Level 24, 44 Market Street
Sydney NSW 2000
Tel: +61 2 8235 2530
Fax: +61 2 9299 3198
acsa@ifsa.com.au
www.custodial.org.au
ACN 072 659 619

14 June 2013

Manager
Corporate Tax Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Email: dividendwashing@treasury.gov.au

Copy to: Daniel Royal – Daniel.royal@treasury.gov.au

Dear Sir/Madam

Preventing Dividend Washing – Discussion Paper

The Australian Custodial Services Association (ACSA) welcomes the opportunity to provide this submission to Treasury on the issues raised in the Discussion Paper on *Preventing Dividend Washing* (Discussion Paper) released in early June.

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 of approximately AUD $1.8 trillion in value in custody and under administration. Members of ACSA include National Australia Bank Asset Servicing, BNP Paribas, RBC Investor Services, JP Morgan, HSBC, State Street, Northern Trust and Citigroup.

One of the main services provided by ACSA members to our clients is tax reporting. Tax reports and tax templates are used by our clients, such as large managed funds and regulated superannuation funds, in calculation of taxable income and completion of taxation returns and other tax related regulatory reporting.

General comments about the 45 day franking credit rule and franking credit avoidance measures

ACSA members understand the need for suitable integrity measures to exist to prevent inappropriate franking credit practices. However, we note the broad experience of members is there are few, if any, indications that the types of entities into which our clients fall are involved in improper franking practices. ACSA members and our clients are invariably risk averse in their approach to tax practices and tax compliance.

Since the introduction of the franking credit avoidance measures in 1997, the general observation of members (and clients) is the reason for franking credits being denied has been inadvertence – that is, franking credits have been denied where a superannuation fund or managed fund has multiple portfolios where the manager Portfolio A has no knowledge of the share purchases and sales of the manager of Portfolio B (and vice versa). Multiple portfolios of a particular client can exceed 200 in number so the instances in which credits are lost through inadvertently breaking the 45 day rule are magnified. We can see merit in the holding period as an integrity rule where person controlling share trades has knowledge of what parcels have been purchased within the last 45 days but we do not see the merit from an integrity perspective where that knowledge does not exist.

General questions

Which option/s would best prevent dividend washing from occurring?

First Option – modifying the holding period rules

From the perspective of custodians with automated accounting and tax systems used to produce tax and other reporting, the first option (modifying the holding period rules as set out in paragraph 3.2 of the Discussion Paper) is not preferred for 3 broad reasons:

- Complexity – the accounting and tax systems currently have 45 day rule calculation functionality to identify the loss of franking credits due to sales of shares after the ex date for a franked dividend using a LIFO parcel methodology. The franking credit module does not distinguish shares purchased in the cum dividend market from shares purchased in the normal ASX market. In fact the accounting and tax systems do not currently separately identify purchases as cum dividend market as it is not part of the fundamental data required to record securities holding and process subsequent corporate actions such as dividends.

  Under current practices it is not necessary to record whether a purchase has been made through the cum dividend market as once the share is purchased all the system needs to know is whether the holder (the custodian for its client) is entitled to the next dividend to be paid after acquisition date. So, all purchases are considered to be CUM in the sense they will be entitled to the next dividend. Note, there is an exception to this for purchases made between the ex date and the record date where they can settle EX or CUM. This is the only time trades are required to have a specific indicator and the option of EX is available. However, this indicator is not recorded in the accounting and tax system. The entitlement or non-entitlement to the next dividend is given effect to through the reconciliation process between the custody system and the accounting and tax system.

  It would seem that a modifying the holding period rule as suggested in the first proposal would potentially require 1 of 2 changes to occur:

- Introducing a new flag into the accounting and tax system applicable to all parcel holdings to identify whether purchased in the cum dividend market[1]. Once this information is available the LIFO methodology would need to be rewritten to modify the acquisition time for the cum dividend market purchase but only where there is a prior sale of the same share after the ex date. This would be a potentially complicated alteration of the holding period LIFO code. A proxy solution might be available to deem all purchases in the cum dividend market to have actually occurred before the ex date although this may need a consequential amendment to ensure that the holding period requirement for such parcels did not become 48 or 49 days. Potentially the main complexity here would be the introduction of a new security flag in the accounting and tax system solely for 45 day reporting purposes.
- An alternative approach might be to introduce functionality to search for post-ex date purchases that have qualified for a franked dividend and then identify whether there have been any prior sales occurring after the ex date. The accounting and tax system rules would then need to be modified to deny the franking credits on the cum dividend market purchase. Also, the existing system LIFO rules would need to be reviewed to consider the impact of this deemed denial and then assess the flow on impact for other trades around the ex date.

Under both approaches it would be necessary to review the impact on any risk diminution file functionality which tests for the impact of derivatives on net delta calculations and the number of days for which parcels are held at risk during the holding period. It is quite possible there would be flow on implications which would require testing and potential rewrite of systems code.

- Cost – Changes to an accounting and tax system such as HiPortfolio or other proprietary systems used by custodians are generally costly due to complexity and the need to ensure changes achieve the required outcome and do not impact on existing functionality. The systems are used not only for accounting and tax purposes but also for unit pricing, valuation, performance and regulatory reporting purposes. At a very high level the change process involves the following steps:
  - Understanding and scoping required changes;
  - Writing detailed requirements;
  - Formulating most effective and efficient enhancement strategy;
  - Seeking approval from systems users;
  - Seeking funding from systems users;
  - Implementing enhancement;
  - Testing phases – user acceptance, regression, etc

- Risk – if it is assumed a fully functional systems upgrade can be developed, there will be interim risk from 1 July 2013 to the date such upgrade goes live. Invariably manual processes will be needed to identify share purchases for which franked dividends should be disallowed.

