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

By email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of Tax Arrangements Applying to Collective Investment Vehicles – Discussion Paper

We are writing in response to the above Discussion Paper on behalf of Australian Foundation Investment Company Limited (AFIC), Australia's largest listed investment company.

AFIC commenced operations in 1928 and for over 80 years has been an investor in shares and other securities of Australian companies. It currently has over 92,000 shareholders. The vast majority of these shareholders are Australian resident retail investors either directly or through self-managed superannuation funds.

The traditional Listed Investment Company (LIC) structure has been extremely attractive to smaller retail investors and charitable institutions. Some of the key reasons for this include the simple structure, the relatively straightforward taxation treatment of the dividends they receive, the ability of the Company to use its reserves to smooth distributions during periods of market declines in earnings and dividends, the predictability of the dividend stream, the very low management expenses of operating traditional LICs and the preferable corporate governance processes that apply to listed companies as opposed to trusts. The characteristics of the traditional LICs are well appreciated and understood by market investors.

Deemed Capital Treatment

Collective Investment Vehicles set up as trusts (Managed Investment Trusts or MITs) are able to make an election that provides them with certainty as regards whether the treatment of their investments are on capital or income account. This certainty has not been extended to LICs. It is one of the arcane matters of law which makes it very difficult in practice for LICs to be completely certain of the tax character of their transactions. This leaves open the possibility that at some point in the future the Tax Office will form a different view regarding their activities from that which the LIC adopted. For example, the Tax Office may regard activities to be on income account whereas the LIC has taken them to be capital, or alternatively, the Tax Office may decide that the activities were on capital account although the LIC has treated them as income. Without the election to adopt deemed capital treatment the determination of whether, in a particular case, a gain is made on income or capital account may only be able to be resolved by the Courts with all the attendant expense that this would incur. The possible retrospective change of tax character of their activities exposes them to additional risk when compared with MITs that are able to make an election with certainty.

As noted in the Discussion Paper, the Board of Taxation originally recommended that consideration be given to LICs having the same option as MITs for electing all gains on disposal of “covered assets” to be on capital account. This suggestion was strongly supported by AFIC, the LIC industry body (ALICA) and many respondents, including from the larger accounting firms. This recommendation has not so far been taken up by the Government. We are unsure why this is the case.

On our understanding of the technical legal meaning of holding investments on capital account, the vast majority of investment activities of traditional LICs like AFIC are long-term investments held on capital account. At present, anyone contemplating the establishment of a new collective investment vehicle, where it is less clear that their investment activities would be of a capital nature, would choose to do so using the MIT structure because they can ensure certainty through the adoption of the deemed capital treatment.

Extension of the deemed capital treatment to LICs would not, we believe, lead to any decline in taxation revenue for the Government. In this context it should also be borne in mind that realised gains made on the sale of investments within one year from purchase under the existing capital gains rules are not eligible for any CGT discount/LIC income tax credit even if deemed to be on capital account. Tax would continue to be paid by the LIC itself on disposal of its investments. Shareholders would only have access to the LIC capital gains tax deduction to the extent that LICs distribute through their dividends the realised gains made on investments held on capital account.

We see it as very important to remove the uncertainty that currently surrounds the capital/income issue for LICs. It also acts as a significant impediment to the use of LICs for new collective investment vehicles. We would therefore once again strongly encourage the Board to recommend that LICs be extended the same treatment with regards to the capital election as MITs.

In addition, we are writing in response to the issues and questions raised largely in Chapter 3 and specifically the issues/questions set out at Q3.2.

Issue /Question 3.2 : Whether the existing definition of LIC capital gains should be restricted to gains made on direct investments only and whether there are reasons to extend this definition to include all gains made in respect of permitted investments by LICs ?

Response

We recommend no major changes be made to the tax legislative framework which underpins the current operation of the LIC regime. That is, as well as direct investments, indirect investments through units (for instance, in MITs), in stapled securities or in other LICs should continue to be counted as permitted investments as part of the LIC regime. This enables LICs and their shareholders to have the maximum flexibility in investment choices, diversifying their risk and access to the skills of other collective investment managers where appropriate.

Issue/Question 3.2 : Whether it is desirable to introduce further changes to the LIC regime to better obtain parity of tax outcome with direct investments in the underlying assets of the LIC ? If so, what changes would be required ?

Response

The current LIC regime reflects the fact that gains made by an LIC are subject to Australian corporate tax, similar to any other corporation and under the imputation regime, the tax paid by LICs or franking credits attached to any dividends received, subject to the holding period rule, accumulate as franking credits which can be passed onto shareholders as part of the dividend paid by the LIC.

The corporate framework of the LIC regime provides simplicity for investors (particularly in their personal taxation) which is reflected in the nature of the distribution paid, that is, receipt by investors of dividend income, rather than a net distribution made of differing components which retain their underlying character for tax purposes.

In terms of “parity of tax outcome”, we do not believe that this requires identical tax arrangements for LICs and MITS. There is a significant legal difference between a company which is a separate legal person and a trust which does not have that status. The advantages and disadvantages of the differing legal status and nature of the vehicles which is recognised in the existing differing tax treatments are understood by investors who can make a choice of vehicle depending on what best suits their investment needs. In our view it is not necessary that the vehicles are taxed completely identically.

Specifically we do not agree that LICs should be forced to adopt the flow through tax arrangements for investors which apply to MITs. To move to a model that required LICs to distribute each year all income and capital gains would be to remove some of the fundamental investment characteristics and attractiveness of LICs. It would introduce significant variability into the distribution stream from year to year and directly remove the ability of LICs to accumulate reserves for difficult times. The distributions made to investors would be made up of differing components of income, franking credits and capital gain and the structures become more complex in their operation.

