QUEENSLAND INVESTMENT CORPORATION

REVIEW OF BUSINESS TAXATION

PLATFORM FOR CONSULTATION

COLLECTIVE INVESTMENT VEHICLES

Queensland Investment Corporation Submission

March 1999

Executive Summary

This submission focuses on the following issues of major significance for large investment trusts:

- implementation of the decision to allow flow through taxation for widely held collective investment vehicles; and

- refundability of franking credits to State Governments.

We have summarised our submissions on these matters below along with our recommendations.

Collective Investment Vehicle (CIV) Implementation Issues

The Federal Government’s recognition of the importance of the collective investment vehicles and the benefits they provide in funding the retirement incomes of Australia’s aging population through the decision to retain a flow through taxation approach for CIVs is welcomed. However, great care is needed in the implementation of CIV flow through taxation to ensure the system is workable and does not result in significant unforeseen adverse consequences.

Our detailed comments on CIV flow through taxation policy and implementation issues can be summarised as follows:

- **Flow Through Taxation for CIVs**

  Implementing a system of flow through taxation for CIVs is a critical aspect of funding the retirement incomes of the Australian population. Without a facility for investors to pool their funds to gain the benefits of economies of scale, diversification and access to professional investment management in a cost effective way, national savings would not be maximised.

  Chapter 16 of the Platform for Consultation (PFC) and the recent announcement by the Federal Treasurer have given in principle approval for flow through taxation for CIVs. Whilst this in principle approval is a positive step, the market practice in the portfolio investment activities of CIVs and the development of sophisticated CIV structures designed to maximise investment flexibility must be taken into account in implementing the CIV flow through taxation proposals.

- **Definition of Widely Held CIV**

  The definition of a widely held CIV should adopt the ultimate ownership principle to ensure flow through taxation is available to all CIVs that are in substance widely held.

  The commercial forces affecting most widely held investment trusts have lead to sophisticated trust structures such as those outlined in Attachments 2.1 and 2.2. Accordingly, a practical approach needs to be adopted to the implementation of the ultimate ownership principle to ensure flow through taxation sufficiently caters for these sophisticated structures. Alternative approaches are discussed in Chapter 3.

  To ensure the CIV flow through taxation proposals are effective, investment entities owned by widely held CIVs must be covered by the definition of widely held CIV.

- **Tax Free Flow Through of Tax-Preferred Income**

  An overriding concept of the taxation of CIVs internationally is the maintenance of Investment Neutrality. The Review of Business Taxation's (RBT) International Perspective Report recognises this fact and therefore supports a direct investment equivalence approach to the taxation of CIVs. This approach requires full flow through taxation in respect of CIV transactions including tax-preferred income. The tax-preferred income of widely held CIVs should not be taxed.

- **Passive Investment vs Active Business Borderline**

  The requirement to define a borderline between portfolio investment and active business is required both as part of the classification of CIVs as eligible for flow through taxation and to ensure competitive neutrality where full flow through taxation is implemented.

  Mechanisms for establishing the portfolio investment vs active business borderline in a practical way that provides certainty are discussed in Attachment 4.1. It is submitted that a test based upon the current Division 6C provisions (with specific modifications) would provide the desired distinction with minimal implementation and compliance issues.

- **Full Distribution of Profits**

  It is proposed CIVs must fully distribute their profit to be eligible for flow through taxation. The profit that is required to be distributed should be based on the taxable income of the CIV and should exclude tax-preferred amounts.

- **Taxation of Tax-preferred Income Where Flow Through Taxation Denied**

  Where the tax-preferred income distributions of CIVs are taxed the taxing unfranked inter-entity distributions approach should be implemented. This approach fits better with the nature of CIVs than the Deferred Company Tax (DCT) or Resident Dividend Withholding Tax (RDWT) approaches.

  Notwithstanding that the unfranked inter-entity distributions approach represents the best of the proposed entity taxation methods, it would still place investors investing through CIVs at a disadvantage to direct investment. This is not consistent with investment neutrality.

- **Restructure Rollovers**

  The liquid nature of investment funds means that the RBT proposals could trigger large-scale restructures of pooled investment vehicles. Accordingly, comprehensive tax rollovers should be provided to allow the reorganisation of investment trusts adversely affected by the RBT proposals.

Refundability of Franking Credits for State Governments

The entity taxation proposals have the potential to give rise to significantly adverse tax consequences for State Governments and other tax exempt investors. As a result, State Governments, including their statutory bodies and related corporate entities should be entitled to refunds of additional underlying tax that arises as a result of the implementation of the RBT proposals. The refundability of additional underlying tax should be implemented as a design feature.

Where the refund of DCT/RDWT to State Governments is rejected, the significance of the cost of the entity taxation proposals to the State of Queensland will depend on how the CIV flow through taxation system is implemented. The position of State Governments should be taken into account in the implementation of the CIV proposals. Key issues will include the definition of widely held trust and the taxation of distributions of tax-preferred income.

Recommendations

Our recommendations are as follows:

- Full flow through taxation should be available for CIVs. The implementation of the CIV tax system should have regard to the portfolio investment activities and investment structures of CIVs.

- The definition of widely held CIV should adopt the ultimate ownership principle. The adoption of the ultimate ownership principle should be implemented through a "scheduler" approach to the definition of widely held CIV that takes into account the economic substance of a CIV's owners.

- Where the definition of widely held CIV is based on the public unit trust definition the "20% superannuation fund/tax exempt ownership" rule should be used and expanded to take into account the economic substance of CIV owners in determining widely held status.

- The full direct investment equivalence principle should be adopted. The tax-preferred income distributions of CIVs should not be taxed to ensure the tax position of a CIV's owners is the same as if they had invested directly.

- If tax-preferred income distributions of CIVs are to be taxed then they should be taxed on a deferred basis through cost base reductions, as is currently the case, and not under the entity taxation regime.

- The portfolio investment vs active business boundary line for restricting the activities of CIVs should be implemented having regard to the limitations of the existing Division 6C rules.

- The full distribution of profit requirement should be limited to taxable income. Distribution of tax-preferred income should be at the option of the CIV.

- Practical issues in respect to investment trust distributions should be considered in the implementation of the profit distribution requirement.

- Where the tax-preferred distributions of CIVs are to be taxed under the entity taxation system then the taxation of unfranked inter-entity distribution approach should be adopted.

- As a transitional measure comprehensive tax rollovers should be provided to allow CIVs to vest their assets or restructure as a result of the RBT proposals without triggering unrealised tax liabilities.

- State Governments and other tax-exempt entities should be entitled to a refund of additional underlying tax caused by the RBT proposals.

- If State Governments and other tax exempt entities are not granted refunds of additional underlying tax caused by the RBT proposals then special consideration of the effect on State Government and tax exempt investors should be taken into account in implementing the CIV flow through taxation system.

Contents

Chapter 1 – QIC Group Background

Overview

QIC was established in 1991 under the provisions of the Queensland Investment Corporation Act 1991, as a State Government owned funds manager. As an organisation, we specialise in managing investments for the Queensland government, State public sector superannuation and insurance schemes and other government bodies. As at 28 February 1999, funds under management with QIC were $22 billion, making us one of the largest wholesale funds managers in Australia.

QIC's clients benefit from a full investment service including asset consulting, advisory services and a range of pooled investment products that are resident unit trusts. As trustee and funds manager, QIC is a major investor in Australia and abroad, ranking amongst the top ten shareholders of most of the 50 leading companies listed on the Australian Stock Exchange. In addition, QIC holds significant investments in prime real estate including office buildings and shopping centres along the east coast of Australia. Investments in Australian and international fixed interest, cash, currency and international shares also form part of the investment portfolios of QIC trusts.

QIC's Trust Products

The product range provides clients with the benefits of collective investing, including superior market diversification and cost efficiencies due to economies of scale. The products are resident unit trusts and are considered to carry on eligible investment businesses as defined in Section 102M of the Income Tax Assessment ACT (1936) as amended.

QIC's products comprise a large balanced fund, the QIC Investment Trust, the QIC Cash Trust and a suite of asset specific trusts collectively termed the QIC Pooled Sector Funds. Clients are able to combine investments in any of QIC's products, tailoring their portfolios to meet individual investment objectives and risk tolerances.

