Managing the tax advantages of collective investment vehicles

CIV managers have tax management techniques not generally available to individuals directly investing and, as GORDON MACKENZIE explains, this provides a significant advantage.

A principle of a good taxation system is that the investments of a Collective Investment Vehicle (CIV) (unit trusts and superannuation funds, for example) are taxed in exactly the same way as if the investors in the CIV had directly invested the same investments. That principle, called tax neutrality, is manifested in a number of tax laws in the Australian taxation system.

Neutrality in taxation between CIVs and direct investment should be distinguished from the rate of tax that CIVs and investors may pay on the income from the investments. The rate of tax and, indeed, the timing of payment, may differ between CIVs and direct investment as a result of government policy initiatives.

For example, the rate of tax on the income of a superannuation fund is 15%, which reflects the Government’s initiative of making saving for retirement attractive, whereas income from direct investments are taxed at the taxpayer’s marginal tax rate.

However, the calculation of the amount of income on which that rate is applied should, in accordance with the principle of neutrality, be the same as between direct investment and a CIV.

However, in practice, CIVs manage tax differently to direct investors and that difference can potentially add materially to the CIV’s after-tax performance compared with investing directly.

One of the questions recently researched was whether that difference is caused by any lack of tax neutrality in the Australian tax system or is it that direct investing is less efficient in managing tax than is the case for CIVs?

Or, to put that question in the converse, are CIVs efficient in managing their tax, when compared with direct investing?

This paper discusses some of the tax law that implements that underlying principle in the Australian tax system and argues that, while it is largely neutral, any difference in tax liability management is explicable by the efficiency of CIVs in managing their tax compared with direct investment. This efficiency is related to the intermediation function of CIVs in terms of professional management, and is achieved through essentially standard portfolio tax management techniques not generally available to individuals directly investing. In turn, these are related to the size of the portfolios managed by CIVs and to their professional management.

These considerations should be taken into account when making investment decisions between investing directly and using a CIV.

NEUTRALITY: GOOD TAX POLICY

A well-established policy of a good tax system is that investments held
in a CIV should be taxed in exactly the same way as if those investments had been held directly by the individuals investing in the CIV.

The intent behind this principle is that taxes should not distort economic decisions. So, in this case, an investor should not choose between investing in a CIV and investing directly based on different taxation outcomes between the two.

Two examples of that in the Australian system are used to illustrate the point. First, the tax rules for listed investment companies (LIC) recently changed so that the discount for capital gains on investment held for more than a year could pass through to their shareholders.\(^6\)

Following those changes, capital gains arising from the LIC’s portfolio can be passed through to shareholders who can claim the discount on capital gains. That then replicates the tax outcome as if the shareholder had directly invested the assets of the LIC.\(^7\)

Secondly, superannuation funds have a number of taxation rules the effect of which is to equate the taxation of investments in the fund with taxation had those investments been held directly.\(^8\)

One particular rule says, in effect, that all gains from disposal of assets are to be treated as being on capital account.\(^9\)

Its purpose and effect is best explained in context. An investor may have a small portfolio of equities that, as an example, are invested on a “buy and hold” long-term basis, rather than for trading. Even then, the investor could trade some of the portfolio in pursuing better returns. In that case all gains on trades will be on capital account and tax will be calculated after taking into account the discount on assessed gains after holding for 12 months.

On the other hand, an industry or other publicly offered superannuation fund might have billions of dollars of assets under management, a large part of which may be in equities. If they actively trade part of that equity portfolio for capital profits from market volatility, then there is an argument that they have changed their status from being a long-term investor who is just realising gains when switching investments to being a share trader.

The potential risk is that all realised gains on the portfolio would be treated for tax as being on revenue account, with no entitlement to the CGT discount.\(^10\)

That would result in an incorrect tax outcome when compared with direct investment by an investor in the fund. Hence the need for the rule that says that all gains are on capital account for tax as, in effect, that would be the case if the investor owned those shares directly.\(^11\)

Nevertheless, overall it is generally correct to say that, in the Australian tax system, it is largely the case that investments in a CIV are taxed on the same basis as if invested directly.\(^12\)

**EXPLAINING THE DIFFERENCE: EFFICIENCY**

However, is tax neutrality really the case in practice? Is there no difference in practice between the ways that CIVs apply the tax law to manage the tax liability on their portfolios compared with direct investment?

