KPMG submission

Exposure Draft

Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2017: (Tax treatment)

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Executive Summary

KPMG welcomes the release of the Exposure Draft ("the ED") of *Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2017 (Tax treatment).*

We have provided two categories of recommendation on the ED. Firstly, we have set out our comments on those features which in our view will impact the practical attractiveness of the corporate collective investment vehicle ("CCIV") to investors and fund managers.

Secondly, we have commented on those items where modification to the drafting may be required in order for the intended outcome to be achieved, or in order to provide sufficient clarity.

Recommendations regarding the overall commercial impact of the ED's tax framework:

1) The Bill should be restructured so that the taxpayer entity is the individual sub-fund rather than the ACCIV. This would be significant in protecting investors in one sub-fund from the adverse tax consequences that would otherwise arise from events occurring in another sub-fund of the ACCIV. It would make the ACCIV regime consistent with the operation of the AMIT regime.
2) The Bill should mitigate the impact of the provision that denies a former ACCIV the ability to frank its distributions. This can be achieved by providing a specific grandfathering period where the failure to meet the requirements is due to investor action.
3) In so far as they would otherwise apply to an ACCIV, the Bill should deactivate those provisions which are generally applicable to a company that is subject to corporate income tax, but which are inconsistent with the status of an ACCIV as a "flow through" entity.
4) The Bill should expand the scope of the "rollover" when an interest in an AMIT or other investment vehicle is exchanged for an interest in an ACCIV, in order that all of the tax attributes attaching to the interest in the former vehicle are also carried over into the ACCIV.
5) In order for transition to the ACCIV structure to be feasible for an existing vehicle that has investments in Australian real estate, Treasury should work with state and territory authorities to ensure that stamp duty relief is available in connection with such a transition.
6) The withholding tax rates for income attributed to non-resident shareholders in the ACCIV should be reconsidered in light of the lower withholding tax rates that fund managers in certain overseas locations will be able to offer.

Technical recommendations:

7) Apply the control and attributable taxpayer tests in Part X ITAA36 to each sub-fund individually, and also treat sub-funds of the same ACCIV as not being associates. In addition, apply the participation test in Subdivision 768-A ITAA97 to each sub-fund individually.

8) Paragraph 104-600(3) (a) should instead read:

   "If the cost base of that asset was nil just before that time – the AIV cost base net amount mentioned in paragraph (1) (c) of this section; or"

9) Paragraph 276-260(5) (e) should be modified to make it clear that payments by the ACCIV to the depositary for services rendered are deductible in arriving at the amount that the ACCIV's AIV components should aggregate to, and are assessable to the depositary.

10) Consistent with Recommendation 1, the treatment of each class of shares in an ACCIV as a separate AIV should be mandatory rather than elective.

11) Allow that an ACCIV may frank a distribution, subject to the usual qualifying criteria, where that distribution is paid out of profits derived while a corporate tax entity, prior to becoming an ACCIV.

12) Include provisions covering how the TOFA provisions will apply to ACCIVs, including the treatment of hedging arrangements and the timing rules.

13) Include an example in the EM which illustrates how the investor in the ACCIV takes on the ACCIV's ownership history in a CGT asset of the ACCIV.

14) Subsection 275-20(4) ITAA97 should be updated to include an ACCIV as a qualifying widely-held investor in another CCIV.

Detailed Comments

1. General

1.1 KPMG welcomes the opportunity to comment on the Exposure Draft of *Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2017* (Exposure Draft) and associated Exposure Draft Explanatory Memorandum (EDEM) as published by Treasury on 20 December 2017.

1.2 The CCIV can be an important step in promoting the export of Australia's funds management capability. The income tax "flow-through" features that the ED proposes are critical to achieving this.

1.3 When assessing which collective investment vehicle ("CIV") structure best suits their needs, fund managers will consider a number of *"what if…?"* scenarios. When considering the CCIV, one of these scenarios would be where the CCIV ceased to qualify as an ACCIV due to events beyond the control of the fund manager. This could occur where one investor in one sub-fund withdraws and causes that sub-fund to fail the widely-held test.

1.4 The ED includes an exception to losing ACCIV status where the failure to meet the requirements is "temporary". However there is uncertainty in how the Australian Taxation Office would apply this relief.

1.5 We recognise Treasury's concern that the introduction of the CCIV should not result in loss to the revenue as a consequence of allowing the CCIV fewer restrictions than the AMIT regime, and that there can be value in a deterrent to those who might exploit the CCIV structure in a manner that goes beyond the policy intent. However the severity of the consequences that the ED proposes for ceasing to qualify as a ACCIV is such that it represents a significant inhibitor to the take-up of the CCIV.