The QIC Investment Trust is the Corporation's core investment product and the preferred investment vehicle of the majority of our clients. The Trust is a balanced portfolio comprising investments in Australian and international shares, Australian and international fixed interest, property and cash. Investments into these asset sectors are facilitated by a combination of direct asset investment and via sub-trusts that provide additional flexibility and maximise diversification. QIC as trustee of the QIC Investment Trust, employs the following investment structures to affect investment into the various asset sectors:

- Australian Cash – via a holding in the QIC Cash Trust;
- Australian Fixed Interest – direct investment;
- International Cash and Fixed Interest – via a holding in the QIC Offshore Fixed Interest Fund;
- Australian Equities – direct investment plus minor holdings in unlisted wholesale equity trusts;

- International Equities – via a holding in the QIC Offshore Investment Trust;

- Property – direct investment and via a holding in the QIC Balanced Property Fund.

The use of sub-trusts provides the QIC Investment Trust with the ability to pool funds with other wholesale investors. While this is relevant for all asset sectors it is particularly appropriate for investment in the property sector. The pooling of funds for investment into the property sector provides investors with exposure to large quality assets while maximising diversification to manage investment risk.

QIC's Performance

QIC is focused on delivering strong investment performance at conservative levels of risk. Over the past 10 years, returns achieved consistently place QIC amongst the top 25% of its peer group. Very few Australian or international funds managers have outperformed so well for so long.

Chapter 2 - Flow Through Taxation for Collective Investment Vehicles (CIVs)

Summary

Chapter 16 of the Platform for Consultations (PFC) discusses the option of allowing "flow through taxation" for CIVs. At the same time as the PFC was released by the Review of Business Taxation (RBT) the Federal Treasurer announced in principle approval for flow through taxation for CIVs such as bond trusts, common funds, managed funds and property trusts.

CIVs allow investors to pool their funds and achieve greater investment returns through the benefits of diversification, economies of scale and access to professional investment management on a cost effective basis.

We have provided background on the portfolio investment activities and sophisticated investment structures that have been developed by investment trusts. To allow investment flexibility CIVs typically offer a range of vehicles with defined investment approaches and separate asset class holding entities. It is important to have regard to the best practice in respect to portfolio investment and investment structures in the implementation of the CIV flow through taxation regime.

Recommendation

Full flow through taxation should be available for CIVs. The implementation of the CIV tax system should have regard to the portfolio investment activities and investment structures of CIVs.

Flow Through Taxation for CIVs

While the key focuses of the PFC are the taxation of individuals and entities, Chapter 16 proposes that CIVs should be taxed under an "intermediate category" that taxes CIVs as "flow through vehicles". That is, distributions of taxable income from a CIV would retain their character in the hands of their owners as opposed to being taxed at the CIV level and distributed as dividend equivalents (as would be the case under Entity Taxation). The QIC strongly supports the flow through taxation proposals announced for widely held CIVs.

The following comments support the adoption of a flow through taxation approach for CIVs:

- "Investment Neutrality" indicates that the same tax treatment should apply to economically similar investments irrespective of the legal form through which the investment is undertaken. Economically, investments through CIVs have the same nature as direct investment. Flow through taxation of CIVs allows investors to obtain the benefits associated with investing as a group such as economies of scale and diversification while maintaining their direct investment taxation profile.

- The RBT commissioned its International Perspectives (IP) paper in recognition that it is appropriate for the Australian tax system to be benchmarked against the tax systems of other countries. The IP paper concludes that flow through taxation for CIVs accords with the treatment of similar investment vehicles internationally. Accordingly, the implementation of flow through taxation for CIVs will ensure that the Australian tax system is appropriately benchmarked against the international treatment of CIVs.

- PFC recognises that significant cash flow problems would arise for owners of CIVs under the Entity Taxation regime due to the timing of deferred company tax payments by CIVs and access to excess franking credit refunds by CIV owners. A flow through regime would allow these significant cash flow detriments to be avoided. The extra administrative costs otherwise arising under Entity Taxation to manage the cash flow problem would also be avoided.

- Taxing CIVs would not lead to an increase in Federal tax revenue other than as a result of the timing of tax payments and refund of excess credits. The timing costs will fall on CIV investors. Investors will tend to back away from pooled investments in favour of direct investment if the additional tax cost is perceived to outweigh performance advantages. Denial of a flow through taxation system for CIVs would therefore influence commercial practice and encourage direct investment by investors. This outcome will not be optimal for national savings.

- Flow through taxation of CIVs facilitates the investment in assets that require large investment sums, the most notable being large property assets. The pooling of funds for investment provides investors with exposure to large quality assets while maximising the investor's ability to diversify investment risk. As a flow on effect, pooling of funds by investors increases the market for these large illiquid assets. Without a flow through taxation system for CIVs, there is likely to be an asset allocation drift away from CIVs with a consequent impact on the pricing of the large assets. For the property sector, this will result in significant development projects being put at risk.

- Flow through taxation for CIVs facilitates the pooled investment by non-resident investors in Australia without the significant adverse tax results that would flow from entity taxation that would make investment by non-residents in Australia less attractive and limit the liquidity of Australian markets.

- Flow through taxation for CIVs also facilitates the pooled investment by State Government and other tax-exempt investors. Without flow through taxation for State Government investments in CIVs, significant adverse tax consequences would arise.

Portfolio Investment Activities of CIVs

One of the eligibility requirements of CIV flow through taxation being available to an entity is the portfolio investment activity limitation. We have outlined below our comments on the appropriate scope of the portfolio investment activity requirement.

- Chapter 16 of PFC discusses whether the property investments of CIVs should be limited to non-controlling interests. We are strongly of the view that this would not be appropriate as it is inconsistent with the market practice of investment trusts. The view that CIVs should be allowed unrestricted ability to invest in the property sector is supported by the Federal Treasurer's announcement of approval for flow through taxation for property trusts.

- Another key consideration is the distinction between active and passive portfolio management. An active equities manager may trade equities with a view to producing superior returns. On the other hand a passive equities manager may simply hold a portfolio of equities with a view to replicating the performance of an index. Both portfolio management approaches are an integral part of the activities of pooled investment vehicles.

For the purposes of this submission we have used the term portfolio investment to describe the current activities of pooled investment vehicles that include holding controlling interests in property and both active and passive management of financial asset portfolios such as equities, fixed interest securities and financial derivatives.

CIV Investment Structures

The competitive nature of the funds management industry and the liquid nature of investment funds drives the development of sophisticated investment trust structures. It is important to have regard to market practice in respect to investment trust structures in implementing the CIV flow through taxation system. The following issues are involved.

- **Wholesale and Retail Investment Trusts**

  Investment trust structures commonly involve both wholesale and retail level trusts. Retail trusts collect funds from small investors for investment. Retail investment trust managers often offer a range of retail investment trusts which each have a different investment strategy and mix of asset class exposures.

  Retail trusts often implement their designated investment strategy by investing in wholesale trusts. Wholesale investors such as large superannuation funds also choose to invest through wholesale trusts. Each wholesale investment trust manager usually offers a choice of wholesale trust investments as discussed below.

- **Investment Flexibility**

  A key driver of the superior returns offered by investment trusts is their ability to maximise diversification by investing in various classes of assets. Historically, a balanced investment approach has been favoured by many investors that has lead to the growth of very large wholesale investment trusts that adopt a balanced investment approach by investing directly in various types of assets.

  Over time retail trusts and other wholesale investors such as large superannuation funds have driven moves to allow greater investment flexibility. Rather than investing all of their funds in balanced wholesale investment trusts, retail investors often wish to have the flexibility to invest in particular asset classes.

  To provide investment flexibility wholesale trusts have moved to the development of asset class specific sub-trusts. While large balanced wholesale investment trusts remain, they increasingly invest through asset class wholesale trusts rather than directly. Wholesale investors tend to place the majority of their funds with one or more large balanced wholesale investment trusts and make additional investments through asset class wholesale trusts as they consider appropriate.

  These comments have been represented diagrammatically in Attachment 2.1.

- **Property Trusts**

  Property is one of the key asset sectors. The illiquid nature of investments in large office buildings and shopping centres that provide attractive property returns and the need to provide investment flexibility has lead to the emergence of multi-level property trust structures rather than direct property investments.

