QUEENSLAND INVESTMENT CORPORATION

REVIEW OF BUSINESS TAXATION

PLATFORM FOR CONSULTATION

Queensland Investment Corporation Submission

April 1999

Executive Summary

We refer to our submission of 30 March 1999 that focussed on the implementation of the decision to allow flow through taxation for widely held Collective Investment Vehicles (CIVs). The purpose of this submission to provide our comments on other aspects of the Review of Business Taxation (RBT) Platform for Consultation (PFC) report applicable to CIVs.

Please note that Attachment 8.2 contains confidential information that we would prefer was not made publicly available. We have no objection to the balance of this submission being made publicly available.

In summary, our comments are as follows:

- The tax depreciation proposals for wasting assets are applicable to the plant and building components of real estate investments of CIVs. We support the PFC proposals to implement an integrated tax amortisation model for wasting assets.

- CIVs incur a number of types of "blackhole" costs related to their real estate investments. We commend the proposals to ensure blackhole costs are tax deductible either on incurrence or through amortisation.

- The flexibility provided to CIVs by the existing trading stock valuation elections should be retained in the context of reviewing the application of the trading stock valuation rules.

- Encouraging long term investment is an important part of maximising Australia's national savings and funding the retirement incomes of our aging population. Providing concessional tax treatment for capital gains is an important factor in encouraging long term investment.

- The slice approach to the taxation of the redemption of ownership interests should not be applied to CIVs because unnecessary compliance costs would arise. The transitional tax rules proposed for trusts should be available to CIVs that utilise a trust structure.

- CIVs structured as trusts should be able to amend their constituent documents without tax implications where the economic substance of ownership is not changed.

- Implementation of the consolidation tax rules must take into account the nature of sophisticated CIV structures.

- The foreign equity portfolio investments of CIVs are not held for tax avoidance purposes and should be exempted from the FIF rules.

Recommendations

Our recommendations are as follows:

- Similar tax rules should be applicable to the amortisation of the plant and building components of real estate investments of CIVs.

- CIVs should be able to elect to claim depreciation from the start of the tax year after the construction of assets is completed.

- Tax amortisation allowances on buildings should be based on the acquisition cost of the building and not the original construction cost.

- Blackhole expenditures that result in the creation of economic assets should be treated as part of the cost of the related asset and tax allowances calculated on that basis.

- Blackhole expenditures that do not result in the creation of economic assets should be tax deductible in the year they are incurred.

- The current trading stock valuation rules should be retained to allow flexibility in the determination of the distributions of CIVs.

- A concessional taxation regime should be applicable to capital gains.

- A scrip for scrip rollover relief should be introduced for mergers and deconsolidations of listed companies. The scrip for scrip rollover should extend to scrip for scrip merger and deconsolidation transactions of unlisted CIVs.

- The slice approach should not be adopted in respect of the redemption of interests in CIVs.

- The transitional rules proposed in respect to trusts should also apply to CIVs that utilise trust structures.

- Changes to the constituent documents of CIVs structured as trusts should be taxed under a value shifting approach rather than as resettlements.

- Consolidation treatment should be able to be elected on an entity by entity basis for wholly owned entities of widely held CIVs

- The foreign equity investments of CIVs eligible for flow through taxation should be exempted from the FIF regime.

- If foreign equity investments of CIVs remain within the scope of the FIF rules, specific CIV portfolio investment exemptions should be implemented.

- Investments in foreign equities through foreign CIVs should be exempted from the FIF regime.

Contents

Chapter 1 – Depreciation of Wasting Assets

Summary

In the context of Collective Investment Vehicles (CIVs) depreciation issues arise in respect of the plant and building components of real estate investments. The purpose of this chapter is to provide input on appropriate tax amortisation rules for plant and building investments of CIVs. We have discussed “blackhole” expenditures in Chapter 2.

Recommendations

Our recommendations are as follows:

- similar tax rules should be applicable to the amortisation of the plant and building components of real estate investments of CIVs;

- CIVs should be able to elect to claim depreciation from the start of the tax year after the construction of assets is completed;

- tax amortisation allowances on buildings should be based on the acquisition cost of the building and not the original construction cost.

Tax Amortisation Regime

We support the adoption of an integrated model that applies similar tax amortisation rules to both the plant and building elements of real estate investments of CIVs. We have outlined below our comments on aspects discussed in Platform for Consultation (PFC) that are applicable to the large shopping centre and office building investments of CIVs.

When Should Deductions Commence?

We support the proposal to allow a standard write-off in the year the asset is acquired or disposed of. This would assist the compliance obligations of many taxpayers. Taxpayers who wished to do so should be entitled to elect to continue to use the existing daily apportionment basis of claiming depreciation in the year of acquisition or disposal.

The PFC discusses a number of practical issues in the context of determining when tax depreciation should commence. Our comments on these aspects are as follows:

- Some of the practical issues applicable to CIVs associated with the staged completion of the development of large retail shopping centres have been identified in paragraph 1.34 of the PFC. Similar issues arise in respect of redevelopments of existing properties. It is often the case that partially redeveloped sections of the property are tenanted before the overall redevelopment is complete. A flexible approach is needed.

- Most widely held investment trusts annually distribute their taxable income to their owners. The majority of owners wish to receive their distributions as soon as possible after year end. This results in the need for CIVs to be able to calculate their taxable income within a short period after year end. Similar issues will arise under the proposed CIV flow through taxation regime where CIVs are required to fully distribute their taxable income.

