by reference to that currency."

The current Government announced in 2013 it would proceed with this measure[21] and recommitted to this in the 2016–17 Budget. The measure remains unenacted.

This measure would permit trusts and partnerships to use the functional currency election under Subdivision 960-D Income Tax Assessment Act 1997 (ITAA 1997) when preparing their Australian income tax returns. The current rules without the benefit of the election are very restrictive and result in a high cost of compliance.

This measure is of more importance . In particular, this would promote the use by Australian fund managers of multi-class trusts under the AMIT regime, with the ability to offer classes in different currencies.

We note at time of writing no Australian fund has been offered under the Passport regime. Fixing the functional currency issue, the gains or losses on bond sales issue, and the foreign exchange hedging issue (noted above) would reduce the tax-related barriers to the use of Australian funds in the Passport (noting these are not the only issues that could be discouraging Australian domiciled Passport funds).

7.8 Address issues with Interest Withholding Tax

The FSC recommends:

- the gains on sales of bonds (ie bond profits) should be treated as interest for Interest Withholding Tax (**IWT**) purposes. Gains on the sale of bonds are economically the same as interest, but are generally subject to a higher withholding tax rate, and cannot access the IWT exemptions.
- An IWT exemption be provided for posted collateral. Under industry practice, the entity paying interest on posted collateral is required to pay the IWT – which means that an Australian business would pay the IWT that is payable in relation to foreign collateral. By comparison, IWT is not charged on collateral in many other jurisdictions, putting Australia at a competitive disadvantage. The details are in a submission that the FSC made with other organisations to Treasury in February 2013.[22] This submission estimated that Australia would be losing 20–25% of

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[21] http://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/integrity-restored-australias-taxation-system
[22] See: https://treasury.gov.au/sites/default/files/2019-03/C2014-009_ABA2.pdf

derivative trades because of this tax, and notes that Australia's IWT exemption would generally not apply.

The FSC also notes that important reforms to foreign exchange hedging rules (see Section 7.8) should also address important problems relating to IWT.

7.9 Allow AMITs to access CGT rollover relief that is available to other trusts

Certain CGT rollover provisions for trusts only operate if CGT event E4 is capable of applying to all of the units and interests in the trust. However, CGT event E4 is no longer available for AMITs, instead AMITs make use of CGT event E10.

Unfortunately, the necessary consequential amendments have not been made to incorporate CGT event E10 in relevant CGT roll-over provisions; as a result AMITs are unable to access these rollover provisions. This puts AMITs at a disadvantage to MITs for no reason other than their election into the AMIT regime.

The CGT relevant roll-over provisions that are not available to AMITs include the following:

- transfer of assets within Trusts (Subdivision 124-N);
- capital gains and losses on demerger (Subdivision 125); and
- transfer of assets between certain trusts (Subdivision 126-G).

7.10 Provide flowthrough tax treatment for foreign trusts

Two tax determinations from the ATO (TD 2017/24 and TD 2017/23) mean that foreign trusts are not eligible under Australian tax law for flowthrough tax treatment in certain circumstances. In particular, an Australian resident may not be able to use the CGT discount or offset CGT losses on an Australian asset that is held indirectly through a foreign trust.

This interpretation runs contrary to tax principles. In particular:

- It means an Australian direct investor is taxed differently from an Australian who invests indirectly through a foreign trust. This is inconsistent with the main tax principle of funds management, which is that indirect and direct investment are subject to the same tax.
- In the rest of the tax law, income generally retains its character when it flows through an Australian trust, but the ATO's determinations mean income does not retain its character when it flows through a foreign trust.
- An Australian investing into managed funds in the Passport could be taxed differently depending on where the Passport fund is located, which is contrary to the principles of the Passport.

Further details on the issue, and proposed solutions, are in a previous FSC submission.[23]

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[23] FSC submission on Treasury portfolio technical amendments, October 2019, Attachments C and D, see: https://www.fsc.org.au/resources/1861-fsc-submission-treasury-portfolio-technical-amendments/file

FSC FINANCIAL SERVICES COUNCIL

8 Attachment A – Extend the Managed Investment Trust (MIT) start up treatment

8.1 Policy Intent

The introduction of the deemed capital account election for managed investment trusts was announced by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 12 May 2009.[24] It was said that allowing for deemed capital account treatment for MITs will provide more certainty and ensure Australia's tax regime is competitive in attracting foreign funds.

The purpose of the start-up treatment is to provide trusts in the start-up phase to have certainty of tax treatment in respect of its assets, even though the trust may not otherwise have the numbers of unitholders required to satisfy the MIT widely held/closely held tests.

This policy intent is better achieved if the start-up treatment could be extended to a longer period as it generally takes 5 to 6 years for a fund to become properly established. The current start-up treatment in subsection 275-10(6) of the *Income Tax Assessment Act 1997* allows a fund a period of up to 24 months to obtain the necessary unitholders to satisfy the widely held and not closely held requirements in subsection 275-10. This may not always be possible within that short timeframe.