Each major property may be held through a separate property specific holding trust. In the event there is to be a reweighting away from property it is far easier to sell units in a trust than sell a portion of each property owned. It is common for large properties to be jointly owned by two or more unrelated wholesale investment trusts / wholesale investors to allow diversification across different properties. Such joint ownership can be achieved through unit holdings in property specific holding trusts.

Investment flexibility is maximised where the property class wholesale trust invests through sectoral property trusts such as commercial and retail sector trusts which themselves hold the units in the property specific holding trusts. Wholesale investors then have the option of investing in a balanced property portfolio, sectoral property trusts or property specific trusts.

These comments have been represented diagrammatically in Attachment 2.2.

Compliance Costs

The PFC raised, at paragraph 16.12, concerns in respect of continued compliance costs flowing from the need for CIVs to separately account for different classes of income under a flow through taxation regime. This aspect is broadly controllable and will not cause significant compliance issues. We provide the following comments in support of this:

- Most CIVs are sophisticated organisations with detailed accounting and tax systems. CIVs currently have detailed compliance systems in place to cope with the current tax system. Accordingly, the continued requirement to break up income into particular classes for tax purposes will not be a significant issue for CIVs.

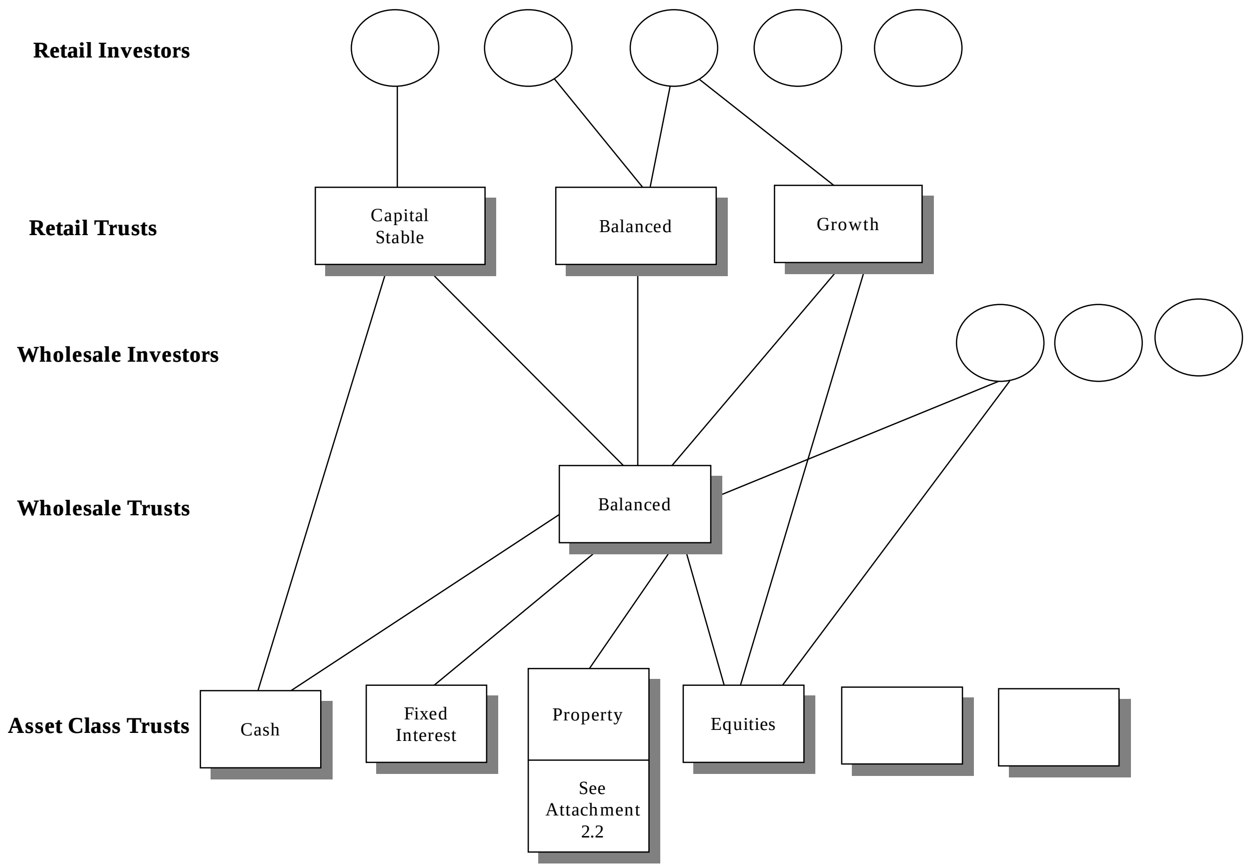
  The adoption of flow through taxation would therefore be of minimal concern for CIVs from a compliance and systems perspective (especially in comparison to the possible detriment in not adopting this approach).

- It is conceded that there is some anecdotal evidence that small investors who hold units in widely held investment trusts are not fully complying with their tax compliance obligations. These compliance issues are largely attributable to the tax complexities involved, especially in relation to the tax treatment of foreign income, foreign tax credits, capital gains, dividends and imputation credits.

  The income class distribution statements produced by investment trusts facilitate a significant reduction in the compliance issues faced by small investors who invest through investment trusts compared with the issues they would face from direct investment. In most cases small investors simply need to transfer the information contained on their distribution statement to their tax return. Direct investors do not have this luxury.

