File Name: 2014/19

2 May 2014

Australian Taxation Office
GPO Box 9977
Adelaide SA 5001

Attention: Mr. Andrew Fort

Email: andrew.fort@ato.gov.au

Dear Andrew,

RE: Draft Taxation Ruling TR 2014/D2

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission with respect to the Draft Taxation Ruling TR 2014/D2 – Income tax: the application of the foreign income tax offset limit under section 770-75 of the *Income Tax Assessment Act 1997* to foreign currency hedging transactions ("the Draft Ruling").

About ASFA

ASFA is a non-profit, non-politically aligned national organisation. We are the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate policy in the best long-term interest of fund members. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

General comments on the Draft Ruling

ASFA welcomes the release of the Draft Ruling, as the superannuation industry has sought greater certainty in respect of the issues addressed by it for a number of years - and specifically since the year ended 30 June 2009, the last year in which many superannuation funds had significant foreign exchange ('FX') hedging losses that exceeded the FX hedging gains in the same investment portfolios.

However, ASFA is concerned that the Draft Ruling, if finalised in its present form, may have significant and unwarranted detrimental effects on the entitlement of superannuation funds to foreign income tax offsets ('FITOs'). The comments below detail these concerns.

All legislative references are to the *Income Tax Assessment Act 1997*, as amended, unless otherwise noted.

Comments on the Draft Ruling

1. Inconsistency with policy underpinning the legislation

ASFA submits that the denial of FITOs as a consequence of a fund's specific arrangements in respect of FX hedging gains and losses is inconsistent with the policy intentions underpinning Division 770. As stated in section 770-5, the object of the Division is to relieve double taxation where a taxpayer has paid foreign income tax on amounts included as assessable income and would, apart from Division 770, pay Australian income tax on the same amounts.

ASFA submits that the FITO limit rules in section 770-75 should be interpreted, as far as possible, to be consistent with this stated object.

In practice, superannuation funds rarely, if ever, pay foreign income tax on FX hedging gains and losses. Rather, they generally pay foreign income tax primarily on foreign dividend income, foreign interest income, on distributions from foreign entities (such as limited partnerships), or on the income from foreign entities that is assessable pursuant to the foreign hybrid rules in Division 830. On rare occasions superannuation funds may also pay foreign tax on capital gains.

The meaning of 'reasonably related', as articulated in paragraphs 14-17 and 103-144 of the Draft Ruling, would appear to require only a tenuous link with foreign income. Given that there would seldom be any link at all between FX hedging losses and foreign income on which tax is paid, this interpretation would appear to be contrary to the stated objects of the Division. This is because, in years in which FX hedging losses exceed FX hedging gains, it is likely that, if FX hedging losses are treated as being 'reasonably related' to foreign income, a superannuation fund will be denied FITOs and thus suffer double tax on its foreign dividends, interest, etc.

ASFA submits that a narrower interpretation of 'reasonably related' should be applied, as that would be more consistent with the objects of Division 770. For example, it should be open to adopt an interpretation that FX hedging losses were *not* reasonably related to foreign income, except to the extent that there was a clear connection with foreign income on which foreign tax was paid, or except to the extent that there was a clear connection with foreign income (excluding FX hedging gains).

If such an interpretation were adopted, superannuation funds would typically only lose some or all of their entitlement to FITOs in those circumstances where the Australian tax payable on net foreign income (as properly calculated consistent with the objects of Division 770) was less than the foreign tax paid.

ASFA submits that such an interpretation, as well as being consistent with the objects of Division 770, would remove the potential for inequities to arise between the FITO entitlements of Australian superannuation funds based on the specific features of their FX hedging arrangements.

2. Effective application date

Paragraph 51 of the Draft Ruling states that, when the final Ruling is issued, it is proposed to apply both before and after its date of issue.

ASFA is aware that there was a variety of treatments adopted in respect of FITO entitlements in the year ended 30 June 2009, being the last year in which FX hedging losses typically exceeded FX hedging gains. Some funds claimed the full FITO entitlement in the income tax returns lodged, whereas some funds initially claimed no FITO entitlement (on a conservative basis) and have subsequently lodged objections or requests for amendment to claim FITOs.

The 4 year period for amendment has expired for those funds that claimed the full FITO entitlement in their income tax returns as lodged, but would still be open in respect of any amended assessments occurring more recently.

We note that the superannuation industry brought the issues associated with the FITO entitlement to the ATO's attention prior to lodgment of the 2009 income tax returns, and sought public guidance from the ATO on the appropriate treatment at that time. The ATO response was that funds could individually seek private rulings, even though the issues were industry-wide in their potential application and they were raised from a whole of industry perspective.

