The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
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Comment Letter on Tax-Neutral Policy in Australia, November 1999

By Facsimile and Federal Express

November 16, 1999

The Hon. Joe Hockey MP
Minister for Financial Services and Regulation
Commonwealth Government
Parliament House
CANBERRA ACT 2600

The Hon. Peter Costello MP
Treasurer
Commonwealth Government
Parliament House
CANBERRA ACT 2600

Dear Messrs. Hockey and Costello:

As the work of the Review of Business Taxation (Review) proceeds, the Investment Company Institute,[1] on behalf of the U.S. mutual fund industry, respectfully requests your prompt consideration of a significant policy concern raised by recommendations in the recently issued report entitled "A New Tax System Redesigned" (Report) and its accompanying legislative proposal (Proposal).

As you know, in July of this year an exemption from the Australian foreign investment fund (FIF) rules was enacted for U.S. mutual funds to encourage their entry into the Australian funds market and to permit competition between similarly-situated U.S. and Australian funds on a tax-neutral basis.[2] The recently issued Report and Proposal would appear to be inconsistent with the policy behind the FIF amendments and would call into question the ability of U.S. firms to make business plans to enter (or to remain in) the Australian funds market in reliance on those amendments.

The Report contemplates preferential, "flow-through" taxation for investors in Australian-based unit trusts that qualify as collective investment vehicles (CIVs).[3] Comparable tax treatment is not available for investors in any non-Australian funds, including U.S. mutual funds that qualify for the exemption from the FIF rules that was enacted this year. We believe that if the recommendations contained in the Report were adopted in their current form, U.S. mutual funds effectively would be precluded from competing in the Australian funds market, even if they otherwise qualified for the new FIF exemption.

Of particular concern, the Report would treat capital gain distributions by U.S. mutual funds as ordinary income (taxed at rates up to 48.5%).[4] In contrast, the Report would allow capital gain distributions by Australian funds to retain their character and, accordingly, be taxed at lower, effective capital gains rates (up to 24.25%).[5] In addition, the Report would subject redemption proceeds from shares of U.S. mutual funds to so-called "slice" accounting, with the likely result that a portion of the proceeds would be taxed at unfavorable ordinary income rates.[6] In contrast, the Report generally would treat the full amount of redemption proceeds from units of Australian funds as capital gains.[7]

This unequal treatment of U.S. mutual funds appears to be inconsistent with two aspects of the policy rationale underlying the recently enacted exemption from the FIF rules for U.S. mutual funds. First, and as described in the 1999 Explanatory Memorandum to the FIF legislation (Memorandum), the exemption was intended to "encourage Australian investment funds to be more efficient by exposing them to competition from US funds."[8] For the reasons described above, we believe that if the Report's recommendations were to be adopted in their present form, U.S. mutual funds effectively would be unable to compete with similarly situated Australian funds. As a result, we would expect few, if any, U.S. mutual funds to decide to remain and/or to enter the Australian funds market, thereby thwarting the intent of the FIF exemption.

Second, prior to enactment of the FIF amendments, it was determined that Australian investors in U.S. mutual funds would not receive inappropriate tax advantages as a result of the amendments. In this regard, the Memorandum explained that the "substantial similarity of US tax rules to those in Australia will ensure tax deferral opportunities do not arise [for Australian investors] because of the exemption."[9] The U.S. taxation of U.S. mutual funds eligible for the FIF exemption has remained unchanged since the enactment of the FIF legislation in July of this year. Now, as then, U.S. mutual funds should not offer Australian investors tax deferral opportunities because they must annually distribute (1) at least 98 percent of their income and gains realized during the year to avoid paying an excise tax and (2) 100 percent of their realized income to eliminate U.S. federal income taxes at the fund level.