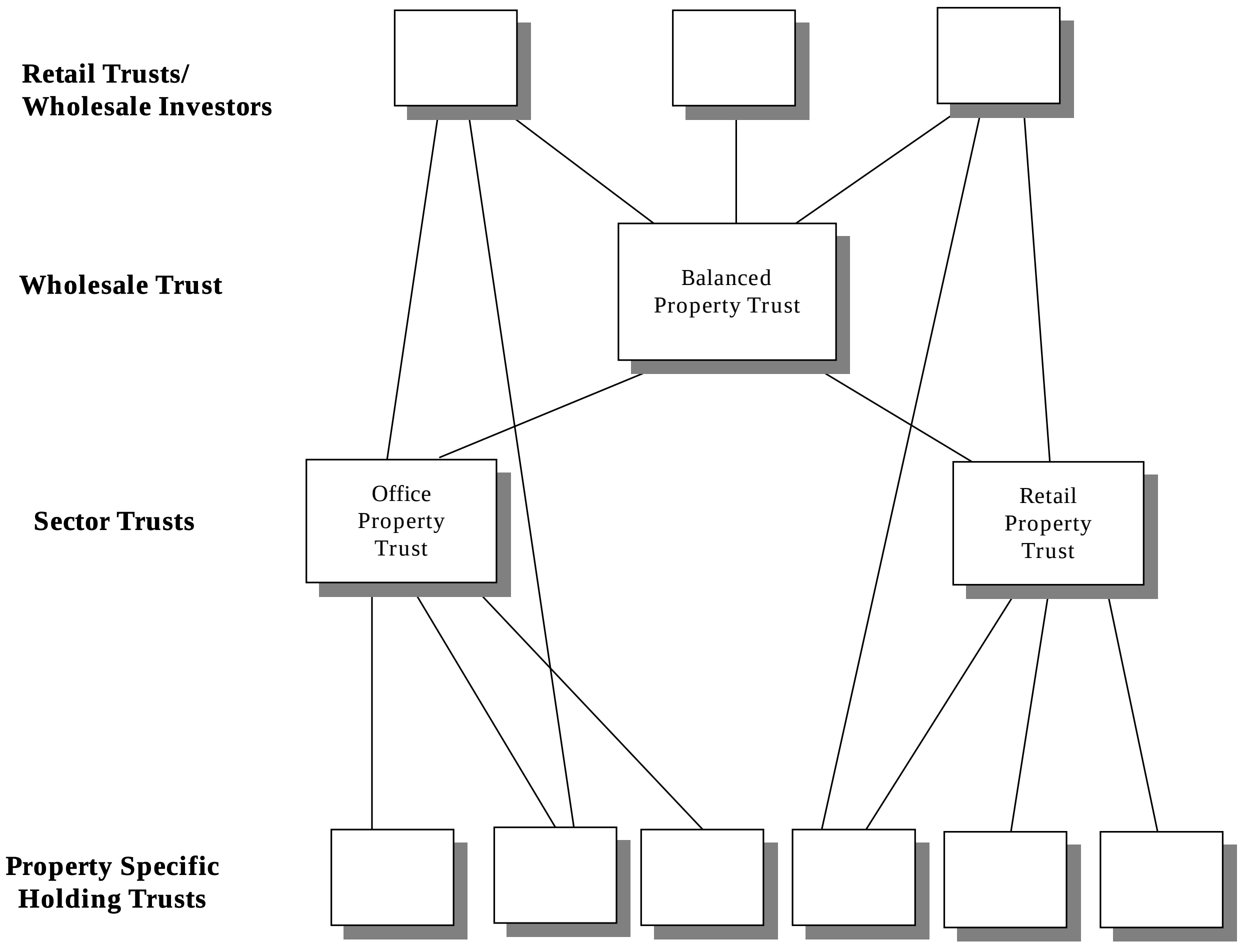
Attachment 2.1

Investment Trust Structures



Attachment 2.2

Property Trust Structure



Chapter 3 - Definition of Widely Held CIV

Summary

Given the investment structures discussed in Chapter 2 the definition of widely held CIV will need to adopt an ultimate ownership principle. If direct ownership was used to determine a CIV's status many sub-trusts could be treated as closely held.

A number of approaches to implementing widely held entity definitions incorporating the ultimate ownership principle are used in the tax law including the public unit trust rules discussed in PFC. The key issue is to implement a definition of "widely held" for CIV purposes that can be applied in practice with certainty.

Recommendation

The definition of widely held CIV should adopt the ultimate ownership principle. The adoption of the ultimate ownership principle should be implemented through a "scheduler" approach to the definition of widely held CIV that takes into account the economic substance of a CIV's owners.

Where the definition of widely held CIV is based on the public unit trust definition the "20% superannuation fund / tax exempt ownership" rule should be used and expanded to take into account the economic substance of CIV owners in determining widely held status.

Ultimate Ownership Principle

Our comments concerning the appropriateness of adopting an ultimate ownership principle in respect of the definition of widely held CIV flow from the application of the Investment Neutrality cornerstone and the legal structures adopted by CIVs in the context of investment trusts. Our comments are as follows:

Investment Trust Structures

As discussed in Chapter 2 sophisticated investment trust structures have been developed to maximise the benefits of pooled investment and to allow investment flexibility. By their nature many of the trusts that form part of investment trust structures are relatively closely held when looked at from a direct ownership perspective.

To give effect to the CIV flow through taxation proposals all trusts in an investment trust structure must be eligible for flow through taxation treatment. If this was not the case significant adverse taxation implications would arise. We have provided comments on implications that would arise where the ultimate ownership principle was not adopted at the end of the chapter.

Investment Neutrality

A cornerstone of the RBT and the PFC is the Investment Neutrality principle. This provides the same tax treatment should be applied to transactions with the same economic substance irrespective of the legal form of the transaction or the vehicle through which the transaction is undertaken.

The Federal Treasurer has approved flow through taxation for widely held CIVs. To ensure the investment neutrality cornerstone is not jeopardised, best practice approaches to investment trust structures issues must be taken into account in defining widely held CIV. This will ensure that the sophisticated structures discussed in Chapter 2 that have evolved for valid commercial reasons do not cause sub-trusts trusts to fall outside the definition of widely held CIV.

Where flow through taxation status is not available to the sub-trusts discussed above, there will be significant amounts of additional underlying tax paid by CIV groups which would destroy the effectiveness of the CIV flow through taxation proposals. This would occur where distributions from sub-trust to sub-trust and from sub-trust to parent trust were subject to tax pursuant to Entity Taxation.

As discussed above, the investment trust structures have developed to allow investors flexibility and liquidity benefits so as to maximise the benefits of pooled investment. To subject sub-trusts to entity taxation merely because a particular legal structure was used in the context of maximising the benefits of pooled investment would be inappropriate.

For completeness, we have summarised in Attachment 3.1 examples of CIV sub-trusts that may not be regarded as widely held based on a direct ownership test but that should be eligible for widely held CIV flow through taxation.

Distinguishing Listed Companies

The Federal Treasurer has announced in principle support for flow through taxation for CIVs including widely held trusts such as bond trusts, common funds, managed funds and property trusts. PFC also discusses allowing flow through taxation status for some companies that are focused on equity investments.

It is clear from the announcements to date that CIV flow through taxation will not be available to listed companies that carry on active business as opposed to portfolio investment activities. On this basis the definition of CIV needs to appropriately distinguish between CIVs entitled to flow through taxation and entities carrying on active businesses.

In principle it is not difficult to distinguish between CIVs that are involved in portfolio investment and entity taxed entities that carry on active business. Even so it is important to ensure that the definition of CIV implements the portfolio investment vs active business distinction so as to provide certainty with a minimum of compliance costs. Approaches to the implementation of investment vs active business distinction are discussed further in Attachment 4.1.

Implementing the Ultimate Ownership Principle

Careful consideration needs to be given to the implementation of the ultimate ownership principle in the context of the widely held CIV definition. Broadly, there are two approaches that could be adopted:

- require CIVs to trace ultimate ownership in accordance with prescribed tracing rules; or
- adopt an in-substance approach that allows a CIV's status to be determined by reference to the economic substance of its direct owners.

While a full tracing approach may be preferred from a pure design perspective, in practice the in-substance approach has clear advantages as it would involve minimal compliance costs and provide certainty. We have the following comments on in-substance approaches:

- public unit trust based approach;
- scheduler approach.

Public Unit Trust Based Approach

Broadly the public unit trust definition (contained in Section 102P of the Income Tax Assessment Act 1936 (the ITAA)) contains the following two tests:

- public ownership subject to a 20 person 75% test;
- 20% ownership by superannuation funds and tax exempt entities deeming rule.

PFC proposes the existing public unit trust rules as one basis for the implementation of the widely held CIV definition. We agree that with appropriate amendment the existing public unit trust rules could be used to implement the ultimate ownership principle in the definition of widely held CIV.

Public Ownership 20 Person 75% Test

To ensure the ultimate ownership principle was taken into the definition of widely held CIV the public ownership 20 person 75% test would need to be applied on an ultimate beneficial ownership basis. Where the number of ultimate beneficial holders of a CIV exceed 50, the CIV should be considered widely held provided 20 or less ultimate owners do not own 75% or more of the beneficial interest in the CIV.

20% Superannuation Fund/Tax Exempt Ownership Rule

To ensure the widely held CIV definition can be applied in practice without unnecessary compliance costs alternative positive tests should apply to confer widely held CIV status.

For the purpose of defining widely held CIVs the extended definition of public unit trust contained in Subsection 102P(2) could be expanded. Currently Section 102P(2) provides an investment trust is a public unit trust where exempt entities or superannuation funds hold a beneficial interest that entitles the exempt entities or superannuation funds to not less than 20% of the income or the property of the investment trust.

To provide a positive economic substance test in the context of the widely held CIV definition, the operation of Section 102P(2) would be expanded to also apply to ownership by widely held CIVs. Entities owned not less than 20% by other widely held CIVs, large superannuation funds and/or tax exempt entities (including State Governments) would be deemed to be widely held. This would ensure that sub-trusts of widely held CIVs are eligible for flow through taxation status.

A practical advantage in applying an adjusted version of the public unit trust rules to define widely held CIV is that many investment trusts are already familiar with the definition.

Scheduler Approach

An alternative approach to implementing the ultimate ownership principle in a practical way would be to adopt a scheduler approach.

The scheduler approach uses a economic substance test in implementing the ultimate ownership principle. As a result most CIVs would not need to actually trace beneficial ownership to determine the ultimate owners. To the extent that large superannuation funds, State Government or other widely held trust/CIVs directly hold at least 75% of the ownership of an entity, the entity would be deemed to be widely held.

The scheduler approach is the most recently developed approach to defining widely held that has been used in the tax law. For example, proposed Section 160APHD (currently in Bill form in Taxation Amendment Bill No 4 of 1998) defines a trust to be widely held where:

> *"at least 75% of the units are held by a person who is, or persons each of whom is, a person referred to in any of paragraphs 160APHR (1) (a) – (j) or a prescribed person in relation to the trust."*

Section 160APHD(1)(a)-(j) and the definition of prescribed persons effectively represent a schedule of direct owners who are considered to be widely held from an economic perspective. Provided at least 75% of an entity's direct owners are covered by the schedule the entity satisfies the widely held test.

