Investment & Financial Services Association Ltd

ABN 82 080 744 163

1 May 2009

Dr Ken Henry AO
Chair – Australia's Future Tax System Review
c/o AFTS Secretariat

By email: AFTSubmissions@treasury.gov.au

Dear Dr Henry

Re: Australia's Future Tax System - Consultation Paper

The Investment and Financial Services Association (IFSA) welcomes the opportunity to contribute to the Australia's Future Tax System Review.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 140 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

IFSA's comments on specific questions posed by the Review follow.

PERSONAL TAX AND TRANSFERS

Q4.3 Is the personal income tax base appropriately defined? Should reforms such as changes to the scope of deductions or other measures be considered?

As highlighted in IFSA's initial submission to the Australia's Future Tax System review, inadequate levels of life insurance has a negative impact on individuals and imposes indirect costs on government through higher spending on social security and other programs. The tax system can play a role in combating underinsurance, in particular through aligning the tax arrangements for insurance inside and outside of superannuation. In particular, this should include making life insurance premiums outside of superannuation fully deductible for individual taxpayers.

TAXING BUSINESS AND INVESTMENT

IFSA's submission focuses on portfolio investment.

Portfolio investment represents a vital source of capital for the Australian economy. As demonstrated in Chart 1, foreign portfolio investment in Australia represents more

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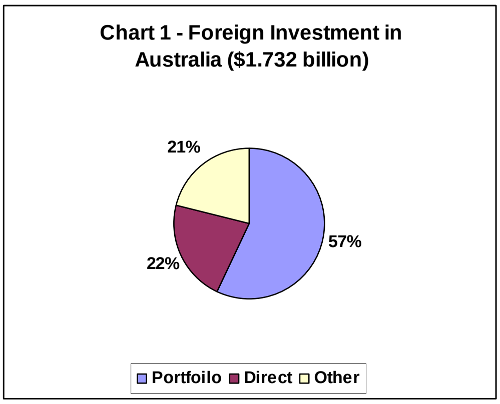
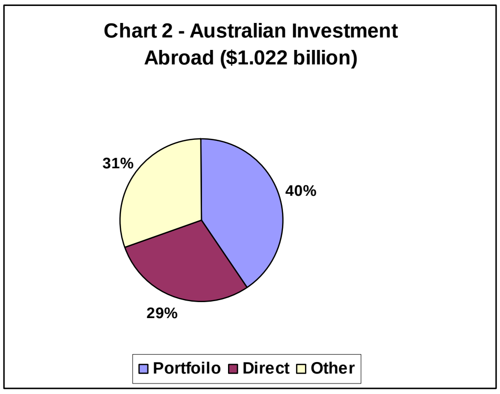
than half of stock of foreign investment and is significantly larger than the stock of direct investment.



Source: ABS



Source: ABS

Similarly, more Australian investment abroad occurs as portfolio investment than as direct investment.

Q6.1 Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how? For any given revenue outcome, what are the relative merits of broader base/lower rate (comprehensive income tax) or narrower base/higher rate (a narrow income tax or an expenditure tax) approaches?

Headline company tax rate

IFSA supports reductions to the company tax rate. In addition, IFSA supports the principle of broadening the base and lowering the rate for all taxes, including company tax.

Care does, however, need to be taken when making international comparisons of headline company tax rates. For example, Singapore and Hong Kong are considered by investors as gateways to investment in South-East Asia and China respectively. Comparisons of corporate tax rates across jurisdictions need to take factors such as this into account.

There is no need to abolish dividend imputation to reduce the company tax rate. Under full dividend imputation, reductions in the company tax rate should only affect non-resident investors. There will, however, be a timing effect on Australian Government revenue.

Dividend Imputation

IFSA supports the retention of dividend imputation.

IFSA considers that the original rationale for the introduction of dividend imputation is as relevant now as it was when the policy was introduced by the Hawke Government. In addition, dividend imputation is now widely understood by Australian investors.

The strengths of the dividend imputation system include:

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- Reducing the bias towards companies funding investment through debt rather than equity. The risks of excessive debt funding have been highlighted by the global financial crisis.

- Reducing the bias towards realising returns on equity through capital gains rather than dividends.

    - Academic literature highlights the role that dividends play in breaking down information asymmetries between managers of widely-held companies and their owners.

- Improving compliance by creating an incentive to pay Australian tax.

Companies are also likely to have segmented investor bases. Finance theory indicates that taxpayers who can utilise imputation credits (including super funds) are more likely to invest in entities paying franked dividends than investors who can't utilise imputation credits. This lessens the impact of foreign investors not being able to utilise franking credits.

<u>Impact on Australian superannuation funds</u>

Superannuation represents a major pool of savings in Australia and has different tax arrangements than savings vehicles in many other countries. Specifically, super funds are taxed on investment earnings.

Australian superannuation funds currently have an effective tax rate for returns of 15% on interest, 10% for capital gains and 15% for franked dividends. If dividend imputation is abolished, the headline corporate tax rate would need to fall below 15% to maintain the relative tax position of franked dividends.

Superannuation is a highly competitive industry with a large number of funds seeking to deliver the highest possible investment returns to members. Abolishing dividend imputation is likely to significantly increase the effective tax rate on superannuation funds and/or result in superannuation funds adjusting their portfolio's to realise more returns as capital gains, interest or through offshore investments rather than franked dividends.

Australia as a Location for International Business

Q6.2 What changes, if any, to the tax system would improve the ability of Australian companies to operate internationally oriented businesses? How should the tax treatment of companies and shareholders be integrated in an open economy?