[1] Note this would also involve changes to trade instructions and processing from investment managers and brokers so the additional information is captured. With the industry moving to STP (Straight Through Processing) business model, non provision of this information will interrupt the fluency of processing and potentially force trade to be processed outside contractually agreed timing with financial consequences for processing failure.

For a systems solution there will be risks associated with correctly understanding the new requirements and having these translated into systems changes and then flow on risks to other parts of the system and to downstream reporting and templates.

Second Option – adding a criterion to the anti avoidance provisions

ACSA understands the benefits of having a rule that is 'self executing' in the sense it does not require the Commissioner to declare an arrangement to be entered into for an avoidance purpose before franking credits are disallowed. However, this benefit should in our view be balanced against the equity consideration of tax compliant superannuation and managed fund investors inadvertently losing franking credits where they have multiple equity portfolios.

From an equity perspective, we believe such investors should at least be able to present circumstances to the Commissioner as to why there should be no denial of franking credits. For example:

- an institutional investor has 50 equity investment portfolios each with a different manager;
- the manager of Portfolio A sells CBA shares on 14 July 2013, one day after the ex date for a franked dividend;
- the manager of Portfolio H purchases CBA shares in the cum dividend market on 15 July 2013 for legitimate reasons (as contemplated by para. 15 of the Discussion Paper);
- the manager of Portfolio H has access only to the share holdings and trading information for Portfolio H – it has no knowledge of holdings or trades for any other portfolio or otherwise at an entity level;
- the manager of Portfolio A has access only the share holdings and trading information for Portfolio A – it has no knowledge of holdings or trades for any other portfolio or otherwise at an entity level.

The alternative is to have a 'strict liability' rule which denies franking credits on purchases in the cum dividend market where there has already been a sale since the ex date. In practice a tax risk conscious entity would manage the risk of losing franking credits by prohibiting its managers from purchasing shares in the cum dividend market and require managers to confirm on an annual (or other periodic) basis that no such purchases have occurred. Arguably, however, this is contrary to the acknowledgement in the Discussion Paper that the cum dividend market exists for legitimate reasons.

On balance, this is the preferred option for ACSA.

Third option – Creating a specific double franking credit integrity rule

This option is effectively the 'strict liability' approach referred to above. If such an approach is favoured by Treasury, then we do not have a strong preference as to where the rules appear – in Part IVA or the rewritten 45 day rule provisions. From a short term perspective it might be easier for the rules to appear in Part IVA so that the gap between the start date and the date of introduction is as short as possible. However, from perspective of designing a coherent and comprehensive code where users of the legislation – who do not necessarily have the benefit of the history and background of the 45 day rule – can readily and sensibly access the rules they

need to apply to determine with certainty the amount of franking credits lost, it would be helpful if these rules are located in the general franking credit provisions of the 1997 Act.

Under this approach, the possible identification methods for transactions leading to the loss of franking credits would likely be as follows:

- the custodian upgrades its systems functionality to allow identification – our comments on the first option are applicable
- the custodian introduces manual processes to routinely search transaction data around ex dates to allow identification – manual processes introduce the risk of human error which can become larger as the number of transactions and number of portfolios increases;
- the client of the custodian will need to seek information from managers about purchases in the cum dividend market. Where there have been such purchases, the client then investigates to determine whether there are prior sales that have occurred after the ex date;
- the client of the custodian prohibits managers from purchasing in the cum dividend market and seeks a regular declaration that no such purchases have occurred.

Would the options canvassed have unintended consequences for taxpayers for legitimate trading?

Potentially yes. As noted above, ACSA members do not track and are generally unaware of purchases made by clients in the cum dividend market. Clients may also be unaware where such purchases are made by a portfolio manager with a discrete mandate. To the extent that clients remove the risk of losing franking credits by prohibiting managers from trading in the cum dividend market then this could be seen as having unintended consequences on legitimate trading.

Would the options canvassed create undue levels of uncertainty for taxpayers?

Yes, for the reasons set out above there would be uncertainty and risk for taxpayers and their intermediaries (eg custodians).

Specific questions

If modifications to the holding period rules were made, would the description of their application in this discussion paper provide taxpayers with enough certainty?

We think there is probably sufficient certainty in the Discussion Paper for taxpayers to know that if they have purchased in the cum dividend market they will need to investigate whether dividends will receive franking entitlements. There will likely be boundary situations where the

entitlements will be unclear due to the lack of detail in the Discussion Paper and the basic trading scenarios that are dealt with.

If modifications to the holding period rules were made, should they be targeted to the period after a share goes ex-dividend on a time basis or concept basis?

From the perspective of automated accounting and tax systems, we believe there are issues with the application of the rules under both scenarios, as noted above. Perhaps the identification on a 'time basis' would provide the more objective criteria for an individual testing in a manual overview process or under an automated process if ultimately this is what is required.

Should adding a criterion to the anti-avoidance rules be adopted as a complementary measure to modifying the holding period, a substitute measure, or not be adopted at all?

Consistent with our view that the first and third options are not preferred, we support adding a criterion to the anti avoidance rules as a substitute measure.

Would it make more sense to modify the holding period rules or insert a specific double franking credit integrity rule to the general anti-avoidance provisions?

In time, if there is a specific double franking credit rule it should be inserted into the rewritten holding period rules.

Yours sincerely

Pierre Jond, Chairman
Australian Custodial Services Association