IFSA

SUBMISSION TO THE

REVIEW OF BUSINESS TAXATION

16 April 1999

INDEX

1. OVERVIEW

1.1. IFSA

The Investment and Financial Services Association ("IFSA") was established in January 1998 to represent the interests of the life insurance, superannuation, unit trust and investment management segments of the Australian financial services industry. IFSA has 60 member companies holding more than $450 billion on behalf of about 9 million Australians who have superannuation, life insurance and public offer unit trust assets. IFSA also has 30 supporting members who provide legal, accounting, research and information technologies to the financial services industry.

One of IFSA's goals is to promote stronger national savings. Another is to build an industry that is robust and efficient that will better serve its consumers. Tax reform is therefore vital to IFSA, its constituents and their customers.

IFSA welcomes the review of business tax arrangements, as it did the Government's package of personal and indirect tax initiatives. We are pleased that Government intends to consult with industry on the details of these changes. IFSA is committed to working with the Business Tax Review to assist in ensuring that the nation achieves a fairer, simpler, and more efficient business tax system that promotes and works in harmony with key national objectives. IFSA has appreciated the lengths to which the Review has gone to ensure that the widest possible input has been provided. The recent round of Forums are an excellent example of the Review's consultation.

Whilst we are prepared to work with the Government to ensure smooth implementation of the enhanced income tax system, we remain committed to the view that direct expenditure tax is the ideal benchmark for the taxation of saving. IFSA reserves the right to pursue this desirable change in future years.

1.2 Objectives

ISFA endorses the approach the Review has taken in setting national tax objectives of optimising economic growth, ensuring equity and facilitating simplification.

IFSA welcomes the way in which the Review has made the connection between the need for economic growth and the concomitant imperative that national savings also needs to be boosted in any tax reform initiatives.

1.2.1 Benchmarks for Ensuring Equity

IFSA strongly supports the principle of equity that is pursued in *A Platform for Consultation* (hereinafter referred to as "Discussion Paper No 2"). As will be stated later in this submission, horizontal equity should be the benchmark.

The ultimate tax regime for personal savings products should aim at neutrality against the tax treatment of direct investment by the same individual investors.

Similarly, the taxation of superannuation invested through collective investment vehicles of any kind should aim at neutrality against direct investment by the same superannuation investors. All superannuation investment vehicles should be taxed under the same regime.

1.3 Summary of Submission

1.3.1 Superannuation

The investment of superannuation funds, irrespective of the form that it takes (whether through direct investments or by investments through PSTs or life insurance companies), should be taxed in the same manner. This is consistent with the RBT's "A Strong Foundation" (hereinafter referred to as the Discussion Paper Number 1) policy design principle 12 that:

> "Economic transactions having the same economic substance should be taxed similarly, irrespective of their form."[1]

Superannuation is arranged either directly or though PSTs and life insurance policies. Each of these mechanisms is subject to legislated prudential regulation. Each type of vehicle needs to be seen as part of the one superannuation system. To be suggesting changes to particular mechanisms amounts to suggesting changes to the entire taxation basis of superannuation.

Part of this Government's platform is the simplification of the tax regime. It is submitted that the ANTS proposals, particularly as they will impact upon superannuation funds, will make the management of superannuation assets vastly more complicated. This will cause inefficient investment and increased compliance costs.

IFSA contends that the investment earnings attributable to superannuation and deferred annuity policies should be taxed at the same 15% tax rate as applies to superannuation and rollover funds generally. We recommend that superannuation policyholders, as at present, should not be taxed in relation to bonuses, ie. superannuation should remain a tax paid product. Our reasons are set out in Chapter 2 of our submission.

The superannuation business of life companies currently accounts for $123 Billion out of $150 Billion of funds under management by life companies. Thus, a change destroying the competitiveness of superannuation business would have major impact on the entire life insurance industry.

1.3.2 Life Insurance Ordinary Investment Policyholders

New policyholders should be taxed at their marginal rate; Existing policyholders should be taxed on the present basis for the remaining term of their policies.

The taxation of life insurance - for both policyholder and shareholder - has differed from that of other financial (specifically, savings) products and activities, because of its unique combination of features, being:

- the very long-term commitments involved, and the over-arching statutory and regulatory framework, designed to ensure that these commitments will be honoured;

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[1] pages xxi, 70 and 78

- the combination of pooled and individual saving;
- the joint deployment of shareholder and policyholder assets in statutory funds;
- the importance of this form of saving (together with superannuation) in terms of creation of pools of long-term investment capital including the ability to support long term savings with capital guarantees; and
- at times, the application of particular government policies (usually expressed in particular taxation treatment) designed to encourage long-term saving and greater self-provision against various risks - both of which reduce burdens on public budgets.

IFSA notes that it is not proposed that current taxation treatment of the risk component of benefits paid to policyholders should change. IFSA's comments are therefore mainly directed to the taxation treatment of life companies and investment policyholders.

IFSA agrees that income attributable to an ordinary investment policy written after the changes should be taxed at the marginal rate of the policyholder. However, we make a number of recommendations in Chapter 3 of this submission as to how these objectives can best be achieved.

IFSA welcomes the proposal for refundability of franking credits as this will ensure that taxpayers who have a marginal rate below the rate applied at the life company level, will ultimately pay tax at their own rate rather than above it.

1.3.3 Entity Taxation Basis for Life Companies

Entity taxation requires that the tax forwarded by the life company each year will be made up of both the tax deducted in respect of policies and that deducted in respect of shareholders. IFSA agrees with the principle that the income derived by a life company that is attributable to shareholders should be taxed in a similar manner to income derived by shareholders of other companies, at the general corporate tax rate. The two main issues therefore are how to identify the profits that are attributable to the shareholders and when the new basis of taxing shareholders should commence. The second issue is not a trivial one. To the extent that an increase in shareholder tax will be passed on as extra charges to policyholders, timing differences could potentially overturn the objective of existing policyholders being minimally impacted by the tax changes.

Notwithstanding past difficulties in determining taxable shareholder income, it is our view that with the advent of more sophisticated systems and more transparent products, a reasonable basis for the taxation of shareholder profits can now be designed. This should involve close consultation between Government and industry experts. The aim of the consultation would be to define income in a manner which is acceptable to the Government but which does not disrupt the position of policyholders. Chapter 4 gives IFSA's suggestions on how those objectives may be achieved.

1.3.4 Protecting Promises to Policyholders

IFSA strongly supports the intention, implicit in ANTS, of ensuring that the expectations of existing policyowners should not be disadvantaged by the change to an entity tax basis for life companies. Policyowners have effected long term contracts in good faith. Often the terms of their contracts are locked in. Neither the policyowners, nor the life company (ie. the shareholders) can breach those contracts without penalty. Any external influence that would break the sanctity of the contract would be retrospective in its effect.

IFSA believes that the impact of the proposed entity tax changes on life insurers would cause serious retrospective damage of this kind. We recommend in Chapter 4 measures to correct this impact.

1.3.5 Start Date for Entity Tax on Life Insurance Companies

There will be a formidable workload within the life companies and the ATO to prepare for the introduction of the new regime. A lead time in excess of 12 months after passage of legislation will be needed. If present timetables are maintained, IFSA believes a start date of 1 July 2001 would be an achievable target.

1.3.6 Collective Investments

IFSA supports and applauds the Government's decision, consistent with one of the options canvassed in Chapter 16 of Discussion Paper No 2, to apply flow-through taxation treatment to cash management trusts and the in principle decision to extend that treatment to other collective investment vehicles ("CIV"). IFSA submissions in this stage of the consultative process relate to:

- ensuring that the in principle decision to apply flow-through taxation treatment to other CIV's is implemented, applying the taxation of direct investment by an individual investor as the benchmark and minimising the compliance costs for the CIV and the investor;
- if there is to be a distinction between CIV's carrying on active and passive investment, Division 6C could be adopted as an appropriate basis;
- ensuring that the definition of CIV is sufficiently comprehensive to include all of the various types of entities which perform the function of such entities;
- providing for the start-up and wind-down of CIV's for the purposes of the CIV definition; and
- seeking codification of the principles of flow-through taxation.
- ensuring that masterfund products are treated as completely look through vehicles and excluded from the entity tax regime.

1.3.7 Other

1.3.7.1 Resettlements

IFSA supports the introduction of a clear rule for determining when a "resettlement" of a trust occurs for tax purposes. However, the possible rules canvassed in Discussion Paper No. 2 do not, in our opinion, reflect the economic substance of collective investment trusts. Accordingly, CIV's should be excluded from any resettlement regime.

1.3.7.2 Trust Losses

IFSA supports the introduction of a "same business test" for the carry forward of trust tax losses.

1.3.7.3 Capital Gains Tax

IFSA supports the adoption of a graded CGT rate approach (a variation on the capped approach) to the taxation of capital gains derived by individuals. It is also necessary to establish an equivalent graded rate for CGT incurred by superannuation funds. Assuming adoption of the Government's proposals for personal income tax rates, we recommend adoption of 30% / 25% / 12% rates graded CGT rates for individuals, and 9% for superannuation funds.

IFSA also supports the extension of scrip-for-scrip rollover relief to a broader range of entities and the extension of similar relief in relation to the normal tax provisions where the conditions for CGT relief are satisfied.

1.3.7.4 TOFA

IFSA believes that the "Timing Adjustment" proposals have been drafted too widely, and accordingly impact normal investment transactions creating significant compliance costs (without a corresponding increase in revenue). These provisions should either be (1) restricted, in operation, to dealing with "tax deferral" transactions, or alternatively, (2) not be applicable to the investment industry.

IFSA is also concerned that many of the proposals outlined in the TOFA chapters create unnecessary compliance costs for savings vehicles. Many of the proposals impact day to day operations - when they should be restricted in operation to only tax driven transactions.

1.3.7.5 Foreign Source Income of Residents

The FIF rules are a significant cost burden on Australian savings vehicles and are a hindrance to competing successfully with foreign products.

The Wallis Committee found that Australian savings vehicles are expensive by international standards and noted a suggestion that allowing foreign competition into the market could drive these costs down. After recent lobbying from the U.S. funds management industry the Government removed the tax barrier that prevented them entering the market. The Australian Financial Review noted recently that we are now preparing to meet an influx of low-cost international players. In an industry where costs are related to scale, we are now required to compete with U.S. mutual funds where some fund managers are larger than our whole industry.

If we are going to be able to compete with these power-houses then unnecessary costs have to be removed from the tax system. Accordingly, the reform of the FIF rules provides an opportunity to remove significant costs without harming the integrity of the system.

1.3.7.6 Corporate Tax Issues

- IFSA supports the reduction of the corporate income tax rate to 30%.
- The potential cash flow problems associated with the introduction of a comprehensive "Pay as You Go" system should be carefully considered by the Review team.

1.3.7.7 Consolidations

IFSA supports, in principle, the adoption of a consolidated tax regime. However, in light of the significant transitional issues associated with the introduction of such a regime and the breadth of tax reform measures that taxpayers already need to come to terms with, in the next few years, we would recommend that the introduction of such a regime be deferred for the time being. This possibility should be reconsidered when the current range of changes has settled down.

2. SUPERANNUATION

2.1. Executive Summary

It is IFSA's submission that superannuation, irrespective of the form that it takes (whether through direct investments or by investments through PSTs or life insurance companies), should be taxed in the same manner. This is consistent with the RBT's "A Strong Foundation" (hereinafter referred to as the Discussion Paper Number 1) policy design principle 12 that:

> "Economic transactions having the same economic substance should be taxed similarly, irrespective of their form."[2]

2.2. Need for a Full Review

IFSA is greatly concerned that changes are being proposed to the taxation of superannuation without having reviewed the appropriateness of the current treatment of retirement incomes. IFSA urges that any changes to the taxation of superannuation be deferred until such a wider review has been completed.

2.3. Superannuation

2.3.1 Choice in Methods of Investment for Superannuation Funds

An important driver for voluntary superannuation saving is the accessibility to simple products - products which remove the consumer's need to deal with the (necessarily) complex regulatory regime.

Superannuation is arranged either directly or through PSTs and life insurance policies. Each type of vehicle needs to be seen as part of the one superannuation system. To be suggesting changes to the tax basis of one particular mechanism is to suggest changes to the entire taxation basis of superannuation.

The existing superannuation system allows wide choice as to how an individual employee's superannuation may be arranged. Many superannuation funds choose to have their assets professionally managed through PSTs and life insurance policies. Each of these can provide access to a wide variety of investment sectors. Each type of vehicle is at present taxed in the same way.

The proposals in ANTS would alter the method of taxing some superannuation vehicles. This would introduce inequity, and would damage competitive neutrality between vehicles. IFSA believes that if these proposals were put in place, they would lead to massive re-organisation of superannuation investments. Investors would seek to move superannuation assets away from the tax disadvantaged vehicles. They would have to bear large costs from cashing in and reinvesting their assets. The end result would be a much larger number of much smaller investment pools, less efficiently managed. These tax driven outcomes would be detrimental to the retirement

[2] pages xxi, 70 and 78

savings of millions of Australians. IFSA contends that this would be contrary to good economic management in Australia. In this chapter, IFSA proposes to the RBT more sensible methods by which the Government could meet all of its policy objectives.

2.3.2 Size of Australia's Superannuation Base

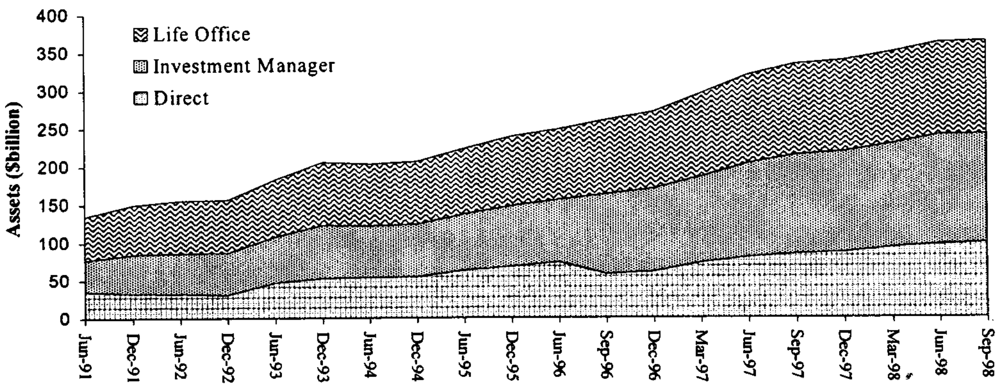
Australia's pool of superannuation assets totals approximately $360 billion - a large pool, but nowhere near enough to fund the nation's future retirement income requirements. Government policy has encouraged the rapid growth of this pool during the 1990's - see chart below.[3]

Additional superannuation funding above the current level of contribution is clearly required. This is even more so in the light of proposed reductions in personal tax rates causing super to be comparatively less attractive. Further changes should seek to encourage super savings, not make superannuation less viable as an effective long term retirement savings vehicle.

In excess of $200 billion of superannuation assets, more than half the total superannuation assets in Australia, are currently managed within a PST or life company environment (see chart). People trust this regulated environment. The fact that the products offered are "tax paid" products is a vital part of their simplicity and appeal. The fact that the superannuation investors can get someone else to be their investment expert, their superannuation law expert and their administration expert is a vital part of the appeal of these products.

Life companies have a long history of providing long term savings and protection products. This well earned market credibility is a key reason for the rapid growth in superannuation assets entrusted to them in the last decade - now totalling in excess of $120 billion. The large pools of savings which have accumulated in life offices (and PST's) are serving the nation well in terms of underwriting the many recent government privatisation and infrastructure projects. Large pools of superannuation assets provide Australian businesses with a pool of patient capital from which to draw.

Superannuation assets by manner of investment



[3] Source APRA Bulletin, September Quarter 1998

2.4. Pooled Superannuation Trusts ("PSTs")

2.4.1. Taxation should not change

Presently, PSTs are a 15% tax paid product. Tax is paid by the PST and the after-tax amounts realised by unitholders upon redemption of units are not subjected to further (double) tax. In other words, the PST is an "end" taxpayer. The current system is the best available. It is well understood and has no revenue leakage. **IFSA recommends continuation of the current system.**

It is to be noted that pooled superannuation trusts are subject to a comprehensive set of prudential requirements under the Superannuation Industry (Supervision) Act 1993. These prudential requirements are designed to operate in conjunction with the prudential requirements imposed upon superannuation funds and Approved Deposit Funds (ADFs) which are regulated under the same Act. The prudential requirements are administered by the Australian Prudential Regulation Authority. The current tax treatment of pooled superannuation trusts has been predicated on the fact that PST unitholders, who can only be investors of superannuation monies, are subject to parallel prudential supervision.

There are fundamental problems with changing the taxing of PSTs. The proposed rapid refund mechanism is inadequate to overcome those problems, as the following difficulties would still exist:

- Administrative inconvenience and cost - multiple transactions for nil economic benefit;
- Large increase in work load for Superannuation Funds and ATO in preparing and processing thousands of additional tax returns;
- Timing - bringing forward of payments and loss of interest until refund is received;
- Need to realise assets to pay tax, then reinvest when the refund is received;
- The need to pay tax would affect investment strategy, by forcing superannuation plans to hold more liquid assets;
- Difficult to calculate the taxable amounts on a per unit basis - ie. definitions of "income" in respect of each superannuation investor;
- Does refund go to superannuation fund, or to its investment manager (eg. PST or Life Company)?
- Need to ensure preservation rules are not breached - will refunds be processed at the level of millions of individual superannuation members?
- Difficulty in passing through tax preferred incomes and unrealised gains to individual superannuation funds;
- Need to redesign products just to make the tax system work (when they work fine with the present system);
- Forcing trustees to revisit existing contracts if their tax efficiency is damaged.

PSTs do not currently distribute income to unitholders, but the ANTS proposals would require them to do so. Whilst A Platform for Consultation (hereafter referred to as Discussion Paper 2) does not make clear how it is proposed that income becomes assessable to PST unitholders on an annual basis, undoubtedly the new requirements will impose upon PSTs considerable systems and administrative costs. IFSA fails to understand why this needs to be done when the applicable tax rate of the unitholder is known at the outset. The benchmark for taxing collective investment vehicles is the marginal tax rate for individual investors. This is easily achieved where the investors are all complying superannuation funds, and so all subject to a uniform 15% tax rate. This is what currently happens in relation to PSTs and the superannuation business of life offices. The difficulty that applies in relation to individual investors, namely that a variety of marginal tax rates can apply and an investor's rate can change from year to year, does not apply to PSTs and the superannuation business of life offices.

The two options outlined for taxing of PST's in Chapter 36 of Discussion Paper 2 are inconsistent with the treatment of stand-alone superannuation funds. It is important to recognise that the benchmark for taxation of PSTs must be the treatment of such superannuation funds.

Further, it would not provide a competitively neutral regime to have income retained in a PST subject to the corporate rate of tax. One of the attractions of PSTs from a savings viewpoint is that, as with superannuation policies, they operate on an automatic reinvestment basis. If it is proposed that PSTs have to convert to making annual distributions to pass on franking credits, this attraction will be lost. This would ensure an inefficient allocation of resources by effectively directing superannuation away from an efficient, cost effective and economically desirable pooling regime.

The possibility of PSTs accepting subscriptions from other than complying superannuation business would not be sufficient compensation for the traditional complying superannuation business moving out due to PSTs being tax-disadvantaged compared to investing directly or via other collective investment vehicles. There are already many collective investment vehicles open to non-superannuation investors. PSTs were developed specially by the government to be available only to superannuation investors, and to make them available to wider use would defeat the government's purpose in establishing PSTs in the first place.

IFSA recommends that PST's remain tax paid products as at present. IFSA supports the move to make imputation credits refundable and would appreciate confirmation that this change will apply to PST investments.

2.5. Life Company Superannuation Policyholders

2.5.1. Tax Rate

IFSA contends that the investment earnings attributable to superannuation and deferred annuity policies should be taxed at the same 15% tax rate as applies to superannuation and rollover funds generally. We recommend that superannuation policyholders, as at present, should not be taxed in relation to bonuses, ie. superannuation should remain a tax paid product. Our reasons are set out in the following section.

2.5.2. Timing Disadvantages of ANTS proposal

If the approach in 2.5.1 is not adopted, there will, in effect, be a "round robin" of tax payments. Tax will be deducted at too high a rate at first, then subsequently corrected to the 15%

superannuation rate or 0% pensions rate. If the corporate rate is applied to superannuation business and the delay between payment of tax by the life company and the receipt of a refund by superannuation funds, as recognised by RBT, is not effectively addressed, it will cause a fundamental restructuring as life companies transfer their superannuation portfolios to, where possible, stand alone super funds. The cost of such transfers (estimated at 2% of the $120bn) would significantly impact on the pool of retirement savings and disrupt investment markets. Further, it would be contrary to policy design principles to effectively have tax driving business structures. IFSA believes a principle of the RBT is that tax should not drive product design. Moreover, the decreased returns and increased costs experienced by superannuation funds as a result of less efficient investment and administration strategies will ultimately reduce the funds which superannuants have to provide for their retirement and thereby increase the call upon the social security system in retirement.

Investment outside of life companies is likely to incur greater costs due to decreased economies of scale; lead to greater risk due to the use of unbalanced portfolios; result in a shorter term view being taken to the detriment of infrastructure development, result in guaranteed products becoming unattractive and uncompetitive, and lead to adoption of a more risk averse investment approach to the disadvantage of new industries.

2.5.3. Inconsistent Treatment

Additionally, contrary to the overall objective of addressing the "inconsistent taxation treatment of business entities and the investments they conduct...[where] [e]xactly the same investment gets very different tax treatment if conducted through collective business structures"[4], the application of the ANTS proposals to superannuation funds will create a problem where one doesn't exist. Under the ANTS proposals, far from achieving neutrality of treatment, a superannuation fund that invests with a life company will be disadvantaged relative to superannuation funds that invest directly or via a collective investment vehicle, the disadvantage flowing from the application of the corporate rate and the DCT (or resident dividend withholding tax) regime to tax preferred income. In relation to tax deferred income, this is a timing disadvantage whereas in relation to "tax free" income, it is a permanent difference.

2.5.4. Simplicity and Compliance Costs

Part of this Government's platform is the simplification of the tax regime. It is submitted that the ANTS proposals, particularly as they will impact upon superannuation funds, will make the management of superannuation assets vastly more complicated. This will cause inefficient investment and increased compliance costs.

2.5.5. Application of Company Tax Rate to Taxable Income

As noted previously, superannuation, irrespective of the form of investment it takes, should be taxed consistently.

IFSA fails to see the logic in taxing complying superannuation policyholders at 36% and then engaging in complicated early refund mechanisms in order to have their rate reduced to 15%. The superannuation business of life companies should be on a 15% tax paid basis (as now) and so be comparable to direct investment by superannuation funds.

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[4] P.107, ANTS Document

Allowing complying superannuation business to be, as at present, a tax paid product would allow life companies to compete on an even basis with other avenues of investment. To compel superannuation funds investing in life policies to seek refunds of excess credits would significantly discourage the use of life companies as an avenue for investment. Superannuation trustees would find such a regime wholly unattractive as it would produce a lower return to members.

IFSA notes that one of the perceived concerns in relation to life company taxation is that the division of policies into classes that are subjected to different tax rates, creates complexity and opens opportunities for “tax planning”. In this regard, however, it is already proposed to continue to treat RSAs and annuities as separate classes that are effectively subject to different tax rates. A similar approach should continue for superannuation policies, namely taxing them at the statutory fund level at their correct rate.

The superannuation business of life companies currently accounts for $123B out of $150B of funds under management by life companies. Thus, a change destroying the competitiveness of superannuation business would have major impact on the entire life insurance industry.

The Refund Mechanism

Even if an effective early refund mechanism were made available, the superannuation business of life companies would cease to exist (for similar reasons to those outlined under 2.4 in relation to PSTs).

- Administrative inconvenience and cost - multiple transactions for nil economic benefit;
- Large increase in workload for superannuation funds and ATO in preparing and processing thousands of additional tax returns;
- Timing - bringing forward of payments and loss of interest until payment is received;
- Need to realise assets to pay tax, then reinvest when the refund is received;
- The need to pay tax would affect investment strategy, by forcing superannuation plans to hold more liquid assets;
- Difficult to calculate the taxable amounts on a per policy basis - ie. definitions of “bonus” and “vesting”;
- Does refund go to superannuation fund, or to its investment manager (eg. PST or Life Company)?
- Need to ensure preservation rules are not breached - ie. tax refunds should not leak to scheme members before age 55;
- Difficulty in passing through tax preferred income and unrealised gains to individual superannuation funds;
- Need to redesign products just to make the tax system work (when they work fine with the present system);
- Forcing trustees to revisit existing contracts if their tax efficiency is damaged.

Allowing life companies to continue to have tax paid products would allow the retention of deferred annuity business which the RBT recognises (Paragraph 34.71 of Discussion Paper 2) would, purely for tax reasons, have to be terminated and rolled over to a captive superannuation or approved deposit funds. This would be contrary to the tax policy position (page 78 of Discussion Paper 1) which means that tax should not direct the way economic activity occurs.

IFSA notes that it has already been announced that public units trusts are not going to be taxed on the entity basis. IFSA believe that life companies, as a similar form of collective investment vehicle, should also have their policyholder business excluded from the proposed entity and DCT (or resident dividend withholding tax) regimes.

Reserving

It is important that income which is not assigned as a bonus in relation to the year of income in which it is derived, but which will be assigned to policyholders in the future, is taxed at the rate applying to those policyholders and not at the corporate rate. Life companies often smooth the return given to some types of policyholders by not assigning all of the income made in a good year so that a larger amount can be assigned in a bad year. Accordingly, such income held back for superannuation policyowners should be limited in taxation to 15%.

IFSA fundamentally disagrees with the statement in Section 34.64 that taxing income on smoothing reserves at 15% would provide life insurers with a competitive advantage. In fact, to tax them at 36% would be to place life insurers at a commercial disadvantage compared to alternative treatment under superannuation funds.

2.5.6. Superannuation v RSA

2.5.6.1. Clarification of RSA treatment

IFSA notes that no changes are proposed to the present treatment of Retirement Savings Accounts (Paragraph 34.9 of Discussion Paper 2) although no explanation of why or how this treatment is to be retained is given. It would seem that life companies will still have three categories of income, being RSA income, annuity/pension income and all other income, with RSA income to be taxed at the rate of 15%.

This concession departs from the objective of removing the requirement for life insurers to "undertake complex and costly allocations of income and deductions into different tax baskets" (paragraph 34.13). Nevertheless, this is a positive advance from the alternative proposed in ANTS, and IFSA explores below whether this approach could be extended to earnings of other types of superannuation business.

2.5.6.2. Neutrality

IFSA's proposals above mean that consistency of treatment will be afforded to superannuation contributors vis a vis RSA contributors. Currently, the income underlying both superannuation funds and RSAs is taxed at the rate of 15% in the fund/account. Under the changes to the taxation of life companies initially proposed in ANTS, tax would be paid on business related to superannuation policies at 36% by the life company. Unless consistency is restored by changes to the ANTS proposals, as IFSA suggests in this submission, RSAs would have a timing advantage in relation to investing through life company superannuation policies, or PST's.

This result would be contrary to the Government's intentions as the treatment would not be neutral and would encourage a flow of business to RSA providers based on a tax advantage.

2.5.6.3. Recommendation - Alternative treatment

It is submitted that all superannuation including RSA business should be taxed on a consistent basis. Without this, superannuation funds will not invest in life policies (or PST's) due to the permanent and timing tax disadvantages as compared to other forms of investment.

2.5.7. The Solutions

Because the operation of life company statutory funds mixes assets of different classes of policyowners and of shareholders, taxation becomes complex and elaborate rules have been established under the Income Tax Assessment Act to deal with this. IFSA supports the objective of the RBT of simplifying this complex basis. There are numerous ways that this could be achieved. IFSA wishes to work with government to develop the most satisfactory solution from the point of view of both parties. In this paper, we explore two options that appear most promising to us - an RSA-style approach or a PST-style approach. (These are consistent with the taxation of shareholders under a modified form of Option 1 in Discussion Paper 2 - refer Chapter 4 of this submission).

2.5.7.1 Need for Allocations of Income

Discussion Paper No. 2 repeats an assertion from ANTS that the entity tax regime will "simplify the taxation arrangements that currently apply to life insurers by removing the need to allocate income and expenses across different classes of business" (paragraph 34.13). Whilst it would be convenient if this hypothesis was correct, the statement in fact shows a lack of understanding of how life companies actually operate.

