CORPORATE SUPER ASSOCIATION

SUBMISSION TO

THE BOARD OF TAXATION

ON

REVIEW OF INTERNATIONAL TAXATION

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Contact: Nicholas D J Brookes, Chief Executive Officer

CORPORATE SUPERANNUATION ASSOCIATION Inc. ABN 467 615 800 25
Level 10, 101 Collins Street, Melbourne, Victoria 3000, Australia
GPO Box 1999S Melbourne, Victoria 3001, Australia
Telephone: 03 9270 8260 Fax: 03 9250 3833 Email: corsuper@netspace.net.au

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CORPORATE SUPER ASSOCIATION

1 BACKGROUND

1.1 The Corporate Super Association

The Corporate Super Association is Australia's representative body for major Not For Profit corporate superannuation funds and their corporate sponsors.

The assets of Association members amount to approximately $60 billion, representing about 85% of total corporate superannuation sector assets in Australia and some 750,000 individual employee fund members.

1.2 Abbreviations used in this submission

The Association	The Corporate Super Association
The Review	Review of international taxation arrangements announced by the Federal Treasurer, Peter Costello, in May 2002
The Paper	*Review of International Taxation Arrangements*, consultation paper prepared by the Department of the Treasury, Canberra, August 2002.
FIF legislation	The Foreign Investment Fund provisions of Part XI of the Income Tax Assessment Act 1936
SIS Act, SIS legislation	Superannuation Industry (Supervision) Act 1993, and related legislation

1.3 Context of submission

The Board of Taxation, at the request of the Federal Treasurer, is consulting with the public on a paper prepared by Treasury and issued in August 2002, entitled *Review of International Taxation Arrangements*. Submissions on the Paper have been called for by 31 October 2002.

2 SUMMARY

The total value of superannuation fund savings in Australia is over $500 billion. Superannuation savings in Australia are currently growing at a rate of over 5% per annum and comprise around 30% of all financial sector assets[1]. Against this backdrop, our major concern is that current tax legislation may be impeding optimal investment decisions and hence reducing the potential returns of Australian corporate superannuation funds and increasing risk.

Reduction in the overall return on Australian funds' investments will have an impact on:

- the living standards of Australians in retirement; and
- the public purse, to the extent that it will be required to make good deficiencies in the above.

In outline our concerns are listed as follows:

- bias in favour of domestic investment resulting from the absence of credit for underlying foreign entity tax on portfolio investments;
- need for simplification and relaxation of FIF rules; and
- need for reform to legislation dealing with transfer of superannuation savings to Australian funds.

We recognise that the first difficulty listed above does not have a straightforward solution, but we urge that consideration be given to extension to international tax and/ or social security and pensions treaties with countries with comparable tax regimes.

In the short term, we support the following proposals:

- easing the situation of multi-member superannuation funds in relation to the FIF rules; and
- implementation of reforms to the legislation governing transfer of superannuation savings from overseas funds.

[1] Source: APRA web site, Superannuation Market Statistics as at 30 June 2002

3 DETAILS OF OUR CONCERNS

3.1 Background: the role of superannuation funds in Australia's investment markets

The Association notes that the principal focus of the Paper is on areas set out by the Treasurer when the Review was announced in May 2002. The brief was to examine, in particular, whether current international tax arrangements

- impede Australian companies expanding offshore;
- impede attraction of domestic and foreign equity;

and the way in which current arrangements affect holding companies and conduit holdings being located in Australia.

The above focus is has enabled major perceived obstacles to be considered in relation to the use of Australia as regional or international centre for business operations, and to the use of Australia as a financial centre.

The issues mentioned above have an impact on the general economic health of Australia and hence are of great importance to resident funds and their members.

There are certain other issues not explicitly addressed in the Paper, which affect Australian superannuation funds investing overseas. In addition, there are issues which affect the ability of Australian superannuation funds to attract the savings of migrating individuals. We believe that these issues should not be ignored, in view of the size of the pool of Australian superannuation savings and its important role in providing for retirement income of a rapidly aging population.