In fact, what was found when taxation of CIVs was looked at more closely were differences in the application of the taxation law, when compared with direct investing.

Importantly, what was observed was that those differences were a function of efficiency in managing tax and not the lack of any neutrality in the tax system.

These differences were attributable to two aspects. First, the size of the portfolios held by CIVs, which can facilitate certain trading techniques that are not practically available to individual direct investors with smaller portfolios.

Secondly, the sophistication of the tax management of CIVs, which also can have a material effect on the tax that they pay. Indeed, these differences can significantly enhance CIV’s after-tax returns, compared with direct investing.

**EFFICIENCY AND PORTFOLIO SIZE: SIZE MATTERS**

The first aspect to be considered is the effect that the size of the CIV’s portfolio has on the tax paid, and five examples of how this is achieved in practice are considered.

First, efficient utilisation of tax losses is a very important part of portfolio management. That is, the earlier that value is obtained for any realised tax losses in the portfolio, the more tax efficient the portfolio will be.

Having a large portfolio means that value for losses on an investment can be more efficiently managed for tax through crystallising an offsetting gain on another investment. That is not necessarily the case in a small directly invested portfolio.

Secondly, trading of investments can be executed more tax efficiently in a large portfolio than is the case in a small portfolio. This occurs because a large portfolio is more likely to have been aggregated over a long period of time, which means that assets will have been acquired at different costs. When a sell decision is made it is possible to choose assets to trade from the portfolio that have a higher tax cost base, consequently reducing the realised taxable gain.

Thirdly, an additional benefit related to this is that the assets chosen from the portfolio that are to be traded can be on the basis of maximising deferral of tax. That is achieved by choosing stock that, again, has the highest cost base, which maximises tax deferral by retaining the stock that has the lowest cost base and, consequently, the highest unrealised tax gain. Clearly, one of the values in investing is the ability to defer tax, as tax deferred is tax saved.

Fourthly, strategies that involve retaining the physical stock and effecting a change in its portfolio weighting by the use of derivatives when making tactical asset allocations also provide tax efficient outcomes, when compared with selling the physical stock.\(^13\)

Changing the weighting of a particular stock in the portfolio by using derivatives does not crystallise taxation on any unrealised gains in the underlying stock, which facilitates deferral of tax on unrealised gains.

Of course, the use of derivatives in this way is available...
to direct investors but without the necessary physical
cover, the risk in execution would be considerable and,
more than likely, inadvisable.
Finally, there are other strategies available to large funds,
such as changing the source of income from foreign
investments by using derivatives that have a domestic
source. These are effective for dealing with foreign
withholding taxes that would otherwise have been paid
on the cross-border income flows.
Equally, these are not practically available to direct
investors.

EFFICIENCY AND PROFESSIONAL MANAGEMENT:
TAX SOPHISTICATION MATTERS
The second reason that CIVs are efficient in their tax
management when compared with direct investment
comes from more sophisticated tax management.
It is generally considered that that the economic
function of intermediation provided by CIVs is risk
management, in terms of diversification of assets,
and professional management, in terms of information
processing, stock selection and record keeping.14
It is in the areas of information processing and of
record keeping that the efficiencies in tax management
of a CIV are evident, when compared with direct investing.
Examples of these types of efficiencies are:

- Imputation credit conservation, which is
  ensuring that any stock selected to be traded
  is not traded around its dividend-ex date, 
  consequently preserving the value of imputation
  credits;
- Imputation credit protection, which is ensuring
  that the 45-day rule is not breached so that the 
  entitlement to imputation credits is protected;15
  Systematically taking the tax effect of 
  imputation credits on a stock into account
  when deciding whether to trade. For example,
  grossing up the dividend yield for imputation
  credits in the sell decision;
- Maximising the value of share buy-backs, which
  is calculating the tax effect of share buy-back
  offers to determine whether they are tax
  efficient for the portfolio; and
- Correctly managing tax outcomes from other
  corporate actions, such as demergers or scrip-
  for-scrip takeovers, where decisions will be
  made based on the most efficient tax outcome
  for the portfolio.
In addition to those tax management issues, CIVs
offer sophisticated IT platforms that allow them to
execute these types of activities far more efficiently
than individual investors ever could.