When a large property development or redevelopment is completed, CIVs generally obtain quantity surveyor reports on the nature of the costs incurred for tax purposes. The preparation of quantity surveyor reports requires reconciliation of cost records and consideration of retention amounts and can often take a number of months to complete. Where property projects are completed towards the end of the year, delays in obtaining quantity surveyor reports and preparing depreciation schedules can delay the calculation of the CIV's taxable income and the payment of distributions to owners. It is important for CIVs to be able to accurately calculate their taxable income. If errors arise in the calculation of taxable income, amended distribution notices would need to be issued to all owners requiring amendment of owner tax returns. This would cause significant administrative and compliance costs.

CIVs could control these aspects if they were able to elect to depreciate developed assets from the start of the next tax year. Allowing such flexibility would delay depreciation claims slightly and as a result would not be a detriment to the revenue.

- The PFC discusses the appropriate treatment of interest expenses incurred prior to property projects becoming rental producing. Such interest deductions and other recurring revenue costs such as rates and land taxes are currently fully tax deductible and do not form part of construction costs. The approach has recently been confirmed by the High Court in Steele's case. It would not be appropriate to adjust the current treatment.

Treatment of Buildings

We support the proposal for tax amortisation to be available based on the acquisition cost of buildings. This would harmonise the tax rules applicable to plant and buildings. It would also remove the significant compliance issues that can currently arise in practice as a result of the requirement to determine the buildings original construction cost.

Calculating tax allowance on the acquisition cost of buildings would require consideration amounts to be allocated between land and building components. This would be preferable to the current system which requires the purchaser to determine the original construction cost of the building.

The implication raised in paragraph 1.39 of PFC that allowing building tax amortisation based on acquisition cost is not comparable with allowing indexation in respect of capital gains is not accepted. Allowing the purchaser tax amortisation for post 30 June 2000 acquisitions based on acquisition cost does not cause an overall cost to the revenue as the total tax benefits available to the purchaser would be adjusted on sale to be limited to the difference between the acquisition cost and sale cost.

While we consider the current 2.5% building allowance as broadly appropriate, it is acknowledged that the rate of building allowance would need to be set having regard to the cost to the revenue. Setting rates of building allowance based on the rate at which particular buildings are expected to be "used up" in the production of assessable income may be problematic due to the long term nature of property investments and market fluctuations. It may be appropriate from a compliance cost and certainty perspective to specify broadly applicable statutory rates of building tax depreciation.

The changes proposed to the regime for tax amortisation on buildings are substantial. Real estate investments have a long term nature. As a result, appropriate transitional rules will be required to limit the application of any new building tax depreciation rules to buildings acquired or constructed after 1 July 2000.

It is not accepted that a recapture of building allowance on the sale of a building acquired prior to 1 July 2000 would be appropriate. Our comments on this aspect are as follows:

- There are already proposals in place to ensure recapture of building allowance on buildings acquired after May 1997.

- As discussed above, there is no overall loss to the revenue by allowing post 30 June 2000 purchasers tax amortisation based on acquisition cost because the total tax benefits available to the purchaser are adjusted on sale.

- The fact that there is no recapture of building allowance on the sale of buildings acquired prior to May 1997 is a consequence of the existing tax rules and is not something that should be reversed retrospectively as part of the RBT proposals.

Who Should be Entitled to Deductions?

Where a CIV acquires real estate for the purpose of deriving rental income, it is normally clear that the CIV is entitled to tax amortisation on the plant and buildings. One area where uncertainty arises in practice is in respect to the fitout of tenancies.

To the extent that the fitout of tenancies involves plant that becomes fixed to the CIV's land, tax technical issues arise concerning the ability of tenants to claim tax depreciation. The proposal to allow tax depreciation to the taxpayer that incurred the expenditure would clarify this position.

Further complexities arise where the tenancy is being fitted out as part of a lease incentive being provided by the CIV. Fitout lease incentives can be structured in a number of ways from a legal perspective. For example, the CIV can make a cash payment or reimbursement to the tenant in which case the tenant normally has ownership of the fitout. Alternatively, the CIV can provide a fitted out tenancy in which case the CIV is the owner of the fitout. The current tax implications to the tenant of receiving the fitout lease incentive generally depend on who is the owner of the fitout.

The uncertainty in the tax treatment of lease incentives has resulted in a number of disputes between the ATO and taxpayers. The proposed changes to the rules for determining who should be entitled to tax amortisation should take these tenancy fitout issues into account to improve the level of certainty for taxpayers involved in fitout lease incentives.

Chapter 2 – Blackhole Expenditure

Summary

The purpose of the chapter is to address the issues raised by the Platform for Consultation (PFC) report in relation to "blackhole expenditure" in the context of the property investments of Collective Investment Vehicles (CIVs).

Recommendation

Our recommendations are as follows:

- blackhole expenditures that result in the creation of economic assets should be treated as part of the cost of the related asset and tax allowances calculated on that basis;
- blackhole expenditures that do not result in the creation of economic assets should be tax deductible in the year they are incurred.