The unequal treatment of U.S. mutual funds contemplated in the Report also appears to be inconsistent with the stated objectives of the Review to optimise growth and to promote equity. With respect to optimising economic growth, the Review begins from the premise that transactions with similar economic substance should be taxed in a similar manner. Allowing "flow-through" treatment for distributions received by Australian investors from Australian funds, but not for distributions received from similarly situated U.S. mutual funds, would violate this premise. Moreover, as demonstrated by the recent decision to enact an exemption from the FIF rules for U.S. mutual funds, "horizontal equity" can be achieved vis-á-vis Australian funds and U.S. mutual funds without jeopardizing the integrity of the tax system.[10]

Importantly, we understand that the uncertainty created by the Report's recommendations has had a chilling effect on sales in Australia of U.S. mutual funds currently registered with Australian Securities & Investment Commission (ASIC) in reliance on the FIF exemption[11] and has caused a reexamination of decisions to enter the Australian market by other U.S. mutual funds. These are immediate, practical consequences for Australian investors who presently hold shares of U.S. mutual funds or who wish to expand their investment portfolios by acquiring shares of U.S. mutual funds. These also are immediate, practical consequences for U.S. mutual funds that already have made significant expenditures to enter (or in preparation for entry into) the Australian market.

To dispel the perception that U.S. mutual funds may shortly become tax-disadvantaged investments in Australia, we respectfully request that the policy rationale underlying the recently enacted exemption for U.S. mutual funds from the FIF rules be reaffirmed as soon as possible. We believe this reaffirmation is necessary to assure Australian investors that they will continue to receive comparable tax treatment for their similarly-situated Australian and U.S. fund investments. This reaffirmation also is necessary to assure U.S. mutual funds that, upon entering the Australian market, they will be able to compete on a tax-neutral basis with Australian funds.

We appreciate the opportunity to share with you concerns raised by the Report's recommendations for the U.S. mutual fund industry. We believe that the objectives of the Review can be achieved by reaffirming the policy rationale underlying the FIF exemption for U.S. mutual funds. We also believe that this reaffirmation should be given prompt, serious consideration because it would benefit Australian investors who already have invested in U.S. mutual funds and expand investment choices for all Australian investors.

If we can provide any additional information regarding this matter, do not hesitate to contact us.

Sincerely,

Deanna J. Flores
Assistant Counsel

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,894 open-end investment companies ("mutual funds"), 495 closed-end investment companies, and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.924 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

[2] See Taxation Laws Amendment Act (No. 2) 1999. For taxable years ending prior to July 2, 1998, an Australian investor in a U.S. mutual fund generally was taxed each year on the fund's realized income, as well as any unrealized gain in the securities held by the fund, thereby accelerating recognition of income to the investor.

[3] See Report, Recommendation 16.1.

[4] See Report, Recommendation 12.3.

[5] Report, Recommendation 16.3. Under the Report, Australian investors in a CIV generally would be taxed at ordinary income rates on only one-half of realised, distributed gains and one-half of any gains on redemption.

[6] See Report, Recommendation 12.17. We note that administrative systems necessary to apply "slice" accounting to U.S. mutual fund redemption proceeds do not exist. We understand that the cost to U.S. mutual funds of developing such systems would be

prohibitive.

[7] See Report, Recommendation 16.7. "Slice" accounting would apply to redemption proceeds received by investors when a "wind-down" of a CIV had been announced.

[8] Memorandum, Part 2 – Exemption from the FIF measures for interests in certain FIFs resident in the United States (US), Section 1, 1.182.

[9] Id.

[10] We note that the concerns raised by Recommendation 23.2 of the Report, if comparable tax treatment were provided for foreign fund management entities, should not be implicated for U.S. mutual funds that qualify for the new FIF exemption. These U.S. funds and Australian CIVs would be subject to broadly consistent tax and regulatory regimes.

[11] ASIC has announced that it will grant conditional relief to U.S. mutual funds from certain procedural and disclosure aspects of Australian securities laws in accordance with ASIC Policy Statement 65: Foreign Collective Investment Schemes (PS 65) because U.S. law requires U.S. mutual funds to meet the key regulatory requirements contained therein.
