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The Board of Taxation
c/- The Treasury
Langton Crescent
Parkes ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of Tax Arrangements Applying to Collective Investment Vehicles – submission on discussion paper

The members of the Australian Custodial Services Association (ACSA) welcome the opportunity to provide this submission to the Board of Taxation on the issues raised in the discussion paper on *Review of Tax Arrangements Applying to Collective Investment Vehicles* (Discussion Paper) that was released in December 2010.

About ACSA

ACSA is the peak industry body representing members of Australia's investment custodial and administration sector. Collectively, the members of ACSA hold securities and investments in excess of AUD $1.85 trillion in value in custody and under administration. Members of ACSA include National Australia Bank Asset Servicing, JP Morgan, HSBC, State Street, RBC Dexia Investor Services, BNP Paribas and Citigroup. Clients of ACSA members include current collective investment vehicles, such as large managed investment trusts, and large superannuation funds. One of the critical functions provided to such clients is the provision of taxation processing and reporting services.

ACSA is a key stakeholder in the CIV reform process as its members will, on behalf of clients that are CIVs or invest in CIVs, be responsible for providing custodial services including tax processing and reporting and distribution and tax statements for non-resident and resident CIV investors. We would like to see the scope of the CIV reforms to include consideration of how the high level measures are capable of being administered at the tax processing and reporting level in a manner the gives effect to the objectives set out in the Johnson Report on Australia's position as a regional financial centre.

ACSA's position on CIV reforms

ACSA supports Government initiatives to promote Australia as a financial and (in particular) an investment centre. We agree with the sentiments expressed in the Discussion Paper that Australian tax rules should not be an impediment or disincentive for Australian based investment or administration operators being able to attract business from foreign (and domestic) investors.

We also agree with the basic design principles which should underpin the CIV system as set out in page v of Foreword to the Discussion Paper. We submit a further factor to be taken into account by the Board of Taxation is the ease with which the new rules can be administered by relevant stakeholders. This factor involves consideration of the following issues:

- The extent to which processes/reporting/statement preparation necessary to facilitate the proper working of the new system can be automated;
- Compatibility of the new rules with existing systems and rules;
- Ease of 'auditability';
- Smooth operation of processes for non-resident investors for tax reclaims and top ups;
- Avoiding excessive and unnecessary costs of investment custodians, CIVs and others in providing tax information and related assistance to investors and the ATO.

In our view if Australia is to become a financial centre it is imperative that administration of the system by the key stakeholders can occur without excessive delays, expense and 'red tape'. We believe this factor is consistent with the approach to reform set out in the Johnson Report.

ACSA does not at this stage want to express a preference for any particular type of entity or entities as being suitable for CIV tax treatment. Investment custodians have in the past been able to develop systems which can deal with tax processing and reporting required for the different types of investment entities held by client (and in fact for different developments in tax law). We acknowledge the possibility that the new CIV entity (or entities) may be one which is not specifically recognised by current systems and that some systems and process development would be required.

We submit that the time and costs of systems development by investment custodians and other key stakeholders should specifically be taken into account by the Board of Taxation as one of the practical implications of the proposed reforms. We also submit that the development of the CIV rules should not occur in isolation from other tax reform projects being undertaken by Government and in particular the projects for reform of tax rules for managed investment trusts, simplification of Division 6 and the discussion paper just released on "*Improving the Taxation of Trust Income*". It is very important, in or view, that the full flow on implications of the new CIV rules are worked through and dealt with the Board's report so as to minimise unintended consequences.

Character and source retention

We would like to comment specifically in respect of question 3.1 set out in the Discussion Paper.

Question 3.1

> *The Board seeks stakeholder comments on ... suggestions on how the complexity of character and source retention under flow-through taxation could be alleviated through alternative CIV vehicles that are more attractive or user-friendly to non-resident investors.*

Character and source retention currently causes complexity for tax processing and reporting and for non resident withholding tax purposes. In the ACSA submission to the Board of Taxation MIT committee (dated 9 January 2009, a copy of which is attached), a model for taxation of a corporate CIV entity was put forward. This included ideas about the simplification of components for CIV investors (resident and non-resident) – see pages 5 and 6 – extracted below. We did not receive any feedback from the Board on these ideas and we would like to put them forward again as worthy of investigation.

> ***"How should a CIV and its investors determine their tax liabilities?***
>
> *ACSA recommends that CIVs and their investors determine their tax liabilities as follows:*
>
> - *CIVs should be treated as non-tax paying corporate entities with a certain level of flow through treatment.*
> - *CIVs should calculate their taxable income in accordance with the general provisions with the Income Tax Assessment Acts. For example, the general rules governing assessable income and allowable deductions should be applicable.*
> - *The cash distribution of CIVs should be required to be, as a minimum, their taxable income on a yearly basis, excluding tax gross ups for credits/offsets*
> - *CIVs should not be entitled to the CGT discount. Therefore, the taxable income of a CIV will include the undiscounted capital gain. Upon distribution of the taxable income, the investors will be entitled to claim the relevant CGT discount that applies to them.*
> - *Investors in CIVs should be assessed on the distributions received on a "receipt basis". This would remove the problems with the term "present entitlement". This possibility is addressed in paragraph 4.28 of the BoT paper. Notwithstanding that paragraph 4.28 relates to the trustee assessment and deduction model referred to above, a similar approach could be adopted in the context of a non-tax paying corporate CIV.*
> - *The components of a CIV distribution should be kept to a minimum. Unlike the current regime which requires trusts to keep track of many different*

types of income, the proposed CIV regime will have less components. ACSA recommends that the components of a distribution from a corporate CIV should be limited to:

