Submission to

The Board of Taxation

Review of Australia's international taxation arrangements

Association of Superannuation Funds of Australia

October 2002

1. Introduction

The Association of Superannuation Funds of Australia (ASFA) is a non-profit, non-party political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. ASFA's over 500 constituent members are estimated to be responsible for around $420 billion of assets, or about 80% of total superannuation funds under management. ASFA's coverage by percentage of assets and members varies between categories, ranging from around 70% for corporate funds to around 90% for industry, public sector and retail funds.

1.1 Asset holdings by superannuation funds

Australian superannuation funds are amongst the most significant investors in both Australian equities and holdings of overseas equities by Australians. In the June quarter 2002, Australian superannuation funds held some $231 billion in Australian equities, which represents some 44% of total superannuation assets, and around 30% of the total market capitalisation of companies listed on the Australian Stock Exchange. Their holdings of overseas assets, principally direct and indirect holdings in overseas equities and government and corporate debt instruments, were $101 billion, around 19% of total superannuation assets. This in turn represents a substantial proportion of the total Australian investment abroad of $417 billion as at 30 June 2001, which included $174 billion of direct investment and $113 billion in portfolio investment.

The percentage of superannuation fund assets in equities, including overseas equities, has gradually increased over time, both as a result of trustees focussing on longer term performance and as a result of choices made by individuals in regard to the fund they contribute to and/or the investment choice they make. For instance, Australian Prudential Regulatory Authority (APRA) data indicate that between June 1995 and June 2002 the proportion of superannuation assets in Australian shares increased from 36.4% to 44%. Over the same period the amount of overseas assets, principally overseas shares, increased from 15% to 19%. This latter growth was fairly steady, at around a percentage point each year.

Overseas shareholdings have tended to follow the weightings that have been applied to indexes such as the Morgan Stanley Capital International (MSCI) that have been compiled covering the major international sharemarkets. North America (the USA and Canada) generally account for just over half the weighting of such indexes, with continental Europe around 20%, the United Kingdom 8%, Japan 11%, and South East Asia less than 2%. Specific superannuation funds will diverge from these weightings depending on the assessment of trustees and their advisers concerning the prospects of each sector.

There have been a number of reasons for the growth in holdings of overseas shares. Pursuit of higher returns has played a factor. Prior to the year 2000, international share portfolios were producing returns over a number of years of between 20% and 30% per annum. While most analysts foresaw the return to more normal results at some stage, these high rates had a very strong persuasive power. This persuasive power has not entirely gone away even though the last two years have not been very kind to funds holding overseas shares. The fall in overseas share

prices has been such that the return from such shares over the last 5 and 7 years is now a little below that which was achieved by Australian shares over the same periods.

The desire for more risk diversification and access to a wider class of investments also have been behind the move to international shares. A number of advisers have pointed to the Australian equities market being around only 2% of the world equities market. On this reasoning a holding of 25% of assets in overseas shares is on the low side. However, there are a number of reasons for home market bias in investment decisions. Investors generally know more about their home market than overseas markets, and hence can avoid some investment risk by investing locally. Overseas investments also involve exposure to the risk that the value of the Australian dollar will change. Depreciation of the currency enhances returns from overseas holdings, while an appreciation will detract from those returns.

Tax arrangements, both in terms of the rate of tax and compliance costs, also may have had an impact on this home market bias. However, as will be discussed in the body of the submission, this is likely to have had only a modest impact.

The bottom line of all these trends is that growth assets have been favoured by corporate, public sector and industry funds as well as by retail funds. As shown by Table 1, the proportions of domestic and international shares have increased in recent years, mostly at the expense of fixed interest and, to a lesser degree, property. Comparable figures for retail funds are not available to ASFA, but information from APRA suggests that holdings of international equities by retail superannuation funds are also around the 25% mark. The overall average for the sector is brought down by the inclusion of Self Managed Funds, which typically have negligible levels of overseas assets, and retirement income stream products backed by Australian fixed interest securities.