Property Investment by CIVs

Property investments are one of the key investment sectors of CIVs. A number of blackhole expenditures currently arise in respect to property investment. The PFC defines blackhole expenditure as:

> *"…the range of expenditures undertaken for the purposes of earning assessable income that currently do not qualify either for deduction or for write-off but which should so qualify either because they produce no enduring benefit or the benefit will endure for a fixed period. The cost of closing a business is an example of the former and a lease premium is an example of the latter"*.

In considering the appropriate treatment of blackhole expenditures applicable to property investment, it is important to take into account the nature of the large office building and retail shopping centre investments of CIVs. The success of these rental producing investments is directly impacted by the ability of the property to attract tenants.

Office buildings must be continually updated to keep pace with newer space coming onto the rental market.

In the case of shopping centres, it is important that customers be attracted to the centre. The more profitable the tenants in the shopping centre the higher the rents that can be demanded by the landlord. The very competitive nature of the regional shopping centre market means that owners must continue to update, develop and reconfigure their centres to ensure customers continue to visit their centres.

Development Feasibility Studies

Feasibility studies in respect of the development/redevelopment of office buildings and shopping centres that do not proceed are an example of blackhole costs incurred by CIVs. This issue is identified in the PFC.

The current tax system penalises proactive property managers who incur significant expenditure investigating development and redevelopment opportunities with a view to maximising the returns from their real estate investments.

We support the proposal in the PFC for feasibility / planning expenditure to be treated as follows:

(i) unsuccessful feasibility / planning study costs should be allowed as an immediate deduction at the time the development / redevelopment proposal under review is abandoned; or

(ii) successful feasibility / planning study costs should be incorporated into the cost of the developed asset and amortised under the tax rules applicable to the developed asset.

Our comments in support of the PFC proposals are as follows:

- Office building and retail shopping centre developments / redevelopments often involve an extended process of negotiation of rezoning, planning and development approvals with a view to maximising the rental income able to be earned from property investments. While these costs can be significant in respect of major projects, success is not guaranteed. Allowing tax deductions for failed property development / redevelopment feasibility / planning reviews of CIVs would remove the effective tax penalty that currently exists.

- In practice, CIV owners of large office buildings and shopping centres conduct ongoing reviews of development, redevelopment and reconfiguration possibilities for their properties. The purpose of these reviews is to ensure the rental income produced by the properties is maximised. In some cases the nature of these ongoing development / redevelopment reviews is part of the ordinary course of the business of investing for the purpose of deriving rental income carried on by CIVs such that the planning costs are arguably tax deductible under current tax law. Legislative confirmation of this position would provide certainty.

Demolition Costs

Many development and redevelopment projects of CIVs involve significant expenditure in demolishing existing buildings or sections of buildings and clearing debris. These expenditures are often blackhole expenditures for tax purposes.

The PFC proposes that demolition costs be included in the cost base of the land. We agree that this approach is appropriate where no replacement building is constructed within a reasonable period.

We propose that demolition expenditures be included in the cost of any developed / redeveloped structure which is erected in place of the demolished building. These expenditures would then be subject to tax amortisation as costs associated with the erection of the income producing building or structure.

Treating demolition costs as part of the cost of replacement assets best accords with the economic substance of the expenditure. Most demolition expenditures can be directly related to proposed development projects. On this basis, no significant compliance costs should arise.

Infrastructure Expenditure

As part of rezoning, planning and development approval for the development/redevelopment of office buildings and retail shopping centres, CIVs are often required to erect infrastructure and ancillary structures on Government land. Examples of such expenditure, include traffic overpasses to provide access to properties being redeveloped and local roads, footpaths etc. Such expenditure is often blackhole expenditure for tax purposes particularly where the structures are not located on the CIV's property.

This infrastructure expenditure should be incorporated into the construction cost of the office building or retail shopping centre that the infrastructure is supporting the development of. Amortisation deductions would then be available.

Lease Surrender Payments

Where a CIV wishes to terminate a tenant's lease, a lease surrender payment will often be made. CIVs are often not entitled to any tax deduction in respect to lease surrender payments. Rather the amount of the lease surrender payment is considered to form part of the cost base of the CIV's land for capital gains tax purposes (Refer to TR97/10). Due to the long term nature of real estate investments of CIVs, it will often be many years, if ever, before the benefit from the higher cost base in respect to the land on which rental producing buildings are located will be realised.

Where lease surrender payments are made with a view to securing a new tenant at a higher rent, then the lease surrender payment should be tax deductible either in the year incurred or over the term of the replacement tenants lease.

Where a lease surrender payment is made to allow redevelopment of the CIV's property, the amount of the lease surrender payment should be treated as part of the cost of the redeveloped building. Building amortisation tax deductions would then be available.

Chapter 3 – Trading Stock Valuation

Summary

The Platform for Consultation (PFC) discusses removal of the flexibility that currently exists in the tax rules in relation to the valuation of trading stock. We have addressed below the reasons why the trading stock valuation rules applicable to Collective Investment Vehicles (CIVs) should not be changed.

Recommendation

We recommend that the current trading stock valuation rules should be retained to allow flexibility in the determination of the distributions of CIVs.

Trading Stock of CIVs

While the majority of the assets of CIVs are not trading stock for tax purposes, CIVs often actively trade a portion of their financial assets such that traded assets are trading stock for tax purposes. The current trading stock valuation rules should be retained for these traded financial assets. Our comments in support of this view in the context of CIVs are as follows:

- Financial assets can both increase and decrease in value depending on market movements. While CIVs often value their trading stock at cost for tax purposes, some CIVs, such as cash management trusts, choose to value their traded financial assets at market selling value for tax purposes. The approach of cash management trusts simplifies the tax issues applicable to unitholders who treat their investment in cash management trusts as equivalent to bank account deposits.

