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Market Conduct Division
Treasury
Langton Cres
PARKES ACT 2600

By Email: *CIVreform@treasury.gov.au*

Dear Sir/Madam

CCIV - REGULATORY AND TAX FRAMEWORKS

1. Thank you for the opportunity to provide comments to the exposure draft legislation and related explanatory materials that seek to implement the Corporate Collective Investment Vehicle ("**CCIV**") regime into Australia's corporate and tax systems.

2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many clients, including both investors and fund managers, that would be impacted by the introduction of the CCIV regime.

3. We apologise that this submission has been provided after the close date. However, we have considered the proposed default taxation regime for CCIVs in more detail and would like to share our comments and thoughts on our considerations.

4. Accordingly, our comments contained in this submission are particularly focused on the tax framework of the CCIV regime. We endorse the broad framework under the current design and believe it is a significant improvement on earlier versions and much simpler to understand and apply. However, we highlight some suggestions that we believe could improve the current design of the regime in a way that would increase its uptake and increase investment into Australia, particularly in the context of unlisted funds.

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Taxation of CCIV sub-fund trusts as AMITs

5. We highlight that proposed section 195-125 of the *Income Tax Assessment Act 1997* ("**ITAA 1997**") applies a deeming rule in order to facilitate the application of Division 6 of Part III of the *Income Tax Assessment Act 1936* ("**ITAA 1936**") to tax a CCIV and shareholders of a sub-fund like a trustee and the beneficiaries of a trust. The deeming rule attempts to do this using the central concept of present entitlement to trust income and equating this to a dividend paid.

6. In our view, this gives rise to many issues of interpretation and would likely create significant uncertainty such that many investors and fund managers alike may avoid the use of the CCIV regime where there is a risk that the sub-fund will be taxed under Division 6.

7. We set out some of these issues in more detail below. In light of these, it is our strong recommendation that all CCIV sub-fund trusts be treated as AMITs for income tax purposes under Division 276 of the ITAA 1997. This would allow all CCIV sub-fund trusts to allocate components of taxable income to beneficiaries on a fair and reasonable basis, instead of based on the concept of notional present entitlements created through the payment of dividends.

8. This could be achieved by amending proposed section 195-135 by also disregarding section 276-10 entirely so that the requirements of a CCIV sub-fund trust to be a managed investment trust ("**MIT**") do not apply. Proposed section 195-125 would then no longer be necessary.

   8.1. We note that the requirement in sections 275-10(3)(b) and (4)(a) should be retained to ensure that a CCIV sub-fund trust can still be treated as a public trading trust and taxed as a corporate tax entity where it would be a public unit trust that carries on the requisite trading activities or controls certain trading businesses.

9. Such a framework would not necessarily provide a CCIV sub-fund trust with benefits of being a MIT, such as the capital account election and access to MIT withholding rates. These concessions could still be determined on the basis of whether the CCIV sub-fund trust meets the requirements of being a MIT or not (as modified by proposed section 195-130). Accordingly, the only real benefit of applying the AMIT regime is certainty with respect to the taxation of the CCIV sub-fund and its members.

10. We note that proposed sections 195-115 and 195-120 already deem a CCIV sub-fund trust to be a fixed unit trust, whether it would be a MIT or not. The nature of shares in a CCIV sub-fund are therefore such that the rights would be clearly defined.

11. If all such CCIV sub-fund trusts were deemed to be AMITs, we believe that there would be little integrity risk in removing the currently proposed Division 6 treatment. Section 276-210 of the ITAA 1997 requires the attribution by an AMIT to be worked out on a fair and reasonable basis and does not permit streaming of amounts based on their tax characteristics.

12. Further, the highly regulated nature of a CCIV requiring the use of a corporate director with an AFSL and the limitations on what CCIVs can do (e.g. prohibition on having employees) should ensure that CCIV sub-fund trusts will not be used for purposes other than intended (i.e. as collective investment vehicles). As such, our view is that all CCIV sub-funds (other than those that would be public trading trusts) should be taxed on an attribution basis like an AMIT.

13. Finally, the public trading trust provisions could still apply to the CCIV sub-fund, to the extent that the CCIV sub-fund is 'public' and carries on 'trading activities'. This adds additional integrity to the proposal contained in this submission.

Issues with proposed section 195-125 taxation via present entitlement

14. Our main concern with proposed section 195-125(1) is that it uses a cash paid basis as the mechanism that enables amounts to flow-through to members of the CCIV sub-fund trust for tax purposes.