Direct owners included on the Section 160APHD schedule include:

- large superannuation funds;
- listed and unlisted retail trusts;
- wholesale investment trusts;
- tax exempt entities including State Governments.

If the scheduler approach was adopted then direct owners that are themselves widely held CIVs would be added to the Section 160APHD schedule.

Investment Trust Structures

Regardless of how the definition of widely held CIV is implemented, it will be important to ensure that the issues discussed above concerning investment trust structures are taken into account. It is imperative for the operation of the "flow through of widely held status" approach that the sub-trusts established to allow investment flexibility and to maximise returns be treated as widely held. Any distributions made from sub-trust to sub-trust or sub-trust to parent trust would then be subject to the flow through taxation regime.

Rejection of Ultimate Ownership Principle

If the ultimate ownership principle is rejected as the basis of defining widely held CIVs in favour of a direct ownership approach, significant adverse results will arise. The adverse implications that would include:

- Without some special rule, distributions by sub-trusts would be subject to Entity Taxation and not flow through taxation. Accordingly, when the parent trust makes a distribution to the ultimate beneficiaries, any portion of that distribution that is sourced from the investment activities of a lower tier trust will have been subject to entity taxation. This means that the distribution by the widely held CIV would have a significant "built in" underlying tax component such that the flow through taxation objective would not be achieved. This will be the case notwithstanding the status of the parent trust as a widely held CIV.

- To the extent that entity taxation was imposed at either the parent CIV or sub-trust level, this would result in a significant cost to State Governments and other tax-exempt entities. The cost of such a result to the State of Queensland has been discussed in Chapter 8.

- In the absence of the implementation of the ultimate ownership principle, pooled investment by exempt entities and non-residents will no longer be viable. The liquidity of investment funds would mean that most (if not all) exempt entities and non-residents and possibly a significant proportion of other investors would cease to invest through CIVs in favour of direct investment. Withdrawal of exempt entities and non-residents from pooled investment vehicles would reduce the size of investment pools and cause a reduction in the pooled investment benefits available to investors who continued to invest through CIVs.

  The absence of CIVs as a viable pooled investment vehicle would drive the development of pooled investment structures based on Joint Venture and partnership models that are not subject to entity taxation. Forcing the use of such alternative structures is likely to result in additional complexity.

Attachment 3.1

Sub-trust Examples

The purpose of this Attachment is to discuss common situations where sub-trusts that may not be treated as widely held based on a direct ownership test are clearly widely held from an economic viewpoint such that flow through taxation should be available.

Wholesale Trusts

The nature of wholesale trusts means that they will often have a limited number of direct owners such that they may not be considered widely held where a direct ownership test was applied. It is quite common for a small number of large wholesale investors such as related retail trusts or large superannuation funds to control a wholesale investment trust.

Even where a wholesale investment trust has relatively few members this should not prevent widely held CIV flow through taxation status from being available where its owners are themselves widely held.

Wholly Owned Sub-Trusts

There are circumstances where widely held CIVs may choose to hold assets through wholly owned sub-trusts, such as where limited liability is desired, where it would be appropriate to adopt a consolidation tax approach. A consolidated tax system would allow the transactions of wholly owned sub-trusts to be effectively treated as part of the widely held holding CIV. As a result flow through taxation of the transactions of the wholly owned sub-trust would be achieved.

However, there are also a range of circumstances where consolidation of wholly owned sub-trusts of widely held CIVs would not be appropriate. Consider for example the wholesale investment trust structures discussed in Chapter 2 that involve a balanced wholesale investment trust investing through asset class investment trusts.

While the asset class investment trusts exist to provide wholesale investors with investment flexibility there is commonly a period during which one or more of the asset class investment trusts are wholly owned by the balanced wholesale investment trust. It would be inappropriate to consolidate an asset class trust with the balanced trust where it is intended that the asset class trust will issue units to wholesale investors and thus cease to be wholly owned which would trigger the requirement to deconsolidate the asset class trust.

Given the likelihood that widely held CIVs will not wish to adopt a consolidated tax position in respect to many wholly owned sub-trusts it will be necessary to ensure that wholly owned sub-trusts of widely held CIVs are treated as widely held CIVs eligible to adopt flow through taxation.

Majority Owned Sub-Trust

Flowing from the investment flexibility structures discussed in Chapter 2, circumstances where a sub-trust is majority owned by a widely held CIV will be common if not the norm. This position will commonly arise for example in respect to a balanced wholesale investment trust's investment in asset class wholesale trusts. The level of ownership of the controlling direct owner will vary depending upon the extent to which investors have taken advantage of the investment flexibility offered. Widely held CIV flow through taxation status should be available to majority owned trusts that are beneficially widely held.

Jointly Owned Trusts

It is common for property specific holding trusts that own major office buildings or retail shopping centres to be owned jointly by two or more wholesale investment trusts. This joint ownership approach allows diversification of the risks involved with full ownership of particular property assets.

Commercial implications dictate that such jointly owned trusts are often 50% owned and controlled by each wholesale investment trust with neither owner wishing to give up control to the other. Similar control issues arise for very large property projects that may be equally owned by three or four wholesale investors.

While such jointly owned trusts may not be considered widely held on a direct ownership basis they are clearly widely held on any reasonable economic analysis and flow through taxation should be available.

Chapter 4 - Tax Free Flow Through of Tax-preferred Income

Summary

An overriding concept of the taxation of CIVs internationally is the maintenance of Investment Neutrality. It is recognised that investment funds are liquid and flow freely between direct investment and pooled investment vehicles. On this basis CIVs are generally taxed on an equivalent basis to direct investment. Taxing tax-preferred distributions would give rise to the situation where individuals investing through a CIV are placed at a disadvantage in comparison to an individual making the same investment in their own right.

The competitive neutrality, revenue cost and retention of tax-preferred income issues discussed in PFC do not justify the taxation of the tax-preferred distributions of CIVs.

Recommendations

The full direct investment equivalence principle should be adopted. The tax-preferred income distributions of CIVs should not be taxed to ensure the tax position of a CIV's owners is the same as if they had invested directly.

If tax-preferred income distributions of CIVs are to be taxed then they should be taxed on a deferred basis through cost base reductions, as is currently the case, and not under the entity taxation regime.

The portfolio investment vs active business boundary line for restricting the activities of CIVs should be implemented having regard to the limitations of the existing Division 6C rules.

The International Experience

The RBT's own international perspectives benchmarking report indicates that a full direct investment equivalence approach is almost uniformly adopted for the taxation of CIVs. As a result most of the major countries allow for the flow through of tax-preferred income to the members. Taxation of the tax-preferred distributions of CIVs would produce an inequitable situation in breach of the investment neutrality principle where an individual can invest in their own personal capacity and derive untaxed tax-preferred income whereas the same individual investing through a CIV with a pool of other investors with a view to earning superior returns cannot take advantage of the same benefit.

The following extracts from the International Perspectives (IP) paper are offered in support of the adoption of direct investment equivalence as the benchmark for the taxation of CIVs:

> *"The overall outcome in several countries is that investors obtain the same taxation outcome from investing through a pooled investment fund as they would if they invested directly in the underlying assets of the fund."* (Paragraph 3.55)
>
> *"an investment by an investor through a pooled investment fund is treated the same as if an investment were made directly by an investor"*. (Paragraph 3.61)

The international tax systems in place for the taxation of pooled investment funds vary from country to country. However, the overriding theory behind the majority of systems is the full direct investment equivalence principle. This has been achieved using a variety of methods. The International Perspectives paper identified the following systems of taxation of investment vehicles:

- Where funds are disregarded for tax purposes. Tax effects occur at the level of the investor and the fund is merely a conduit by which the individual derives the income. This treatment applies in Australia (currently), Canada (Mutual Fund Trusts), Germany, Japan and the Netherlands;

- The fund is recognised for tax purposes and is potentially subject to tax but it is in fact exempt from tax or taxed at a low rate, usually because it fulfils certain tax criteria specifically designed for pooled investment funds (for example, in France, Ireland, Singapore and the United States);

- The fund is recognised for tax purposes and is subject to tax at normal rates, but usually the tax is nil or close to nil because of the way its taxable income is defined (usually featuring a deduction for distributions). Examples include Authorised Unit Trusts in the United Kingdom and Open-Ended Investment Companies in the United States;

- The fund is recognised for tax purposes and is subject to tax, but at concessional rates (eg Canada – Mutual Fund Corporations); and

- The fund is recognised for tax purposes and subject to tax at normal rates on a normal tax base, with full integration of the tax on the fund and tax on the investor in the fund (for example, by way of exemption of distributions or full imputation). Countries include, Chile – Mutual Funds, New Zealand, United Kingdom – Approved Investment Trust Companies.