- Other CIVs aim to pay relatively constant levels of cash distributions each year. This allows self-funded retirees investing through CIVs to better plan the cash flow they require to supplement their incomes.

  As discussed in Chapter 1, many CIVs distribute in cash an amount equal to their taxable income. As a result, the ability to smooth the amount of their taxable income each year is important. Being able to value trading stock at the end of the year in a particular manner affords CIVs some ability to smooth their cash distributions either by increasing or decreasing taxable income. The trading stock valuation election also assists with the quick and efficient calculation of taxable income and distributions to owners.

  There is no tax avoidance motive associated with the use of trading stock elections to smooth the taxable income of CIVs. The availability of the election merely allows administrative convenience and should be retained.

Chapter 4 - Capital Gains Tax Reform

Summary

A capital gains tax (CGT) regime that encourages long term investment is imperative in encouraging national savings. The purpose of this chapter is to summarise our comments on proposed CGT reform in the context of Collective Investment Vehicles (CIVs). We have focussed our comments on the following matters:

- the appropriateness of a concessional CGT regime for long term investment;
- scrip for scrip rollover relief.

Recommendations

Our recommendations are as follows:

- a concessional taxation regime should be applicable to capital gains;
- a scrip for scrip CGT rollover relief should be introduced for mergers and deconsolidation of listed companies. The scrip for scrip rollover should extend to scrip for scrip merger and deconsolidation transactions of unlisted CIVs.

Concessional CGT Regime for Long Term Investment

It is acknowledged that accurate assessment of the economy wide costs and benefits of allowing concessional CGT treatment for long term investment is difficult. Even so, we believe there is ample anecdotal evidence that CGT concessions for long term investment will encourage national savings and produce net economic benefits.

Encouraging national savings is a key imperative for Australia’s aging population. A dual focus is appropriate that both encourages saving and discourages short-termism in favour of long term investment that produces higher returns.

As identified in the Platform for Consultation (PFC) Australia’s taxation of capital gains is harsh compared to other countries. The USA and UK have reduced their effective CGT rates and experienced increased investment, business development and long term national savings.

In recent times the superannuation system has been a key driver in funding Australia’s retirement incomes. While the compulsory superannuation regime remains to provide a base level of retirement income, a myriad of changes to the superannuation system have reduced its attractiveness over recent years. Many taxpayers hold the view that superannuation no longer encourages additional saving to allow for top up of base retirement income.

CGT Indexation

The existing system of CGT indexation provides an element of concessional taxation of long term capital gains. While the benefit of CGT indexation is reduced in the low inflation environment that has been experienced in the late 1990s the realised and unrealised CGT indexation benefits available since the introduction of CGT in 1985 have been significant for long term investors like CIVs. If the CGT indexation is to be retained, it needs to be updated so that it provides a meaningful long term investment incentive in the context of the current low inflation environment.

Stepped CGT Rate

We are supportive of a stepped CGT rate as an alternative CGT concession mechanism for the encouragement of long term national savings. However, as acknowledged in the PFC, care would be needed in the implementation of a stepped or reduced CGT rate in the context of the CIV and superannuation systems that facilitate a significant portion of long term national savings. Our comments are as follows:

- capital gains realised by CIVs would need to retain their character when they flow through to investors to allow the incentive to be effective for CIV investors;

- ensuring the availability of a stepped CGT rate concession for superannuation funds would be important as superannuation funds hold a significant portion of the Australian retirement savings. The most simple and effective approach for superannuation funds would be to reduce the tax rate superannuation funds pay on realised capital gains.

Scrip for Scrip Rollovers for Companies

We support the proposal to introduce scrip for scrip CGT rollovers both where scrip is offered in the case of a takeover or merger of two entities and on deconsolidation. The existing CGT rules that treat a scrip for scrip transaction as a trigger for the realisation of capital gains reduce takeover activity which limits liquidity and the ability of businesses to reorganise and to take advantage of underperforming assets and synergies.

The proposal to allow scrip for scrip deconsolidation rollovers is as important as for mergers. The emerging trend for listed conglomerates to refocus on core activities is evidence of the need for a deconsolidation rollover that would allow conglomerates to be split into separate core businesses.

Scrip for Scrip Rollovers for CIVs

The scrip for scrip rollover relief should be extended to mergers and deconsolidation of listed and non-listed widely held trusts and other CIVs. The competitive nature of the funds management industry and the liquid nature of investment funds drives the development of sophisticated investment structures. The market practices and associated issues are discussed at length in Chapter 2 of our submission of 30 March 1999.

Under the existing CGT rules reorganisations of CIV structures can crystallise unrealised taxable capital gains even though there has been no change in economic ownership. CGT is a cost of the reorganisation where there has been an increase in the value of underlying assets of the particular trust. The CGT which may be realised can impact on the decision to restructure and ultimately effect the efficiency of the CIV investment structure. The allowance of a scrip for scrip rollover for merger and deconsolidation of unlisted CIVs would ensure that CGT is not an impediment to a restructure of CIV structures.

The case for allowing scrip for scrip rollover for deconsolidations of widely held unlisted CIVs is supported by the economic substance approach adopted throughout the PFC. The deconsolidation of a CIV would not cause any change in the economic interests in the underlying assets of the CIV.

