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The Board of Taxation
c/ The Treasury
Langton Crescent
CANBERRA ACT 2600

25 February 2011

Dear Board of Taxation

Equity Trustees Limited - Submission in relation to the Review of Tax Arrangements Applying to Collective Investment Vehicles

As Head of Corporate Fiduciary & Financial Services at Equity Trustees Limited ("EQT"), I am writing in response to the "Review of Tax Arrangements Applying to Collective Investment Vehicles" Discussion Paper released in December 2010.

EQT was established by a group of prominent Victorian businessmen in Melbourne in 1888. Since then, it has evolved into a provider of a broad range of financial products and services. A special Act of Parliament was needed to grant a company the authority to perform the services of trustee and executor roles previously confined to individuals. The aim of the Act was to "remove much of the uncertainty and insecurity that occurred when private individuals were appointed as trustees". In Victorian times successful merchants and graziers needed to have confidence in any arrangements made to look after their affairs and estate when they took extended visits to the "home land".

EQT is listed on the Australian Securities Exchange and has a market capitalisation of approximately $140 million. EQT employs 160 staff along the Eastern seaboard, primarily in Melbourne and Sydney and has revenue of approximately $38 million.

The company operates through four main business activity groupings: Wealth Management and Estate Planning; Asset Management, Corporate Fiduciary & Financial Services and Superannuation.

EQT Corporate Fiduciary Services offers the following services:

- Responsible Entity and Corporate Trustee services; and
- Custody and asset administration

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This business unit is responsible for approximately $18 billion of Funds under trustee. The Responsible Entity role covers over 44 leading local and international fund managers.

Collective Investment Vehicles

EQT supports the principle of a collective investment vehicles ("CIV") regime. It is important that the Board of Taxation take this opportunity to design a CIV framework and policy that will enhance Australia's competitiveness as a funds management sector, including removing current impediments in terms of managing funds for offshore clients.

The following policy matters should be reflected in designing an appropriate CIV framework:

1. **Enabling foreign exchange hedging to be on capital account / multi currency classes**

Many managed funds hedge against foreign currencies in order to manage the financial risk of currency fluctuations with respect to investments. For instance, foreign exchange movements may be hedged in relation to shares that are listed on foreign stock exchanges in a foreign currency. Generally, the gains and losses that arise under such foreign exchange hedging are treated as revenue in nature for tax purposes.

However, if the underlying assets are held on capital account (which will be the case for many funds, particularly given the Managed Investment Trust capital election), there is a mismatch in the tax treatment of the gains/losses in relation to the underlying assets and the gains/losses in relation to the foreign exchange hedge. For example, a capital loss from the disposal of assets may not be able to be offset against a foreign exchange gain from the related hedging instrument.

Although the Taxation Of Financial Arrangements regime ("TOFA") may provide a solution to the mismatch by way of the hedging election, the relevant TOFA rules are extremely complex and prescriptive, to the exclusion of practical application by many funds. For instance, many funds do not adopt hedge accounting, which is required to make the hedging election.

These outcomes are very unattractive to non-resident investors and also prevent managed funds from establishing multi currency classes of units, which is leaving the Australian funds industry behind in terms of product offerings.

Therefore, the tax treatment of foreign exchange hedging should follow the tax treatment of the underlying assets being hedged in order to enhance the attractiveness of Australia's funds management sector to offshore investors.

Also please note this same logic can be applied to certain options and derivates used to hedge capital.

2. Ability for CIVs to retain net income

Under the current rules, trusts must distribute 100% of the net income derived each year in order to avoid the trustee paying tax at the highest marginal rate. However, there are instances where distributing all net income is not the optimal commercial outcome. For example, in the case of realised capital gains, a CIV should have the ability to retain these gains in the CIV if so desired.

Similar to corporate entities, CIVs should have the ability to retain net income for distribution in the future without the penalty of paying tax at the highest marginal rate. This would provide greater flexibility for CIVs and encourage growth in funds management in Australia.