Australia should introduce an Investment Manager Regime (IMR) to facilitate the use of Australian investment managers by non resident investors.
Fundamentally, the IMR seeks to ensure internationally consistent and unambiguous investment outcomes for non-resident investors who use Australian investment managers through adherence to the following key principles:

a) non resident investors should not be subject to Australian tax on non Australian source income;

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b) non resident investors should be exempt from Australian tax on profits on marketable securities whether dealing on capital or revenue account and whether they use an Australian manager or not; and

c) investors should face the same tax outcomes for indirect investment through a collective investment vehicle as for direct investment.

Australia is out of step with most sophisticated international financial centres in terms of the treatment of foreign investors in Australian managed funds. Consequently, significant flows of capital, particularly from Asia, will continue to remain outside Australia, with a detrimental impact on employment and economic growth.

This is especially frustrating where Australian fund managers are technically considered some of the best in the world yet often end up having to go overseas to apply their expertise. Clearly this issue has become even more important given the current economic crisis.

As such, it is important that Australia provide taxation arrangements that are at least equivalent to those offered overseas.

In this regard, the United Kingdom has an 'investment management exemption' which allows a manager acting for a non-resident to be exempt from assessment on behalf of its non-resident client, including offshore funds. The exemption was introduced to encourage non-residents to invest through British institutions.

In the US, the exemption for foreign investors trading in US stocks even where a local agent / manager is present in the US has been in place for many years.

Hong Kong has also implemented such an exemption clarifying that offshore funds with Hong Kong fund managers and investment advisors may now confidently state that they are not subject to tax in Hong Kong on profits derived in Hong Kong.

Similar taxation arrangements could be used in Australia, to address situations in which Australian and foreign source income flowing through to non-residents is taken to be Australian source income under Australian tax law because the management and control function is performed by an Australian fund manager. So doing would provide a significant boost to the export activities of the funds management industry.

Capital Gains Tax (CGT)

Q6.4 What principal goals should inform the taxation of capital gains in Australia, and what, if any, changes should be made to capital gains tax as a result?

<u>CGT Discount</u>

IFSA supports the retention of the CGT discount. Some level of discount relative to income tax is justified to compensate for inflation (in the absence of cost base indexation) and reward innovation and risk-taking.

As highlighted in IFSA's initial submission to the Australia's Future Tax System review, the most important issue is that the taxation of capital gains is consistent for direct and collective investments.

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IFSA recommends that a flat CGT discount be maintained on simplicity grounds. A tiered discount, for example a discount based on years of ownership, would be significantly more difficult for collective investment vehicles to administer and for individual investors to comply with.

CGT and Complexity

The CGT rules should also facilitate product rationalisation in the financial services industry.

Economically inefficient and out-of-date financial products (i.e. legacy products) arise through regulatory change, product innovation and technological advancements. IFSA estimates that 25% of all funds under management are invested in legacy products.

These products are usually run on old computer systems which make them increasingly difficult to support. This means that they require a great deal of manual processing which makes them vulnerable to errors and fraud. In turn, this increases costs for product providers and ultimately for investors. As these costs of maintaining legacy products are distributed among an ever-decreasing number of investors, it places the pool of investors at further disadvantage.

Legal and tax impediments exist in rationalising these products. In response, IFSA made a submission on 27 July 2005 to the Government seeking legislative reform to introduce a single legislative mechanism to facilitate product rationalisation in the financial services industry. In June 2006, IFSA also submitted a Regulation Impact Statement to Government in support of the financial product rationalisation proposal. The IFSA proposal enabled customers to be moved from these legacy products, and permit them to roll-over their investment into other competitively more efficient products or be compensated for the termination of the legacy product.

The previous Government released a product rationalisation issues paper on 27 June 2007 and, the current Government has indicated its support by establishing in mid 2008 an Advisory Panel to examine options make recommendation to Government on the form and structure of the legislative framework to facilitate financial product rationalisation. To date, legislation has not eventuated from Government with respect to product rationalisation in the financial services industry.

Critical to the proposal is that a transfer of an investor account from one product to another through the rationalisation process should not trigger a capital gain or loss for the investor or fund.

The Review should endorse the principle that CGT should not impede product rationalisation.

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STATE AND LOCAL TAXES AND TRANSFERS

Q9.1 Noting the overall structure of Australia's federal financial arrangements, what changes, if any, should be made to the assignment of revenue raising powers and intergovernmental transfers in Australia?

Q9.2: Given the widely held view in submissions that the current state tax arrangements need to be reformed, what changes should be made to state and local government own source revenue instruments? What scope is there for greater use of user charging to bring social, environmental or economic benefits?

IFSA congratulates the Review Panel on commissioning analysis of the efficiency of Australia's main taxes. Inefficient taxes divert resources from productive uses and economic growth can be increased by replacing them with more efficient taxes.

IFSA's initial submission to the Review identified stamp duties levied by state and territory governments on life insurance (as well as other forms of insurance) as one of the least efficient taxes in Australia. Since IFSA's initial submission, some states and territories have continued to backslide on their commitments under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* by delaying the abolishment of another highly inefficient tax, non-quoted marketable securities duty.

IFSA endorses the Centre for International Economics report *State Business Tax Reform – Seeding the Tax Reform Debate* prepared for the Business Coalition on Tax Reform. The report identifies various reform options and quantifies the economic benefits of increased reliance on more efficient federal taxes and more efficient state government own source revenue instruments.

IFSA also welcomes the Victorian Government submission to the Review which supports the principle of abolishing State stamp duties, financed through sharing the income tax base with Commonwealth.

Should you have any questions regarding the submission, please contact myself or Daniel Caruso on 02 9299 3022.

We look forward to discussing our submission with you.

Yours sincerely,

John O'Shaughnessy
Deputy Chief Executive Officer

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