Chapter 5 - Collective Investment Vehicle Distributions

Summary

We refer to our submission of 30 March 1999 in which we discussed in detail the key policy issues applicable to the distributions of Collective Investment Vehicles (CIVs). A number of related issues are also discussed in the Platform for Consultation (PFC) report. We have outlined our comments on these detailed issues below.

Recommendation

Our recommendations are as follows:

- the slice approach should not be adopted in respect of the redemption of interests in CIVs;
- the transitional rules proposed in respect of trusts should also apply to CIVs that utilise trust structures.

Widely Held CIVs

The key distribution issues applicable to CIVs are the review of the appropriate tax treatment of tax-preferred income distributions and the requirement to fully distribute profit each year. We have provided our detailed comments in respect of these matters in our submission of 30 March 1999.

The PFC also discusses a number of other issues of detail applicable to the distributions of widely held unlisted CIVs and related matters. We have discussed these below.

Profits First Rule

The intention of the profits first rule proposed by the PFC is to deem entity distributions as coming from taxed profits in the first instance then from untaxed profits and finally from capital.

CIVs will be required to fully distribute their taxable income to be entitled to adopt the flow through taxation approach. Consistent with the profits first rule approach, we expect CIV distributions in excess of taxable income would be treated as distributions of tax-preferred income rather than capital. This would fit well with the economic substance of CIV distributions which generally do not distribute contributed capital other than on redemption of an owner’s interest in the CIV.

Slice Approach Rule

Changes in ownership interests in unlisted widely held CIVs generally take place through unit issues and redemptions rather than ownership interests being transferred between owners. The PFC proposes a “slice approach” for determining the tax implications of the extinguishment of an ownership interest in an entity taxed entity. The slice approach rule attributes different components to the distribution to taxed profits, untaxed profits and contributed capital.

The application of the slice approach to the redemption of interests in CIVs may in some circumstances produce results that are more equitable than the current tax rules because the slice approach may assist to some degree with the control of double taxation. While this may be the case, our review has indicated that significant double taxation issues would continue and implementation of the slice approach would involve significant compliance obligations for CIVs.

As a result, we have concluded that the existing tax treatment of the redemption of interests in CIVs should be retained. The amount a CIV owner receives on redemption should continue to be treated as the consideration for the disposal of their interest without any part of the consideration being deemed to be a distribution.

Our comments on issues that would arise from the application of the slice approach to the redemption of CIV interests are outlined below.

Taxed Profit Component

For entity taxed entities, the franking account balance is a convenient and objective measure of the retained taxed profits of an entity. This concept is not applicable to CIVs which are not taxed provided they distribute all taxable income each year. In the context of CIVs, the only profit that could be equated with taxed profits would be current year taxable income that has not yet been distributed.

The application of the slice approach to the redemption of interests in a CIV may help to manage some of the double taxation issues identified in the PFC. Where an investor redeems their investment in a CIV part way through the year, there is a fraction of current year taxable income of the CIV reflected in the redemption consideration. While taxing redeeming CIV owners under a deemed distribution approach on a portion of the CIV's current year undistributed taxable income would avoid the need for this income to be subsequently distributed to year end owners, significant compliance problems would be likely to arise in practice.

The taxable income of a CIV is not determined until the end of the year. It would be impractical to require CIVs to determine the taxable income for the year up to the time of the redemption of an owner's interest. Accordingly, a CIV would at best only be able to make a reasonable estimate of a redeeming owner's share of current year taxable income up to the date of extinguishment.

Untaxed Profit Component

In the context of widely held CIVs, retained tax-preferred income could be equated to the untaxed profit of entity taxed entities. Application of the slice approach to redemption of interests in CIVs would treat a portion of the consideration paid on the redemption of an owner's interest as a distribution of tax-preferred income.

From an equity viewpoint it is appropriate to consider the application of the slice approach to the portion of undistributed tax-preferred income that arose after the owner invested in the CIV. Such an approach may manage some of the double taxation issues in respect to tax-preferred income attributable to permanent differences. Unfortunately no double taxation benefits would arise in respect to tax-preferred income attributable to timing differences that make up the vast majority of the tax-preferred income of CIVs. On the subsequent reversal of timing differences, taxable income would still arise that would be distributed to the then owners. Please refer to our comments on double taxation in chapter 4 of our 30 March 1999 submission.

In any case, in practice it would not be possible for CIVs to track the portion of undistributed tax-preferred income that arose after each investor joined the CIV. As a result, some type of arbitrary approach for allocating undistributed tax-preferred income to owners redeeming their interests would be required. This would mean that very limited relief from double taxation would be realised.

Capital Component

Practical issues would also arise concerning an appropriate basis for the allocation of a CIV's contributed capital to an owner redeeming their interest in the CIV. Unless the amount of capital actually contributed by each owner was tracked, which would involve significant compliance costs, some type of arbitrary approach would need to be adopted.

Contributed Capital

As a transitional measure, the PFC proposes that a separate definition of contributed capital be formulated for trusts in existence on 1 July 2000. These special transitional rules should also be available to CIVs that utilise trust structures.

Our comments on issues applicable to CIVs are as follows. These issues are most significant where it is decided to tax tax-preferred distributions of CIVs.

