File Name: 2014/30

2 September 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 – request for additional information

This letter is in response to your request of 25 July 2014 for additional information regarding determination of the source of FX hedging gains.

The information has been sourced from ASFA members who in turn have sought advice and information from their service providers.

We note that the ATO website lists the scheduled date for release of TR 2014/D2 as December 2014. ASFA is concerned that large superannuation funds are required, for the financial year ended 30 June 2014, to pay the estimated balance of any tax payable by 1 December 2014 and that this will be done on the basis of their understanding of the application of the law at that time. To have the law clarified between the 1 December payment data and the 15 January 1014 year tax return lodgment date would place these superannuation funds in an invidious position.

Given the lengthy consultation process and the significant difference in view between the ATO and Industry ASFA on the specific issue of the source of an FX hedging gain, ASFA requests that should such a release date eventuate, then in our view the earliest the ruling should apply is to the 2015 and subsequent income years.

However, should the final outcome require the industry to collect and record additional information with respect to FX trades then ASFA considers that the earliest practicable commencement date would be the first date of the fund's financial year following publication of the 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.

Response to your questions

Source of the gain

With respect to the specific questions contained in your letter, we offer the following:

1. *Current practice*
   We would welcome views on whether:
   1.1 One method is used more than another;

- Advice from ASFA members would indicate that no one method is used more than another. For example, for one large fund the split between domestic and foreign is based on what the fund has advised the custodian to use for each manager.

1.2 There are any further practices not identified above being used to determine the split between foreign and domestic FX hedging gains;

- Advice from ASFA members is that there are no other methods used beyond the four identified in your letter.

1.3 Why looking to where the ISDA was formed would create less distortions regarding decision making than looking to place where the individual transactions are formed.

- ASFA members are of the view that using the place of formation of the ISDA International Swaps and Derivatives Association) master agreement would give more certainty as to the source of the FX hedging gains and would appropriately recognise that the actual FX trade is merely the implementation of a number of agreements and decisions that preceded it. Further, for any trading position, the opening trade may be placed at one trading desk of counterparty and closed out at another trading desk of the same counterparty. Under the ATO proposal this would lead to the possibility that an FX hedging gain could have two sources, creating uncertainty in the operation of the law.

2. A proxy for the place of formation

To that end, we would appreciate views/guidance on the following:

2.1 If the transaction was accepted by an Australian counter party with an Australian desk during Australian trading hours, would this typically occur in Australia? And if it was accepted outside of Australian trading hours, would this always occur through a foreign desk of that Australian counter party?

- The advice of ASFA members is that where a transaction was accepted by an Australian counter party with an Australian desk during Australian trading hours then this would typically occur in Australia. However, applying such a ruling would require a clear definition of Australian trading hours. We understand that it is reasonably common that trading desks are open 24 hours a day and that the traders take shifts and manage the Australian desk 24 hours a day. ASFA members have also raised concerns that using such an approach would present challenges and could be open to abuse whereby orders could be placed merely to influence a specific outcome.

- Separately, ASFA members advise that If the transaction was accepted outside of (appropriately defined) Australian trading hours then this would most likely occur through a foreign desk of that Australian counter party, unless the Australian counter party carried out a 24 hour trading facility in Australia.

- Finally, our members have been advised of by their members of the increasing growth in algorithmic FX trading. This trading method is used as a means of ensuring best execution by slicing orders through time to minimise market impact. Under such an approach the final contract may be an aggregation of hundreds of contracts across different time zones.

2.2 Following on from 2.1, is it therefore possible to approximate how many transactions would be accepted via a foreign/Australian desk in respect of each counter party?

- Advice from ASFA members is that if an electronic trading platform is used to place trades, then it would be possible to approximate the number of transactions that have been accepted via a foreign versus Australian trading desk based on the time the transaction occurred. However, where for example a phone order is placed, no such record of the time or place would normally be kept.

