7 February 2018

By email

Tax framework for Corporate Collective Investment Vehicles

The Financial Services Council (FSC) welcomes the opportunity to make submissions to the Treasury on the draft tax framework for Corporate Collective Investment Vehicles (CCIVs).

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

We thank the Treasury for the substantial work that has been put into developing this important regulatory reform.

The FSC is a strong proponent of the establishment of a CCIV regime in Australia. Along with the Asia Region Funds Passport, this new structure is vital to securing Australia's growth prospects and will deliver on key recommendations of the 2009 Johnson Review, *Australia as a Financial Centre — building on our strengths*.

The new range of collective investment vehicles should increase exports of Australian investment products, as foreign investors will have Australian investment products that are more familiar and more internationally acceptable. The new CCIV will allow Australian fund managers to compete globally, if it has an appropriate cost structure.

This submission considers a range of issues that we consider are important to ensuring the new CCIV regime is successful. We also note changes to Australia's withholding tax regime for managed funds remain essential unfinished business and should be addressed as part of this process.

The FSC comments on the draft tax framework are attached.

Please contact me with any questions in relation to this submission on [redacted].

Yours sincerely,

Michael Potter
Senior Policy Manager

Comments on draft tax framework

Tainting of sub-funds

The FSC has significant concerns that events relating to one sub-fund in a CCIV could taint every other sub-fund in the same CCIV (this is also called sub-fund contagion or contamination). A number of tests under the draft tax framework are assessed at the sub-fund level, but then affect all other sub-funds in the same CCIV, including the following:

- the widely held test and the closely held restrictions (these tests are termed the ownership tests for the rest of this submission);
- the trading business test (see EM paragraph 1.64); and
- the tests for being a withholding ACCIV (see EM paragraphs 1.106 and following).

In some cases, the tainting could involve the loss of flowthrough tax treatment, taxation at 30%, a complete loss of imputation credits, and the full deregistration of the entire CCIV. This would be a disastrous outcome for the CCIV and investors. Our concerns with tainting of sub-funds is linked to the punitive fallback taxation treatment. Not only do the events affecting one sub-fund affect all, but the outcome is harsh. A later section of this submission makes further comments on the harsh fallback tax treatment.

The risk of tainting increases with the number of sub-funds. A CCIV with 60 sub-funds would have to disclose that the tax treatment, or the very existence, of one sub-fund can be affected by what happens in the 59 other funds. There would be substantial complexities involved in adequately disclosing these relevant risks to the investor via documents such as Product Disclosure Statements (PDSs) and Statements of Advice (SoAs)/Records of Advice (RoAs), both of which are required under Australian law when dealing or advising on a retail product offering.

We have raised similar concerns in relation to the previously released CCIV regulatory rules, particularly the proposal in those rules that the classification of one sub-fund as 'retail' means a depositary is required for all sub-funds.[1] The draft tax framework has increased our level of concern over this issue.

We have the following additional concerns with tainting:

- Events outside of the control of one sub-fund could affect all others. For example, a listed sub-fund might change ownership and fail the ownership tests for reasons outside the CCIV's control, and this will affect all other sub-funds.
- Trustees of AMITs may consider that rollover into a CCIV with multiple sub-funds fails to meet their fiduciary duties because of the risks caused by tainting. In other words, fiduciary duties could prevent some trustees from converting AMITs into CCIVs.
- Potential investors in a sub-fund of a CCIV may need to do due diligence on every other sub-fund in the same CCIV. This could deter many substantial investors from using CCIVs with multiple sub-funds.
- We understand the government is making a considerable effort to ensure the insolvency of one sub-fund does not affect (taint) any other sub-fund. This focus on preventing tainting in one situation (insolvency) is important; but appears completely different from the approach taken for the tax rules where tainting of other sub-funds is a feature of the rules.

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[1] See FSC submission on draft CCIV regulatory regime, available from: https://consult.treasury.gov.au/financial-system-division/asia-region-funds-passport/consultation/view_respondent?uuId=807684398

- From a policy perspective, tax rules should generally not drive investment decisions unless there is a specific policy intent — just as the government does not want tax avoidance to be driving investment decisions, neither should punitive tax rules be preventing investment.
- The ATO has already examined whether AMITs with multiple classes raised tax integrity issues and considered that existing provisions of the tax law could address any such issues (see Law Companion Guideline LCG 2015/5). Similar arguments should apply to CCIVs.

As a result of the problems with sub-funds listed above, the use of CCIVs with multiple sub-funds would be strongly discouraged by the tax rules.