- Under the existing tax rules CIVs that utilise trust structures are entitled to distribute tax-preferred income as tax deferred distributions as they see fit. The transitional rules applicable to taxation of CIV tax-preferred distributions should allow distributions of pre-1 July 2000 tax-preferred income with the same tax treatment as currently applies.

- Of the types of income that are to be treated as capital for the purposes of the trust transitional rules, the capital gains tax indexation shelter on assets held on 1 July 2000 would be the major type of income applicable to CIVs.

Chapter 6 - Trusts - Resettlements

Summary

Chapter 22 of the Platform for Consultation (PFC) addresses the taxation issues associated with the resettlement of trusts. The trust resettlement proposals should also be applied to widely held Collective Investment Vehicles (CIVs) which are structured as trusts.

Recommendation

We recommend that changes to the constituent documents of CIVs structured as trusts should be taxed under a value shifting approach rather than as resettlements.

Reforming the taxation treatment of trust resettlements

The PFC correctly notes that the resettlement of a trust results in the creation of a new trust for the purposes of both the general law and taxation law. Under the current tax laws a trust resettlement can result in significant tax implications. This is the case irrespective of the fact that there may be no change in the underlying economic ownership of the trust assets.

The PFC proposes a substance over form approach in a number of respects. It is proposed that transactions with the same economic substance should have the same tax treatment regardless of their legal form. It follows from the PFC approach that amendment of a trust deed should not trigger tax liabilities where the economic substance is not altered.

We support the proposals put forward by the PFC for the resettlement of a trust to be ignored for taxation purposes, such that any alteration in the proportional interest of beneficiaries in the trust are taxed under a value shifting approach. This proposal should be extended to cover CIVs that utilise trust structures.

Chapter 7 - Consolidations – CIVs

Summary

The Platform for Consultation (PFC) addresses the taxation issues associated with the consolidation of wholly owned groups into a single entity for tax purposes. We have addressed below the issues raised as they relate to widely held Collective Investment Vehicles (CIVs).

Recommendation

We recommend that consolidation treatment should be able to be elected on an entity by entity basis for wholly owned entities of widely held CIVs.

Widely Held CIVs and their sub-trusts

There are a range of 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. As discussed in Chapter 3 of our submission of 30 March 1999 a circumstance where wholly owned CIV sub-trusts should not need to be consolidated relates to asset class wholesale trusts.

Asset class wholesale trusts exist to provide wholesale investors with investment flexibility. Even so there is commonly a “seed” period during which asset class investment trusts are wholly owned by a balanced wholesale investment trust or other wholesale investor. 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.

As a result, the decision on whether to consolidate a particular wholly owned entity of a CIV should be able to be elected on an entity by entity basis. The application of the “all-in” principle would cause adverse results for CIVs.

The PFC discussion on deconsolidation of previously consolidated entities is quite complex. In the context of CIVs, it will be important to ensure that no tax penalty is associated with a deconsolidation or the “exit” of a wholly owned asset investment trust. As mentioned in our submission of 30 March 1999, widely held investment trusts obtain maximum returns with minimum risk through the use of sophisticated investment structures. Should the market dictate that it is no longer feasible to wholly own an asset class investment trust within the “CIV group”, then there should be no tax impediment arising as a result.

Chapter 8 - Foreign Investment Funds (FIF)

Summary

Chapter 32 of Platform for Consultation (PFC) discusses proposals for the amendment of the FIF regime. The PFC notes that special issues are applicable to portfolio investors. The purpose of this chapter is to discuss the implications of the current and proposed FIF regimes in the context of portfolio investment by collective investment vehicles (CIVs).

Recommendations

Our recommendations are as follows:

- The foreign equity investments of CIVs eligible for flow through taxation should be exempted from the FIF regime.

- If foreign equity investments of CIVs remain with in the scope of the FIF rules, broad CIV portfolio investment exemptions should be implemented

- Investments in foreign equities through foreign CIVs should be exempted from the FIF regime.

Foreign Equity Investment By CIVs

Key drivers of the superior returns offered by CIVs are diversification and cost-effective access to a wide variety of asset classes. Both diversification and cost effectiveness are particularly important in respect of the foreign equities asset class. We have outlined below our comments on commercial issues applicable to foreign equity investment by CIVs so these aspects can be appropriately taken into account in any proposed changes to the FIF regime.

While significant from a regional basis, Australia's economy and equity markets are relatively small from a worldwide viewpoint. Investment in foreign equities increases the level of diversification available in a CIV's investment portfolio. The QIC foreign equities investments are focussed in stocks listed on the world's major stock exchanges. As at the end of March 1999 the QIC's foreign equities investments were valued at approximately A$4.6 billion.

The existing FIF rules have a significant impact on the way foreign equities investments of CIVs are implemented. CIVs are effectively forced to invest in foreign equities either directly or through Australian CIVs that themselves invest directly. The FIF rules prevent investment through foreign CIVs. The direct investment requirement significantly increases the cost of foreign equities investment faced by Australian CIVs.

It is important when implementing foreign equities investments to ensure access to high level expertise in the relevant foreign equities markets. Obtaining sufficient in-house expertise to allow the day to day management of foreign equities investments can be expensive. The alternative is to appoint external foreign investment managers who charge a fee to manage foreign equities investments. The need to hire experienced in-house staff or appoint foreign equities investment managers increases the cost of investment in foreign equities. The QIC use a combination of in-house staff and foreign equities managers.