Cash items

- *Australian sourced income*
- *Foreign sourced income*
- *Capital gains*
- *Return of capital*

Non-cash items

- *Franking credits*
- *Foreign Tax Credits*

- *As the cash component to a distribution would only consist of taxable income and capital, the concept of tax deferred distributions would be removed.*

- *The distribution entitlement of each investor should be determined based on the units held as a proportion to total units on issue as at declaration date.*

Benefits of proposed corporate CIV regime

The proposed corporate CIV regime will provide many benefits to the funds management industry and assist in addressing many of the current problems. The benefits will include:

- *Similar to the current rules, tax is payable in the hands of the investors but there are fewer components making the treatment less complex. This is consistent with Policy Principle 1 referred to in the BoT's paper as one of the terms of reference for the BoT's review. That is, the tax treatment for investors who derive income from the MIT should largely replicate the tax treatment for taxpayers as if they had derived the income directly.*

- *The distribution of fewer components will simplify the withholding requirements for distributions made to foreign investors (see further comments under Section 3 below).*

- *No tax deferred distributions would mean no revenue deferral to the Government as all amounts of distributions are assessable upon receipt.*

- *Any return of capital would give rise to an adjustment to the cost base of units in the CIV, as per the current rules.*

- *As CIVs would be treated as corporates for Double Tax Agreement (DTA) purposes, this would ensure the CIVs are recognised for treaty purposes thereby removing the current problems of units trusts not being recognised.*

- *The corporate CIV regime would be easier to understand globally thereby making Australia more internationally competitive."*

With the focus of the proposed CIV rules being on attracting foreign investors, we note that section 3 of the ACSA January 2009 submission referred to some of the complexities and issues for foreign investors under the current system. For ease of reference we set out the comments again:

"Chapter 5 of the BoT paper outlines the current international tax treatment of MITs. The BoT highlights that where a MIT distributes income to a non-resident, 2 separate sets of tax rules are applicable (i.e. Division 11A and Subdivision 12-H) and that the rules are very complex and cause administrative difficulties. It also highlights the fact that double tax agreements (DTAs) are difficult to administer where trusts are involved. However, the paper neglects to mention the following additional problems in respect of the current withholding rules for Australian trusts distributing to non-residents:

- *The withholding provisions under the general trust tax rules can also apply in addition to the 2 abovementioned sets of tax rules (i.e. Section 98 of Division 6).*

- *Subdivision12-H has been drafted without knowledge of the intricacies of the funds management industry and systems requirements and is therefore administratively difficult to comply with and will often lead to double taxation.*

- *Subdivision12-H applies withholding tax to a 'fund payment' as defined. The definition is complex and is not a term that is used outside Australia such that it is not recognised internationally.*

- *Subdivision12-H was drafted without consideration of the recent changes to the taxation of foreign income rules, generally applicable from 1 July 2008. For example, the quarantining of foreign loss rules were removed from the general tax loss rules. However, technically foreign losses need to be quarantined for the purposes of the Subdivision12-H withholding rules. The practical implication of this is that it gives rise to the need for 2 registry systems to be maintained.*

- *The fact that foreign losses and Non-taxable Australian property (NTAP) capital losses must be disregarded when calculating the Subdivision 12-H withholding tax payable can lead to the amount of withholding tax payable being greater than the cash distribution from the MIT.*

- *Subdivision 12-H imposes withholding obligations on MITs, custodians and any other entity that passes a fund payment on to a non-resident. The wide range of entities covered by Subdivision 12-H imposes an additional administrative burden on non-MIT/custodian entities.*

- *Information on the components of a distribution is not generally available at the time withholding tax is payable and therefore it is not possible to determine the correct amount of withholding tax payable. The rules do not* *cater for later adjustments to pay extra or obtain refunds for incorrect withholdings.*

- *The complexity in the rules is an impediment to foreign investors.*

The above problems would be substantially reduced should the corporate CIV regime recommended by ACSA be introduced. The reasons for this are that:

- *Corporate CIVs would qualify for treaty benefits in their own right. The BoT paper at paragraph 5.16 states that the OECD considers it desirable for MITs to be able to claim treaty benefits on behalf of beneficiaries, and also that income derived by corporate CIVs should be recognised as flow-through for treaty purposes.*

- *There would be fewer components for the CIV to calculate withholding tax on."*

We would be very happy to discuss our views on how character/component flow through and source retention can be simplified under the new regime.

If you would like to discuss this letter and ACSA's position on the CIV reforms and other tax reforms please contact the Chairman of ACSA's Tax Working Group, Mick Giddings on (03) 8641 0898.

Yours sincerely

Chairman
Tax Working Group
Australian Custodial Services Association