

# **Australian Equities Tax Issues for Individual Investors**

By

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## Section 1A

### Introduction and Australian equities tax dynamics

#### Genesis for this paper

During the course of studying Advanced Portfolio Management under the task force chair of Dr Phillip Dolan in 2003, issues arose that triggered questioning of tax issues in relation to exposure to Australian equities. This resulted in a proposal, presented to class, for “TEMBEF” – a tax effective, meritorious borderless equity fund. This concept was met with some scepticism – although Phil Dolan commented that Macquarie had looked at a similar idea. It has since been discovered that one boutique fund manager has formulated an approach to “HomeGlobal”<sup>1</sup> investing, which is not far removed from the TEMBEF concept.

Suffice to say, that my idea was largely tax centric, and this triggered further thoughts in other areas of tax management, and how this impacted the after tax returns to Australian investors in domestic equities. A table of contents was agreed with Dr Dennis Sams, and this has been largely followed in the composition of this paper.

As a private client adviser, virtually all of the matters covered in this paper are germane to personal professional development and practical application – hopefully, to the benefit of clients.

#### Reason for comparative overview

In order to appreciate the full benefits of our imputation system, and to see how the case for home bias (under tax considerations) stacked up, it was decided to look into the US and UK positions, to compare the approach they take to taxing returns from equities. This proved to be beneficial, as it highlighted just how unique our tax system is, and it added further dimensions to the issues that were identified in Australia – particularly in relation to managed funds.

The UK was visited in January 2004, and this provided helpful insights into the EC trends in relation to the taxation of dividends – see Acknowledgements above. It also showed that the UK had stopped the cash refund of Advanced Corporations Tax, and provided corroboration for a view that our refund of franking credits (eg, within pension funds) might not last forever.

The US work was invaluable for the access it provided to a great volume of research papers. The issues faced by private investors in the US are very similar to those faced by Australians, and thus there is a large body of material available to illustrate what might soon appear on our horizon. Certainly, in relation to managed funds, it does seem that we really do have to lift our game on disclosure – and this is drawn out in Section 2B. Although the US was not visited, two fund managers in particular<sup>2</sup> provided ready access to their US located tax experts, and in both cases an illuminating dialogue ensued.

#### Imputation systems and the value of franking credits

When considering the tax aspects of exposure to Australian equities, this issue looms in importance over everything else. Moreover, after the changes introduced in July 2002 by the *New Business Tax System (Imputation) Act 2002*, it is even more important, due to the universality of the benefits of franking. Under the post 2002 regime: dividends are still

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<sup>1</sup> Constellation Capital Management, who have patented their theories.

<sup>2</sup> Dimensional Fund Advisors and Vanguard.

assessable in the hands of shareholders at marginal tax rates (**MTRs**); the “franked” cash amount is paid with a “franking credit” which is added to the cash amount (the, so called “gross-up”) for the application of MTRs, and in effect the shareholder is thus taxed on the pre-tax profits of the paying company; and the system grants a “tax offset” of the amount of franking credit. This credit either goes to reduce tax payable by the shareholder on the dividend income, or on any other income, or, if the franking credit cannot be off-set against tax, it is refunded in cash, and so – in effect – the cash paid by the company is refunded to the shareholder.

This refund feature has consequences for valuation of franking credits, and, together with the anti-franking-trafficking rules referred to below, places a timing caveat over some of the former research on the imputation system and the valuation of franking credits.<sup>3</sup> Today, for a resident Australian investor, franking credits have as much value, dollar for dollar, as for cash dividends – subject to some small discount for the time value of money, for the period from the corporate tax payment to the benefit derivation of the shareholder; say 5%.

Therefore, as has been well put,<sup>4</sup> the corporate tax paid by a company may be considered a pre-collection of personal tax. The resident individual shareholder either gets a set-off against tax due, or they receive a refund where they cannot use the set-off – for example, a non-taxpaying religious institution, or a pension fund, or simply an investor with taxable income under the MTR threshold. It follows from this, that in the case of resident individual investors, there is, in commercial substance, *no corporate tax*. By buying a share, the investor effectively gets access to 100% of pre-tax corporate profits. That is a fairly attractive proposition and a quite fundamental conclusion.

By contrast, in the case of the inbound non-resident investor (eg, US institution buying BHP), Australian companies do pay corporate tax at 30%. Through franking, dividends paid to such investors are free of dividend withholding tax, which is superficially an advantage, but may be illusory, in that the offshore investor, if resident in a Treaty country, will get a credit for such withholding tax in their country of residence in any event – and hence for them, payment of Australian withholding tax might be considered as being a pre-payment of their domestic tax exposure. If they do not pay local tax on income, then the saving of dividend withholding tax is a benefit derived from imputation.

The next issue is how listed shares are priced, and whether inbound international investors attribute any value to franking credits. It is here that the work of Professor Stephen Gray and his colleagues at the University of Queensland Business School is so important and revealing.<sup>5</sup> In the first paper (Cannavan et al, 2003), they show how to infer the value of imputation credits from pricing of derivative securities. They also tested whether the tax law amendments designed to prevent the trading of imputation credits affect their economic value. They found that “before the amendments, tax credits were worth up to 50% of face value in large, high yielding companies, but subsequently it is difficult to detect any value at all.” The views/findings from this paper that are relevant to our considerations may be summarised:

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<sup>3</sup> Professor Bob Officer has done a great deal of work in this area, eg: Officer, R. R. 1994. “The cost of capital under an imputation tax system.” *Accounting and Finance* 34, pp 1 – 18. ; and see Brown, P., Clarke A. 1993 “The ex-dividend day behaviour of Australian share prices before and after dividend imputation.” *Australian Journal of Management* 18, pp 1 – 40.

<sup>4</sup> Cannavan, Damien., Frank Finn., and Stephen Gray. 2003 “The value of dividend imputation tax credits in Australia.” *Journal of Financial Economics*, pp 1 – 31.

<sup>5</sup> Cannavan, *Ibid*; and Bellamy, David., and Stephen Gray. 3 March 2004. “Using stock price changes to estimate the value of dividend franking credits.” Working paper kindly provided by the authors, pp 1 – 40.

- Tax arbitrage schemes have the effect of increasing the value of imputation credits to investors who are unable to utilise the credits directly – ie, offshore investors
- There are major problems with the traditional ex-dividend research techniques, and instead of using dividend drop-off, they prefer using the relative prices of futures contracts and the individual stocks to which they are based
- On the buy side of the individual share futures contract (ISFs) the market is dominated by foreign institutions that use the ISFs as a cost effective way of gaining exposure to the Australian market
- After the introduction of the 45 day rule, one dollar of imputation tax credits is worthless in the hands of a (marginal) foreign investor
- Foreign investors will only invest in a small open economy such as Australia if they receive a return that is fair by world standards. If imputation credits are worthless to these investors, they will only invest if they are provided a sufficient return by way of cash dividends and capital gains – C/F the resident investor who also receives imputation credits, and who thereby receive a higher return. The marginal investor will then be a non-resident.

In the second paper (Bellamy and Gray 2004), the authors found that older methods of using the ex-dividend drop-off to estimate the value of cash dividends and associated tax credits, is highly sensitive to the choice of econometric method and to sample selection issues. They found that the application of this technique to Australian data suggests that it is difficult to separately estimate the value of cash dividends and tax credits, and that the “most appropriate interpretation of the data is that cash dividends are fully valued and the associated tax credits are worthless to the marginal trader around the ex-date.”<sup>6</sup>

If it be concluded that offshore investors (ie, foreign institutions) are the marginal price setters for, say, S&P/ASX 200 stocks<sup>7</sup>, and that they ascribe no value to imputation credits, then these stocks are valued on an ex-franking basis – or, to put it another way, such (inbound) valuation assumes that these companies *do* pay corporations tax. Most valuation techniques (eg, price/earnings multiples and discounted cash flow) are calculated on an after tax basis, and in Australia, all such analysis work is done by including the impost of taxation. It is not done by applying the bold contention made above, that corporate taxation does not really exist for Australian individual resident shareholders. Further there has been work done on the impact on value through the impost of taxes on dividends, and it has been found that value is positively correlated to tax basis, suggesting that future dividend taxes are capitalised into share prices.<sup>8</sup> This is a different point to that which contends that inbound international investors ascribe no value to imputation credits – due to the anti-trafficking tax laws. Rather this point says that “investors capitalise a substantial amount of dividend taxes into prices

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<sup>6</sup> This is a significant finding and further corroborates the contention that imputation anti-trafficking laws are working in Australia, as there is ample evidence in the US of an efficient market and of abnormal trading activity at the ex-dividend date due to tax motivated trading in relation to withholding taxes: Callaghan, Sandra, Renfro., and Christopher, B. Barry. 2003. “Tax-Induced Trading of Equity Securities: Evidence from the ADR Market.” *The Journal of Finance*, Vol, LVIII, No 4, August, pp 1583 – 1611.

<sup>7</sup> Approximately 40% of the listed Australian equity market is owned by foreign investors, who regularly compare Australian companies to their offshore peers: UBS Institutional Daily Research, 1 July 2004, p 4.

