ROTHSCHILD AUSTRALIA ASSET MANAGEMENT LIMITED
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Submission

Review of Business Taxation

Collective Investment Vehicles (CIVs)

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8 April, 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir / Madam,

Review of Business Taxation - Collective Investment Vehicles (CIVs)

Executive Summary

Rothschild is one of Australia's leading providers of CIVs. The attached submission makes the following observations arising from A Platform for Consultation:

- We support the principle of intermediate taxation of CIVs, aligned with an individual taxation benchmark. However it is essential for equity and competitive neutrality purposes that measures do not impair the attractiveness of CIVs compared to individual investing directly.

- We welcome the Treasurer's announcement of 22 February 1999 that cash management trusts and in principle other widely held collective investment vehicles would be considered as CIVs qualifying for flow through taxation treatment.

- It is essential that flow through taxation treatment is also provided to wholesale widely held CIVs, adopting the definition precedent of qualifying holders developed in Subdivisions 272-F to I of the Income Tax Assessment Act 1936.

- We strongly oppose any increase in taxation of pooled superannuation trusts. This would be an exceptionally disruptive and destructive measure.

- We support the non-taxation of distributions of tax preferred income from CIVs; but would equally support the present system. We strongly oppose the taxation of tax preferred income on equity grounds.

- We strongly oppose the option of removing cost base indexation for capital gains tax purposes. We support the suggestion that rollover relief be given for mergers of listed and unlisted widely held trusts and superannuation funds.

- We make the general observation that in our experience, CIVs are not a source of significant tax abuse, inequity, or a threat to competitive neutrality. The present taxation of CIVs does not require significant change. Significant change would in fact be damaging to the interests of investors and Australia's ambitions to become a regional financial centre.

We are available to provide further information and / or assistance to the Review as requested. Please feel free to contact me on (02) 9323 2178.

Yours faithfully,

Andrew Baker
Associate Director

8 April, 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir / Madam,

Review of Business Taxation - Collective Investment Vehicles (CIVs)

Rothschild's role in CIVs

Rothschild Australia Asset Management manages over $7 billion in a range of collective investments. Rothschild was established in Australia in 1967 and was one of the first merchant banking groups to offer investment management services to investors in Australia.

We now manage money on behalf of many hundreds of thousands of Australians, particularly including individuals, superannuation fund members and charities.

Rothschild is a leading provider of CIVs, the more notable aspects of which for this purpose include:

- Australia's third largest pooled superannuation trust
- A number of Australia's largest wholesale unit trusts
- A leading provider of retail unit trusts

We believe we are therefore well placed to provide comments on the impact of the proposed changes to the taxation of CIVs.

Principles of CIV taxation

We strongly support the principle of an intermediate category of taxation for collective investments which is **aligned with individual**, rather than entity, taxation.

It is essential for general equity to ensure that there are no taxation drawbacks to a decision to invest via a CIV compared to investing individually. Certain options in the RBT discussed in this submission, such as changes to the taxation of tax preferred income, have this effect.

It needs to be borne in mind that CIVs are primarily selected by **small investors** to purchase investment assets which would be beyond their individual capability. Wealthy investors can typically purchase these assets directly. The effect of taxation measures which disadvantage CIVs compared to individual investment therefore **places small investors at a taxation disadvantage to the wealthy**, something inequitable within a progressive taxation system.

Defining CIVs

In addition to fully distributing non-taxed public unit trusts, we consider CIVs as including public offer complying superannuation funds and pooled superannuation trusts.

However, the former are outside the scope of the RBT and the latter will be discussed separately, so we have confined detailed comments to non-taxed vehicles.

We would support a general principle of defining CIVs as “widely held vehicles undertaking investments delivery a full flow-through of annual profits to participants” (A Platform for Consultation p 372), **plus** public offer complying superannuation funds and pooled superannuation trusts which are taxed at 15%.

We note and welcome the Treasurer’s announcement of 22 February 1999 that cash management trusts and in principle other widely held collective investment vehicles would be considered as CIVs qualifying for flow through taxation treatment.

Widely Held CIVs

As noted by A Platform for Consultation, it will be necessary to define widely held CIVs.

