BARRIERS TO GROWTH IN SERVICES EXPORTS SUBMISSION

18 September 2015
Australian Services Exports
Productivity Commission
Locked Bag 2, Collins Street
Melbourne VIC 8003

Submitted by email: services.exports@pc.gov.au

Dear Commissioner MacRae

Thank you for the opportunity to provide a submission on the draft Productivity Commission report on 'Barriers to Growth in Services Exports'. Please find our submission below.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees. The Council has over 125 members who are responsible for investing more than $2.5 trillion on behalf of 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world. The Financial Services Council (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.

Should you wish to discuss this submission further please do not hesitate to contact me

ANDREW BRAGG
Director of Policy

CONTENTS

INTRODUCTION 3
FUNDS MANAGEMENT AND MUTUAL RECOGNITION 4
TAX 6
COLLECTIVE INVESTMENT VEHICLES 6
WITHHOLDING TAX 12
DOUBLE TAX TREATIES 18
FUNDS MANAGEMENT VALUE CHAIN 19
TRUST LAW REFORM 20
PROPOSAL FOR AN ALTERNATIVE TRUST LAW 20
LIFE INSURANCE 22
RECOMMENDATIONS 25
APPENDIX A – WITHHOLDING TAX COMPARISON TABLES 26

PC SERVICES EXPORTS SUBMISSION

INTRODUCTION

Thank you for the opportunity to provide a submission to the draft report on 'Barriers to Growth in Services Exports'. We hope our submission will assist and influence the final report.

This study by the Productivity Commission is timely and extremely important to the Australian economy. The final report will be the only Government review to comprehensively address reforms necessary to increase services exports, and in particular financial services exports.

The Financial System Inquiry failed to target necessary reforms for financial services exports. The 2009 Johnson Review contained a roadmap necessary for trade in financial services, but many of its recommendations are yet to be implemented.

The Productivity Commission final report is therefore highly important to the financial services sector, to be able to expand and significantly contribute to Australia's productivity and economy. We thank the draft report for accurately representing the sector's issues and for providing a contemporary update to the Johnson recommendations.

Services exports face additional barriers to trade compared to goods exports. These include licencing, tax, commercial presence requirements as well as domestic settings affecting competitiveness.

The reforms required must be made in tandem in order to make an impact. Mark Johnson intended the reforms to be implemented as a package.

It is imperative the reforms are progressed as soon as possible with the upcoming Asia Region Funds Passport as well as the negotiation of the North Asian and regional free trade agreements. For instance, without a range of collective investment vehicles, Australia will be unlikely to be able to offer a fund under the Passport.

The Financial Services Council welcomes the draft report and we agree with many of the draft recommendations. This submission will cover funds management, tax, life insurance, and trust law reform.

In particular, we welcome the comments and recommendations on funds management, domestic regulatory reform, and mutual recognition processes. Namely that:

- Australian financial services providers may be well placed to take advantage of increased demand for financial services resulting from rising incomes in Asia.
- Policy changes, including some already underway could facilitate growth in financial services.
- The Government should support and progress the Asia Region Funds Passport.
- The Australian Government should create a framework for developing and implementing mutual recognition arrangements.

We also will significantly address tax as an important element of success to financial services exports. We will address some of the statements and recommendations in the draft report

and outline how we have some differing views - in particular on Collective Investment Vehicles and withholding taxes.

The Productivity Commission draft report has said that the low proportion of foreign funds under management in Australia is not, of itself, a policy concern.

We would disagree. Given the size of Australia's market, the low proportion of foreign funds under management is a clear indicator that there are significant barriers preventing a greater proportion of service exports. The scale of foreign funds under management is disproportionally low.

The two key barriers that are preventing Australian managers from exporting more of their capabilities offshore are:

1. Having a competitive range of collective investment vehicles; and
2. Uncompetitive withholding tax rates.

In addition we provide information regarding the Funds Management value chain.

This submission will outline a response to the information request on trust law reform. We also ask the final report to address life insurance issues.

Please find our submission below.

FUNDS MANAGEMENT AND MUTUAL RECOGNITION

We were pleased to see the inclusion of support for funds management as an export opportunity, support for the Asia Region Funds Passport and recommendation on the development of a mutual recognition framework.

We very much support recommendations 6.1 (Asia Region Funds Passport) and 9.2 (development of a mutual recognition framework).

As the report notes, rising incomes in Asia are going to increase demand for financial services products and Australian financial services firms are well placed to capitalise on this opportunity.

This opportunity will only be available for access if domestic and international barriers are removed and the architecture is in place including the Asia Region Funds Passport, free trade agreements and mutual recognition between financial services regulators.

Increasing funds management exports will have significant positive benefits to the Australian economy and productivity. Therefore we argue that the policy settings required to facilitate this will be made to the benefit to the Australian community as a whole.

The economic benefits of increasing funds management exports were outlined in our first submission in detail. In summary, if Australia increased funds management exports to the level of Hong Kong (i.e. 60% of funds under management is exported), this would:

- Increase GDP by $4.22 billion;

- Increase tax revenue by $1.25 billion; and
- Create 9,982 jobs (FTE).

In terms of a mutual recognition framework, we recommend that including international competitiveness as a mandate for ASIC and appointing an ASIC commissioner to deal with these issues, would enable this recommendation to be progressed.

Further, the support for the Asia Region Funds Passport is welcome. However, Australia will not be a successful participant in this program unless accompanying domestic reforms are undertaken including introduction of a range of collective investment vehicles. This is elaborated on below in the tax section.

To elaborate on our first submission, in the negotiation of free trade agreements, best practice should be to establish architecture for financial services committees under the agreements.

These committees would ideally meet on a regular basis and include representatives from Treasury, ASIC and APRA. The purpose of these committees would be twofold.

Firstly, the committee would settle issues and disputes, and discuss how the commitments were functioning in practice under the FTA.

