FINANCIAL SERVICES COUNCIL

31 May 2012

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Dear Committee Secretary

Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2012 (*the Bill*)

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The FSC has 128 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC thanks the House Standing Committee on Economics (*the Committee*) for the opportunity to provide a submission on the Bill.

Fundamentally, the FSC requests that the Committee recommend that this measure not proceed. Our submission outlines a number of reasons why proceeding with this measure would be counter-productive and result in considerable damage to our reputation as a desirable investment destination for global capital.

Should the Committee not agree with our primary recommendation, we ask that the Committee consider recommending that a more comprehensive analysis of the impact of this measure be undertaken prior to the Bill being voted on in Parliament.

We note that this change was first announced in the Budget and that there was, therefore, no prior consultation or opportunity for the industry or foreign investors to contribute to policy design or the assumptions which underpin the revenue forecasts in the Budget.

Importantly, the Budget revenue forecasts do not take account of related adverse impacts on State Budgets which will arise as a result of lower stamp duty, land tax and payroll tax receipts should construction and employment activity decrease as a result of this measure.

Finally, as a minimum, the FSC requests that the Committee recommend that foreign investors be able to access a lower rate where Australian superannuation funds are themselves the beneficiary of a lower tax rate in that investor's home jurisdiction.

We urge the Committee to consider the broader implications of this measure in reaching its conclusions.

Yours sincerely

MARTIN CODINA
Director of Policy

1 History of the policy

A reduction in the WHT rate was first canvassed in May 2007 by the Hon Kevin Rudd, then leader of the Opposition, where he made an election commitment to halve the rate from 30% to 15%.[1]

On 13 May 2008, Treasurer Wayne Swan announced the 2008-09 Budget and issued a joint press release[2] with then Assistant Treasurer the Hon Chris Bowen announcing that the WHT rate would be substantially reduced from a non-final rate of 30% to a final rate of 7.5% on certain distributions from Australian MITs to foreign resident investors. The Treasurer stated:

> "Residents of jurisdictions with which Australia has effective exchange of information arrangements, to be specified by regulation, be subject to a non-final withholding tax at the rate of 22.5% for the first income year (in turn to be 2008-09); a final withholding tax of 15% for the second income year (in turn to be 2009-10); and a final withholding tax of 7.5% for the third (intended to be 2010-11) and later income years".[3]

Of note was the Government's explicit commitment that the 7.5% rate would carry forward in later income years. This formed the premise for foreign investors to invest into MIT structures in Australia (often in precedence to other less favourable jurisdictions).

The announcement stated the arrangements were intended to make Australia's withholding tax rate:

> "one of the most competitive in the world, and provide a significant boost to Australia's ability to compete globally.
>
> The arrangements will ensure Australian property trusts (which will be primarily affected by the new arrangements) are well placed to attract future foreign investment now and into the future.
>
> This will provide a major boost to Australia's goal of becoming a financial hub in the Asia-Pacific region and goes beyond the commitment made during the election."[4]

Consistent with the 2008-09 Budget announcement, the measure was included in the 2008-09 Budget Papers, where it was reported under the heading 'Election Commitments' that a final withholding tax rate of 7.5% was intended to apply for the "2010-11 and later" income years.[5]

The government subsequently implemented these staged changes in accordance with the announcement.

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[1] Kevin Rudd, Federal Opposition Leader, *Budget Reply Speech,* 10 May 2007 http://australianpolitics.com/2007/05/10/2007-budget-reply-speech-kevin-rudd.html

[2] Wayne Swan, Deputy Prime Minister & Treasurer and Chris Bowen, Assistant Treasurer & Minister for Competition Policy and Consumer Affairs, *Joint Press Release - Establishing Australia as a Regional Financial Hub* http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/043.htm&pageID=003&min=wms&Year=&DocType=0

[3] Treasurer's Press Release no. 043 of 2008

[4] Ibid

[5] Budget Measures 2008-09, Budget Paper 2, p13, at http://www.budget.gov.au/2008-09/content/bp2/html/revenue-07.htm

As recently as 18 October 2010, the then Assistant Treasurer and Minister for Superannuation and Financial Services, the Hon Bill Shorten, released a discussion paper on the new tax system for managed investment trusts which referred to the 7.5% rate.[6]

The discussion paper called for comment on additional measures that were to have effect from 1 July 2011 and stated that:

> "Two major features of the Government's new tax system for MITs have **already been legislated.**
>
> The trustee of a MIT can choose to apply the capital gains and losses (capital gains tax) regime to disposal of eligible assets.
>
> Also, **a reduced rate of final withholding tax (of 7.5 per cent) applies to most foreign investors on fund payments from a MIT.**"[7]

On the basis of these and many other statements, foreign investors committed long term capital, often at an opportunity cost of investment elsewhere.