<sup>8</sup> Gentry, William. M., Deen, Kemsley., and Christopher, J. Mayer. 2003. “Dividend Taxes and Share Prices: Evidence from Real Estate Investment Trusts.” *The Journal of Finance*, Vol LVII, No 1, Feb 2003, pp 261 – 282, which is relevant to the Australian REIT position as the tax issues/dynamics are virtually the same.

when dividend policy is largely non-discretionary, there are no corporate taxes, and share repurchases do not offer a tax advantage relative to dividends”<sup>9</sup>

Is this then, for Australian residents, the elusive investment free lunch? Yes, in one sense it is, at least in comparison to the alternative of investing in international shares. Let it be assumed that the reader has the choice of investing in two shares: “D” shares provide a share in 100% of pre-tax corporate profits, due to (effectively) nil corporations tax; and “I” shares, where the corporate profits are subject to (say) 30% tax and no tax credit is afforded for this impost. Significantly, both of these shares are valued on the same basis, and in the case of D shares, it is (erroneously to you, a resident) assumed that your share of profit is 70% of pre-tax profits, when in reality it is 100%. All other things being equal, the D shares are 30% more attractive to you. Of course, all other things are not equal, and in particular there are two categories of qualifications to this hypothesis:

### **Imputation leakage**

- All imputation credits may not be paid out, but carried forward in surplus franking accounts – an effective interest free loan to the Federal Government<sup>10</sup>
- Many companies have offshore earnings, and lower franking levels due to a lower proportion of Australian tax paid on aggregate (global) corporate profits – but of course, this can be a valuation plus if growth prospects are enhanced, eg the Westfield Group
- Some companies seek to optimise the value of their franking account by lowering their cost of capital; and rather than simply paying credits out with dividends, they use these to issue hybrid securities or to buy-back shares at a discount.

### **Investment merits/demerits**

- Investment in international shares does provide diversification benefits<sup>11</sup>
- Many industrial sectors are not available in Australia, in terms of company size or not at all, eg buying ION is not the same as buying Toyota, and there are no major pharmaceutical companies in Australia, etc
- Differing industry/sector economic growth prospects
- Foreign exchange complications and increased volatility – if unhedged, and a cost if hedged
- Generally lower domestic transacting costs<sup>12</sup>
- Lower domestic holding costs through local custodians.

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<sup>9</sup> *Ibid.*

<sup>10</sup> Hathaway, N. J., and R. R. Officer. 2002. “The Value of Imputation Tax Credits.” *Working paper*, relating to 1998 analysis but up-dated to 2002, and hence pre-July 2002 imputation law changes, found that the “access factor” (proportion of all franking credits issued) was 88% and rising, and that the “utilisation” (redeeming by shareholders) rate was 53%.

<sup>11</sup> Uthartharm, Direk. 2003. “Sector diversification, home-country bias and global investments.” *JASSA Issue 2*, Winter, pp 2 – 6, where the sector issues are analysed (distortions in Australia and increasing importance over country allocation), home country bias and appropriate authority citation as to diversification advantages.

<sup>12</sup> “Specialist help needed.” *The Economist* 26 April 2003, p 63 – activities and cost inefficiencies of specialists in N Y Stock Exchange, “front running” etc.

Taking all these matters into account, one can do no more than guess at the comparative pricing advantage of Australian equities over international equities to the resident investor: it is somewhere between 30% and zero – perhaps 20% is not unrealistic.

It was this analysis that gave rise to arguments for an alternative approach to the segregated fund domestic/international allocation approach – traditionally determined by mean variance optimisation. The proposed solution, was partially sector based using GICS for filling gaps in those sectors not well covered in Australia, but this would be subject to bottom up stock picking on the merits, taking after tax return metrics into account. Due to the fact that Australia's full imputation system is used by very few other countries (see: Section 3A for UK comparisons and EC developments) it is unlikely that this domestic/international integrated fund approach will gain much traction, as there is not the same base domestic tax advantage with most other OECD countries under the classical tax system – see Sections 2A and 3A. It follows that Australian resident investors will probably continue to have exposure to international equity funds, which will contain international banks and resources companies, when investment into Australian banks or resource companies is – post tax – *circa* 20% more attractive.<sup>13</sup> Moreover, the process of determining the allocation as between domestic and international equities is open to question, particularly when it is governed by some mathematical model such as mean-variance optimisation. As recently explained by Truman A. Clark:<sup>14</sup>

“Some investors find the allure of mean-variance optimizers irresistible. Optimizers have the cachet of being based on Harry Markowitz's Nobel Prize-winning portfolio selection theory. They produce dazzling optimal charts of efficient frontiers, and they spew forth precise compositions of optimal portfolios. Optimizers create the illusion of scientific accuracy into the investment decision-making process.” Clarke found that tiny errors with inputs (which are unavoidable), say down to 2%, lead to massive changes in portfolio composition, which can look bizarre in terms of practical application, and can only be expunged with the imposition of modelling constraints – which, of course, go to defeat the theoretical integrity of the model. Thus, in the late 1990s when Australian fund managers were jumping on the international equity bandwagon,<sup>15</sup> optimisers were employed as justification for large exposures to international shares, with somewhat disappointing consequences through to March 2003 – approximately 50% loss of capital over three years.

And finally, on the issue of optimisation, it might be recognised that most modern portfolio theory and choice has been developed without reference to taxes. As pointed out by Poterba<sup>16</sup> an investor's optimal portfolio holdings will depend on after-tax expected returns and after-tax covariances – and one wonders to what extent this was taken into account in Australia in 1999?

After considering these valuation and tax issues, the investor might finally look to history, and how Australian stocks have performed in relation to other markets, and for this a visit to Global Financial Data would be rewarding, see: [www.globalfindata.com](http://www.globalfindata.com). This web site contains a wealth of data, much of which is free, and there are papers by Dr Bryan Taylor,

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<sup>13</sup> After News Corporations departure from the S&P/ASX 200, if this should occur, the average Australian equity fund investor is also likely to already have very large exposure to these sectors in any event.

<sup>14</sup> Truman A. Clarke, Summer 2004. “Stop Playing with Your Optimizer.” Dimensional's Journal, in the DFA web site, adviser access required: [www.dfa.com/financial\\_advisors](http://www.dfa.com/financial_advisors).

<sup>15</sup> Attributed to the late Sir James Goldsmith: “If you see a bandwagon, it is too late.”

<sup>16</sup> Poterba, James M., December 1999, revised March 2000. “Taxation and Portfolio Structure: Issues and Implications.” *MIT and NBER working paper*, pp 43.

President Global Financial Data, Inc.<sup>17</sup> In nominal AUD, the Australian equity return for the past century was 12.53% (ie, 1901-2001), and similar for shorter periods to the end of the twentieth century, with a stand-out 15.40% for 1976-2001. Backing out the annual currency depreciation of the AUD against the USD for the 100 years to 2001, would still leave a nominal return from the Australian equity market at close to 11% p/a in USD. For the 76 years to 2001, the USD return from the Australian market would only be 140 bps less P/A than the almighty S&P 500. As Dr Taylor says:

“Australia has provided some of the most consistently good returns of any major country in the world. In nominal Australian pounds/dollars, Australian equity investors did not have a single decade with negative returns in the past century. The 1970s provided negative returns after adjusting for inflation, and the 1930s provided negative returns as measured in US dollars. ... Unlike the United States, the *real return* to Australian equity investors has not risen over time, but has remained around 8%. ... Countries such as the United States, Switzerland, Sweden and Australia that were stable for most of the twentieth century, provided good opportunities for consistent returns to investors who sought a buy-and-hold strategy.”

Of course, history does not (unfortunately) provide a certain road map for the future.

### **Outline and conclusions**

This paper is divided into two sections: Section A, where the comparative position is analysed; and Section B, where each of the several approaches for exposure to Australian equities is examined.

For direct ownership there is an overview of the basic issues and strategies, and finally an investigation into the difficult question faced by investors where they wish to sell down a stock which has unrealised capital gains. Many of the portfolio management issues addressed in Section 2B are flagged, but are not duplicated in coverage – as these mostly apply to both. Properly managed, there is every prospect for this direct ownership approach to be the most tax effective of all the approaches.

The bulk of this paper, and the empirical research, is contained in Section 2B dealing with funds. Considerable reliance is placed on US research, for most of this is applicable to the Australian context. Several conclusions are reached and fundamental questions are raised in relation to: after-tax return reporting; fund tax management (ie, passive accounting methodology, and active loss harvesting); disclosure of unrealised capital gains; and how the ATO seems to have turned a blind eye to share trading.

Listed Investment Companies are found to be relatively efficient and more transparent than funds, although there are issues in relation to “smoothing” of distributions, and the possibility for accretions to the franking account to build up – to the detriment of investors.

Exchange Traded Funds are seen to be incredibly tax efficient, and indeed quite attractive as a cost efficient alternative to index funds. Conclusions are drawn as to why ETFs have not become popular in Australia.

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<sup>17</sup> “GFD Guide to Total Returns on Stocks, Bonds and Bills”, and “Ten Lessons for the Twenty-first Century Investor.”, from which the subject comments are extracted.

Separately Managed Accounts do appear to solve one problem, and quite possibly (here) only one problem: the up-front unrealised capital gain issue for unit trusts. The size of the Australian market and the lower average quantum of private client account is likely to be one reason why SMAs have languished here.

## Section 2A US comparisons

### 2003 changes

President Bush first announced his reform package in January 2003 and then sought to eliminate the double taxation of corporate profits – that is, he proposed abandonment of the “classical” system of taxing corporate profits both within operating companies, and then again in the hands of shareholders, but only where post tax profits were distributed. This first proposal specifically sought to eliminate shareholder tax on dividends, which were paid out of taxed earnings. Initial observations from Australia were that our form of imputation system might be introduced, or some variant of it. This did not happen.<sup>18</sup>

In May 2003 President Bush signed into law the *Jobs and Growth Tax Relief Reconciliation Act of 2003*, (**2003 Act**), which was said to have an overall cost of US\$350 billion, with US\$320 billion of this being tax cuts. This Act made significant changes for US resident investors in equities, both US and foreign, as it greatly reduced the tax take from dividend income and capital gains. There are interesting comparisons to Australia, for the concept of calculating “excluded dividends” as originally contemplated, was rejected on the grounds of complexity, due to additional record keeping for companies and shareholders – as we require through the imputation system. The legislation was passed with sunset provisions, taking it out to 2008, when presumably it will be reviewed. The 2003 Act is significant in that it stopped dividends being taxed at prevailing marginal tax rates, as had happened in the US since 1936.