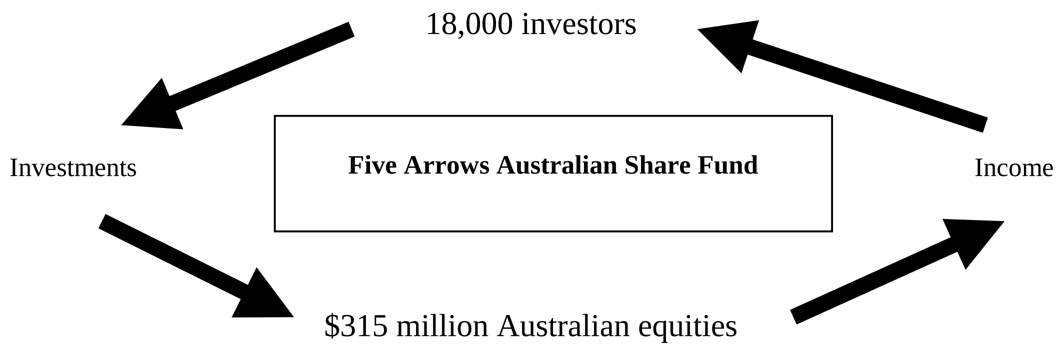
This needs to be done with extreme care, with the adoption of appropriate provisions which permit **wholesale widely held CIVs** such as wholesale unit trusts to qualify for flow through taxation.

We support restricting flow through taxation treatment to widely held CIVs.

One of the proposed tests is that 20 or fewer persons do not hold 75% or more of beneficial interests (eg units) in the CIV (eg unit trust). This is easily passed by retail unit trusts, an example of which is shown in Figure 1.

We have used live Rothschild CIV examples to demonstrate the impact on specific investors as Rothschild examples are comparable to the rest of the industry.

Figure 1 – Retail CIV



The Five Arrows Australian Share Fund is a typical larger retail CIV. It is structured as a public unit trust regulated under Corporations Law, has a large number of investors, holds a wide range of Australian shares as its assets, and distributes all income each year to its unitholders.

Wholesale widely held CIVs

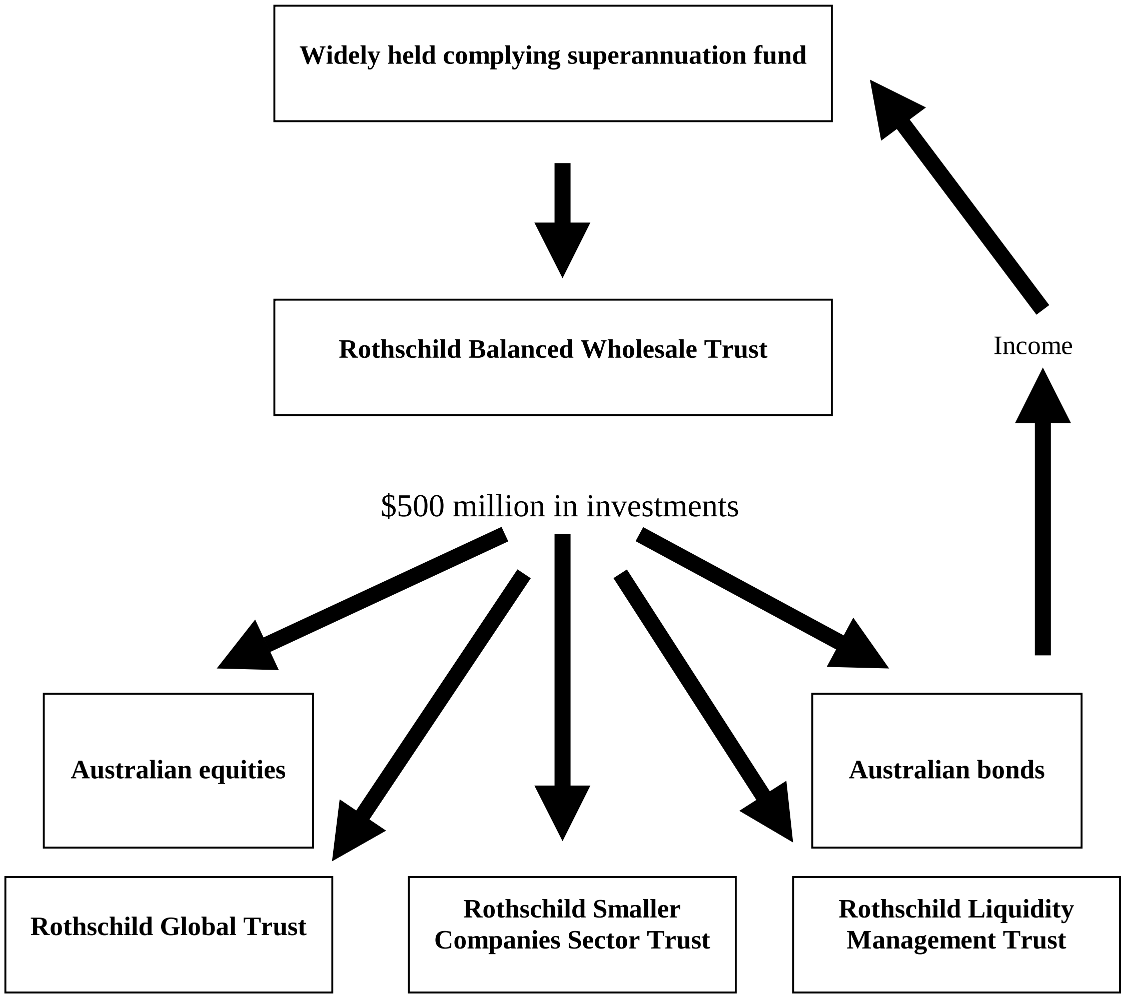
Figure 1 above depicts the structure of an important segment of the CIV market.