Prior to issuing the draft ruling the ATO has provided no public guidance. Releasing the Draft Ruling after the expiry of the 4 year period for amendment of 2009 income tax returns has disadvantaged many superannuation funds. Equally importantly, and as noted in paragraph 52 of the Draft Ruling, some funds did seek and obtain private rulings in respect of the source of FX hedging gains, and a number of these private rulings expressed views contrary to those in the Draft Ruling.

Finally, we note that if the ATO re-opens the 2009 or prior year assessments for those funds which may have amended their income tax returns for those years so as to claim additional FITOs, and the ATO then denies all or part of these additional FITOs, it is the *present* members of those superannuation funds that ultimately bear the cost of this denial. As the members of funds, and their present investment options and balances, may have changed significantly from those in the year in which the FITOs were claimed, the denial of the FITOs at a future date may impose a significant disadvantage on a different group of members to those who originally benefited from the claiming of the FITOs.

In all of these circumstances, ASFA submits that it would be unfair for those funds who originally lodged on a conservative basis if the ATO were to re-open their 2009 income tax assessments to deny the FITOs based on the principles in the Draft Ruling.

Accordingly, ASFA submits that, at a minimum, the Ruling when finalised should expressly state that it will *not* apply to income tax assessments for the year ended 30 June 2009 or prior years.

Furthermore, the principles in the Draft Ruling, if unchanged in the final Ruling, will likely necessitate most superannuation funds reviewing their present FX hedging arrangements so as to mitigate the risk of loss of the FITO entitlement in years in which FX hedging losses exceed FX hedging gains. If, as a consequence of these reviews, superannuation funds determine to change their present FX hedging arrangements to minimise the risk of loss of the FITO entitlement, such changes cannot be implemented instantaneously.

For this reason, some lead time for the application of the principles in the Draft Ruling would be appropriate. For example, amending present arrangements to ensure that execution of forward FX contracts occurs in Australia may require amendment to investment management agreements (‘IMAs’), or even appointment of new investment managers. Given that the typical term of forward FX contracts is 3 months, some existing contracts will expire (and gains/losses crystallise) after 1 July 2014. As a result, ASFA submits that an application date of no earlier than 1 July 2015 would appear to be appropriate.

To the extent that the final Ruling applies from 1 July 2014 or a later date, the issue arises as to how superannuation funds are to prepare their income tax returns for the year ended 30 June 2014. This is particularly relevant as it is likely that this will be the first year since the year ended 30 June 2009 in which FX hedging losses may exceed FX hedging gains, and thus where the application of the principles in the draft Ruling may result in the loss of FITOs for many superannuation funds. ASFA submits that the Ruling should state that, for the year ended 30 June 2014, the Commissioner will accept treatment by taxpayers of relevant FX hedging gains and losses in a manner that is consistent with that adopted in the income tax returns lodged by funds for the years ended 30 June 2009 to 30 June 2013 (or with the most recent of those years if the treatment had changed over this time).

3. Source of foreign currency hedging gains

Paragraph 13 states that the Commissioner will place significant weight on the place where the foreign currency hedging transactions are formed (and not where the master International Swap Dealers Association agreement ('ISDA') or IMA is formed).

In practice, this 'place' may not be clearly identified in any of the documentation presently available to funds. Even in those situations with the strongest domestic links (involving an Australian ISDA/IMA, an Australian trading desk for forward FX contracts, Australian decision making in respect of which trades to execute, and what would appear to be primarily Australian counterparties and execution), there may be instances of potential foreign counterparties or execution.

For example, we are aware of arrangements where superannuation funds have a major Australian bank undertaking all of the forward FX contracts, with that bank being the counterparty in all cases. However, even in this situation, which would appear to result in wholly domestic-sourced FX gains, where the Australian bank's trading desk closes each evening and there are remaining unexecuted trades, these trades may then be executed by the Australian bank's foreign desks (for example, their London or New York desks). ASFA is concerned that funds are unaware of the extent of the trades that were executed in London or New York, that the execution in these locations is somewhat arbitrary in any case, and it is unlikely that the documentation in respect of the trades will clearly differentiate between those trades executed during the usual trading hours by the Australian desk and those executed after hours by foreign desks.

If the final Ruling retains this emphasis on the significance of the place in which the foreign currency hedging transaction is formed, ASFA submits that the ATO should more clearly articulate the relevant principles, and the extent to which:

- The mere execution (after Australian trading hours) may render some of the trades foreign-sourced; and
- The identity (or residency) of the counterparty is relevant.

