Australian Financial Centre Forum
An Australian Government Initiative

The Chair
Australia's Future Tax System Review
C/- AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

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Dear Dr. Henry

The Australian Financial Centre Forum (AFCF) has, in the course of its task of preparing a policy blueprint for promoting Australia as a leading financial services centre, received views from industry on a range of issues. Many of those views relate to Australia's tax system.

The Prime Minister, in a joint media release with the Assistant Treasurer in July last year that announced a platform for future action by Government and industry to secure Australia's future as a financial services centre, indicated that taxation issues raised by industry in this context would be considered by the AFTS Review and by the Board of Taxation. I am writing on behalf of the AFCF to bring those views raised by industry that we believe are relevant to your Review to your attention.

In the submissions we have received in the course of conducting our own enquiry, and even more strongly in discussions with senior executives in the financial sector, two major underlying constraints that have been identified to the development of Australia as a financial centre are tax uncertainty issues and competitive access to offshore sources of funding. These issues are discussed in more detail below.

Tax uncertainty

We have encountered a widespread view that tax uncertainties are not only a major cost and source of frustration to the financial services industry but are also causing a loss of economic activity. These views have been put to us frequently and strongly, and supported with abundant examples of financial services companies either restructuring their activities offshore or simply choosing not to undertake domestic activities in order to avoid the business risk associated with these uncertainties.

While the evidence is anecdotal, it is the clear view of many executives in the financial services sector that Australia's tax system and its administration have fallen behind what is necessary and expected in a modern, competitive and internationalised financial sector.

A number of examples of tax uncertainty concerns have been put to us, including uncertainty as to whether income earned on disposal of investments assets by managed investment trusts is deemed to be on revenue or capital account; uncertainty about the deductibility of interest on certain types of instruments; and uncertainty resulting from the interaction between thin capitalisation rules and transfer pricing provisions. One of the clearest examples of tax uncertainty and of resultant lost opportunities for Australia relates to the definition of "permanent establishment", the definition of "Australian resident" and the definition of what constitutes "Australian sourced income". Because these particular areas of uncertainty and their ramifications are good examples of some much

broader underlying concerns put to us relating to tax administration practices, we have gone into them below in some detail.

One of the striking features of Australia's funds management industry is that, despite having one of the world's largest and most sophisticated funds management sectors, only a very small proportion of the $1 trillion or so of funds under management are sourced from offshore. The reasons for this may reflect a whole range of business factors, but our discussions with senior executives in the funds management industry indicate that, to an important extent, the lack of a significant amount of offshore funds under management from Australia reflects the business risk associated with a number of major tax uncertainties:

- *Permanent establishment and Australian residency*: the uncertainty relates to whether a foreign fund or a foreign entity may be deemed to have a "permanent establishment" in Australia or "Australian residency", and hence be subject to Australian income tax, merely as a result of that foreign fund or entity having an investment advisory, discretionary funds management or other similar presence in Australia. If the foreign fund is deemed to have a permanent establishment in Australia, or a foreign entity is deemed to be an Australian resident, this would have two consequences: firstly, it would mean that where the fund or entity transacts on capital account the capital gains tax exemption for non-residents no longer applies; and secondly, if the fund or entity transacts on revenue account then the gains will be taxed as domestic income.

- *Source*: the uncertainty as to what constitutes Australian sourced income is a reflection of two factors. The first is the lack of any statutory rules in this area and the associated complex set of common law principles, and the second but related factor is the increasing internationalization of financial markets. The interaction of these factors means that the determination of source can depend on the place where the contract was concluded, which may in turn depend on whether or not a local broker or manager has been used. These uncertainties result in a wide variety of distorted behaviour by both Australian based and indeed foreign fund managers designed to try and ensure that particular transactions might not be seen as Australian sourced and hence taxable in Australia.

The concern for the funds management industry resulting from the above uncertainties is that both foreign and domestically sourced income flowing through to non-residents may be taken to be taxable under Australian tax law simply because some of the associated funds management activities are conducted in Australia. This concern extends right through to the situation where all the investors in the fund are domiciled offshore, and none of the assets in the funds are $A denominated assets.

The result of this lack of clarity and certainty is an unwillingness on the part of many potential offshore investors to invest via Australian based vehicles or investment advisers; an unwillingness on the part of overseas financial advisers and counsel to give the "all clear" to their clients in terms of investing in vehicles which use an Australian based investment advisers; and unwillingness on the part of some Australian fund managers to actively seek to expand their funds under management from offshore clients, or alternatively a decision to do so by setting up offshore vehicles which are run and managed offshore.

The effect of the above is that financial transactions, investment flows and new business opportunities are driven away from Australia, with the obvious implications in terms of the liquidity of domestic markets, domestic job opportunities and, ultimately, domestic revenue from the fees that would otherwise be generated by the Australian based investment adviser.

It is worth noting that these tax ambiguities and associated business risks are not only inhibiting the capacity of Australian fund managers to grow their business by increasing their funds under management sourced from offshore: they are also strongly inhibiting offshore fund managers and brokers from doing business in or through Australia. This is evidenced from a number of discussions and submissions, particularly from the Managed Funds Association, a US based alternative investment industry body. Their concerns with respect to their US members have been further heightened by *Interpretation No. 48, Accounting for Uncertainty in Income Taxes of FASB Statement No. 109("FIN 48")*, which going forward will require that U.S. private enterprises account for uncertainties in their income taxes. The application of *FIN 48* to the uncertainties regarding Australian tax law will likely act as a further impediment to U.S. investment funds investing in Australia or establishing or maintaining an office in Australia.