Costs associated with the services of foreign asset custodians appointed to administer investments in foreign equities contribute to the cost of direct investment by CIVs. Foreign asset custodians are responsible for safe keeping of assets, arrange for the settlement of foreign equities trades, as well as report on a CIV's foreign equities investments from a valuation, performance, accounting and tax viewpoint.

An investment mandate is generally agreed for foreign equities investments. Foreign equities trades are made within the scope of the agreed mandate. The mandate will generally limit the foreign equities that may be acquired as well as such matters as the amount invested in each stock. Examples of the types of investment mandates commonly adopted include:

- **Index Mandate** – Australian CIVs often arrange for a significant proportion of their foreign equities investments to be managed under an index mandate. The objective of index mandates is to track the relevant foreign equities index by holding a foreign equities portfolio that replicates a particular index such as the United States S&P500 Index. Where an index mandate is adopted holdings are acquired in the key foreign equities that make up the relevant index.

  A variation to the index mandate is for foreign equities holdings to focus on stocks that form part of a particular index that are expected to outperform based on value or growth models/criteria. This is referred to as an enhanced or optimised mandate.

  A significant portion of the QIC foreign equities portfolio is currently held under passive index mandates. Please refer to Attachment 8.2 for details of the mandates applicable to the QIC foreign equities as at the end of March 1999.

  The QIC benchmarks its foreign equities portfolios against the indices created by Morgan Stanley International Capital. We have provided background on these indices in Attachment 8.1.

- **Active Mandate** – Active mandates encourage foreign equities managers to attempt to outperform the relevant benchmark index by identifying undervalued foreign equities and selling them once they reach full value. The QIC had a relatively small amount of foreign equities allocated to active mandates as at the end of March 1999.

Impact of Current FIF Rules

The key impacts of the current FIF rules on the foreign equity investments of CIVs are the costs associated with the forced requirement to invest directly rather than through foreign CIVs and tax compliance costs. The policy objective of the FIF rules was to prevent groups of Australian resident taxpayers jointly holding portfolio investments in foreign entities such that they avoided the controlled foreign corporation rules and achieved inappropriate tax deferral advantages. It is acknowledged that it is appropriate for such blatant tax avoidance to be prevented by the FIF rules.

It was never the policy objective of the FIF rules to ensure there was never any possibility of any incidental tax deferral in the context of portfolio investments of CIVs. The FIF proposals need to be better targeted so that they focus on their policy objective and do not inappropriately draw the foreign equities portfolio investments of CIVs into the tax avoidance net.

The QIC's foreign equities investments focus on listed blue chip stocks in major stock markets. The majority of the foreign equities the QIC invests in are exempt from the FIF rules under the existing "active business" exemptions. The balance of the QIC's foreign equities investments are exempt under the portfolio investment 5% exemption. In recent years, the portion of the QIC's foreign equities investments exempt under the existing portfolio investment exemption has been approximately 2.7%.

Despite the fact that historical experience shows that the FIF income attribution rules are not triggered by the QIC's foreign equities investment strategies, the QIC still has an obligation to monitor its FIF position on an ongoing basis. This results in significant unnecessary tax compliance costs due to inappropriate targeting of the FIF rules that are not justified having regard to the nature of CIV portfolio investments and the policy objective of the FIF rules.

FIF Proposals for Portfolio Investors

Our comments on the FIF proposals outlined in PFC as they apply to portfolio investors are outlined below.

Removal of Exemption

Removal of the existing FIF exemptions relied upon by portfolio investors would be wholly inappropriate. CIV investment in foreign equities is driven by the quest for superior returns through diversification and not by tax avoidance. Where the existing FIF exemptions were removed, due to perceived avoidance issues applicable to non-portfolio investors, replacement exemptions should be introduced for portfolio investors. It would be appropriate to exempt widely held CIVs entitled to flow through taxation from the FIF rules.

Replacement of Active Business Exemption

We reject the presumption underlying paragraph 32.49 of the PFC that foreign equity portfolio interests offer any inappropriate tax deferral opportunities. CIVs invest in equities listed on foreign stock exchanges for the same commercial reasons as they invest in equities listed in Australia. No element of tax avoidance is involved. CIV investment in foreign equities listed on the world's major stock exchanges should be exempt from the FIF rules.

The possibility of introducing a jurisdictional exemption approach for FIF purposes is discussed in the PFC. In the context of widely held CIVs, the discussion of the proposed jurisdictional exemptions places undue focus on preventing tax deferral opportunities and as a result are too restrictive. Any tax deferrals that arise in respect to CIV investment in foreign equities are incidental. The focus should be on rules that can be implemented by CIVs with certainty without causing significant compliance obligations.

Our comments on the jurisdictional exemption approaches discussed in the PFC in the context of portfolio investment by CIVs are as follows:

- Limiting FIF exemption to entities taxed on a worldwide basis would be too restrictive in the context of CIV portfolio investors. The requirement that exempt foreign equities also be subject attribution regimes in the foreign country would make the proposed exemption even more difficult to satisfy.

- The proposal to limit FIF exemption to entities listed on approved stock exchanges that carry on business in a listed country would also be too restrictive in the context of CIV portfolio investors. Significant eligibility concerns arise due to the global nature of modern business.