### Marginal tax rates (MTRs)

The first issue to appreciate in the US, is that we are here dealing with federal tax laws, and to this there are possibly added state and local taxes which vary throughout the country. In the US there are different federal marginal rates for single individuals, “marrieds” filing jointly, marrieds filing separately and heads of households etc. We shall focus on singles and joint marrieds. For 2003 the rates were

#### Single individual

Taxable income Over	Taxable income not over	Pay tax	+ on excess	Of amount over
0	7,000	0	<b>10%</b>	<b>0</b>
7,000	28,400	700	<b>15%</b>	<b>7,000</b>
28,400	68,800	3,910	25%	<b>28,400</b>
68,800	143,500	14,010	28%	<b>68,800</b>
143,500	311,950	34,962	33%	<b>143,500</b>
<b>311,950</b>	<b>n/a</b>	<b>90,514</b>	35%	<b>311,950</b>

<sup>18</sup> The law and commentary for this section on the US is largely sourced from 2003 Tax Legislation, Jobs and Growth Tax Relief Reconciliation Act of 2003 – Law, Explanation and Analysis, CCH Chicago, May 2003.

Married filing jointly

Taxable income Over	Taxable income not over	Pay tax	+ on excess	Of amount over
0	14,000	0	<b>10%</b>	<b>0</b>
14,000	56,800	1,400	<b>15%</b>	<b>14,000</b>
56,800	114,650	7,820	25%	<b>56,800</b>
114,650	174,700	22,282	28%	<b>114,650</b>
174,311,950	311,959	39,096	33%	<b>174,700</b>
<b>311,950</b>	<b>n/a</b>	<b>84,389</b>	35%	<b>311,950</b>

For our purposes, there are three MTRs of particular interest, and for this reason AUD equivalents<sup>19</sup> of taxable income are inserted thus:

- The MTRs for both capital gains and dividend income are lower for tax payers in the 10 or 15% MTR – and the threshold is \$28,400 (AUD\$37,867) for singles and \$56,800 (AUD \$75,733) for marrieds filing jointly – thereby exposing a very large proportion of investors to the lower rate for both CGT and dividends
- The top MTRs of 35% are 28% lower than our 48.5% and cut in only above AUD\$415,933, as opposed to our current AUD\$62,500 hurdle. Of significance, is the single Australian taxpayer having, say AUD\$90,000 taxable income, as such a person in the US would be limited to a top MTR of 25%, as opposed to nearly double this rate in Australia. The same would apply to one spouse earning AUD\$150,000, where the other spouse is not earning taxable income – ie, 25% top MTR.<sup>20</sup>

### Dividend income

As the US has maintained the classical system, the tax on dividends takes no account of whether tax has been paid at the corporate level – which is at 35% for taxable income over USD\$18.3 million. Thus, US shareholders are – in-so-far as their personal tax position is concerned – indifferent as whether a US company pays US or foreign tax, or no tax at all. The 2003 Act effectively applies double taxation, but for qualified dividends at a greatly reduced rate for the shareholder: 5% for those individuals in the 10% or 15% MTR bands, and (the maximum) rate of 15% for all others. These are the same rates as are now applied to capital gains – see below.

Eligible dividends are not restricted to those flowing from domestic corporations, and apply also to dividends from qualified foreign corporations: those companies listed in the US, or incorporated in a US possession, or those resident in countries that comply with certain treaty requirements, as determined by the IRS – ie, many OECD countries.

Given the uniform tie-in with CGT rates, the only possible advantage to receiving capital gains over dividends, is now deferral. Many US commentators have flagged the changes this may make to the dividend distribution ratios of US listed companies, as many of the old arguments against the payment of dividends are now gone or greatly diminished. Already the

<sup>19</sup> All USD and AUD conversions are at 0.75 USD to the AUD.

<sup>20</sup> It should however be noted that under the combination of federal, state and local taxes, many US investors pay an all-up effective MTR of around 50%: Berkin, Andrew L., and Jia, Ye. 2003. “Tax Management, Loss Harvesting, and FIFO Accounting.” *The Financial Analysts Journal*, July/August pp 91 – 102.

tide appears to be turning in favour of starting/lifting dividend payments, although corporations often plead other, non-tax, rationale – eg Microsoft.

Like Australia in relation to franking credits,<sup>21</sup> the reduced rates require a minimum holding period for stocks, and there are limitations on negative gearing. The investor, or fund, must hold the stock for more than 60 days during the 120 day period beginning 60 days before the ex-dividend date.<sup>22</sup> If a taxpayer with a geared portfolio elects to apply a dividend towards calculation of the maximum permissible investment interest deduction, then the reduced dividend tax rates do not apply. In the absence of such election, then the reduced rates apply, but the shareholder could be short changing themselves on the deductibility side.

### **Capital gains**

As stated, the same CGT rates now apply as to the reduced dividend rates for qualified dividends – ie, those within the 10% or the 15% MTR band at 5% and above this at 15%. As an additional benefit to investors, the five year holding period has been repealed and the reduced rates now only require one year holding, as in Australia for the 50% concession. This, and the low 5% rate, has opened considerable planning opportunities for the alert investor – and it may well have helped liquidity levels in the US equity market, as it has doubtless released assets for transacting where this would previously have been imprudent, given the CGT exposure. For many US investors, they are now largely indifferent as to how they derive return – whether from dividends or capital appreciation. All else being equal, they might prefer to re-weight into income stocks giving a high cash yield, in preference to ‘growth’ companies.

Also, the home/foreign equity investment issue is now largely tax neutral, provided they invest in corporations resident in full treaty countries. They may be exposed to 15% dividend withholding taxes, and receive a US tax credit for this, which covers the reduced 15% dividend taxation. This is very different to the position of Australian resident investors weighing up the home/foreign issue. Surprisingly, US tax laws are substantially non-discriminatory when it comes to domestic/outbound equity investing. Australian laws are not.

### **Flow through and strategy issues**

For our purposes it is relevant to know that under the 2003 changes, the reduced rates for dividends and CGT are broadly granted flow through facilitation in relation to collective investment vehicles: mutual funds and other forms of flow through entities. Like our unit trusts, US mutuals are dealing with the identification of realised gains, and will have to pass through information to investors as to eligibility. Likewise, mutual funds and investment companies will have to advise investors on the proportion of pass-through dividends which are eligible for the reduced tax rate applicable to qualified dividends.

However, this may not be a windfall, in that management expense ratios of US funds often reach 1%, and are generally set-off against dividend income.<sup>23</sup> Given the low dividend yield in the US market (currently around 1.4 percent on the S&P 500), the reduced dividend tax rate

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<sup>21</sup> Ie, the 45 day holding rule.

<sup>22</sup> For Mutual funds, this holding requirement applies both at the fund level and the investor level: Freed, Glenn. 2003. “Qualified Dividend Income – Make Sure You Earn It” in Dimensional Fund Advisors web site: [www.dfaus.com](http://www.dfaus.com), Tax Planner, password required.

<sup>23</sup> *Ibid*, where the point is made that “Investment company taxable income” is calculated by a US mutual fund to first offset all its expenses against non-qualified dividend income, and the to offset remaining expenses against qualified dividend income – which would clearly be more advantageous, depending upon the quantum of such non-qualifying income.

is likely to be more advantageous to direct investor as opposed to those through managed funds – contra our position, where franking credits are passed through whole with nil dilution of value.

Moreover, the reduced rates for both CGT and dividends are making some US investors reconsider tax strategies for retirement. This is because the reduced rates have no value to 401(k)s, IRAs and tax deferred annuities – unlike in Australia where franking credits reduce tax (accumulation super funds) or are refunded in cash to zero taxpayers (eg, allocated pension funds). And then, when these US tax effective retirement vehicles pay an income stream, these distributions will be subject to MTRs, notwithstanding that they may be paid from income within the fund that would be subject to reduced rates if paid to a tax paying entity. This is an illustration of why caution is required with long term financial models (for retirement planning) which apply robust assumptions – viz, that tax laws will not change in the future.

## Section 3A

### UK comparisons

#### Departure from imputation

The UK first imposed a special corporations tax in 1965, and this established the “classical system”, whereby corporate profits are first taxed at the corporate level and then in the hands of shareholders as distributed dividends. Thus, subject to any capital gains taxes on the accretion of value in shares (eg, through retained earnings), corporate profits are effectively taxed at higher rates if distributed than if retained.

Before 1999, when a company paid a dividend it had to account to the Revenue for advanced corporation tax (ACT), and the benefit of this was passed onto shareholders as a form of franking credit. This imputed tax, passed on to the shareholder, represented a tax credit, which was available to set-off against tax liability of the shareholder arising from the dividend. The company was able to set-off the ACT paid to the Revenue against its liability to mainstream corporation tax. Hence, this form of imputation provided significant relief to the double taxation of corporate profits under the classical system – the tax credit rate was then 20%.