The need to allocate income and expenses is inescapable. Within a mixed statutory fund, as currently maintained by most offices, there may be a need to allocate between shareholders, ordinary investment policies, risk policies, superannuation policies and annuity policies. Even within a class, ordinary or superannuation, there will still be a need to allocate expenses and income. Changes to tax rules do not remove the need for allocations, as the benefits accruing to each policy owner rely on such allocations.

It is understood that Treasury has had a project reviewing life insurance tax underway for ten years. During that time, legislative change in the form of the Life Insurance Act (1995) and the enforceable standards set by the ISC (now APRA) under that Act have removed many of the objections that may have existed ten years ago. All allocations can now only be approved by a life company after receiving advice from the Appointed Actuary. The actuary must abide by the standards set by APRA's Life Insurance Actuarial Standards Board (LIASB) and these allocations must also be signed off by an approved auditor.[5] Once the allocation to policyholders has been completed, there is no possibility of reversing it later. The alternatives IFSA explores below would use the allocations already completed for public reporting.

Discussion Paper 2 itself acknowledges that the theoretical position will not work in practice. For example, the treatment of amounts credited by the life insurer to retirement savings account policyholders (RSA) cannot be determined as discussed in paragraph 34.9 without an allocation taking place. Nor can the tax treatment of interest credited to pensions and annuity business (paragraph 34.44). The discussion of pooled superannuation trusts in Chapter 36 also acknowledges that some departure from the theoretical position may be essential.

Since a process of allocations of income and expenses is a necessity, it is essential that the basis of doing so should be established in a way that is satisfactory to all stakeholders - Government, ATO, policyholders and shareholders. The process should be robust and tamper proof. IFSA and its members are willing to help Government select a suitable approach from the many possibilities that are available.

In the following sections, we describe two of the most promising alternatives for allocating investment income. We have labelled these, in terms of the exposition already set out in Discussion Paper No. 2, as the "Virtual RSA" model, and the "Virtual PST" model.

It is important to note that either alternative would produce very similar results. The choice between them or other alternatives should be resolved in detailed discussion between Government and industry. These discussions would flesh out the details of the broad concepts outlined below.

2.5.7.2 Virtual RSA Model

This model works directly on the actual investment income earned within a mixed fund. For every type of business in that fund, the actual distribution of investment income to policyholders is a known fact. The total investment income is also a known fact. Thus, the investment income attributed to shareholders can be determined by subtraction. If necessary, the shareholder income can be separately determined in respect of each of the identified product groups. (Related product groups are separately valued each year as a building block of life insurance reporting).

Thus, the total income credited to superannuation policies can be determined, and subjected to the correct tax rate of 15%, in exactly the way envisaged in paragraph 34.9 for RSA's. Following the same process, investment income could also be apportioned to other classes of business, and to shareholders.

The discussion so far has addressed the issue in the broadest sense. In reality, the allocation process will need to identify separate types of earnings - interest dividends and rents, realised gains and losses, unrealised gains and losses, tax preferred income amounts (if tax preferences continue after the conclusion of the RBT) and so on. Most of this categorisation already occurs, with appropriate overview by the actuary and auditor, so that this process would not be unduly onerous to implement.

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[5] Refer Sections 79 and 80 of the Life Insurance Act 1995

If necessary, rules could be established to lock in the percentages for each type of earnings belonging to policyowners and shareholders - eg. dividing unrealised gains in the same proportion as derived for investment income.

Smoothing of returns is undertaken in relation to some types of superannuation policies. As this smoothing entails that the income derived is not necessarily credited to the policyholder's account, timing differences would arise if tax were paid in relation to amounts credited as compared to the actual earnings. Similarly, in relation to immediate annuity business, not all earnings made in relation to the assets that back that business are necessarily paid out when earned. Reserves are often held to ensure that future annuity payments can be met. These smoothing reserves would be taxed in the same way as the policies to which they relate. Calculating taxable income on a policy class basis within a statutory fund would cope with the appropriate treatment of earnings on smoothing reserves - ie. split earnings on policyholder retained profits and shareholder retained profits in the manner mandated for statutory purposes.

The appropriate policy reserve for the superannuation policies should be calculated according to the solvency requirement. That is, capital needed to support those policyholders should also be, initially, taxed at the rate applicable to the business that it supports.

Note that the Virtual RSA model, by operating on investment incomes directly, does not require hypothecation of assets to product lines (although life companies could choose to hypothecate assets if they wished). It is thus a little simpler than the Virtual PST model (described next) which effectively ring fences groups of assets. However, the Virtual RSA model and the Virtual PST model both end up by identifying the incomes of policyholders and shareholders, one by apportioning incomes and the other by allocation of assets, and so should produce substantially the same taxation outcomes.

Another difference from the Virtual PST model is that the virtual RSA does not require the identification of fee transfers as it operates only on investment income. Some types of business have embedded fees, rather than explicit charges, and the RSA model does not require any special attention to be given to these products.

It is important to note that both the RSA and PST style approach can operate consistently with the Options outlined in Chapter 34 of Discussion Paper 2 in relation to the Taxation of Shareholders.

2.5.7.3 The Virtual PST-style model

Under this proposal, as in the virtual RSA model, shareholder funds and interests associated with this business would continue to be subject to the entity tax regime. Superannuation policies would continue to be "tax paid", as currently. Under this alternative, variations would be made to the proposals for life office taxation as follows:

- a separate superannuation subfund would be established, within the Statutory Fund, which contains its own earmarked assets. This could possibly be mandated by APRA and its operations be the subject of audit. If a large asset has to be jointly owned by the policyholders and shareholders, the percentage owned by each group would be clearly defined;

- it would operate as a "virtual PST", with the taxable income and allowable deductions of the subfund being taxed according to the principles by which a PST is taxed. This assumes PST's remain taxed as at present, rather than being affected by the RBT proposals;

- the remainder of the Statutory Fund would be taxed according to the entity tax regime;

- there would be restrictions on amounts paid into the subfund, and mandatory transfer of certain amounts out of the subfund, in order to ensure moneys to which the shareholder is entitled within the Statutory Fund would sit within the entity tax regime rather than the superannuation tax regime. Details are given in the bullet points below;

- Transfer of assets between the subfund and the remainder of the statutory fund would constitute a realisation for tax purposes;

- As a broad principle, except for investment expenses directly incurred in producing assessable income of the subfund such as brokerage and stamp duty etc, all expenses of the virtual PST will be equal to the fees charged[6] on the products.;

- The fees charged to the policy owners would be immediately transferred from the subfund to the entity taxed component of the Statutory Fund. These would be subject to the corporate tax rate (currently 36%) as income of the entity, after deductions for the expenses of operating the business;

- The fees paid by the subfund would be a deduction against the subfund's assessable income;

- Tax on the net assessable income of the subfund would be deducted at the superannuation rate of 15%;

- Apart from these transfers, the subfund would stand alone. Thus, payments of investment benefits to superannuation policyowners, eg. to meet resignation benefits of members, would be drawn from the subfund. Eligible termination benefit payments may be subject to tax in the hands of the recipient, but are not subject to further tax within the life company;

- Insurance premiums for risk benefits, and corresponding claim amounts, would usually be paid across to, and met from, the entity taxed portion of the Statutory Fund. The net cash flow contributes to underwriting profit (or loss) of the entity taxed subfund;

- The Statutory Fund as a whole would, of course, be ultimately liable to meet obligations under policies. To the extent the subfund had insufficient funds to meet such obligations

[6] Fees would be determined broadly as follows:

- For policies classed as non participating under the Life Insurance Act, "fees" means the fees as defined in the policy.

- For policies classed as participating, "fees" are subject to a minimum of the actual Statutory Fund expenses of the superannuation participating business as disclosed in the annual return to APRA.

We note that shareholders of life companies have a very strong incentive not to under-allocate expenses to participating business, as a minimum of 80% of any under apportionment accrues as a permanent gain to the participating policyholders - ie. the restrictions imposed by the Life Insurance Act prevent the shareholders from recovering 80% of undercharged expenses.

these would be met from the entity taxed portion of the fund and would be a deductible expense. This would only arise if the subfund had zero net assets;

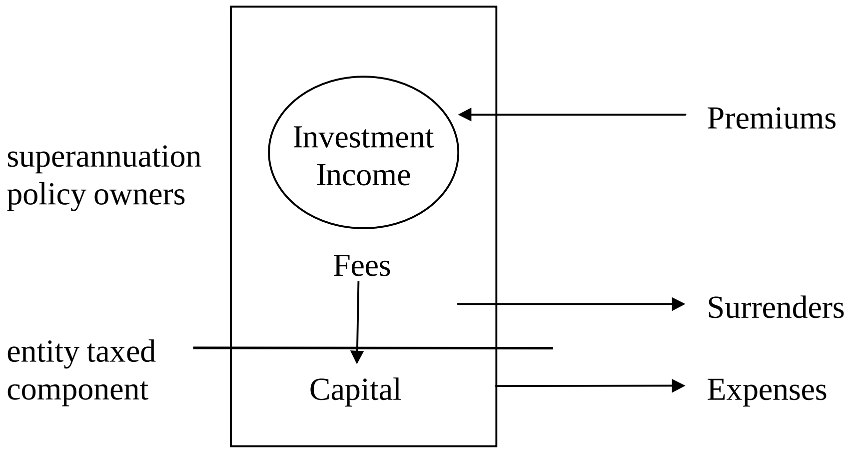
- only the initial transfer, future superannuation contributions and rollovers may be paid into the subfund;

- the initial transfer, except for business classed as participating under the Life Insurance Act, would be the solvency requirements of policies at date of transfer. For participating superannuation business, the initial amount transferred would be the sum of policy liabilities and policy owners' retained profits in respect of this business. This transfer amount may be more or less than the solvency requirements of policies at the date of transfer depending whether the amount held for investment smoothing is positive or negative.

- the subfund would be created by way of an asset apportionment, and would not be deemed to be a realisation. The aggregate market value of assets transferred would include provision for deferred tax on unrealised capital gains.[7]

This alternative would satisfy the aim of the RBT in taxing shareholders on the basis their income from managing the superannuation business of the Life Company, while taxing policyholders in accordance with superannuation rules. The income of shareholders will be fees, less expenses, plus underwriting profit. Either this approach, or the virtual RSA approach, would meet the objective of consistency in tax treatment against other forms of superannuation, both for superannuation investors and for shareholders.

In diagrammatic from, the ring fence PST-style model takes the following form:



[7] Within each asset section, the average cost base for CGT purposes of transferred assets, expressed as a percentage of current market value of those assets, should not be less than the corresponding percentage for all the assets of that sector held by the statutory fund. Sector for this purpose would mean the asset classes used for investment management purposes, such as Australian equities, Australian fixed interest, international equities, etc.

2.5.7.4 Need for Consultation on Details

Whichever one of these options is preferred, there will be many matters of detail needing to be resolved in consultation with government experts. IFSA would be pleased to commence detailed discussions as soon as convenient.

2.6 Taxation of Superannuation Pensions and Annuities

The taxation of pensions (and annuities) is currently dealt with appropriately by taxation at the level of the recipient, the objective being to tax pensioners on their incomes at their marginal tax rate. In relation to current pension business of life companies, as with other superannuation business, there is no sensible rationale for levying tax at 36% (or even 15%) and then refunding it.

The taxation of pension business has not been adequately dealt with. Taxing pension business income, whether within a superannuation fund, PST or life insurance company would be inconsistent with the taxation of the pension in the hands of the pensioner. To tax the earnings that flow into a pension at the life company level can only mean reduced income streams for pensioners. This would not add value in the context of trying to ensure that there are sensible retirement income stream arrangements in Australia.

Accordingly, a regime that ensures that what is effectively pensioner income is only taxed in the hands of the pensioner, should be maintained.

IFSA generally accepts the proposals put forward in the paper for the treatment of annuity business of life insurers, although we have some reservations about the detailed implementation. IFSA does not support the proposal in paragraph 34.48 to apply the "methodology for variable interest debt" to allocated annuities. This method is not only difficult to apply, but will also distort the allocation of income between policyholders and shareholders, when the actual allocation is readily available. The minimum payment rule was designed to ensure that policyholder amounts could not accumulate excessively within the tax free environment, which should address any tax deferral concerns the RBT may have.

IFSA submits that life policies backing current pensions should also continue to be exempt from tax at the life company level.

2.7. Other

2.7.1. Transfers of Taxable Contributions

Discussion Paper No.2 suggests (at para 37.3) that there are practical difficulties in relation to s.275 transfers of taxable contributions by superannuation funds and approved deposit funds to life insurance companies and PSTs. Those difficulties are said to include:

1. the requirement for the transferors to retain taxable contributions to cover allowable deductions;

2. Irrevocability; and

3. Identification by certain transferees of transferred contributions.

The paper then argues that such transfers are inequitable on the basis that no other entity is able to transfer its tax liability to another taxpayer.

IFSA believes that this is a incorrect premise. Transfers of losses and foreign tax credits by companies within a group are essentially a transfer of a tax liability by the gain company to the loss company and this is evidenced by subvention payments which are often made between the entities.

The paper also notes that shareholders of life insurers are able to access imputation credits reflecting part (20%) of the tax paid by the insurer on behalf of the transferor. However, we note that the 80:20 rule was never meant to be scientifically precise and an element of "swings and roundabouts" was always anticipated. For example, in respect of the disability class of business (known in tax parlance as AD business), shareholders had 80% of franking credits cancelled even though they were entitled to 100% of the profits for this business.

The practical difficulties referred to can be overcome with relative ease rather than abolishing the ability to transfer tax or contributions altogether. The retention of taxable contributions to cover deductions can be dealt with in a number of ways. They could include, for example:

1. allow super funds to transfer all of their contributions together with their deductions;

2. allow super funds that transfer taxable contributions but have held back some part to cover expenses of the fund to be freed from any obligation to lodge tax returns.

The difficulties in relation to irrevocability can be overcome by allowing the notice to become revocable or altered as long as the transferor and transferee agree. The retention of the ability to transfer taxable contributions is attractive to superannuation funds seeking to invest in the most efficient manner by obviating the need to undertake certain administrative obligations (such as lodging tax returns). This is of assistance to the ATO as it reduces its administrative costs (and this was presumably one reason why the Government set up Section 275 transfer facilities in the first place). The ability to change a prior agreement would allow funds that make errors in the amount transferred to "revoke" that agreement to the extent it is incorrect. It is up to the life insurance company or PST to agree to such a change. Presumably, where errors occur in a superannuation fund, they would otherwise require an amendment to be lodged with the Tax Office. A mechanism by which such amendments can be collated at one source outside the Tax Office must be attractive in terms of the ATO's administration costs. Such amendments by the life company or PST could be done on the basis of an adjustment to a subsequent year (eg. the year in which the amended transfer notice is agreed).

The Discussion Paper also indicates (at para 37.3) that there is some difficulty in identifying taxable contributions transferred. This is a compliance issue and should not be confused with the structure and integrity of the tax system.

2.7.2 Capital Gains Tax Rate

Chapter 8 of this submission gives IFSA's recommendations for treatment of Capital Gains Tax, with a full discussion of our reasoning. Our preference is for a graded scale, being approximately 60% of the marginal tax rate for investors. Applying the same reasoning for superannuation investors means that the CGT rate applying to them should be 9% (ie. 60% of their standard 15% tax rate).

2.7.3 Possible Creation of New Statutory Funds

It is possible that the eventual outworkings of the RBT would be made easier if life companies were to create new statutory funds. These may, for example, be established so that Classes of business currently held in a mixed fund are, in future, held in separate statutory funds -eg. ordinary, superannuation and pensions/annuity business. Conceivably also, some life companies may wish to consider separating new business from the grandfathered old business so that each of their statutory funds is subject to only a single style and rate of policyholder tax. The decision whether or not to create separate funds will require careful consideration of the individual circumstances within each life company. Capital and policyholder security considerations may be just as important as tax considerations.

If any life companies do decide to separate statutory funds, IFSA requests that APRA should take all possible steps to facilitate this move. We would alert the RBT of this need, as APRA has responsibility under the Life Insurance Act 1995 to supervise the operations of Life Companies, and a fund split cannot proceed without APRA's approval.

3. TAXATION OF LIFE INSURANCE (NON-SUPERANNUATION)

3.1. Executive Summary

New policyholders to be taxed at their marginal rate: Existing policyholders to be taxed on the present basis for the remaining term of their policies.

The taxation of life insurance - for both policyholder and shareholder - has differed from that of other financial (specifically, savings) products and activities, because of its unique combination of features, being:

- the very long-term commitments involved, and the over-arching statutory and regulatory framework, designed to ensure that these commitments will be honoured;
- the combination of pooled and individual saving;
- the joint deployment of shareholder and policyholder capital in statutory funds;
- the importance of this form of saving (together with superannuation) in terms of creation of pools of long-term investment capital including the ability to support long term savings with capital guarantees; and
- at times, the application of particular government policies (usually expressed in particular taxation treatment) designed to encourage long-term saving and greater self-provision against various risks - both of which reduce burdens on public budgets.

IFSA notes that it is not proposed that current taxation treatment of the risk component of benefits paid to policyholders should change. IFSA's comments are therefore mainly directed to the taxation treatment of ordinary investment policyholders (this chapter) and life company shareholders (next chapter).

IFSA agrees that income attributable to an ordinary investment policy written after the changes should be taxed at the marginal rate of the policyholder. However, we make a number of recommendations in this submission as to how these objectives can best be achieved.

IFSA welcomes the proposal for refundability of franking credits as this will ensure that taxpayers who have a marginal rate below the rate applied at the life company level, will ultimately pay tax at their own rate rather than above it.

3.2. Policy Framework

The investment policies sold by life insurance companies, be they ordinary or superannuation, unit linked or traditional, are a form of long term collective investment by policyholders. It is therefore appropriate that the tax treatment of policyholders accord with the treatment of such investors who are making direct investments. IFSA considers that this comparison with direct investment is also the appropriate benchmark for other forms of comparable collective investment vehicles, such as public unit trusts. Thus, taxation at the investor's marginal rate will achieve neutrality as between different forms of investment.

The proposed changes to the tax arrangements for life insurers are based on the objectives to reduce complexity and compliance costs and produce consistent results in relation to other business entities. IFSA agrees that the ideal for any taxation system is that it is **equitable, efficient (or neutral) and simple**.

In this submission, the ANTS proposals in relation to the taxation of life insurance companies and their policyholders are considered in light of these objectives and the policy framework appropriate for the achievement of these objectives. We conclude that the detailed suggestion in Discussion Paper No. 2 are not the best ways of achieving these desirable aims. We suggest more practical and equitable alternatives below.

3.2.1 Treatment of Policyholders

As a general point, the tax regime should follow the nature of the investment activity rather than the form of investment vehicle. Neutrality, and therefore economic efficiency are only achieved where the taxation system is, as far as is practical, not dictated by the vehicle through which the activity is undertaken, but rather by reference to the activity itself, whether by the direct investment of an individual, or via investment in a collective investment vehicle which, in turn, invests in the particular activity. IFSA's recommendations for the achievement of this objective are summarised in the boxes immediately following and discussed in more detail in subsequent sections of this chapter.

3.2.2 New Investment Policyholders

RECOMMENDATION	REASON
1 IFSA's preference is for taxation of policyholders (and shareholders) to be by Option 1 (paragraph 34.22 of Discussion Paper 2). IFSA recognises that Option 1 needs to be refined in order to ensure that all taxable items are taxed once and once only. (We provide amended formulae in Chapter 4 of this submission).	Option 1 is the simplest to operate especially when policies offer combined risk and investment. Policy liabilities should be defined as the solvency requirement. The solvency requirement is subject to prescribed actuarial standards and is audited.
2 Policyholder funds should be entitled to capital gains tax ("CGT") treatment in relation to the disposal of assets, including:-	This recommendation has two elements: 1. The collective investments made on behalf of all policyholders by life companies should be entitled to the same treatment in

RECOMMENDATION		REASON
	• taxation of gains/losses only when realised; • the allowance of indexation where assets have been held for more than 12 months (if this remains generally available to direct investors); and • taxation of capital gains derived by non-superannuation business according to the same principles as applicable to all other taxpayers.	relation to the disposal of assets as other collective investment vehicles. The net capital gain/loss is identified and therefore, the application of a special tax rate would not be a problem at the life company level. 2. When Investment Policyholders collect their policy proceeds they should be entitled to the same treatment in relation to the disposal of assets as other participants in other collective investment vehicles. The net capital gain/loss is identified and therefore can be separately advised when bonuses are distributed.
3	Aside from the transitional measures (discussed later in this submission), the holders of such policies should be taxed, at the time bonuses are assigned, with some averaging relief. Assigned bonuses should be franked by reference to an ordinary policyholder franking account and excess credits should be refundable. Tax preferred income should be permitted to be identified and distributed tax-free, as is recommended for public unit trusts.	The appropriate benchmark for taxation of the policyholders' funds is the individual investor. Accordingly, if by direct investment an investor is entitled to the benefit of mandated preferences, then this should also flow through to policyholders (who invest indirectly).
4	Policyholders should not be subjected to the Deferred Company Tax ("DCT") regime. Should there be acceptance of the RBT's suggestion that there be a resident dividend withholding tax in lieu of DCT, the resident withholding tax should not apply to bonuses.	Application of the DCT (or resident dividend withholding tax) regimes to policyholders would remove the attainment of the principles sought to be achieved by IFSA's recommendations. It would make life companies uncompetitive with investing directly or via other collective investment vehicles.
5	The new taxation basis for new ordinary business should commence from a common start date. IFSA suggests this should be 1 July 2001.	The majority of Life Companies use substituted accounting periods. To adopt a year of income would effectively bring forward the start date for early balancing companies and delay it for late balancing companies. Using a consistent start date is better from the point of view of competitive neutrality. The start date must be chosen to give enough time for the substantial system changes to be completed by life companies and the ATO.

3.2.3 Some Problems with the Old Tax Basis have been Overstated

Life companies have paid tax according to the existing Tax Laws. There has been no other basis on which tax could be paid.

The Government has been considering the need for change to that tax basis since 1988, without taking any action, or presenting any firm proposals to the industry, up until the ANTS paper. Because of a lack of consultation to date, some of the assertions in ANTS and the Discussion Papers are incorrect. IFSA has previously provided Government with substantial information about the workings of the life insurance industry. For example, IFSA's April 1998 paper to the Gibson Committee proved that the (I-E) basis of taxation does, contrary to the Government's assertion in ANTS and later documents, already tax management fees and underwriting profits, albeit not entirely at the corporate tax rate. (Our proof of this is repeated in Appendix B).

Treasury has not disputed IFSA's conclusion and we are disappointed that statements to the contrary were included in the ANTS paper, and the RBT Discussion paper No.2.

The collective investment status of life companies needs to be recognised just as it has already been recognised in the case of public unit trusts. The different distribution mechanisms applying to life policies lead to a different tax treatment having to be adopted to obtain a similar result for policyholders as compared to unitholders.

The automatic reinvestment that currently happens under most life investment policies should be retained. Automatic reinvestment encourages the growth of long term savings and is therefore to be supported.

3.2.4 Deferred Company Tax

The application of DCT would result in the taxing of tax preferred income at the time of receipt. It needs to be recognised that the taxing of this income leads to double tax as deductions that give rise to the tax preferred income reduce the cost of the underlying assets such that a greater gain or smaller loss is made when the asset is sold. IFSA notes that the Federal Treasurer in advising that certain collective investment vehicles will be taxed on a "flow through" basis, did indicate that the tax treatment of tax preferred income derived by such vehicles was under review. It would be a substantial departure from the concept of there being a level playing field if policyholders were to be treated more harshly than unitholders. Further, if the timing advantage is to be retained for direct investors, then it should be allowed to small investors who pool their resources.

Another area where the application of DCT may lead to unfair results is in relation to the taxing of the distribution of unrealised gains. Discussion Paper No. 2 of the Review of Business Taxation ("RBT") (at paras. 35.15, 35.40) rightly highlights this as an issue of concern, particularly if policyholders are to be the only taxpayers bearing tax in relation to unrealised gains.

3.3 Taxation of Ordinary Policyholders

The *ANTS* proposals incorporate a major change to the manner in which policyholders who effect new policies after the date of change are to be taxed in relation to life insurance investments. It is our view that the general entity model proposed in relation to the taxation of policyholders does not achieve the Government's stated objectives of neutrality and equity, particularly due to the inappropriate overlay of the proposed DCT regime upon policyholders. While it is agreed that a form of the imputation model (albeit altered from that incorporated in the ANTS proposals) should form the basis for the taxation of new ordinary policyholders, it is submitted that the DCT (or alternative resident dividend withholding tax) regime should not be applied to policyholders generally. Modifications to the ANTS proposals in order to achieve these objectives are discussed below.

3.4. Taxation of New Ordinary Investment Policyholders

IFSA's preferred option for taxing new investment policyholders is Option 3. (Under para 35.32 of Discussion Paper No.2).

3.4.1 Option 3 Pay net tax when bonuses are assigned.

As was recognised by the RBT (para.35.35), if this option is selected, then the life industry is likely to design its products so that it may write policies that assign bonuses annually or policies that assign bonuses only upon termination.

IFSA believes that it is important that life policies be allowed to defer assignment of bonuses until termination as this allows the tax system to make a distinction between committed long-term savings and less committed short-term savings. A decline in long term saving would have adverse impacts from a national perspective, as long term saving is the main form of funding for long-term projects such as infrastructure development.

Of course, low marginal rate taxpayers would generally acquire policies that assign bonuses annually and, therefore, access refunds attributable to excess franking credits attached to the bonus. High marginal rate taxpayers would opt for policies that assign the bonus at termination.

Life companies should be at liberty to only assign realised income and gains as bonuses such that there is likely to be a difference between the amount by which the surrender value of a policy increases during a year of income and the bonus assigned in relation to that year. This is somewhat similar to the value of units in a unit trust increasing by reference to unrealised gains and unitholders usually only receiving a distribution of realised income and gains. Consistency and fairness demand that negative bonuses assigned to policies can be claimed as deductions by policyholders in relation to the year of assignment.

In relation to most policyholders, IFSA's preferred Option No.3 will lead to the same result as under Option 1. Option 3, however, is preferred as it does not have the complication of allowing policyholders to make an annual election. The policyholder effectively makes a once-only election when selecting which type of policy to take out. In our opinion, Option 3 is therefore preferable to Options 1 and 2. Further, under Option 3 no tracking issues arise.

Where it is necessary to define the annual "bonus" assigned, IFSA believes this should be calculated similarly to the current s.26AH calculation - ie. increase in surrender value less the net premium paid (as premium is a capital deposit). We note that if necessary, this form of calculation could also be applied to unit linked policies, contrary to the assertion in paragraph 35.44 of Discussion Paper 2.

3.4.2. Possible Model

IFSA believes it would be worthwhile to examine a model incorporating the following characteristics:-

- Income attributable to **non-super/RSA and non-annuity/pension policies** is taxed at the life company level at the corporate rate;
- Policyholders in relation to non-super/RSA and non-annuity policies would be assessed in the year that bonuses are assigned;
  - Bonuses attributable to tax preferred income are to be exempt from tax within the life company;
  - Gains should not be taxed until realised;
  - Other bonuses will be franked, ie. the bonus is to be grossed up by the franking credit and the credit is to be refundable;
  - Averaging relief, similar to that currently applicable to the taxation of capital gains should be allowed in relation to policies that only assign bonuses upon surrender or maturity.
- The DCT (or resident dividend withholding tax) regimes should not apply to life company policyholders, particularly due to already taxed foreign income and its impact in relation to tax preferred income including the capital gains tax treatment for the assets of the life company underlying policies.

It is submitted that this variation of the imputation model would come closest to the ideal regime under which ordinary policyholders are taxed on the earnings attributable to their policy at their marginal rate of tax.

As some of the proposed marginal tax rates would exceed the tax rate applied to the ordinary business, a deferral advantage can be obtained in relation to ordinary investment policies that do not assign bonuses until termination. This is not out of line with the outcome the policyholder could have obtained by investing directly.

IFSA has provided evidence that the overwhelming majority of life company policyholders are on low marginal tax rates. Research was quoted in IFSA's submission on "Taxation of the Life Insurance Business of Life Insurance Companies" of 14 April 1998.[8] This research shows that, weighted by the number of policyholders, the average marginal tax rate over the period 1991-1995 was 24.2%. Weighted by the amount of bonus paid it was 32.2% (reflecting the fact that higher income earners received higher bonuses on average). The ANTS proposals to reduce average personal rates of tax will bring about a further reduction. Average marginal tax rates for policyholders will be less than 30% - the target entity rate set for the RBT. Accordingly, most policyholders will receive refunds under the new tax basis when they present their tax claims including the amounts of assigned bonuses.

