Chapter 16

AN ALTERNATIVE TREATMENT FOR COLLECTIVE INVESTMENT VEHICLES

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The framework for reform

16.1 *A New Tax System* is based on consistent tax treatment of entities undertaking business activities and a high level of integration with individual taxation. The achievement of the benefits intended by the Government's entity reforms are of central importance, for both efficiency and equity reasons, in a fundamental reform of business taxation.

A strategy for reform

An intermediate category of taxation treatment

16.2 Essentially, those entity reforms distinguish two categories of taxation treatment for investments — *individual taxation* and *entity taxation*. Elaborating on and consistent with the Government's policy approach is an intermediate category of taxation treatment — *flow-through taxation* of *collective investment vehicles* (CIVs). This raises the question of how distributions from CIVs — representing arrangements where individuals join together in widely held investment vehicles to undertake investments delivering a full flow-through of income in each year to participants — should be treated.

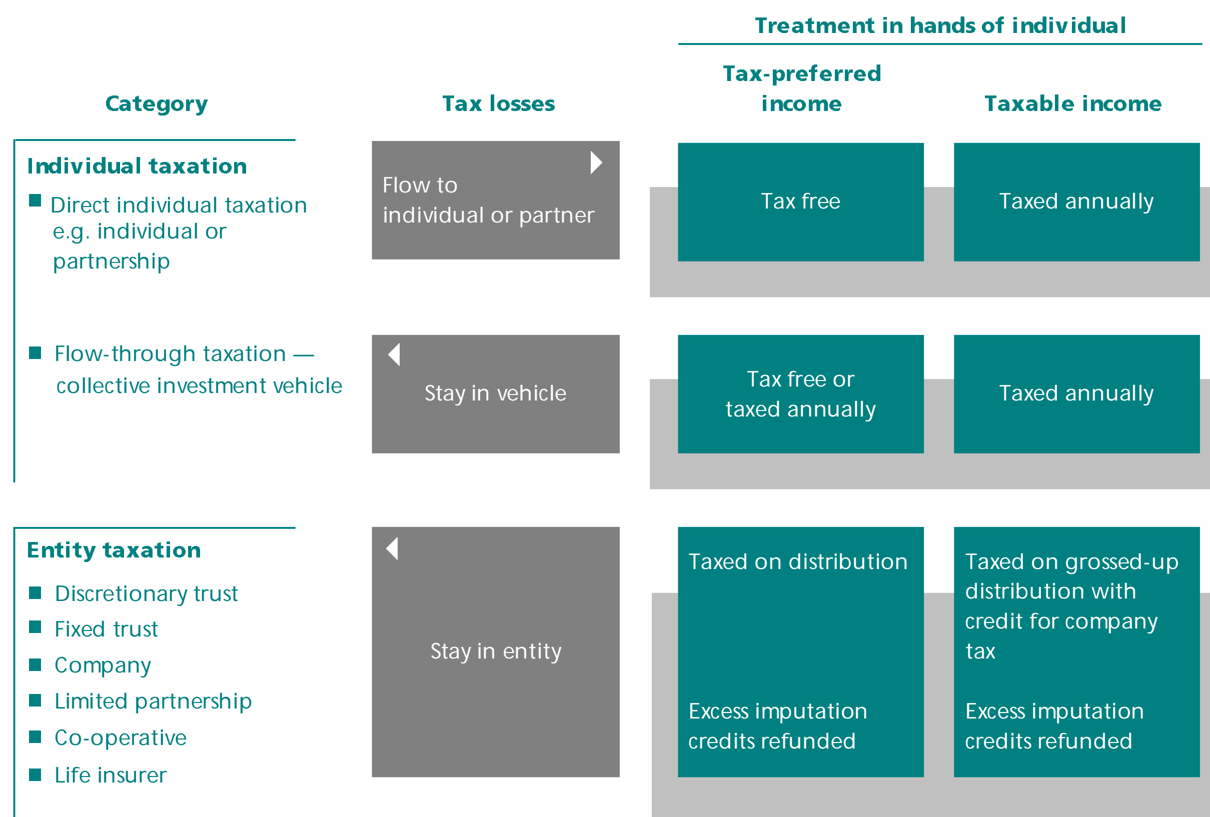
16.3 Most CIVs are established as unit trusts in Australia. They are typically widely held, distribute profits fully, and offer managed portfolio investments across local and overseas equities, property and bonds. They are a widely used form of investment by retired Australians and by non-resident portfolio investors, as well as others. Some CIVs in Australia are in the form of companies. These are usually focused on equity investments.

16.4 Treating CIVs on a flow-through basis for taxation would provide individual taxpayers with the same capital aggregation and risk pooling benefits as the alternative entity treatment discussed in Chapter 15, but would offer different compliance benefits relative to that treatment.