These problems can be avoided by fund managers offering numerous CCIVs with only one sub-fund each instead of one CCIV with numerous sub-funds. However this is not a real solution to the issue, as it would call into question the whole purpose of having sub-funds and the CCIVs themselves (for domestic investors there would likely be no benefits from CCIVs compared to AMITs). This approach would mean substantial cost increases as many of the economies of scale would be lost. In addition, each CCIV would be able to choose different depositaries and corporate directors, which would further increase costs compared to a single CCIV with many sub-funds.

The increase in cost caused by tainting, or mechanisms to avoid tainting, are problematic in an environment of compressed margins which mean additional costs of even a few basis points can make a material differences to whether creating or distributing a product is viable or not.

There are several ways the concerns with tainting can be addressed, as discussed below.

Temporary circumstances test

The existing draft tax framework includes a mechanism to address tainting: the test permitting CCIVs to remain as ACCIVs in temporary circumstances (see EM paragraph 1.71 and following). However, we do not consider this fallback test is adequate protection for the following reasons:

- A punitive rule does not become lenient by adding exclusions to it. The underlying problems with the rule should be addressed rather than a sweeping expectation that all problems with the rule can be fixed by using the exclusions.
- The risk of the punitive tax regime remains. The risk might be reduced, but it is still there. Documents such as PDSs and SoAs/RoAs will still need to explain this risk, and will become more complicated as a result. Some fund managers may not offer CCIVs on this basis alone.
- There can be no guarantees as to how leniently or strictly the temporary circumstances test will be applied. It may potentially not protect *any* CCIV from the punitive tax regime.
- Use of the temporary circumstances test could come at substantial cost to the CCIV, for example requiring an ATO private ruling with all the necessary documentary evidence completed, including a robust reasonably arguable position. A CCIV faced with punitive tax will likely have no choice but to incur these costs with no certainty of a favourable outcome in order to attempt to escape the significantly worse alternative.
    - In addition, it generally takes some time for a ruling to be made; in the meantime the CCIV is in limbo completely uncertain about its status. During this period, the uncertainty would likely cause substantial harm to investors, particularly if the uncertainty caused a run on the fund.[2]
        - Investors are more likely to redeem their investment where there is uncertainty. So by the time a ruling is received by the sub-fund, it may be effectively useless.
- Certainty of outcomes is something that Australia's competitors will offer. To be globally competitive, we must provide this certainty.

[2] If the CCIV prevented redemptions to stop a run this would cause harm to other investors who needed funds.

- Overseas jurisdictions have in the past highlighted technical risks and exposures with Australia as a financial centre as a means of establishing or maintaining their own centres. The approach proposed in the draft rules will aggravate this problem.

Preferred option: testing and outcomes at a sub-fund level

The FSC prefers options involving all the relevant tests being performed at a sub-fund level, and the effects of these tests also applying at the sub-fund level.

This would have the following advantages:

- There would be consistency in the testing of sub-funds and applying the effects of these tests to the same sub-funds.
- The risks of tainting from one sub-fund to other sub-funds would be removed.
- A barrier to trustees and investors choosing to use CCIVs would be removed.
- Disclosure statements (such as PDSs) would be less complex.
- Each sub-fund would be examined and treated on its own facts and circumstances.
- There would be no need for prospective investors to do due diligence on other sub-funds in the same CCIV.
- Investors in a sub-fund will not take on risks relating to other sub-funds that are outside their control.

Testing at the sub-fund level may raise concerns about potential abuse of the rules. However, there will be strict segregation of assets and liabilities between sub-funds by the corporate director, so it is difficult to see how performing relevant tests at a sub-fund level could increase risks for abuse. It is also hard to see how CCIVs would be able to enable substantial abuse when we have not seen substantial abuse from MITs (and even if this were occurring, it is unclear why Part IVA is not adequate to address this issue). As noted earlier, the ATO considers existing rules are able to deal with potential abuse of MITs through sub-funds — and a similar argument should apply to CCIVs.

There is also the issue of what to do with a sub-fund that does not pass one of the tests (called the 'problematic sub-fund' below). There are several further options:

- The problematic sub-fund could be retained as part of the CCIV. The CCIV would continue to submit one tax return but separately calculate tax for the problematic sub-fund, using the appropriate tax treatment. This is similar to the approach currently used for life insurance companies who are taxed differently on different parts of their business.
- The CCIV could be required to put in a separate tax return for the problematic sub-fund, while the untainted remainder of the CCIV puts in a tax return calculated in the normal manner. If this approach is followed, rules will need to be developed to deal with the transition of assets from one taxpayer to another.
- The CCIV could be required to separate out the problematic sub-fund as a new entity, perhaps as a company.