2.3 *Depending on the responses to the above, we invite views on an approach under which entities can approximate source based on the above and whether de minimus rules would be appropriate. For example, if a certain percentage (eg 90%) of the transactions are, or are likely to be, executed other than in Australia, the whole FX hedging gain for the income year is considered to be from a foreign source (and vice versa).*

- ASFA does not support the use of a de minimus rule. It is our firm view that looking toward where the ISDA was formed is a more appropriate basis for determining the source of a resulting FX hedging gain given that the ISDA/IMA is the founding document under which the FX trades occur.

Additional comments

ASFA would like to reiterate the detailed comments made in our previous submissions and specifically that the draft taxation ruling takes the incorrect interpretation of subparagraph 770-75(4)(b)(ii) as to whether a loss "reasonably relates" to the disregarded income.

ASFA considers that, correctly interpreted, subparagraph 770-75(4)(b)(ii) renders the arbitrary allocation of source of the gains irrelevant for the calculation of the FITO. The focus of the analysis is that it needs to be determined whether the taxpayer has "net foreign income" and the argument presented in the draft ruling is that losses on hedges "reasonably relate" to gains on hedges. In doing this it is not necessary to analyse the source of the losses but only the gains to which the losses "reasonably relate"

The analysis in the draft ruling simplistically assumes that all the hedges are non-Australian sourced and therefore the losses "reasonably relate" to these ex-Australian gains. However it does not contemplate the reasonably likely situation that the hedges ara a mixture of Australian and non-Australian sourced. In such a situation which losses relate to which gains?

As the analysis moves away from the simplistic starting position of a single transaction where there is a clear offer and acceptance and the location of the offer and acceptance is easily identifiable we encounter a myriad of issues which cascade through the analysis. Additionally, it should be noted that any arbitrary conclusion regarding source and also that the losses relate to foreign gains would result in Australian investors being denied the freedom to access the best pricing available in the FX market. In the context of the Australian superannuation fund market with its large size and high exposure to international investment this is particularly relevant. For any given order size the bid-offer spread will tend to be narrower when more liquidity is available as the market maker will be required to hold inventory for a shorter period of time. Recent central bank semi-annual surveys from the UK, US, Japan, Australia and Singapore taken in April 2014 and published on 28th July 2014 continue to demonstrate the significantly higher relative liquidity levels available outside the Australian time zone.

ASFA considers it important to ensure that Australian investors have the freedom of choice to select the best overseas or domestic hedge managers based on results and experience and that this decision is not influenced by the need to determine the source of the individual trades for tax treatment purposes.

In relation to the comments in your letter about source, ASFA considers that arguing that the source of income derived from the foreign exchange hedging transactions undertaken by Australian superfunds should depend on where the transaction was entered into is not practical and should not be considered correct given the manner in which the market actually operates. The ATO position assumes that there is a distinct point in time at which each trade is accepted/offered and that the location of the acceptance is clearly identifiable. ASFA considers that these assumptions are not consistent with market practice and we set out a number of reasons for this below.

- To begin with, such an approach would, in our view, be highly artificial and capable of producing arbitrary results. Where the parties to a transaction are located in different jurisdictions, the place where the transaction is entered into will, technically, depend on where the relevant contractual offer is accepted. Although such a principle is easy to express, there will be extreme difficulty in determining exactly which party made the contractual offer. Where a transaction is concluded by telephone, for example, a discussion about the terms of the transaction will result in the parties reaching a consensus. However, who made the contractual offer and who accepted it will depend on how the conversation progressed. This information will simply not be available and, even if it were, for the point to turn on this highly technical distinction would seem to be extremely arbitrary and subject to conjecture.
- Secondly, many transactions are entered into by computer (using certain trading algorithms), without any human intervention. As noted earlier, algorithmic trading in FX continues to grow in popularity as a method of ensuring best execution by slicing orders through time to minimise market impact. Algorithms and other techniques spread out the trade to avoid detection during the most liquid hours. The final contract is an aggregation of potentially hundreds of smaller sub orders which can cross time zones. It remains unclear as to where these types of order are accepted as the communications that give rise to the contracts are between computer servers and these are typically located in the vicinity of London and New Jersey to counter the risk of high-frequency traders impacting the trade. Again, it would appear somewhat artificial to answer the question of whether the income in question has an Australian source by examining where the servers are located and which server can be regarded as having accepted a contractual offer made to it. It would be more appropriate to consider the location of the parties for whose account the servers are acting (refer below).
- Finally, it is often the case that an investment manager will enter into a transaction on behalf of a number of clients without having identified the specific client(s) for which it is acting at the time of trading. Post completion, the transaction will be allocated to specific clients on a proportionate basis. In such circumstances, it is not clear whether the place where the transaction is entered into depends on where the contractual offer is accepted, where the allocation takes place or where the client is at the time of the allocation. Indeed, this may depend on the governing law of the transaction, which could vary from jurisdiction to jurisdiction.