2 Broader implications of the policy change

The doubling of the WHT rate has a wider impact than just the headline tax rate increase.

Inconsistency with government policy to develop Australia into a leading international financial centre

The Johnson review found that only around 3-5% of total funds managed by Australian based fund managers are sourced from overseas investors.[8] It concluded that the main reason for this extremely low level of export activity was that Australian policy settings were not conducive to the exporting of financial services – largely because our tax system fails to provide the necessary certainty that global investors require.

The reduction in the MIT WHT to 7.5% was one of the signature measures introduced by this government to address this issue. It was backed by successive Ministers and strongly welcomed by the industry. Government related bodies such as Austrade consistently promoted the measures as part of a broader campaign to attract foreign investment into Australia.

In fact, the industry has been championing the government's policy agenda in this area around the world – with senior industry delegations providing presentations on a regular basis to promote the changes and the government's desire to attract international capital to be managed out of Australia.

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[6] Bill Shorten, Assistant Treasurer & Minister for Superannuation and Financial Services, *Press Release - Release of Discussion Paper on Implementation of the New Tax System for Managed Investment Trusts* 18 October 2010
http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/004.htm&pageID=003&min=brs&Year=&DocType=

[7] Ibid

[8] *Australia as a Financial Centre – Building on our Strengths*, Report by the Australian Financial Centre Forum, November 2009
http://cache.treasury.gov.au/treasury/afcf/content/final_report/downloads/AFCF_Building_on_Our_Strengths_Report.pdf

By doubling the rate and not providing any advance warning, the signal sent to all foreign investors is that Government announcements can no longer be relied upon in the future.

Evidence has already emerged of this distrust with a number of foreign investors questioning whether the 15% rate is the final increase or whether there are further plans to return the rate to the original 30%.

Employment

The MIT measure was expressly introduced to encourage employment in the managed fund sector. To give effect to this intent, a specific clause was included in the definition of an MIT to ensure that in order to access the concessional tax treatment afforded to MIT investors, a substantial proportion of the investment management activities carried out in relation to the trust had to be carried out in Australia.

Indeed, at the time the legislation was introduced into Parliament, the then Assistant Treasurer noted that:

> "[T]he new definition includes a requirement, for MIT withholding tax purposes, that the investment management activities of the fund are carried out in Australia. This will support the Australian funds management industry."[9]

Specifically, the legislation (*Tax Laws Amendment (2010 Measures No. 3) Act 2010)* requires:

> **12-400 Meaning of *managed investment trust***
>
> (1) A trust is a ***managed investment trust*** in relation to an income year if:
>
> ...
>
> (c) a substantial proportion of the investment management activities carried out in relation to the trust in respect of all of the following assets of the trust are carried out in Australia throughout the income year:
>
> (i) assets that are situated in Australia at any time in the income year;
>
> (ii) assets that are *taxable Australian property at any time in the income year;
>
> (iii) assets that are *shares, units or interests listed for quotation in the official list of an *approved stock exchange in Australia at any time in the income year; and

In our view, subsequently increasing the WHT rate to 15% risks the intent of the original MIT measure and may in fact result in a reduction in employment if investment levels decline as a result.

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[9] See Media Release No.118 of 26 May 2010: http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/118.htm&pageID=003&min=njsa&Year=&DocType=0

3 Operation of proposed budget measure

Whilst the FSC welcomes clarification provided by Treasurer, the Hon Wayne Swan, and Assistant Treasurer, the Hon David Bradbury, that "the 15 per cent rate applies to distributions (fund payments) relating to income years commencing on or after 1 July 2012"[10] we still express concern in relation to the treatment of capital gains.

There is a significant retrospective aspect in relation to capital gains as future capital gains will now be subject to the 15% rate. This is despite:

- investments being entered into at a time when a rate of 7.5% had been publically committed to, and
- decisions to realise capital gains being deferred due to the rate of 7.5% being expected to continue in later years, per the 2008-09 Budget announcement.

