AUSTRALIAN LISTED INVESTMENT COMPANIES ASSOCIATION

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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 the Australian Listed Investment Companies Association ("ALICA"), the industry body representing many of Australia's traditional Listed Investment Companies ("LICs" – a list of members attached).

ALICA membership is restricted to companies listed in Australia whose principal activity is investing in a diversified portfolio of listed marketable securities on a long term basis for the purpose of deriving income from dividends, interest and other distributions rather than from the sale of such securities. Its nine members have a combined market capitalisation (and funds under management) of approximately $13 billion.

ALICA members are traditional LICs that have been established for the benefit of their shareholders and not to establish a funds management business that provides fee income to a third party manager. Collectively the ALICA members have more than 200,000 shareholders who are predominantly Australian resident, retail investors. For many of these shareholders, their investment in an LIC represents an important source of their current or future retirement income.

Summary

ALICA supports the principle of consistency of tax treatment for investment income in the hands of the investor in CIVs.

The amendments made in 2001 to Division 115 of the ITAA 1997 enabled certain shareholders in LICs to effectively reduce the eligible capital gain component of a dividend by the CGT discount. These amendments largely achieved this consistency.

Extending the deemed capital treatment for MITs to LICs, as previously recommended by the Board and supported by ALICA and many others, and allowing capital gains distributed by trusts in which an LIC invests to also be deemed to be on 'capital account' would be the final elements remaining in this process.

It is important however not to confuse maintaining the principle of consistency with reducing the choices available to Australian resident investors and removing the simplicity and benefits that the LIC structure, as a corporate vehicle, allows.

It is regarded as very important by ALCIA member's shareholders that they receive their income in the simple form of a dividend, without the complexities of a trust distribution statement. The dividend is determined by the Board who are able to utilise past profits and gains to maintain such a dividend in years when income is lower than previously – as witnessed during the recent Global Financial Crisis ("GFC").

Currently investors can receive gross income by electing to invest in an MIT. Should they prefer a more consistent income stream they can invest in an LIC. Apart from the issue of the timing of the receipt of income, with LICs 'smoothing' the distribution (but still paying tax annually at the corporate level, so the ATO suffers no fall in revenue) the after-tax position of the investor will be largely similar, thanks to the already-acknowledged principles of consistency.

We are grateful for the opportunity to comment on matters that are particularly pertinent to its members, particularly the issues and questions raised 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 believe that it is important that no changes be made to the current tax legislative framework which underpins the current operation of the LIC regime. However, consideration should be given, again, to the possible introduction of a capital election for LICs similar to that available for eligible MITs.

In our view it is important for the LIC regime to continue to function as it has, and as it is currently understood – the system is now familiar to the shareholders of our members.

Therefore, investments in units (for instance, in MITs) or in other LICs should continue to be counted as permitted investments as part of the LIC regime which gives maximum flexibility in diversifying their risk whilst utilising the skills of other investment managers.

Consideration should also be given to permitting capital gains distributed to LICs by trusts that they own to effectively 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.

As noted in the Discussion Paper, the Board 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 ALICA and many respondents, including from the larger accounting firms.

Some LICs maintain small trading accounts but the gains on these are usually made by sale within one year. Such gains would not, of course, be eligible for any CGT discount/LIC income tax credit.

Therefore, adoption of the 'deemed capital' treatment should not, we believe, lead to any decline in revenue for the ATO as tax would continue to be paid by the LIC itself on disposal and LICs such as our members have long recognised the requirements of the current LIC legislation in ensuring that LIC gains are only paid out of disposals on the gains made on investments held on capital account.

It would, however, be very important to remove any uncertainty that currently surrounds the capital/revenue issue. This uncertainty leads some investors to regard LICs as being less advantageous from a personal taxation perspective than an MIT.

This uncertainty defeats the purpose of the original LIC legislation which was designed to remove any such perceptions of disadvantage and promote consistency of treatment.

We would therefore once again encourage the Board to recommend that LICs be extended the same treatment with regards to the capital election as MITs.

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

No. The current regime is well understood and accepted by the industry, by shareholders and by investors.

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 LIC's (or franking credits attached to any dividends received, subject to the holding period rule) accumulates 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 character.

To attempt to obtain a 'parity of tax outcome' (as opposed to the consistency of treatment which ALICA would argue largely already exists) would most likely require such gains to be distributed gross to shareholders, as is the case elsewhere.

To move to a model that required LICs to distribute all gains would be to remove one of the fundamental advantages of LICs that has proved itself during the GFC – namely the ability to accumulate reserves in order to maintain distributions to shareholders, many of whom rely on LICs for a significant proportion of their retirement income, when the revenue received from companies in which they invest falls significantly.

We believe that Australian investors value being able to make a choice between the two different investment models of LICs and MITs – the MIT provides the benefits of gross income (which retains its characterisation) and sometimes a higher yield when Australian corporate revenue is high whereas the LICs provide investors with (often) a more stable and secure income flow and a simplicity of taxation outcomes, which is well appreciated particularly by retired shareholders.

It would be inadvisable, and would result in a reduction of options for resident investors without noticeable revenue gain, to remove the advantages of one in order to provide the same tax outcome as the other.

Even assuming LICs maintain the ability to accumulate income (i.e. not required to distribute all gains) there may be a timing impact for the Tax Authorities from a tax revenue collection perspective if LICs were to distribute gains gross at their discretion and for such gains to be treated as capital gains in the hands of the share-holder when received. This would result in at least a delay in the ATO raising tax revenue and conceivably may even be a decline in revenue if such gains are re-invested rather than re-distributed.

It would therefore not be appropriate for ALICA members to be deemed as trusts for tax purposes, as suggested in Q4.2. ALICA shareholders value the simplicity of the current corporate structure and the resulting consistency of distribution.

However, it may be that some LICs that are not ALICA members would prefer to be treated as flow-through vehicles (although it raises the question as to why these often newer LICs were not structured as listed closed-end trusts to begin with). The Board may therefore wish to consider whether an irrevocable election should be introduced which would enable LICs to be taxed as trusts (i.e. on a flow-through basis).

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

ALICA is of the view, as expressed above, that the LIC regime does not need to be amended in its current form, with the exception of extending the capital election available to MITs to LICs.

We make no comments about the appropriateness of parts of the current LIC regime to other widely-held investment companies, but would note we believe that the requirement to be "listed" is important to our shareholders as it ensures that the Company is bound by the reporting and governance requirements of the ASX and it provides a liquid market for the purchase and sale of shares.

We would appreciate the opportunity to discuss our views with you in more detail should you have any questions.

Yours faithfully

Frank Gooch
Chairman
Australian Listed Investment Companies Association