Secondly, the committee would progress the agreement's implementation and mutual recognition so that it can be utilised by businesses in both countries.

We further agree with the PC that commercial presence restrictions are a significant barrier to trade in financial services. Ultimately, we would like to see the ability for Australian fund managers to export on a cross border basis with little or no requirements for a commercial presence.

Recommendations

- The final report should reiterate support for funds management as a significant export opportunity and outline the economic benefits that these could bring to Australia.
- Clarify that support for the Asia Region Funds Passport should be coupled with domestic reforms to enable its success.
- Recommend that ASIC's mandate includes international competitiveness and that a commissioner should be appointed to deal with mutual recognition issues.
- Include architecture for financial services committees under Australia's free trade agreements, and negotiate little or no restrictions on cross-border export i.e. not requiring a commercial presence.

TAX

COLLECTIVE INVESTMENT VEHICLES

Executive Summary

This section addresses a critical outstanding recommendation from the Johnson Report – broadening the range collective investment vehicles.

In 2009 the Johnson Report recommended Australia establish a broader range of tax flow-through vehicles than just the unit trust structure.

Increasing the range of Australian collective investment vehicles will drive financial services exports. The two most critical vehicles Australia requires immediately are a 'corporate' vehicle and a 'limited partnership' vehicle.

In this submission we focus specifically on the corporate collective investment vehicle (Corporate CIV) and how it can be implemented. The need for a Corporate CIV is more time critical than the limited partnership vehicle due to the intended commencement of the Asia Region Funds Passport (Passport) in 2016.

The Corporate CIV is needed by Australian fund managers seeking to participate in the Passport as the existing unit trust structure will not be well received by Asian investors.

A government announcement expediting the Corporate CIV and extracting the collective investment vehicle regime from the current Tax White Paper process is needed immediately.

Without such announcement there will not be sufficient time for the industry to develop competitive products prior to the Passport's 2016 start date.

Recommendation

The FSC recommends that the Collective Investment Vehicle (CIV) regime proposal should be removed from the Tax White Paper process and legislation for a Corporate CIV expedited. It is imperative that a Corporate CIV regime be in place prior to commencement of the Asia Region Funds Passport and there is sufficient industry consensus on vehicle structure for the regime not to be delayed further.

Immediate need for a Corporate CIV

The government has made significant progress on the Passport with other participating jurisdictions and we commend this progress. However it is now critical that the remaining domestic changes are put in places so that Australian fund managers can benefit from the Passport.

A Corporate CIV will allow Australian managers to capitalise on the recent free trade agreements with Japan, Korea and China.

Inclusion of an expanded CIV regime in the government's tax whitepaper process will result in lengthy delays to the regime's implementation.

We urge the government to progress a Corporate CIV as a matter of urgency, so that a framework can be developed and tested with industry prior to the Passport's commencement in 2016.

Integrity concerns – preventing revenue leakage

The FSC maintains that appropriate policy constraints can be developed such that a Corporate CIV does not result in lost government revenue or other integrity concerns.

A well-designed CIV regime should be seen as an opportunity to grow the pie and increase the number of funds currently domiciled in Australia. This will in turn result in increased economic activity through the necessary fund formation services which must be provided by the jurisdiction in which the fund is domiciled.

The creation of new of CIVs will allow fund managers to attract new money from offshore investors. The increased activity will not significantly impact the existing Managed Investment Trust (MIT) base because this activity is not currently undertaken in Australia.

It is anticipated that in time most fund flows into the new vehicle types will be new money from offshore investors.

Whilst there will be some natural transfer of investment from existing MIT structures into new CIVs we expect this would be minimal and no greater than the transfers which occur between MIT structures currently. This is due to MITs currently being predominantly domestic vehicles targeted at attracting domestic investors.

Proposed model

Importantly, a Corporate CIV can be developed which will not result in revenue leakage from the existing corporate tax base.

The two key ways this can be achieved are:

1. Employ existing eligible activity tests for MITs as the basis of gateway provisions for eligibility as a Corporate CIV; and

2. Conceptualise the Corporate CIV as a managed investment scheme which has some of the features of a company, rather than as a company that enjoys tax flow through status.

Eligible activities

The eligibility tests that currently exist for MITs include should be employed as the basis for a Corporate CIV.

Key elements of this test are that the Corporate CIV:

- Undertakes eligible investment business;

- Is not a trading entity;
- Is not controlling another trading entity;
- Is formed for the purpose of collective investment vehicle

Corporate CIV as a managed investment scheme

There is a fundamental difference between conclusions drawn by the Board of Tax in its *Review of the Taxation of Collective investment Vehicles* and how the industry conceptualises a Corporate CIV.

Industry sees a Corporate CIV as being a managed investment scheme which has some of the features of a Company, such as:

- The fundamental interest purchased by an investor is a share in a company (instead of a unit in a trust);
- Governance arrangements including a Board of Directors and Management;
- Rights and obligations of a shareholder (instead of a unitholder) in the event of failure or financial distress/windup.

This approach is different to conceptualising the Corporate CIV as a company that enjoys tax flow-through status for dividend payments.

Instead, the Corporate CIV is a new kind of entity which does not currently exist in Australia's regulatory regime. It is a collective investment vehicle subject to the same activity tests as a MIT but with some of the features of a company.

Whilst this concept is foreign to Australia's existing regime, it is quite commonplace overseas. The United Kingdom and Luxembourg both have well-established precedents for how such a vehicle can operate and be regulated, for example the Open Ended Investment Company (OEIC) and the Société d'Investissement à Capital Variable (SICAV), respectively. There are models to choose from that Australia can adapt to its existing regulatory framework, it is not necessary to start from scratch.

Importantly, the addition of new collective investment vehicles should be approached as an expansion of the regulatory regime for managed investment schemes, rather than a new taxation regime. The taxation regime for MITs already provides the overarching taxation principles from which the rules for any new collective investment vehicles should be drawn.