The FSC is willing to work with the government to explore these options.

Non preferred option: testing and outcomes at CCIV level

We do not prefer the option involving any test causing a harmful effect to all sub-funds, for the many reasons noted earlier.

However, if this option is followed, then we submit the way the test applies should be altered. The draft rules state that the CCIV is a single entity and single taxpayer (EM 1.24). It appears this

approach may be based on existing taxation law which looks at a corporate entity as a taxpayer. However, the ability for a CCIV to have separate subfunds requires a new way of thinking (and leads to our preferred approach of differentiating between sub-funds). Nonetheless, with a single taxpayer approach in mind, it does not seem appropriate to require tests to be performed at the sub-fund level. Instead, the relevant tests should be applied at the level of the whole CCIV. So for example, the closely held restrictions should be tested at the CCIV level and not at the sub-fund level. This option would ensure a degree of consistency: the outcomes of tests apply at the CCIV level; and so the tests leading to these outcomes are applies at the CCIV level as well.

Nevertheless, the FSC strongly prefers the option stated above: both testing and outcomes should occur at the sub-fund level.

Other issues relating to tainting

- Paragraph 1.15 of the EM states "the entity, through one or more of its sub-funds or otherwise, satisfies the trading business restrictions" (see also 1.43). This appears to suggest a CCIV with multiple sub-funds is assessed for this test at the CCIV level. This appears inconsistent with other requirements that *each* sub-fund of a CCIV satisfy the trading business test (see paragraph 1.64).
- It is not clear how the tests will work for new sub-funds established during a year. The new sub-fund could easily not meet the ownership tests in the start-up phase and this could jeopardise the tax treatment of the whole CCIV, notwithstanding the start-up year concessions.
- The ownership tests are quite restrictive. In some cases managers may have sub-funds that are offered to institutional clients via institutional classes only, and they may not be deemed to be widely held. It may not be appropriate to give this particular sub-fund the ability to use the attribution rules. However, preventing the entire CCIV from using attribution for this reason would be quite limiting, particularly for many managers who would wish to create a single CCIV and house funds under the single umbrella.
- There would be benefit in being able to aggregate sub-funds for the purposes of evaluating the relevant tests. For example, the 'widely held' test should be assessed collectively for an unhedged sub-fund investing into global equities along with a separate sub-fund investing into the unhedged fund and adding hedging. In this case, it should be possible for sub-funds to be aggregated for the ownership and trading tests. This will mean that either the aggregated sub-funds all pass the test, or all fail the test.

Significant divergence from AMIT rules

The draft tax framework for CCIVs does not fully mirror the tax rules for AMITs (or MITs more broadly). These differences include the following:

MIT rules	CCIV rules
A MIT that fails ownership tests becomes taxed under Division 6 (flow through).	An ACCIV that fails ownership tests is taxed as a company and franking prohibited
A MIT that fails trading test is taxed under Division 6C as a company, franking is permitted	An ACCIV failing trading test is taxed as a company and franking prohibited
For unlisted MITs, no loss recoupment rules for capital losses	Company loss recoupment rules apply: Continuity of Ownership Test & Same Business Test
Eligible for capital gains tax discount	Not eligible for CGT discount (1.93)
No equivalent	Unrealised loss and loss anti-duplication rules in Subdivisions 165-CC and 165-CD seemingly will apply to an ACCIV

Punitive tax treatment for CCIVs that fail relevant tests

In relation to the first two points in the table above, the tax treatment of a CCIV that fails the relevant tests is punitive. A CCIV would be taxed as a company, and be unable to frank distributions. This is very different from the rules that apply to an MIT that fails relevant tests — this MIT would generally be taxed as a company but be able to frank distributions under Division 6C. While this could be a tax increase for many MITs, it would generally not be punitive, particularly for domestic investors in MITs. Trusts taxed under Division 6 will remain flow through for tax purposes.

It is also unclear why this punitive treatment is required when a CCIV will likely be required to be deregistered if it fails the relevant tests (1.124).

The FSC therefore recommends that there be a less punitive tax treatment for a CCIV (or CCIV sub-fund) that fails the relevant tests. This could include the option for the problematic fund or sub-fund to become a company, or be taxed under the rules in Division 6C with franking credits able to be passed on.