This provides strong incentive for capital gains to be realised prior to the doubling of the rate to 15%, which could in turn lead to an over-supply in the market and a further decrease in asset values.

Further, the doubling of the rate without any phase-in or transition period is also of concern.

When reducing the rate an incremental approach was adopted that provided clear signalling and confidence to the market.

Recommendation 3.1: Should the Committee recommend that the measure proceed, transitional measures should be introduced along with a phasing-in of the higher rate to alleviate the unintended impacts of the measure.

4 Nature of Investments affected

Investments typically subject to WHT are property and infrastructure investments. In addition to these types of real property investments, the WHT applies to relevant renewable energy investments. By their nature, these investments are longer term and often in the hundreds of millions of dollars.

Investors make rigorous long term investment decisions based on assumptions around prevailing tax rates and rely on government publications in relation to government policy when doing so.

Significantly, foreign investors make up a large propoertion of investors in these assets. By way of example, foreign investors represented 24% of commercial property transactions and 55% of office sales in Sydney in 2011.[11]

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[10] Letter to FSC dated 22 May 2012 from Treasurer, the Hon Wayne Swan, Treasurer and personal communication with Assistant Treasurer, the Hon David Bradbury,

[11] CLSA Asia-Pacific Markets "Australia Real World – Sector Outlook" 23 May 2012

5 Foreign investor reactions

A number of foreign investors have contacted the FSC expressing their significant concerns about the sudden change. Their concerns relate to both the scale of the change (i.e. doubling of the rate) and the lack of consultation or advance warning.

The foreign investors which have been affected are large institutional investors who provide patient capital to fund significant property, infrastructure and renewable energy projects which cannot otherwise be funded domestically. These investors are sophisticated and are free to invest anywhere in the world.

Certainty and tax efficiency are paramount considerations for these investors – primarily because they are usually fiduciaries (such as pension funds) and often do not pay tax in their home country on like investments. Any level of tax is therefore seen as a "drag" on their portfolio.

The original reduction from 30 – 7.5% was explicitly targeted at attracting capital from these institutions.

6 Significant opportunity for arbitrage

In raising the MIT WHT to 15%, the government will create a significant arbitrage opportunity which will encourage foreign investment in debt rather than equity. At present, interest withholding tax (IWT) generally applies at the rate of 10% (it can be even lower for certain tax payers).

Put simply, foreign investors will not subject themselves to a 15% tax rate for investment in equity when they can invest in debt at 10% and have the returns taxed at 10%. Given this, the FSC questions the revenue estimates contained in the Budget.

7 Implications of less investment in equity

Should less foreign capital in the form of equity be available, then large property and infrastructure projects will need to be funded through debt (borrowings).

This has significant implications in the current context – where international credit markets are strained and where domestic banks are attempting to diminish their reliance on foreign fund raising.[12]

Additionally, a significant re-weighting to debt (versus equity) is contrary to the deleveraging that has been occurring in Australia and across the world.

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[12] Standard & Poor's estimates that companies in Europe, the US and the major Asian economies require a combination of refinancing and new money to fund growth over the next four years of between $43 trillion and $46 trillion, see http://www.telegraph.co.uk/finance/comment/jeremy-warner/9296117/Debt-crisis-a-46-trillion-problem-comes-sweeping-in.html

The FSC believes that a higher reliance on debt funding, rather than equity funding, is undesirable and could have broader systemic impacts on the property and banking sectors, with flow on impacts across the economy.

Recommendation 7.1: A wide-ranging assessment be undertaken of the potential impact of a significant re-weighting to debt financing in the property and infrastructure sectors as a consequence of this change.

8 Competitiveness assessment

With a WHT rate of 15%, it will be much easier for an investor to choose another country over Australia when making future investment decisions.

This is most clearly illustrated through use of an example. Take a hypothetical investor who invests $100 million into a commercial property and earns a 7% pa return over 10 years, with a capital yield of 10% pa over the same period.

If the investment were in Australia (15% WHT), they would earn $144.5 million. Should the investment have been made in Singapore, they would earn $158.1 million, and were it in Hong Kong, they would earn $158.5 million.

Based on this example, the investor is better off by $13.6 million (9.41%) if they invested in Singapore or $14 million (9.7%) if they invested in Hong Kong as compared to Australia.