Another major and increasingly important segment of the CIV market – wholesale widely held, fully distributing CIVs – needs to be considered. We concur with IFSA's estimate that several hundred billion dollars of assets are managed in such vehicles.

Such CIVs are extensively used by superannuation funds, pooled superannuation trusts, and retail CIVs to gain exposure to investment assets which:

- Require very large investments, such as international equities
- Are illiquid, such as corporate fixed interest securities and real estate
- Can only be purchased in small lots, such as small companies and venture capital
- Are most efficiently and cost effectively administered through a CIV.

Figure 2 – Wholesale CIVs



The Rothschild Balanced Wholesale Trust is a typical larger wholesale CIV. Like many retail CIVs, it is structured as a unit trust and distributes all income each year to unitholders.

However, wholesale CIVs feature two critical differences:

- The number of unitholders is typically much smaller and is usually dominated by other CIVs, especially complying superannuation funds and pooled superannuation trusts, and to a lesser extent retail CIVs such as widely held distributing unit trusts.

  The Rothschild Balanced Wholesale Trust, for example, has only 430 unitholders (compare this to the example in Figure 1), and the top 20 unitholders – principally widely held superannuation funds - account for over 75% of the units on issue.

- Many wholesale CIVs (many retail CIVs as well) often gain exposure to certain investment assets via other CIVs.

  For example, the Rothschild Balanced Wholesale Trust in Figure 2 gains exposure to international equities through the Rothschild Global Trust. This is because deal sizes are so large in international equity markets that it is necessary to pool the international equity allocations of all Rothschild CIVs into a single international equity CIV. The Global Trust provides the other Rothschild CIVs the scale to invest efficiently and cost effectively in international markets.

  The Balanced Wholesale Trust gains exposure to Australian smaller companies through another CIV, the Smaller Companies Sector Trust. This time the reasons are different. Smaller companies are relatively illiquid investments and can often be purchased only in relatively small amounts over a period of time. It is considerably more cost effective to secure such exposure by investing in a specialist CIV rather than seeking to build a separate portfolio for each CIV desiring exposure.

  Finally, rather than holding cash directly, the Balanced Wholesale Trust invests into a third CIV, the Rothschild Liquidity Management Trust. The large size of the Liquidity Management Trust permits the Balanced Wholesale Trust to maximise its returns from its cash investments.

Solution – Wholesale CIVs

In Figure 2, none of the wholesale CIVs involved are directly widely held. This will be the case for much of the industry.

Those wholesale CIVs which are open to the public will typically feature 20 or less investors accounting for 75% of more of beneficial interests. However, those investors will predominantly be other CIVs, especially complying superannuation funds.

Wholesale CIVs which are not open to the public are typically specialist investment vehicles such as those depicted at the bottom of Figure 2. Investors will typically be restricted to other CIVs managed by the responsible entity.

We submit that wholesale widely held CIVs should qualify for flow through taxation where they satisfy the definition of a wholesale widely held trust.