[8] Page 17 of submission to the Gibson Committee.

3.4.3. RBT: Franking Account Allocations

IFSA's recommendation is that only new ordinary investment policies need to be subjected to imputation. As argued above, in relation to the other forms of business (superannuation and pension/annuity business) where the tax rate applicable to the investor is known with certainty in advance, it is simpler to merely apply that rate at the outset and allow life companies to compete on a level basis. In relation to pension and immediate annuity business, it is the pensioner or annuitant who is to be taxed and, therefore, broadly, exemptions need to apply at the life company level. If this is accepted, then what remains is the ordinary investment business.

Allocation issues arise in relation to franking credits from dividends received and tax paid. The portions relating to the fully tax paid products, "exempt" products and existing ordinary investment policies would need to be excluded.

Further, as the RBT acknowledges, if a full imputation system is to apply, then there will be a need to make franking account adjustments in relation to existing life investment policies. Adjustments will be required to exclude future credits to the extent that existing policies retain their existing treatment. Care would need to be taken to ensure that the amount of franking credits cancelled under this approach is not greater than the tax generated by the bonus credited. For example, unrealised gains and tax preferences would have been credited as bonuses to policyholders.

The RBT (para.34.75), suggested that franking credits in relation to tax paid should be allocated to new ordinary investment policies and shareholders on the same basis that tax is allocated for regulatory purposes. IFSA has followed the Government's proposed approach for allocating investment earnings in making our Chapter 2 suggestions in regard to Superannuation business. We propose that the basis adopted for investment earnings should also be used as the basis for allocating incoming franking credits on the investments.

In order to allow life companies to compete on a level basis, we submit that life companies, like public unit trusts, should be permitted to distribute tax preferred income to policyholders without those policyholders having to pay tax. Of course, if tax preferred income is to no longer exist, then this mechanism would not be required. If tax preferred income is to continue, then we fail to see why it should not be available to investors who pool their resources via a life company.

3.5. Taxation Treatment of Existing Ordinary Investment Policies

Option 1: Discussion Paper 2, paragraph 35.69. Apply the current taxation treatment.

In ANTS, the Government proposed that "individuals holding policies before the commencement of the entity tax regime would continue to attract the current treatment of their bonuses after commencement: exemption for policies held for more than ten years and assessment and rebate arrangements for policies held for less than ten years".[9] Option 1 is the option that fulfils this promise. However, IFSA does not believe policyholders should not be given the option to seek new treatment.

This is IFSA's preferred option. IFSA believes that it is to be preferred because it makes no changes and therefore honours policyholder expectations at the time of taking out the policy.

[9] *Tax Reform: not a new tax, a new tax system*, p 121.

Further, by making no changes, it will be less costly to administer than Options 2 and 3. It also has the advantage of not having to communicate the changes to millions of policyholders which would be certain to lead to confusion and greatly increase training times and compliance costs for no purpose.

IFSA holds a strong view that rebate arrangements for surrenders under 10 years should have regard to actual tax paid - ie. 39% prior to changeover. Thus, we strongly support the proposal in paragraph 35.70 of Discussion Paper 2. We cannot support the alternative in 35.72 as this is clearly inequitable.

3.6 Transition

3.6.1. Capital Gains Tax

Under the current regime in Australia, tax is currently paid by the life company, on behalf of ordinary policyholders, in respect of all realised gains / losses on a revenue account basis. That is, the gains and losses are not determined under the capital gains tax regime, and the benefit of indexation is not allowed where the assets are held by the life company for greater than twelve months. (Note, this differs from the treatment of most assets underlying superannuation policies for which indexation of the base is recognised.)

IFSA recommends that all policyholders should be allowed capital gains tax treatment, and the benefit of indexation (if it is to continue), in relation to their investment in the underlying investments.

This would allow investment via life insurance to be placed on an equal footing with other forms of competing collective investment, ensuring neutral treatment. The current lack of indexation allows inflation to have an eroding effect on the protections and savings provided under life insurance policies, a matter which should be taken into account in the taxation system. Furthermore, the application of capital gains tax treatment should apply only to realised (as opposed to unrealised) gains and losses. If the tax rate applied to capital gains is capped, or graded as IFSA has supported in Chapter 9 of this submission then the CGT rate corresponding to a 30% marginal tax rate paying individual should also apply to life companies in respect of their ordinary business.

3.6.1.1. Neutrality and Indexation of CGT Base

It is submitted, that in the interests of neutrality and economic efficiency, the current CGT treatment for assets relating to the superannuation business of a life company should be extended to all statutory fund assets of a life company.

The appropriateness of CGT treatment has been recognised for superannuation purposes for many years and consistency demands non-superannuation investments of a life insurance company should receive similar treatment to competing products. The current treatment places life insurance companies at a competitive disadvantage with other funds managers (such as retail trusts) with respect to investment type non superannuation products. If indexation is to continue after the RBT, it should therefore be available to life companies in order to place this form of collective investment on an equal footing with both unit trust investments and direct investment generally.

Furthermore, the current treatment in Australia does not accord with the treatment in other jurisdictions, such as the UK, where indexation is allowed in determining the chargeable gain upon the realisation of most assets in life companies.

3.6.1.2 DCT Would Wash-Out the Benefit of Indexation

Assuming indexation is retained, it is submitted that the entity tax and DCT (or resident dividend withholding tax) regimes should not effectively remove the benefit of indexation for investors in collective investment vehicles, such as policyholders. Requiring full imputation of bonuses would put policyholders at a disadvantage compared to direct investors and possibly those investing via an alternative collective investment entity, due to the loss of indexation and other concessions such as building allowance and tax depreciation.

If the savings were held directly by an individual, this issue would not arise. For this reason, the announced changes discriminate against small investors who do not have the funds to invest directly or who prefer to pool their investments through specialist investment management facilities, such as life companies. Investors should not suffer the possibility of losing what is a valuable concession when wealthy individuals who can afford to invest directly will continue to gain the benefit of the concession.

Furthermore, modern unit linked policies closely resemble unit trust investments. It is therefore imperative to achieving an equitable, neutral result, that the tax treatment afforded to the investors in these products is similar. The Federal Treasurer has already agreed, in principle, that collective investment vehicles, such as widely held unit trusts that annually distribute all, or almost all, of their income, are not to be subject to either the entity tax or DCT regimes.

The application of the entity and DCT regimes to holders of unit linked ordinary life policies is as inappropriate as it is to collective investment vehicles.

3.6.2. Averaging Relief

Where a low income policyholder receives the proceeds under a long term savings policy including the accrued bonus, the amount of that bonus, which is required to be included in the policyholder assessable income, may be of sufficient magnitude to cause the policyholder's marginal tax rate to rise by one or more tax brackets. This outcome is similar to that which would be the case where a low income earning taxpayer disposes of an asset subject to capital gains tax. In that instance, Parliament has specifically provided an averaging mechanism which minimises potential bracket creep.

Since the majority of the industry's policyholders are low income earners, IFSA believes that the introduction of an averaging mechanism is essential if these policyholders are not to be disadvantaged on the maturity of their policies.

In IFSA's view, a system of averaging should apply to bonuses received in respect of policies of life assurance to ensure that low income policyholders who may receive such amounts are not disadvantaged. The averaging could be calculated on a basis similar to that applying to capital gains. Alternatively, and in IFSA's view preferably, the averaging could be calculated by applying an average marginal tax rate, determined over the preceding ten years of income, to the amount of the bonus.

3.6.3. Financing Costs for Investment Policies

The cost of financing an investment in a life insurance policy should be placed on an equal footing with other forms of investment. Specifically, this would require repeal of s.67AAA of the *Income Tax Assessment Act 1936.*

3.6.3.1. Deductibility of Financing Costs

Section 67AAA(2) currently provides that financing costs in relation to a premium for a life assurance policy are not deductible unless:-

- the whole of the premium received by the insurer is a risk premium; and
- each amount which the insurer is liable to pay under the policy would be included in the taxpayer's assessable income if it were paid.

IFSA notes as part of the ANTS package it is proposed to address the "current inconsistencies and uncertainties associated with the tax deductibility of interest".[10] In this context s.67AAA should be repealed.

Life insurance policies which are used as a form of investment by policy holders should be treated in the same way as other forms of investment, such as unit trusts. Thus, in accordance with the ordinary principles in relation to tax deductibility, the cost of financing an investment in a life policy should be tax deductible, particularly as under the ANTS proposals, the earnings attributable to new policies will become taxable either as they accrue, or upon distribution.

It is also submitted that the deferral of the taxation in the hands of the policyholder of the earnings until distribution should not prevent the cost of financing the investment from being immediately deductible.

Generally, outgoings are deductible under s8-1 provided they are incurred in gaining or producing assessable income or in carrying on a business for that purpose, except to the extent to which they are of a capital, private or domestic nature or incurred in gaining or producing exempt income. The fact that interest expenditure is deductible has long been recognised by the courts.

In *FC of T v Total Holdings (Australia) Pty Ltd 79 ATC 4729*, Lockhart J stated that:

> *The question whether interest is actually incurred in gaining or producing assessable income is one mainly of fact...In my opinion if a taxpayer incurs a recurrent liability for interest for the purpose of furthering his present or prospective income producing activities, whether those activities are properly characterised as the carrying on of a business or not, generally the payment by him of that interest will be an allowable deduction under sec. 51.*

Although the income which arises from life assurance policies tends only to arise at a later time, it is clear from the authorities that this would not constitute an impediment to deductibility as such (refer *FC of T v Finn (1961) 106 CLR 60*, and *Fletcher v Federal Commissioner of Taxation 1991) 173 CLR 1*, where the Court held that:

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10 *Tax Reform: not a new tax, a new tax system*, p 126.

> *A point to be made about s 51(1) is that the reference in it to 'the assessable income' is not to be read as confined to assessable income actually derived in the particular tax year. It is to be construed as an abstract phrase which refers not only to assessable income derived in that or in some other tax year but also to assessable income which the relevant outgoing 'would be expected to produce.'*

More recently, this has been confirmed by the High Court in *Steele v Deputy Commissioner of Taxation (1999) HCA 7*, in the joint judgment of Gleeson CJ, Gaudron and Gummow JJ which stated that:

> *Undisputedly, it is evident that interest expenses for which the borrowed funds are expended for the purposes of gaining or producing assessable income would be deductible under s8-1, even though the income may not be gained in the year the expenditure was incurred and may only crystallise in the future.*

The immediate repeal of s.67AAA is therefore more than adequately justified in order to place investors in life policies on an equal footing with other investors.

3.6.4 Deductibility of Management Fees to Policyholders

The treatment of commissions or other fees (in effect) paid by the policyholder should accord with the treatment of expenses of this nature incurred by investors in other forms of collective investment.

Given that IFSA agrees the investment income in respect of a new life insurance product is to be included in the assessable income of the policyholder, it is also appropriate that the policy management fees be tax deductible to the policyholder in accordance with the ordinary principles in relation to tax deductibility of outgoings. Further, the fees will clearly be part of assessable income to the life company shareholders so that fees (net of expenses) will be taxed at the general corporate rate. While the fact that the fees are assessable in the hands of one taxpayer is not necessarily determinative of whether the fees should be deductible to the payer, deductibility of the fees would ensure consistent treatment overall.

It is submitted that the current non-deductibility of the management fee component of premiums places life insurers at a competitive disadvantage to the offerers of other forms of collective investment and prevents a neutral treatment as between life insurance and any other form of investment where management fees are deducted in accordance with general principles.

In order to place this principle beyond doubt, it is recommended that specific legislative recognition be made of the tax deductibility of management fees paid as part of a premium in relation to a policy of life insurance that includes an investment component (as opposed to a pure risk policy).

3.6.5 Risk Component of Policy Benefits

At present, amounts paid in respect of death are not usually assessable. This would change under the Government's proposal. Amounts representing bonuses on investment earnings may become taxable whereas amounts representing the proceeds of risk insurance would remain untaxed, as at present. This will require the proceeds of "bundled" policies to be clearly separable into a risk component and an investment component. IFSA notes that the investment component will be subject to a tax adjustment. This may be either up or down, depending whether the policyholders average marginal rate is higher or lower than the entity rate used as a withholding tax. This is a change which the Government will need to explain to taxpayers as it may be seen as a form of "death duty" or "inheritance tax".

3.6.6 Recording of Details for Policy Tax Purposes

The system envisaged in the Discussion Paper 2 will require a substantial increase in the amount of records kept for each policy by a life company. In the form set out by IFSA in this submission, the company may need to record the following information, or at least be able to generate it when the proceeds of an investment policy are to be paid out.

1. the realised gains earned by each policy
2. plus the CGT indexation applying to those
3. plus the unrealised gain
4. plus the indexation with respect to the unrealised gain
5. plus any other tax preferred amounts
6. plus any overseas earnings.

In effect, the whole regime becomes like a unit trust. Whilst life companies have not needed to record this level of detail in the past, most have experience already in managing unit trusts. Setting up the necessary recording systems would be part of the policy redesign that appears to be almost inevitable as a result of these tax changes. IFSA comments in the next section on the need to allow a realistic timeframe for the implementation of those major changes - eg. systems development, training for staff and agents and rewriting of point of sale and marketing materials.

3.6.7 Suggested Commencement Date to be 1 July 2001

3.6.7.1 Long Lead Time Required

There is going to be a formidable workload in altering life company practices to cope with the new tax system. This will include completely new design of policies, development of new systems to administer policies according to the new tax basis, new accounting systems to record the information, possible establishment of new statutory funds and complete retraining of staff and agents. Equally considerable system changes and retraining will be required at the ATO and possibly at APRA and ASIC. Industry estimates are that the time and effort to set-up those changes will be at least as much as for the superannuation surcharge and not much short of Year 2000 rectification work.

IFSA requests that the start date of the new regime should be a minimum of one calendar year after the passage of the legislation. It needs to be a year after the passage of legislation, not after the release of draft legislation. Experience with superannuation changes over the last decade is that late changes are often introduced in the Parliamentary debate - eg. to correct problems uncovered during the final review process. The timetable for the RBT envisages passage around the end of 1999, hence IFSA suggests 1 July 2001 as a suitable target implementation date. This should allow sufficient time to redeploy resources at present engaged in Year 2000 work onto the tax changes.

3.6.7.2 Use the Same Start Date for All Companies

The life industry is notable for the number of participants using substituted accounting dates. Fiscal years ending either at 31 December or 30 September are common. The ANTS proposal for entity tax talked about implementation of the new tax rules being based on reporting years. IFSA life insurer members have considered this possibility. Their view is that this would create competitive advantages and disadvantages. Early balancing companies would have their lead time foreshortened, and the target implementation date will already be difficult to achieve. On the other hand, late balancing companies would gain an advantage from a longer lead time, and a later start on the new tax basis. In the interests of competitive neutrality, IFSA therefore recommends that the new rules should start for everyone from the same date. This should be 1 July, matching the ATO’s standard fiscal year. For companies with substituted accounting periods, this will mean part of their transition year being on the old tax rules and part of the new. There is precedent for this, with the introduction of tax on superannuation earnings in the 1980’s.

IFSA members are willing to work towards a uniform start date of 1 July 2001, in the expectation that this will give them a lead time in excess of twelve months.

3.6.7.3 Delay in Legislation Must Delay Start Date

Whilst IFSA has suggested a start date of 1 July 2001 above, we would remind the RBT that in practice a one year lead time is our requirement. If the legislation is delayed, the implementation date for life companies will have to be put back. For example, if legislation is not passed until the second half of 2000, the implementation date should become 1 July 2002.

3.6.8 Stamp Duty on Life Policies should be Abolished

Unlike other parts of the financial sector, insurance (including life insurance) will not, under the proposed changes to income tax (and the implementation of GST), benefit from offsetting reductions in transactions taxes. IFSA see no reasonable basis for the distinction that has been made between other areas of the financial sector and the insurance sector in selecting the particular financial transactions taxes, mainly levied at the State level, to be removed as part of the offsets for the GST. The case for removing the State stamp duties on insurance is essentially identical to that for removal of other inefficient transactions taxes, such as financial institutions duty and debits tax. Such taxes are expensive to collect relative to the revenue raised, there are gross inconsistencies between States and in State practices and interpretations. For life companies, there is an adverse effect on their competitive position, vis-a-vis providers of other financial products.

4. ENTITY TAXATION FRAMEWORK FOR LIFE COMPANIES

4.1 Executive Summary

The discussion in earlier chapters has concentrated on the tax payable by policy owners. Entity taxation requires that the tax forwarded by the life company each year will be made up of both the tax deducted in respect of policies and that deducted in respect of shareholders. In this chapter, we concentrate on how the shareholder aspects are to be combined with the policyholder aspects.

IFSA agrees with the principle that the income derived by a life company that is attributable to shareholders should be taxed in a similar manner to income derived by shareholders of other companies. Furthermore, we accept that the profits attributable to shareholders should be taxed at the life company level at the general corporate tax rate. The two main issues therefore are how to identify the profits that are attributable to the shareholders, as opposed to the policyholders, and when the new basis of taxing shareholders should commence. The second issue is not a trivial one. To the extent that an increase in shareholder tax will be passed on as extra charges to policyholders, timing differences could potentially overturn the Government's objective that existing policyholders should be minimally impacted by the tax changes.

A number of comments in relation to the determination of the shareholder income are made below, including comments in relation to the appropriate methodology for assessing the underwriting income of a life company.

Notwithstanding past difficulties in determining taxable shareholder income, it is our view that with the advent of more sophisticated systems and more transparent products, a reasonable basis for the taxation of shareholder profits can now be designed. This should involve close consultation between Government and industry experts. The aim of the consultation would be to define income in a manner which is acceptable to the Government but which does not disrupt the position of policyholders.

4.1.1. Identifying Shareholder Profits

4.1.1.1 Allocation of Investment Income between Shareholders and Policyholders

It is submitted that the current legislative requirements, embodied in s.79 and 80 of the Life Insurance Act 1995, for apportionment of items of income or outgo between classes of businesses, would provide a sound basis for the allocation of income, at the first level, as between policyholders and shareholders. The Act requires that all income attributable to statutory funds must be determined on an equitable basis and in accordance with generally accepted accounting principles. Furthermore, the written advice of the company's appointed actuary must be obtained concerning the appropriateness of the method of apportionment and the basis of apportionment must be signed off by the approved auditor.

The next level of allocation will then require consideration of the additional profits, such as underwriting and management fee profits, that are to be taxed in the hands of shareholders (and in some cases, participating policyholders).

4.1.1.2. Reform Proposals - Other Types of Shareholder Income

Under the ANTS proposals, the tax base for life insurers would be expanded to include all net income from funds management, underwriting and other sources derived from managing life insurance and annuity business.

4.1.1.3 Underwriting Income

The taxation of underwriting income, at the corporate rate and at the life company level, is accepted in order to achieve consistency of treatment as between the shareholders in life companies and general insurance companies. Taxation of the underwriting income of a life company should therefore be comparable with the basis used in relation to general insurance business, with some minor variations. As outlined in IT 2663, this involves, in general terms:-

- net premium income being apportioned over time in relation to the spread of the risk exposure over time;

- claims and actuarially determined provisions for claims outstanding at the end of a year being treated as deductible; and

- acquisition and general management expenses also being regarded as deductible.

In relation to the particular circumstances of life insurance, the annual increase in calculated policy liabilities would also need to be regarded as deductible. A net decrease in the calculated policy liabilities, on the other hand, should be included in the assessable income of the company.

The policy liability to be used in this calculation should be the solvency requirement as set by the LIASB and audited in the company’s annual valuation process.

This model is already used in relation to the taxation of the accident and disability business of life companies. The preferred Option 1 (paragraph 34.22 of Discussion Paper 2) should achieve a broadly comparable result.

4.1.1.4 Income from Managing Pensions and Annuities

IFSA broadly supports the proposal to tax the profits made by life companies on their immediate annuity and pension business, but to leave the “interest” paid to annuitants to be taxed once only, in the hands of the annuitant.

IFSA also supports the methodology proposed to determine the “interest” paid to fixed term and lifetime annuitants, which is then exempt from tax at life company level. (In Chapter 2 of this submission IFSA has discussed how that methodology can also be applied to other identifiable classes of life insurance policy business).

Allocated annuities are, however, more complicated. Quite often the assets backing allocated annuities are a combination of equities, interest-bearing securities, derivatives and other assets. The annuitant’s “account” is debited or credited according to the movement in the market value of the assets backing the policy. This amount is easily determined, and we support the proposal in paragraph 34.51 to determine the interest component of the annuity by reference to the amount credited to the account in the particular year (adjusted for unrealised gains and losses). This method has the advantage of reflecting actual entitlements.

We do not support the proposal in paragraph 34.48 to apply the "methodology for variable interest debt" to allocated annuities. This method is not only difficult to apply, but also will distort the allocation of income between policyholders and shareholders, when the actual allocation is readily available. The minimum payment rule was designed to ensure that policyholder amounts could not accumulate excessively within the tax free environment, which should address any tax deferral concerns the RBT may have.

In calculating the profits made by life companies on their pension and annuities business, transitional measures will be necessary to ensure that it is only profits arising after implementation date that are subjected to the new tax. This will involve provisions similar to those required when superannuation first became taxable, which exempted income accrued before 1 July 1988 (section 110B of the 1936 Act), and provided for CGT assets to be deemed to have been acquired on 1 July 1988, with appropriate cost base rules (sections 110 and 306-315 of the 1936 Act). It should be noted that equivalent provisions for revenue account assets will be required here.

4.2 Taxation Framework for the Life Company Entity

4.2.1 IFSA Supports Option 1 - Para 34.22

Paragraphs 34.20 to 34.42 of Discussion Paper 2 discuss how the taxable income of the life company should be calculated. Embedded in this discussion is consideration of the appropriate tax basis for the income of the company, representing the interests of the shareholders.

IFSA endorses Tax Policy Design Principle No 4, as set out in Discussion paper No.1 (p xx, and p74) under the heading "Integration of ownership interests - for business tax purposes, entities should be considered as extensions of their ultimate owners". Thus, IFSA accepts that tax at entity level is the first step. Income received by the shareholders, in the form of direct income through dividends or as capital gains through sales of shares, should eventually be taxed appropriately at each shareholder's marginal rate of income tax, or at alternative rates applying to capital gains.

Three options are given in Discussion Paper 2 for calculating the taxable income of a life insurer. Of these, IFSA prefers Option 1, although we believe some modifications to the calculation process set out in paragraph 34.22 are essential to make the process work correctly. These modifications also slightly alter the overall approach taken by the RBT in Option 1

These needs are best demonstrated by developing the appropriate formula. The algebra behind this derivation is given in the next section. We have also included numerical examples in Appendix A showing how the calculations work in practice for different types of policies.

4.2.2 Derivation of Accurate Formula

The aim of the proposal set out in paragraph 34.22 is to levy tax at the corporate rate for the <u>whole company</u> on:

(i) investment income, plus

(ii) fee income, less

(iii) allowable expenses (including claims under policies), plus

(iv) underwriting profits.

The major part of most companies' investment income is attributable to policy holders. Policy benefits are reduced by the tax on such income. The balance of investment is effectively retained by the shareholders.

Accordingly, the effect is for shareholders to bear tax at the corporate rate on:

(1) total investment income, less income attributed to policyholders, plus

(2) fee income, less

(3) allowable expenses, plus

(4) underwriting profits.

IFSA supports this general framework, although we believe some relief will need to be given in respect of shareholder support to business in force at the date of changeover - Refer Section 4.3. The derivation following can be restricted to new business if necessary.

Shareholder Tax

The basic intention of the Government proposals is that all shareholder income will be taxed at the corporate tax rate, ie.

Taxable Income attributable to Shareholder
x Company Tax Rate (currently 36%)

In principle, this is consistent with the tax structure applicable to other business entities.

Policyholder Tax

Discussion Paper 2 recognises the need to make special allowance for types of business where policyholders should be taxed at a lower rate than the corporate rate. These include immediate annuities and pensions, and RSAs.

In this submission, IFSA has recommended that policyholder benefits under superannuation policies also be exempted from the Business Entity Tax Regime. (We have recommended that such business continue to be taxed at 15% at source).

IFSA's reason for supporting the adoption of Option 1, in principle, is that this option appears closest to focusing on taxing shareholders on the profits of life companies.

The adjustments suggested below are simply those necessary to ensure that it is <u>distributable</u> profits which are taxed, and to recognise where policyholders' tax is applied at a different rate from that for the shareholders.

The Adjusted Formula

Option 1 requires taxable income (TI) to equal Premiums (P) + Management Fees (F) + Investment Income and other income (I) - Expenses (E) - Policy Claims (C) - [Increase in the value of Policy Liability ($\blacktriangle$L) - Policyholders' Taxable Income (PTI)], ie.

$$TI = P + F + I - E - C - \blacktriangle L + PTI$$

To determine these items in a robust manner, it is desirable to utilise numbers from statutory returns as far as possible. These amounts have been statutorily validated. They are subject to independent audit and sign off by the appointed actuary as a requirement of the Life Insurance Act 1995.

For this purpose, it would be usual for the fees described as Management Fees in Discussion Paper 2 to be deducted from the policyholder "accounts" - whether under an investment linked policy or an investment account policy. Thus, the increase in the policy liabilities in the formula is an amount determined <u>after</u> the deduction of these Management Fees.

To include the item (F) in the formula would effectively "double count" such fees in determining shareholder taxable income, when utilising the statutory accounts numbers.[11]

It is noted that the increase in Policyholders Liabilities ($\blacktriangle$L) will have been reduced by the amount of taxation attributable to policyholders (PT). This will need to be added back for the purpose of determining the increase in policy liabilities deduction in the formula.

Accordingly, we suggest that the formula be restated:-

$$TI = P + I - E - C - (\blacktriangle L + PT) + PTI$$

where "I" is investment income plus all other income which does not correspond with amounts which have been debited to policyholders' accounts.

The total taxable income for the company in this formula may be said to equal the sum of :-

(i) Shareholders' Taxable Income (STI) = P + I - E - C - ($\blacktriangle$L + PT), and

(ii) Policyholders' Taxable Income (PTI) = Policyholders' Investment Income (PI) less Fees (F)

where both elements are taxed at the company tax rate of 36%.[12]

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[11] We have assumed that all fees payable by policyholders will be deductible to them. Our arguments in support of this position have been given in Section 3.6.4 of this submission.

[12] Note, that as IFSA has pointed out in earlier submissions, where both elements are taxed at 36%, the sum of tax payable on both shareholder and policyholder income becomes t x (I-E). This means that the t x (I-E) formula currently used to calculate tax does, in fact, (and contrary to the assertions in ANTS and Discussion Paper 2), already tax both management fees and underwriting profits for "bundled" business. As this point seems to be generally misunderstood, we have repeated the proof in Appendix B.

Need to treat separately with policyholder and shareholder income

To allow for the different rates of tax attributable to RSA accountholders, immediate and deferred annuitants, and, as proposed in this submission, superannuation policies, PTI will need to be made equal to (PI - F) x PTR/0.36 where PTR is the policyholders'/accountholders' tax rate.

The formula for Taxable Income (TI) to be taxed at 36% would then become:-

$$TI = P + I - E - C - (\blacktriangle L + PT) + (PI - F) \times PTR/0.36$$

Note 1: This is equivalent to the basis which currently applies to the determination of taxable income for RSAs.

Risk Business

Under Risk Business, there is no policyholder tax. Accordingly, the last two items in the above formula fall away, ie. PT and (PI - F) x PTR/0.36.

Note 2: Option 1 then corresponds with the regime currently applicable to the Accident and Disability business of Life Insurers, and all the business of General Insurers.

4.2.3 Option 1 Advantages and Disadvantages

Some advantages of Option 1 are set out in Discussion Paper 2. To these should be added the consistency of treatment for all life insurance business, and the avoidance of the need to separate the calculations in respect of "bundled" investment and risk policies.

The disadvantages noted in the paper comprise essentially:-

(i) uncertainty with regard to the determination of the actuarial liabilities,

(ii) the need to exclude investment income from the change in actuarial liabilities, and

(iii) identifying adjustments to avoid duplication of income or deductions in the calculation of taxable income may be difficult.

These can all be addressed by the methods suggested by IFSA, as we show below.