3. Certainty of "fixed trust" status

All CIVs should have the certainty of being a "fixed trust" to avoid the ambiguity of whether concessional tax treatment is available, particularly in light of the recent Federal Court decision in *Colonial First State Investments Limited v Commissioner of Taxation*.

Uncertainty over the "fixed trust" status raises concerns over managed funds' ability to access concessions in relation to recoupment of tax losses and providing flow-through of franking credits to investors. This is also an issue that discourages offshore investors from investing in Australian managed funds.

Multi-class funds where there are different management fees per class but where the rights and interest are the same per class should be treated as fixed trusts.

4. Access to treaty benefits and foreign income tax offsets

All CIVs should have full access to treaty benefits in their own right so that investors do not have to separately claim treaty benefits. Where foreign tax withholding has been made on foreign source income, CIVs should be able to pass on the foreign tax credits associated with the foreign source income to investors on a flow-through basis and without restriction.

Under current law, there are complexities with the flow through of foreign tax credits and certain foreign tax credits that are not able to be distributed, cannot be carried forward and are an ultimate cost to managed funds and investors.

These design features would both simplify the process of claiming treaty benefits for investors as it would be done through a vehicle which is a resident of the one jurisdiction, being Australia, and also provide certainty of flow through of foreign tax credits to investors for foreign tax withheld.

This would also ensure that investors choices are not influenced between investing directly or through a CIV in the same underlying investments. A CIV

regime should be consistent with the tax outcomes of direct investment. This is also consistent with many international regimes that promote neutrality by ensuring the outcomes that arise are as if the investor had directly acquired the underlying investment.

5. Flow-through of losses to investors

Consideration should be given to allow losses to directly flow through to investors, with the appropriate integrity measures. Currently, managed funds are unable to distribute losses to investors and are required to retain them in the fund until revenue/gains are derived against which the relevant losses may be offset.

This transparency in tax treatment will help to achieve greater tax neutrality between direct and indirect investment, as losses are available to investors where they undertake the relevant investment activities directly.

Greater tax neutrality in respect of losses will enhance Australia's status as a leading regional financial centre by encouraging greater investment activity, as it will lower the tax cost of investing where CIV's do incur losses.

6. Transition from the MIT regime to a new CIV regime

In light of the proposed Government enactment of a new regime for Managed Investment Trusts (the MIT regime) that is to be effective from 1 July 2011, if a better CIV regime is designed as a result of the Boards review, entities presently under the MIT regime should have the ability to easily transition into the CIV regime.

From a policy perspective, this should provide comfort to fund managers to engage in continued investment activity through MITs, so that there is no disadvantage to funds that may enter the MIT regime prior to a CIV regime being developed and enacted.

Further, the capital vs income election should be able to be reviewed at this time so as to better align the decision based on the new rules.

7. Foreign Investment Fund (FIF) repeal and uncertainty over anti-deferral rule

A CIV regime should also ensure that the anti-deferral roll up rule is appropriately developed so that it does not inadvertently disadvantage managed funds investing overseas. With the repeal of the FIF rules from 1 July 2010, this is an opportunity for the Board to ensure an appropriate anti-deferral rule is developed and will also provide certainty to managed funds by not making an anti-deferral rule that is developed retrospectively.

8. Election on Capital account and mismatches with offshore CIV's

Currently a feeder fund into an offshore fund cannot elect to be on capital if the underlying fund in is a company style collective investments vehicle. In

taking to account any new CIV for Australia, the tax nature of feeding into an offshore CIV needs to be taken into account so that a long equity fund can elect to be on capital account and not be disadvantaged due to the feeder structure.

We trust that you will take into consideration the issues raised above for the purposes of designing a new CIV regime, that will deliver a framework for the Australian funds management industry, that is attractive to offshore investors and achieves the aim of making Australia a financial services hub.

I would appreciate the opportunity to discuss these matters with you in further detail.

In the meantime, please do not hesitate to contact me on (03) 8623 5301 or via email HKalman@eqt.com.au, if you have any questions in relation to the above.

Yours faithfully

Harvey H Kalman
Head of EQT Corporate Fiduciary & Financial Services
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