Four of the five approaches to CIV taxation identified in the IP Report produce a result that is equivalent with or more favourable than full direct investment equivalence. This supports the appropriateness of allowing full flow through taxation for CIVs.

Issues for Consultation

PFC raises the following issues for consultation in respect of not taxing the tax-preferred income of CIVs:

- competitive neutrality would require investment criteria;

- revenue cost

- retentions of tax-preferred income.

We have outlined our comments on these aspects below.

Competitive Neutrality Would Require Investment Criteria

A concern raised in PFC concerning full flow through taxation for the tax-preferred income of CIVs is the practical difficulty that exists in drawing boundary lines between portfolio investments of CIVs and active business activities that fall outside normal portfolio investment activities. PFC appears to conclude that the “drawing boundary lines” issue does not arise where the tax-preferred income of CIVs is taxed.

Our comments on comparison of taxing vs not taxing the tax-preferred income of CIVs based on the “drawing boundary lines” issue are as follows:

- it is accepted that where tax-preferred income is not taxed the activities of CIVs would need to be limited to portfolio investments;

- even where tax-preferred income is taxed it is still necessary to ensure that the activities of the CIV are limited to portfolio investments. If this was not the case public listed companies carrying on significant businesses may choose to fully distribute their profit so they fall outside the entity taxation proposals and be treated as CIVs.

In conclusion, unless CIV flow through status is to be extended to all widely held entities that fully distribute their profit it will be necessary to draw boundary lines between portfolio investment and active business activities regardless of how the tax-preferred income of CIVs is taxed. On this basis the difficulty in drawing boundary lines is not a valid differentiation point in favour of taxing the tax-preferred income of CIVs.

We have outlined our comments on approaches to drawing boundary lines between portfolio investment and active business activities in Attachment 4.1.

Revenue Cost

PFC also notes that allowing CIVs flow through taxation in respect of tax-preferred income could give rise to a more favourable position than currently applies which would involve a cost to the Federal Revenues. The cost would arise where the existing tax provisions ensuring that tax-preferred distributions of unit trusts are ultimately taxed via a reduction in the owner’s cost base are to be abolished. We understand that this abolition is part of the process of implementing a more simplified tax system.

To the extent that the internationally competitive approach of allowing flow through of tax-preferred income is seen to be too detrimental to the Federal revenue, it is submitted that the following methods could be adopted to ensure that the revenue position is maintained (while maintaining simplicity):

- The existing system of cost base reduction could be retained. To the extent that the proposed abolition of CGT indexation proceeds then this would simplify cost base reduction calculations significantly.

- The application of the cost base reduction provisions in the context of widely held CIVs could be further simplified to ensure that any CGT liability will only arise upon the sale of the investment. This would avoid the need for constant tracking of the cost base of the units. A once off CGT calculation could be performed when the units are actually sold.

Retention of tax-preferred Income

The historical performance of the QIC Group investment trust indicates that the major source of tax-preferred income of widely held investment trusts is attributable to unrealised gains. Unrealised gains are treated as income under the Generally Accepted Accounting Principles applicable to investment trusts. However, for tax purposes most unrealised gains do not form part of taxable income until they are realised. The sources of the tax-preferred income of the QIC Group's largest trust are illustrated by the following table.

	1993 $'000	1994 $'000	1995 $'000	1996 $'000	1997 $'000	1998 $'000	Total $'000
Tax-preferred Income							
Building Allowance	10,893	11,795	12,895	14,526	19,829	18,535	88,473
Depreciation	21,596	20,474	16,821	28,028	30,016	37,116	154,051
Deductible Capital Expenditure	1,424	5,059	3,433	1,354	1,133	1,165	13,568
Indexation	4,673	36,258	10,641	19,052	24,380	6,895	101,899
Other Differences	53,145	(8,467)	8,724	1,384	19,066	(18,659)	55,193
Sub-Total	91,731	65,119	52,514	64,344	94,424	45,052	413,184
Asset Revaluation	183,061	96,099	467,853	321,716	1,080,658	179,998	2,329,385
Total	274,792	161,218	520,367	386,060	1,175,082	225,050	2,742,569
% Attributable to Asset Revaluation	66.6	59.6	89.9	83.3	92.0	80.0	84.9

It is market practice for many large investment trusts to retain a large proportion of their tax-preferred income, particularly to the extent the tax-preferred income relates to unrealised gains. As a result, unitholders in widely held investment trusts often realise taxable gains on the sale of their units prior to the trust realising its unrealised gain. Once the trust does subsequently realise the gain the taxable income derived is generally distributed to the investors who own units at that time. The unitholders who are taxed on the distribution of the CIVs' realised gains are often different to the unitholders who benefited when the trust made the unrealised gain.

Similar issues are discussed briefly in Chapter 28 of PFC in the context of the duplication of realised and unrealised gains. Chapter 28 concludes that no double taxation occurs in the case of portfolio interests as a capital loss or capital gain shelter will be available when the owner who was taxed on the distribution of the realised gain ultimately disposes of their interest. With respect, this conclusion is not sustainable in the context of widely held investment trusts having regard to the time value of money and the very long time frames that can be involved for the double taxation effect to be reversed.

PFC includes quite extensive discussion on mechanisms to prevent double utilisation of losses but does not propose any mechanism to prevent the long-term effect of the double taxation of gains discussed above. While the double utilisation of losses in the context of CIVs is not considered a significant issue it is accepted that the double utilisation of losses is inappropriate. The key issue for CIVs is the double taxation of gains.

It may be that the double taxation of gains issues discussed above cannot be eliminated without the introduction of significant complexity. The approach sanctioned by many widely held trust deeds of allowing a provision for the tax ultimately payable on unrealised gains when calculating unit prices could be the best position that can be achieved. However, it is important that any proposals introduced by RBT to prevent the double utilisation of losses also prevent the double taxation of realised and unrealised gains.

Like tax-preferred income attributable to unrealised gains the majority of other classes of tax-preferred income that arise to investment trusts represent mere timing differences. In fact all the tax-preferred income of investment trusts other than CGT indexation allowance and building allowance on buildings acquired before May 1997 relate to timing differences. The issues discussed above in respect to unrealised gains tax-preferred income apply equally to other tax-preferred income attributable to timing differences.

PFC points out that where tax-preferred distributions of CIVs were not taxed then retained tax-preferred income would still effectively be taxed where an owner disposed of their interest in the CIV. While it is accepted this is a correct conclusion we reject the implication drawn in PFC that this supports the proposal to tax distributions of tax-preferred income. In fact the taxation of distributions of tax-preferred income would not correct the potential for very long-term adverse timing issues discussed above and would significantly exacerbate the overall double taxation problems caused when the timing differences reverse and became part of normal taxable income. The significant double taxation issues that arise in respect to timing differences are acknowledged in Chapter 15 of PFC.

Attachment 4.1

Portfolio Investment vs Active Business Boundary Lines

The flow through taxation approach that is to apply to CIVs requires a distinction between portfolio investment and active businesses to allow classification of entities eligible for CIV status and to ensure CIVs do not gain competitive neutrality advantages over entity taxed entities.

The purpose of this attachment is to discuss practical and other issues associated with drawing boundary lines between portfolio investment and active business for the purposes of the CIV flow through taxation approach.

Application of Division 6C

The tax law already includes rules that are applicable to widely held investment trusts that distinguish between portfolio investment and active business. These rules are contained in Division 6C.