After 1999 ACT was abolished and shareholders received a “tax credit” on qualifying dividends – broadly, all dividends from resident companies, save for bonus issues. This tax credit is available irrespective of any tax paid by the company. Hence this represents a departure from the full imputation system and pass-through of the corporate tax, as this arrangement is simply a form of concessional tax impost for resident shareholders receiving dividends from resident companies and is not linked to corporate tax paid by the dividend payer – just as the payment of ACT was not dependent upon tax paid on corporate profits, ACT was simply a set-off against such corporate taxation, where it occurred.

The tax credit equates to the cash divided x  $1/9^{\text{th}}$ , and hence for a 90p cash dividend, the credit is 10p, and the individual is taxed on the grossed up GBP1.00 with a tax credit of 10p. If the shareholder is within the basic rate (see below), which for dividends is 10%, this income is effectively tax free. The following numbers will illustrate how shareholder friendly the UK is to individuals in comparison to Australia.

#### Marginal tax rates and dividend income

The following table is for UK residents in the 2003/4 tax year and shows marginal tax rates (MTRs) with the concessional rates applicable to qualifying UK dividends.

GBP bands	Band name	MTRs	Div tax credit	Div MTRs on grossed up div	Effective Div MTRs on cash distribution
0–1,960	Starting	10%	1/9 of cash div	10%	<b>NIL</b>
1,961–30,500	Basic	22%	1/9 of cash div	10%	<b>NIL</b>
<b>Over 30,500</b>	<b>Higher Rate</b>	<b>40%</b>	<b>1/9 of cash div</b>	<b>32.5%</b>	<b>25%</b>

In all the discussion below, we shall ignore the UK “personal allowance” – the UK equivalent of our tax free threshold, being GBP 4,615 in 2003/4. Calculations do not allow for lower (band) MTRs.

The tax credit is added to taxable income, as it is in Australia, and the dividend MTRs are applied to the grossed up amount.

Dividend income is treated as being the top slice of income, and hence is exposed to the higher rate (32.5%) where taxable income is over GBP30,500. There is no cash refund of any excess/unused tax credit, as there is in Australia, and hence for very low or nil tax payers there is loss of value in the credit, if this cannot be set off against tax liability on the grossed up amount. But, for most individuals, the effective tax rates on dividend income are incredibly low. For dividend income that forms the top slice and is located above the GBP30,500 income line, one derives an effective rate of 25% on dividends thus: 1,000 cash dividend x 1/9, gives tax credit of 111.11, gives grossed up dividend of 1,111 x MTR of 32.5% = 361 tax, less 111 tax credit (which is 10% of the grossed up amount) = 250 tax.

The contrast to Australia is remarkable. Assume a portfolio of UK listed stocks designed to yield 3% and assume an exchange rate of GBP0.40, to the AUD. A retiree with no other income could hold a domestic equity portfolio of GBP1,016,667 (AUD 2,541,667) and pay no tax on dividend income. This is to be contrasted with the UK effective MTR of 98% on “unearned income” in the mid seventies. And, on capital/income over this level (ie, income over GBP30,500 or AUD 76,250 level) the effective tax rate is 25% on dividend income.

To make a realistic comparison to Australia, assume a top MTR of 48.5%, and 70% franking and the same dividend yield of 3% (admittedly low). Under AUD62,500 the effective tax rate naturally tracks the MTR of the individual (less franking credits), but above this level at the top MTR of 48.5% a 70% franking level gives an effective MTR on the cash dividends of 33%. Derived from, say: 1,000 cash dividend + 300 franking credit ( $[1,000 \times 3/7 \times 70\%]$ ), gives grossed up dividend  $1,300 \times 48.5\% = 630.50$  tax less 300 franking credit = 330.50 tax = 33% on 1,000 cash dividend. For a fully franked dividend the effective MTR is 26% on the cash dividend, and not, as is often mistakenly supposed 18.5% (48.5% less 30%), as the simplistic 18.5% applies to the grossed-up or pre-corporations tax income.

Hence, under the UK regime/rules, an Australian might have a portfolio of \$2.5 million yielding \$76,000 P/A and pay nil tax, and for dividend income from the next \$1 million of capital (ie, \$3.5 million all up) they would pay 25% - or 7% when averaged over the entire portfolio, or lower with due allowance for lower band MTRs.

The other major difference is in relation to the nil cash refund in the UK with unused credits, as pension funds currently enjoy in Australia – eg, for allocated pensions, and perhaps, the new “growth pensions”. It is questionable how long this concession will apply in Australia, which the UK stopped in 1997. Example: BHP earns \$100, pays \$30 tax, pays \$70 cash dividend to pension fund, pension funds receives \$30 cash refund, compounds earning tax free on \$100 over 20 years (buys more BHP shares) and pays nil tax within fund; and in year 21 pays fully rebateable allocated pension distribution to member, whose total taxable income is under a 15% average MTR, so that the rebate results in nil personal tax. Result: Government receives no tax on BHP corporate profits – ever . Given the demographics, that does not appear to be a sustainable policy.

### **The corporate tax take**

In UK the rate of corporation tax is 30% and special CGT rates do not apply to companies, as they pay corporations tax on chargeable gains. For capital gains, indexation is still allowed to companies but not the UK “taper relief”.

### Collective investment schemes

The position with UK collective investment vehicles is complex and not well understood. After guidance from CCH, senior counsel and two Cambridge professors in tax law, I visited six global fund managers in the City to discover a degree of unease with the taxation complexities and nomenclature. There is an entire practitioner's tax work dedicated to the subject: Tolleys, *Taxation of Collective Investments*. It is said that asset consultants try to side-step the matter of tax, for they wish to avoid the quagmire. Of course, due to market conditions in the three years prior to 2003, tax has not been a burning issue in the UK investment industry.

Broadly put, there is no transparent pass through of (franked) income and realised capital gains as there is for unit trusts in Australia. Most vehicles are taxed as companies, whatever they are called, and the investor's exposure to tax on growth (capital gains within the vehicle) is back-ended to the disposal of shares or units – ie, realised capital gains are not distributed. Dividends paid by UK companies into the vehicle are mostly exempt income, and hence the corporate tax rate of 30%<sup>24</sup> is effectively only applied once at the operating investee company level and not within the fund (ie, investment vehicle) itself. As there is generally no tax within the fund, there is no available deduction for (eg) a 1.5% management expense ratio. However, the incidence of such cost reduces the revenue distributed to investors, and hence effectively reduces their exposure to tax. All net revenue is distributed, or is treated as distributed for tax purposes, as some fund offer accumulation units, as with Australian re-investment of distributions into new units.

Dividends paid into the vehicle from offshore companies are taxed at the 30%<sup>25</sup> corporation tax rate, and are therefore less attractive – as this impost is on top of any foreign corporation tax levied against the operating investee company, but is reduced by any dividend withholding tax – where this can be quantified and successfully reclaimed, which is often an administrative headache and value leakage and delays can occur. Given low international dividend yields, and the management expenses within the fund, net revenue distributions are often quite low, and investors look to accretion of capital value and control over the realisation of capital gains. Therefore, foreign investments through a UK resident investment vehicle is not that attractive. Whether it is worse than a unit trust in Australia is not clear: positive, that capital gains are compounded tax free and back-ended to disposal of units/shares; negative, that there is imposed another level of corporate taxation, diluted only by foreign withholding taxes, assuming double tax treaty credits. Emerging market collective investment through a UK vehicle would be particularly unattractive.

Authorised unit trusts, investment trusts and approved investment trusts, are in fact taxed as companies – as are investment companies. A variety of the latter is the “OEIC”, for open ended investment company, and this vehicle issues shares (C/F units) and has a board of directors etc. This vehicle, as with authorised unit trusts or approved investment trusts, is capital gains tax exempt and does not distribute such gains, and hence the investor is only exposed to CGT on disposal. As each vehicle is taxed as a company (although, recall, UK dividend income is exempt) on income, the treatment of trust/company distributions is mostly as stated above as for UK dividends – with the basic rate of 10% to GBP30,500 being expunged by the associated tax credit in the hands of the investor. It follows that for high

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<sup>24</sup> The 30% rate is applicable to investment trust (closed end investment companies), but authorised open ended fund vehicles (OEICs and authorised unit trusts) pay a special rate of 20%.

<sup>25</sup> Or the lower rates for OEICs etc, as stated: *Ibid*.

MTRs investors, the UK vehicles appear to be more attractive than a unit trust in Australia. In the UK there is one 30% impost at the UK operating corporate level, no further shareholder tax if inside the basic band, and CGT is deferred – which could be ameliorated with taper relief or the annual exemption of GBP7,900 taxable amount for 2003/4.

UK taper relief for CGT makes investment fund vehicles more beneficial than direct investment in terms of tax management. Taper relief acts such that investors are taxed on a smaller proportion of capital gain, the longer they have held the investment. A portfolio can be actively managed within a fund (nil distribution of realised gains), but as long as the investor holds units of the fund for a longer term, even short term gains generated within the fund benefit from taper relief. Thus, efficient tax management of an individual's personal investments is at a premium.

It follows that there is no incentive for the fund manager to tax manage portfolio turnover, as capital gains are mostly exempt, and there is no disclosure issue for unrealised capital gains as there is in the US and Australia. For very low or nil MTR investors, the UK is less attractive, as the minimum total tax on corporate profits is still 30% and there is no cash refund of this as there is in Australia with surplus franking credits. But this is a result of the tax regime, not of investing through a collective investment vehicle.

Distribution rates are quite modest as only revenue is distributed and realised capital gains are accrued within the fund and reflected in the net asset value of the fund. Thus, there is significant tax deferral of tax on total return, and no problem (as in Australia) with lumpy distributions during good return years due to portfolio turnover.