ASFA also submits, however, that the Draft Ruling places undue weight on the individual forward FX contracts. This interpretation appears to result from a selective reading of the case law. For example, in *FCT v Mitcham (1965)113 CLR 401*, (Mitcham) the High Court held that the source of a contract depended on a weighting of a number of factors, with the most important being the location where the decision making was made or the location where the primary value was added.

In practice, as noted above, the place of the actual execution of a forward FX trade is somewhat inconsequential, as this can happen anywhere around the world depending on which trading desks are open at the time of the trade. Indeed, obtaining information as to where individual forward FX contracts were formed would be problematic as this is not presently separately identified by custodians in their tax or other reporting.

By way of example, a $15 billion superannuation fund may execute thousands of individual forward FX contracts per annum. Where the FX hedging manager uses a mix of its domestic and foreign trading desks to execute trades, the present accounting and tax reporting provided by the fund's custodians in respect of these trades is incapable of identifying the location of execution for each individual trade (and thus the quantum of the FX gains and losses for trades executed on the domestic desk, and the quantum of the FX gains and losses for trades executed on the various foreign desks).

ASFA understands that the motivation for trading in different time zones is based on market liquidity, which in turn impacts the trading benchmarks which funds provide to their FX hedging managers. For example, some FX hedging managers manage to a London 4pm benchmark (which is the global standard used by all passive index managers and the predominant volume point of the global day for all developed market currencies). FX hedging managers may thus take funds' instructions and pass them through their Australian offices but ultimately execute at least some of the trades in the London time zone in order to meet their benchmarks.

In addition, if a decision were made to trade only on the domestic desk, unless this desk were to remain open 24 hours per day, funds would be incurring significant additional risk in respect of their FX hedging arrangements. For example, if the Australian dollar were to move significantly on international markets outside the domestic desk trading hours, funds would be unable to take action to mitigate part of the impact of these movements until the domestic desk re-opened on the following day.

For all of these reasons, ASFA submits that the placement of significant weight on the place where the foreign currency hedging transactions are formed (and not where the Master ISDA or IMA is formed) is impractical and, in practice, likely to result in the denial of FITOs to most if not all funds in circumstances where FX hedging losses exceed FX hedging gains. For most funds, based on the principles in the Draft Ruling, significant and potentially insuperable changes would be necessary in some or all of the following aspects of their operations, if funds sought to mitigate the risk of loss of FITOs:

- Manager selection (requiring funds to select only FX hedging managers with an Australian trading desk);
- Investment management agreements (requiring funds to execute trades only on the Australian trading desk);
- Risk management (requiring funds to accept the risk associated with the inability to trade outside the trading hours for the Australian trading desk); and
- Custody accounting and tax reporting (requiring funds to liaise with their custodians to implement procedures that would enable the identification of the location in which each individual forward FX contract is executed, and the separate reporting of the quantum of the FX gains and losses based on this location).

ASFA submits that it is neither appropriate nor practical to place such significance on the location of execution of the individual forward FX contracts. ASFA submits that, based on the principles established from a comprehensive analysis of the case law, including those in *Mitcham*, with respect to individual forward FX contracts, significant weight must be given to the location of the ISDA/IMA, as this is the location where the primary decision making occurs, and the location where the primary value is added.

4. Competitive neutrality

If the principles in the Draft Ruling were strictly applied, an FX gain resulting from a forward FX contract would only be domestic-sourced if:

- The ISDA/IMA was Australian;
- The trading desk for the investment manager was located in Australia; and
- The individual FX gain resulted from a particular forward FX contract that was executed in Australia and had an Australian counterparty.

Subject to the comments above on trading outside the usual Australian trading hours, it may be possible for some Australian superannuation funds to amend their present FX hedging arrangements to ensure that each of these conditions were satisfied. As noted in section 3 above, this may result in an increase in the risk profile of funds' FX hedging arrangements as it may impede the ability of funds to mitigate risks associated with large movements in the Australian dollar outside the trading hours for the Australian trading desk.

It is also likely that, for some Australian superannuation funds, the sheer size and volume of individual contracts within their FX hedging arrangements may render it impossible to ensure that each of these conditions were satisfied. For example, market liquidity considerations may mean that it is impossible for some Australian superannuation funds to obtain Australian counterparties for each and every one of their individual forward FX contracts. Given the size of the Australian superannuation industry, there may be insufficient Australian holders of the required foreign currencies to match the needs of the larger Australian superannuation funds.