15. This is a fundamental shift from the basis of taxing income of trust estates that has existed for over 100 years, as the trust taxation system is based on entitlements to distributions of income rather than actual distributions. Any system of taxation that requires all current year income to be determined and paid to members prior to the end of the year is, in our opinion, unworkable and would result in limited uptake of CCIVs where they are not taxed like AMITs.

16. It would not be commercially feasible for CCIVs to have calculated their "income" with 100% certainty prior to year-end. To the extent the amount of "income" was underestimated, the undistributed amounts would be subject to top rates of taxation under section 99A of the ITAA 1936 under the current proposed system for taxing non-AMIT CCIV sub-fund trusts. Further, the requirement to pay dividends out in full to enable effective flow-through taxation may place needless cash flow pressures on CCIV sub-funds where surplus cash is not immediately available for distribution.

17. We note that the deemed fixed entitlements in proposed section 195-120 are based on rights to receive dividends and capital distributions, rather than actual dividends and capital distributions that occurred during the year. Also, section 195-125(2) determines the individual interests in shares of exempt and non-assessable non-exempt income based on these deemed fixed entitlements to income held from time-to-time rather than actual dividends paid throughout the year.

18. In our view, it would seem unusual to allocate exempt income for a particular year based on a member merely holding shares in the sub-fund, but require a dividend to be paid in order to have a share of the trust's assessable income allocated to the same member.

19. This type of outcome would be avoided by relying on the AMIT attribution method, which would allow a fair and reasonable allocation of the taxable income to members, irrespective of cash distributions.

20. If AMIT-type attribution is not permitted for all CCIV sub-fund trusts, the "fixed entitlements" approach in proposed section 195-125(2) should be adopted in preference to the "dividends paid" approach in proposed section 195-125(1) to determine present entitlements to income of the trust estate. We highlight that while this is better than the currently proposed Division 6 approach, this is not our preferred option, as difficulties can arise where (for example) there are interests carrying differing entitlements. For example, it is common for debt funds to distribute to members based on the number of days units are held. This mechanism is accepted in PCG 2016/16 (para 19, dot point 4) when determining whether a trust is fixed. It may be difficult to apply the "fixed entitlements" approach to such interests. We note that there is a common industry allocation method for providing an exact allocation of taxable income to members based on a fair and reasonable allocation approach for AMITs (i.e. allocated on days the units have been held) such that we still believe the deemed AMIT approach is preferable.

21. Another potential solution could be to allow dividends paid within a short period after year-end (e.g. 2 months) to be effective in creating the notional present entitlement for the income year. Again, while this may be better than the proposed Division 6 approach, allowing extensions for payment of distributions has created problems historically.

22. Overall, we think there are many fundamental flaws in Division 6 of Part III of the ITAA 1936 which has been in long need of reform, such that it should no longer be adopted for any new forms of collective investment vehicles. These include, but are not limited to:

    22.1. Fundamental uncertainty about the concept of "income of the trust estate". The ATO's draft Taxation Ruling TR 2012/D1 on this issue is complex, leaves many questions unanswered and is still yet to be finalised nearly 10 years after its publication in draft form. While proposed section 195-125 attempts to formulate a mechanism to determine the amount of a beneficiary's present entitlement, there is no attempt to define the "income of the trust estate" in the context of a CCIV sub-fund trust. It is unclear if this is accounting profit or something else and whether anything in the CCIV's constitution would be effective in determining the CCIV's notional "income of the trust". The judicial authority on this issue is based on trust law concepts and pays regard to the terms of a trust deed and powers and discretions given to the trustee. Attempting to apply these principles to a corporate entity that is not in reality a trust is fraught with difficulty and uncertainty. For example, if the constitution of a CCIV said that the income of a particular sub-fund equates to taxable income, this may not have any legal effect whatsoever, as members of a CCIV sub-fund are in reality only entitled to dividends that the CCIV determines to pay. The current system of the taxation of trusts works in such a way whereby the tax consequences follow the general law trust consequences. As CCIV sub-funds are not trusts at general law, one may even argue that (in the absence of a deeming rule) the "income of a CCIV sub-fund trust" is simply a concept that does not exist at law such that proposed section 195-125(1) can never work to enable flow-through taxation to members of the CCIV.

22.2. Division 6 currently allows a trust to recharacterise taxable (but unrealised) income as capital (to ensure it is not distributed to members) in the year where it constitutes unrealised income. For example, accrued interest income for money lending trusts. This mechanism allows the income to be capitalised and distributed in the period that the Fund receives the cash. The proposed rules for CCIV sub-funds does not appear to allow recharacterisation as it is dependent on “dividend rights”, which is linked to profits. Accordingly, the CCIV sub-fund may be required to distribute the unrealised income in order to ensure that the taxable income flows through to the respective members.