### **The EC, retreating from imputation and tackling home bias**

Last year there was only Italy, France and Finland that applied a form of full imputation system. France is abolishing this and Finland is reviewing it. It appears likely that Australia and New Zealand may soon be the only OECD countries left that continue with full imputation – which has within it, a clear home bias for investment. This home bias has aroused debate in the EC as this constitutes a fetter on the free movement of capital as between Member States.

Under Article 56 of the EC Treaty “all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited”.

This issue has been squarely raised in COM(2003) 810 final, issued Brussels 19.12 2003 in *Dividend taxation of individuals in the Internal Market*, being a Communication from the Commission of the Council, the European Parliament and the European Economic and Social Committee. This paper reviews the current taxation of dividends by Member States, and it classifies tax treatment into: classical, schedular, half income, imputation and exemption. It categorises the UK system as a form of imputation system (notwithstanding that this system is not dependent upon corporate tax being paid and is not pass-through as in Australia).

Chapter 3.2 of the paper says that with inbound dividends “each time the conclusion is the same: Under the EC Treaty Members States cannot effectively tax inbound dividends higher than domestic dividends”, and it illustrates the home bias under this example:

“Under imputation system credits are usually only given for domestic dividends. The effect of not granting an imputation credit to inbound dividends is that the taxpayer pays more income tax on inbound dividends than on domestic dividends. The example below illustrates

the higher taxation, assuming a corporate tax rate of 30% in both countries, and marginal income tax rate of 50%, and full tax credit for the 30% corporate tax in the domestic situation, and no withholding taxes.

The effect of not granting a credit on inbound dividends”

	Domestic dividend	Inbound dividend
Profit	100	<b>100</b>
Corporation tax 30%	30	<b>30</b>
Dividend	70	<b>70</b>
Grossed-up dividend	100	
Income tax 50%	50	<b>35</b>
Full credit	30	
Remaining income tax	20	
<b>Net dividend</b>	<b>50</b>	<b>35</b>

This example is a concise illustration of the Australian issues and of our home bias.

EC case law on Article 56 deals with the “proportionality principle”, and the paper contends that it is disproportionate to maintain an imputation system for domestic dividends (thus eliminating double taxation) and a classical system for inbound dividends. It comes to a similar conclusion for outbound dividends.

The paper has no legislative weight and only calls upon the Member States “to work with it to deal quickly and effectively with the issues” – but the direction of this wind is unmistakable, and will doubtless arrive at Australia’s shores one day. Discriminatory taxation of cross border dividends could easily become an issue one day under some economic/geo-political debate between Australia and its trading partners. Then, if not before, the imputation system will come under scrutiny. Until that happens, it is clear from this analysis alone, that domestic dividends are more favourable to Australian resident taxpayers, and this issue is examined in Section 1A above, for it has after tax return implications for investors.

## Section 1B

### Direct individual ownership and management

#### Holding platform and data

There is no doubt that in Australia, a properly managed individual share portfolio will be more tax efficient than any other alternative for exposure. Of course, tax efficiency is not the primary or only issue for portfolio management, but it is the subject of this paper, and it is a very important issue which requires careful, systemic, management. In Section 2B there are ample references to US academic papers as to the value leakage due to tax, albeit mostly from exposure to equity through mutual funds, but for individuals, whatever the form of exposure (direct, funds, listed investment companies, exchange traded funds or separately managed accounts), the impost of tax for high marginal tax rate (**MTR**) investors, will have more impact than fees, costs or anything else.

It is impossible to tax manage a portfolio without access to data, and – due to the failings of human nature – it must be user friendly and immediately accessible data. If, for example, in June, an advising stockbroker does not have such access, or the investor does not have such access, and the client/investor needs to obtain data from a spreadsheet prepared by an accountant, and that spreadsheet is prepared in July each year, there is a chance of an investment decision being sub-optimal, if it involves a sale. Worse if there is no spread sheet, but a file full of old contract notes, or – nearly as bad – a spreadsheet where the spin-offs, and share split of BHP (eg) have not been properly accounted for in terms of cost base adjustments.

This happens frequently.

Portfolio management aimed at the optimization of *after tax* return over time, has to be the overriding objective, and cannot be achieved without access to accurate, timely tax data. Hopefully, that data is available in such a form that it contains in-built optimisation, so that for example, it automatically calculates the 50% CGT discount where shares have been held for 12 months, and it also shows pre-netted gains in discounted and indexed terms – for the reason that although a taxable gain may be less under the 50% discount, the indexed method may still be preferable where losses are to be applied to set-off against such gain, as gains are reduced under set-off before the 50% discount.

Today, most private broking houses have web sites containing client data, but this is often not in a format that states lot acquisition date and cost base – which is essential for efficient tax management. Generally the account data only contains average cost, and current value of each stock, with no lot data. Of course, if a client has engaged in DRPs over an extended period, this is a serious omission in terms of tax management.

#### Accounting treatment

If it be accepted that stock-broking holding reports and statements are not tax accounts, then the next issues is maintenance of such accounts and the ability or otherwise to apply stock selection (eg, cherry picking) and special accounting rules for transacting. The general rule which many accountants and “platform providers” (eg, through “WRAP” accounts) use is FIFO (first in first out), whereas the most efficient accounting rules for CGT minimisation is HIFO (highest in first out).<sup>26</sup> Under Australian tax laws, one is not constrained to use one

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<sup>26</sup> See: Berkin, Andrew L., and Jia Ye. 2003. “Tax Management, Loss Harvesting, and HIFO Accounting.” *Financial Analysts Journal*, 91 – 102, and the other papers cited in Section 2B below.

rule in preference to the other, and the investor may choose and apply the most advantageous (including cherry picking), provided that the source data and accounting methodology has integrity,<sup>27</sup> and lots may be property identified by reference to contemporaneous records with requisite information.

Certain of the current “WRAP” services do provide the three essential requirements: timely portfolio holding data, down to lot details; the ability to determine (ie, chose) the best accounting transaction rule at any given time; and production at year end of tax reports on this pre-determined basis. These services are officially termed “IDPS” for investor directed portfolio services, and they are regulated under the *Corporations Act*. They are used in conjunction with an adviser, but are “directed” by the client (hence the title and the non-discretionary nature) and are all web based.<sup>28</sup> There are also software/systems vendors who provide similar web based solutions (access to data and accounting), and these may even include optimisation facilities to address the issues outlined above.

Essentially, the individual has to decide whether they are placing a premium on fee/cost containment, which will certainly involve them dealing with the paper war, and then using some form of web based data/accounting package; or whether they will pay for advice through a WRAP service with integrated reporting. Whatever the approach, the twin requirements of timely data access and optimal integral accounting has to be in place.

### **Location**

Tax planning is not the subject of this paper,<sup>29</sup> but in terms of individual investment in Australian equities, there is reason to flag the choice of vehicle, as this can have a major impact on after tax return. This is not an explanation or summary of superannuation (etc) law, and indeed assumes prior knowledge.<sup>30</sup>

In relation to imputation, and as of now, whatever the **MTR** (marginal tax rate) of the individual, the same dollar for dollar value from franking will be given in a personal non-super account, as it will be in the accumulation or pension phase of super: thus, whether the individual is on 48.5% and the franking credits go to diminish tax, or whether the investor pays no tax and gets a full cash refund of excess franking, or whether dividends are taxed at 15% in super/accumulation, or not at all in super/pension; the same dollar value is given. However, if the reader shares the same observations and concerns as are expressed in Part A above, as to the future of the imputation system in Australia, they may well conclude – for example – that franking credit cash refunds might not be given within a pension fund in future years. In that event, they would obviously have more value outside of super (at least in the pension phase) than within it, and through the process of asset allocation and location analysis, the investor may rationally locate the lions share of their exposure to Australian equities outside of super.

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<sup>27</sup> See TD 33 and TR 96/4 and other ATO rulings where the approach approved in TD 33 has been confirmed, eg: IT 185, IT 2289, IT 2548 - and in TR 96/4 which deals primarily with revenue account and trading stock, but which also clarifies the position for shares held on capital account.

<sup>28</sup> Eg, the Macquarie Investment Manager – broadly, a custody, administration, transacting and reporting service.

<sup>29</sup> The location and asset allocation of private investment assets is itself a highly complex and inexact science, and for a thorough introduction to the issues, see: Shoven, John B. 1999. “The Location and Allocation of Assets in Pension and Conventional Savings Accounts.” *NBER Working Paper Series, Working Paper 7007*, [www.nber.org/papers/w7007](http://www.nber.org/papers/w7007).

<sup>30</sup> For a thorough overview of the issues from the US perspective, see: Poterba, James. M., December 1999, revised March 2000 (and hence the tax law is partially out of date). “Taxation and Portfolio Structures: Issues and Implications.” *MIT and NBER working paper* pp 34 – and the reference to “tax habitats” for asset classes etc.

However, franking is not everything, and this is well illustrated in the situation of share buy-backs, where the intricacies of MTRs (on the dividend component and taxable gains), capital gains treatment (indexation/concession, and loss valuation), and acceptance mechanics, cloud the picture considerably. In the case of most recent off-market share buy-backs (eg, 2002, 03 and 04) the buy-back offer is more attractive to nil or lower MTR payers, than for high MTR payers. This is largely driven by the cash refund of franking credits to nil/low MTR payers, whereas high payers still pay tax on the large (grossed up) dividend component, even after the franking credit – and this impost is not expunged by the value of any loss they might create on the capital transaction. It follows from this, by way of illustration, that – all other things being equal – for higher MTR payers, it is better to hold shares in super than outside of super, as the dividends and realised capital gains<sup>31</sup> during accumulation are subject to higher tax outside of super.