Our funds have in aggregate $60 billion to invest, and a duty to invest this capital in a responsible and efficient way. Whilst we recognize the importance of maintaining the integrity of the tax system, we believe that unnecessary complexity or lack of clarity in tax legislation may have the effect of impeding rational investment decisions and hence reducing the potential return and diversification of risk in Australian funds. We also acknowledge that some of the difficulties outlined below are not uniquely caused by the Australian taxation laws and may only be remedied by extension to international tax and/ or social security and pensions treaties with countries with comparable tax regimes. We believe such treaties should be expedited in order to encourage the free flow of investment, reduce irrational investment behaviour, and maximise retirement savings in the participating jurisdictions through the minimisation of compliance costs.

3.2 The need for geographic diversification

It is a requirement under the SIS Act that trustees

"formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity including, but not limited to, the following:

(i) *the risk involved in making, holding and realising, and the likely return from, the entity's investments having regard to its objectives and its expected cash flow requirements;*

(ii) *the composition of the entity's investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risks from inadequate diversification;*

(iii) *the liquidity of the entity's investments having regard to its expected cash flow requirements;*

(iv) *the ability of the entity to discharge its existing and prospective liabilities;[2]"*

The effect is that trustees are required to invest in a way that spreads risk and adopts appropriate diversification of investments. It is also recognised that diversification should encompass geographical as well as sectoral spread. Not only does this approach minimise risk, there is further evidence that a spread of overseas investment in a variety of different sectors and vehicles will enable funds to provide better returns over time. Hence, it is important for the security and growth of Australians' retirement savings (and for the minimisation of future dependency on the Age Pension) that geographical diversification should be adopted.

Portfolio investments in offshore companies and trusts by multi-member funds are made with the objectives of diversifying exposure and maximising the final benefits for Australian retirees. There is no suggestion that local superannuation funds should turn their backs on Australian production and infrastructure. There is evidence that they maintain a heavy weighting in domestic investment (80.6% of aggregate superannuation savings are in domestic investments[3]). The total local equity investment market stood at $654 billion as at September 2002[4], and the Australian fixed interest market at approximately $210 billion at the same date[5], while institutional investment property not already included in the equity market amounted to about $30 billion[6]. Given the size of the Australian superannuation investment pool ($500 billion[7]) compared to the aggregate value of domestic investment opportunities, there would be some difficulty in providing a home for all these funds and their future growth within the domestic market. Even if there were not other strong arguments for geographical diversification, the limits on the size of the local market would dictate that a substantial amount be invested overseas.

[2] SIS Act, subsection 52(f).
[3] Source: APRA web site, statistics as at 30 June 2002
[4] Source: ASX web site, Historical Market Statistics as at 30 September 2002
[5] Source: Towers Perrin
[6] See article on page 62, Australian Financial Review, 23 October 2002, drawing on AMP Henderson and UBS Warburg research
[7] APRA web site as above

3.3 Tax Bias in favour of domestic investment

There is a tax bias in favour of domestic investment, resulting from the absence of credit for underlying foreign entity tax on portfolio investments. This contrasts with the general availability of credit to Australian resident investors for tax paid on the income of Australian companies. The Paper discusses and suggests ways of alleviating the problem for non-portfolio overseas investments. We recognize that there are necessary limitations to the scope of the current Review, whose main focus is on barriers to using Australia as a regional and multinational centre for business. However, we would like consideration given to an extension of the proposed solution to include portfolio investments of multi-member complying superannuation funds. We believe that it is in the national interest to make it possible for funds to invest in a rational and efficient way, thus maximizing retirement savings and reducing the burden on the public purse in the future.

The lack of credit for underlying tax on foreign portfolio investments is not confined to the Australian context. Many countries are prepared to provide credit to local portfolio investors for taxes paid by domestic corporations but not for those paid by corporations resident overseas. The bias may be very awkward to overcome in the short term and would be likely to require significant extension to treaty arrangements.

3.4 Impact of FIF legislation

As indicated above, portfolio investments in offshore companies and trusts by multi-member funds are made with the principal objective of diversifying exposure. It is important for funds to achieve diversification of risk by exposure to a range of economies from developed economies to emerging markets, and by a spread of geographical exposure.