Use of Solvency Requirement for the Policies (SRP) as "Actuarial Liabilities"

Paragraph 34.42 of Discussion paper 2 asks for comment on the appropriate method for valuing policy liabilities for taxation purposes. IFSA recommends that the Solvency Requirement be used.

The Solvency Requirement is the amount of assets required to meet the statutory Solvency Standard. The basis is prescribed by the Life Insurance Actuarial Standards Board (LIASB) in its standard AS2.01. Using this basis for policy liabilities leaves negligible room for uncertainty with regard to the calculation, or for manipulation.

The Solvency Requirement includes the value placed on non policy liabilities, so this should be deducted to arrive at the Solvency Requirement for the policies (SRP). Other similar adjustments may be required.

Note 3: SRP effectively represents the current termination values of the policies together with prudential margins. As such, it corresponds with the value of liabilities adopted in the determination of tax for General Insurers. For Life Insurers, it reflects the current approach adopted for the taxation of Accident and Disability Business.

With regard to disadvantage (i) we submit therefore, that the use of the Solvency Requirement for the policies, as calculated for Statutory purposes, as the "actuarial liabilities", is particularly suitable for the purpose of determining a Life Company's taxable income.

With regard to disadvantage (ii), the suggested adjustment to the formula indicates that policyholder income must be calculated anyway as it forms the basis of the calculation for taxation attributable to policyholders, and so will be readily available.

For non participating business, the prudential margins will be represented by Shareholders Capital and Retained Profits. However, the Option 1 formula, modified as suggested, will still levy tax at the corporate rate on the income from the assets representing <u>all</u> Shareholders' Capital and Retained Profits. The existence of the prudential margins in the "Actuarial Liabilities" only serves to defer taxation, which is justified as such amounts are not distributable.

As regards disadvantage (iii), adjustments to avoid duplication of income and deductions, we believe these can be readily identified.

4.2.4 RSAs, Annuities, Superannuation Business

Under the proposals in the paper, the business of RSAs and Annuities would be "quarantined" in such a way as to ensure that the policyholders' investment income was taxed only at 15% and 0% respectively. IFSA is proposing that this approach also applies to superannuation business, including deferred annuities.

The Option 1 formula, adjusted in conjunction with the use of the Solvency Requirement for the policies as the actuarial liabilities, operates appropriately for the purpose of determination of taxable income for this business.

4.2.5 Participating Business/Discretionary Business

The management of this business demands the retention of some profits to assist in the smoothing of bonus and interest crediting rates. Such Retained Profits may comprise a mix of both Policyholders' and Shareholders' Retained Profits.

Policyholders' Retained Profits represent an additional "collective" form of amounts due to Policyholders and should therefore be added to the Solvency Requirement for policies for the purpose of determining actuarial liabilities.

In the case of RSA and Other Superannuation business subject to the 15% tax regime, this procedure will result in the investment earnings on such Policyholder Retained Profits being taxed at 15%. This is consistent with the treatment of tax on investment earnings from surpluses in Superannuation Funds.

4.2.6 Unrealised Gains

Under the current tax regime, investment gains are only taxed on realisation. This is consistent with the well established principle of levying tax when the benefit is received. It also recognises that, until an investment is realised, there is no cash available to pay tax on any gains.

The investment income (I) and the Policyholders income (PI) in the Option 1 formula cannot therefore be obtained directly from accounting entries for Financial Statements as these include (by virtue of statutory requirements) unrealised gains.

Suitable adjustment will therefore be required to these items to exclude unrealised gains arising during the financial year, ie ▲UG, and ▲UGP, for total amounts arising, and amounts attributable to policyholders respectively. ▲UGP will also need to be adjusted if the policyholder tax rate is other than 36%, ie. to ▲UGP x PTR/0.36.

The Policy Liability will have been reduced by the increase in the deferred tax reserve attributable to policyholders, ie. ▲DTRP. This should be added back for the purpose of determining the increase in Policy Liability deduction in the formula.

Revised Option 1 Formula

Allowing for the above adjustments, the Option 1 formula becomes:-

Total Taxable Income = shareholders taxable income and policyholders taxable income.

TI = P + I - E - C - (▲L + PT + ▲DTRP) + ▲UGS + (PI - F - ▲UGP) x PTR/0.36

Numerical illustrations, demonstrating the practical application of this formula for different product types, are enclosed as Appendix A to this submission.

4.2.7 Further Development Work

While we have included a reasonably detailed derivation of the tax formulae, we believe further development work will be needed to ensure all details are agreed. This should be conducted with wide consultation between experts from Government regulators and the industry.

4.3 Protecting Promises to Policyholders

IFSA strongly supports the intention, implicit in ANTS, of ensuring that the expectations of existing policy owners should not be disadvantaged by the change to an entity tax basis for life companies. Policyowners have effected long term contracts in good faith. Often the terms of their contracts are locked in. Neither the policyowners, nor the life company (ie. the shareholders) can breach those contracts without penalty. Any external influence that would break the sanctity of the contract would be retrospective in its effect.

IFSA believes that the impact of the proposed entity tax changes on life insurers would cause serious retrospective damage of this kind. We recommend below measures to correct this impact. To do otherwise would fail the test of practicality set out by the RBT:

"It would be impractical to apply any new rules to existing arrangements entered into before the commencement date. Many of the options discussed are not sensibly capable of being applied to existing transactions... In other cases, retrospective application would alter expected commercial outcomes and impose significant compliance costs."[13]

Also, the effect of these reforms would be to make the tax base incorrect for existing insurance contracts.

4.3.1 Existing tax base is correct for ordinary contracts

The existing system for taxing ordinary business (that is income minus expenses or I-E) produces a result that appropriately taxes the joint interest of policyholders and shareholders for ordinary business (refer our Appendix B).

The taxable income of life companies in this class of business includes income that is to be assigned or otherwise distributed to policyholders. This is the long established trustee principle, where the insurer pays tax on behalf of the policyholder. Under this regime, transactions are excluded from the tax base where they are between the life insurer and the policyholder. Transactions are included in the tax base only where they involve third parties. In simple terms, this means that the management fees transaction between the policyholder and the life insurer offset each other.

The proposed basis for taxing existing ordinary policy owners under ANTS is to remain unaltered. So, if an additional element, the management fee, is identified and becomes taxable as shareholder income, that will introduce an element which is <u>already included</u> in the tax base. This will cause the tax base to be incorrect.

That would then make these contracts competitively non-neutral with other investment media as they would be over taxed.

4.3.2 Need to Ensure Equitable Results for Policyholders

The basic RBT proposal (with which we do not disagree) is to tax all shareholder income referable to life insurance business at the corporate rate of tax. What appears not to have been understood is that the changes proposed by ANTS would actually affect both shareholder and policyholder returns on established business, as they would change one of the fundamental assumptions on which the policies were written. To the extent that they impact existing policies, the changes are retrospective. The following factors are important in understanding how policyholder and shareholder factors are linked in life insurance:

- Life insurers have expended considerable sums of money in establishing their in-force business. Most of this procurement expenditure has already been incurred and has received only limited tax relief under the current regime. Future revenue from in-force business is to a large extent recovering the establishment costs of the business.

- Existing investment and insurance contracts have been sold to policyholders on the basis of the current tax regime. They have been priced after taking into account the tax outcomes for both policyholders and shareholders under the current regime.

[13] P. 229, Discussion Paper No 2.

Premiums, sums insured, fee structures, policy benefits, guaranteed investment returns, fixed future premium rates, guaranteed annuity payments – have all been set with reference to the current tax regime. Application of the new regime to existing business would require renegotiation of existing policies, to restore fairness in the new environment.

- A good example of the difficulties faced with existing policies is immediate annuity policies. These policies are unique to the life insurance industry. They are sold, predominantly to retirees, on the basis of guaranteed income payments over the life of the policy. One of the factors that goes into determining the level of income that can be paid to the annuitant, is tax on life company earnings. Some contracts have a clause providing that if there is any relevant change to the tax system, income payments can be adjusted accordingly. It is difficult to anticipate how all companies will react, but it is more than likely that, where it is possible, any increase in tax will be passed on to annuitants in the form of a reduced income stream. Some contracts, however, do not allow for any changes, in which case the tax will be borne by the shareholder. Because they are guaranteed, neither party can exit these policies without penalty.

- Another unique facility offered to investors by life companies is capital guaranteed products. These too have been entered into as long term contracts. Often they are "participating" products, ie. the policyholders participate with shareholders in the fortunes of the business. The Life Insurance Act requires that a minimum of 80% of the profits must belong to policyowners. Thus, any move to tax either underwriting profits or the fees charged through premiums would, in fact, flow through 80% to policyowners.

- Few contracts are cancellable without some sort of penalty on the part of the policyholder - whether it be the loss of opportunity to recoup up-front fees, entry costs of new investments, or reduced payouts to reflect interest rate changes. Even term life cover, which is renewable annually at the option of the policyholder (if the policyholder elects to renew, the life company has no option but to honour the election), can have a cost associated with it, being the loss of guaranteed renewability.

IFSA submits that the application of the new regime should, on equitable grounds, be restricted to new business. To impose the tax on existing business would be unreasonable and disruptive.

Similar protections have been applied to changes in the depreciation regime – existing assets have the old rules applied because businesses have already committed and spent their funds in acquiring equipment - knowing what their tax outcome will be. It is right that they are protected. Life insurers have already "spent their money" in establishing their in-force business. Similar protection of in-force business should therefore apply.

4.3.3 How would protection be applied?

4.3.3.1 Two possible methods

There are two possible approaches to the protection of interlocking policyholder/shareholder interests.

1. Apply the current tax regime to shareholder income streams from existing business; or

2. Apply the new regime to all business but with adjustments to apply the protection to established polices– a "protection adjustment".

IFSA prefers the second approach as it will obviate the need to maintain two tax systems.

Under this approach, shareholder taxable income would be calculated by applying the new regime and then making deductions in respect of fee income, underwriting profit and expenses referable to existing business that is to be protected. These deductions would be calculated to restore the existing business to the same tax status as under the present (I-E) basis of combining shareholder and policyholder tax calculations.

For superannuation business, the existing group business has been priced allowing for a normal flow of exits from, and new entrants into, plans and allowing for expected future salary increases of employees. All such day to day operational effects would be included in the grandfathering provisions.

4.3.3.2 Which business should have protection applied?

The annuity and capital guaranteed products discussed in 4.3.2 provide the clearest example of inequity to investors causing a failure in the integrity of the Government's commitment to protect existing policyowners. IFSA would not want to compromise on protecting these policyholders.

Investment linked policies are also long term in nature and the proposals would have significant impact on these. A different approach to these policies, such as a grandfathering for a period of 7 years (reflecting the average life of these contracts) would be appropriate for management fees and underwriting profits. This would allow time for policyholders and life companies to make orderly adjustments and minimise market disruption. There is recent precedent for a seven year transition to taxing of existing contracts in the Government's proposals for introduction of GST.

We have summarised in the following table the different types of products that would need to be considered, and our initial thoughts on protection measures.

Product Type	Protection of Shareholder Income Applied To	How is Protection to be Applied?
Ordinary -		
Capital Guaranteed Savings Account (conventional, investment account)	Existing policies to be protected.	Existing taxation basis to be retained, by adjustment
Other ordinary savings and investment business (unit linked).	New tax basis to be introduced after 7 years.	Existing taxation basis to be retained for 7 years, by adjustment.
Annuities.	Existing policies to be protected.	All profits referable to existing business to continue to be treated as exempt from tax.[14]
Superannuation -		
Capital Guaranteed retail super and deferred annuities.	Policies covering existing members to be protected. New policies to be issued for members added after commencement date.	Profits referable to existing business to continue to be taxed at 15%.[15]
Other super (unit linked).	New tax basis to be introduced after 7 years.	Existing taxation basis to be retained for 7 years, by adjustment.
Annuities	As per annuities above	

4.3.3.3 Further Development Work

While we have tabulated our initial proposals above, we believe further development work will be needed to ensure all details are agreed. This should be conducted with wide consultation between experts from Government, regulators and the industry.

4.4 Shareholder Earnings on Excess Capital

IFSA accepts that investment earnings on shareholder excess capital should be subject to the new regime from the commencement date. These earnings are not earmarked to support policies, and this element of shareholder income should be outside the protection regime discussed in 4.3.

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[14] Profits from investing existing shareholder capital not supporting this business (ie: that in excess of solvency requirements) will be taxed at corporate rates.

[15] Policies held by employer funds and other external funds, in respect of which life companies do not have access to member information.

5. COLLECTIVE INVESTMENTS

5.1. Executive Summary

IFSA applauds the Government's decision, consistent with one of the options canvassed in Chapter 16 of Discussion Paper No 2, to apply flow-through taxation treatment to cash management trusts and, in principle, other collective investment vehicles ("CIVs"). IFSA submissions in this stage of the consultative process relate to:

- ensuring that the "in principle decision to apply flow-through taxation treatment to other CIVs" is implemented, applying the taxation of direct investment by an individual investor as the benchmark and minimising the compliance costs for the CIV and the investor;

- ensuring that the definition of CIV includes all of the various types of entities which perform similar functions;

- providing for the start-up and wind-down of CIV's for the purposes of the CIV definition; and

- seeking codification of the principles of flow-through taxation.

For completeness, Appendix C sets out in detail the problems which arise for CIV's other than cash management trusts under the Government's original proposals (and reflected in some of the options raised in Chapter 16 of Discussion Paper No 2), particularly those flowing from the decision to treat distributions as dividends and to apply the deferred company tax rules to untaxed distributions.

IFSA believes that if flow-through taxation is not provided to CIVs, the proposed measures will cause tax distortions which skew the average Australian investor towards direct investment and away from highly productive assets yielding high returns (such as venture capital enterprises and small and medium size enterprises). Typically low and middle income earners do not have the ability that high income earners have to diversify investments on their own account and will lose the benefit of investment management expertise if they invest directly.

Furthermore, the measures would introduce potentially substantial tax detriments to all of the almost 3 million people who invest via public managed investment trusts, as compared to both their current tax treatment and the proposed treatment if they invest directly.

The measures would also create massive tax distortions between public managed investment trusts and direct investments, to the point where the competitive characteristics of some Australian markets are threatened and jeopardise the international competitiveness of Australia's $150 billion public managed investment trusts industry. Specifically, it would:

- place Australia out of step with and under threat from comparative international regimes; and

- undermine Australia's opportunity to become a global financial centre.

5.2. Definition of CIV

5.2.1. General - the appropriate criteria

CIV's provide access for small investors to a wide range of investments including equities (both Australian and offshore), property, fixed interest and cash.

By pooling their savings in a CIV, small investors, such as retirees, are able to obtain access to many of the investment benefits which would only otherwise be available to larger, wealthy and more sophisticated investors. These benefits include:

- capital aggregation;
- investment expertise; and
- risk diversification and liquidity.

The purpose and method of operation of CIV's is therefore quite different from discretionary trusts and family trusts. CIV's are simply a convenient and efficient mechanism for the pooling of investments which currently provide a taxation treatment broadly equating with direct investment.

In this regard, there are also significant differences between the carrying on by a company of an active business and the activities conducted by a CIV (there are existing provisions within Division 6C which operate to tax public unit trusts as companies if they carry on an active business), and there is no obvious reason why the activities of a CIV should, for any reason, be taxed other than as a proxy for direct investment.

We accept the proposal raised by the Review during the consultation that companies as well as trusts should be able to be CIVs. The other vehicle that the Review may want to consider including is limited partnerships. These are a popular way of structuring collective investments in other jurisdictions.

The collective investments industry operates by pooling assets to achieve scale and thereby reduce costs. The first risk involved in not defining collective investment vehicles broadly enough is that pools of assets will have to be broken down into smaller pools. This could threaten the profitability of small and medium sized fund managers to the advantage of the larger fund managers. It would create a barrier to entry into the industry and would reduce competition. It would also reduce the competitiveness of Australian-based products relative to foreign products.

The second risk is that fund managers may be put in the position of turning away potential clients because they could jeopardise the fund's standing as a CIV. These clients will then move to use foreign products rather than local ones.

5.2.2. Criteria suggested in Discussion Paper No 2

It is noted in Discussion Paper No 2 that CIVs would be defined as a vehicle that is:-

- widely held;
- delivers a full-flow through of annual profits to participants; and

- undertakes investments that are less of an active business nature and much more of a passive portfolio, or intermediated, nature not involving control of business operations.

Each of these criteria and their appropriate scope are addressed in turn below. IFSA would be happy to work with either the Ralph Committee or the Government with a view to determining a definition of CIV which would result in certainty for both the Government and markets.

5.2.3. How should "widely held" be defined?

5.2.3.1. Purpose

The ultimate purpose of the application of flow-through taxation treatment to CIVs is to provide a simple and equitable framework for structures which allow individuals to amalgamate their savings (both superannuation and ordinary savings) to obtain all of the non-tax benefits associated with the pooling of funds.

5.2.3.2. Criteria suggested in Discussion Paper No 2

It is proposed at paragraph 16.16 of Discussion Paper No 2 that the principles underlying the definition of "public unit trusts" in Division 6C of the 36 Act may be adopted as the basis for determining whether a CIV is "widely held". Under this proposal, vehicles would satisfy this part of the CIV criteria only if either:-

- either
    - the vehicle is listed for quotation on a stock exchange; or
    - interests in the vehicle are offered to the public; or
- interests in the vehicles are held by not fewer than 50 persons.

5.2.3.3. Submission - institutional investors inclusion as CIVs

To allow existing asset pools to continue intact, what we describe as 'wholesale clients' need to be able to invest in CIVs. Because wholesale clients invest large sums of money, a viable pool can be created with less than 50 direct unitholders.

An entity should be able to qualify as a CIV when its investors are (in addition to meeting the criteria in 5.2.3.3 above):

- **Other CIVs;**
- **Complying superannuation funds, approved deposit funds and pooled superannuation trusts** (this is the majority of wholesale clients);
- **Life companies**

  Investment business, including superannuation, is also written by life companies.
- **Non-residents**

  For Australia to be a regional financial centre writing global collective investment business, non-resident investors need to be able to be pooled with resident investors for cost reasons. Provided the withholding tax system applying to CIVs is effective, this does not detract from the integrity of the system. It is not possible to limit this to a finite list of foreign institutions because every country has different institutions and many are not easily classified under our concepts. If necessary, non-resident individuals could be excluded.

- **Charities, schools and other tax exempts**

  These institutions are a significant part of the wholesale market. Because they do not have a tax liability, including them does not reduce the integrity of the system.

- **Governments, Government agencies and statutory authorities**

  These institutions are also a significant part of the wholesale market. To include them avoids having to deal with the difficult constitutional issues.

To treat an entity as a CIV when it is 100% owned by these investors would still not allow current arrangement to persist. To leave the current market practice totally in tact, the rule should be extended to include an entity that is 75% owned by value by these types of investors.

5.2.3.4. Why have an all-inclusive CIV definition?

By incorporating this additional criteria for qualifying as a "widely held" vehicle, it is submitted that the definition of "widely held" should be broad enough to include *all* pooled investment structures in which individuals or superannuation funds hold a direct or an indirect interest. By expanding the definition outlined in Discussion Paper No 2 along the lines suggested above, the wholesale unit trust will qualify for CIV status.

Wholesale unit trusts play an integral role in the funds management industry which is best illustrated by reference to the current structure of the Australian funds management industry.

Fund managers, typically, create two major pools of assets.

The first pool – referred to as the Retail Trust pool – is the pool of assets into which individuals directly invest. The second type of pool – referred to as the Wholesale Trust pool – is the pool into which large institutional clients (the majority of which are superannuation funds, approved deposit funds, non-resident superannuation and savings funds) directly invest. In order to obtain efficiencies and economies of scale benefits, monies held by the retail pools are generally invested into the wholesale trust pools. Managers of retail trusts with small funds under management are commercially required to pool funds in a wholesale trust as the funds attributable to the individual retail trust pool do not meet the threshold levels at which the efficiencies and the benefits of economies of scale become available. In many cases, other products (ie, interests in Public Offer Superannuation Funds, Pooled Superannuation Funds and Approved Deposit Fund) are also offered by fund managers, with all monies contributed ultimately finding their way into the fund manager's wholesale trust pools.

In the majority of cases, a fund manager would typically create wholesale pools for different asset classes (eg, cash, Australian fixed interest securities, Australian equities, International equities) in order to achieve efficiencies for each asset class.

In relation to all wholesale pools, there is a distribution of income at least annually as the income needs to be passed to the investors, be they retail trust investors, superannuation funds or approved deposit funds.

There are sound business reasons why retail and wholesale investment pools currently exist, namely:-

- Lower fees are charged on investments made into wholesale investment trusts. Due to the operational efficiencies and the benefits of economies of scale involved with accepting and administering larger amounts of money, lower management fees are charged by fund managers within wholesale trusts.

- Efficient and fair financial markets which result in reduced costs to consumers was one of the principles upon which the Wallis Report was based.[16] It was specifically recognised in the Report that large scale economies which reduce costs are necessary in order for Australian mutual funds (and by extension, all Australian funds management operations) to be internationally competitive. Thus, without the cost benefits of wholesale investment pools, Australian funds managers suffer a natural disadvantage relative to their international competitors.[17]

- Different regulatory regimes apply to retail and wholesale investment trusts. Different offer documentation, as well as different reporting requirement apply to these trusts. Amalgamating retail and wholesale unit holders would simply increase the administration and compliance costs associated with wholesale clients.

If wholesale unit trusts are not treated as CIVs (assuming there would be no restructuring to direct investments) this would defeat Government's policy behind the application of CIVs to retail unit trusts.

The same cash flow costs which applied to individual unitholders of retail trusts would still exist to the extent to which assets of a retail unit trust are invested in wholesale unit trusts. [In addition, IFSA believe that the refund mechanisms put forward in Chapter 16 do not deal with the cash flow detriment in a fair and equitable manner. When compared to the existing tax regime that applies to wholesale and retail unit trusts, it is clear that the refund mechanism will simply add extensive administration costs and complexity, which will ultimately impact investment returns of thousands of Australians.]

It is also our opinion that this would result in the Australian treatment of wholesale unit trusts being out of step with international best practice, thereby hindering the attempts to promote Australian funds internationally and to promote Australia as a global financial centre for investment.

We believe that the exclusion of wholesale unit trusts from the CIV definition will have wide ranging implications for the fund management industry. It would force a major restructure of

[16] *Financial System Inquiry Final Report*, March 1997, p 2. It was also noted at p 15 that "[a] principal aim of the Inquiry [was] to achieve a more competitive and efficient financial system".

[17] Id, pp 481-482.

investments, and in particular, force those entities which use wholesale unit trusts into direct investments.

This would be detrimental for a number of reasons:-

- *It would add operational inefficiencies to existing fund management operations*

  Fund managers will be forced to manage numerous pools of assets, which will in turn, reverse the efficiencies of scale currently being passed on to all investors (both individual and institutional investors). This will lead to an inefficient use of resources within the Australian economy. It will also adversely impact investment returns (as the benefits of pooling are unwound) hence reducing the incentive to save for all Australians. This result is clearly not good for the ongoing health and well being of the Australian economy.

- *It would create significant asset shifts, market movements and distortions*

  IFSA estimate that wholesale unit trusts currently own assets in excess of $300 Billion . A restructure of these asset pools will force wholesale trusts to divest themselves of stocks and assets which a retail fund or superannuation fund may not wish to hold directly and thus incur (unnecessarily) all of the usual attendant transaction costs. This may cause significant market movements between asset classes, or specific assets within such classes – causing distortion within the market.

  At present, wholesale unit trusts are a big source of capital within the Australian economy. A reduction in portfolio sizes will mean that smaller companies (as opposed to large, listed companies) will find it harder to attract capital.

  Additionally, exclusion of wholesale units trusts from the CIV definition would create a distortion as between small and large funds managers. Large funds often have sufficient funds to obtain the economies of scale and diversification benefits resulting from large investment pools without having to invest in wholesale unit trusts. Thus, provided the large fund qualifies as a CIV it will be provided with a competitive advantage over smaller funds (that can only achieve economies of scale through investment in wholesale unit trusts). This result would be contrary to one of the fundamental principles underlying the Review of Business Taxation, that there be "[c]omplete neutrality with respect to business and investment decision-making".[18]

  None of these implications would be to the benefit of the Australian economy.

- *It would reduce the investment options available to investors*

  The existing wholesale unit trust structure also allows small superannuation funds to access investment options which may not, due to their size, be available.

  An example of this is indexed funds. Indexed funds management is a style of investment management which simply ensures that the client receives a return equal to that of a particular asset index. For example, an Australian equities index fund aims to ensure that the rate of return for that trust tracks that of the All Ordinaries Index. In order to track the relevant index accurately, a fund manager is required to have a basic "minimum" amount

[18] Discussion Paper No 2, p 11.

of funds under management. Small superannuation funds currently access this type of investment option via wholesale unit trusts. Such investment options will no longer be available to them if they are forced by the proposed entity tax regime to hold assets directly.

- **Retail Master Trusts**

  A rising share of the retail unit trust market is being captured in retail master trusts. These trusts offer the advantage of access to numerous different fund managers via one trust. Invariably, the fund manager diversification is obtained by the retail master trust investing into wholesale trusts offered by different fund managers. If those wholesale trusts were not taxed on the flow-through basis, it would be the same as not applying the flow-through basis to the widely-held master trust.

5.2.3.5. Transitional aspects of definition

The start-up phase

It is not possible for an unlisted vehicle to begin with 50 unitholders. It has to build to this point.

The entity has to know whether it is a CIV when it makes its first distribution which will be within three months of coming into existence. The 50 person threshold will not necessarily have been reached at this point.

> **Therefore, there needs to be a rule that an entity is qualified to be a CIV during the first 12 months of its existence if it expects to meet the widely-held test at the end of the 12 months.**

If a product designed to be widely-held fails to achieve this within 12 months, the product will be a significant money-loser for the product-provider and it will not have a long life.

The wind-down phase

A CIV that ceases to exist will at some point drop below the widely-held threshold, at least for a short period of time. It is not appropriate that it ceases to qualify to be a CIV for this period.

> **Therefore, there needs to be a rule that an entity that has been a CIV for two years continues to qualify to be a CIV for 12 months after it fails the widely-held test (provided that it would otherwise qualify to be a CIV).**

Losing CIV status

The system could hypothetically be that :

- once an entity is a CIV it is always a CIV; and
- unless an entity is a CIV from the beginning of its existence, it can never be a CIV.

The first limb of this would create an opportunity for people to traffic in vehicles with CIV status so is not acceptable. The test for qualifying to be a CIV therefore needs to be a continuing requirement.

There is no business need for a vehicle that switches from being a CIV to not being one. The rules are therefore only to deal cleanly with things going wrong.

Subject to the wind-down rule referred to above, to be a CIV an entity must qualify to be a CIV at all times during the year. If it does not, then we would recommend that a rule be adopted so that it pays tax on its taxable income from the start of the following year at the entity rate.

If the entity makes a distribution during the year and at that point it qualifies to be a CIV but later in the year fails the test, the distribution should be taxed as a CIV distribution rather than a distribution subject to franking and deferred company tax or something similar.

Because this distribution will not be franked but there will be tax paid in respect of this profit, this is an undesirable situation for the entity to be in. This is enough to prevent an entity intentionally getting into this situation.

The other transitional rule needed to allow an entity to deal with an unavoidable loss of CIV status is to allow a CIV to elect to cease being a CIV from the beginning of a year of income.

We do not foresee a business need for an entity that is not a CIV to become a CIV except for the situation of a CIV that has temporarily lost that status.

There can therefore be a rule that an entity that is not a CIV when it comes into existence (after taking into account the start-up phase rules referred to above) never qualifies to be a CIV.

An entity that fails to be a CIV because it did not meet the qualifying test for the whole of a year should be able to be a CIV the following year if it meets the test then.

5.2.4. Full-flow through of annual profits

5.2.4.1. Criteria suggested in Discussion Paper No 2

It is indicated at para 16.15 of Discussion Paper No 2 that “CIVs would be required to make full distributions of all income”. In the subsequent Press Release by the Treasurer it was noted that “[c]ollective investment vehicles include widely held unit trusts that distribute all, **or virtually all** [emphasis added], of their income annually”.