Definition precedent

We note that the concept of a wholesale widely held trust has already been fully developed in **Subdivisions 272-F to I** of the Income Tax Assessment Act 1936. This (in summary) defines a wholesale widely held trust as:

- A trust that is unlisted widely held but not unlisted very widely held;
- 75% or more of the units in the trust are one or more qualifying holders;
- All units carry the same rights;
- Where units are redeemable, they are redeemed at the trust's net asset value;
- Total market value of units held by each particular unitholder in the trust is at least $500,000;
- The trust can only engage in certain qualifying activities.

Qualifying holders include:

- A listed widely held trust;
- An unlisted very widely held trust;
- A life assurance company;
- A registered organisation;
- A complying approved deposit fund;
- A complying superannuation fund;
- A pooled superannuation trust.

Certain qualifying holders defined above such as complying superannuation funds and pooled superannuation trusts, while they do not distribute their income to investors, are taxed CIVs, and thus prevent revenue leakage. Further, they are regulated by APRA; and in the case of complying superannuation funds, have been specifically excluded from the RBT.

We strongly believe that wholesale widely held trusts, as already defined in Subdivisions 272-F to I, should be used as a basis for defining and permitting wholesale widely held CIVs to qualify for flow through taxation. Given market evolution, we suggest that the $500,000 investment requirement be expanded to permit **at least $100,000 where a Corporations Law regulated prospectus exists**.

Pooled Superannuation Trusts (PSTs)

We note that an option proposed is that PSTs be taxed at the entity taxation rate of 36% compared to the current rate of 15%.

We strongly believe that this option is severely flawed and that the status quo should be maintained.

PSTs exist only as investment vehicles for complying superannuation funds, themselves taxed at 15%, and a small number of other qualifying investors.

The appropriate taxation benchmark for PSTs is quite clearly superannuation funds rather than entities. We do not believe the principle of competitive neutrality is applicable in these circumstances.

We have reviewed the suggestion that franking credits would be available to investing superannuation funds should PSTs be taxed at the entity taxation rate. We have concluded that this is very unlikely to adequately compensate superannuation funds for losses arising from cash flow losses, timing differences, and additional administrative burdens.

We have further concluded that given the fiduciary responsibilities of superannuation fund trustees, super funds would be compelled to withdraw their investments from PSTs in favour of alternative CIVs in the event that PSTs faced entity taxation.

There is around $100 billion invested in PSTs. We believe that imposition of entity taxation would result in much of these assets being withdrawn in a relatively short period of time, **creating chaos in capital markets, and imposing substantial transaction, taxation, and administrative costs on fund members**. This cannot be justified under any foreseeable scenario.

We are aware of concerns of revenue leakage arising from the current ability of complying superannuation funds to transfer their contributions taxation liability to PSTs. It should be noted that Rothschild does not permit such transfers. If this is a significant concern with PSTs, we believe that the solution is simply to introduce specific anti-avoidance measures. This would not materially alter the attractiveness of PSTs as a bona fide investment vehicle.

Distributions of tax preferred income from CIVs

We note the options discussed at pp373-375 of A Platform for Consultation.

Tax preferred income arises in CIVs from three main sources:

- Tax deferred income which represents deductions relating to plant, property fittings, timing differences between taxable and accounting income etc.

- Tax exempt income which relates to building allowances.

- Other tax exempt income which relates to certain other, particularly infrastructure related investments.

We are surprised that the option of maintaining the present system of distributing tax preferred income from CIVs has not been considered in more detail. The present system, although somewhat complex, simply represents an equivalent situation to investing in such assets directly.

It is proposed at p370, and we concur, that the appropriate benchmark for taxation of CIVs is individual rather than entity taxation. Yet the two options discussed create a situation where the taxation of tax preferred income in a CIV environment is different and disadvantageous to the taxation of tax preferred income in an individual environment. We submit that this is contrary to the general taxation principles of competitive neutrality and equity.

Option 1, not taxing tax-preferred income, simplifies the current system, but makes it slightly more generous. Option 2, taxing tax-preferred income, effectively aligns the taxation of tax preferred income in a CIV environment with an entity taxation benchmark rather than individual.

Of the two options discussed, Option 1 is clearly superior in meeting competitive neutrality and equity objectives, as it is much closer to the individual taxation benchmark.

We believe that Option 2 would be **severely regressive** in equity terms. Option 2 would place CIVs at a significant taxation disadvantage to individuals investing directly in assets such as property, listed property trusts, and infrastructure.

Option 2 effectively provides a **significant taxation advantage to wealthy investors** who can afford to purchase such assets directly, compared to small investors who cannot, and instead use CIVs. This is quite clearly unfair and unsupportable.