The FIF legislation inhibits the above in a number of ways. The main focus of the legislation is to deter resident entities from using portfolio investment in overseas companies and trusts as a method of deferring recognition of income. Any investment in a foreign company or trust is treated as a potential tax deferral vehicle, unless it qualifies for one of the available exemptions. These exemptions apply to investments in certain countries, certain sectors, and certain *de minimis* levels of investment. Whilst investments in company structures in mature economies may be relatively straightforward to classify as exempt, the task is less straightforward in developing economies and where the investment structure is less conventional.

Where an exemption is not available, income is attributed to the domestic investor as it accrues in the overseas entity. Where actual income data is not available, a deemed level of income is assessed based on increase in capital value of the investment or on a statutory deemed rate of return – which is unrealistically high for most economic conditions.

The major difficulties which arise from this system are well canvassed in the Paper. The main difficulty applying to superannuation funds is the complexity of compliance with the legislation. A superannuation fund, as indicated above, must diversify its investments. This will necessarily involve investing in both well-established markets and in developing economies. It will also involve investing in a range of vehicles. The task of classifying the vehicles, identifying relevant exemptions, and accounting where appropriate for the attributed income becomes very complex.

The cost of compliance is high, but the risk of deliberate tax avoidance or deferral, amongst multi-member complying superannuation funds, is very low. As set out at Table 4.2 in the Paper and related discussion, the potential gains from deferral are minimal for a complying superannuation fund. In addition, the investment strategy of a multi-member complying superannuation fund is subject to significant controls and due diligence and is of necessity driven by the need to maximise return through the control and diversification of risk, rather than by tax avoidance motives.

Because of the above arguments, we support Option 4.4, the exemption of complying superannuation funds from the FIF measures. As highlighted in the paper, the opportunities for complying superannuation funds to gain any major tax advantage from the deferral of income through offshore portfolio investments is very limited. If there is any concern about tax avoidance, this could be mitigated by stipulating that the concession be restricted to multi-member funds. In such funds, there should be a well-documented process for setting and implementing the fund's investment strategy and it is to be expected that the investment decisions should be made in the interests of all members, and in accordance with the law. In such circumstances the risk of tax avoidance is low.

In the alternative, we would support Option 4.2, the increase in the balanced portfolio exemption to (say) 10%, and/or the exemption of Australian managed funds which follow widely recognised indices (Option 4.3).

3.5 Transfer of foreign superannuation balances

The transfer to Australia of foreign superannuation balances by or in respect of individuals who have relocated to Australia has been the subject of a Senate Select Committee enquiry this year. Currently, where such transfers are made within six months of taking up Australian residence, the transfer is exempt from tax. Where the exemption time limit has expired, tax is paid by the individual on the growth in entitlement (after excluding the effect of contributions) during the period of residency. The taxing of this growth is intended to complement the tax on non-exempt FIF share and trust investments attributable to resident individuals. By contrast with amounts assessed under the FIF provisions, the growth on overseas superannuation balances is not assessed until the capital is returned to Australia.

The tax is assessed on the individual regardless whether he or she can access the funds. In many instances the transferred money is inaccessible because the overseas fund has been required to transfer direct to an Australian complying fund, where preservation requirements apply. Significant hardship can result where a fund-to fund transfer has been made and the individual may be faced with a tax bill of tens of thousands of dollars relating to capital which will remain inaccessible for years to come.

4 RECOMMENDATIONS

We note that the Senate Committee[8] made certain key recommendations based on evidence provided by various key bodies, including our Association. We strongly support the following recommendations:

- extension of the exemption time limit from six months to a longer period (Recommendation 11);
- release of such amounts of preserved benefits as is required to meet tax liabilities resulting from the transfer (Recommendation 5);
- averaging of tax rates for individuals (Recommendation 3);
- amendments to clarify the interaction of the FIF measures with section 27CAA of the ITAA 1936 (Recommendations 7 and 8);
- other amendments intended to clarify the operation of the legislation and ensure there is no unintended double taxation (Recommendations 12 to 15).

We do not believe that it is necessary to adopt Recommendation 2, which would transfer the liability for the tax to the superannuation fund. This would lead to significant administrative complexity for the fund. We believe that adoption of Recommendation 5, permitting the release of such benefits as are required to meet the tax obligations of individuals in respect to overseas transfers, would provide the necessary relief to individuals without further complicating the situation.

[8] Senate Select Committee on Superannuation, *Taxation of transfers from Overseas Superannuation Funds*, Canberra, July 2002