Things are seldom this simple, and the location decision often involves assessment of: pre-existing portfolios held by the client; the weighting to other asset classes (which may well be better located within super, forcing Australian shares out of super); and it may be prudent to come to the view that a managed Australian share fund is better located within super due to lumpy distributions with low franking levels – see Section 2B below.

In the end, location may come to down to judgement, rather than being susceptible to precise mathematical analysis.

Holding shares within company vehicles is inefficient due to the absence of the 50% CGT discount concession. We have enjoyed low inflation of late, but companies hold the uninviting prospect that tax may be payable on the crystallisation of real capital losses – due to tax being levied on nominal gains.

Trusts are still efficient for income splitting, but special rules apply to streaming of franking credits through trust and require careful monitoring and tax reporting. They also give rise to tricky succession issues in terms of control and beneficial interest sharing.

### **Issues and objectives**

For the private investor, there are two overriding concerns: risk (ie, volatility or standard deviation); and *after tax* real return. Naturally this implicitly involves after fee/costs returns, but for many investors, tax take is the prime issue, and the one requiring more thought than it generally gets. For the equity investor inflation is of less concern, but for the bond investor the twin ravages of tax and inflation can be truly depressing. Bob Litterman and the Quantitative Resources Group of Goldman Sachs Asset Management<sup>32</sup> cite one table sourced from Ibbotson Associates, with tax adjustments from Goldmans Sachs, which places the challenge in chilling relief using US average annual nominal and real returns 1926 through 2001:

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<sup>31</sup> Two thirds of the capital gains are brought to account under the 12 month hold discount, and as the MTR of a super fund in accumulation is 15%, the effective CGT rate for 12 month plus holds is 10%. It is nil in the pension phase, as pension funds in super pay nil tax.

<sup>32</sup> Bob Litterman. Et al. 2003. *Modern Investment Management*. John Wiley & Sons. Hoboken, New Jersey. Chapters 29 and 30 contain an excellent explanation of after tax investing, from where many of these observations are taken.

	Nominal	Real	Real After Tax
Stocks	10.61	7.41	<b>5.57</b>
Bonds	5.33	2.21	<b>0.66</b>
<b>Cash</b>	<b>3.81</b>	<b>0.73</b>	<b>-0.39</b>

For the compilation of this 76 year table, somewhat arbitrary assumptions had to be made for tax, and essentially they applied a MTR of 20% for stocks<sup>33</sup> and 30% for bonds, as allowance was made for deferment of capital gains for stocks and the lower US long hold capital gains tax rate. Suffice to say, that for a top MTR payer, even after making allowance for the Australian Imputation system, which still leaves 48.5% tax payers with a MTR of 26% (see Section 3A above) on fully franked dividends, and our effective MTR for 12 months-plus gains at 24%; this 20% US rate does not seem unreasonable for Australian high net worth investors. Taxes, it must be remembered, are paid on nominal returns, and the impact on compounded returns over time can be immense. Compounding a *real* return of 7.41% on \$1 over 30 years gives \$8.54, and at the post tax 5.57% gives \$5.08 – ie, a 40% reduction in wealth.

The objective is therefore to avoid, or defer paying tax. It is said in many articles on this issue (mostly, admittedly, US) that tax has to be paid eventually; and hence the practice has been to analyse the issue over time, on a pre-liquidation and post liquidation basis.<sup>34</sup> Thus, if a personal portfolio or a mutual fund (ie, our unit trust) is tax managed efficiently, and tax is deferred today, it is said to create an effective “interest free loan” from the government<sup>35</sup>, but that tax is back-ended and has to be paid in the end.

### Australian rules

Whatever the comparative US/UK/Australia nuances might be, this inevitability of tax-take is not strictly true in the Australian context, for at least two reasons. Firstly, under CGT law, assets may pass from one person to another on death, with the beneficiary effectively stepping into the shoes of the deceased for all post 1987 assets, and thus, if the beneficiary continues to hold the asset, tax will not be paid and could be deferred indefinitely within a family. Secondly, under the current superannuation regime, assets may pass within a complying super fund from accumulation phase to pension phase, without triggering CGT (there is no CGT “event”); and once supporting a pension paid by the fund, any disposal does not give rise to a taxable gain. It follows that the numerics of certain US papers<sup>36</sup> dealing with “tax-advantaged” portfolio management, and the incremental tax efficiencies in the post-liquidation context, may understand the case for tax management.

Australian direct equity investment objectives are enmeshed with several issues and these include, purely from the tax perspective:

<sup>33</sup> There seems to be a consensus developing around this number, see: Evensky, Harold. 2002. “Changing Equity Premium Implications for Wealth Management Portfolio Design and Implementation.” *Journal of Financial Planning*, June, p 76 et seq – where the author settled on 20% as being a “conservative estimate” for the average percent of total return paid in taxes. But, note: the 2003 changes outlined in Section 2A above might dilute this now.

<sup>34</sup> Indeed, the 2001 SEC regulations requiring US mutual funds to report post-tax returns, requires this pre and post liquidation approach – see Section 2B below.

<sup>35</sup> Arnott, R. D., A. L. Berkin., and Jia. Ye. 2001. “Loss harvesting: What’s It Worth to the Taxable Investor?” *The Journal of Wealth Management*. Spring pp 10-18.

<sup>36</sup> These are cited at length in Section 2B.

- Optimising franking credits – the lower the dividend yield the better, and the higher the franking the better. Naturally, to some investors higher yield may be preferable for cashflow management. This issue may require nice judgemental trade-offs to be made in terms of sector diversification and stock preferences, but such trade-offs should include the value of franking credits, which currently approximate to 80% - the rate of franking in relation to the maximum permissible credits
- No franking credit value leakage under the 45 day rule<sup>37</sup> - to be avoided at all costs, and an issue to monitor in share buy-backs
- Holding for over 12 months to secure the 50% discount
- Not selling “locked-in” shares, with high unrealised gains, unless the investment metrics/opinion is compelling – see below
- Active tax loss harvesting throughout the fiscal year (not just at year end), so as to minimise capital gains tax on realised gains due to favourable turnover – without attracting the anti-avoidance provision of Part VI A
- Up-front portfolio structuring with a view to the object of low portfolio turnover, so that stock selection is made with this long term holding objective in mind, perhaps involving some sacrifice of opportunistic plays and incrementally lower pre-tax return – arguable the most important issue of all.

The limits of this paper do not admit of a comprehensive analysis of all issues going to personal portfolio management, even those concerning tax. Moreover, many of the issues faced by managed funds, and the solutions (eg, accounting strategies and tax loss harvesting) that are applied to them, are relevant to direct stock portfolio management – and these issues are discussed in detail in Section 2B below. This Section will therefore focus on certain of the ideas and theories that have surfaced in recent times in relation to a major issue in private, direct, portfolio management:

### **Giving away a bird in the hand for one in the bush**

Arguably this is the most testing issue for direct portfolio management, and is referred to variously as “paralysis” or “lock-up”. It is the incidence of unrealised capital gains, and the appreciation that the tax incurred on sale, is so prohibitive that active management for alpha cannot take place. Happily, many private clients have this problem.

In his recent paper, Kevin Mean<sup>38</sup> gives thought to this and makes a number of points:

- The lock-up problem fundamentally involves a tricky trade-off between the know tax impost for selling down, and the uncertain alpha gain to be derived from reinvesting the proceeds. Thus, the term “confidence-adjusted alpha” is coined
- With managed funds, even under very low turnover of 25%, over half of the loss to capital gains remains – citing Jeffrey and Arnott (1993) – see Section 2B below

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<sup>37</sup> Requires the shareholder to hold for the period commencing on the day after the day the taxpayer acquires the shares, and ends on the 45th day after the day on which the shares become ex-dividend. LIFO accounting applies, and days do not count where the taxpayer has “materially diminished risk of loss and opportunities for gain” – thus shares must be held at risk.

<sup>38</sup> Mean, Kevin. 2002. “A Proposal for Tax-Efficient Active Equity Investing.” *The Journal of Wealth Management*, Winter, pp 57 – 66.

- Given that stock analysts and most alpha models look forward only around 12 months, the return “pick-up” period, during which the tax cost has to be recovered, should be correspondingly short, and probably one year is fair – which makes it very testing indeed when considering crystallisation of large unrealised gains
- First quantify the tax cost as a percentage of the current holding, and then apply a formula for deriving the confidence adjusted alpha to be, hopefully, derived from both the sale and the purchase, so that there will be a confidence adjusted return accretion from: (1) not underperforming the market on the sell side, and; (2) an accretion from the confidence adjusted return from outperforming on the buy side of the transaction – less transaction costs.

This rational approach is bolstered with a formula:

$$\text{Alpha} = \text{Volatility} \times \text{IC} \times \text{Score}$$

Were:

Alpha	= expected residual return
Volatility	= residual from the risk model (Grinold used the BARRA model)
IC	= information coefficient, or the correlation between forecast residual return and the realised residual return – from prior transactions
Score	= a standardised measure of stock preference (mean = 0, standard deviation = 1).

It is confessed that forecasts of residual volatility “are themselves fraught with uncertainty”, and he retreats to the assumption that residual volatility approximates to total volatility. In his example the tax cost is a known 5.1%. He then uses a standard deviation below the mean to derive a negative 10.4% annual loss for the sale candidate. Then adjust this for confidence: he has to look into the manager’s (ie, investor or their adviser) past track record to fix the “IC” – what is the correlation between past forecast and actual outcomes. That, of course, might be a depressing statistic, and one which stock-brokers may not keep fulsome records of. He falls back on the wisdom of Grinold (1989, p 10 – 11) to derive a reasonable IC for an outstanding (top 5%) forecaster of S & P 500 stocks, at about 0.06%. Thus the confidence adjusted forecast comes out at  $-10.4\% \times 0.06 = -0.62\%$ .