16.5 Where taxed on a flow-through basis, CIVs with appropriate design features would also provide a suitable investment vehicle for non-resident portfolio investors. Their availability would substitute for the introduction of a special investment vehicle otherwise required for such investors under taxation arrangements based solely on individual or entity treatments.

16.6 In summary, as illustrated in Figure 16.1, such a flow-through approach to CIV taxation would result in most investments falling into the following categories of taxation treatment: *individual taxation*, either *directly* or through *flow-through taxation*; or *entity taxation*.

Figure 16.1: An intermediate category of taxation treatment



16.7 As noted in the Review's December 1998 information paper, *An International Perspective*, many countries have developed special tax rules for CIVs, with their legal form varying within and between countries. The Regulated Investment Company measures applying to US mutual funds are an example of such rules. The US rules are designed to align more closely the tax treatment of investors in these types of funds and investors making equivalent direct (that is, non-intermediated) investments.

Key policy issues

Advantages and disadvantages of taxing collective investment vehicles on a flow-through basis

Retention of character facilitates non-resident investment

16.8 Taxing CIVs on a flow-through basis would result in distributions of taxable income retaining their *character* — for example, as capital gains or interest income — instead of all such distributions being received as the equivalent of dividends, as would be the case under entity treatment (some

distributions of CIVs could be dividends flowing through the CIV). This is particularly relevant for non-resident investors where different withholding tax rates currently apply to different forms of income. Allowing income to retain its character on distribution would achieve, in the absence of taxation of distributions of tax-preferred income, taxation treatment closer to the taxation of direct investors. The issue of whether distributions of tax-preferred income should retain their character is discussed below.

Flow-through taxation avoids cash flow detriments

16.9 Under the alternative entity tax treatment — discussed in Chapter 15 —some CIVs with uncomplicated income flows, such as cash management trusts, would face extra administrative costs in order to avoid cash flow detriments.

16.10 These costs would arise from tax applying at the entity level and any consequent mechanisms for early refunds of imputation credits. Taxing cash management trusts as entities could disadvantage some low marginal tax rate investors in these funds compared with investors in bank account products. Such investors with much of their saving in this form of investment are relying on the full distribution of profits from the CIV and could have their cash flow reduced during the year by the effect of tax at the entity level. The overall tax paid for the year would be unaffected — the proposed refunds of excess imputation credits would ensure that. But if the refund were only available on assessment there would be a delay before refunds were received, as well as additional compliance requirements.

16.11 One way of handling this issue would be through early refund mechanisms. These are discussed in Chapter 15. Such mechanisms would necessitate identification of people eligible for early refunds and add to the number of times investors would have to interact with CIVs or the Australian Taxation Office during the year. Flow-through tax treatment of CIVs directly sidesteps these cash flow and compliance problems.

Existing compliance costs would be maintained

16.12 A disadvantage with retaining the character of income is that it would maintain the current compliance complexity for fund managers (who have to report the separate categories of income to unit holders) and for unit holders when completing their tax return.

How would collective investment vehicles be defined?

16.13 CIVs would be defined as widely held vehicles undertaking investments delivering a full flow-through of annual profits to participants. Such investments are less of an active business nature and much more of a

passive portfolio, or intermediated, nature not involving control of business operations.

16.14 Unless tax-preferred distributions were taxed, CIVs would need to meet eligibility criteria to ensure they are not able to deliver competitive advantages over other entities engaged in 'active' business. Widely held fixed trusts, including cash management trusts, that are required to distribute all their gains annually would qualify, subject to any restrictions applying to investment activities. Discretionary and trading trusts, or closely held entities, would not qualify and would be taxed as entities as *A New Tax System* proposes.

16.15 CIVs would be required to make full distributions of all income. One way of treating any distributable profits which are not paid out annually to investors — thus defaulting on eligibility criteria — would be to apply tax at the company rate to those retentions. The benefit of imputation would not apply when the profits are subsequently distributed. This would result in a classical taxation outcome, thereby preventing tax deferral benefits for those investors on higher marginal rates — and so removing any tax-driven incentive to default on full distribution.

How would 'widely held' be defined?

16.16 It would be necessary to define such widely held entities. Under current tax law, a public unit trust is a unit trust where any of the units are listed for quotation on a stock exchange, the units are held by 50 or more persons, or any of the units are offered to the public. A unit trust where 20 or fewer persons hold 75 per cent or more of the beneficial interests in the income or property of the trust is specifically excluded from being a public unit trust. (For the purposes of special tax treatment it would also be necessary for the trust to be a resident unit trust.) This definition, suitably modified if applying to entities other than unit trusts, may be an appropriate way of defining *widely held* vehicles.

16.17 The definition of 'widely held' would need to be cognisant of the interest withholding tax arrangements — that, for example, provide related exemptions for widely distributed bonds. That would remove the need for a special vehicle to handle the effects on non-resident investors of taxing trusts like companies, discussed in Chapter 30.