Table 1: Asset holdings by type of fund (%)

Investment option	**Corporate**		***Industry***		**Public Sector**	
	1998-99	***2000-01***	***1998-99***	***2000-01***	***1998-99***	***2000-01***
Australian Equities	34.8	38.7	32.7	36.1	34.7	35.9
International Equities	19.0	24.2	18.4	22.0	24.3	25.4
Property	14.1	10.1	14.6	10.3	9.3	10.5
Fixed Interest	22.8	19.1	26.8	20.7	13.4	18.3
Cash	8.5	5.9	9.7	6.0	7.0	6.5

Source: ASFA *Superfunds* surveys, assorted years.

1.2 Form of overseas asset holdings by superannuation funds

Unlike Australian companies, Australian superannuation funds are not able to establish an overseas branch which conducts manufacturing, trading activity or other operations of some kind. For legal reasons, such as the sole purpose test applying to superannuation funds and practical considerations relating to running an overseas business, such investments are not possible.

Instead, Australian superannuation funds obtain exposure to international equity investments in a number of ways:

- direct ownership of shares in overseas and international companies (eg, buying shares in, say, General Electric);
- investment into Australian wholesale unit trusts or pooled superannuation trusts which, either directly or via other trusts, directly invest into international companies;
- investment into foreign-based pooled vehicles (eg, mutual funds, limited partnerships) which, either directly or via other trusts, directly invest into international companies, ventures or properties; or
- investment into Australian companies which themselves have significant foreign operations.

Clearly, investments in the last category would only occasionally be made to obtain specific exposure to particular foreign operations. More commonly, investments of this type would merely form part of the general Australian equity portfolio of super funds.

1.3 Rationale for overseas equity holdings by superannuation funds

In assessing a security for possible inclusion in an Australian equity portfolio, an investment manager acting for a superannuation fund generally would assess the expected dividend yield (including the extent to which the dividend is expected to be franked), and the expected capital gain. Generally actual and expected absolute investment returns and impact on the overall risk and volatility of an investment portfolio tend to dominate considerations of comparative taxation treatment when overseas investments are being considered.

The tax treatment of business activity conducted overseas relative to business activity conducted within Australia is likely to be only one of many factors influencing investment decisions, and a minor one at that. Investment markets do not demonstrate uniform underlying investment returns differentiated only by slightly varying risk premiums and tax treatments. For instance, as shown by Table 2, there can be significant differences in the rate of return to specific asset classes in any given year. These differences were particularly marked in regard to overseas equities in the most recent financial year. Movements in exchange rates can also have a significant impact. Perceptions in regard to future performance in absolute terms tend to dominate over differences in taxation treatment.

Table 2: Performance of asset classes over year to 30 June 2002

Asset class	Percentage annual return
Australian shares	-4.7
International shares	-23.5
International shares (hedged)	-19.3
Unlisted property	9.4
Listed property	14.9
Australian bonds	6.2
Inflation-linked bonds	7.3
International bonds	2.9
International bonds (hedged)	7.7
Cash	4.7

Source: InTech Growth Funds Performance Survey.

Whilst expansion by Australian companies offshore, over time, may be expected to reduce the likely percentage of dividends receiving franking credits, such companies are often favoured by the market as having higher growth prospects (and thus higher potential capital gains) that companies limited by the size of the Australian market. In a similar way superannuation funds have been increasing their investment in overseas companies. This was particularly so when there was a 'bull' market for overseas shares. Time will tell whether the percentage of superannuation fund assets in overseas assets will continue to increase in an environment of lower returns from overseas shares. However, as shown by Table 3, over the longer term overseas (and domestic) shares tend to perform well compared to other asset classes.