CGT discount

Paragraph 1.93 indicates that ACCIVs are not entitled to a CGT discount, consistent with the operation of the CGT discount rules for companies. However, in other aspects the proposed tax treatment of a CCIV will not follow the tax treatment of companies. For example, the draft tax framework indicates that CCIVs are taxed on a character flow through basis (paragraph 1.2), which would not otherwise be the case for a company.

The FSC submits that excluding CCIVs from a CGT discount would place the vehicle at a significant disadvantage to AMITs and may have the following outcomes:

- In allocating deductible expenses against assessable components, an AMIT would allocate deductions against only the discount capital gains component, while a CCIV would be required to allocate deductions to the gross capital gain. This can lead to worse outcomes for investors in CCIVs compared with investors in AMITs.
- In recouping prior year tax losses, or determining current year tax losses, the CCIV would recognise the gross amount of the capital gain as assessable income.

In addition, there is the potential to complicate systems where there is an AMIT or a CCIV investing into other AMITs and CCIVs:

- If an AMIT invests into another AMIT, systems are set-up to gross up the discount capital gain, perform the calculation and then apply the discount again where appropriate. Should it invest in a CCIV, it would then have to alter the systems so as to not gross-up the 'discountable gain' but then ensure that the discount is applied at the end of the process.
- If a CCIV invests into an AMIT, systems would need to be set-up to gross up the discount capital gain, perform the calculation and then **not** apply the discount. Should it invest in a CCIV, it would then need to not gross-up the 'discountable gain', not apply the discount but then ensure that amount is marked as a discountable gain for distribution.
- There are 4 ways of having to configure systems — 3 of which are unnecessary — given the policy intention of the end investor being eligible to receive a discountable gain form a CCIV.

Other concerns about lack of consistency with AMIT rules

Any difference between CCIV and MIT rules will increase costs for funds management, as new systems will need to be set up to accommodate these differences. Fund managers currently

managing MITs have systems set up to comply with MIT/AMIT rules; they will have to incur additional (and in our view unnecessary) costs to have a different system running for any CCIVs they manage. A key part of a successful transition into the CCIV Regime is the ability to leverage off the existing systems and this will be reduced or lost if there are these type of differences.

In addition, differences between MITs and CCIVs will likely cause confusion for both managers and investors. This will increase the potential for significant operational error where managers are reporting in respect of both CCIVs and AMITs, and investors hold both categories of vehicle.

Yet more confusion will occur in the different ways this information will need to be reported for the AMMA/AIVMA process. This could cause further errors for managers, investors or the ATO.

More broadly, in relation to all the points in the table above, it is unclear why the CCIV rules do not replicate the AMIT rules. In every case listed above, CCIVs or investors in CCIVs bear more tax than MITs or investors in MITs. We do not consider there are suitable arguments for there being a difference when the structures are similar and should be used in broadly the same way.

We also note the following:

- if CCIVs are to be globally competitive, then the use of flowthrough tax treatment should be maximised. The divergences from flowthrough tax treatment in the table above hinder the ability for CCIVs to succeed in reaching this goal.
- The differences between MIT and CCIV rules appear to be based on the implicit view that tax minimisation is easier and more likely through CCIVs than through MITs. However, there is no clear evidence that this is the case. This is a view that is difficult to justify as the AMIT regime is broadly intended to apply to CCIVs. If tax avoidance is not being facilitated by MITs, then they will neither be able to be facilitated by CCIVs.
- Conversely, if it is considered that some attribution investment vehicles (such as ACCIVs) need a harsher tax treatment because they can facilitate tax avoidance, then we should already see AMITs engaging in tax avoidance of the same kind. We have not seen any arguments put forward that this is the case.

Rollover relief

The draft tax rules propose a welcome CGT rollover relief for the conversion of AMITs to CCIVs. However, we consider this relief is too narrow, and does not cover a substantial range of other tax characteristics that should be rolled over from an existing entity into the CCIV. This includes:

- Capital losses
- Gains and losses on non-CGT (revenue) assets
- Tax elections, such as the deemed capital account election and TOFA hedging elections.
  - We note that if tax elections are not rolled over into the new entity this could in some cases provide for substantial tax minimisation opportunities[3] — this is the whole reason why tax elections are irrevocable.
- AMIT 'unders and overs' (where amounts initially reported to investors in an AMIT overstate or understate the correct amount of their share of the net income of the trust).

Broadly, to address these points we consider the rollover relief should involve the CCIV taking on all the tax history of the entity it replaces. We note the draft framework proposes the tax history of *members* will be transferred (1.127) but does not make a similar statement about the tax history of the entity.

[3] Arguably this opportunity for tax minimisation or 'abuse' poses a much greater threat than any of the other abuse envisaged (and which drives the punitive tests for widely held, trading requirements etc.).