How would tax preferences be treated?

16.18 Preservation of the character of profit distributions from CIVs under flow-through tax treatment poses the further question as to whether tax-preferred income distributed from CIVs should be taxed in members' hands. Cash management trusts, for example, derive little tax-preferred profits

so that virtually all of their profits would be taxable. On the other hand, property trusts distribute tax-preferred income — for example, profits freed from tax by depreciation allowances. The following discussion addresses a number of issues as a basis for consultation on the appropriate treatment of tax preferences.

Option 1: Not taxing tax-preferred income

16.19 A flow-through treatment for tax preferences distributed by CIVs, under which tax-preferred distributions would not be assessable in investors' hands, is one possible approach.

16.20 On that basis, distributed tax preferred income would be non-assessable income for investors. This would effectively preserve the effect of any tax preferences — as is the case for direct investments by individuals — but would have revenue costs as well as significant implications for competitive neutrality between operating entities and CIVs.

Revenue cost

16.21 Allowing flow-through would result in generally more favourable taxation than presently applies. As explained in the Overview, tax-preferred income of unit trusts is currently usually taxed via a reduction in the cost base of the units when tax-preferred profits are distributed. Thus, tax applies when the units are sold or when the cost base of the units is reduced to zero (that is, when accumulated tax preferences exceed the units' original cost). Certain forms of tax-preferred income are not subject to the cost base adjustment — most notably profits of property trusts freed from tax by building depreciation allowances.

16.22 The more favourable treatment of allowing tax preferences to flow-through CIVs untaxed would also involve a cost to revenue. This could build up to around $100 million per year (36 per cent company tax rate). That revenue cost could also affect consideration by the Review of the scope for reductions in the company tax rate.

Competitive neutrality would require investment criteria

16.23 Taking this approach would raise the following competitive neutrality considerations.

- To guard against CIVs competing against 'active' businesses, for example, it would be necessary to consider how to define the activities that CIVs could undertake.
- Furthermore, it would also be necessary to consider the competitive position of life insurance offices. Subject to entity

taxation, as proposed, life offices would be unable to pass on tax preferences. Hence superannuation funds now investing through life offices may prefer to invest through a CIV able to attract flow-through of both taxable and tax-preferred profits.

16.24 If tax preferences were preserved through CIVs, it would be necessary to consider whether they can acquire controlling or non-portfolio interests in part of the asset base of an 'active' business — such as office buildings and shopping centres. Yet the distinction between such an entity and 'active' businesses is often difficult to make. Allowing investment vehicles with such controlling interests to be excluded from the entity regime could allow them to obtain a competitive advantage over entities still within that regime.

16.25 Rules governing the taxation of US mutual funds (formally Regulated Investment Companies) provide tests to ensure that such a fund is diversified and that individual investments made by it are genuinely passive non-controlling interests. When such tests are met, the activity of the entity should closely parallel portfolio investments made directly by investors. This suggests a requirement, if tax preferences are preserved, that the CIV undertake portfolio investments in the shares of other entities and/or invest in fixed interest securities and other financial instruments, such as derivatives.

Treatment of retentions of tax-preferred income

16.26 With the flow-through of tax preferences, investors would be taxed only on their share of the *taxable income* of the CIV. Hence tax-preferred income would be non-assessable in the hands of the investor.

16.27 The current complex cost base adjustments with fixed trusts would not be relevant with tax-preferred income flowing through untaxed. It would, however, be necessary to consider whether the potential taxation of capital gains before a distribution of non-taxable profits is made would disrupt the market for interests in CIVs. Increases in the cost base of interests in the CIV as the income builds up in the CIV during the year would deal with this — but significant complexities would be involved.

Option 2: Taxing tax-preferred income

16.28 As noted, despite arguments for flow-through of tax preferences, there are competitive neutrality, equity and revenue reasons that would support no such flow-through.

16.29 Adopting a 'no flow-through' approach to tax preferences would acknowledge the otherwise unavoidable practical difficulties of drawing boundary lines between *passive* investments conducted through collective *vehicles* and *active* investments conducted through operating *entities*.

16.30 Under this option, tax-preferred income distributed by a CIV would be taxed in a way equivalent to distributions by entities. However, distributions of taxable income would retain their character, which would result in distributed capital gains and foreign source income being taxed in a different manner to similar distributions by other entities. This treatment would put CIVs, and business structures incorporating a CIV, on a similar competitive footing to other entities.

16.31 Under this treatment, investment vehicles that met widely held and full distribution criteria then would qualify as CIVs. The taxation of tax-preferred income would obviate the need, on competitive neutrality grounds, for CIVs also to have to meet investment criteria. Relative to other entities, CIVs would receive no competitive advantages from distributing tax-preferred income but certain forms of taxable income would retain their character.