In the following section we outline a high level model of how a Corporate CIV could be incorporated into the Australian regime.

Incorporating the Corporate CIV into Australia's regime

Overview

The purpose of this section is to outline how a Corporate CIV could be implemented in the Australian context. It proposes solutions for how potential issues can be addressed and a best

practice regime be implemented in a timely and efficient manner. It draws on experiences and examples from other jurisdictions wherever possible.

There are a number of key policy objectives which a collective investment vehicle regime must meet. The regime must be internationally competitive and provide a range of modern, attractive investment vehicles. The regime must offer an effective investment structure for Australian managers to compete with global investment managers offering existing products in the global market, particularly in Asia.

This section outlines the key policy objectives, consumer protection, governance issues and taxation features that industry supports for a Corporate CIV.

Corporate CIV Policy Features

Key policy objectives

The overarching principles of the Corporate CIV are that it should:

- Be internationally competitive by providing a modern, attractive investment vehicle through:
    - providing an effective investment structure for Australian managers to compete with global investment managers offering existing products in the global market particularly the Asian market,
    - creating a vehicle which allows for the fund to be created and take advantage of existing economies of scale for existing investment products in Australia; and
    - increasing Australia's attractiveness as a fund formation location by only applying to Australian domiciled vehicles;
- Leverage pre-existing frameworks from leading jurisdictions, wherever possible;
- Provide clear outcomes for investors regarding taxation treatment – must eliminate any unacceptable Australian tax drag on returns generated in the CIV for non-resident investors;
- Be available to both domestic and foreign investors (which may necessitate different currency classes);
- Be a simple vehicle that does not involve additional regulatory or administrative burdens on Australian managers;
- Be an appropriate vehicle to be a long term viable replacement for unit trusts for Australian domestic investors;
- Be consistent with vehicle requirements for the Asia Region Funds Passport; and
- Incorporate necessary integrity measures to prevent abuse

Consumer protection

The following consumer protection measures should be adopted:

- Registration by ASIC
- Interest in a Corporate CIV is a financial product

Governance

Governance of Collective Investment Vehicles will follow principles from Chapter 7 Corporations Act, or similar principles where concepts are not currently contemplated under existing Australian law.

Taxation treatment

Collective Investment Vehicles under the new regime will have the following features:

- Disregarded entity or tax transparent entity for tax purposes;
- Retention of character of income receipts;
- CIV entity or investors should have access to treaty benefits;
- Investors investment in the CIV should be taxed as capital gain – that is, non-taxable for non residents unless Taxable Australian Real Property;
- Ability to undertake differential classes with different base currencies;
- Foreign currency (FX) gains and losses, used for hedging will be treated on capital account and offset against capital gains, instead of income gains.

Tax treatment will only be available to vehicles which have been registered with ASIC. Registration with ASIC will require that only eligible activities can be undertaken by the entity.

Eligible activities include

Eligible activities should be drawn from the existing eligible activity rules, including that the Corporate CIV should:

- Only undertake eligible investment business;
- Not be a trading entity;
- Not control another trading entity; and
- Be formed for the purpose of collective investment.

Other conditions include:

Other conditions for the Corporate CIV should include that it:

- Be a unitised vehicle such as an OEIC or SICAV;

- Be widely held or deemed widely held (or wholly owned by a widely held entity/entities). The basis for establishing its widely held status should be clear. It may be based on similar considerations as those that are proposed to exist in relation to the new attribution MIT regime;
- Be established in Australia with appropriate Australian board representation;
- May have appropriate integrity rules to prevent the conversion of otherwise active income into a passive form;
- Apply the Corporate CIV rules on a "cell" basis rather than on a "whole of entity" basis.

Rather than detailed provisions, an approach similar to that which currently exist in relation to venture capital limited partnerships could apply to deem the corporation to be a MIT (or partnership) for the purposes of the MIT/Tax assessment rules.

Background

Collective Investment Vehicles (CIVs) allow investors to pool their money together to achieve economies of scale, diversification of risk, segregation of the assets and access to investment opportunities that individual investors alone could not otherwise enjoy.

Like a trust, a CIV offer tax flow-through treatment so that the end investor is taxed at their marginal tax rate. For foreign investors, withholding tax is taken from distribution payments and remitted to the ATO by the CIV operator.

Australia is limited in the type and number of CIVs that can be used by investors. Australia solely uses unit trusts, which are not well understood throughout Asia. For example, many Asian nations do not operate under a trust law (common law) system and refuse to use it for foreign investment. Currently, trusts are the only legal vehicles available to Australian fund managers.

The Johnson Report recommended a CIV regime be developed so that Australia could develop as a fund formation centre. It will be essential for Australian fund managers to have a suite of vehicle types to choose from when developing for the Asia Region Funds Passport ("Passport") funds but a CIV regime will also have broader benefits outside the Passport. It will allow Australian managers to better market Australian domiciled funds offshore.

Feedback from the industry has been that Corporate CIV will be essential for managers wishing to utilise the Passport, as Australia's existing trusts are not well understood by foreign investors.

WITHHOLDING TAX

Executive Summary

Changes to Australia's withholding tax regime are needed to ensure the competitiveness of Australian funds. This submission outlines our view on how withholding tax could be simplified for Passport funds and a flat 5% rate of withholding applied to income derived from 'withholdable' assets.

In this section we outline the current approach to withholding tax, compare rates with other Passport jurisdictions and advocate for a simplified approach with a flat 5% withholding rate.

The key driver of this proposal is that the Passport is targeted at retail investors, therefore the taxation approach must be easy to explain and simple to understand. Investors in each of the Passport jurisdictions will be presented with many fund opportunities and the market will quickly become competitive. A complex and high taxation approach will not stand Australia's managers in good stead.