5.2.4.2. Submission

It is submitted that in developing the definition of "CIV", a flexible and commercial distribution test needs to be put in place such that that:-

- **in all cases, the majority of the taxable income accrued within the CIV must be distributed to unitholders, and**
- **there is accordingly no need for unnecessary and draconian anti-avoidance rules (of the type set out in para 16.15) to be put into place to deal with entities which do not distribute in accordance with the requirement set out above**

5.2.4.3. Distribution test - 95% of taxable income, within reason

The integrity of the CIV provisions should be ensured if there are rules in place requiring CIVs to annually distribute a substantial portion (if not all) of their income. With this in mind, it is submitted by us that a requirement that at least 95% of the taxable income of the vehicle (within reason) be distributed each year should provide a sound basis for the determination of CIV status.

The existing "present entitlement" provisions within Division 6 of the ITAA (1936) currently contain a strong foundation from which to work. IFSA would accordingly suggest that present entitlement clauses within existing Trust Deeds be used to show compliance with the "annual distribution" test.

The majority of retail and wholesale unit trusts currently in existence are required, in accordance with their Trust Deeds, to distribute all taxable income to unitholders. This is a legal requirement which can be legally enforced by unitholders if it is not complied with. Such legal sanctions should be sufficient to ensure the integrity of the annual distribution test. It should also be noted, that this test, in conjunction with the "widely held" test should stop any likelihood of collusion between the unitholders and trustees which would result in distributions other than in accordance with the requirements imposed by the Trust Deeds.

IFSA note that this test could present a problem for CIVs which are companies, given that the dividend policy of companies is regulated by the Corporations Law. A practical solution may therefore need to be put into place (ie, an annual distribution requirement subject to the Corporation Laws which restrict certain dividend payments to be made) to deal with corporate CIVs. IFSA would be willing to work with the Review in developing an appropriate test in relation to such vehicles.

5.2.4.4. What happens when the 95% test is not satisfied?

As mentioned above, IFSA also recommend that the "annual distribution test" provide some flexibility to deal with the inevitable non-intentional errors leading to a breach of this test so that investors are not unduly penalised.

Accordingly, it is submitted that the "annual distribution" test should include scope for the exercise of the Commissioner's discretion to allow a vehicle to continue to be treated as a CIV despite technical non-compliance with this test.

In making this submission, we draw your attention to the following matters in support of a flexible annual distribution test:-

- *Practical rules need to be put into place to assist with compliance issues*

  Competitive market pressures force many fund managers to arrange for annual distributions of income to unitholders within days of the close of the financial year. Particularly in the case of retail unit trusts, there is the need to make the distribution and provide distribution details to unitholders as soon as is practical in order to enable them to lodge personal income tax returns in July.

  This provides most fund managers with a limited amount of time to draw up accounts and calculate distribution details. In most cases, final audited accounts are not ascertained until latter (ie, post distribution). This frequently leads to a discrepancy (in most cases less than 5% of taxable income) between taxable income and the amount distributed to unitholders. Given the commercial imperatives which force early distribution, we believe that the Government should provide a practical and simple "carry forward" mechanism to deal with such differences (which arise unintentionally) without imposing draconian rules (of the type outlined in Chapter 16, particularly para 16.15 of Discussion Paper No 2).

- *Any anti-avoidance provisions proposed should be restricted to cases where there has been collusion between the Trustee, Manager and all unitholders.*

  IFSA submit that anti-avoidance rules of the type outlined at paragraph 16.15 should only be invoked where some form of collusion has taken place. Where there Trustee, Manager and all unitholders have acted with the best intention of distributing in accordance with the 95% test, the unitholders should not be disadvantaged by the application of a punitive regime.

5.2.4.5 Different unitholders receiving different returns

In response to questions raised by the Review during focus group meetings, we believe that a CIV can have different types of unitholders which are entitled to different types of returns. This is particularly the case where it can be shown that the unitholder's entitlements are linked to particular groups of assets held by the trust. We do not believe that these arrangements produce "streaming" – as the return paid to each unitholder is based on the rate of return of a particular group of assets. These arrangements are different to those which simply pay different unithholders different classes of income (eg, where Unitholder A receives interest income, and Unitholder B receives franked dividends). Hence, any streaming proposals should ensure that the arrangements outlined above do not catch normal commercial arrangements of the type outlined above.

5.2.5. Active v Passive Test

5.2.5.1 Criteria suggested in Discussion Paper No 2

The concern is raised at paragraph 16.13 of Discussion Paper No 2 that CIVs should only be those vehicles which do not hold active business investments. Thus the investments held by a CIV should be of a passive portfolio or intermediated nature so as to ensure that CIVs are not in a position to deliver competitive advantages to their investors, as opposed to the investors in other vehicles engaged in "active" business.

IFSA note that this criteria was not specifically mentioned in the Treasurer's Press Release of 22 February 1999 in which it was announced that the Government had decided, in principle, to grant "flow-through" taxation treatment to cash management trusts and, in principle, to other collective investments.

5.2.5.2 Submission

IFSA submit that there is no need to change the existing distinctions in relation to the businesses carried on by trusts. As noted above, there are existing provisions within Division 6C which operate to tax public unit trusts as companies if they carry on an active business. The restrictions placed upon CIVs should be no wider than this.

IFSA believes any extension of the existing Division 6C rules will create uncertainty and may well lead to considerable restructuring. Further, it will allow for tax planning opportunities.

The real issue in this regard is the appropriate treatment of any "tax preferred" income which passes through the CIV. IFSA's submission in relation to the options canvassed in Discussion Paper No 2 is discussed below. However, it should be noted at this point that we are of the opinion, consistent with the statements made by the Treasurer in his Press Release of 22 February 1999[19], that the guiding principle for the achievement of a legitimate system of "flow-through" taxation, is that the treatment of the individual investing via a CIV should be benchmarked against the treatment afforded to direct investment.

5.3. Treatment of Tax Preferences

5.3.1. Alternatives canvassed in Discussion Paper No 2

Discussion Paper No 2 identifies the treatment of tax preferred income as the crucial issue to be considered in the next phase of consultation and offers three alternative treatments:

[19] Press Release No 009 "The Review of Business Taxation: Cash Management Trusts"

1. ***Retention of the existing treatment***

The tax deferred portion is effectively recaptured on disposal of the underlying investment whereas the tax free (or building allowance component) will, in relation to recently constructed premises, be dealt with on disposal of the relevant assets;

2. ***Aligning the treatment of tax preferred income with the treatment of such income in the hands of an individual making a direct investment.***

This would involve the tax deferred component not being recaptured unless there was a subsequent and offsetting adjustment within the CIV itself (eg the reversal of a provision or the disposal of a depreciable asset resulting in a balancing charge). The tax-free component would only be recaptured on the disposal of buildings constructed after commencement of the new regime. Again, the impact of the recapture will be reflected in the distributions made by the CIV's.

IFSA also note that this alternative would involve the retrospective clawback of all tax preferences which are available under the current law.

3. ***Applying whatever rules are ultimately adopted for the taxation of untaxed distributions by corporate entities.***

This would involve the payment of deferred company tax at the level of the CIV in relation to all tax preferred income distributed to unitholders and the operation of a complex and inefficient system of providing a credit/refund to the unitholders.

Because of the disadvantages of such a system, there would be a shift to direct investment by individuals and superannuation funds (provided the benefits of tax preferred income are still available to these taxpayers), as opposed to investment via CIVs. An example of those disadvantages is contained in Appendix D.

5.3.2. Alignment with investment by individuals making direct investment

IFSA believe that the choice of the appropriate methodology should be determined within the framework of a clearly understood policy rationale for the adoption of flow-through rules in the first place. Once the policy behind the decision to treat widely held vehicles as CIVs is clear, the question of tax preferences is straightforward.

A reasoned consideration of the various policy issues outlined below (consistent with the policy reasons for the adoption of flow-through taxation in the first place), it is submitted, lead one to the inevitable conclusion that CIV's should be taxed on a flow-through basis with the taxation of direct investment by individuals as the benchmark. No deviation from this benchmark appears to be justified on a policy basis.

It follows that, if the tax preference in question is of the type that an individual would have been entitled to had they held the assets directly – then the tax preference should flow through to the individual if the asset is held in a CIV.

There would appear to be no justification, at this stage, for any other result. Trusts currently pass tax preferences to unitholders, as do other investment products (including life insurance policies, to a certain extent). Any tax reform proposals that change the efficient operation and competitiveness of existing products within the market cannot be sustained – the tax reform process must ensure it does not create problems with proposals which, whilst providing integrity in one respect, create inequity and inefficiencies in other respects.

5.3.2.1. Justification based on policy

As outlined above, it is IFSA's position that it is not appropriate to align the taxation of CIVs with companies. Rather, the taxation of these entities should be aligned with the taxation of individuals making direct investments.

CIVs and direct investments are closely aligned. CIVs have developed and been marketed as vehicles which allow the benefits of collective investment whilst providing essentially the same taxation consequences as direct investment. The flow through concept of taxation allows investors who currently pool their investments into CIVs to be taxed in a similar manner to those who invest directly. This system is simple, fair, transparent and well understood by investors.

The proposed entity regime would mean that the same investment attracts a different treatment depending on whether it is undertaken directly or through a CIV. This distortion favours direct investments with consequent detrimental effects on risk profile, access to markets and the level of savings.

The reasons for this include:

- It is generally accepted and implicit in the revised approach to imputation under the Government's proposals that entity taxation should be a proxy for taxation at the individual level and should not result in distortions when compared to the position of an individual taxpayer in the same circumstances.

- Individuals who are able to invest in property in their own right will be entitled to and retain the benefits of the tax concessions referred to above. As such, whilst the existing treatment already skews the result in favour of the individual investor, the proposal to treat the distribution of tax preferences as, in effect, unfranked dividends will mean that wealthy individuals capable of investing in property in their own right are in a better position than small investors (ie. low income earners) who invest collectively.

Refer to Appendix C for a fuller discourse in relation to the problems under the proposed corporate regime.

5.3.2.2. Other adverse impacts

Compliance Costs

Discussion Paper No 2 notes, as a key policy issue in deciding the nature and extent of flow-through taxation, that existing compliance costs would be maintained if the existing system were to be retained.

A number of comments can be made in relation to this issue:

- if the position of CIV's is aligned with that of individuals such that no further adjustment is made in relation to tax preferred income, current compliance costs will actually be reduced (ie. the current cost of making adjustments to cost base in relation to buildings allowances and accelerated depreciation would be eliminated);

- whilst it is no doubt true that fund managers incur costs in administering the current system and that improvements could be made to this system, the current system is well developed and, in general, well understood. Any change is likely to increase compliance costs significantly in the short term and, at least, maintain them at their current levels over time. There are a number of reasons for this including:

  - the transitional costs involved in understanding and implementing new taxation arrangements;

  - the cost involved in dumping or substantially revamping existing systems (computer and otherwise);

  - the cost of educating staff, the market and investors;

  - the maintenance (if not an increase in) compliance costs for investors. The need to lodge (perhaps only because of the proposed changes) returns and/or other documents in order to claim refunds will increase the current compliance burden on investors;

  - the ongoing cost of maintaining systems to collect and remit tax (under whatever system applies to untaxed distributions and therefore, on one view, tax preferred income) and provide investors with the information necessary to claim refunds. It is unlikely that the resultant administrative arrangements for fund managers will be any less onerous than the current arrangements.

The treatment of non-residents.

A review of the position internationally clearly supports the contention that there is a need for collective investment vehicles and a tax system which fosters their continued existence and viability.

The position of non-residents investors has also previously been discussed in detail and has been recognised in Discussion Paper No 2 as a key policy issue. The comments dealing with the treatment of non-residents under the proposed entity taxation rules are equally relevant here. The retention by income of its character under the flow-through approach provides an appropriate mechanism for the taxation of these investors' CIV income, particularly when it is considered that many of these investors are themselves CIV's (or similar entities) in their home jurisdiction.

International experience suggests there is a need to provide a mechanism for collective investment.

The international treatment of collective investment vehicles should provide a benchmark for the treatment to be adopted by Australia. International competitiveness of Australian industry and the attraction of foreign investment requires that the taxation treatment of CIVs in Australia be at least as attractive from the perspective of investors as the treatment afforded by our international competitors (or even more attractive given the natural cost disadvantages experienced by the Australian funds management industry).

Whilst, many countries tax ordinary unit trusts as companies, many also provide various tax concessions to trusts investing in particular sectors (notably property) to reflect their role as collective investment vehicles. The type of concessions provided include concessional tax treatment of dividend income and capital gains tax relief.

In addition, Japan, Singapore, New Zealand, UK and the US all have specific tax rules for collective investment vehicles investing in either the securities and/or property sectors. Australia is therefore moving against the tide in this area, which is inconsistent with the Government's stated aim of building Australia's status as the leading regional financial centre.

The US treatment of REIT's is effectively equivalent (albeit via a slightly different mechanism) to our current system for the taxation of trusts and both Singapore and Japan are currently moving in the same direction.

The disadvantages already suffered by participants in the Australian funds management industry were noted in the Wallis Report:-

> "Industry experience in the US suggests that the break even scale for equity funds in US$85 million to US$185 million and in excess of US$250 million for money market funds. The fragmentation of the Australian industry means therefore that domestic funds fail to capture large scale economies which reduce costs".[20]

In light of the treatment afforded to such vehicles by our international competitors, it is unclear why Australia is considering a tax treatment in relation to CIVs which will further hamper our aspirations of becoming a global financial centre.

5.4. Treatment of Retained Income

Consistent with our comments above in relation to the "annual distribution" test, there seems little policy or other basis for the punitive approach set out at paragraph 16.15 of Discussion Paper No. 2. If the entity has otherwise satisfied the eligibility criteria for flow-through taxation, the treatment of retained income should be no harsher than the treatment of income retained and distributed by companies. If, for example, the retained income were taxed to the CIV (at least to the extent that it represented taxable income) on a current basis, there is no warrant for any different treatment.

[20] *Financial System Inquiry Final Report,* March 1997, pp 481.

6. MASTER TRUSTS EXCLUDED FROM THE ENTITY TAX REGIME

6.1. Executive Summary

Masterfund products should be treated as completely look through vehicles and excluded from the entity tax regime.

6.2. Comments in Discussion Paper No 2

In Chapter 22 of Discussion Paper No 2 there is a discussion of the types of trusts that may be excluded from the entity tax regime. At page 481, it is noted that the types of trusts which may be excluded include the following:-

- trusts where the trustee holds property on trust, with no interest in or duty as to the trust property other than to hold that property for the absolute benefit of specified beneficial owners - that is the owners are “absolutely entitled” to the trust property; and

- constructive trusts.

At page 482 it is further noted that trusts for an “absolutely entitled” beneficiary (the first category referred to above) to, in effect, be treated as the owner of the property of the trust, the beneficiary would need to be absolutely entitled to the income and the capital of the trust from its inception.

6.3. Submission

A masterfund arrangement is the use of a single trust deed (usually subject to Corporations Law requirements of making offers to the public) to establish arrangements with investors. Under these arrangements, investors are absolutely entitled, as against the trustee, to the separately identifiable assets held on their behalf. That is to say, a separate trust is created in respect of each investor.

Typically, masterfunds allow for the member to direct the trustee to invest in either other collective investment vehicles or in direct assets such as listed equities. The member has full power to direct the trustee to buy and sell such investments and otherwise deal with the assets as the member directs.

IFSA believe that the best approach in relation to such arrangements is to ignore the trust relationship and treat the investor as the sole entity/individual subject to taxation in accordance with the suggestion in paragraph 22.8 of Discussion Paper 2 (page 482). This would also involve treating the acts of the trustees as those of the beneficiaries.

This treatment would also be in line with the current tax treatment (in effect) of masterfund products. That is, the beneficiary is regarded as the owner of the assets of the trust for capital gains tax purposes and presently entitled, at all times, to the taxable income of the trust.

7. RESETTLEMENTS

7.1 Executive Summary

IFSA supports the introduction of a clear rule for determining when a “resettlement” of a trust occurs for tax purposes. However, the possible rules canvassed in Discussion Paper No. 2 do not, in our opinion, reflect the economic substance of collective investment trusts.

7.2 Submission

There needs to be a rule for resettlements which is based on economic substance rather than legal technicalities

We welcome the proposal in paragraph 22.50 to establish a clear rule for when a ‘resettlement’ of a trust will be taken to occur for tax law purposes.

The Tax Office has been informally suggesting a view that even minor amendments to trust deeds can result in a trust ceasing exist and a new trust coming into existence. This has caused paralysis in the collective investments industry. Trustees are too scared to amend their deeds and lawyers are too scared to advise when it is safe to do so.

The Government’s Managed Investments Act 1998 amending the Corporations Law regulation of our industry was almost a disaster because of this uncertainty. It was only saved in the end by the Government promising that specific relief would be introduced into the tax legislation to avoid the ‘resettlement’ question.

This issue is either a situation where legal form does not reflect economic substance or it is a situation where the law is so unclear that people are unable to act. Either way there is an urgent need for progress.

It is rare for there to be a resettlement of a collective investment trust

Whether an event causes a trust to cease to exist depends on the terms of the trust. An event that is contemplated from the beginning as part of the operation of the trust cannot cause the trust to cease to exist.

Collective investment trusts are designed to be constantly adding and losing beneficiaries and to be constantly adding and disposing of assets. These events are intended steps in the life of the trust and cannot be the cause of the trust ceasing to exist.

Similarly, these trusts are designed to exist for long periods of time providing an investment opportunity for an ever-changing group of beneficiaries. Each trust is designed to operate as efficiently as possible in the regulatory and economic environment that it faces. It is recognised from the beginning of the trust’s existence that this environment will change and that the operation of the trust will have to evolve to continue to be efficient.

These trusts therefore have mechanisms by which the terms of the trust can be changed, either because the environment has changed or because a better way of doing things has been discovered. Almost all changes to the terms of the trust will be within the scope contemplated at its creation as part of its continuing operation. These changes are part of how the trust was always supposed to work and cannot cause the trust to cease to exist.

The Administrative Appeals Tribunal in Case 22/98 said:-

> *"Amendments – even far-reaching amendments – are … not only usual but are accepted and expected in the indefinitely continuing life of the fund"*.[21]

This case has been unfairly criticised as finding, incorrectly at law, that the trust in the case was a "trust for purpose". A 'purpose trust' is a trust which does not have sufficient certainty as to beneficiaries to normally be treated in equity as a trust, but is so treated because it of its special circumstances.[22]

There is no question in the case of the trust failing for want of certainty of beneficiaries. The Deputy President's reference to purpose was in a different context.

The Deputy President was testing whether, as a question of fact, this was still the same trust as was originally created or whether a new trust had come into existence. This is the point of the case.

His finding was that the changes that were made were of a type that were part of the continuing operation of the trust. His way of distinguishing the continuing operation of the trust from terminating the trust was to look at the factual purpose of the trust. Because the trust continued to pursue the same purpose, he concluded that the trust was continuing in its operation.

The Commissioner may want to take issue with whether, in fact, this particular trust was continuing the same purpose or may want to take issue with whether the same purpose is enough in this particular case to indicate that the trust has continued its existence. Putting those issues aside we would ask that the Review of Business Taxation recognise the principle here that changes to the terms of a trust, including some quite significant changes, are a intended aspect of the life of a trust and do not cause a trust to cease to exist.

It must always be borne in mind that questions about trusts are matters of equity rather than matters of law. One of the maxims of equity is that 'equity looks to the intent, rather than to the form'[23]. It should not be possible for a trust where all the parties intend it to continue, to cease to exist because of a formal technicality.

The equity cases that can be cited as 'resettlement' cases can all be easily understood as the court finding the intentions of the settlor or trustee and seeking justice between the parties. The intention in the creation of a collective investment trust is that it will be long-lived and that it will adapt its terms when necessary. This is the basis on which beneficiaries choose to join the trust. It

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[21] 98 ATC 282, 290.

[22] Jacobs' Law of Trusts in Australia, R P Meagher and W M C Gummow, Sixth Edition, Butterworths, Sydney, 1997, Chapter 11

[23] Equity; Doctrines and Remedies, R P Meagher, W M C Gummow and J P Lehane, Second Edition, Butterworths, Sydney, 1984, paragraphs 331 et seq

would be rare either on the basis of intention or justice for there to be equitable grounds to find that a collective investment trust had ceased to exist.

Option 1 is too arbitrary because it does not take the specific characteristics of the trust into account.

Paragraphs 22.51 to 22.53 propose a statutory test where factors that can be relevant in different situations are all listed and are all weighed up whether they are factually relevant to the situation at hand or not.

This will increase uncertainty rather than reduce it. The current situation is that a question of fact, albeit an obscure one, has to be determined. This may be difficult but at least there is a touchstone: what has really happened. The statutory test would require the application of factors in a contextual vacuum. The result could only be arbitrary.

The inevitable outcome of the proposed statutory test is that events that would not cause a trust to cease to exist will be deemed to do so for tax law purposes. Collective investment trusts are often very large and this could be an arbitrary tax penalty of tens of millions of dollars.

There needs to be a rule that supports the economic substance of collective investment trusts.

Policy design principle 12 of *A Strong Foundation*[24] is that the law should tax the economic substance not the form.

The economic substance of a collective investment trust is that is a continuing vehicle no matter what changes are made to its terms. If Australia is going to have a collective investment industry that can compete with foreign products and that can make Australia a regional financial centre, the uncertainty caused by this ‘resettlement’ issue needs to be removed.

Whether by legislation or tax ruling, there needs to be a rule that recognises that collective investment trusts can make significant amendments to their deeds in the ordinary course of their operations without the threat of a large tax liability.

In the case of trusts which are to be taxed as collective investment vehicles in the new regime, the appropriate rule is a complete exclusion from any risk of an event being treated as causing the end of the trust. There is therefore no chance of a total exclusion being abused by someone taking control of the trust.

A rule that there cannot be a resettlement should be extended to trusts that meet all of the criteria to be a collective investment vehicle except that they don't distribute sufficient income to meet the annual distribution test referred to above at 5.2.4.3. This one difference does not change the economic reality that these vehicles have long lives. These trusts will be taxed as companies under the new regime which will remove any potential for abuse.

[24] Page xxi

A 50% change in ownership is a normal event for a collective investment trust and should not be penalised.

A rule that treats a 50% change in ownership of a collective investment trust as the end of the existence of that trust, as is proposed in paragraph 22.55, would be arbitrary and in conflict with economic substance. A collective investment trust is a constantly changing group of beneficiaries. The 50% test could be failed many times during its life.

This unsatisfactory situation is already imposed on these trusts through the trust loss rules. These rules currently impose a large compliance burden and a tax penalty on collective investment trusts by taking a concept from closely-held trusts, control, and applying it to widely-held trusts where there is no controller.

The proposal in paragraph 21.7 to allow a ‘same business’ test for trusts will almost totally remove this problem; although this does not mean that the other structural flaws in the trust loss rules should not be addressed.

Direct value shifting rules would work better for collective investment trusts.

CGT or income rules apply to the beneficiaries’ interests in collective investment trusts. These are fixed trusts not discretionary trusts so the problem referred to in paragraph 22.56 does not apply.

The rules that Chapter 29 begins to develop would be simpler and less arbitrary than an artificial resettlement rule. There are a lot of similarities between the units in these trusts and shares in a company so these rules could be effective.

8. TRUST LOSSES

8.1 Executive Summary

IFSA supports the introduction of a “same business test” for the carry forward of trust tax losses.

8.2 Submission

The rules for losses in trusts need to be based on economic substance

The proposal in paragraph 21.7 that a ‘same business’ test apply to the carry forward of tax losses is an important reform for collective investment trusts. As well as being equitable and consistent with economic substance, it would protect these trusts most of the time from the other flaws in the legislation.

The proposed rules are based on an incorrect notion: that a 50% change in ownership in a collective investment trust is an economically significant event. It is the economic nature of these trusts that there is a constantly changing group of beneficiaries. The rules breach policy design principle 12 in A Strong Foundation[25] that the law be based on economic substance not form.

This problem could be relieved somewhat by the concept in paragraph 21.7, that widely-held trusts will not be required to test for a change in ownership unless there has been an abnormal trade. This is an appropriate concept but its execution in the current legislation is seriously flawed. It is the normal operation of these trusts that beneficiaries come and go. The 5% rule and the 20%/60-day rule deem common events to be ‘abnormal’.

A very real example is the early life of a trust. Under these rules the second, third and probably the next twenty investors entering the trust will all be treated as abnormal events. This is a nonsensical result.

Another example is wholesale trusts where a small group of investors each pool a large sum of money. It is very common for these trusts to have five or less investors. Each time a new investor enters or an investor leaves, the 5% rule and often the 20% / 60% day rule is triggered; even though this is a normal event in the operation of the trust.

To add to the unrealistic outcome, the 20% rule deems there to be an abnormal trade on sixty consecutive days. So one wholesale client entering or leaving a fund can cause the accounting period to be divided into sixty one sub-periods each of which requires its own tax accounting.

[25] Page xxi.

9. CAPITAL GAINS TAX

9.1. Executive Summary

There are a number of proposals in Discussion Paper 2 on possible treatment of capital gains tax. Changes to the current CGT regime appear to be favoured by the RBT as a means of achieving revenue neutrality. It is thus likely that discussions on alternatives and development of new models may continue for some time. In this chapter, IFSA gives its response to the proposals currently under discussion. We would wish to be involved further as new ideas continue to evolve.

IFSA supports the adoption of a graded CGT rate approach (a variation on the capped approach) to the taxation of capital gains derived by individuals. It is also necessary to establish an equivalent graded rate for CGT on superannuation funds. In determining the graded rate, we recommend adoption of 30% / 25% / 12% rates for individuals, and 9% for superannuation funds.

IFSA also supports the extension of scrip-for-scrip rollover relief to a broader range of entities and the extension of similar relief in relation to the normal tax provisions where the conditions for CGT relief are satisfied.

IFSA believes that the graded rate approach is an appropriate trade off for the loss of indexation. IFSA further believes that any abolition of averaging could be used to fund other proposals contained in this submission. IFSA's view is based on what is appropriate for its investors and recognises that different views may exist in the wider community.

9.2. CGT Rates

9.2.1. Options

The following options are outlined in Chapter 16 of Discussion Paper No. 2 for reforms in relation to the rate at which capital gains are taxed in the hands of individuals:-

1. Cap CGT rate at 30%
2. Stepped – rate CGT depending on length of time that an asset is held
3. CGT tax-free threshold of $1,000

9.2.2. IFSA's preferred approach applied to individual investors in CIVs or Life Policies - variation of the capped rate approach

Assuming flow-through treatment of CIVs is retained, investors in CIVs must be entitled to the same relief as direct investors, at both the level of investments made by the fund and the level of their own investment in the fund.

For instance, at present the fund manager calculates the capital gain made by the fund (after indexation) for the year, and allocates that gain to unitholders at year-end. Those unitholders then include the gain in their own tax returns, for offset against any capital losses they may have and for averaging (if applicable). In addition, any gain the unitholder has made on the disposal of units in the fund must also be returned.

A straight 30% capped CGT rate and a flat $1,000 tax-free threshold are regressive in nature and would make these options inappropriate.

A stepped CGT rate which allows lower CGT rates on gains from assets the longer the asset is held would be administratively cumbersome when applied at the fund level – assuming that the determining time for underlying assets is the length of time an asset is held by the fund, the fund would have to distribute capital gains at the various tax levels, after having offset losses and expenses at those appropriate levels. Assuming that CIVs are afforded flow through taxation in the manner recommended by us in Chapter 5, the application of this type of stepped CGT rate at the level of the individual would also be administratively impractical.

However, a different form of graded CGT rate which is dependant, not upon the length of time that a particular asset has been held, but on the marginal rate applicable to the individual investor, would provide a relatively simple and progressive system for the taxation of capital gains, whilst also encouraging investment. This is a form of the capped rate option discussed in Paragraph 11.29 of Discussion Paper 2. To distinguish this from the named alternatives set out in Discussion paper 2, IFSA uses the expression “graded CGT rate” to describe this system.

IFSA would therefore support adoption of graded rates for individuals of 30%, 25% and 12%, as set out in Table 39.2 of Chapter 39 of Discussion Paper No 2. The 30% rate would be available to taxpayers in the 40% and 47% marginal tax brackets, while the other rates would be applicable to taxpayers on the other marginal rates.

In addition, we would recommend the adoption of a 9% flat rate for the taxation of capital gains derived by superannuation funds. This rate represents the same proportion of the income tax rate applicable to superannuation funds (ie, 60% of 15% rate) as the suggested 12% CGT rate represents of the lowest marginal income tax rate for individuals (ie, 12% = 60% of the 20% rate).