Analysts have estimated the impact of the change as leading to a 1% decline in returns. This reduction in returns is equivalent in impact on the investor to a doubling in the management fees they pay, assuming a 1% management fee.

This means that either management fees will be need to be reduced (resulting in lower company tax receipts) or investors will look elsewhere for comparable returns on a lower after fees and taxes basis.

9 Revenue implications

Direct revenue implications

The Budget measure is anticipated to collect $260 million over the forward estimates. We have serious doubts about the veracity of this estimate and we believe that the wider tax implications of the measure have not been factored in.

As indicated above, since the announcement on Budget night, we are aware of about $1 billion in proposed investments which are now in jeopardy, frozen or no longer proceeding. This only relates live projects and does not include future projects which are yet to be marketed.

Below is a partial analysis of the foregone revenue impact of the measure, resulting from lower management fees alone.

Based on discussions with our members and press reports, we understand that around $1 billion of investment is now unlikely to proceed as a result of the announcement. Assuming a

1.0% management fee is levied across the industry, the consequence of \$1 billion of investment not proceeding equates to \$10 million less in management fees.

Additionally, analyst reports are now estimating that the change will result in a 5% reduction in the value of existing investments. This part of the sector is estimated to manage approximately \$129 billion worth of assets. A 5% reduction in the value of these investments equates to \$6.84 billion. Again, assuming a 1.0% management fee is levied across the industry, an additional \$68 million in management fees would have been earned on this amount.

The combined foregone management fees amount to at least \$78 million. This translates into a reduction in corporate tax receipts of \$23 million. This is almost half the reported revenue gain in the first year of the measure.

Indirect revenue implications

Additionally, it is necessary to consider the broader tax/revenue implications of these changes.

The nature of MIT projects is that they generate significant levels of employment – particularly in the construction industry but not exclusively. Should these projects stall, there will be a reduction in associated income tax collections.

Further, fund managers earn fees from managing MIT funds which are subject to tax at the company tax rate (30%). Again, should these and future projects not go ahead there will be a commensurate reduction in company tax receipts.

Finally, State taxes are also paid in respect of these projects – typically land tax, stamp duty and payroll tax. State budgets are also therefore likely to be adversely affected.

The lower investment will also lead to job losses in the industry, further eroding government revenues.

10 Comparison with superannuation

The FSC is aware of suggestions that the 7.5% WHT rate is potentially considered by some to be overly generous to foreign investors at the expense of local investors.

For a number of reasons, this proposition is incorrect.

The MIT WHT applies to widely-held foreign institutional investors. Domestically, institutional investors typically comprise superannuation funds which pay tax on long term capital gains (where the asset has been held for longer than 12 months) at the rate of 10%.[13]

Additionally, if the funds used to purchase the relevant assets are in the 'pension phase', then the fund pays no tax on the earnings.

Finally, foreign investor capital is complementary to local capital. Most large property and infrastructure projects involve a combination of domestic and foreign investors coming

[13] Superannuation funds are generally taxed at 15% on investment earnings, however they receive a 33% discount on long term capital gains (where the asset has been held for longer than 12 months), bringing the rate down to 10%.

together to co-invest. In the absence of foreign capital, many Australian superannuation funds would be unable to invest in these same projects as they would not be in a position to allocate the large sums of capital required.

This has the effect of both restricting the domestic investment opportunities of superannuation funds but also capping the level of property and infrastructure development that can be undertaken.

The suggestion therefore that foreign investors benefit from a 7.5% WHT at the expense of local investors is a complete fallacy.

11 Risk of reciprocity

Australian superannuation funds are the beneficiaries of comparable regimes offshore.

Indeed, in a number of jurisdictions Australian superannuation funds are exempted from tax altogether. These jurisdictions recognise the benefits of the "patient capital" provided by these types of institutional investors.

The doubling of the rate applied to investors from these jurisdictions investing in Australia risks a similar response from their governments. In the current global environment it is not hard to imagine a foreign government who might be attracted to a populist response in order to ensure parity.

Further, this Budget measure is also inconsistent with the downward direction of withholding rates generally across the OECD as reflected in our own recent treaties. Even in respect of dividends, our recently renegotiated treaty with Japan has a maximum 10% rate of withholding.

Recommendation 11.1: That the Australian government amend existing DTA's so that foreign investors are able to access a lower WHT rate where Australian superannuation funds are themselves the beneficiary of a lower tax rate in that investor's home jurisdiction.