In addition, even for those funds that may be able to amend their present FX hedging arrangements, this would potentially place those managers that have an Australian trading desk and can source Australian counterparties at a significant competitive advantage. This advantage would not arise as a consequence of the higher skills or better technology of those managers, or the lower fees charged by those managers, but solely as a consequence of a narrow interpretation of source rules in Australian income tax legislation.

ASFA is concerned that, over time, this could result in Australian superannuation funds incurring additional risks in respect of their FX hedging arrangements, higher fees and/or inferior technology or investment skills (due to the absence of competitive pressures from overseas managers), purely as a result of funds seeking to minimise the risk of loss of FITO entitlements.

ASFA submits that this is not an appropriate outcome of the legislation. That is, where a narrow interpretation of source, combined with the broadest possible interpretation of 'reasonably related', results in superannuation funds making decisions to incur additional risks, pay higher fees or suffer inferior technology or skills in order to reduce the risk of loss of FITO entitlements.

All Australian superannuation funds, and their members, would ultimately bear the cost associated with any increase in funds' risk profiles, higher fees or application of inferior technology or skills in their FX hedging arrangements.

5. 'Reasonably relates'

In paragraph 16 of the Draft Ruling the principle is set out that a loss or outgoing may be 'reasonably related' to an amount even where the amount is more reasonably related to another amount. Neither this paragraph, nor the associated commentary in the Draft Ruling, sets any boundaries to this principle.

Accordingly, this interpretation of 'reasonably relates' appears potentially to require only the most tenuous of links to foreign income.

ASFA submits that such a principle is inconsistent with the general construction of income tax legislation, and (as per point 1 above) is inconsistent with the object of Division 770.

In particular, there is no economic relationship between a forward FX hedging loss and a forward FX hedging gain, except in 'active' hedging portfolios, where the relevant manager is mandated to seek to produce net gains from the relevant trading activities.

In 'passive' hedging portfolios, the economic relationship between both forward FX hedging gains and forward FX hedging losses is with the corresponding realised and unrealised market movements in the underlying physical assets being hedged. A forward FX loss would appear to be overwhelmingly more 'reasonably related' to the realised and unrealised gains in the Australian dollar value of the underlying physical assets than to the forward FX gains in the same hedging portfolio. Thus, in the absence of finding more than the most tenuous link between a forward FX loss and a forward FX gain, ASFA submits that any such relationship should be considered reasonable.

There also appears to be an inconsistency between this interpretation of 'reasonably relates' and the emphasis on the individual forward FX contract (rather than the ISDA or IMA) as the basis for the source of any resultant FX gains. In particular, it would appear easier to observe a relationship between forward FX losses and forward FX gains within the same portfolio if the ISDA or IMA is viewed as the contract. The Draft Ruling appears to accept this point at paragraph 154 in stating that it *"is appropriate to find the relationship at the level of the hedging strategy because the gains and losses both stem from this hedging strategy"*. This argument appears tenuous at best when looking at the relationship between a forward FX loss (on one or more individual forward FX contracts) and an individual forward FX gain. The two do not then appear to be related at all.

6. Apportionment

Paragraph 139 of the Draft Ruling sets out the principle that a loss or outgoing may be 'reasonably related' to more than one amount of income, only one of which may be disregarded, and that, in such a situation, there is no part of the deduction which is not related to disregarded income and apportionment is not required.

However, as noted in paragraphs 17 and 142 to 144 of the Draft Ruling, issues of apportionment may arise where a deduction is only partly reasonably related to any disregarded income.

The only example provided within the Draft Ruling considers the situation where the relevant FX hedging gains are Australian-sourced, there is an underlying net capital gain on the physical assets being hedged, and this underlying net capital gain arises only in respect of that portion of the physical assets that were disposed of (whereas the FX hedging losses may relate to the entire portfolio of physical assets).

ASFA submits that the final Ruling should also include an example of apportionment addressing the relationship between FX hedging gains and losses in respect of a fixed interest portfolio, where the relevant other assessable income and deductions arising within this portfolio includes both interest income (including that arising pursuant to the Taxation of Financial Arrangements ('TOFA') rules) as well as gains and losses on the disposal of the underlying fixed interest securities (including TOFA balancing gains and losses).

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I trust that the information contained in this submission is of value.

If you have any queries or comments regarding the contents of our submission, please contact ASFA's Principal Policy Adviser, Robert Hodge, on (02) 8079 0806 or by email rhodge@superannuation.asn.au.

Yours sincerely

Fiona Galbraith
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