Complex withholding arrangements

The taxation of foreign investors accessing Passport funds is a significant issue which must be addressed for Australia to receive its fair share of Passport activity. We understand that each country will be responsible for ensuring its tax rate is sufficiently competitive.

In Australia's case we have a complex and high withholding tax regime for foreign investors. Different rates of withholding tax applying depending on the character of the income received by the investors.

There are individual rates of withholding tax for dividends, interest and royalties in addition to withholding tax on certain fund payments from Managed Investment Trusts. The rate for each is determined by the type of income, country, tax treaty or exchange of information agreement.

In Appendix A we have included a summary of Australia's taxation approach, along with the corresponding rates charged by other Passport jurisdictions.

It is clear from this information that the most attractive destination from which to operate a Passport fund will be Singapore. We are concerned that Australia is in danger of losing its competitive advantage in funds management to Singapore if a more competitive approach to withholding tax is not adopted.

Australia's taxation objectives

Examination of the tables in Appendix A reveals the following:

- Australia's headline rates are high;
- Australia's actual taxation rates are significantly lower than the headline rates, where taxation treaties exist;
- Taxable Australian real property is the main focus of taxation, through the Managed Investment Trust fund payment withholding tax and the proposed foreign resident capital gains withholding tax;

- Fully franked dividends are not taxed; and
- Exemptions exist for gains from 'portfolio' holdings (e.g. holdings of less than 10%).

Two broad issues arise from this analysis:

1. Australia's headline taxation rates do not reflect the actual rates of taxation;
2. Not all Australian sourced income received by foreign investors is taxed.

The FSC submits that the current state of Australia's withholding tax rates will not be marketable in the competitive environment that the Asia Region Funds Passport seeks to create.

The Passport is focussed on retail clients. It will be necessary for foreign investors located other Passport jurisdictions to receive simple and clear tax advice regarding the consequences of investing in an Australian Passport fund.

It is hard to see how this can be achieved in the current environment.

Case Study: Impact of previous changes to Managed investment Trust withholding tax

In 2009 the Johnson Report recommended a reduction of the Managed Investment Trust (MIT) withholding tax rate from 30 per cent. Whilst the rate was progressively reduced to 7.5 per cent, it was subsequently increased to 15 per cent from 1 July 2012 and remains at 15 per cent today.

The MIT WHT rate is inconsistent with interest withholding tax rate of 10 per cent and is encouraging investment to be structured as debt instead of equity.

Clarity of taxation objectives required

The FSC submits that Australia's withholding tax regime should be modified for Passport funds to provide clarity and certainty of taxation outcomes for retail investors seeking to invest in Australian Passport funds.

The existing regime is not clear. Previous changes to the MIT withholding rates have caused further confusion in the global marketplace.

In short, it needs to be clear that investors will only be taxed on those types of income that are 'withholdable' under the Australian regime.

Under the Passport rules, permitted investment for Passport funds will be limited to the following types of assets:

(a) currency;

(b) deposits;

(c) depository receipts over gold;

(d) transferable securities; and

(e) money market instruments.[1]

To the extent that these items are Australian sourced, we expect the rates and types of withholding attaching to each of these asset types to be as follows:

Passport category	**Asset types**	**Withholding type**	**Rate**
(a) currency;	Foreign exchange contracts	MIT Fund payment	15 or 30*
(b) deposits;	Bank & government deposits	Interest	10
(c) depository receipts over gold;	Negotiable financial instruments	MIT Fund payment	15 or 30*
(d) transferable securities; and	Shares - dividends - capital gains	Dividend - franked - unfranked Capital gains exemption (non-taxable Australian real property)^	 0 15 0
(e) money market instruments	Bonds Traditional securities	Interest MIT Fund payment	10 15 or 30*

*Investors from the Philippines will suffer 30% MIT Fund payment rate due to lack of an effective Exchange of Information Agreement with Australia

^Capital gains on shares will be exempt provided the interest is less than 10% (i.e. 'portfolio' interest)

The 'withholdable' elements from the above table can be simplified as:

- Domestic interest (Deposits and Bonds);
- Unfranked dividends from shares; and

[1] Part 6-Passport Fund Investments, Division 6.2, par 19, APEC *Asia Region Funds Passport consultation on the detailed rules and operational arrangements* <http://fundspassport.apec.org/files/2015/03/ARFP-Annex-1-2-and-3-UPDATED-for-release.pdf>

- Other income (currency, negotiable financial instruments and traditional securities).

Franked dividends and capital gains on non-taxable Australian real property will not attract withholding tax.

Overlaying the asset mix of a typical Australian equities fund that would be sold into the Passport regime, we expect that the lions share of the residual 'withholdable' income derived from foreign investors would therefore be attributable to domestic interest.

Minor elements of unfranked dividends and 'other' income may be present however we expect this would be a small proportion of the overall gains from a Passport fund (e.g. less than 10%)

Impact on government revenue

Regardless of the rate of withholding, any withholding tax revenue arising from the Passport will be 'new' revenue for the Government.

Fund managers currently cannot market products to retail customers in Passport markets. Whilst a very small number of customers currently exist in these markets, they have arisen from the rare instances where a product is purchased in Australia and the investor later moves (such as an Australian ex-pat moving to another jurisdiction and keeping their fund product active – or where a foreigner works in Australia for a period of time and returns home but again remains invested in the product.)

An FSC survey of members in late 2014 showed that $2.1 million withholding tax was withheld by Managed investment Trusts on behalf of foreign investors in the previous year. This figure incorporated withholding tax for dividends, interest, royalties and MIT Fund Payments for funds with investments similar to the Asia Region Funds Passport criteria.

FSC Survey Results – non-property funds

Member entities surveyed	7
% of market by retail assets under management	70%
Total investors	5,000 approximately
Total withholding tax	$2.1 million per annum approximately
Investor location	Majority of investors are from the US/Europe/UK. A very small percentage (less than 10%) are from Asia - even fewer would be from Passport signatory nations.