The start-up treatment provides certainty for investors who have invested in the fund in good faith. Investors prefer to invest into an equity fund on the basis that gains on equities would benefit from the CGT discount, to mirror the tax treatment that investors would obtain if they had invested directly into the underlying equities.

Further, foreign investors in the MIT would generally not be taxed on the MIT distribution referable to a CGT gain unless the gain relates to taxable Australian property. As stated in the Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No. 1) Bill 2010*, which introduced the deemed capital account treatment at paragraph 3.6:

> *"In the 2009-10 Budget the Government announced that it would allow eligible Australian MITs that are not taxed like companies to make an irrevocable election to treat gains and losses on the disposal of certain assets (primarily shares, units and real property) on capital account for taxation purposes, subject to appropriate integrity rules.* ***This measure is an important part of the Government's reforms to provide a more certain and competitive Australian tax regime for attracting foreign funds under management****." [emphasis added]*

If the fund fails to have enough investors by the end of the startup period (despite best efforts from the manager in marketing the fund to investors), then the fund either reverts to revenue account or is forced to close due to the uncertainty arising from the capital vs revenue classification. In these cases, it is the investors who are punished due to the fund being unable to rely on the deemed capital account election available to MITs. This would be contrary to the stated policy intent of the MIT regime.

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[24] https://ministers.treasury.gov.au/ministers/chris-bowen-2007/media-releases/next-major-steps-promote-australia-regional-financial-hub

8.2 Typical process on commencement of a new fund

Most investors in retail funds invest through platforms, and there is generally a long lag time involved in getting investors allocated to products. For example, most platforms require sufficient ratings on a fund before it would consider placing the fund on its platform. However, in order for a fund to get a rating, the fund first needs to be established before it can be presented to a ratings agency. Most ratings agencies operate on a 12 month cycle in reviewing different products (rotating between different product types). Therefore, it may sometimes take up to 12 months for a particular fund to get a rating. The starting rating would generally be a ‘neutral’ rating. There is then an additional period of 12 to 24 months before a fund may achieve a ‘favourable’ rating. Many platforms would only consider products which have a favourable rating. Given the competitive landscape, there is no guarantee that a platform would take the fund onto its platform even with a favourable rating. Platforms would typically undertake its own research, having regard to the ratings, and most would expect to see a proven demand for a product before they will consider offering it on their platform. Based on our experience, most funds have a 3-5 year window to get any traction.

8.3 Integrity concerns

Treasury and the ATO may have integrity concerns as MIT status affords concessional withholding tax treatment on distributions to non-resident investors. These might be addressed by measures which minimises WHT impact to the revenue but at the same time provides the required certainty to funds and their investors.

Treasury and the ATO may also be concerned about funds which would otherwise be holding assets on revenue account being able to access the deemed capital account election. However, even if the fund can pass on the benefit of the CGT discount, this may not necessarily be reflected as a discount in the hands of the unitholders if, for example, they are a corporate unitholder. For other types of unitholders (such as superannuation funds and trusts), it is arguably the correct outcome that the assets be treated on capital account regardless of the status of the investment fund as they would likely be on capital account if held directly by the unitholder. Therefore, it is submitted that there should not be any integrity concerns relating to the ability for a fund to make the deemed capital account election.

8.4 Comparison to IMR start up treatment

We note that a start-up treatment is available in respect of the widely held requirements of the Investment Management Regime (**IMR**) rules. Section 842(2)(b) provides that an entity will be a widely held entity for the purposes of the IMR rules if the entity has never satisfied the widely held requirements in subsection 842(2)(a) “but the investment in the entity is being actively marketed with the intention that the entity satisfies the requirements of that paragraph”. This would allow a reasonable start up period which is appropriate to the fund’s circumstances, depending on the type of fund, market conditions etc.

In the Revised Explanatory Memorandum to the *Tax and Superannuation Laws Amendment (2015 Measures No 1) Bill 2015* which introduced subsection 842-230(2)(b), paragraph 7.58 states that “It will be a question of fact whether an IMR entity is being actively marketed and

this requires evidence of ongoing genuine attempts to obtain third party investment to meet the total participation interests test". Paragraphs 7.59 and 7.60 also notes as follows:

> "7.59 Although there is no express time limit on how long an IMR entity can be actively marketed with such an intention before it is taken to fail this test, an IMR entity that has not satisfied the total participation interest tests within a reasonable period of time (such as 18 months) of receiving its first investor may need to provide compelling evidence about its genuine attempts to obtain third party investment to rebut any presumption that it is not being actively marketed with such an intention.
>
> 7.60 Depending on the circumstances, there may be other forms of evidence indicating that an IMR entity is not being actively marketed with the intention of satisfying the total participation interest tests."

A benefit of not specifying a fixed number of years for the start-up treatment is that a start-up period could be applied which is reasonable and appropriate in the particular circumstances to enable the MIT to achieve the stated policy intent of the regime. In order to provide more certainty to taxpayers and to not overload the ATO with ruling requests from taxpayers seeking to confirm what would be considered to be a reasonable timeframe, it is submitted that some guidance should be provided in the legislation for the MIT start up treatment with a discretion for the Commissioner to extend the period in appropriate circumstances.