1.6 Our following recommendations address in section 2 how the ED could be modified to make the CCIV more practically attractive to investment managers and their clients, having regard to Treasury's objectives for revenue neutrality. In section 3 we address technical amendments which we believe are required in order to enhance the clarity of the legislation or to remove unintended outcomes.

2. Practical issues impacting the take-up of the CCIV structure

2.1 Impact of one sub-fund causing the whole ACCIV to cease eligibility

There are various situations which could cause a sub-fund of an ACCIV to cease to meet the qualifying criteria, and which could be beyond the scope of the operator to rectify within a period of time that the Commissioner may consider reasonable for the purpose of proposed section 276-45.

These situations could include:

- One or more investors withdraw their investment, causing a sub-fund to fail either the widely-held requirement or the closely-held restriction due to the reduction in the number of members of the sub-fund.
- An individual who holds an interest of 10% or more in a sub-fund ceases to be an Australian tax resident.

The eligibility rules for an ACCIV are similar to those that apply to an AMIT, however they operate more severely in that they apply to the whole ACCIV even where it is only one sub-fund that ceases to meet the requirements. It is not clear that

the election under proposed section 276-48, which would allow each sub-fund of an ACCIV to be treated as a separate AIV, operates to eliminate this risk.

This would be a significant disincentive for investors to invest in an ACCIV structure, as the outcomes for an investor in one sub-fund of the ACCIV could be adversely impacted by the circumstances of a separate sub-fund in which the investor has no interest.

It would be more reasonable for the imposition of corporate income tax to be restricted to the sub-fund which breaches the ownership or trading business rules. This could be achieved by restructuring the Bill such that the taxpayer entity is the individual sub-fund, rather than the overall ACCIV, with the corporate director of the CCIV being responsible for ensuring that the appropriate tax profile is reported and paid.

This would be comparable to the situation with an AMIT, where the loss of AMIT status by one fund would not impact other AMITs operated by the same trustee.

We recognise that this would introduce some complexity into the tax profile of the CCIV. However the CCIV is required to separately identify the assets of each sub-fund in its records, and there should be little difficulty in isolating the income between the different sub-funds, and then applying corporate income tax to the income of the sub-fund that had ceased to meet the ACCIV requirements.

2.2 Recommendation 1

The Bill should be modified to treat the taxpayer entity as each individual sub-fund of the ACCIV on a separate and independent basis, and to apply all ACCIV eligibility tests at the individual sub-fund level. In this way, investors in one sub-fund would not be impacted by the failure of another sub-fund to continue to comply with the ACCIV eligibility requirements.

2.3 Inability of former ACCIV to frank dividends

The consequences of ceasing to be an ACCIV are much more severe on the operator and the investor than in the case of an AMIT.

The operator and investors in relation to an ACCIV face the possibility that all future distributions from the ACCIV will be taxed as unfranked dividends (including where the CCIV has paid corporate income tax on the relevant profits). This would be a particularly adverse consequence for government and other tax-exempt entities which invested in an ACCIV.

These issues represent a significant barrier to the adoption of the CCIV structure.

One alternative approach which we believe would provide a more constructive balance between Treasury's reasonable concerns about integrity and the presentation of an attractive investment structure to the market, is as follows:

- Allow the sub-fund of an ACCIV that has met the qualifying criteria for at least two years of income to be deemed to continue to be an ACCIV for a specified further period after it has failed to meet one of the requirements, where this failure is due to investor action (eg withdrawal of investment or ceasing tax residence). The specified further period should include the income year in which the failure occurs, and the next following income year.
- Allow the other sub-funds of an ACCIV that have continued to meet the requirements, to continue to be treated as eligible for the ACCIV tax treatment.

2.4 Recommendation 2

The Bill should be modified to mitigate the impact of the provision that denies a former ACCIV the ability to frank its distributions. This can be achieved by providing a specific grandfathering period where the failure to meet the requirements is due to investor action.

2.5 Application of other standard corporate income tax rules to an ACCIV

The ED does not "switch off" certain standard corporate income tax rules from applying to an ACCIV. These rules do not apply to AMITs, and are inconsistent with the objective of the ACCIV concept as providing another form of collective passive investment vehicle.

The continued application of these rules would impose significant complexity and compliance cost on the ACCIV, and provide another disincentive to using the structure when compared to an AMIT.

Examples of these provisions include the continuity of ownership and same business tests for losses, and the provisions of Subdivisions 165-CC and 165-CD ITAA97.

2.6 Recommendation 3

In so far as they would otherwise apply to an ACCIV, the Bill should deactivate those provisions which are generally applicable to a company that is subject to corporate income tax, but which are inconsistent with the status of an ACCIV as a "flow through" entity.