We also note the draft framework does not contemplate a rollover from an entity other than an AMIT. However, some other entities may wish to roll over into this regime, for example Listed Investment Companies and trusts that are not AMITs. Some other bodies, such as super funds and life companies, may wish to transfer assets that are directly held into a CCIV. These other entities should, as a matter of principle, be afforded rollover relief as well.

The tax framework should permit multiple existing funds being rolled over into a single sub-fund, for example a fund that undertakes unhedged investments plus another fund that invests into this underlying fund and then hedges this exposure.

In addition, the stamp duties levied by state/territory governments will likely act as a barrier to rollover into the new CCIV regime. We request that Treasury and the federal government take all necessary steps to encourage state/territory governments to provide appropriate relief for rollovers into CCIVs. We would be keen to assist the federal government in any work on this issue.

Non-resident withholding tax

The FSC has an ongoing concern with the non-resident withholding tax (NRWT) applying to collective investments, particularly funds that will be part of the Asia Region Funds Passport (ARFP or Passport). This will include many funds that could be established as CCIVs or converted into CCIVs.

The FSC considers it important for the government to implement reforms to NRWT applying to the ARFP at the same time as implementing the CCIV regime. This will enable Australian fund managers to compete with other countries involved in the ARFP. Currently, Australia's rates of NRWT are noticeably higher than the equivalent tax rates in other ARFP jurisdictions as shown in the FSC's research.[4] The NRWT system is also particularly complex compared to other ARFP countries, as a result of:

- multiple rates
- complexity and difficulty of determining appropriate rate;
- interactions with tax treaties (including how the treaties deal with trusts);
- no overarching consistent principle of application; and
- relatively simpler approaches in competitor jurisdictions, with Singapore in particular charging a zero withholding tax rate.

The complexity of the application of Australia's NRWT means the possible tax consequences for foreign investors cannot be explained a simple and easy to understand manner. The ARFP is specifically designed for retail investors so the mere inability to explain these tax outcomes simply will put Australia at a substantial disadvantage.

As a result, Australia's NRWT regime is not globally competitive or congruent with Australia's aspirations of becoming a global financial centre and exporting fund management services to the rest of the world and in particular Asia. The policy argument for reducing or removing NRWT is similar to the argument for the Offshore Banking Unit (OBU) concession — the lower tax rate encourages funds to come to Australia that would otherwise not come.

In addition, other countries are reducing their NRWT over time, making our system more uncompetitive as time passes. Therefore, if Australia does not set NRWTs at a competitive rate compared to other ARFP countries, investors won't participate in Australian ARFP funds and the ATO

[4] See FSC (2015) *MYEFO consideration – competitive withholding taxes* – letter to Treasury; and KPMG (2016) *Asia Region Funds Passport – comparison of withholding taxes*. Papers available on request.

will receive 100% of nothing, while Australia will miss out on revenue, jobs and growth of our funds management industry (including back end operations as well as higher value added operations such as investment management and advisory and legal services).

As investors will be choosing Passport products from a number of competing jurisdictions, Australia's current withholding tax will place Australian funds behind others on a like-for-like comparison. If tax disadvantages are removed for Australian funds then Australian fund managers will be able to compete on a like-for-like basis. In addition, a globally competitive non-resident withholding tax regime would remove the largest barrier to the success of Australia's funds management export industry.

Further details on the FSC's concerns are in Attachment 1.

New penalty relating to lack of reasonable care

The draft tax framework inserts a new penalty for attribution 'unders and overs' for both AMITs and CCIVs that result from a lack of reasonable care. We completely oppose this change.

This change is revisiting a key AMIT provision less than a year on with no apparent basis. The CCIV rules should not be an exercise in making a change of this type.

Early exposure drafts of the AMIT Regime legislation included administrative penalties relating to 'unders and overs' where there had been a lack of reasonable case. However, this was removed as part of the consultation process, in recognition of stakeholder concern about the application of the reasonable care concept. The absence of the reasonable care requirement in the AMIT rules was not an oversight that requires correction. It was a deliberate removal based upon Treasury consultation on that point. Adding it into the AIV Regime without evidence of the need for this requirement would be ignoring this consultation.