Division 6C applies the concept of an "eligible investment business" to distinguish portfolio investment from active business. Portfolio investment activities for Division 6C purposes cover:

> "*investing in land for the purpose, or primarily for the purpose, of deriving rent, or investing or trading in any or all of the following*:
>
> – *Secured or unsecured loans;*
>
> – *Bonds, debentures, stock or other securities;*
>
> – *Shares in a company;*
>
> – *Units in a unit trust;*
>
> – *Futures, interest rate swap, currency swap and forward contracts;*
>
> – *Forward interest rate swap contracts;*
>
> – *Etc…*"

The existing Division 6C criteria could be used as a starting point for the development of the portfolio investment vs active business distinction. Our comments are as follows:

- The Division 6C eligible investment business rules were specifically introduced to ensure trusts carrying on active businesses did not obtain tax advantages over companies. This is a similar objective to the distinction required for CIV flow through taxation proposals. On this basis a similar test could be used.

- The investment trusts that are likely to make up a large portion of CIVs have needed to comply with Division 6C since the late 1980s. Many large investment trusts have extensive systems in place to ensure they do not breach Division 6C. As a result, a test based on Division 6C could be implemented with minimal restructuring of existing investment portfolios.

Refinement of Division 6C Tests

Our comments on aspects of Division 6C that should be modified are as follows:

- As Division 6C currently applies, it is possible for a small amount of active business income to cause all of the activities of the entity to be treated adversely for tax purposes. This aspect of Division 6C should be adjusted if Division 6C is used as a basis for the CIV flow through taxation eligibility rule. Where the majority of an entity's income is derived from portfolio investment then flow through taxation should be available for all portfolio investment income. It is only any active business income that needs to be subject to entity taxation.

- In practice a concept has developed that allows incidental amounts of active business income to be derived without triggering Division 6C. However, the ATO often takes an extremely narrow view of what amounts to incidental income.

  It would be appropriate to introduce an objectively calculated active business income de minimus rule. For example, provided the active business income of a CIV does not exceed 5% of its total income then the active business income should be ignored for the purposes of determining eligibility of the CIV's income for flow through taxation treatment. Where active business income exceeded 5% the active business income could be subjected to entity taxation.

- A number of real estate based investments such as direct investment in hotel and rural property are treated as active businesses rather than portfolio investments for Division 6C purposes. This is because the operation of a hotel or a rural property are considered active business activities.

  As a result Division 6C currently prevents widely held investment trusts from investing in the hotel or rural property sectors. Given widely held unit trusts are a major provider of investment funds the current rules restrict the investment capital available to the hotel and rural property sectors. The rules implemented to define the portfolio investment vs active business borderline should allow investment in the hotel and rural property sectors.

- Division 6C prevents an investment trust from owning controlling interests in entities that carry on active businesses. This rule reduces the ability of investment trusts to provide seed capital to start up businesses that involve controlling interests or to take controlling positions in entities where this is otherwise appropriate.

  It is acknowledged the activities of CIVs must be controlled to ensure they are not able to achieve unfair advantages over entities subject to the entity taxation proposals. This objective would not be breached by allowing CIVs to make controlling investments in entity taxed entities. The entity-taxed entity would be subject to 36% income tax and deferred company tax on its distributions of tax-preferred income. CIVs that took a controlling interest in an entity taxed entity would not achieve any tax advantage compared to other shareholders of entity taxed entities.

  On this basis the rules implemented to define portfolio investments of CIVs should allow majority interests in entities subject to the entity tax system.

- We understand the ATO considers that some abuse of the Division 6C rules has arisen through activity splitting structures. A common example of this practice is a staple security structure where shares in a hotel operating company are stapled to units in a property trust. The hotel operating company operates a hotel business and pays rent to the property trust.

  The incentives for widely held investment trusts to utilise split activity structures would be substantially diminished if investment trusts were allowed to take controlling investments in entity taxed entities.

Chapter 5 - Full Distribution of Profits

Summary

One of the criteria set in the PFC concerning the availability of flow through taxation to widely held CIVs is the full distribution of profits by the CIV. The purpose of this Chapter is to discuss this full distribution of profit requirement.

A key aspect on which PFC requests consultation input is the appropriate tax treatment of the tax-preferred income of CIVs.

We have concluded that regardless of the approach adopted to the taxation of the tax-preferred distributions of CIVs the full distribution requirement should be limited to the taxable income of CIVs.

We have also provided comments on the implementation of the CIV full profit distribution requirement in practice.

Recommendation

The full distribution of profit requirement should be limited to taxable income. Distribution of tax-preferred income should be at the option of the CIV.

Practical issues in respect to investment trust distributions should be considered in the implementation of the profit distribution requirement.

Full Flow Through Taxation

As discussed in Chapter 4 we have concluded that a full flow through taxation system should be implemented for CIVs to allow tax-preferred income to be distributed without being taxable in the hands of members.

Where a full flow through tax system is adopted for CIVs then the profit distribution requirement should be limited to the CIVs' taxable income. This approach has the following advantages:

- The majority of CIVs are trusts. The existing trust tax rules encourage trusts to make sure their beneficiaries are presently entitled to each year's taxable income. In practice widely held investment trusts also pay out in cash each beneficiary's share of the trust's taxable income. Adopting a distribution of taxable income requirement as part of the CIV regime would be consistent with the current system.

- CIVs are investment vehicles. The variation on the investment profiles and strategies of investors make it important to provide flexibility in the development of investment products to ensure that investments with a range of commercial attributes are available to suit the needs of particular investors. Investors living from the cash flow produced by their investments may wish to receive distributions of tax-preferred income in addition to taxable income and will choose a CIV that adopts such a distribution policy. However, investors who are accumulating capital and building their savings may prefer a CIV that retains and reinvests tax-preferred income. Allowing CIVs to retain tax-preferred income would provide flexibility and allow the development of a range of investment products.

Taxing Tax-preferred Income

Where it is decided that the tax-preferred income of CIVs should be taxed, the profit distribution requirement should still focus on normal taxable income excluding tax-preferred income. A requirement for the distribution of tax-preferred income (as well as taxable income) combined with the taxing of tax-preferred income is not appropriate. Our comments on this issue are as follows:

- To require a full distribution of tax-preferred amounts would create cash flow issues for CIV investors. CIVs would be subject to entity tax on the amount of their tax preferred income distributions resulting in the need to implement special systems to ensure investors are entitled to refunds of excess franking credits on a timely basis. Given that one of the foreseen advantages of the flow through system is reduced cash flow problems, it would seem inconsistent to impose a requirement that adds additional complications from a cash flow perspective.

- A system that requires CIVs to distribute tax-preferred income would impose more onerous requirements then that proposed for entities under the Entity Taxation regime. Under the Entity Taxation regime DCT/RDWT is only imposed upon distributions of tax-preferred income. There is no proposal to require widely held entity-taxed entities to distribute the tax-preferred income they earn each year. The imposition of a CIV system that requires full distribution of tax-preferred income would be inequitable in comparison with Entity Taxation.

- Given the wide definition of tax-preferred income adopted in PFC, requiring CIVs to distribute both their taxable income and tax-preferred amounts could leave investors in the same position as would be the case if a comprehensive income tax base was adopted in an undiluted manner. PFC itself concludes that a comprehensive income tax base cannot be implemented in practice. It would therefore be inappropriate to impose such a requirement on investors in widely held CIVs.

- Accounting principles applicable to various CIVs should not be applied to ascertain the amount required to satisfy the full distribution of profits. Different types of CIVs may apply different accounting approaches to the recognition of unrealised gains. Inequitable results would arise to the extent that the full distribution of profits rules took into account profit where the profit recognition method used varied between CIVs. The use of taxable income would produce more consistent distributions.

Implementing Full Profit Distribution

The requirement for CIVs to fully distribute their profit is similar to the existing requirements of investment trusts to make their beneficiaries presently entitled to each year's taxable income. There are a number of practical issues applicable to the current tax rules that apply to trusts that should be considered in the context of the implementation of the full profit distribution requirement.

We have provided our comments on some of the relevant issues in Attachment 5.1.

Attachment 5.1

Timing of Taxation of Trust Distributions

The current tax rules concerning the timing of the taxation of distributions from investment trusts, cause administrative problems for the managers of investment trusts when they are determining their taxable income, the taxable amount of their trust distributions and ultimately the tax implications for their beneficiaries. This is particularly the case where an investment trust makes a cash distribution that is equal to or based on its taxable income.