On a generous extrapolation to the rest of the industry it could be assumed that no more than $5 million of withholding tax is being withheld by non-property Managed Investment Trusts.

Competitive rate required

The Passport will allow Australian managers access to markets and investors that they currently cannot service. This is an integral point in understanding the implications of any variations to the existing Australian withholding tax structure.

For Australia to compete effectively it will be necessary to better align the withholding tax regime with the comparable withholding tax rates charged by other jurisdictions. More importantly it will also be necessary to send a clear message to the global market place that Australia is open for business.

Finally the rate must set in a way which still maintains Australia's taxing right over the taxable Australian sourced income derived by Passport investors.

If the withholding tax rates are uncompetitive then no taxation revenue will be collected from the Passport because no fund products will be sold from Australia. Instead managers will establish or utilise Singaporean operations.

Arguments can be mounted against changes to Australia's withholding taxation regime. The Productivity Commission in its draft report has suggested that the addition of a special withholding tax rate for Passport funds would add an additional distortion to Australia's taxation regime. The Commission has further argued that international competitiveness should not be the sole determinant of taxation policy.

Whilst these views are valid in a closed economy, we argue that this is not the environment in which Australian fund managers currently operate, nor one in which they will be operating under the Passport.

Foreign investors will be choosing which Passport products to invest in based on a number of factors and the impact of taxation will be a significant consideration. The attraction of highly mobile investment capital represents one of Australia's greatest opportunities to increase productivity and gross domestic product in the future.

Discounts to headline withholding tax rates should not be seen as 'lost revenue' or 'distortions' but rather as a pricing decision made by the government to ensure Australian managers are not at a competitive disadvantage compared to their peers in the Passport regime.

As discussed above, the majority of income expected to be generated from Passport funds will be in areas which already receive concessional taxation treatment, such as income from fully franked dividends and capital gains from non-taxable Australian real property, or from interest on bonds.

The FSC recommends the withholding tax rate for 'withholdable' income receipts from Passport funds is reduced to a flat 5% rate.

Proposed Passport withholding regime

Passport category	Asset types	Withholding type	Rate
(a) currency;	Foreign exchange	MIT Fund payment	5

	contracts		
(b) deposits;	Bank & government deposits	Interest	5
(c) depository receipts over gold;	Negotiable financial instruments	MIT Fund payment	5
(d) transferable securities; and	Shares - dividends - capital gains	Dividend - franked - unfranked Capital gains exemption (non-taxable Australian real property)^	 0 5 0
(e) money market instruments	Bonds Traditional securities	Interest MIT Fund payment	5 5

Simplified representation

These changes to the withholding tax regime can be simplified for marketing purposes to the following:

A flat 5% withholding tax on 'withholdable' elements:

- Domestic interest (Deposits and Bonds);
- Unfranked dividends from shares; and
- Other income (currency, negotiable financial instruments and traditional securities).

No withholding on non-withholdable elements:

- Franked dividends
- Capital gains on non-taxable Australian real property

Expected Budget Impact

Small positive increase. Currently there no withholding tax collection forecasts are included in the Budget. The Passport will result in additional revenue being collected as it is not currently

possible to market directly to retail clients in participating jurisdictions (excluding New Zealand).

The FSC proposal would result in a slightly smaller amount of withholding tax being collected than if there were no change to rates. However the impact on corporate tax revenue would be different as fund managers will generate fee revenue on the assets they manage and this will be subject to corporate income tax.

Recommendation

The withholding tax rate for receipts from Passport funds should be simplified with a 5% rate applying only to 'withholdable' income.

DOUBLE TAX TREATIES

Many of Australia's double tax treaties are out of date and/or uncompetitive. We urge the Productivity Commission to recommend Australia's double tax treaties be updated; especially those countries with which we are negotiating free trade agreements. The tax arrangements between jurisdictions can mean the free trade agreements cannot be utilised or are uncompetitive. This should be a standard step in the free trade agreement process.

Recommendation

FSC urges the Productivity Commission to recommend that Australia's double tax treaties are updated as a standard step in the free trade agreement process.

FUNDS MANAGEMENT VALUE CHAIN

Overview

Many of the activities undertaken in the funds management value chain are driven by where the fund is domiciled. Hence the recommendations in the Johnson report to expand the allowable set of collective investment vehicles, initiatives which are aimed at increasing the number of funds domiciled in Australia so that Australia can benefit from associated fund administration activities occurring here instead of offshore.

The chart below provides a breakdown of the different elements of the funds management value chain and what impacts the decision as to where these services will be located. Fund domicile dictates many of these decisions.

Funds Management Value Chain

Activity	Components of activity	Factors determining location of activity
Portfolio Management	Investment management – asset allocation & acquisition/disposal decisions	Skillset, attracting talent, location of research analysts
Research & Analysis	• Fundamental • Quantitative	- Location of assets/investments, skillset - Skillset, attracting talent
Execution/ Trading	Execution of trade – ie actual purchase/sale of asset	Timezone, Skillset, location of asset & sell side brokers
Settlement/ Custody	"Middle office" – Settlement of trades, physical holding of asset or legal title	Cost, timezone
Accounting	Fund accounting – ie unit pricing, tax & distribution calculations	Cost, skillset, timezone, fund domicile sometimes
Registry	Maintenance of unit registry and investor communications regarding holdings	Cost, skillset, timezone, fund domicile
Compliance/ Legal	Oversight of other activities to ensure regulatory/legal requirements are met	Cost, skillset, timezone, fund domicile, location of PM & Trading & Marketing
Marketing	Seeding & promotion of fund	Location of investors, skillset

The key point is that these associated activities will generate fee revenue in the country in which they're undertaken. This will attract tax at the Corporate tax rate.