2.7 *Transition from another investment vehicle to an ACCIV*

The ED contains CGT rollover provisions where assets transfer from another kind of investment vehicle (for example an AMIT) into an ACCIV, and units in the other vehicle are exchanged for shares in the ACCIV. This assists in enabling the operators of existing collective investment vehicles to transition to the ACCIV structure if they wish to.

However other potential barriers to such a transition still remain. These include:

- There is no provision for accumulated capital losses of the AMIT or other vehicle to be transferred to the ACCIV.
- There is no provision for accumulated revenue losses of the AMIT or other vehicle to be transferred to the ACCIV.
- There is no provision for the distribution history and balance of unders and overs (from an AMIT) to be carried across.

Unless the above features can be carried across into the ACCIV structure, operators and investors in an AMIT with these features will face a barrier to adopting the ACCIV structure.

We suggest that continuity and integrity could be best achieved by treating the replacement shares in the ACCIV as being a continuation of the units in the AMIT for all tax purposes.

2.8 Recommendation 4

The Bill should expand the scope of the "rollover" when an interest in an AMIT or other investment vehicle is exchanged for an interest in an ACCIV, in order that all of the tax attributes attaching to the interest in the former vehicle are also carried over into the ACCIV.

2.9 Application to the Australian real estate investment sector

A state and territory stamp duty exemption would be required in order for it to be realistic to expect an AMIT or other investment vehicle with real estate holdings to transition to an ACCIV structure.

We therefore encourage Treasury to continue to explore this with the state and territory revenue authorities.

2.10 Recommendation 5

In order for transition to the ACCIV structure to be feasible for an existing vehicle that has investments in Australian real estate, Treasury should work with state and territory authorities to ensure that stamp duty relief is available in connection with such a transition.

2.11 Withholding tax on income and gains attributed to foreign resident investors

The ED proposes that the same rates of withholding tax will apply to distributions of income and gains from an ACCIV as currently apply to an AMIT.

Having regard to the forthcoming introduction of the Asia Region Funds Passport ("ARFP"), with which the ACCIV is intended to be compatible, and the stated objective of encouraging foreign residents to invest in funds managed in Australia, we believe that Treasury should consider reducing the withholding tax rates for AIVs.

Singapore and Hong Kong are established financial centres, and are both on the pathway to legislating tax-transparent funds management vehicles which would then compete with the Australian ACCIV. The expectation is that the withholding tax on distributions from the Hong Kong and Singapore vehicles would be very low, or nil, in respect of dividends and capital gains.

In addition, the United Kingdom's Open-ended Investment Company ("OEIC") vehicle has zero withholding tax in respect of distributions relating to dividends and fixed income securities.

2.12 Recommendation 6

The withholding tax rates applying to fund payments from an AIV and other distributions from AIVs should be reduced in order to enable the Australian funds management industry to more effectively compete with overseas financial centres, thereby increasing the taxable profits of the Australian funds management industry.

3. Technical clarifications to the ED and removal of unintended outcomes

3.1 *Interests in a foreign company that may be a controlled foreign company ("CFC")*

The ED does not specify how the "attributable taxpayer" assessment in section 361 *Income Tax Assessment Act 1936* ("ITAA36") will apply to an ACCIV. That is, do the relevant tests apply at the sub-fund level, or at the aggregate ACCIV level?

Our view is that the tests should apply at the individual sub-fund level, and that sub-funds should not be treated as associates of other sub-funds of the same ACCIV for the purpose of the control and attributable taxpayer tests in Part X ITAA36.

Otherwise investors in one sub-fund could be adversely impacted by the investment decisions made in respect of another sub-fund of the ACCIV, over which they would have no influence.

In addition, we consider that it would also be more appropriate to apply the 10% participation test in Subdivision 768-A ITAA97 (for determining whether a distribution from a foreign company is assessable income or not) to each sub-fund individually, rather than on an aggregated basis for the ACCIV.

3.2 **Recommendation 7**

The Bill should include provisions which would apply the tests in Part X ITAA36 to each sub-fund individually, and also treat sub-funds of the same ACCIV as not being associates. In addition, the Bill should require the application of the participation test in Subdivision 768-A ITAA97 to each sub-fund individually.

3.3 *CGT event M1 - clarification*

Proposed subsection 104-600(3) requires modification.

We expect that paragraph 104-600(3) (a) is intended to refer to a situation where the cost base of the asset (ie the share in the AIV) has already been reduced to nil as a result of the operation of subsection 104-605(2) in prior years. Otherwise subsection 104-600(3) would result in double taxation of the cost base net amount for the year of income.