Finally the quality, in terms of knowledge and
sophistication, of both the internal and external tax
advisers to CIVs is far superior to that which individual
investors can ever hope to achieve on a directly invested
portfolio.

CONCLUSION
It is considered that the Australian taxation system largely
implements the principle of tax neutrality between investing
in a CIV and direct investing such that tax is not a driving
consideration in the decision to use a CIV or invest directly.

What is observed in practice, however, is that CIVs manage
their tax liabilities differently from direct investment.
These differences are exploitable by efficiencies of CIVs in
terms of tax management over direct investment, rather than
any tax non-neutrality.
First, efficiencies come from the size of the portfolios that
CIVs manage, which facilitates efficient loss utilisation,
selecting stock yielding the smallest taxable gain and
maximum deferral, reweighting portfolios using derivatives
without crystallising taxable gains and changing the tax
source of income.
Secondly, in terms of professional management, where the
efficiencies of CIVs emerge in things such as imputation
credit conservation, imputation credit protection, accounting
for imputation credits in the sell decision, maximising share
buy-backs and other corporate actions.
These hidden advantageous of CIV over direct investing
should be considered when making the investment decisions.

Notes
1 See for example Charles v FCT (1954) 90 CLR 598 
(income retains its character when distributed from a trust) 
and Div 6 Part III ITAA 1936 generally in respect of unit 
trusts. Also, part IX ITAA 1936 in respect of superannuation 
and Div 320 ITAA1997 in respect of the taxation 
of life insurance business.
2 Or 10% in respect of gains on assets held for at least 
12 months. In fact, the aggregate rate of tax on lump 
sum benefits from superannuation funds is 30% above the 
low rate threshold and at the marginal tax rate for benefits 
paid as pensions.
3 See the discussion under the subheading ‘Neutrality:
Good Tax Policy’ which highlights some of the rules that 
achieves this result. Also, see note 1 above for legislation

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The reference to ‘hidden’ recognises that CIVs report pre-tax
returns to investors, which masks the tax benefits of CIVs to
investors.
that implements this principle in respect of each of the different types of CIVs.

4 For example, US theory is that trading a portfolio to maximise unrealised gains can add significantly (up to 150 bps) to the after-tax return on the portfolio. “Is Your Alpha Big Enough To Cover Your Taxes?”, Robert H. Jeffrey and Robert D. Arnott, The Journal of Portfolio Management, Spring 1993.

5 The results reported here are part of a larger research project the object of which is to validate or otherwise a market-held view that the differences in the way that CIVs manage tax can increase after-tax returns from CIVs by up to 210 basis points.


7 Previously, listed investment companies (indeed, all companies) were not entitled to the 50% discount on assessed gains otherwise available to individuals, trusts and superannuation funds (33% in the case of the later). That change was also made to remove a competitive disadvantage for LICs compared with the way that capital gains passed through a unit trust to investors.

8 For present purposes only one of those is considered in detail. However, another example is the entitlement to a tax deduction for the cost of life insurance. This deduction compensates the investor for the tax on contributions made to the fund that pay for that insurance and removes a distortion.

9 Note that gains on two classes of investment are excluded from this effect. See note 8. S 304 ITAA1936.

10 See discussion in AGC (Investments) Ltd v FCT (1992) 23 ATR 287.

11 The two classes that are excluded from this beneficial treatment (gains on certain debt instruments and on movements in foreign currencies) are, in essence, just another way of receiving interest income, as the movement in the value of these two classes is a function of interest rate movements. S 304 (2) and (3) ITAA 1936.

12 However, there are some exceptions to this such as participating policyholders in life insurance companies where those companies are still taxed on an I – E basis. Div 320 ITAA 1936.

13 Generally called “overlay strategies”. Care needs to be exercised here to avoid losing the imputation credits from application of the “at risk” 45-day rules. S 160 AQZH ITAA 1936. Also note the small shareholder exemption to this rule in ss160AQU, 160 AQX and 160 AQZ if the sum of credits is less than $5,000. This more efficient outcome comes from the fact that derivative instruments can be taxed differently to the underlying investment, say, a realisation basis rather than an accruals basis.

14 Taxation of Investment Funds in the European Union, Tomi Viitala, Doctoral Series 8, p. 17 IBFD.

15 See note 10 above.