The research by KPMG that was undertaken for the United Kingdom HMRC Treasury illustrates this point in more detail. The greater the number of investment vehicles that are domiciled in Australia, the more associated fee revenue can be taxed by the Australian government.

TRUST LAW REFORM

PROPOSAL FOR AN ALTERNATIVE TRUST LAW

The Financial System Inquiry's interim report highlighted the need for greater codification of Australian trust law. Similarly, the draft report of the Productivity Commission queried whether Australia's trust law should be updated.

The FSC believes that reform of Australian trust law is overdue, and advocates for the creation of an Alternative Australian Trusts Act (AATA), at the Commonwealth level, which would provide new, fit for purpose, legal infrastructure for Australian trusts. Such legislation would provide a modern, codified and nationally consistent trust law.

The AATA proposal is sensible reform - instead of creating another layer of (confusing) regulation it gives trust users a **choice** of legal infrastructure – that is, it would operate as an alternative regime which new users could choose to opt-in to. This means that there would be no interference with existing trusts in Australia which would remain governed by the existing law (a mixture of the common law, and State/Territory legislation). Accordingly, the AATA would have no impact upon existing State and Territory legislation as it would operate alongside them.

Further, the broad scope of the corporations power in the Commonwealth Constitution, recognised by the High Court, means that it is within the Commonwealth parliament's power to pass AATA-type legislation without the need for State or Territory agreement (assuming the use of a licensed corporate trustee with its attendant protections and safeguards -- see Chapter 5D, Corporations Act).

The current system of State and Territory laws is unduly complex and differs across jurisdictions. Instead an AATA would deal with the substantive trust law principles applicable to personal trusts and foreign trusts. Essentially it would act as a comprehensive code for the establishment, management and regulation of trusts, in a similar way to how the Corporations Act deals with corporations. (We propose that the AATA would not apply to Managed Investment Schemes (i.e. unit trusts).

Modernising and codifying Australian trust law is essential to ensure that Australia's regulatory structures are competitive with other sophisticated financial system economies, including the UK, US, Singapore and Hong Kong, each of which has gone through its own reform process. These jurisdictions undertook these reforms precisely to attract foreign resident trust users and provide financial services that better meet the needs of today's consumer. Research has shown that these jurisdictions underwent reforms, precisely so as to maintain their international competitiveness.

Given the strength of the sector, there is great scope for Australia to provide traditional trustee company (including estate management) and wealth management services to the emerging middle, HNW and ultra-HNW classes of Asia. As the Productivity Commission notes

in its draft report, “the market in Asia is expected to continue to grow – there has been strong growth in the number of ultra-high net worth individuals and these individuals are most likely to be consumer of private wealth management and succession planning services offered by trustee corporations”.

While it is impossible to provide a firm number regarding the value of potential exports, the AATA would encourage wealthy individuals overseas (especially in Asia) to create a trust in Australia, or alternatively, create a trust in an overseas jurisdiction, but have it administered here by our private wealth industry. Essentially, trust law reform would be one part of a package of reforms intended at promoting Australia as a global financial hub, given trusts are essentially one form of wealth management tool/vehicle.

Currently, our arcane trust laws are out of step with overseas practice and laws. If Australia was to update its trust law to give settlors more autonomy and to recognise foreign trusts - as proposed by the AATA - then we would expect more foreigners to establish trusts in Australia or at least bring their already established trusts here to be administered by Australian financial services experts.

The draft Productivity Commission report notes that other factors that settlors consider, in addition to substantive trust law, are taxation arrangements and the competitiveness of the domestic financial providers offering trust management services. Australia enjoys a high quality of professional trustee service providers, some of which have been operating for over 120 years, and branched into broader wealth management businesses.

(The FSC’s views regarding the necessary tax reforms to stimulate services exports are outlined elsewhere in this submission).

We are unable to identify any significant costs associated with the AATA, particularly given that the federal regime would operate alongside, rather to the exclusion of, existing State and Territory trust legislation.

Recommendation

The FSC recommends that the Government introduce an Alternative Australian Trusts Act which would support financial integration, especially in the Asia Pacific region, and provide new, fit for purpose, legal infrastructure.

LIFE INSURANCE

Introduction

This supplementary submission to the Productivity Commission's Review of Services Exports is intended to provide some additional information in areas that were not fully covered in the Financial Services Council's initial submission to the Inquiry on [insert date].

The gap between life and general insurers with respect to penetration in Asian markets is one such issue which warrants further discussion. Currently 3 of the 19 general insurers domiciled in Australia operate beyond Australia's borders[2]. In life insurance currently only one Australian domiciled insurer offers products in Asian markets[3].

Gap between general and life insurance

Australian life insurance companies have lagged behind their European and American counterparts in entering the Asian market, despite their proximity to the continent. However, Australia is fast becoming a mature market for life insurance, which makes overseas markets more attractive growth targets.

The same maturation was a factor in driving the general insurance industry to begin its expansion in Asia over a decade ago. Early in the last decade, the Australian non-life insurance market, having seen significant consolidation in the domestic market arrived at a commonly held view that insurers will struggle to achieve sustained growth in the mature Australian market[4]. As a result, some of the large Australian insurers started following their European and American counterparts and looking for growth opportunities offshore.

Lured by the low insurance penetration rates and rapidly developing economies in the region, Asia became a very attractive prospect for Australian non-life insurers looking to secure the growth in new markets. As such, the major Australian general insurers have established outposts in the region and other Australian domiciled insurers are set to join them due in part to the trade agreements the Australian Government has secured with key economies in the region[5].

Australian general insurers also offered some advantages to joint venture partners (often required under host country regulations) with respect to systems and processes capabilities that could be transferred to the host economies. This included advantages in relation to underwriting; claims management; product development; distribution; risk rating and pricing and supply chain management.