He then does a similar exercise on the buy side, starting with a massive raw return forecast of 72%, which translates into a measly confidence adjusted forecast of 4.32% - and adding this to the sale saving 0.62%, gives 4.94%, which does not cover tax, and hence the deal is off and the position is “locked up”. This somewhat sobering analysis brings the problem into relief, and the numerics are not that distant from our shores. Conclusion: many high net worth direct portfolios are locked-up, and the competent adviser/broker should think very hard before re-balancing them.

Given that this issue is tax centric and is of great concern to the well-being of many Australians, curtesy of our market performance for the past decade or more, it is permissible to make related observations. Firstly, the theory of this process is sound, and broadly unimpeachable, but – being realistic – how often will it be applied to private clients? At the very least, the tax cost should be calculated and annualised for capital return, as this provides a very good starting point. Then, it comes down to quality of stock research, and the all-levelling confidence factor. Perhaps, in a given factual matrix, it is appropriate to use a

greater return recovery or pick-up period – which of course would lower the residual return hurdle. Whatever the approach, the decision should be taken – as with all stock-picking – with some degree of apprehension.

Secondly, it is fair to observe that there might not be complete coincidence of interest as between adviser and client, if the adviser is charging commission on the trade. Such a remuneration approach is highly dangerous for clients with locked-in portfolios. To extend this one step further on the buy side, take this example: Arguably the best investment that a private client could have made for the past 44 years, would have been to buy Westfield Holdings, and to have simply held the stock. That, of course, is the worst possible outcome for a stockbroker on commission. It is this issue, and other factors, which is driving the broking industry to recurrent fees. Such fees may be small bear if the best advice a client can have, is to do nothing.

Indeed, as Mr Means concludes: “The capital tax bite from active trading is indeed onerous. In fact, with a realistic set of assumptions regarding an investor’s ability to forecast alpha, most stocks that have appreciated more than 30% should probably be considered locked-up for an upper bracket taxable investor.” Given the current tax rates in Australia, that yardstick seems apposite.

David Stein, et al,<sup>39</sup> take a different tack, by focussing on the risk side of the equation. They examine the standard deviation of the locked-up stock, its volatility and that of the overall portfolio. What is the concentration cost of holding this stock, and does the risk reduction from a substitute investment compensate fully for tax? What is the optimum substitute investment for enhancing diversification – etc. In dealing with tax-locked concentration risks, they admit that “in the presence of taxes, however, there is no standard approach for arriving at a considered choice.” However, as diversification makes the expected return more readily available, it is worth paying for, but the question, with locked-in stocks is: how much?

They apply a formula based approach, using the Sharpe ratio, and in contradistinction to the return analysis above, they justify longer returns for comparing the risk reduction benefits – 20 years in the numeric example. Observations during their explanation include:

- Many securities such as those with volatility of more than 30%, should be almost completely diversified. There is less need to diversify low-volatility initial assets – CSL and Cochlear might have been candidates?
- For low-volatility initial holdings, the time horizon is more important
- For time horizons greater than 20 years, differences are not very great, and the risk of holding the single stock quickly overwhelm the tax benefit of retention.

Whilst, the application of this model may well raise real confidence issues, the approach of this paper does illuminate the other side of portfolio construction, and it does show what a tricky and intractable issue the lock-up problem is. Any advice in the area has to weigh complex risk and return issues, and judgment may be as good as mathematics – albeit within the important parameters outline in these two papers.

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<sup>39</sup> Stein, David M., Siegel, Andrew F., Premkumar Narasimhan., and Charles, E. Appeadu. 2000. “Diversification in the Presence of Taxes” *The Journal of Portfolio Management*, Fall, pp 61 – 71.

## Section 2B

### Managed funds

#### Structure and tax features

This Section is concerned with the taxation aspects of management investment schemes which are regulated under Chapter 5C of the *Corporations Act 2001* (Cth)<sup>40</sup>, in so far as they facilitate investment in Australian equities. There is no set industry nomenclature or label for such funds, and they are variously described as “managed funds”, “mutual funds” or “collective investment vehicles”. They are open ended unit trusts and thus issue and redeem units, and are different in this respect to closed end listed investment companies.

Their fixed unit trust structure, which gives the unit holder an equitable interest in trust assets, leads to a number of tax consequences and features:

- All taxable net income is distributed each year, so that this income is taxed in the hands of unitholders and not within the trust – which pays no tax, as all unitholders are “presently entitled” to their share of income and realised gains generated by the fund
- There is full flow-through of the composition of such realised gains, ie whether they may be assessed against an indexed cost base, or have the 50% discount due to gains from assets held over 12 months (they are effectively grossed up in the hands of the unitholder to 100% of the realised gain, and then the investor claims the 50% discount – relevant for loss set-off)<sup>41</sup>
- There is full flow-through of franking credits, and as these are attached to dividends that must be distributed each year, so there is no surplus franking credit carry forward, as there might be – for example – with a listed investment company. Oddly, the rate of franking can be over 100% due to fees/expenses within the fund and other matters
- Capital gains are only distributable once realised, and unrealised gains are reflected in the net asset value (NAV) of the unit price of the fund. When capital gains are realised and distributed, NAV goes down by the designated pre-tax or pre-discount amount
- Realised capital losses cannot be distributed, and are locked within the trust and flow into NAV, as do unrealised losses. Realised losses are set-off against realised gains within the fund, and hence can impact distribution levels
- Funds flow into the trust by applications for units, and funds flow out for redemptions; all at unit prices determined by NAV, which does not take into account any potential tax liability for accrued income or realised or unrealised gains or the tax treatment of such gains – eg, whether they relate to assets held over 12 months that will enjoy the 50% discount. Unit pricing is therefore tax blind, and the in/out funds flow can trigger capital gains or losses by the manager, due to cashflow management. This feature can itself impinge upon the investment strategy of the manager, for example whether the manager will stay fully invested in equities, and this wash of funds (eg, into new

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<sup>40</sup> This Chapter of the *Corporations Act* was established by incorporation of the provisions of the *Managed Investments Act 1998*.

<sup>41</sup> Chincarini, L., and Daehwan Kim. 2001. “The Advantages of Tax-Managed Investing.” *The Journal of Portfolio Management*, Fall 2001 pp 56 – 72, note managing short term gains into concessionally taxed long term gains in the US (similar discount to Australia) will unambiguously improve the after tax return.

investments) can effectively lower the proportion of unrealised capital gain imbedded in the unit price, as the cost basis is increasing – see below, where this issue is analysed

- The fund is bound by the 45 day rule for the preservation of franking credits, although fund manager institutions (being unlisted “very” widely held trusts) may elect to use the formula based ceiling under s 160APHR(1). Once an election is made and the manager is treated as a qualified person, the 45 day holding period requirement is replaced by the formula method, pursuant to which a franking credit ceiling is established by reference to an anticipated notional level of franking yield from the All Ordinaries Index, increased by 20%
- Unitholders are exposed to taxable capital gains or losses on their units (assuming that they are held on capital account by the investor – see below) when these are redeemed, and they may receive revenue and capital gain distributions whilst they retain their units. Such distributions are made at prescribed times of the tax year, as determined by the constitution of the fund, and this itself opens up issues for investor pro-active tax management<sup>42</sup>
- It follows that there are two levels of potential tax management: at the manager level within the fund, for this activity will dictate distribution levels and the composition of taxable amounts; and at the investor level, in relation to crystallisation of gains/losses and avoidance of distributions by deferring application or redeeming pre-distribution. In reality, the investor effectively delegates a significant portion of tax planning to the manager, who very seldom has any thought for tax.

These funds are “financial products” within the new FSR regime and have a single responsible entity (**RE**), generally a bank or major institution, with prescribed asset backing. Investment into these funds is now made under a Product Disclosure Statement, as prescribed by Part 7.9 of the *Corporations Act 2001* – and see below regarding disclosure. Each fund must have a “constitution” (previously a trust deed) which regulates the relationship between the investor and the RE: s 601EA(4) and s 601GB.

The tax attributes outlined above for Australian funds are remarkably similar to the US tax position for mutual funds, where they also have: concessional rates for “qualified dividend income”<sup>43</sup> (different to imputation, but of similar net effect); short term capital gains taxed at higher rates than long term gains (as we have); the wash sale<sup>44</sup> rule for short term trades used to implement tax loss harvesting (see below, and note our Part IVA and the 45 day rule for imputation credits). The UK is quite different due to nil distribution of realised capital gains from funds, and significant differences in capital gains tax rates/structure. Happily, there is a great volume of research material from the US on the taxation aspects of managed funds, and this is analysed in this Section.

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<sup>42</sup> A few tax alert managers do forewarn unitholders of anticipated year-end distributions, eg Equity Trustees letter May 2004 regarding their SGH Small Companies Fund, which had enjoyed exceptional performance, but where a “higher than expected volume of fund inflows and outflows has meant that a larger than usual amount of capital gains have been realised.”

<sup>43</sup> Fund must hold stock for more than 60 days during the 120 day period beginning 60 days before the ex-dividend date – discussed by Dr Glenn Freed, Dimensional Fund Advisors, Tax Planner. *Qualified Dividend Income – make Sure You Earn It*. August 2003. See [www.dfaus.com/financial](http://www.dfaus.com/financial) (password required).