In making these recommendations, we recognise that the RBT has been asked to comment on proposals that are able to reduce the tax rate applicable to capital gains in a “revenue neutral” manner. IFSA notes from the figures provided at Table 39.2 in Discussion Paper No. 2 that the adoption of the 30%, 25%, 12% rates for individuals would be at a cost to the revenue of $1.5 billion during the first three years of operation. The removal of indexation would provide a benefit to the revenue of $1.55 billion during the period 1 July 2000 to 30 June 2004.

9.2.3. Scrip-for-scrip Rollover Relief

IFSA supports the consideration by the Review team of the CGT impediments to scrip-for-scrip mergers and takeovers, particularly in light of the comments in the Wallis Report that taxation inhibitors to such transactions cause institutions to miss out on the significant economic benefits that can be obtained from a reduction in the fragmentation of certain financial industries[26].

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[26] *Inquiry into the Financial System Final Report* March 1997, pp496-497.

There have been suggestions from certain sectors that no economic inefficiency results from the CGT treatment of scrip-for-scrip swaps in a merger/takeover situation. IFSA adamantly refutes such suggestions.

The experience of our members is that the prospect of a capital gains tax liability arising as a result of a scrip-for scrip swap can act as a real deterrent to small investors. The solution often adopted is to make a blended scrip/cash offer, which introduces a further complicating factor to the deal and obviously incurs funding costs.

Further, the administrative cost to the purchasing entity is high. Whilst the tax impact falls on the shareholders accepting the offer, in the context of public company bids it is generally the offeror who has the burden of explaining the tax impact to shareholders. In some cases the issues are so complex that a tax ruling is required before advice can comfortably be given in offer documents. Generally these issues relate to valuation of the shares on offer. For instance, it is by no means clear-cut as to which date should be used when valuing the shares offered - an offer may be accepted on one date, the information memorandum may become unconditional on another (eg: when the target number of shares has been reached), and the shares may actually be issued on yet another date. Shareholders will not have the information necessary to calculate their own liability, and so are dependent upon the offeror company. Introducing rollover relief would avoid this confusion.

It is submitted that if such rollover relief is to be effective, it must be extended beyond CGT to normal income tax relief. A number of taxpayers, notably banks and insurance companies, are subject to normal income tax provisions (ie: are taxed “on revenue account”) in relation to gains and losses made on the disposal of their investments. If scrip-for-scrip relief is extended only to CGT assets, and not granted to those on revenue account, a significant number of investors will remain taxable on a scrip-for-scrip swap, and the same valuation issues will arise.

Additionally, scrip-for-scrip relief should not be confined to publicly listed companies, but should be extended to units in publicly listed trusts, units in public offer funds, interests in superannuation funds, and to exchanges of life insurance policies. Indeed, the Wallis Report specifically indicated that the benefits of minimal tax inhibitors should be extended to the public unit trust and superannuation industries.

In our experience, the lack of such relief for trusts has already led to the inefficient existence of small trusts. In a survey conducted by IFSA, 42 investment trusts were identified with funds under management of $1.2987 billion, which would significantly benefit from the economics of scale that would be available upon mergers. More than 39,000 unitholders (being the unitholders in the 42 trusts identified) are thus forced to suffer the cost of inefficiencies that could be prevented if the trusts were able to merge without any tax costs.

There are a number of instances where a funds management business is taken over, or merged with, another funds management business. Often a number of the trusts taken over are similar to those already managed by the takeover manager, but they cannot be merged due to the CGT costs to the unitholders. The underlying investments may be turned over any number of times, but especially if the unitholders are of long standing, they are reluctant to realise a capital gain on the disposal of their units and so remain in the original trusts. It is extremely difficult to wind down active trusts, which can create huge inefficiencies within the funds management industry.

10. TAXATION OF FINANCIAL ARRANGEMENTS

10.1 Executive Summary

IFSA believes that the "Timing Adjustment" proposals have been drafted too widely, and accordingly impact normal investment transactions creating significant compliance costs (without a corresponding increase in revenue). These provisions should either be:-

- restricted, in operation, to dealing with "tax deferral" transactions, or alternatively,
- not be applicable to the investment industry.

IFSA is also concerned that many of the proposals outlined in the Taxation of Financial Arrangements (TOFA) chapters create unnecessary compliance costs for savings vehicles. Many of the proposals impact day to day operations – when they should be restricted in operation only to tax driven transactions.

10.2 Application of the "Timing Adjustment" Proposals

IFSA supports the general proposition outlined in Chapter 5 that:-

> *"Taxation policy should not drive the choices between economically equivalent financial instruments or the timing of purchase and disposal decisions. It should aim to tax income in as neutral a manner as possible."*

However, we believe that the timing adjustment proposals have been drafted too widely, and as a result:-

- Introduce significant compliance costs (without a significant increase in revenue);
- Produce a bias towards direct investment within the economy; and
- Create uncertainty within the funds management industry.

IFSA believe that the Timing Adjustment proposals should, therefore, either:-

- Be amended so as to exclude securities which are not caught by the existing Division 16E provisions, or
- Exclude CIVs, superannuation funds, ADFs and life companies from being required to make such adjustments as this would impose an "unreasonable compliance cost burden" on these taxpayers.

10.2.1 Reducing the scope of the Timing Adjustments

Chapter 6 of *A Platform for Consultation* set out three general principles behind the application of the timing adjustment provisions. These are:-

- Is there a high degree of certainty attaching to estimates of future returns ?
- Would tax deferral opportunities arise if the timing adjustments were not applied ?

- Would the taxpayer face an unreasonable compliance cost burden to calculate the timing adjustment ?

We believe that application of these principles supports the general propositions being put forward above by IFSA.

Scope of existing proposals

The timing adjustment, as currently proposed, applies to fixed rate and floating rate debt securities and interest rate swaps.

Our concerns in relation to fixed rate and floating rate debt securities are as follows:-

- *Expansion of the existing Division 16E provisions*

  There are currently in existence, accrual provisions dealing with zero coupon bonds and debt securities issued to the market at a discount.

  We do not question the need for these rules – it is clear that these type of securities provide tax deferral opportunities. Nor are we opposed to any proposals which seek to reduce compliance costs associated with the existing Division 16E rules.

  However, we do not believe that these provisions should be extended to catch premiums or market discounts that emerge after issue – ie, where the security is bought and sold on the secondary market.

  Premiums and discounts on securities, post-issue, result from changes in market interest rates, and to a smaller degree, the amount of coupon interest due to be received on purchase or sale of the debt security. Therefore, unlike a security which has been issued at a discount (in such cases, there is a clear intention for the security to provide a return to the holders by way of periodic interest and capital on maturity), a tax deferral opportunity cannot be said to exist. This is namely due to the fact that it is the secondary market, and not the buyer or the seller, that sets the amount of the discount or premium. Clearly, these transactions should not fall within the application of the Timing Adjustment provisions.

  It is also worth noting that the timing adjustments made in respect of these extended transactions will ultimately depend on the interest rate movements. As interest rates move up and down, so will the majority of the timing adjustments made to securities purchased on the secondary markets. Therefore, over the long term, this should not create any additional tax recoveries to the Revenue – instead it will simply add to the compliance costs of the superannuation members and unitholders (in the same way superannuation surcharge added to superannuation fund costs).

- *There is a need for a practical threshold test*

  The timing adjustment proposals, as currently drafted, apply to all transactions where a discount or premium arises on purchase of a debt security – regardless of the relative value of the discount or premium to the capital sum invested. This means that taxpayers will be required to calculate complex timing adjustments for all transactions in order to ascertain whether the accounting treatment of the security is a “reasonable approximation of the economic accrual" for tax purposes. This result is clearly uncommercial and costly.

The preferred option is for the provisions to contain a threshold test – similar to that applicable for Division 16E (ie, the definition of "security" contains a 1.5% threshold test).

- *When do we have a "high degree of certainty"?*

  There needs to be clear rules as to what is meant by a "high degree of certainty" for the purposes of calculating estimates of future returns. Greater certainty creates a simpler compliance system – one that both taxpayers and the ATO can work within with greater confidence.

Lastly, it is not clear why there is a need to include interest rate swaps within the scope of the timing adjustment provisions – considering most taxpayers are currently required to accrue "earnings" from SWAPs under the current regime. We would question the need to upset settled tax practice on this issue. We also consider that the accounting principles currently used for this purpose more than adequately deal with SWAP arrangements – we therefore see no need for an additional calculation to be added to the process.

10.2.2 Exclusion for CIVs, Superannuation Funds, ADFs, and life companies

An alternative approach would be to exempt Collective Investment Vehicles, Superannuation funds, ADFs and life companies from the need to make timing adjustments.

We believe that this exclusion can be supported for the following reasons:-

- *Bias created towards direct investment*

  Given the complexity involved with the timing adjustment calculations, individuals who directly own debt securities, or who operate excluded superannuation funds will be excluded from the operation of these provisions.

  Since CIVs, superannuation funds, ADFs and life companies represent the pooled funds of many individual investors – the tax treatment afforded to assets held by these entities should correspond with that applied to individuals. This means, in order to promote efficiencies and equity within the tax system – the appropriate benchmark to apply to the tax treatment of investments held by such entities is the individual (and not the corporate entity).

Any other outcome would create a bias towards direct investment of such assets by individuals (or their personal superannuation funds).

- *Creates additional transaction costs*

  In relation to CIVs, application of timing adjustments will require the trust to distribute income that has not been received. In order to fund such amounts, assets which ordinarily would have been held, may need to be liquidated to meet these liabilities. Forced asset sales simply add to the transaction costs of the trust – which ultimately reduces investments returns for all unitholders.

10.3 Other Issues

There are a number of other issues upon which we wish to briefly comment.

10.3.1 Wash Sales

IFSA is concerned that an automatic wash sale rule which operates within a specified time period may, inadvertently impact on the day to day operations of fund managers.

For example, a fund manager who is managing a diversified portfolio is constantly making adjustments by buying and selling securities in the same companies just to keep the portfolio "in structure". The manager is required to do this because:-

- The size of the fund is constantly fluctuating, and
- The relative values between different asset classes are constantly changing.

Example : The portfolio manager decides to have 20% of the portfolio invested in Australian Equities and 5% of this (1% of the whole portfolio) invested in Westpac shares. The portfolio is $100 million so the portfolio has $1 million of Westpac shares. There is a net outflow of funds and the portfolio goes down to $99 million. The portfolio manager sells $100,000 worth of Westpac shares. There is then a net inflow of $2 million and $200,000 of Westpac shares are bought. This can happen in the space of a few days. Then there is a realignment between the bond market and the share market. The shares are now worth relatively more than the bonds. The Australian equities are not 22% of the portfolio where as the bond proportion of the portfolio has gone down. The $1.02 million of Westpac shares have to be reduced to $0.93 million so shares are sold. There is then an inflow of money so more shares are bought

Depending on the timing, an automatic wash sale rule (with a specified time period) may catch some of these "rebalancing" sales. Some of these sales will generate losses - whilst others will generate gains.

From the above, it is clear that an automatic wash sale rule may impact normal funds management operations. The result is increased compliance costs – even though tax is not the driving force behind the transaction.

We do not dispute the need for an anti-avoidance rule to deal with wash sales. We do not, however, support the introduction of anti-avoidance rules which have such a wide scope that they catch both tax driven and normal commercial transactions. We believe that any anti-avoidance rule developed should specifically require the transaction to be carried out for the purpose of obtaining a tax benefit (ie. the transaction should essentially be tax driven and have no commercial basis).

10.3.2 Other miscellaneous issues

There are grave concerns within industry in relation to the many and varied proposals outlined in Chapters 5 to 7. Amongst others, those rules dealing with loss quarantining, the timing adjustments for foreign currency debt, disposals rules based on changes in economic ownership, the rules relating to structured debt/equity instruments and the rules relating to synthetic arrangements. The compliance burden imposed by the uncertainty and complexity of these rules is enormous, especially given most of these provisions are expressed so widely that they apply to normal commercial arrangements. Examples of highly complex and artificial rules that have recently been introduced that are still unsettled and causing considerable consternation and practical difficulty include the franking credit streaming and 45 day rules. IFSA would be greatly concerned if the TOFA proposals give rise to the same complexity.

IFSA believe that, in the majority of cases, the anti-avoidance provisions of Part IVA more than adequately deal with the practices that these proposals aim to destroy. Simply imposing additional compliance burdens on the investment industry is not the answer.

11. FOREIGN SOURCE INCOME OF RESIDENTS : ANTI-TAX-DEFERRAL MEASURES

11.1 Executive Summary

The FIF rules[27] need to be made easier, not harder

> ***The treatment of foreign sourced income derived through trusts*** : *Economic growth could be enhanced by changes that would help ensure that resident collective investment vehicles remain competitive with foreign counterparts.*
>
> \- *A Platform for Consultation*, paragraph 32.10

The FIF rules are a significant cost burden on Australian savings vehicles and are a hindrance to competing successfully with foreign products. Numbers provided below show that this is a serious flaw in the tax system.

The Wallis Committee found that Australian savings vehicles are expensive by international standards[28] and noted a suggestion that allowing foreign competition into the market could drive these costs down[29]. After recent lobbying from the U.S. funds management industry the Government removed the tax barrier that prevented them entering the market. The Australian Financial Review noted recently that we are now preparing to meet an influx of low-cost international players[30].

In an industry where costs are related to scale[31], we are now to compete with U.S. mutual funds where some fund managers are larger than our whole industry[32].

If we are going to be able to compete with these power-houses then unnecessary costs have to be removed from the tax system. The FIF rules are a chance to remove significant costs without harming the integrity of the system.

11.2 The current system - the FIF rules seek to tax untaxed income

The primary tax law provisions for dealing with offshore tax-deferral are the CFC rules[33]. These rules look through the corporate veil of offshore companies controlled by Australian

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[27] 'Foreign Investment Funds', Part XI, Income Tax Assessment Act 1936.

[28] Financial System Inquiry Final Report, ('the Wallis Report'), Stan Wallis et al, Commonwealth of Australia, March 1997, paragraph 11.2.1.

[29] ibid.

[30] The Australian Financial Review, 17 March 1999, page 34.

[31] See the Wallis Report, id at paragraph 11.2.1.

[32] The Wallis Report, op cit, at paragraph 6.2.4, identified that $370 billion was held in managed funds in Australia in 1996. The Australian Financial Review, ibid, recently used the figure $470 billion. The Wallis report also says, ibid, that only 230 out of 2,500 Australian funds have assets in excess of $100 million. U.S. fund manager Fidelity has more than $900 billion under management (see www151.fidelity.com/about/world/manage.html). One fund, the Fidelity Magellan fund is $63 billion (see www.usnews.com/usnews/issue/980202/2fido.htm).

shareholders. If there is any offshore passive income that is not taxed at a rate comparable to Australia's corporate tax rate, it is included in the Australian shareholder's assessable income.

This is a timing adjustment. This passive income would have been subject to Australian tax when it was eventually remitted to Australia as a dividend. The effect of the CFC rules is to bring the income to tax in Australia in the year the offshore company derives it rather than the year in which it is remitted to Australia. The CFC rules are therefore called 'accruals' rules or 'anti-deferral' rules. Although often discussed as anti-avoidance provisions, the rules apply whether the deferral effect is intentional tax-planning or merely accidental.

The CFC rules cannot be applied to all shareholders. The Australian shareholder will not always know whether there is untaxed passive income in the offshore company. Corporate groups are very complex and non-controlling shareholders are not entitled to detailed information about their structure or their activities. The CFC rules therefore currently apply when the shareholder 'controls' the offshore company.

The FIF rules are designed to complement the CFC rules. When the shareholder does not control the offshore company, any deferral situations have to be identified indirectly. The FIF rules attempt to identify companies that are deferral opportunities by looking at the activities that they carry on. If this imprecise approach identifies a company as a deferral opportunity, there is a tax penalty whether there is any actual deferral or not.

11.3 It would be wrong to change the line between the CFC rules and the FIF rules

> *"[A] problem is that the active business exemption for interests in closely held company FIF's that fall outside the CFC measures is markedly different to the exemption available to CFC's"*
>
> \- *A Platform for Consultation,* paragraph 32.8

The Review expresses the view that there are "closely-held" offshore companies that somehow are outside the 'control' tests, or perhaps the 'associate' tests, in the CFC rules.

It is understood from the consultation process that the view is that the interest of a substantial minority shareholder, for example someone holding 30% of a company, is sufficiently similar to a controlling shareholder and that they should therefore be taxed in the same way.

This view is not correct. There is a significant factual difference between having a controlling interest and having a large share of a company without having control. A shareholder who does not have control is not able to arrange the affairs of the company to suit their own commercial needs. The directors of the company have a duty to all shareholders and cannot do things merely for the benefit of a substantial but non-controlling shareholder. This is not only the theoretical legal outcome, it is also a commercial reality.

Even if there is a theoretical appeal in a neutrality between controlling shareholders and substantial non-controlling shareholders, extending the CFC provisions is unworkable. The directors of the company cannot release commercially confidential information to such a

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[33] 'Controlled Foreign Companies', Part X, Income Tax Assessment Act 1936.

minority shareholder. It is practically impossible for a non-controlling shareholder to apply anything along the lines of the CFC rules.

11.3.1 *To apply harsher rules to the non-controlling interests of savings vehicles would be contrary to* A Strong Foundation *and* A Platform for Consultation

To apply the CFC rules or some modified version of them to non-controlling shareholders would contradict the principle in *A Strong Foundation* that tax legislation be designed from the perspective of those who must comply with it[34].

To do so would in effect introduce a third foreign source income regime:

- the CFC rules;
- the "modified CFC rules" ; and
- the FIF rules.

This would impose a further significant compliance and cost burden on Australian fund managers and do nothing to enhance international competitiveness.

It would also be contrary to the proposals on anti-avoidance provisions in Chapter 24 of *A Platform for Consultation*.

Paragraph 24.19 provides a series of questions that should be asked before a specific anti-avoidance provision is introduced. Applying those questions to this situation produces the following analysis:

- **How much revenue is being lost to any deferral advantage enjoyed by non-controlling shareholders?** No details are provided of any specific problems that have been discovered with the FIF rules. There may be information arising from the 'High Net Wealth' project that the Tax Office is unable to release. If there is, this is quite a separate matter from the proper taxation of savings vehicles. Indeed revenue estimates made at the time the FIF measures were introduced appear to have substantially overstated the expected revenue from this regime.

  See the comments below on the amount of revenue that the FIF rules currently collect.

- **Is it appropriate to deny this advantage?** As is discussed below, there is no advantage being enjoyed by savings vehicles.

- **Are the compliance costs and the complexity warranted?** The substantial difficulty of complying with the current attribution accounting rules is detailed below. Broadening them cannot be warranted. If there are some taxpayers who can manipulate deferral advantages without being caught by the CFC rules, it is still unwarranted to place an immovable burden on other taxpayers such as savings vehicles. The taxpayers who are manipulating the system need to be targeted more accurately.

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[34] Legislative Design Principle number 4, page xxii.

- **What secondary effects will the provision cause?** Excessive costs will reduce the competitiveness of Australian-based savings vehicles against foreign-based competition. Compliance problems will reduce the integrity of savings products, particularly Australian-based ones, to the detriment of economic growth and the efficiency of the capital markets. Introducing further bias against offshore investment would encourage investors into less diversified and less rewarding portfolios.

- **Are the general anti-avoidance provisions sufficient to deal with the problem?** The effect of the general anti-avoidance provisions is often underestimated. This is particularly the case in situations like savings vehicles where there is a separation between the parties who benefit from the advantage, the investors in the vehicle, and the party who has to arrange for the advantage to come into existence, the fund manager. At best, arranging a tax advantage for investors only produces a small indirect flow-on benefit for the fund manager. It is not rational or commercial for the fund manager to take any sort of compliance risk to get this benefit. As was recognised by the Government in designing the franking credit rules, these are "low-revenue risk, high-compliance cost" taxpayers[35].

Extending the CFC rules to non-controlling interests held by savings vehicles would be an unwarranted imposition that would collect little, if any, revenue.

11.3.2 There are 800,000,000,000,000 reasons why the current application of the FIF rules to savings vehicles is also contrary to A Strong Foundation and A Platform for Consultation.

The FIF rules as they stand already contradict the design principle in A Strong Foundation cited above.

They are also contrary to the proposals on anti-avoidance provisions in Chapter 24 of A Platform for Consultation. Repeating the above analysis from paragraph 24.19 :

- **How much revenue do the FIF provisions collect?** In 1996/97 the FIF rules raised only $11 million from trusts and funds.[36] For legislation that, by design, captures accidental deferral rather than actual avoidance, this is not a large number; particularly as much of the deferral may be reversed soon after. Since some of the revenue is only collected because of inaccuracy of the active business exemption, discussed below, a more equitable system would collect even less.

  If there is any deferral advantage being enjoyed by investors in savings vehicles, it is very small. In a savings vehicle, the trustee has a fiduciary duty to maximise the investment performance subject to a reasonable risk of volatility. This is done by holding a diversified portfolio which, to varying degrees, will be biased towards companies which are expected to outperform the general market. The trustee has little scope to acquire

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[35] *Taxation Laws Amendment Bill (No. 4) 1998,* Explanatory Memorandum, paragraph 4.105.

[36] In 1997/97, $3.8 million was returned as FIF income from trusts. Applying the average individual tax rate of 22.8%, this is revenue of $866,000. The FIF income from funds was $73.9 million; almost all of it from just 11 taxpayers. Even if none of this was pension income and the 15% tax rate applied to the whole lot this is only revenue of $11 million. *Taxation Statistics 1996-97, Australian Taxation Office, www.ato.gov.au/general/business/bus.htm, Trusts Table 1 All items by grade of income and Funds Table 1 All items by grade of income*

interests in companies that offer deferral benefits. Even if some of the best investment opportunities coincidentally offer deferral advantages, the need to diversify means that these advantaged investments would only be a very small part of the portfolio. Even if the trustee did want to chase a deferral advantage, being a non-controlling shareholder they wouldn't have enough information to properly identify where those advantages might be.

- **Is it appropriate to deny this advantage?** Since this advantage (if any) is not a deliberately sought one, there is less policy reason for denying it. The advantage flows to most taxpayers in Australia because almost every Australian holds foreign shares through our superannuation funds. Denying the advantage is therefore less a matter of equity than might otherwise be the case.

- **Are the compliance costs and the complexity warranted?** Professor Arnold of the University of Western Ontario in his independent report on the implementation of the FIF rules found that the compliance problems were:

> "*especially daunting for institutional investors and custodians. They will have severe difficulties not only in identifying the FIF interests in their investment portfolios, but also in reporting accurately to investors about FIF income and losses, distributions and gains and losses on the disposal of FIF interests*".[37]

One large custodian estimates that the 2,500 different foreign companies it has held in its various portfolios in recent years have required about 5,000 work-hours to classify them. Up to 2,000 further companies could be added this year. That is, 5,000 work-hours so far to determine whether the company is exempt and, if so, the section of the Act under which it is exempt. 5,000 hours just to determine an amount of income that should be moved from one year of income to another; and there are lots of costs on top of this.

The same custodian has approximately 400,000 investors holding interests in these companies. At any given time each one has an interest in approximately 200 different companies; only about 90% of which would be exempt from attribution. There are therefore approximately 8,000,000 attribution accounts that have to be kept.

There are approximately 50 movements each year in respect of the investment; that is income received or an increase or decrease in the number of shares owned. There are also approximately 500 movements each business day where new investors come in or old investors go out. Each movement in respect of an investment or in respect of an investor is a change in each investor's ownership of the underlying companies. Each movement requires an entry in the attribution account for each investor. When you multiply this out, the number of attribution account entries each year would be 50,000,000,000,000; 50 trillion[38]. At 5 minutes per entry, this would cost more than $800,000,000,000,000, $8 hundred trillion dollars, for an accounting firm to do.

[37] *Report on the Implementation Issues arising from the Foreign Investment Fund Legislation*, 14 August 1992, p 8-9.

[38] Using the common U.S. definition of 'trillion'.

Given the near impossibility of this, fund managers have no choice but to actively seek to invest their portfolios such that attribution accounting need not be considered. To bring the collective investment vehicle into compliance with the Act, enough shares may be sold, at market value, before the end of the financial year to bring the portfolio within the balanced portfolio exemption. Because holding a sub-optimal portfolio would be a breach of the trustee's duty to maximise the vehicle's investment performance, the shares are typically bought back, at market value, early in the new financial year.

- **What secondary effects do the provisions cause?** In addition to the secondary effects noted above, the impossibility of attribution accounting for savings vehicles imposes fiduciary risks on the trustees and incurs unnecessary transaction costs.

- **Are the general anti-avoidance provisions sufficient to deal with the problem?** Deliberate structuring to maximise or create a deferral advantage could be dealt with under the general anti-avoidance provisions.

The application of the FIF rules to savings vehicles is a huge imposition without justification. It is also a failure of Government policy. When introducing the FIF rules the Minister Assisting the Treasurer in the Second Reading Speech said :

> "*[the process] demonstrates this Government's commitment to tackle the hard issue of tax minimisation and deferral opportunities available to Australians through some types of offshore investment while recognising some taxpayers' legitimate need to invest offshore to achieve portfolio diversification. … [T]he adoption of the bulk of Professor Arnold's recommendations … is a demonstration of this Government's commitment to ... target areas of tax minimisation and deferral and where possible reduce compliance and administration costs*".[39]

11.3.3 Removing the active business exemption would be contrary to tax reform principles

> "*The active business exemption will ensure that there is no tax hindrance to portfolio diversification…. These active businesses provide little or no scope for tax minimisation and deferral*".
>
> - Explanatory Memorandum, Taxation Laws Amendment Act (No. 2) 1993

A Platform for Consultation canvasses an option that it calls removing the active business exemption[40]. It actually means removing all the exemptions. It rightly acknowledges that this would greatly increase compliance costs and would create a bias in favour of domestic investment[41].

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[39] Second Reading Speech, Income Tax Assessment Act (Foreign Investment) Act 1992

[40] Para 32.45

[41] Ibid.

The FIF rules would cease to have any connection with tax deferral. **They would become no more than a tax penalty on foreign investment. This would be contrary to the investment neutrality principle in *A Strong Foundation*[42].**

This sort of penalty has nothing to do with reform of the tax system and is not a part of the Government's mandate. The Government should not take such a radical step without explaining it in full to the public. This sort of disincentive is contrary to the principle in A Strong Foundation that the tax law should not be used for other policy objectives without a full impact statement[43].

If Australian savings vehicles are penalised for investing in foreign securities, Australian investors will use foreign investment vehicles, such as U.S. mutual funds, to the detriment of the local industry. Other Australian investors will reduce the diversification in their portfolios causing greater volatility and making investment a less rewarding experience. They will reduce their investments to their own detriment and to the detriment of the economy and local industry.

Australia cannot be a regional financial centre if it cannot be the base for the management of foreign investment. Without a healthy collective investments industry it will not have an efficient capital market and will not have large enough financial markets to attract any sort of overseas interest at all.

11.3.4 Replacing the active business exemption could be as bad as removing it

A Platform for Consultation also canvasses an option of replacing the active business exemption[44]. Replacing the exemption still involves removing it. Unless it is replaced with something at least as effective this will bring all the negative consequences described above.

Any replacement has to be at least as effective as the active business exemption in providing a simple way to exempt the majority of inoffensive investments in a diversified portfolio.

The primary suggestion for a replacement provision for portfolio investments is a jurisdictional test based on countries with effective anti-deferral regimes. It has been suggested by the Review during the consultation process that the U.S. may be the only jurisdiction for which an exemption is granted. Since this is an exemption that already exists, this suggestion is just a disguised version of removing the active business exemption without offering any replacement. IFSA's modelling concludes that if the U.S. is the only exemption, about 89% of FIFs would be subject to attribution.

If the exemption were given for the seven CFC listed countries, about 53% of FIFs would be subject to attribution. This is still not an acceptable solution.

Unless the exemption covers all jurisdictions except those tax havens that have no real industry, it will operate as a winding-back of the active business exemption.

The alternative suggestion is for a jurisdictional test based on approved stock exchanges and the carrying on of a business in a listed country. The Review is of the opinion that this is not

[42] Policy Design Principle 7, page xxi.

[43] Policy Design Principle 10, page xxi.

[44] Paragraphs 32.46 to 32.52.

sufficiently robust. For it to work the test would have to be sufficiently wide. Savings vehicles diversify their portfolios throughout the whole of the industrialised and semi-industrialised world and the companies they invest in are often multinationals rather than localised businesses.

11.3.5 The active business exemption actually needs to be broadened

For savings vehicles the problem with the active business exemption is that it is poorly targeted. The policy objective quoted above of allowing investments in active businesses, as stated in the explanatory memorandum, is only being partly met.