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[2] Insurance Council of Australia, Submission to Productivity Commission Barriers to Services Exports, 2015

[3] Financial Services Council, Survey of Life Insurance Company members, September 2015

[4] Institute of Actuaries of Australia, The development of non-life markets in Asia with a focus on China and India –Opportunities and risks for foreign investors, 2005

[5] Insurance Business, Insurer to expand into SME sector as part of three-year Aussie strategy, 2014, accessed at: http://www.insurancebusinessonline.com.au/news/insurer-to-expand-into-sme-sector-as-part-of-threeyear-aussie-strategy-186515.aspx

Foreign Barriers

Entering Asia comes with big risks, despite the allure of strong returns. Competition for customers' business is stiff and the domestic and external barriers to doing business make international expansion expensive and time consuming. Some of these barriers include:

- Foreign equity caps—the need for elimination of unjustifiable and anticompetitive foreign equity caps which are prevalent in Asia;
- Limitations on cross border reinsurance—protectionist governments (India, Indonesia etc.) have made moves to restrict foreign reinsurance business;
- Restrictions on cross border data flows—maintaining data in the policy holder's jurisdiction is restrictive and prevents efficient business practices made possible by centralising this work offshore; and
- Regulatory predictability and transparency.

KPMG has reported[6] it could take up to 15 years for insurance businesses to break even on their investments in China, but it could take up to two decades before they fully reap the benefits of their ventures.

Domestic Barriers

It is increasingly important that Australian regulations not prejudice the relative ability of Australian general insurers to achieve commercial presence offshore, compared with competitors based in other jurisdictions. A competitive disadvantage is created, for example, when the minimum capital requirements in Australia are significantly higher than those of our competitors.

The FSC's submission to the Australian Prudential Regulation Authority's consultation in relation to the Review of Capital Standards for General Insurers and Life Insurers (LAGIC) indicated that the life insurance industry is fully supportive of capital standards that are "in step with global developments"[7]. In this respect, the FSC supports regular assessment of the capital requirements in Australia to ensure they are competitive with the capital requirements of offshore insurance supervisory agencies.

The FSI final report in November 2014 recommended that the Federal Government do more to address unnecessary barriers to international competitiveness and market access in Australia's regulatory framework. Specifically the FSI recommended that:

> *Government and regulators should develop and implement regulatory frameworks in ways that do not impose unnecessary costs on Australian firms operating offshore but support improved access to offshore markets.*

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[6] KPMG, 2015, Perspective: Trends driving the insurance M&A landscape in 2015, pp. 4

[7] Financial Services Council, Submission to APRA Discussion Paper: Review of Capital Standards for General Insurers and Life Insurers, 2010, accessed at:

Government and regulators should identify rules and procedures that create barriers to competition and consider whether these can be modified or removed.[8]

One such area of focus should be the limitation under the *Life Insurance Act* that Australian life insurers can not write overseas policies without a separate statutory fund. Under Part 4 of the Act, a separate statutory fund must be created for any life policies written outside of Australia:

A life company that carries on life insurance business outside Australia (other than an eligible foreign life insurance company) must have a statutory fund or statutory funds exclusively in respect of that business[9]*.*

The only exemptions for this requirement are if the fund relates only to business carried on in a country or countries in which the company was carrying on life insurance business immediately before the commencement of this Act and if the company is not an eligible foreign life insurance company. The Australian Prudential Regulation Authority has a fairly tight rein on this as a rule.

This constitutes a significant entry barrier for insurers who must create duplicate practices for its overseas insurance statutory fund. Life insurance business is conducted through one or more statutory funds of a life company. Each fund must be created in the records of the life company so as to be separately identifiable from the shareholders fund.

Part 4 of the Act deals with the requirements relating to statutory funds including, amongst other things, the company's duties in respect to each fund, restrictions on their operations, requirements in relation to financial accounting, the holding of capital and distribution of surplus. Each statutory fund is effectively a supervised entity in its own right and is subject to its own capital adequacy and solvency requirements.

Recommendation

The FSC urges that the Productivity Commission recommend abolishing domestic barriers to exporting life insurance services. These obstructions include the requirement to operate separate statutory funds for offshore life polices and the approach of APRA to setting capital and prudential standards.

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[8] Commonwealth of Australia, Financial System Inquiry—Final Report, 2014, pp. 21

[9] Commonwealth of Australia, Life Insurance Act 1995, Part 4, Sect. 32

RECOMMENDATIONS

1. Funds Management and Mutual Recognition

- The final report should reiterate support for funds management as a significant export opportunity and outline the economic benefits that these could bring to Australia.
- Clarify that support for the Asia Region Funds Passport should be coupled with domestic reforms to enable its success.
- Recommend that ASIC's mandate includes international competitiveness and that a commissioner should be appointed to deal with mutual recognition issues.
- Include architecture for financial services committees under Australia's free trade agreements, and negotiate little or no restrictions on cross-border export i.e. not requiring a commercial presence.

2. Collective Investment Vehicles

The FSC recommends that the Collective Investment Vehicle (CIV) regime proposal should be removed from the Tax White Paper process and legislation for a Corporate CIV expedited. It is imperative that a Corporate CIV regime be in place prior to commencement of the Asia Region Funds Passport and there is sufficient industry consensus on vehicle structure for the regime not to be delayed further.

3. Withholding tax rate

The withholding tax rate for receipts from Passport funds should be simplified with a 5% rate applying only to 'withholdable' income.

4. Double tax treaties

FSC urges the Productivity Commission to recommend that Australia's double tax treaties are updated as a standard step in the free trade agreement process.

5. Trust law reform

The FSC recommends that the Government introduce an Alternative Australian Trusts Act which would support financial integration, especially in the Asia Pacific region, and provide new, fit for purpose, legal infrastructure.

6. Life Insurance

The FSC urges that the Productivity Commission recommend abolishing domestic barriers to exporting life insurance services. These obstructions include the requirement to operate separate statutory funds for offshore life polices and the approach of APRA to setting capital and prudential standards.