In addition:

- The government has not demonstrated there is a substantial problem with excessive attribution 'unders and overs'.
- Evidence has not been presented showing the current approach (involving penalties for errors due to recklessness) is not working adequately.
- It has not been shown that the addition of this new penalty is of net benefit (noting the costs of the new penalty system, including added costs and uncertainty).
- There is at least some risk that a lack of reasonable care penalty could apply to any situation with 'unders and overs'. This is yet another risk attached to the new regime, discouraging its use (see the concerns raised earlier about risk relating to tainting and the punitive fallback tax regime).
- This proposal will strongly discourage investment into assets that are more likely to produce 'unders and overs' such as property. Investment managers may just not want the risk of being confronted with a penalty for using the 'unders and overs' provisions.
- Large fund managers at the end of the tax year have to conduct a very large number of calculations very quickly to calculate distributions. In this context, lowering the bar for prosecution of errors is inappropriate and ignores commercial realities.

Comments relating to reporting requirements, including AIVMA

We consider the reporting requirements should be consistent where possible for CCIVs and AMITs. If there are differences for no real reason or benefit, then this results in additional costs, complexities and effort for all parties involved: REs, fund managers, custodians and registry providers. Systems

will need to be re-configured and changed — bearing in mind these have already been changed for AMIT. It seems uncommercial to require further systems changes for no real reason.

We also consider inadequate justification has been provided in changing terminology particularly AMMA to AIVMA. Fund managers refer to AMMA statements being provided to investors (for example, in Product Disclosure Statements and client communications) and would now have to change these references to AIVMA. This is in addition to changes in the terminology of items referred to on the statement itself, and the flow on effect for reporting systems. These changes in terminology may also cause confusion for investors.

Other issues

We request clarification or amendment in several other areas of the draft tax framework:

- We note the draft framework indicates no foreign investor can hold more than 10% of an ACCIV (EM paragraph 1.60). This should be reconsidered in the context of the purposes of CCIVs, which include to attract foreign investment through the ARFP. Putting strict limits on foreign investment is not consistent with this aim. It is also unclear what public policy objective this limit has in the context of all the other regulations and requirements imposed on foreign investment into Australian assets.
- The Exposure Draft does not comment on how ownership and control interests will be tested under other areas of income tax law. For example, will interests in foreign subsidiaries held by sub-funds be aggregated or treated separately in determining control interests for CFC purposes or whether the 10% participation test in Subdivision 768-A is satisfied (and whether foreign equity distributions are non-assessable non-exempt income)? Consistent with the FSC's preference for applying testing and outcomes at a sub-fund level, it would be preferable to treat each sub-fund separately for these purposes.
- Further clarification is requested on how tax administration will work for CCIVs. Will income tax returns, GST calculations, BAS returns, and third party reports (eg AIIR) all be done at the CCIV level or the sub-fund level? Broadly, we consider it would be preferable for consistency across all these answers.
    - As a starting point, costs would generally be reduced if the taxpayer is the CCIV rather than individual sub-funds.
- For an AMIT that converts to a CCIV during an income year, we request clarification on the eligibility requirements. In particular, will the transitioning entity need to satisfy the AMIT eligibility requirements for part of the year and the ACCIV requirements for the remainder, or will both requirements (AMIT and ACCIV) need to be satisfied in parallel for the whole year?
    - Paragraph 1.47 of the Explanatory Memorandum states that a corporate entity which registers as a CCIV mid-year will apply company taxation for the part of the income year it was a corporate taxpayer (and ACCIV tax treatment for the remainder of the income year). However, once it becomes a CCIV, there is no mechanism for distributing franking credits on tax paid whilst the corporate entity is taxed as a company. Rather, on becoming a CCIV, new paragraph 202-15(b) would treat the entity as no longer being a "franking entity" and any surplus franking credits would be eliminated by virtue of the franking debit that automatically arises on ceasing to be a franking entity (Item 4 subsection 205-30(1)). Accordingly, a mechanism is needed to both switch off the debit against all franking credits at the time of ceasing to be a franking entity and allow those pre-CCIV franking credits to be distributed to members (the AMIT regime contained similar provisions to this effect).
- The entities eligible for use in the ownership tests should include platforms: specifically the widely held test with no wholesale membership in paragraph 1.57 and the alternative test in paragraph 1.62.

- The draft rules may mean that rollover relief will only be available for rollover into a new CCIV and not into an existing CCIV. In particular, rollover is not allowed into a CCIV that has losses of any kind (1.134). This could mean after a large market correction, rollovers into most CCIVs would be prevented, and this prohibition on rollovers could last for many years, given how long it takes for accumulated losses to be used up.
- The FSC has for some time had concerns about the foreign exchange hedging rules. An FSC submission on this issue is at Attachment 2 (these concerns were raised with Treasury in 2015). These concerns are relevant for all taxpayers, but should be addressed for CCIVs — if these issues are not dealt with this will add to the cost/competitiveness problems with the CCIV raised earlier.