Your letter expresses significant doubt as to whether the ATO will accept that where the ISDA and IMA are taken to be formed should be taken into account in determining source. The view appears to be based on the fact that such an approach is open to manipulation and that the relevant agreements do not provide the actual source of the profit derived under the hedge transactions but rather provide the framework under which the actual source of the profits (i.e. the individual trades) arise.

As stated above, we consider that identifying the necessary details of each of the trades is impractical and even the information available, it would remain be enormously difficult to determine where the relevant contract was actually formed. Advice to ASFA indicates that the administration and cost involved in such an exercise would be very significant and would lead to various practices (outside the normal market practices) being instituted to attempt to create a source in a particular jurisdiction.

In ASFA's view, should it be decided that the source of *each transaction* is relevant in determining the entitlement of the superfund to a FITO, an acceptable position would be to identify the parties to the relevant transaction under the ISDA. In this regard, the Australian superfund will be the principal which is trading. If the counterparty to that ISDA (and therefore the trade) is either an Australian resident acting through an office in Australia or a non-resident acting through an office in Australia, the gains income arising from that transaction should be regarded as having an Australian source. This should be the case regardless of whether the transaction is executed within or outside of Australia. In such cases, all payments and deliveries to the Australian superfund will be made through an office in Australia. As the income derived from the transaction is a function of the payments and deliveries that are made, the source of the income will be the party's Australian office. It would also be the case that, if the recipient of any payments and deliveries is acting from an office in Australia, the income will be accounted for as part of the profits or losses of that

office. For both these reasons, the income derived from the transaction has a closer connection with Australia than the jurisdiction in which the transaction is entered into.

This approach also has the advantage of certainty given that the office through which the relevant party is contracting will be specified in the ISDA Master Agreement governing the transactions. Where a party has only a single office the position will, of course, be clear anyway, but where it operates through a number of offices, Section 10(c) of the ISDA Master Agreement requires that:

> … the Office through which it makes and receives payments and deliveries with respect to a Transaction will be specified in the relevant Confirmation.

The ISDA Master Agreement itself is a highly respected and very widely used agreement in the world of finance. In one recent English law case (*Lomas* v *JFB Firth Rixson, Inc*) it was said that:

> [t]he ISDA master agreement is one of the most widely used forms of agreement in the world. It is probably the most important standard market agreement used in the financial world.

Specifying the office through which a party is acting for the purposes of the Agreement, and the transactions entered into, therefore involves no artificiality but is a normal commercial mechanism to identify the office which is responsible for the making of any payments and deliveries that are due.

If the counterparty to the Australian superfund is not acting through an office in Australia then the source can definitively be taken to be outside Australia.

ASFA considers that, for all of the above reasons, identifying the parties to the relevant transaction under the ISDA would be a practical and sensible approach to determining the source of an FX transaction, it would not be open to manipulation or lead to uncommercial practices and it would reflect the true source of the transaction. It would also be consistent with the Government's stated objective of avoiding unnecessary red tape.

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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

Robert Hodge
Principal Policy Adviser