3.4 **Recommendation 8**

Paragraph 104-600(3) (a) should be modified to read:

"If the cost base of that asset was nil just before that time – the AIV cost base net amount mentioned in paragraph (1) (c) of this section; or"

We believe this would achieve the appropriate outcome.

3.5 *Payments to a third-party depositary for services rendered*

Proposed paragraph 276-260(5) (e) states that payments that the ACCIV makes to the depositary should be disregarded when working out the ACCIV's AIV component of a particular character.

This implies that the payment to the depositary would not be deductible in working out the aggregate of the AIV components. Such an outcome would appear to be at odds with paragraph 1.82 of the EDEM which states that:

"payments made by the ACCIV to the depositary in its capacity as a depositary (such as fees paid by the ACCIV for services rendered by the depositary) will be recognised for tax purposes."

3.6 Recommendation 9

Paragraph 276-260(5) (e) should be modified to make it clear that payments by the ACCIV to the depositary for services rendered are deductible in arriving at the amount that the ACCIV's AIV components should aggregate to, and are assessable to the depositary.

3.7 Election under proposed paragraph 276-48(1) (d) to treat different classes of share in an ACCIV as separate ACCIVs

The ED does not require the operator of an ACCIV to treat each sub-fund (which would typically be represented by a separate class of shares in the ACCIV) as a separate AIV. However section 276-48 allows the operator to elect for this treatment to apply to an income year and all subsequent income years.

We consider that the proposed legislation would operate more effectively if the treatment of each class of shares in an ACCIV as a separate AIV was mandatory. This would strengthen the requirement for income to be allocated on a fair and reasonable basis between the entities holding an interest in the AIV.

3.8 Recommendation 10

The treatment of each class of shares in an ACCIV as a separate AIV should be mandatory rather than elective.

3.9 Where a corporate entity becomes a CCIV and subsequently distributes profits

Paragraph 1.47 of the EDEM indicates that a corporate entity may register as a CCIV and become an ACCIV during the course of an income year. It also suggests that such an entity would apply "*company taxation*" for the part of the year for which it was a corporate taxpayer, and ACCIV treatment for the remainder.

Equally, an entity that becomes an ACCIV at the start of an income year, having previously been a corporate tax entity, may not be in a position to pay a dividend out of prior-year profits until after it has become an ACCIV.

In these situations, it is necessary for the Bill to provide a mechanism such that an entity would be entitled to frank any dividend paid out of the profits derived prior to becoming an ACCIV, where the entity paid this dividend after becoming an ACCIV. This would require the ACCIV to be entitled to retain its status as a franking entity in relation to those profits that had been subject to corporate income tax.

3.10 Recommendation 11

The Bill should allow that an ACCIV may frank a distribution, subject to the usual qualifying criteria, where that distribution is paid out of profits derived while a corporate tax entity, prior to becoming an ACCIV.

3.11 *Hedging under the taxation of financial arrangements ("TOFA") provisions*

The ED does not address how the TOFA provisions should apply to hedging arrangements that an ACCIV may enter into. It will be important for fund managers and investors that there is clarity on how these provisions will apply to an ACCIV, in order that assess the impact on the investment strategy of the ACCIV in a timely manner.

3.12 **Recommendation 12**

The Bill should include provisions covering how the TOFA provisions will apply to ACCIVs, including the treatment of hedging arrangements and the timing rules.

3.13 Investor eligibility for discount capital gains

Proposed subsection 276-80(2) suggests that an investor in an ACCIV will be deemed to have realised the CGT event in their own right, where the investor receives an attribution of capital gains or losses from the ACCIV.

Further the proposed paragraph 276-80(2) (b) indicates that the investor's situation would be treated as being:

"*in the same circumstances as the *AIV derived, received or made that amount, to the extent that those circumstances gave rise to the particular character of that component."*

It would be helpful if Treasury could include an example in the Explanatory Memorandum to the Bill which illustrates that the investor would assume all of the ownership history of the ACCIV in relation to the CGT asset (for example acquisition date).

3.14 **Recommendation 13**

The EM to the Bill should include an example which illustrates how the investor in the ACCIV takes on the ACCIV's ownership history in a CGT asset of the ACCIV, where the investor receives an attribution of the gain or loss arising from a CGT event in relation to that asset.

3.15 Qualifying widely-held investors in an ACCIV

The Bill should align subsection 275-20(4) and proposed paragraph 276-20(2) (b). The latter includes an ACCIV as a widely-held investor, whose status would contribute to the eligibility of a CCIV that it invested in for ACCIV status.

For consistency, it would make sense for subsection 275-20(4) to also include an ACCIV.

3.16 **Recommendation 14**

Subsection 275-20(4) ITAA97 should be updated to include an ACCIV as a qualifying widely-held investor in another CCIV.