APPENDIX A – WITHHOLDING TAX COMPARISON TABLES

COMPARISON OF MANAGED INVESTMENT TRUST FUND PAYMENT WITHHOLDING TAX RATES

The following tables compare Australia's Withholding tax on Managed Investment Trust (MIT) fund payments with other Passport jurisdictions. It is important to note that Australia is the only jurisdiction that charges a 'fund payment' withholding tax. As such comparisons are with the equivalent dividend withholding tax payments in other jurisdictions.

Investors into Australian Domiciled MITs

Location	Fund Payments	Dividends (Unfranked)	Dividends (Franked)	Capital gains tax on sale of units^
Korea	15	15	0	only on taxable Australian property
Philippines*	30	15/25	0	only on taxable Australian property
Thailand	15	15/20	0	only on taxable Australian property
Singapore	15	15	0	only on taxable Australian property
New Zealand	15	15	0	only on taxable Australian property

* Philippines is not in EOI country list, despite having DTA this is because the EOI country list determines rate see https://www.ato.gov.au/General/International-tax/In-detail/Investing-in-Australia/Withholding-tax-arrangements-for-managed-investment-trust-fund-payments/; Regulation: http://www.austlii.edu.au/au/legis/cth/consol_reg/tar1976378/s44e.html

^10% withholding for non-resident capital gains is proposed from 1 July 2016 but is yet to pass through Parliament, withholding will be made by the purchaser

Source: EY Report - http://www.ey.com/Publication/vwLUAssets/Worldwide_corporate_tax_guide_2014/$FILE/Worldwide%20Corporate%20Tax%20Guide%202014.pdf

Investors into Korean Domiciled Vehicles

Dividends (note no Fund Payment rate exists, dividend rate has been compared instead)

Location	Controlling parent	Other shareholders
Australia	15	15
Philippines	11	27.5
Thailand	10	15
Singapore	10	15
New Zealand	15	15

Source: https://www.kpmg.com/Global/en/services/Tax/regional-tax-centers/asia-pacific-tax-centre/Documents/CountryProfiles/Korea.pdf

Capital gains

Korean sourced capital gains derived by a non-resident are taxed at the lesser of 11% of the sales proceeds received or 22% of the gains realised. Progressive tax rates (of up to 22%) apply depending on the level of taxable income. A local surtax of 10% of the corporate income tax due applies.

Investors into Singapore Domiciled Vehicles

Location	**Dividends** (note no Fund Payment rate exists, dividend rate has been compared instead)
Australia	0
Korea	0
Philippines	0
Thailand	0
New Zealand	0

Capital gains

Capital gains are not taxed in Singapore. However, some exceptions apply. Corporate income tax rate is 17% at fund level.

Note, considerable corporate tax concessions and incentives exist for companies domiciling their business activities in Singapore, these are not being compared

Example includes financial sector incentive, p1216 EY report - 5% or 12% concessional tax rate

COMPARISON OF WITHHOLDING TAXES – HEADLINE RATES

The following table compares the headline rates charged by Australia, Singapore and South Korea

Australia	**Headline rate**	**Tax Treaty rates**
Interest	10%	10% in most treaties
Dividends - franked - unfranked	 0% 30%	 Franked dividends subject to no withholding tax Unfranked dividends to non-resident - rate is lowered to 15%, 10% or 5% according to tax treaties
Royalties	30%	5%, 10% and 15% according to tax treaty
CGT	30%	Capital gains are taxed at the corporate income level at 30%. Foreign residents are subject to CGT if the asset is "taxable Australian property". The government will introduce a non-final withholding regime to support the foreign CGT regime, effective from 1 July 2016.
MIT Fund Payments	15%	A 7.5% rate applied for fund payments made with respect to the 2012 income year. Effective from 1 July 2012, Managed Investment Trusts that hold only newly constructed energy-efficient commercial buildings may be eligible for a 10% withholding tax rate.
Singapore	**Headline rate**	*Tax Treaty with Australia*
Interest	15%	SG and AU tax treaty rate for interest is 10%. Ranging from 5- 15% for different countries. Exemption: Interest paid by approved bank on deposits held by non-residents, other than individuals or permanent establishment in Singapore, is exempt from tax if the non-residents do not have a permanent establishment in Singapore and do not carry on business in Singapore by themselves or in association with others or do not use the funds from the operation of a permanent establishment in Singapore to make the deposit.
Dividends	0%	Dividends paid by a Singapore tax-resident company are exempt from income tax in the hands of shareholders, regardless of whether the dividends are paid out of taxed income or tax-free gains. No withholding tax on dividend
Royalties	10%	Tax treaty rate for Australia of 10%
CGT	0%	Capital gains are generally not taxed.
South Korea	**Headline rate**	*Tax Treaty with Australia*
Interest	22%	Korea and AU have tax treaty: 15% for interest income; Other countries may be lower

Dividends	22%	KN and AU have tax treaty: 15% for dividend income; Other countries may be lower; different treatments/rates for controlling parent and other shareholders
Royalties	22%	KN and AU have tax treaty: 15% for royalties income; Other countries may be lower; different treatments/rates for controlling parent and other shareholders
CGT	22%	CG for companies are taxed as ordinary taxable income; Australian companies faces 15% of corporate income tax rate

Sources:

Australian Treasury Tax Treaties page http://www.treasury.gov.au/Policy-Topics/Taxation/Tax-Treaties/HTML/Income-Tax-Treaties

EY Worldwide Corporate Tax Guide 2014
http://www.ey.com/Publication/vwLUAssets/Worldwide_corporate_tax_guide_2014/$FILE/Worldwide%20Corporate%20Tax%20Guide%202014.pdf KPMG: https://www.kpmg.com/Global/en/services/Tax/regional-tax-centers/asia-pacific-tax-centre/Documents/CountryProfiles/Korea.pdf