Real compliance issues would arise as a result of the limited information available to portfolio investors that would be similar in nature to the issues currently faced by portfolio investors. The best source of information available to portfolio investors is generally the foreign entities annual report. Annual reports often do not provide sufficient information to allow portfolio investors to satisfy their onus of proof that the current FIF exemptions are available. Similar issues would likely arise where a portfolio investor needs to determine whether modern global businesses are sufficiently carried on in listed countries.

- Where a jurisdictional exemption approach is adopted then, as a minimum, portfolio investments by CIVs in foreign equities listed on the world's major stock exchanges should be exempt from the FIF rules. We have attached as Attachment 8.2 a table that shows a snapshot of the QIC's foreign equities portfolio as at the end of March 1999. Stocks listed on each of the stock exchanges identified in Attachment 8.2 should be granted FIF exemption under a jurisdictional approach.

If the FIF rules are amended as proposed, it will be critical that a broadly applicable portfolio investment exemption is retained to ensure that CIV portfolio investment in unlisted country businesses in the context of a foreign equities portfolio continues to be exempt from the FIF rules.

Given the likelihood that both of the proposed changes to the FIF exemptions would increase the proportion of foreign equities that would become non-exempt FIF interests, the existing portfolio exemption would need to be expanded. While a portfolio exemption threshold of at least 10% would be required it is possible that the portfolio exemption level may need to be substantially higher where a restrictive jurisdictional exemption was adopted.

Interests in Foreign CIVs

As discussed above, the existing FIF rules force direct investment in foreign equities. For Australian CIVs, this results in additional investment management costs and the risk of potentially significant benchmark tracking deviations compared with investing through large foreign CIVs that offer very close tracking of the target indexes with competitive management expense ratios. As a result, we commend the proposal to provide FIF exemption for interests in foreign index trusts.

As discussed above, the QIC currently holds a direct portfolio of listed US equities with the view of replicating the movement in the US stock markets. The value of the QIC's US index portfolio as at the end of March 1999 was A$1.9 billion.

The large size of US index funds that operate in the US allow for the minimisation of investment management costs and benchmark tracking risk. Commercially, it would be beneficial for the QIC to be able to invest in the US stock market through a US index common fund.

We have discussed above our view that portfolio investment in foreign equities listed on the world's major stock exchanges should be FIF exempt. On a similar basis, investments in foreign CIVs that themselves invest in listed equities should also be FIF exempt.

As a minimum, large Australian CIVs and superannuation funds that invest in foreign index CIVs that benchmark their return against the major US, European and Japanese stock market indices should be FIF exempt. Consider the US by way of example. Having regard to the highly regulated tax and regulatory regimes applicable in the US, investment through US Index Common Funds that invest in US listed equities could be granted FIF exemption without any revenue risk. Similar considerations apply to the European and Japanese stock markets.

We support an FIF exemption for investment in foreign CIVs that is drafted in general terms. Interests in widely held foreign CIVs that invest in listed foreign equities that are benchmarked against internationally recognised performance indices should be FIF exempt.

Amendments to the FIF rules currently before Parliament propose a quite limited FIF exemption for investment in US CIVs. The proposed exemption for US CIVs does not extend to the large US index common funds that the large CIVs would like to invest through. The restrictive nature of the proposed amendments means that they are likely to be largely ineffective. This is an example of the difficulty that arises where the significance of incidental tax deferral potential of CIV portfolio investments is overstated. If this narrow approach to drafting FIF exemptions is to continue then the only workable solution may be to grant the Australian Taxation Office the ability to grant FIF exemption for foreign CIVs on a case by case basis, based on submissions for CIVs requesting exempt status. It is acknowledged that this would require appropriate ATO resources. A user pays system may be appropriate.

The issues discussed above are particularly important in respect to foreign equity investment in emerging stock markets. Given the high risk profile of emerging markets, CIVs allocate a relatively small portion of their portfolio to emerging markets. The smaller the amount being invested the higher the relative investment costs. As a result many CIVs do not currently invest in emerging markets. Providing FIF exemption for emerging market CIVs managed in the world's major financial centres may facilitate emerging market investment in a cost effective manner.

Attachment 8.1

MSCI Foreign Equities Indices

The QIC uses the Morgan Stanley Capital International (MSCI) indices as performance benchmarks for its foreign equities portfolio. The purpose of this attachment is to provide background details on the MSCI indices.

MSCI USA/MSCI Japan

To construct country specific indices such as the MSCI USA and MSCI Japan indices every listed security in a particular country's stock market is identified, and data on its price, shares, significant owners, free float, and monthly trading volume are collected. The securities are then sorted by industry group and the most "investable" stocks (as determined by size, long and short term volume, and free float) are selected until 60% coverage of that industry is reached.

Securities are also screened for cross-ownership to avoid including two companies in the index that own one another, which would result in double-counting. By including 60% of each industry group, each MSCI country index captures 60% of the total country market capitalisation while maintaining the overall risk structure of the market – because industry, more than any other single factor, captures the risk characteristics of a portfolio or a market.

Once stocks are selected for the index, they are included at their full market capitalisation weight. (In very rare circumstances where a significant company is privatised with a small percentage of its shares outstanding, it may be included in the index at a portion of its market cap weight).

MSCI Europe 15 Index

MSCI also produces benchmarks for regional stock markets such as the MSCI Europe 15 Index. Regional indices are made up of the country specific indices for each stock market in the region with an appropriate weighting based on the size of each market.