IFSA's modelling[45] concludes that only about 90% of investments in active businesses actually meet the legislative tests.

There are numerous deficiencies in the legislation. They include :

- Not approving stock exchanges even though they are used by investment professionals to make genuine investments. For example, the exchanges in Poland, Pakistan and Russia.
- Relying on balance sheets when they are often inaccessible for various reasons. Latin American countries and others like Russia don't require the same level of disclosure as we are used to. Differences in accounting periods mean that information is often significantly out of date. Balance sheets from countries such as Japan are often not available in English.
- Even though instruments such as options and convertible notes are included in the definition of a 'FIF', they are excluded from some of the exemptions. For example section 504 exempts shares in banks but not other investments.
- Some exemptions, such as section 504, have a meaningless requirement that the activity can't be carried on through subsidiaries that are not wholly owned. A lot of countries don't require this fact to be disclosed. It is not relevant to the decision of whether to invest in the company or not.
- The multiple business exemption in section 523 inexplicably excludes banking from being an eligible activity.
- Funds management and real estate businesses are unreasonably tainted as being passive. The list of permissible activities should be expanded to include both these active businesses.

The Review's analysis of its jurisdictional test suggestion betrays the main flaw in applying the FIF rules to savings vehicles. Paragraph 32.51 identifies that it will be difficult for portfolio investors to know whether a company is taxed in a listed country on a worldwide basis. This is a fact much easier to determine than the myriad of facts required to be known under the current rules. This information burden needs to be removed but not at the cost of penalising foreign investment.

A telling symptom of the weakness of the system is that there is great variation between fund managers when they classify the same company.

[45] The details of all modelling can be provided on a confidential basis.

11.3.6 One suggestion in A Platform for Consultation should be converted to an exclusion from the FIF rules for all diversified investment portfolios

There is one suggestion in A Platform for Consultation during the discussion of the active business exemption that deserves exploring. Paragraph 32.52 raises the idea of an exemption for portfolio interests in foreign trusts that "for example, offer investment portfolios that track a share market index".

The positive idea inherent in this suggestion is that it recognises that the diversified investment-driven portfolio of a fund that tracks an index is the same order of low risk that a country with an effective anti-deferral regime. The investment objective and the fiduciary duty that binds the fund to that objective prevents it exploiting deferral opportunities.

The negative aspect of the suggestion as it is currently expressed is that it could create two serious distortions to competition in the collective investments industry.

While some funds have an objective of tracking an index as closely as possible, a lot of funds seek to outperform the index. This sort of fund still holds a broad diversified portfolio that resembles the index to some degree. Different managers have different styles. Some will depart further from the index but some will hold portfolios that are quite close.

There should be recognition of the fact that fund managers generally, whether they manage with reference to an index, or manage to out-perform the index, do so and are measured (ie. performance), with reference to the pre tax return of the fund. Hence, this supports exclusion of both index and other active managers from the operation of the FIF regime.

It would also be inappropriate to draw a line between different investment styles. To only exempt index funds would produce a bias against funds that are not significantly different to index funds.

The second distortion to competition that could be created is that the proposal is to grant an advantage to foreign savings vehicles over Australian investment vehicles. An Australian investor would be able to avoid the costs of the FIF rules by choosing a foreign product over a local one. As has been discussed above, this is contrary to the objective of making Australia a regional financial centre.

The way to remove these undesirable features from the proposal is to convert it to an exclusion from the FIF rules for all genuine diversified investment portfolios.

11.3.7 The balanced portfolio exemption threshold needs to be increased

Provided 95% by value of a portfolio is exempt from FIF attribution, there is a provision to exempt the last 5%. This is often referred to as the balanced portfolio exemption.

It is sometimes argued that this exemption makes up for weaknesses in the active business exemption. IFSA's modelling[46] concludes that a diversified portfolio of genuine investments will meet this test only 53% of the time even where there is a U.S. jurisdictional exemption.

[46] Ibid.

This is another failure of Government policy. In the Explanatory Memorandum the Government said that:-

> *[i]n designing the Foreign Investment Fund measures, the Government has carefully targeted those non-controlling interests in foreign entities that provide the greatest scope for tax avoidance. The particular focus of the measures is on long-term interests in multi-tiered, offshore investments that enable the deferral of Australian tax through the accumulation of low taxed income offshore. That income is usually converted into concessionally taxed capital gains on the disposal of the interests.*[47]

This is not how the FIF rules operate.

The threshold needs to be increased from 5%. IFSA's modelling concludes that at 10%, genuine portfolios will qualify 94% of the time. At 15% they would qualify 99.9% of the time.

If it was considered that such a move created risks for the Revenue, the higher threshold could be limited to low-risk taxpayers such as savings vehicles, complying superannuation funds, approved deposit funds, pooled superannuation trusts and life companies.

11.3.8 The proposal to remove the deemed present entitlement rules should be implemented but there should be no discrimination between companies and trusts

Paragraph 32.54 of A Platform for Consultation proposes removing the deemed present entitlement rules[48] and dealing with interests in trusts through the FIF rules.

We support this proposal. The deemed present entitlement rules are seriously flawed in that they can result in income being taxed twice.

In implementing this, the investment neutrality principle in A Strong Foundation of not discriminating between companies and trusts[49] needs to be included in the design.

11.3.9 Industry position

IFSA's preferred position is for savings vehicles to be excluded from the FIF regime. This will provide greatly reduced compliance costs for industry without any corresponding increase in tax deferral.

[47] Income Tax Assessment Amendment (Foreign Investment) Act 1992

[48] Sections 96B and 96C.

[49] Policy Design Principle 7, page xxi.

12. CORPORATE TAX ISSUES

12.1. Executive Summary

- IFSA support the reduction of the corporate income tax rate to 30%. However, it is submitted that the top marginal rate for personal income tax and FBT should also be reduced to 30% removing incentives for individual to structure income through corporate entities.
- The potential cash flow problems associated with the introduction of a comprehensive "Pay as You Go" system should be carefully considered by the Review team.

12.2. 30% Company tax rate

12.2.1. A reduction in the company tax rate

The current company tax rate is in the upper band of international global rates. There is therefore a good economic argument for its reduction. However, should this be offset by abolishing existing tax concessions?

With the introduction of the proposed equalisation tax, in a practical sense, the benefit of any concessional tax deductions will effectively disappear for Australian companies and trusts (except those specifically excluded from the new regime). This is because they will be paying tax on any tax preferred items distributed to shareholders or beneficiaries. Items such as building write offs, depreciation, research and development concessions etc will no longer have any real value. The effect of any formal cancellation of these benefits for these entities will not therefore have as dramatic effect as would otherwise be contemplated.

To allow other taxpayers to continue to take advantage of these deductions may well involve a schedular approach to the ITAA (specific deductions being specifically non allowable to categories of taxpayers). This will add a further layer of complexity to the ITAA. The alternative is to abolish such deductions across the board.

IFSA would not recommend the abolition of any particular deduction. However, we do realise that if issues of revenue neutrality are regarded as pre-eminent in discussions on the reduction in the corporate tax rate, it is highly probable that many of the current concessions available to corporate Australia may disappear.

A reduction in the corporate tax rate is recommended.

12.2.2. The discrepancy between corporate and individual rates

The top marginal rate for personal income tax and FBT should equate with the company rate.

The present differential acts as a positive encouragement for individuals to restructure their tax affairs in such a way to channel income through interposed entities. To retain, and in fact to further increase the present differential, will merely encourage further this activity. Future Government's cannot therefore complain about the extent of income being channelled through trusts and companies with the existence of such a tax differential.

The top marginal rate for personal income tax and FBT should equate with the company rate.

12.3. The introduction of Pay As You Go

The five existing payment and reporting systems for taxpayers are to be replaced with a new Pay As You Go System. Because tax payments under this system are to be calculated based on turnover (as used for GST purposes), the provisional tax uplift factor will be obsolete.

There is concern that, particularly in its first year of introduction, this new system will bring forward the tax payments of most taxpayers, particularly companies. Perhaps the most obvious example is in the case of large companies (those with an annual tax liability of more than $300,000). In the case of these taxpayers, the tax payments will be brought forward by 5 months. This represents an effective increase in the tax rate. A 30% nominal tax rate therefore would be equivalent to a 31.25%[50] rate under the current system when the PAYG changes are taken into account. In the first year of the PAYG system, companies in this category may be liable to make more than one payment in the same quarter. The government has indicated that transitional measures will be introduced to reduce the cash flow impact of the accelerated payment in the case of large taxpayers. However, the measure is clearly designed to bring forward Government revenues and will create cash flow problems for many taxpayers, particularly in the first year of introduction.

IFSA recommends against any measure which further brings forward the payment of tax by taxpayers as it will merely create cash flow problems.

12.4. Non-resident shareholders

12.4.1. Application of the Deferred Company Tax (DCT) regime to non-resident shareholders

Adoption of the DCT regime in respect of non-residents would be a significant setback to Australia's aspirations for becoming a major regional centre for offshore investment. The proposed mechanism for refunding some of the entity tax is complex and would be difficult to explain to foreign investors.

We support the view (apparently held by the RBT) that implementing DCT would cause a major outflow of existing foreign capital from Australia and severely restrict our ability to attract new capital. The DCT regime is therefore not supported. The proposed resident dividend withholding tax regime is preferred for shareholders.

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[50] Loss of interest assuming a 10% internal rate of return, a 30% tax rate, and a five month delay is 10 x 30 x $^{5}/_{12}$ = .0125

12.4.2. *Conduit Investment*

IFSA applauds and echoes the Review's comments that Australia should not cause double tax to apply to income from foreign investment flowing through Australian entities to non-resident investors where that income has been comparably taxed in the country of derivation. IFSA questions, however, why this principle should not extend to active income derived from countries which do not have a comparable taxing regimes to Australia's. The existing Controlled Foreign Corporation ("CFC") provisions are sufficiently robust to prevent the relocation of passive income into unlisted countries.

IFSA supports the proposals to extend the current Foreign Dividend Account ("FDA") arrangements to relieve more types of foreign source income passing to non-resident investors. In terms of the operation of the proposed Foreign Income Accounts, we are supportive of Option 1 (p.657)– crediting total foreign income receipts to the account – for the following reasons:

- It is simple;
- It encourages repatriation of profit from foreign investments and therefore brings money back to Australia to the extent of Australian shareholder participation in the investment;
- It encourages the use of Australia as a financial centre for Asian (and beyond) investment;
- It encourages joint ventures with Australian investors by not "watering down" the crediting mechanism for the effects of Australian participation – as is proposed in option 2.

12.4.3. *Treatment of Foreign Shareholders: International Competitiveness*

One of the general concerns posed by the DCT regime is that it will fall particularly harshly on foreign owned companies and foreign shareholders of Australian companies. They do not now enjoy the benefit of imputation credits, and will not under the proposals.

However, elimination of unfranked dividends (made out of so-called "tax preferred" income), which at present attract only dividend withholding tax - typically 15% under double tax treaties - will substantially raise the Australian tax payable on their distributions. All distributions will be taxed (via company tax or deferred company tax) at the standard entity rate, now 36%. This will "wash out" for foreign shareholders "concessions" such as CGT, cost base indexation and accelerated depreciation - which, in the main, are designed to avoid taxing capital itself, as distinct from economic income. Moreover, the new treatment seems inconsistent with at least the spirit of treaty commitments.

Such proposals appear to give insufficient weight to the fundamental reality of Australia's very heavy dependence on foreign capital - given our low domestic saving. The debt component of the foreign capital invested in Australia is uncomfortably large, and it is of national importance that we are attractive to equity investors. In this, it is important to recognise that we cannot significantly influence the post-tax rate of return on equity that they require, which is set in world capital markets. Raising our effective company tax rate, which is already uncompetitive, vis-a-vis relevant benchmarks, will inevitably reduce the proportion of our external deficit that is funded by direct and other equity investment as distinct from debt.

The life insurance industry provides a specific example. Its major activity nowadays is funds management - an activity for which Australia is a potentially competitive centre in the Asia

Pacific. The proposed treatment of foreign investors, and the exclusion of the industry from stamp duty relief, appear somewhat at odds with the Government's policy to promote Australia's competitive position as an international financial centre.

IFSA therefore favours the use of resident dividend withholding tax as suggested in Discussion Paper 2 in relation to dividend income.

13. CONSOLIDATIONS

13.1. Executive Summary

IFSA supports, in principle, the adoption of a consolidated tax regime. However, in light of the significant transitional issues associated with the introductions of such a regime and the breadth of tax reform measures that taxpayers already need to come to terms with, in the next few years, we would recommend that the introduction of such a regime be deferred for the time being. This possibility should be reconsidered when the current range of changes has settled down.

13.2. Comments

At Chapter 26 of Discussion Paper No 2 it is proposed that the taxation of group entities (companies and trusts) as a single entity would provide a fairer and simpler taxation regime for companies and trusts. It is noted that the design of an appropriate consolidated taxation regime, based on the six principles outlined in that chapter will still require considerable submission and discussion with business representatives.

However, it is submitted that the introduction of the regime, whilst it may ultimately reduce compliance burdens, would require significant overhauling of compliance systems that are currently in place. IFSA believes that the resources of its members are currently being stretched in order to deal with Y2K problems and the imminent introduction of GST and the multitude of other tax changes certain to follow from the RBT. It is therefore not appropriate to introduce a consolidated tax regime at this point in time.

Further, it is submitted that there are still significant issues in relation to a consolidated tax regime that are to be adequately resolved. A list of such issues is provided below. IFSA would welcome the opportunity to work with the Government or the Review team in dealing with this issue at a later stage.

The key issues that must be addressed to introduce a successful consolidation regime are as follows:

- There is little flexibility in the consolidation regime. Although it is optional to apply the regime, there are clear penalties built into the system going forward for those who do not elect the consolidation regime.

  Benchmarking with NZ and U.S. indicates that the rules are considered quite complex. In NZ, where the system is truly optional, we understand that very few companies have elected consolidation. Feedback from the U.S. is that more companies have applied consolidation, but they have complained of compliance complexity.

- The system will impose joint and several liability on each member for the group's total tax debts. This creates difficulties when selling companies and for special financial companies.

- It may not be appropriate to have all companies within the consolidation regime. For instance, an entity may have certain contractual obligations with third parties under which losses or other credits are shared on a certain basis. If that company is within the group, such losses would be forced to be shared within the consolidated group upsetting those contractual arrangements. However, unless the company is within the consolidated group, other tax treatments such as dividend rebates etc will be disallowed.

- Consolidation can only occur between 100% group companies. This is a rather inflexible rule (benchmark to the US where 80% is required). Minority interests, particularly finance shares etc have not been accommodated.

  There is no recognition of the need to deal with employee shares but no specific proposals are made.

- Consolidation is not available unless groups have a single Australian holding company. Some groups do not have this structure and therefore cannot consolidate their companies resulting in penalties outside the consolidation regime.

  Where restructure is possible, rollover and other relief (eg stamp duty relief) is necessary to allow restructuring for consolidation.

- There need to be clear rules to allow trusts to be included in consolidation groups It is common for trusts to be established to hold certain assets to conduct certain businesses within groups.

- The compliance requirements for entry to and exit from groups is quite significant. Depending on the option selected, it would be necessary to value all assets within a company entering a group or when that company transfers any assets to another group company.

- Current tax rules are drafted to apply differently based on the status of specific companies. For instance, treatment of bad debts for banks and finance companies, treatment of assets held by life companies, special treatment of assets held by mining companies, etc.

  It is unclear as to whether those tax attributes will apply on transactions within the group will be handled. The profile of the asset or item could change depending on where it is transferred within the group. This will not really relieve the compliance burden.

- The rules do not seem to take account of different stakeholders in corporate groups. For instance, stakeholders will include shareholders, policyholders, creditors and contractors. It is unclear whether the simplified consolidation system will allow transfers of losses etc between stakeholders for consideration within groups. Without this flexibility there will be groups within consolidated groups adding to complexity.

- There will need to be a pragmatic approach to bring losses, franking credits and assets into and out of groups. Rules designed to protect the revenue (eg possibility that losses are quarantined within a company or lost altogether) are potentially complex and possibly inequitable.

- Pursuant to paragraph 26.52 of Discussion Paper No 2, it is proposed that foreign rollover of assets may no longer be recognised when calculating attributable income under our CFC regime. This would result in a considerable disadvantage for Australian based international groups. It would not be possible to rationalise and restructure global groups as required. IFSA is not of the view that such rollovers should continue to be recognised.

APPENDIX A

LIFE INSURANCE TAXATION – EXAMPLES:

INVESTMENT LINKED BUSINESS

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
Assets at Start of Period			
Represented by:			
- Solvency Requirement for Policies	9850	9850	
- Deferred Tax Reserve	15	150	
- Other	1000	-	1000
- Total Liabilities and Capital	11000	10000	1000
Unrealised Gains at Start	1430	1300	130

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
Revenue Account			
Premiums	5000 (P)	5000 (P)	
Investment Income			
- Interest, Dividends, etc.	55	500	5
- Realised Gains	220	200	20
less Unrealised amounts at start of period			
	(165) 55	(150) 50	(15) 5
- Unrealised Gains	275	250	25
- Total	880 (I)	800 (PI)	80
Increase in Unrealised Gains	110 ΔUG	100 ΔUGP	10 (UGS)

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
Fees	-	(100) (F)	100 (F)
Expenses	(95) (E)	-	(95) (E)
Policy Claims	(1400) (C)	(1400) (C)	-
Increase in Policyholders' Liabilities			
- Solvency Requirement	(4195) (ΔL)	(4195) (ΔL)	-
- Current Taxation			
[15% x (Inv. Inc. – Fees – Inc. Unreal. Gains)]	**(90) (PT)**	**(90) (PT)**	**-**
- Deferred Tax Reserves	(15) (ΔDTRP)	(15) (ΔDTRP)	-
- Total	(4300)	(4300)	-
Shareholders' "Profit" Before Tax	95	-	95
Shareholders' Taxation [(36% x (Shareholders' Profit less increase in Shareholders Unrealised Gains)]	**(27)**		**(27)**
Shareholders' "Profit" After Tax	68		68
Total Tax payable by Company	**117**	**90**	**27**

LIFE COMPANY TAXATION – EXAMPLE: INVESTMENT LINKED BUSINESS

Ralph Committee Paper Option 1, with adjusted formula

Total Taxable Income (TI)

-	Premiums (P)	5000
+	Investment Income (I)	880
-	Expenses (E)	(95)
-	Policy Claims (C)	(1400)
-	Increase in Policy Liabilities (Solvency Requirement) (ΔL)	(4195)
-	Policyholders' Taxation (PT)	(90)
	15% x (PI – F – E - ΔUPG)	
-	Increase in Policyholders' Deferred Tax Reserve (ΔDTRP)	(15)
-	Increase in Unrealised Gains attributable to Shareholders (UGS)	(10)
+	Policyholders' Taxable Income (PI – F – ΔUGP) x PTR/0.36	
	(800 – 100 – 100) x 0.15/0.36	250
=	**Total Taxable Income**	**325**

Life Company Taxation = 325 x 0.36 = 117

LIFE INSURANCE TAXATION – EXAMPLE: RISK BUSINESS

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
Assets at Start of Period			
Represented by:			
- Solvency Requirement for Policies	4000	4000	
- Other	600	-	600
- Total Liabilities and Capital	4600	4000	600

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
Revenue Account			
Premiums	5000 (P)	5000 (P)	
Investment Income	250 (I)	220 (PI)*	3
Fees (including Underwriting Profit)	-	(2520) (F)	2520 (F)
Expenses	(2000) (E)	-	(2000) (E)
Policy Claims	(2400) (C)	(2400) (C)	
Increase in Policyholders' Liabilities			
- Solvency Requirement	(300) (ΔL)	(300) (ΔL)	
Shareholders' "Profit" Before Tax	550	-	550
Shareholders' Taxation [(36% x Shareholders' "Profit"]	**(198)**		**(198)**
Shareholders' "Profit" After Tax	352		352
Total Tax payable by Company	**198**	**-**	**198**

* This will not be recognised as income to policyholders on claim, so no tax has been deducted from the policyholders "accounts". Income from the investments supporting the Solvency Requirement simply increases the "fee" (including profit) payable to the shareholders.

Life Company Taxation – Example – Risk Business

Ralph Committee Paper Option 1, with adjusted formula

Total Taxable Income (TI)

-	Premiums (P)	5000
+	Investment Income (I)	250
-	Expenses (E)	(2000)
-	Policy Claims (C)	(2400)
-	Increase in Policy Liabilities (Solvency Requirement)(ΔL)	(300)
=	**Total Taxable Income**	**550**

Life Company Taxation = 550 x 0.36 = **198**

LIFE INSURANCE TAXATION – EXAMPLE: ORDINARY PARTICIPATING BUSINESS

	Statutory Fund		Policyholder "Accounts"		Shareholder Interest	
Assets at Start of Period						
Represented by:						
- Solvency Requirement for Policies		9850		9850		
- Deferred Tax Reserve		150		150		
- Other		1000		-		1000
- Total Liabilities and Capital		11000		10000		1000
Unrealised Gains at Start		1430		1300		130
Revenue Account						
Premiums		1400 (P)		1400 (P)		
Investment Income						
- Interest, Dividends, etc.		550		500		50
- Realised Gains	220		200		20	
less Unrealised amounts at start of period	(165)	55	(150)	50	(15)	5
- Unrealised Gains		275		250		25
- Total		880 (I)		800 (PI)		80
Increase in Unrealised Gains		110 ΔUG		100 ΔUGP		10 (UGS)

	Statutory Fund	Policyholder "Accounts"	Shareholder Interest
"Fees " (= Shareholders' share of investment income plus profits)	-	(145) (F)	145 (F)
Expenses	(95) (E)	(95) (E)	-
Policy Claims	(1800) (C)	(1800) (C)	-
Decrease (Increase) in Policyholders' Liabilities			
- Solvency Requirement	31 (ΔL)	31 (ΔL)	-
- Current Taxation			
[36% x (Inv. Inc. – Fees – Expenses – Inc. in Unreal. Gains)]	**(166) (PT)**	**(166) (PT)**	**-**
- Deferred Tax Reserve	(25) (ΔDTRP)	(25) (ΔDTRP)	
- Total	(160)	(160)	
Shareholders' "Profit" Before Tax	225	-	225
Shareholders' Taxation [(36% x (Shareholders' Profit less increase in Shareholders' Unrealised Gains (UGS)]	**(77)**		**(77)**
Shareholders' "Profit" After Tax	148		148
Total Tax payable by Company	**243**	**166**	**7**

Life Company Taxation – Examples – Ordinary Participating Business

Ralph Committee Paper Option 1, with adjusted formula

<u>Total Taxable Income (TI)</u>

-	Premiums (P)	1400
+	Investment Income (I)	880
-	Expenses (E)	(95)
-	Policy Claims (C)	(1800)
+	Decrease in Policy Liabilities (Solvency Requirement) (ΔL)	31
-	Policyholders' Taxation (PT)	(166)
	15% x (Inv. Inc. – Fees – Expenses – Inc. in Unreal. Gains)	
-	Increase in Policyholders' Deferred Tax Reserve (ΔDTRP)	(25)
-	Increase in Unrealised Gains attributable to Shareholders (UGS)	(10)
+	Policyholders' Taxable Income (PI – E – F – ΔUGP) x PTR/0.36	
	(800 – 145 – 95 – 100) x 0.36/0.36	460
=	**Total Taxable Income**	**675**

Life Company Taxation = 675 x 0.36 = 243

APPENDIX B

INCIDENCE OF LIFE COMPANY TAX IN THE PRESENT SITUATION[51]

The apparent official concerns that premiums and underwriting income are not being taxed do not take account of the fact that *because* ordinary life insurance is typically a bundled product with a substantial investment component, and *because* the risk and investment components are typically combined in a single fund whose *net income* is taxed, the present treatment for this major category is in fact equivalent to taxing *all* policyholder and shareholder gains.

- For the shareholder, this includes *both* underwriting income and management fees - albeit with certain exceptions (as noted below).

Present Effective Tax Incidence

For typical ordinary life insurance business, the present 39 per cent tax on the excess of investment income over expenses - the "t*(I-E)" tax basis - can be shown as equivalent to taking the gains of both policyholders and shareholders, basically because transactions between the two, including both management fees and experience profits (including mortality profits), "cancel out", leaving only transactions with third parties - ie. investment income and expenses.

The apparent simplicity of t*(I-E) hides the power of this mechanism for jointly taxing both parties. Much of the concern about the current basis, we believe, is based on a misconception that some parts of income escape tax. The following derivation shows the integrity of the (I-E) approach.

If the policyholders as a group were to be taxed separately, they would be taxed on net "income", where "income" is in the form of growth in the value of their assets.

Policyholder net income

= Income - Outgo

Claims and Increase in Policy Values - (fees + premiums)

= C + (CPV - OPV) - (F + P)

Where

CPV = closing policy values

OPV = opening policy values

P = premiums paid by the policy owners

F = fees paid by the policy owners

[51] Extract from IFSA submission to the Gibson Committee - April 1998, page 24

Similarly, if the office was separately taxed, it would pay tax on net “income”.

Office net income

$$= \text{Income} - \text{Outgo}$$

$$= \{(F+P) + I\} - \{C + E + (CPV - OPV)\}$$

Where

I = investment income

E = expenses

Adding the two, and applying a single statutory rate of tax (t), means tax paid becomes:

$$t \times \{C + (CPV - OPV) - (F+P)\} + t \times \{[(F + P) + I\} - [C + E + (CPV - OPV)]\} = t \times (I - E)$$

Thus, the basis is theoretically sound, simple administratively and easy for the ATO to collect. The policyholders cannot avoid tax.

In other words, a tax on (I - E) is, in these circumstances, equivalent to a tax on pre-tax policyholder plus shareholder gains. For the shareholder, these gains include both management fees and underwriting profits. If these were to be separately taxed on top of (I-E), they would be effectively taxed twice *unless* the tax on the shareholder is offset by an explicit tax deduction to the policyholder.

An exception to the above analysis is where a policyholder’s net gain in a year is negative (ie. premiums exceed claims plus increased policy value) and cannot be offset against other gains for tax purposes. The main instances of this are in respect of *pure risk insurances* (term, disability etc) with no investment component and no build-up of surrender value. A tax basis like that applying to accident and disability (AD) - or to general insurance - will be more appropriate for these risk insurances. If such a basis were applied to bundled products (providing both risk cover and investment), it would be necessary to separate the risk gains and losses, for both parties, from the (I-E) basis to ensure they were effectively taxed only once.

As regards *management fees* on ordinary life insurance business, the conclusion is that if these were to be identified and brought separately to tax, ie. outside the t*(I-E) calculation, then clearly the treatment would have to be symmetrical. If assessable to the company, they must also be deductible to the policyholder - to avoid double taxation. Any changes should try to avoid the complication of asking individual taxpayers to claim such deductions in their yearly income tax returns.

Issues and Principles

The main principle applying to these issues is the principle of *neutrality* of treatment for both policyholder and life insurance company.

IFSA’s position, is that:

(x) The *definition* of life business should be consistent with that in the new Life Insurance Act, with AD/trauma policies continuing to be treated as non-life.

(xi) For typical ordinary life business combining risk and investment, the present “t*(I-E)” tax basis is equivalent to taking all policyholder and shareholder gains, including *management fees* paid by the former and received by the latter, and underwriting income. (Pure risk insurances are an exception to this equivalence). Any revised treatment must be neutral and symmetrical, to avoid double taxation. And, in particular, any change of treatment to have management fees explicitly included in assessable income of a life insurance company must be matched by making them deductible to the policyholder.

(xii) A similar conclusion applies to *life underwriting income*. Any more direct treatment of life underwriting should avoid duplication of taxation and be neutral, in particular vis-a-vis the treatment of general insurance underwriting. Pure risk insurances could in fact be taxed on the same basis and at the same rate as applies to general insurance.

(xiii) Life insurers who have the necessary systems should have the option to apportion *expenses* on a fair and reasonable/factual basis. Such apportionments are already subject to a rigorous statutory reporting regime and appointed actuary sign-off.

APPENDIX C

PROBLEMS WITH TAXING CIV's AS COMPANIES

The system originally proposed for the taxation of CIV's gives rise to a number of issues which have the effect of distorting the investment decision towards direct investment.

Cash flow impact

The proposed changes operated to :

- deem all distributions by CIV's to be taxable dividends; and
- treat the proceeds of redemption as a taxable dividends to the extent the redemption proceeds exceed the capital allocated to the redemption.