What the industry is essentially looking for in this as in many other areas of tax law and administration is greater clarity: in this instance, greater clarity regarding the tax treatment of offshore investors who are investing through an Australian collective investment vehicle or are using an Australian fund manager. They are also looking for the relevant tax principles in this area to be administered on a consistent basis going forward. The underlying principles being sought, which from our discussions are unlikely to be seen as objectionable from a policy perspective, would be that:

- non-residents investing in a fund domiciled or managed in Australia should not be subject to Australian tax on income and gains on non-Australian assets; and

- the tax treatment of such non-resident investors with respect to income and gains on Australian assets should be the same as if those investments had been made directly.

A statement by the Australian Tax Office that these principles will be applied consistently in the case of Australian fund managers or investment advisers managing funds for non-residents would be a major step forward. Furthermore, the above principles would be consistent with the intentional move toward a more residence-based approach to taxation adopted in Australia's recent tax treaties. They would also help to bring the tax law into line with what we understand to have been longstanding realities in terms of administration of the law, which has been not to treat profits on Australian or non - Australian assets for non-resident investors in funds as being on revenue account and hence taxable.

However, while such clarification would be extremely welcome by industry, the widely held industry view is that it would in fact be a very difficult process getting the Australian Tax Office to give such a clear clarification of the existing tax principles and realities, for at least two reasons:

- a perceived unwillingness on the part of the tax authorities to rule out retrospectively collecting taxes on cases which would fall within the above principles; and

- a perceived desire on the part of the Tax Office to avoid giving clear cut definitions of "permanent establishment", "Australian residence" and "source" due to revenue integrity concerns.

If this interpretation is correct, it would appear to get to the heart of two broader underlying concerns of business: the *inherent* uncertainties resulting from features of our tax administration process; and retrospectivity. With respect to tax administration, the broader concerns expressed to us relate to:

- An excessive reliance on administrative discretion and also on case law which is often lacking sufficient rigour and volume to provide the clarity needed;

- A need for alignment between the practice of tax administration and the law. Even if the tax administration is seen by business as "reasonable" on a particular issue, there is a perceived risk that the administrative approach to this issue could change, unless the status quo was supported by legislation; and

- A view that the Tax Office is overly focussed on "protecting the revenue", rather than providing an independent and unbiased interpretation of the intent of the law.

With respect to retrospectivity, regardless of how widespread or otherwise its use is, the mere fact that such action could be taken is seen as a significant impediment to business, both in the specific case above relating to funds management and more generally.

The AFCF has been exploring the option of a specific legislative solution to the "tax uncertainty" example above relating to non-residents investing in a fund domiciled or managed in Australia. We have written to the Board of Taxation on this specific matter. More generally, however, we do not know what the best possible solution to the broader tax uncertainty and tax administration issues we have raised may be. However, we have certainly formed the judgement from our discussions to date that these issues are acting as a significant constraint to the Government's expressed objective of positioning Australia as a financial services centre in the region. We would therefore welcome a close examination of these broad issues relating to tax uncertainty and administration, and of possible ways of rectifying or alleviating them, in your Final Report.

Withholding Tax

From the submissions received and our discussions with the financial services industry, it is clear that the application of interest withholding taxes have a material impact on the behaviour of financial institutions, with consequences for the broader economy. There are three areas of concern:

- Interest withholding tax on funds provided by an overseas parent to its branch bank in Australia;

- Interest withholding tax paid on foreign bank subsidiaries in Australia borrowing from related parties offshore; and

- Interest withholding tax paid on foreign raised funding by Australian financial institutions, including offshore deposits.

The funding pressure on Australian bank branches and subsidiaries resulting from the current very difficult domestic wholesale funding environment is now well known and understood. It is putting considerable pressure on their capacity to facilitate lending to many areas of domestic activity that they have traditionally supported. So far as offshore banking deposits are concerned, a number of banks have access to significant pools of overseas savings through their offshore banking operations. In many cases these potential offshore savings pools are well beyond what they can use in the country of source, and hence could be used to support their lending and leasing arrangements conducted out of Australia were it not for the fact that interest withholding tax makes them an uncompetitive and largely unattractive source of funding.

We have provided earlier briefing to the Assistant Treasurer on the reasons why - particularly in the current very difficult conditions in credit markets - we saw a strong case for removing withholding tax on the above transactions. More broadly, and looking beyond the current financial crisis, our discussions with senior banking executives to date have reinforced our view that these applications of interest withholding tax to offshore borrowings are inconsistent with Australia's need, as a

capital importing country, to access a diversity of offshore sources of funding at competitive rates. They also sit uneasily with the Government's desire to develop Australia as a major regional financial centre: increasingly, overseas financial centres do not charge interest withholding tax on such transactions.

We are aware of the substantial pressures on the Commonwealth Budget and hence the possible need to consider these proposals in a broader fiscal context, which arguably make them of particular relevance to your broad ranging enquiry.

Conclusion

The AFCF is charged with identifying impediments to the international competitiveness of the Australian financial services sector, with a view to benefiting all Australians. The taxation issues raised above have been identified by industry specifically in this context. The Forum trusts that the AFTS Review will give these matters careful consideration.

Yours Sincerely

Mark Johnson
Chairman
Australian Financial Centre Forum