Table 3: Annual percentage investment return over period to 30 June 2002

	Last 7 years	Last 10 years	Last 14 years	Cumulative difference over 14 years from balanced fund
Average balanced fund	8.4	8.6	9.1	One and the same
Australian shares	10.9	11.0	9.8	10% more than balanced fund
Overseas shares	9.4	11.0	9.5	6% more than balanced fund
Cash	5.9	7.3	8.2	20% less than balanced fund

1.4 Conclusion

Superannuation funds are the most important single source of equity capital for Australian companies, and are the dominant source of overseas portfolio investment sourced from Australia. If taxation arrangements relating to direct or indirect overseas investments are appropriate or are

made appropriate for superannuation funds, then a substantial part of the goals of the review of Australia's international taxation arrangements will have been achieved.

2. Attracting equity capital for offshore expansion by Australian companies

Table 2.1 of the Consultation Paper shows a 13.4% difference from benchmark between an Australian superannuation fund investing in an Australian company that utilises the money in direct operations in a high tax country offshore compared with the same investment in an Australian company investing wholly onshore.

This would appear to overstate the role of tax bias in the availability of equity capital from superannuation funds to Australian companies for offshore expansion, even when that expansion is in a high tax country rather than the more typical comparable tax countries favoured by Australian companies. Indeed, as implied by Section 1.3 above, for a portfolio investor, such as the typical superannuation fund, the presence or otherwise of foreign corporate taxes are rarely if ever acknowledged (or even directly known) in any analysis of an Australian company's operations. Though the impact of high foreign taxes on overall yield is clear, there is little evidence that capital available from Australian superannuation funds, or indeed any other Australian resident taxpayer, has been impeded by such bias.

To the extent that there is any tax bias against raising capital in Australia for overseas operations by Australian companies, ASFA does not support any measure that would have a detrimental impact on the current system in Australia of dividend imputation. Neither a part nor full exemption of dividends from tax, nor a partial tax credit, would substitute for the effective negative 15% tax rate that presently applies to franked dividends derived by Australian superannuation funds. ASFA agrees with the suggestion in the consultation paper that removing the link between Australian company tax paid and shareholder tax relief would have a number of significant adverse impacts.

In terms of the options presented in Chapter 2 of the consultation paper for removing any bias at the resident shareholder level against direct investment offshore by Australian companies, ASFA has no real preference for Option A, B or C. Option B might have some marginal advantages in terms of lower compliance burden at both the company and shareholder levels.

ASFA considers that any proposal for providing further tax relief at the shareholder level should be given careful consideration in regard to the prospective costs and benefits, and should be considered relative to other possible tax options, including reducing the tax on superannuation contributions.

ASFA endorses the recommendation of the Business Coalition for Tax Reform that any policy measures seeking to provide tax relief in regard to overseas investments should operate side by side with dividend imputation. Policy measures that favour the tax treatment of foreign over domestic income are not supported by ASFA.

3. The attractiveness of Australia as a location for Australian based multinationals and regional holding companies

The matters raised in Chapter 3 of the consultation paper have little or no direct relevance to Australian superannuation funds, and ASFA does not propose to provide any detailed comments on the options canvassed in the Chapter.

4. The impact of the FIF rules on superannuation funds

Presently, Australian superannuation funds have contact with the FIF rules in a variety of ways: their net effect is to substantially raise compliance costs for a number of funds, and to limit investment opportunities available to superannuation funds. There is little or no offsetting public benefit from the FIF rules in their application to superannuation funds, as superannuation funds are subject to a low rate of tax which significantly reduces any incentive to accumulate income in low tax environments overseas. As well, while superannuation funds are generally relatively long term investors, for liquidity and other reasons superannuation funds often need access to income from overseas investments rather than deferring the receipt of income indefinitely.

Accordingly, ASFA strongly endorses the proposal in Option 4.1 for consideration to be given to a replacement of the current foreign investment fund rules to provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers. Insofar as superannuation funds are concerned, the rules generate significant compliance costs but bring about little or no improvement in collection of appropriate taxation from superannuation funds.