The deemed dividend would be required to be fully franked. If the CIV did not have sufficient franking credits to fully frank the deemed dividends then it would be required to pay deferred company tax (or apply one of the alternative treatments referred to in the second discussion paper).

The investor would use the franking credits attached to the distribution to offset the investor's personal tax liability. In the case of some investors, the excess franking credits (if any) would be refunded.

The distribution to the investor would therefore be net of tax, resulting in the investor receiving less cash at the time of the distribution. The franking credits represent a prepayment of the investor's tax liability, irrespective of the type of income distributed. For example, if the CIV solely derives interest income and distributes this income to the investor, the distribution must be made net of tax. If the investor had invested directly in interest bearing securities, the interest would have been paid gross (assuming the investor had provided their TFN) and the tax liability would not arise until a later date.

Consequently, a distinct cash flow disadvantage arises from investing in a CIV under the proposed changes. The cash flow disadvantage may be exacerbated where the investor receives excess franking credits and must claim a refund. A significant period of time may elapse between the taxpayer's receipt of the distribution, net of tax, and the subsequent refund of any excess franking credits. During this period the taxpayer does not have use of the cash, notwithstanding that the amount withheld is in excess of the tax liability which will arise for the investor for that particular year.

By way of example, tax may be deducted by a public unit trust from its September distribution and a unitholder may not receive a refund until after the unitholder has lodged their return in, say, the following October.

Clearly, there is an incentive for investors such as superannuation funds and retirees on low marginal rates to contemplate direct investment to avoid the cash flow disadvantages imposed on investments through CIV's under the proposed changes.

This cash flow impact is particularly harsh for hundreds of thousands of retirees who are full or part pensioners. For these low income earners, who rely on distributions to supplement the age pension, cash flows are critical. In addition, many full pensioners will for the first time be required to lodge a tax return simply to claim back the franking credit. It is submitted that this is both inefficient and unfair.

Loss of income character on flow through and redemption

A basic tenet of trust and taxation law is the principle, laid down in various cases, that income retains its character when it passes through a trust. That is, if trust income comprises, say, capital gains, dividends and interest, these characteristics are imputed to the trust distribution. Under the Government's proposals, the distribution from trusts which are CIV's will be deemed to be a taxable dividend and will not retain the character of the underlying income.

The loss of character will have a direct impact on resident unitholders where the trust is distributing capital gains, property income and foreign income as discussed immediately below.

Capital gains

Under the current rules, if a trust derives a capital gain and distributes it to unitholders, then the distribution is treated as a capital gain derived by the unitholder. This retention of the capital character through a trust is important to unitholders with carry-forward capital losses and/or who will be entitled to indexation and/or averaging of the capital gain.

Capital losses

A fundamental principle of the capital gains tax ("CGT") legislation is that capital losses may not be offset against revenue income. Capital losses may only be offset against capital gains. Currently, a unitholder may offset capital losses against a trust distribution to the extent it constitutes a capital gain.

Under the proposed regime, trust distributions (including the redemption profits on exiting the trust) are treated as dividends and will no longer be of a capital nature. Thus investors in a trust which derives a capital gain will be subject to tax on the capital gain without the opportunity to offset other capital losses against this gain.

Clearly, investors will be discriminated against for investing through a trust rather than investing directly in the underlying asset. Direct investment in capital assets would generate a capital gain on disposal of the asset. The capital gain could then be offset by any capital losses of the investor. This will directly affect small investors who would normally hold assets on capital account.

Further, should an investor redeem their interest in a trust and incur a capital loss on redemption, under the Government's proposals that capital loss can never be recouped out of future gains made on public unit trusts. An investor will be forced to hold some other type of direct investment in order to have potential to derive a capital gain.

Indexation

A capital gain distributed by a trust to a unitholder is only assessable to the extent that the disposal proceeds exceed the indexed cost base of the asset. That is, the unitholder is entitled to the benefit of indexation on the underlying asset. The indexation component distributed to the unitholder under the current taxation regime is not immediately assessable, but rather reduces the cost base of the units in the trust held by the unitholder. This is not a deliberate tax deferral mechanism. The intention of the tax law is to reflect the unitholder's beneficial interest in the underlying asset.

Under the proposals, the indexation component distributed to unitholders will constitute a taxable dividend. Consequently, there will again be a preference for unitholders to invest directly in assets in order to obtain the benefit of indexation.

Averaging provisions

The CGT legislation contains concessionary measures which provide for the averaging of income for individual taxpayers who derive a capital gain. Essentially, these provisions allow a capital gain to be taxed in the investor's hands at the marginal tax rate for that investor before inclusion of that capital gain. This concessionary measure is aimed at low income earners since individuals who are subject to the top marginal rate (excluding the capital gain) will not benefit from this concession.

The proposed measures provide for certain other concessionary measures (specifically, the primary producer provisions and small business goodwill exemption) to continue, notwithstanding the taxation of trusts as companies. However, the announcements were silent on the treatment of capital gains derived through trusts.

Again, the loss of this concession may encourage an investor to invest directly into the market rather than through a public unit trust.

Foreign income

Foreign income derived by public unit trusts is generally subject to foreign tax in the first instance. This foreign tax is usually then creditable against the Australian tax payable on such income. Unitholders receiving distributions of foreign income from unit trusts will normally be entitled to utilise any foreign tax credits against their Australian tax.

Presumably the foreign tax credit system will continue to apply under the new regime, with credits being granted at the trust level. The Australian tax paid by the trust would therefore be reduced by the foreign tax credits.

Under the proposed measures, when the unit trust makes a distribution of offshore income to unitholders, it would not have sufficient Australian franking credits available with which to fully frank the income. Accordingly, deferred company tax at the rate of 36% would be payable on this distribution. This means that unitholders will be subject to double taxation (foreign tax and deferred company tax) on any foreign source income.

The following example illustrates this point:

	$
Foreign income received	75
Gross up for foreign tax paid	25

Taxable income	100
	=====
Tax thereon	36
less Foreign tax credit	(25)

Trust tax payable	$11
	=====
Cash available for distribution (being $75 received less $11 Australian tax payable)	$64

As the trust only pays Australian tax of $11, it will be unable to distribute the cash available for distribution (ie $64) as fully franked. Accordingly, in addition to the foreign tax paid ($25) and the Australian tax paid by the trust ($11), deferred company tax of $25 will have to be paid by the trust when the income is distributed to unitholders. This means that of the $100 income derived, only $39 may be distributed to unitholders. The total tax paid on the income of $100 is $61 (or 61% of the foreign income).

Investing offshore is a necessary part of creating a well balanced portfolio. By subjecting such income to double taxation, a distortion will be created towards direct investment. Clearly, such direct investment may significantly increase the risk profile of Australian investors and potentially close an investment option to all but the wealthy.

Property income

Investing in property through a public unit trust is not a tax deferral mechanism. Rather, it is comparable to the tax position of an individual holding property directly. The tax free and tax deferred distributions (which mainly comprise building allowance and depreciation) can be likened to the tax deductions available to an individual holding the property directly.

Subject to any change in overall view arising from the second discussion paper, the new regime would treat the distribution of tax preferred income as an unfranked dividend. The effect of this is that investors holding property through a trust are denied the deductions for building allowance and depreciation which would be available to them had they invested directly in property.

This clearly prejudices investors who elect to invest via a trust rather than directly. Again, this change will significantly impact small investors who may not have sufficient capital to directly invest in property.

The inequity of the proposed new regime is likely to result in investors reconsidering their property trust investments and either:

- Attempting to invest directly in property (with the attendant increase in risk profile as, individually, investors will not be able to achieve the same level of diversification); or

- being denied access to property investment and either investing in other asset classes (reducing diversification and increasing risk) or not investing in a savings vehicle.

Redemption of units

The proposed taxation of trusts as companies will raise a number of complex issues in relation to the redemption of units in a unit trust.

The precise taxation implications that are proposed to arise upon redemption of units have not been detailed. However, for the purposes of this submission, we have considered the process which applies under the New Zealand tax regime, together with issues of double taxation on redemption and the lack of symmetry when a capital loss is incurred.

New Zealand redemption position

Background

The following outline is largely based on details contained in New Zealand Inland Revenue Tax Information Bulletin Volume 7, No 9, February 1996.

In New Zealand, the redemption of a unit will give rise to a taxable dividend to the extent that the amount paid out upon redemption of the unit exceeds the capital allocated to that unit. Two methods are available for determining the allocated capital upon redemption of the unit. The methods are commonly referred to as the "slice" rule and the "ordering" rule.

The slice rule only applies in relation to unlisted unit trusts where the units redeemed were originally issued on the basis that the slice rule applies. In all other circumstances the ordering rule will apply.

Operation of the ordering rule

The ordering rule provides that the proceeds of the redemption are taken first from the "available subscribed capital per unit cancelled." The available subscribed capital per unit cancelled is an amount calculated by dividing the subscribed capital available to be redeemed for a particular class of units by the number of units in that class being redeemed. A taxable dividend will arise to the extent (if any) that the redemption proceeds exceed this amount of capital. An example illustrating the application of the ordering rule is set out below:

On 1 September 1996 a unit trust is formed. The unit trust issues 100,000 units at $1 per unit. The units are taken up in equal shares by 200 investors, that is 500 units per investor. Entry to the unit trust is closed after this date. On 18 May 1997 the units have risen in value to $1.75. On that day 50 investors redeem their units with the unit trust.

The available subscribed capital per unit cancelled will be 100,000/25,000 which is $4 per unit (even though each investor only subscribed $1 per unit). No dividend arises as the amount distributed to the investors ($1.75 per unit) does not exceed the available subscribed capital per unit cancelled ($4 per unit). The "available subscribed capital" of the unit trust is now reduced to $56,250 ($100,000 - $43,750).

Operation of the slice rule

Under the slice rule the amount of capital allocated to the redemption of a unit will be the "available subscribed capital per unit." This amount is defined as the total subscribed capital available to be redeemed for the particular class of units divided by the number of units in the class. A taxable dividend will arise to the extent that the redemption proceeds exceed this amount of capital. An example of the operation of the slice rule is set out below:

> **On 1 July 1996 a unit trust is formed. The unit trust issued 20 million units at $2 per unit. All units in the unit trust are issued on such terms that their redemption is subject to the slice rule. The performance of the unit trust has been outstanding. The value of the units as at 30 September 1997, when the trust's financial results for the year were announced, was $5 per unit.**
>
> **A company which has held units since the start of the unit trust decides to redeem its unit holding of 2,000 units. The available subscribed capital per unit is $2 as all units issued at the time the trust was formed went into the one class.**
>
> **Upon redemption the company received $10,000 which is comprised of available subscribed capital of $4,000 and a dividend of $6,000.**

The ordering rule is inequitable

The application of the ordering rule to redemptions from a unit trust is clearly inequitable. Assuming that all the units in the trust belong to the same class, then the ordering rule provides inequitable advantages to investors who redeem their units at times when the unit trust has significant amounts of capital. These investors will be deemed to receive a disproportionate amount of returned capital upon redemption of their units, with the amount potentially being equal to the entire redemption proceeds. The amount of deemed returned capital will not have any relationship with the actual amount of capital originally invested by the investor.

The ordering rule operates to the detriment of investors who will redeem their units at other times when the capital of the trust has been deemed to have been substantially exhausted under the ordering rule. Such investors will be deemed to receive a large taxable dividend upon redemption of their units.

The inequities of the ordering rule are illustrated in the first example above, where redeeming investors could be allocated up to $4 returned capital per unit notwithstanding that the investors originally contributed $1 capital per unit. The excess capital returned upon redemption has effectively been reallocated from investors remaining in the fund.

The slice rule also has problems

Variations in subscribed capital per unit

On its face, the slice rule appears to be more equitable in that investors should hopefully be allocated an amount of returned capital equal to the capital they originally invested in the unit trust. In fact, this result can only be achieved if the issue price of units in the class remains stable. Unfortunately this is an unrealistic assumption.

The issue price of units will be determined by the nominal value of the unit plus the accrued income/loss of the trust at the time of issue. Consequently the unit price will constantly vary to reflect variations in the accrued income/loss of the trust at any particular time. A simple example illustrates the inequities which can arise under the slice rule.

On 1 October 1998 a unit trust is formed. The unit trust issues 40,000 units at $1.00 per unit. On 1 November 1998 a new investor applies for and is issued 10,000 units in the trust of the same class. The issue price is $1.20 reflecting the income which has accrued in the trust during October 1998. The same investor redeems the units on 2 November 1998. The redemption price is $1.20 as there has been no change in the accrued income of the trust.

Under the slice rule, the available subscribed capital per unit is $1.04 (52,000/50,000). The unitholder will be deemed to receive a taxable dividend of $0.16 per unit notwithstanding that the unitholder bought and redeemed the units for the same price. Part of the capital subscribed by the unitholder (ie $0.16 per unit) has been converted from capital into revenue in the hands of the unitholder.

This issue largely arises from the fact that the company taxation model assumes a relatively stable capital base and that capital reductions and issues are relatively uncommon. As noted earlier in this submission, this assumption is not consistent with the operation of public unit trusts. Further, whereas investors in companies are able to take gains or losses in the market, unitholders typically are obliged to transact with the unit trust. Accordingly, profit taking or loss making by unitholders has a direct impact on the capital base of the unit trust. The difficulty is that transactions with the unit trust will be deemed to be a dividend (ie a distribution from a company to a shareholder) to the extent they exceed the capital amount allocated to the redemption (which will usually be different to the capital originally subscribed by the unitholder).

Units held on revenue account – potential double tax

If the gain on disposal of a unit is treated as being on revenue account to the unitholder, then the gain will be taxed both as a revenue gain upon disposal of the units and also as a deemed taxable dividend. A specific provision would be required to avoid the double taxation. Although the New Zealand law contains a provision to minimise the potential double tax effect (achieved by reducing the consideration received on disposal by the amount of any dividend), mismatch issues arise as the cost used by the unitholder will not necessarily be the same as the capital amount allocated to the redemption under the slice rule (as illustrated above).

The mismatch and inequities arising under the slice rule could potentially be minimised by the tax law permitting a “class” of units to be narrowly defined. For example, the class could be restricted to units issued on a particular day (assuming the unit price is set on a daily basis) or the class could be restricted to a single unitholder. Obviously, these solutions could involve significant administrative costs. In addition, the solutions give rise to their own practical problems.

If the class is restricted to a single unitholder the slice rule results in the unit trust allocating capital to the redemption on a weighted average basis. In calculating the profit on disposal, the unitholder may calculate the cost of the unit redeemed on a different basis. Accordingly, for example, if the unitholder used a FIFO basis for calculating the profit on disposal, but the unit trust has used a weighted average cost of the unitholder’s units to calculate the dividend, there would be a difference in the disposal profit made and the dividend received (with tax credits attached). While this difference will reverse on a final divestment, the mismatch can result in a tax cost in the interim.

If the class is limited to units issued on a particular day, problems can arise where a unitholder redeems units from different classes. For example, assume three lots of 10,000 units are issued to an investor on three different days at prices of $1, $2 and $3. All 30,000 units are subsequently redeemed on the same day for $2. The slice rule will apply separately to the three classes of units. A taxable dividend of $1 will arise in relation to the units issued for $1. If the unitholder applies the weighted average method to determine the cost on disposal of the units (ie. $2 per unit) no other gain or loss arises from the redemption. Consequently, the unitholder would be deemed to derive a dividend notwithstanding that no gain or loss has arisen.

Additional complexities may arise to the extent that the capital gains provisions have residual application in relation to revenue assets which may or may not equate with the revenue treatment.

Units held on capital account

If the gain on disposal of units is on capital account the majority of any double taxation may be avoided by the existing provisions of Australia's CGT legislation. However, there is likely to be a difference in the gain on sale of units and the dividend due to the mismatch between the method adopted for calculating the capital gain on disposal of the unit and the method adopted by the public unit trust to determine the dividend. In particular, whilst the weighted average basis may be used in determining the dividend, it is not currently permitted for use on the disposal of units for CGT purposes.

Double taxation/franking on redemption

The trustee of a unit trust will be required to fully frank any taxable dividend which will be deemed to have been received by an investor on redemption. It is quite possible that the trustee will have no franking credits presently available to frank the deemed taxable dividend. This could be due to the fact that there is a mismatch between the timing of the tax payable by the trustee on its taxable income and the time the taxable dividend is deemed to have been paid by the trustee to the redeeming unitholder. A clear example of such a situation would be in relation to unrealised capital gains accruing in the unit trust.

Consequently the trustee will be required to not only fund the redemption to the unitholder but also make a payment of sufficient tax to create the requisite franking credits. Presumably the redemption proceeds paid to the unitholder will be reduced by the amount of tax required to be deducted by the public unit trust.

There will however be a doubling up of the tax required to be paid by the trustee of the unit trust. To take a simple example, assume that the unit trust holds a single asset and that an unrealised capital gain of $100 has accrued in relation to the asset at the time of the redemption of the units. Also assume that a new, unrelated investor subscribes for units at or around the time of redemption by the existing unitholder. Finally, assume that the unit trust shortly thereafter sells the asset. This sale realises a taxable gain of $100 which is distributed to the remaining unitholder.

The redemption of the units at the time of the unrealised capital gain will result in a deemed taxable dividend to the unitholder. The trustee will be required to make a payment of tax in order to generate sufficient franking credits to fully frank the deemed taxable dividend. It is noted that, at the present time, the Government has not provided details as to whether this payment of tax by the trustee may be carried forward to be offset against the future tax liability of the trustee or whether it is effectively treated as a withholding tax payable in relation to the deemed taxable dividend.

When the trustee disposes of the underlying asset, a taxable capital gain will arise and will be distributed to the remaining unitholder. The distribution will also be a deemed taxable dividend that must be fully franked. The tax arising on the capital gain will be payable by the trustee. If the trustee is entitled to offset the previously paid tax against this liability then little or no outstanding tax may be payable. However, the trustee will not have any franking credits to fully frank the distribution to the remaining unitholder (the franking credits arising from the earlier payment of tax having been allocated to the investor who previously redeemed units). Consequently the trustee would be required to make an additional payment of deferred company tax to fully frank the present distribution.

If the previous payment of tax is treated as an effective withholding tax on the earlier distribution then the trustee will be required to make a further payment upon realisation of the gain on the underlying asset. That payment will generate franking credits for the distribution to the remaining investor.

In both of the abovementioned situations the trustee would be required to pay tax twice in relation to the same gain.

Lack of symmetry when capital loss

There are inequities arising from the different taxation treatment which will apply to an investor who holds units on capital account, depending upon whether a gain or loss arises from the redemption of the units. If a gain arises from redemption of the units then a taxable dividend is deemed to arise to the extent that the redemption proceeds exceed the returned capital. That is, the capital gain derived by the investor is re-characterised as a revenue amount. If, however, the investor suffers a capital loss from the redemption of the units then the loss remains on capital account and is then quarantined to be offset only against capital gains derived by the investor. This lack of symmetry is clearly inequitable where the underlying transaction is identical in both situations and the only difference relates to the amount of the redemption proceeds received by the unitholder.

The ultimate result is that a public unit trust investor who incurs a capital loss on redemption will not be in a position to utilise that loss against any other public unit trust gains. The unitholder will be forced to hold other assets that may give rise to capital gains.

Potential loss of deduction for expenses in certain trusts

Under the proposed new regime trusts will be taxed as if they were companies. When companies receive a franked dividend, they do not gross up for the franking credits they receive, rather they are allowed an inter-corporate dividend rebate and a credit to their franking account.

On the basis of the current taxation rules the benefit of a portion of the dividend rebate will be lost where deductible expenses and/or losses of a company reduce the taxable income of that company below the amount of the dividend. This is because excess dividend rebates cannot be carried forward, nor can they create a tax loss.

Essentially this means that expenses associated with running a trust which invests purely in equities, or indeed other trusts, are effectively unable to be used to offset taxable income. Such expenses would have been deductible to an investor who invested directly. Accordingly, there is a distortion away from investing into public unit trusts, with a potential costly restructuring of the current "fund of fund" arrangements within the industry and a bias towards direct investment.

Franking credits trapped within certain trusts

Under the proposed regime certain public unit trusts may not have sufficient taxable income to distribute all of their franking credits. The current taxation regime has the effect that trusts which are fully invested into equities are able to distribute all their franking credits even though expenses may have reduced taxable net income in the unit trust.

However, under the proposed regime it appears that trusts will only be able to utilise their franking credits up to the quantum of taxable income (which is calculated net of deductible expenses). Therefore any excess franking credits arising due to expenses of the trust will be trapped in the trust and may not be distributed for the benefit of the unitholders. This means that not only may unitholders be effectively denied the benefit of a deduction for expenses associated with running the trust, but also the franking credits associated with tax already paid on the income are effectively denied to them.

For example, an equity trust receives a fully franked dividend of $64 (with imputation credits of $36 attached) and has expenses of $14.

	Current Regime/ Direct Investor	**Proposed Regime**
	$	**$**
Franked dividend received	**64**	**64**
Gross up	**36**	**0**
Total income	**100**	**64**
Less expenses	**(14)**	**(14)**
	---------	---------
	86	**50**
Less imputation credits	**(36)**	**0**
	---------	---------
Distributable/Taxable income	**$ 50**	**$ 50**
	=====	=====
Tax thereon (at trust level)	**Nil**	**18**
Dividend rebate	**Nil**	**(18)**
Tax payable (at trust level)	**$Nil**	**$Nil**

The above example indicates that the trust has effectively lost the benefit of its deductions (ie $14) as it was unable to utilise the entire amount of the dividend rebate (ie $23, being $64 x 36%). In this regard, the trust would still have had a nil taxable income if no expenses were incurred and as such it has not received the benefit for its deductions that a direct investor would enjoy.

Even though the unitholder still receives $50 distributable income from the trust under the new regime, the imputation credits attaching to the distribution are only $28 (ie $50 x 36/64) rather than $36. The excess franking credits (ie $8) are now trapped in the trust and can only be distributed for the benefit of the unitholders if there is sufficient taxable income (ie. a further $14) from other sources.

This means that pure equity trusts and retail trusts investing into wholesale funds could be forced to diversify their investments to other direct investments to ensure that there is sufficient unfranked income (eg interest, capital gains) in the trust to overcome these disadvantages. The trust's investment decisions are therefore distorted by the new tax system.

It is noted for completeness that some excess franking credits may be able to be offset against the abovementioned deficiency in credits arising in relation to the redemption of units. Clearly, the extent of the offset (if any) will be dependent upon the circumstances of each unit trust.

Compliance issues

In addition to the various franking issues raised both above and also earlier in relation to the redemption of units, there will be significant compliance costs associated with undertaking the proposed regime. These costs include:

- Educating "back office" staff concerning the new measures and how they will apply;
- Educating client service staff who will be responsible for answering the myriad of queries from investors confused by the new system;
- Employment of additional "back office" and client service staff;
- Various printing and other costs associated with the reformatting of investor distribution notices and preparation of information pamphlets;
- Rewriting of computer programs to cater for the new system;
- Additional transaction costs arising from the various cash payments to be sent to the ATO; and
- Various costs arising from the complexities affecting the unit trust's pricing mechanism as a result of the new system.

Transitional measures

The transitional measures announced are likely to have a significant impact on CIV's at the date of introduction of the proposed new measures.

As announced, the transitional measures do not provide relief for any unrealised gains in excess of indexation protection or any tax losses available to the trust as at the date of introduction of the new regime.

Accordingly, tax may have to be immediately provided for on day one of the new regime. The effect of this is that the unit price in any trust which has such gains will immediately fall on the date of introduction of the new regime. This may mean that unitholders will redeem their investment prior to the introduction of the new regime. This could result in a cash drain and consequent fire sale of assets by public unit trusts prior to the introduction of the new regime.

The transitional measures announced in conjunction with the proposals make reference to certain types of income falling outside the new measures (eg capital gains on pre-CGT assets and the indexation protection on assets existing in trusts on the commencement date of the new regime).

Since separate categories of income will no longer be required to be identified in the trust (as their character will not flow through to unitholders on distribution), complex tracing rules may have to be developed and set out in order for trusts to identify this income and gain the benefit of these transitional measures. Apart from the administrative burden on public unit trusts of tracking the assets until such time as they are ultimately disposed of and the proceeds distributed to unitholders (conceivably, many years down the track) this will add a further layer of complexity to the proposed “simplification” of the tax legislation.

APPENDIX D

CASE STUDY:

IMPACT OF TAX REFORM ON INVESTORS IN PROPERTY SECURITIES FUNDS

Scenario:

Mr Z, aged 40, is saving for the future by investing in a widely held Unit Trust (**Property Securities Fund**). This fund invests in a portfolio of Australian listed property trusts. His current balance in the fund is $80,000 and he is re-investing all distributions:

Unit Trust distributions per annum = $6,000 [ie. $80,000 @ 7.5% yield]

Historically approximately 1/3 of the income distributed by property securities funds comes in the form of tax preferred income this is comprised of tax free income relating to building allowances and tax deferred income relating to depreciation allowances. Therefore, assuming that distributions from the above Property Securities Fund are made quarterly, $500 of tax preferred income will be received by Mr Z per quarter. Following the implementation of the new tax regime however, this tax preferred income will be net of 36% tax.

Year 1 of Proposed New Tax Regime for <u>tax preferred</u> income in Unit Trusts

Current Situation		**Proposed Situation**		
Quarterly Distribution		Quarterly Distribution (net of 36% tax)		Tax Deducted
$500	Aug	$320	Aug	$180
$500	Nov	$320	Nov	$180
$500	Feb	$320	Feb	$180
<u>$500</u>	May	<u>$320</u>	May	<u>$180</u>
$2,000		**$1,280**		**$720**

It should be noted that currently Mr Z pays no tax on the $2,000 he receives as tax preferred income. Under the proposed legislation this class of income will now be taxed by the listed property trust and an imputation credit attached. This income and imputation credit will be passed on to Mr Z by the unit trust included in his assessable income. The benefit of having tax preferred income from the property fund is now lost in the hands of Mr Z as a unitholder as he will be required to pay tax on this income at his marginal rate (MTR). Assuming Mr Z's MTR is 48.5% (incl. Medicare levy) he will now have a tax liability of $970 ($720 paid by the property fund and $250 funded by Mr Z) which he previously did not have.

The capital gains tax lability that Mr Z will incur on the ultimate sale of his units in the property trust will no longer be subject to the reduced cost base adjustment arising from tax deferred income.

Given that Mr Z is re-investing his distributions, he will be significantly disadvantaged under the proposed tax arrangements if markets rise overall between the date of receipt of his distribution and the date of payment of his tax liability. This is because the price of the units in the trust will have increased in line with increases in the value of underlying assets (Australian listed property trusts)

Note: The converse would apply if markets fell in this period.

The table below outlines a scenario where the price of units in the trust has fluctuated during the period between the date of the first distribution and receipt of value for imputation credits (overall increase 10% for the year).

Year 1 : Re-Investment of Distributions

		Current Situation		**Proposed Situation**	
Month	Unit Price	Amount Available for Re-investment	Units Purchased	Amount Available for Re-investment	Units Purchased
Aug	$1.00	$ 500	500	$ 320	320
Nov	$ 0.85	$ 500	588	$ 320	376
Feb	$1.00	$ 500	500	$ 320	320
May	$1.05	$ 500	476	$ 320	305
Sept	$1.10	-	-	$ (250)	(227)
Total		**$2,000**	**2,064**	**$1,030**	**1,094**

Value of Re-investment Distributions at End of Period

		Current Situation		**Proposed Situation**	
Month	Unit Price	Value	Units	Value	Units
Sept	$1.10	$2,270.40	2,064	$1,203.40	1,094

In this example, under the proposed tax regime Mr Z will hold 930 fewer units in the trust than if the present arrangement had been allowed to continue. That is, his investment would be worth $1,067 (ie. 930 x $1.10) less than under the existing system.

The implications of the new tax regime for Mr Z (as per the above example) are as follows:

- **He will now have to pay an extra $970 tax that would not have had to be paid under the current taxation legislation.**
- **His quarterly distributions will be lower, therefore he will have <u>a lesser amount to re-invest each quarter</u> (ie. $320 per quarter instead of $500 per quarter);**
- **In order to re-invest the full value of his distributions he will have to obtain a current prospectus for the Trust <u>and lodge a new application form</u> with the value of the imputation credits he has received from the ATO; and**
- **The value of his investment after the first full year of the new tax regime will be <u>worth less than under the existing arrangement</u>.**