Technical issues

- Paragraph 104-600(3)(a) appears to achieve the wrong outcome as it does not appear to limit the capital gain to the extent that an amount of pre-existing cost base has been reduced. It should be reworded as follows:

  *(3) You make a **capital gain** equal to:*

  *(a) if the *cost base of that asset was ~~is reduced to~~ nil just before that time ~~under subsection 104 605(2)—~~the *AIV cost base net amount mentioned in paragraph (1)(c) of this section; or*
- Subsection 275-20(4) should be amended to include an ACCIV in the list of qualifying widely held investors for AIV status. ACCIVs are recognised as “good” widely held investors in the proposed new paragraph 276-20(2)(b) so it seems to be an oversight that subsection 275-20(4) has not been updated.
- New paragraph 276-260(5)(e) states that you will disregard any payments an ACCIV makes to another entity in its capacity as a depositary. This seems in conflict with paragraph 1.82 of the Explanatory Memorandum which states that the purpose of this provision is so that payments to the depositary for services rendered will be recognised. Should paragraph (e) instead state that you disregard any payments the ACCIV makes to the other entity “other than” in its capacity as the ACCIV’s depositary?
- We request conformation that to achieve character flow-through of discountable capital gains, an investor in an ACCIV will be deemed to have all of the tax history of the ACCIV (i.e. acquisition date of the underlying asset as relevant to the 12 month qualifying period for the CGT discount). Would this be achieved under subsection 276-80(2)? An example in the Explanatory Memorandum should provide clarity.
- We request clarification of how the off-market share buyback rules apply to CCIVs. Division 16K could treat part of the redemption as a dividend, which could result in double taxation. This would not arise where an AMIT structure is used.

Attachment 1

Non-resident withholding tax – further details

Potential budget impact

The ARFP only allows investments into very simple ('vanilla') products such as listed equities and bonds. This means that income generated by non-resident investors will comprise dividends and interest.

Analysis of these income types shows that little government revenue from NRWT (outside of property) will be received as a result of ARFP funds under existing policy settings:

- Just over 90% of Australian top 100 company dividends are franked therefore dividend withholding tax collections will be small. A portion of the remaining unfranked dividend also qualifies for conduit foreign income (CFI) exemption. For example, the unfranked component of AMP's dividends has historically been CFI and therefore withholding tax free.
- Interest will be either overseas sourced or substantially subject to section128F; as a result it would not be subject to NRWT.
- Capital gains from Australian assets that are not taxable Australian real property are not subject to a withholding obligation when derived by non-residents. The permitted investment class only allows for listed equities which are all treated as non-taxable Australian real property.
- Some treaties may operate to allocate the taxation of gains to the treaty partner.

As a result of these points, a reduction in NRWT on the ARFP will have limited budget impact, however it will have significant impact on the ability of Australian managers to market their funds, as it will allow confident statements to be made about the taxation impact of investing in an Australian fund.

There are two additional cases where the current positive rate of NRWT is incorrect and we consider no NRWT should be levied on *any* payment of these types: These are hedging profits and profit on traditional security sales, discussed in more detail below.

Profits on foreign exchange hedging activity are normally treated as being on revenue account and therefore potentially bear MIT withholding tax. This has been a source of frustration to the industry for many years as such hedging is incidental and normally related to the holding of foreign assets which generate income and gains that are exempt from withholding tax.

On the FSC's recent delegation to Korea, one of Korea's largest investment managers specifically raised the issue of Australia's taxation treatment of FX hedging being a barrier to offering their Australian asset funds in Korea won. Their Korean investors would prefer to bear the foreign exchange risk themselves, by investing into an Australian dollar fund and undertaking their own hedging back to Korean won, as opposed to having the hedging undertaken in the fund. They noted that this was an Australian-specific problem that they did not have when investing in other jurisdictions.

The FSC has previously suggested that section 230E of the TOFA provisions be clarified to eliminate uncertainty as to its application to passive investment portfolios. In the absence of such clarification it would be appropriate to effectively exempt FX hedging profits from MIT withholding tax as part of a general NRWT exemption for ARFP vehicles.

Bond sale profits are really akin to interest but arguably are ordinary income and potentially subject to MIT withholding tax. In order to eliminate the risk of a technical application damaging the ARFP message we suggest a complete exemption.

We also understand previous costings of this proposal have used data from the ATO's Annual investment income report (AIIR). However this data is misleading as it combines property income to foreigners and non-property income to foreigners. This means the AIIR data (at least in in its current form) is unlikely to be helpful for this costing.