Where an investment trust invests in another trust, the investment trust must technically wait for the other trust to finalise their taxable income calculation before the investment trust can determine their share of the taxable distribution. This causes delays in the calculation of the taxable income and taxable distributions of investment trusts that are becoming unacceptable to investors.

Similar issues could arise where CIVs are required to fully distribute their taxable income as one of the conditions to being eligible for flow through taxation. The implementation of the full profit distribution requirement should take the current practice into account and allow CIVs to distribute the estimated amount of their taxable income.

Present Entitlement - Trust Income different to Taxable Income

Two issues arise in respect to the current present entitlement rules that achieve flow through taxation treatment of trusts. These issues should be taken into account in implementing the CIV flow through taxation system to ensure similar problems do not arise.

- **Timing of Assessability**

  Some small investors incorrectly return taxable trust distributions in the year they receive the cash and their distribution statement rather than the year they are presently entitled to the income. Much of the confusion arises because investors are normally taxable on a cash basis and they assume this approach also applies to trust distributions.

  In the context of the implementation of the CIV flow through taxation approach simplicity would be achieved by allowing small investors to return taxable CIV distributions on a cash basis.

- **Different Cash and Tax Distributions**

  While the general trust tax rules have been in place for many years, there is still uncertainty on how these rules operate, particularly concerning the concept of present entitlement to the trust income and the taxable income of a trust. These uncertainties were recently discussed in the Federal Court case of *Richardson v The Federal Commissioner of Taxation*. In *Richardson's* case, the Court considered that the words of Section 97 are unclear and ambiguous where the taxable income of the trust differs from the trust income.

  The problems with the existing trust rules should be taken into account in the implementation of the CIV flow through taxation approach.

Chapter 6 - Taxation of Tax-preferred Income Where Flow Through Taxation Denied

Summary

Where it is decided that distributions of tax-preferred income by CIVs will be taxed it is intended an approach similar to distributions by entity taxed entities would be adopted. The Platform for Consultation (PFC) proposes three alternative approaches to the implementing of the entity taxation system.

Our review indicates that the "Taxation of Unfranked Inter-entity Distributions" approach to the implementation of entity taxation would be the most appropriate in the context of CIVs. We have discussed this conclusion and the issues that arise under each of the alternatives to implementing the entity taxation system below.

Recommendation

Where the tax-preferred distributions of CIVs are to be taxed under the entity taxation system then the taxation of unfranked inter-entity distribution approach should be adopted.

Taxation of Tax-preferred Income

Where distributions of tax-preferred income of CIVs are to be taxed under the entity taxation proposals it is appropriate to consider which of the entity taxation implementation options best fits with the CIV flow through taxation concept. We have outlined our comments on this aspect below along with comments on special considerations that arise where a CIV has significant State Government owners.

Proposal Outlined in the RBT

The PFC discusses three options to implement entity taxation. These three options are as follows:

- tax unfranked inter-entity distributions;
- apply a resident dividend withholding tax; and
- impose a deferred company tax.

Tax Unfranked Inter-Entity Distributions

The taxing unfranked inter-entity distributions approach to implementing entity taxation treats distributions of tax-preferred income as taxable income in the hands of recipients. Tax-preferred income would be taxed on the same basis as the current treatment of unfranked dividends.

Simply treating tax-deferred distributions of CIVs as taxable income in the hands of the recipients fits well with the CIV proposals. A key driver of the adoption of the CIV flow through taxation outlined in PFC is to control the cash flow detriments that would otherwise arise. Applying either the DCT or RDWT systems to CIV distributions of tax-preferred income would give rise to cash flow issues that it is the objective of the CIV flow through taxation approach to avoid.

This approach is also appropriate in the context of the sophisticated CIV structures discussed in Chapter 2. Tax-preferred distributions of lower tier entities would be treated as taxable income of the direct owner entity. Provided the direct CIV owner entity and the other entities in the CIV's structure were entitled to adopt flow through taxation the taxable income received attributable to the tax-preferred distribution would flow through and be taxable in the hands of the ultimate owners.

Treating tax-preferred distributions of CIVs as taxable income to their owners would facilitate investment through CIVs by non-residents and State Governments. This would be critical in the context of the State Government investment funds of the QIC Group where our submissions on the refundability of franking credits to State Governments discussed in Chapter 8 are not accepted.

Even though this approach is the most appropriate of the three options discussed in the PFC report there is clear potential for adverse taxation implications to arise. For example, treating tax-preferred distributions from sub-trusts as taxable income of the owner trust will increase the distribution the owner trust is required to make to its owner. This could restrict the ability of widely held CIVs to retain tax-preferred income.

Resident Dividend Withholding Tax (RDWT)

The RDWT approach to the implementation of entity taxation is to apply a withholding tax on unfranked distributions paid from a resident entity to resident investors, including other resident entities.

Applying the RDWT approach to the taxation of CIV tax-preferred distributions would be suboptimal.

The RDWT approach would cause cash flow issues to arise in respect of the tax-preferred distributions of CIVs. One of the key objectives noted in PFC in respect to the CIV flow through taxation approach would then not be achieved.

While the RDWT approach may allow the position of non-resident investors to be managed this would involve quite a deal more complication than the much simpler approach discussed above of simply treating CIV tax-deferred distributions as taxable income.

Significant adverse tax results would arise for State Government investors.

Deferred Company Tax (DCT

DCT would cause significant adverse tax results for both non-resident and State Government investors.

Chapter 7 - Restructure Rollovers

Summary

Having regard to the liquid nature of investment funds, changes in the tax system applicable to CIVs that operate to the detriment of CIVs compared with direct investment have the potential to cause large scale restructures of CIVs. Without appropriate transitional rules such restructure would give rise to significant income tax and / or CGT liabilities.

Recommendation

As a transitional measure comprehensive tax rollovers should be provided to allow CIVs to vest their assets or restructure as a result of the RBT proposals without triggering unrealised tax liabilities.

Pooled vs Direct Investment

The choice between pooled and direct investment involves a cost benefit analysis. In the context of investment trusts the cost benefit analysis currently involves consideration of:

- the potential benefits of superior returns through pooled investment compared to direct investment; and

- the deferred taxation of tax-preferred income earned through investment trusts vs tax-free status under direct investment.

The large amount of funds currently invested through investment trusts indicates many investors reach a positive conclusion in respect of the current pooled vs direct investment cost benefit analysis.

From 1 July 2000 it is proposed the RBT rules will be applicable to pooled investment through investment trusts. The tax rules applicable to direct investment will remain largely unaltered. As a result, investors will need to review their cost benefit analysis in respect of the pooled vs direct investment.

Where the implementation of the RBT proposals causes investors to reach a negative conclusion in respect to the pooled vs direct investment cost benefit analysis investors will wish to withdraw from pooled investment in favour of direct investment. Whether there will be a large shift from pooled to direct investment will depend on the tax status of each investor and the resolutions of the CIV flow through taxation implementation issues discussed above.

The liquid nature of investment funds means that any shift from pooled investment to direct could be triggered quite quickly.

Transitional Issues

The structures of existing investment trust pooled investment products have been developed and operate under existing law. The normal approach to major changes in tax laws is to restrict the application of the new laws to transactions that take place after introduction. We understand that this is not proposed in respect to the RBT proposals due to the complexity that would be involved.

Where the RBT proposals are to be applied to existing investments of investment trusts alternative transitional issues need to be considered. Key issues include:

- Many large investment trusts have significant balances of unrealised taxable gains. Where investors wish to withdraw from pooled investment, assets will need to be disposed of which will realise taxable gains that would not otherwise be realised.

- The nature of investment trusts means that investors at the time unrealised gains are realised are taxable on the realisation of the gains. As a result many investment trusts would distribute taxable gains realised to remaining investors rather than to investors who withdraw their funds. This aspect of the nature of investment trusts may tend to cause investors to wish to withdraw their funds when they may not otherwise do so.

We recommend that broad transitional rules be introduced to ensure pooled investment vehicles can be reorganised as required without unrealised taxable gains being realised. The transitional rules should allow rollover of both unrealised capital and normal taxable gains and cover the distribution in specie of some or all of the assets of a CIV in the context of reorganisations triggered by the RBT proposals.