4.1 Compliance costs for superannuation funds from the FIF rules

4.1.1 The calculation of the % each year, under the 5% balanced portfolio exemption in section 525.

For funds using a master custodian (typically, the largest funds), this exemption entails additional costs in requiring relevant reports from the custodian. It also entails an additional aspect of income tax compliance on which the funds are reliant on the records of the custodian (or significant costs, if the fund seek to test the integrity of such records from time to time). For funds with direct international equities, there are significant costs in assessing the exemption or otherwise of each and every security held.

For funds investing via managed funds, the costs of compliance with the FIF requirements are borne by the managed funds, but are ultimately borne by the superannuation funds through the management fees charged.

4.1.2 Significant impediments to investment in alternative international investments

Most alternative international investments (private equity or venture capital vehicles, diversified international property, leveraged or distressed debt, hedge funds, etc) are structured as unlisted vehicles. Unlike investment in listed international equities, none of the usual exemptions from the FIF rules typically apply. This is despite the insertion of section 513, which exempts investment in a range of US-based vehicles. Many of the vehicles are not established in the United States (some are established in Europe, Asia or elsewhere) or have the capacity to invest outside the United States and accordingly do not satisfy section 513.

As a result, a relatively small percentage of assets allocated by superannuation funds to alternative international investments can result in breach of the 5% balanced portfolio test. Additionally, 'sell down and buy back' strategies are not usually available, as no ready market for sale of the interest in the alternative investment usually exists. **There are many examples of superannuation funds that have considered alternative international investments where the tax implications (particularly FIF administration and compliance) have represented the main impediment to investment.**

More recently, the response of the funds management industry, particularly those with international connections where alternative investment may be a significant part of the overall suite of products, have responded by establishing Australian-based trusts or pooled superannuation trusts, to 'shield' Australian superannuation funds from the direct connection with the FIF rules. While this has lowered direct tax compliance costs for superannuation funds and allowed costs to be shared between a number of Australian superannuation funds, there still are compliance costs to be borne. There also are a number of technical taxation problems faced by superannuation funds, such as the lack of apparent consistency between the attribution account rules in section 605 and the capital gains tax relief in section 613.

4.1.3 Continuing and ongoing lack of clarity in respect to the operation of the FIF rules

The complexity of the FIF rules together with a lack of definitive official rulings on specific aspects of their application means that there is considerable uncertainty in regard to certain aspects of their operation. Putting the substantive effect of the FIF rules to one side, this can discourage funds and other investors from undertaking overseas investments.

Some examples include:

- Sell down and buy back ('bed and breakfast') arrangements. There remain conflicting views as to whether sell-down and buyback strategies, adopted to enable compliance with the 5% balanced portfolio exemption in section 525, are acceptable to the Australian Taxation Office, or whether the general anti-avoidance provisions in Part IVA may apply. In particular, it is not clear from ATO comments whether arrangements are acceptable only if everything is sold down (rather than just sufficient holdings to bring the year end holding below 5%).
- Limited partnerships and similar 'see-through' investments. There still remains a lack of clarity and guidance from Treasury and/or the ATO on issues in connection with such investments. Issues include what is the nature of such interests in terms of the FIF rules, for example, is the value of the investment the total commitment (eg, US$10 million) or the individual draw downs? .
- Lack of internal consistency within the FIF provisions. Section 605(8) has the effect that the attribution account for an investment by an Australian superannuation fund in an Australian unit trust is that of the fund, rather than the trust. Section 613 provides tax relief, where an interest in a FIF is disposed of, to reduce the consideration for the purposes of calculation of any capital gain, by any unutilised surplus in the FIF attribution account at that time. The two sections together result in the apparent and inequitable circumstance that, should a capital gain arise as a result of the disposal of the underlying interest in the FIF, the usual tax relief in section 613 is not available.

This is because the trust derives the capital gain, whereas the fund has the attribution surplus.