The ability to accumulate reserves in order to maintain distributions to shareholders is a key issue. In AFIC’s case this has proved extremely valuable during periods of recession when the revenue received from companies in which we invest falls significantly. It has enabled us to maintain our dividends to shareholders from reserves. This is of great value to many shareholders who rely on our dividends for a significant proportion of their retirement incomes.

We believe Australian investors value being able to make a choice between the two different investment models of LICs and MITs. It would be inadvisable, and would result in a reduction of options for resident investors to remove the characteristics of LICs to provide the same tax outcome as MITs. Our long experience of running an LIC leads us to the view that a change in the taxation treatment of LICs so that they were treated for tax purposes like Managed Investment Trusts (MITs) would be against the interests of our retail investors. Furthermore LICs, as companies, are already taxed so there would be no increases in taxation revenue for the Government in moving to such a regime.

In our view it would therefore not be appropriate for LICs to be deemed as trusts for tax purposes, as suggested in Q4.2.

On the other hand, we believe that it is very important that investors have similar effective tax outcomes. That is, one type of collective vehicle should not have a significantly preferred tax outcome vis-à-vis another. This is already reflected in the existing legislation by the changes that were made some years ago to allow for LICs to provide their investors with tax deductions in respect of realised capital gains that place them in the same position as direct investors or investors through MITs.

As outlined above, we do think that LICs should have the ability to elect that their transactions are on capital account as with MITs. The arguments for this change are set out above so we do not repeat them here.

Consideration should also be given to permitting capital gains distributed to LICs from MITs in which they invest to retain their character when they are distributed to LIC shareholders. This would involve permitting such gains, upon which LICs pay tax, to be eligible for distribution as LIC gains – currently, they are excluded and treated differently from all other capital gains that are made on an LIC’s investments. This would also provide for equality of outcome for such gains which are allowed to pass through MITs which invest in other MITs.

Issue/Question 3.2 : Should an amended collective investment company regime be limited to listed vehicles or applied more broadly including other widely held non-listed investment companies defined in a similar way as the widely held rules for MITs ?

Response

We believe there is a place for other widely-held but not listed investment companies to be given tax treatment like listed investment companies. This would mirror the situation of MITs where both listed and unlisted widely held MITs exist and have the same tax rules. However we do note that for many retail investors the public listing of the LIC on the Australian Securities Exchange is important as it ensures that the Company is bound by the reporting and governance requirements of the Exchange. It also provides a liquid market for the purchase and sale of shares. The absence of these factors would in our view create significant but not insurmountable disadvantages for unlisted investment companies.

Issue/Question 3.2 : Is there a trade-off between preserving character and source of income and simplifying distribution statements for investors that are more familiar with a dividend distribution statement? Are there minimal tax outcomes that would meet non-resident investor expectations without requiring complete tax flow-through ? Is there any way to preserve character and source of income under a new corporate CIV regime ? If so, how would that operate ?

Response

The current LIC regime is one that works well for AFIC and similar LICs that invest predominantly in Australian companies for Australian shareholders. Investors understand and appreciate the fact that the tax is paid first by the company and to the extent that the income and capital gains are distributed as dividends with attached franking credits and the LIC tax deduction for realised capital gains they are in substantially the same position as they would be if they invested directly or through an MIT. This is reflected in the relative simplicity of LIC dividend statements in comparison with MITs. We do not believe that this should be changed.

Also, investors in LICs do not have the potential tax issue facing investors in MITs who acquire holdings late in a financial year. Such MIT investors face the possibility of taking on a large but undisclosed tax obligation when the trust declares its distribution at the end of the financial year. Investors subscribing for MIT units do so at the Net Asset Backing per Unit before tax. So that while the investor may have been in the MIT for only a very short time, at financial year end, they receive a trust distribution and associated tax obligation applicable to the whole of the financial year covering a large period of time before the investor took up the investment. This does not apply to LICs because they include tax obligations on realised gains in their calculation of Net Tangible Asset Backing per Share upon which share prices are usually based.

There is theoretically, another possible model whereby an LIC or other collective investment vehicle has the ability to accumulate reserves of both realised income and realised capital gains but are only taxed on the income in the year of receipt (because of dividend franking, most dividend income would not incur additional tax). The realised capital gains would not be taxed at the collective level but only when distributed. This removes the possibility of double taxation of capital gains, that is once in the hands of the collective investment vehicle and then in the hands of the investor through capital appreciation in their investment. However, as this would result in a timing impact from a tax revenue collection perspective (as capital gains, if distributed, would be distributed after the year in which they were realised) and may even result in a decline in revenue if such gains are re-invested rather than ever being distributed, it is unlikely that this option will be supported by the Treasury.

As the Discussion Paper notes, the current LIC structure is not designed to appeal to non-resident investors and, consequently, generally speaking, it does not. We do have a number of mostly retail shareholders in New Zealand who use AFIC as their exposure to the Australian equity market. They are significantly disadvantaged by the loss of franking credits and the fact that they cannot claim LIC capital gain deductions on the dividends they receive from AFIC. A mechanism whereby New Zealand shareholders would be able to have some benefit from the franking credits and or LIC capital gains on the dividends would be of great value to them. It would increase the attractiveness of Australian LICs to New Zealand investors. This could be in a form of a full or partial gross up of the dividend paid to allow for the underlying tax paid.

We would be happy to discuss AFIC's views with you in more detail should you have any questions.

Yours faithfully

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