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Dr Sarah Bachelard
The Secretary
Senate Economics Legislation Committee
Room SG.64
Parliament House
CANBERRA ACT 2600

Dear Dr Bachelard

NEW INTERNATIONAL TAXATION ARRANGEMENTS BILL 2003

Thank you for the opportunity to make a written submission to the Senate Economics Legislation Committee.

IFSA represents the retail and wholesale funds management and life insurance industry and has over 100 members who are responsible for investing approximately $A655 billion on behalf of over nine million Australians.

The Senate has particularly asked the Committee to consider the effect of the proposed increase in the "balanced portfolio exemption threshold" from 5% to 10%. This issue shall be the focus of our submission.

Background

Under the Foreign Investment Fund ("FIF") regime contained in Part XI of the *Income Tax Assessment Act 1936* all overseas investments by all Australian taxpayers are treated as potentially subject to attribution. Attribution requires taxable income to be recognised regardless of whether income or gains have been derived or realised. The division then contains a number of exemptions. Should the relevant investments fall within the exemptions attribution is not required

When the FIF rules were originally developed by the Government it was recognised that investors holding a portfolio of overseas investments needed some concessions

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in order that they not be required to attribute income on small parts of their portfolios. To this end a balanced portfolio exemption was created. Under this exemption attribution is not required where investments that are not otherwise exempt constitute less than 5% of a taxpayer's total overseas investment. Therefore if an investment trust held 20 to 30 stocks listed on European exchanges and, say, 3% were in non exempt Finance companies then attribution would not be required in respect of those Finance company investments.

Why a change is necessary

The existing concession does make it possible to offer the general public, superannuation funds etc products that are based upon global portfolios. However, the concession has a number of failings.

Firstly, it is still necessary to examine the portfolio at year-end and ascertain what proportion does not qualify for exemption. In practice this means paying a custodian or accounting firm a fee to review the investments held and advise which are or are not exempt.

Secondly, if it is found that non-exempt investments represent in excess of 5% of the portfolio it is necessary to sell the excess prior to year-end. Normally the non-exempt investments are in the portfolio for sound economic reasons and hence are bought back immediately after year-end. The sale and repurchase, often referred to as a "bed and breakfast "arrangement, will result in transaction costs.

Thirdly, the 5% test is calculated using total foreign investments as the denominator. Consequently if foreign stocks are an incidental part of a much larger portfolio the percentage is not based upon the total portfolio but rather the smaller foreign component. This can produce some bizarre results. For example attribution can be required where a fund holds a portfolio of Australian stocks which happens to contain a 1% investment in a New Zealand entity with listing in both New Zealand and Australia.

Comments on the measure contained in the *New International Tax Arrangements Bill 2003*

IFSA supports the measure to increase the balanced portfolio exemption from 5 to 10%.
For the vast majority of properly constructed foreign portfolios this will eliminate the need to conduct a year end sell down and repurchase. The experience of our industry is that for most global portfolios 5% is not quite enough to eliminate year end problems with total non exempt investments of 6 to 7% quite common and higher levels not unusual. Such levels of investment do not qualify for the existing concession but will under the new concession. Consequently the measure will significantly reduce the costs discussed in the second point raised above.

The other matters identified above are not really addressed by this measure.

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In conclusion IFSA supports this measure but notes that reform to the broader FIF rules is needed and hopefully will be addressed in the "tranche 3 measures".

Yours sincerely

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