4.2 Options for reducing compliance costs faced by superannuation funds in respect of the FIF provisions

As can be seen from the analysis presented above, case studies of problems encountered by superannuation funds in regard to the 5% balanced portfolio exemption threshold would be useful for the Review. **ASFA accordingly strongly supports Option 4.2 regarding the conduct of case studies with a view to increasing the 5% balanced portfolio exemption threshold in the foreign investment fund rules. These case studies should include investments made by superannuation funds.**

There also are large costs in complying with the provisions, even where the 5% balanced portfolio threshold is not breached. There is substantial anecdotal evidence from internationally based fund managers dealing with alternative investments that the Australian FIF provisions have been a significant impediment to attracting investments from Australian superannuation funds. One major Australian fund, which has actually invested widely in alternative investments, and which therefore has breached the 5% threshold, suggests that more than 70% of its total tax compliance costs is comprised of costs associated with the FIF investments.

This is a growing problem. While the introduction of the general exemption for US securities in section 513 led to the level of listed FIF interests held by many Australian superannuation funds rarely exceeding the 5% level, this is now changing. More recently, a number of Australian superannuation funds have been making significant investments in unlisted FIF interests, primarily in new asset classes such as international private equity or venture capital, international real estate, international distressed debt, and so on. The size of the required commitments to such investments means that, where a fund was to directly invest in such unlisted FIF interests, the 5% threshold is exceeded.

In practice, however, only a few Australian superannuation funds have had sufficient resources to make such investments in their own right. More commonly, such investments are made through an Australian pooled vehicle, such as an Australian unit trust or pooled superannuation trust. An increase in the threshold would not remove disincentives to investments by Australian superannuation funds in such investments through Australian trusts, as an Australian trust established to pool investment into international alternative investments would itself have up to a 100% level of non-exempt FIFs. Accordingly, a broader exemption for superannuation funds, including PSTs, may be required.

ASFA also supports Option 4.3 of the Consultation Paper, which is to consider exempting from the FIF rules Australian managed funds that follow widely recognised indices. ASFA agrees with the analysis in the paper which recognises that Australian funds with investments that follow a widely recognised overseas index are unlikely to invest in offshore accumulation entities. As well, keeping to the index weightings requires regular sales and purchases, which is not supportive of accumulating assets in a low tax environment. This option would result in lower administration and compliance costs for Australian managed funds. As major investors in Australian managed funds, Australian superannuation funds should benefit from this option, to the extent that the cost savings are passed on to them in lower management fees.

ASFA strongly supports Option 4.4, which considers exempting complying superannuation funds from the foreign investment fund rules. Clearly, it is this option that has the most direct effect on Australian superannuation funds, and ASFA submits that superannuation funds have a strong case for exemption from the FIF rules. As Table 4.2 in the Consultation Paper shows, the benefits for taxpayers from investment in offshore accumulation entities diminish as marginal tax rates and CGT discount reduces. This suggests that Australian superannuation funds would obtain relatively low benefit from such investment, and hence have little incentive to engage in behaviours that the FIF rules seek to discourage. The available evidence indicates Australian superannuation funds undertake minimal if any present activities in tax deferral of the type contemplated by the original policy intent behind the FIF rules. Accordingly, there is little or no point in having the FIF rules apply to superannuation funds, particularly given the relatively high compliance costs associated with their operation and their substantial impact on superannuation funds.

There is also a case for an exemption flowing beyond superannuation funds. Because many superannuation funds choose to pool their investment in alternative international investments, via the use of Pooled Superannuation Trusts (PSTs) or Australian investment trusts established for this purpose, an exemption for superannuation funds would still have considerable limitations. Extension of the exemption to PSTs would partly solve this issue.

However, a PST is not an appropriate vehicle for investments where foreign taxes are anticipated to exceed the Australian tax rate of 15%, as foreign taxes are then 'trapped' in the PST. In these circumstances, an Australian unit trust is more commonly utilised, and an exemption for Australian superannuation funds would not then be of assistance. ASFA considers that further options should be explored to deal with this (increasingly common) structure. However, ultimately, option 4.1, the broad re-write of the FIF provisions to better target the policy intent of accrual in circumstances of offshore accumulation, may be the only option that adequately addresses all concerns.