22.3. The modifications made to Division 6 in 2011 through the introduction of Division 6E and changes to Subdivisions 115-C and 207-B of the ITAA 1997 to allow for the tax effective streaming of capital gains and franked distributions were described as “interim changes” to the taxation of trusts pending wholesale reform that never eventuated. These rules are complex and contain errors in places that prevent them from working as intended. Applying these rules to CCIV sub-fund trusts would give rise to yet further complex interaction issues. For example, whether or not a beneficiary of the CCIV sub-fund trust could (without receiving a dividend prior to year-end) be made “specifically entitled” by being “reasonably expected to receive” an amount of a financial benefit referable to a capital gain or franked distribution in accordance with sections 115-228 and 207-58 of the ITAA 1997. In particular, it is not clear how one would apply those provisions in order to have regard to the powers conferred by the terms of a trust or rules of common law or the rules of equity in relation to a CCIV sub-fund.

22.4. The effect of the deeming provisions such as section 95A which deal with vested and indefeasible interests in income (and deem a present entitlement to that income) is unclear in the context of CCIV sub-fund trusts. One may argue that the beneficiaries of the sub-fund trust, due to the nature of their entitlements (as well as the deeming rule in proposed section 195-120) have rights that could be characterised as vested and indefeasible on the assumption that the CCIV sub-fund was a trust. If so, section 95A could then operate to deem a present entitlement without a dividend being paid.

22.5. The current “fixed entitlement” rule in section 195-120 does not extend to the franking credit rules, which requires (as per former section 160APHL(11) of the ITAA 1936) “vested and indefeasible interest in so much of the **corpus** of the trust as is comprised by the trust holding”. This is an additional requirement and is not catered for in the proposed provision. We note that this extension is not required if the AMIT provisions are adopted (as members are taken to hold the shares directly).

22.6. We understand the ATO are increasing their focus on the use of section 99B of the ITAA 1936 and may be seeking to apply this provision to domestic trusts. We note that the provision has exclusion for amounts

paid from corpus. Again, this is a trust law concept which may be difficult to apply to a fictional trust such as a CCIV sub-fund.

Other items for clarification

23. We do not understand the reference to sections 272-10 and 272-15 in Schedule 2F in proposed section 195-120(3). These sections define the concepts of fixed entitlement to shares of income or capital of a company and partnership respectively. It is not clearly why the fixed entitlements relating to a trust that are taken to exist because of proposed section 195-120(3) are relevant for fixed entitlements relating to a company or partnership.

24. We also do not support the prohibition of a CCIV sub-fund trust from being the head company of a tax consolidated group as per proposed section 703-20(3). Where a sub-trust trust becomes a trading trust, it is often desirable to form a tax consolidated group to enable it to permanently retain its corporate status rather than potentially move in an out of being a public trading trust and the complexities associated with that (e.g. loss of franking credits). If a CCIV sub-fund trust can be taxed like a company if it becomes a public trading trust, we do not see any coherent reason why it cannot also form a tax consolidated group if it has one or more wholly-owned subsidiaries.

25. We highlight that this preclusion will treat a CCIV sub-fund differently to other managed investment schemes ("**MIS**"). For example, a MIS can currently be established to invest in alternative investments (e.g. Crypto) which may result in the trust being a public trading trust. For various reasons, that MIS can elect to consolidate to ensure it is treated as a company for all periods going forward. It is unclear why a CCIV sub-fund would not be provided with the same option.

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26. In summary, we submit the following:

    26.1. We are highly supportive of the approach to adopt Division 195 and in principle we believe this addresses the majority of issues that occurred in the previous tax bill.

    26.2. We support the proposed amendments contained in sections 195-105, 195-110 and 195-115.

    26.3. We support the proposal to treat members as having fixed entitlements, but note that the provision needs to appropriately cater for franking credit requirements contained in former section 160APHL(11).

    26.4. We do not support the proposed Division 6 mechanism contained in sections 195-120 and 195-125.

    26.5. We would support a broader approach to allocating income based on the AMIT rules for all CCIV sub funds that do not otherwise breach the public trading trust provisions.

26.6. We support the approach of not providing additional concessions to CCIV sub-funds where they do not meet the definition of a MIT (e.g., capital account election or the withholding tax concession rules).

If you would like to discuss any aspect of this submission, please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director