Taxation of capital gains

We support the general principle of reform to capital gains tax in order to develop a more internationally competitive regime.

It is recognised that in the interests of revenue neutrality, reductions in the rate of capital gains tax may require offsetting savings.

In terms of the options for savings, we support the abolition of the averaging provisions.

We strongly oppose the option of removing indexation of the cost base of an asset for the impact of inflation.

The existence of cost base indexation is one of the key factors which makes Australian capital gains tax equitable. It compensates investors for the change in asset values due simply to inflation – something which is not in the investor's control.

Removal of indexation may seem relatively trivial while inflation is at current very low levels. However, should inflation increase to levels as modest as 5% pa, the removal of indexation would represent a significant increase in taxation rates, especially for low and middle income earners who may not benefit from a 30% capped rate for capital gains.

We draw attention to and strongly support the suggestion that **rollover relief be given for mergers of unlisted widely held trusts and superannuation funds**.

This generally involves a small CIV being absorbed by a large CIV and is therefore **entirely consistent with scrip rollover** in company takeover situations.

The managed funds industry is littered with numerous small CIVs whose investors would benefit from significant gains in efficiency and reduced costs via mergers; but where the capital gains tax cost is prohibitive. Although there is an apparent revenue cost in forgoing capital gains tax revenue, this is illusory as such mergers simply do not and will not take place in the absence of relief.

Foreign investment funds

The review states that the active business exemption within the FIF regime is considered to "provide little protection from tax deferral" and needs to be replaced with tougher measures. However, no evidence is provided for this claim.

It is proposed to replace the eligible activity exemption with an exemption based on whether the company is taxed in a listed comparable tax jurisdiction. This option is highly impractical given portfolio investors will have difficulty in obtaining information on the taxation of profits of FIF interests.

We therefore strongly recommend that the current active income test be retained.

Passive / active trusts

A Platform for Consultation proposes to limit flow through taxation for those CIVs which carry on passive activities (ie do not carry on an active business).

We oppose any such measures because of the difficulty in drawing the line between these two categories. We believe that the widely held criteria are sufficient to ensure integrity of the tax system.

If it is felt necessary to make the distinction, then it should be made in accordance with the existing tests in Divisions 6B and 6C of the ITAA 1936.

Summary - Australia as a regional financial centre

A critical element of regional financial centres around the world is a thriving funds management and CIV industry. We believe that it is funds management rather than traditional banking which will become the major source of growth in financial services as we move into the next century.

Responsible taxation and a thriving funds management industry can and do co-exist.

Australian funds management does not require taxation concessions, but it must not face taxation disadvantages compared to either individual investment or taxation regimes prevailing on major competing financial centres.

Adoption of disadvantageous CIV taxation options such as the taxation of CIVs would see Australia's hopes to be a regional financial centre evaporate as significant elements of the industry would move offshore rather than gravitating towards Australia.

If we had to summarise our views within this submission, it would be:

CIV taxation ain't broke so don't fix it

While all arrangements are open to abuse, widely held fully distributing CIVs, wholesale widely held fully distributing CIVs, pooled superannuation trusts and complying superannuation funds do not feature as significant sources in our experience.

Comfort can be drawn from the fact that the former two vehicles are regulated under Corporations Law while the latter two are regulated by APRA under the Superannuation Industry (Supervision) Act.

In our experience, it is within private non-CIV vehicles which are not subject to such regulation, where abuse occurs.

Changes to the taxation arrangements of CIVs will not enhance Australia's reputation as a stable domicile for CIVs and will result in the movement of billions of dollars in assets as investors re-arrange their affairs. Such movements are likely to have unpredictable but disruptive effects on markets and result in the imposition of significant costs on investors.

Measures which place CIVs at a disadvantage to individual direct investment, such as taxation of distributions of tax preferred income should be dropped. Such measures disadvantage small investors compared to wealthy investors and are inequitable and unfair.

If Australia is to be seriously promoted as a regional financial centre, measures should be taken where possible to enhance the attractiveness of CIVs. An internationally competitive capital gains tax regime is a step forward in this respect.

However the key measure which would have little or no revenue cost would be rollover relief for mergers of widely held trusts and superannuation funds. This would substantially improve the industry's efficiency and ability to deliver for investors.

Contact Details

For further information, please contact the undersigned on (02) 9323 2178.

Yours faithfully,

Andrew Baker
Associate Director