It also sometimes is the case that an Australian superannuation fund is the first investor in a particular foreign investment. In these circumstances, there can be a short period, that is, the period until additional investors sign up, in which the foreign investment is a CFC or CFT, rather than a FIF. It is submitted that any broader exemptions for Australian superannuation funds take account of this possibility, perhaps by affording similar exemption from the operation of the CFC or CFT measures.

4.3 Priority with which any options should be addressed

In ASFA's view, the options in chapter 4 are by far the most significant to the superannuation and funds management industry. Option 4.1, the replacement of the current foreign investment rules, has the potential to fully address all industry concerns. However, it is appreciated that full replacement of the FIF provisions with better targeted measures may take significant time. **In the interim, it is ASFA's view that highest priority amongst the various options be given to option 4.4, given the importance of superannuation funds as overseas investors and the lack of any evidence that superannuation funds have or would attempt to accumulate investment earnings in an overseas low tax environment**. It is further submitted that option

4.4 would be better targeted if it included an exemption for both PSTs, and for Australian resident unit trusts where 100% of the unitholders were Australian superannuation funds

5. Improving Australia's tax treatment of foreign expatriates

Chapter 5 of the Consultation Paper primarily deals with issues associated with Australia's tax treatment of foreign expatriates, focussing on aspects of existing legislation that may impede the attraction of skilled personnel to Australia. Within Chapter 5, none of the options canvassed directly relate to superannuation. However, the commentary on pages 76 to 78 does refer to exemptions from the application of Superannuation Guarantee legislation for some expatriates and to recent measures enabling certain temporary residents to access Australian superannuation entitlements upon permanent departure from Australia.

ASFA was a strong supporter of this latter measure. As to the first measure, it is submitted that the present regulations relating to exemption from Superannuation Guarantee for expatriates are quite unwieldy and unnecessarily complex. More generally, there are a number of superannuation issues which can arise when employees move to or depart from Australia on either a temporary or permanent basis:

1. Will the employer get tax deduction for contributions made to a fund in the country of origin of the employee?
2. Will the employer get a tax deduction for contributions made to a fund in the country of employment?
3. Will any mandatory superannuation or like requirements in the country of origin continue to apply to the employee and, if so, can such requirements be satisfied by making contributions to a fund in the country of employment?
4. Will any mandatory superannuation or like requirements in the country of employment apply to the employee and, if so, can such requirements be satisfied by making contributions to a fund in the country of origin?
5. Will the employee be required to include any contributions in his or her assessable income in the country of employment?
6. What limitations on access to superannuation entitlements exist in the country of origin, if the employee wishes to transfer moneys to a fund in the country of employment?
7. What taxes are payable on moneys transferred from a fund in the country of origin to a fund in the country of employment?

ASFA supports the concept of 'treaties', equivalent to double tax treaties, to address these issues. Superannuation Double Coverage agreements deal with some, but not all, of the relevant issues. It is desirable that broader agreements evolve.

5.1 Transfers of foreign superannuation entitlements to Australian funds

Also relevant to the tax treatment of expatriates, but not explicitly canvassed in the Consultation Paper, is the Senate Select Committee report of July 2002, entitled "Taxation of transfers from Overseas Superannuation Funds". A number of measures proposed in this report would assist persons who enter Australia perhaps initially for temporary secondments, but who ultimately decide to retire in Australia.

ASFA supports the following recommendations within this report:

- extension of the exemption time limit from six months to a longer period (perhaps two years, or six months after obtaining permanent residency) (Recommendation 11);
- release of such amounts of moneys from the Australian fund following transfers, to enable any associated Australian tax liability on the employee associated with the transfer to be met (Recommendation 5);
- averaging the tax rates for affected individuals (Recommendation 3);
- amendments to clarify the interaction of the FIF measures, and sections 96A et seq, with section 27CAA (Recommendations 7 and 8); and
- other amendments intended to clarify the operation of the legislation and ensure there is no unintended double taxation (Recommendations 12 to 15).

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