We expect this change will reduce compliance costs for all funds without property income, as only one rate of withholding tax will apply. A fund with property income might face higher compliance costs from complying with the property-related NRWT, but this will be offset by a reduction in compliance costs from collapsing multiple non-property rates into one rate.

Attachment 2: Foreign exchange hedging rules

A common cause of frustration in respect of investment management is the way that for income tax purposes, foreign exchange ("FX") hedging profits and losses are viewed separately to the portfolio assets that they relate to. This is an important issue for the multi-currency class functionality to work in practice.

We submit that FX gains and losses must be able to be placed on capital account. This is because FX gains and losses associated with a multi-currency class fund relate to the underlying asset that is being hedged, rather than income-type gains from foreign currency trading activities (i.e. hedge fund activities).

FX hedging is undertaken by investment funds such as MITs (and CCIVs) so that FX rate risk is eliminated for the fund's investors. In the case of a global shares portfolio, rather than performance being partly attributable to movement in the Australian dollar, FX hedging can ensure that performance is solely attributable to movement in the price of the relevant equities as currency risk is removed.

Under current Australian tax law, realised profits and losses on FX hedging are recognised for tax purposes in the year of realisation and are treated as ordinary income or expenses regardless of whether the underlying assets are still on hand and the nature of those assets. FX hedging is typically performed using either 90 day forward contracts or cross currency swaps. The former are realised within 90 days and the latter may last up to two years; however the underlying assets will normally be held for a period longer than two years. Hence the timing of recognition is disconnected from the underlying assets.

Similarly for many classes of assets a MIT is currently able to make a capital account election meaning that profits and losses are on capital account. However, under current Australian tax laws any profit of loss on hedging will also be considered to be on revenue account. Hence the nature of the FX profit or loss is also disconnected from the nature of the underlying assets.

Under Division 230E of the Income Tax Assessment Act 1997 it is possible for entities within the TOFA regime to make an election in respect of hedging such that the timing and nature of hedging profits and losses is based upon the underlying asset / liability. However, the availability of this election is problematic for investment funds with portfolios of assets.

It is therefore suggested that rather than waiting for the TOFA provisions to be corrected that the CCIV/MIT rules confirm that FX hedging profits and losses of MITs and CCIVs are of the same character as the underlying portfolio and that recognition be deferred until realisation of the relevant component of the portfolio.

Such a provision might be similar to the following:

(1) (a) If a CIV holds a portfolio of assets that substantially consist of assets that are not **Australian things** as defined in section 121DA(5); and

(b) the CIV has entered into * hedging financial arrangements in respect of that portfolio; and

(c) the hedging financial arrangements hedge a risk in relation to movements in currency exchange rates; and

(d) the * foreign currency hedges in their totality are highly effective in reducing exposure to changes in the value of the hedged portfolio that are attributable to foreign exchange rate movements ; and

(e) the CIV regularly monitors the effectiveness of the above hedging and keeps appropriate records, then

(f) the CIV may make an election under subsection (3)

(2) Only CIVs that are registered with ASIC or a comparable overseas regulator are able to make an election under (3)

(3) a CIV makes an election in writing pursuant to this subsection that subsections (6), (8) and (9) apply.

(4) For the purposes of subsection (1) a portfolio substantially consists of assets that are not Australian things if such assets exceed 60% of the value of the portfolio.

(5) For the purposes of subsection (1)(d) hedging arrangements are highly effective if across the course of a financial year the hedging effectiveness is within the band 80 to 125%.

(6) If a CIV has made an election under (3) then income, profits and losses from *foreign currency hedges are not recognised in the year of realisation but instead in years that are representative of when the underlying portfolio of assets are realised.

(7) If a CIV is unable to determine the years that are representative of when the underlying portfolio of assets are realised it may irrevocably elect to recognise such income, profits and losses on a pro rata basis over the financial year and the following three financial years.

(8) If a CIV has made an election under (3) and the underlying portfolio of assets consists of assets for which CGT is the primary code for the determination of gains and losses as a result of an election under section 275- 115 or XXXXXX then CGT is the primary code for the determination of gains and losses from the *foreign currency hedges.

(9) Profits and losses from the *foreign currency hedges the subject of the election in subsection (3) are deemed not to have an *Australian source.

Such a set of provisions will result in FX hedging profits being of the same character as the underlying portfolio and align recognition times. By defining effectiveness by totality of hedges the limitations of international accounting standards, which focus on specific assets and liabilities, are addressed.