<sup>44</sup> Analysed in depth in: Schizer, David, M. 2004. “Scrubbing the Wash Sale Rules.” *Taxes*, 67 Volume 82, Issue 3.

### **Australian investor experience and focus**

In Australia, scant attention has been paid to tax in relation to funds, notwithstanding that the impost of tax-take is likely to have more impact on returns than fees or manager alpha – depending, of course, upon the investor’s marginal tax rate (**MTR**). This may be partially due to the tax concessions available through superannuation, although even here, much of what follows in this Section is relevant to super funds, albeit at a lower level of impact due to the accumulation MTR of 15% (effectively 10% for capital gains if discounted) and nil tax within a pension fund.

The Australian equity market has not seen the same volatility as the US in recent years, and this perhaps has left the distribution issue to remain at rest, partially camouflaged by our higher dividend yields and the cushion of imputation. Performance levels for the year to June 2004 and distributions by active managers, may well waken the sleeping dog. In contrast, market volatility in the US gave Representative Paul Gillmore the impetus to challenge disclosure by introducing the *Mutual Fund Tax Awareness Act* when his wife suffered a large taxable distribution in a down year, when her investments actually lost money.<sup>45</sup> Additionally, the positive funds flow enjoyed by most Australian unit trusts, has meant that structural dynamics have helped tax “management” even in the absence of any policy of efficient tax management – eg, there have been few instances of large forced asset liquidations due to excessive redemption demands.

This quietude on the tax horizon has manifested itself in the total focus on pre-tax total return, and performance assessment against a pre-tax accumulation index or pre-tax benchmarking against peers. Tax has been off the radar screen, even where it has direct impact upon fund investment decisions, such as in the case of share buy-backs. Today, buy-backs have fallen into a normal structure whereby their pricing is largely driven by the **MTR** of the shareholder and the quantum of franking credits distributed. Of course, the manager of a (non-super) fund cannot know the MTR of each unitholder in the fund, and therefore cannot take this into account. By contrast, the manager of a public offer superannuation fund does know such MTR, and a decision can be made to take advantage of the buy-back offer – which is generally favourable to low MTR payers, and thus is attractive to super funds. The unit pricing of public offer super funds does include a form of accruals accounting for tax, and hence the franking credits will positively impact performance numbers to some extent. However, the non-super fund manager of a unit trust will know that the sale of shares into a buy-back, although probably advantageous to many members of the fund, will dilute pre-tax performance numbers, as franking credits are not recognised in return calculations or NAV – for all the fund data that is in the public domain, they may as well not exist. This creates a dilemma.

There have been faint rumblings about tax in the finance industry press, but this has not been particularly well informed, and major institutions have a vested interest in keeping the issue buried.<sup>46</sup> One example was of a \$100,000 investment into a well know property fund at the beginning of 2000 by a top MTR payer. The cum-distribution unit price on application was \$1.45 (= 68,965 units) and the fund distributed \$0.42 at June 30, 70% of which was assessable capital gain – the fund having sold property. Thus, \$0.294 of the distribution per unit was assessable, resulting in a taxable gain of \$20,276. Even with the current 50% discount the

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<sup>45</sup> The author gratefully acknowledges the incisive comments and background information provided by Dr Joel Dickson of Vanguard, US, in relation to the new SEC rules re after tax returns and the path of the US Mutual Fund Tax Awareness Act, which was overtaken by SEC implementation of after tax disclosure.

<sup>46</sup> Masterfunds Quarterly. *Unit trusts, tax and the problem with platforms*, where Matthew Dell was misquoted in his example of distributed capital gains – the numbers do not reconcile. September 2003, pp 26-29.

investor would have to pay some \$5,000 in tax, bringing the after tax return down 5% before other more positive developments.<sup>47</sup> The argument for using IMAs/SMAs (individually/separately managed accounts) is generally founded on the tax inefficiencies of managed funds, but it has been observed that this innovation is a “bit of a graveyard”, as these vehicles have not blossomed in Australia.<sup>48</sup> And, as pointed out in Section 5B below, IMAs/SMAs are not always a practical solution to all the tax issues, and certainly there are few, if any, mainstream SMAs in Australia where the investor can “switch fund managers” by taking out shares in specie from one mandate and then transferring them in specie into a new manager mandate. This cannot be done with ASGARD, as applications have to be in cash.<sup>49</sup>

Overall, it is this lack of prominence of tax concerns which is puzzling to the rational observer, in that what the investor is, or should be, primarily concerned with (ie, after tax return);<sup>50</sup> is not in the mind of the supplier of the investment product – and, as will be seen below, there is virtually zero disclosure of matters that impact upon after tax return. In short, there is objective disconnect between the consumer and the provider.

### **Internal tax management of funds**

Given that after tax returns are not in the mind of the average Australian fund manager, it is hardly surprising that tax efficiencies and issues going to tax management are not considered by most Australian managers. This may well be prejudicial to the interest of investors, certainly to those investors exposed to higher MTRs.

Firstly, there is the issue of active management, and the vexed question as to whether any alpha added to Australian equity exposure by such management outweighs the tax and transacting cost detriment caused by active management and high turnover. It may serve at this stage, to overpass the issue as to whether “active” does outperform passive on a pre-tax basis, as this is not the focus of this paper.<sup>51</sup> At the least, there are real question marks, and over the years, the efficiency of the Australian market has been improving. Even relatively unscientific analysis tells a story: in the Weekend AFR, June 12-14, 2004, according to the Morningstar tables, of 52 retail managers for “Australian Equity General” reporting three year performance numbers, 16 outperformed Vanguard Index Australian Shares – which fund might be taken as a fair surrogate for the accumulation index. Put another way, 69% underperformed. That, is pre-tax, and as will be seen, passive funds do have certain tax advantages.

The US research on whether active management delivers sufficient outperformance to compensate for additional tax is prolific, and the debate was moved forward by Jeffrey and Arnott (1993)<sup>52</sup> to howls of protest from active managers, where “alpha” had become the holy grail – and in this context “alpha” is simplified in portfolio parlance to mean outperformance

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<sup>47</sup> *Ibid* – and corrected by Matthew Dell.

<sup>48</sup> *Ibid*, see: *IMAs: It is tax, stupid*. p 58

<sup>49</sup> *Ibid*, where the contra is suggested as a solution.

<sup>50</sup> See the discussion of this in Section 1B above.

<sup>51</sup> See Phil Graham. 2002. “Do active managers really outperform?”. *JASSA* Issue 4 Summer, p 5 et esq.; and Dolan, Phil., P. Hodgens., and G. Wells. “The performance of active equity fund managers”. *JASSA* Issue 1 Autumn 2003, p6 et esq. – which raise many question marks against the outperformance prospects for active managers after fees.

<sup>52</sup> Jeffrey, R. H., and R. Arnott. 1993. “Is Your Alpha Big Enough to Cover Its Taxes?” *The Journal of Portfolio Management*, Spring p 15-25.; followed by: Hertog, R., and M. R. Gordon. 1994. “Is Your Alpha Big Enough to Cover Its Taxes?: Comment”. *Journal of Portfolio Management*, Summer p 93-95; followed by: Jeffrey, R. H., and R. D. Arnott. 1994. “Is Your Alpha Big Enough to Cover Its Taxes?: Reply to Comment”. *Journal of Portfolio Management*, Summer p 96-97.

due to trading. Jeffrey and Arnott analysed history, going back to Garland (1987), and reached conclusions, which may be summarised:

- US taxable mutuals were then typically managed as if they were tax exempt, and this was irresponsible – ditto in Australia?
- Turnover begets tax – a concept that is applicable to Australia, due to similarity of tax laws. See sample data below
- Active taxable strategies should always be benchmarked against the after-tax performance of an index alternative<sup>53</sup>, and whilst it is conceivable that an active manager can add value on an after-tax basis, this will occur only with careful planning that results in maximising the build-up of unrealised capital gains
- Capital gains typically have a substantially greater impact on after-tax returns than do dividend taxes – Australian issues worthy of more thought and analysis: notwithstanding our higher dividend yields, the incidence of franking may well result in this being so here, especially with small cap funds
- Unrealised capital gains may be thought of as an interest free loan from the government, and the longer the loan endures due to deferment, the greater the benefit of the loan under compounding and value accretion. Thus, \$100 compounding at 6% per year grows to \$321 in twenty years if there is no turnover with no tax impost, but with just 5% turnover the after-tax terminal value drops to \$284; and at 50% turnover the terminal value is barely above the \$215 when turnover is 100% - see below regarding tax efficiency of Australian funds
- Surprising as it may seem, the tax consequences of trading are a function, not of turnover, but of the holding period. Turnover is a straight-line function that varies directly with trading activity, but holding period, which is the reciprocal of turnover, is non-linear with respect to activity. Thus, from a very low level, the tax impact of turnover increases rapidly, so that for example, a seemingly low 25% turnover actually incurs over 80% of the taxes that would be generated at turnover levels of 100% - this has significant implications for any fund which seeks to be tax effective in Australia
- Most alphas cannot support their taxes – examples given of high turnover funds where pre-tax outperformance was consumed by tax impost. Comparing ten year results for 71 active funds with a passively managed S&P/500 index fund, gives no indication that turnover adds enough value to compensate for the turnover generated capital gains taxes. In fact, the evidence is to the contrary. On a pre-tax basis, only 15 of these actively managed funds outperformed the index, but after taxes (and after an average 75% annual turnover<sup>54</sup>) ten *fewer* active funds outperformed – what chances for post-tax return fund pickers?
- Realised losses are like cash in the bank
- After tax returns are best where the up-front portfolio construction is designed to be long-lived – the more it is changed, the more value leakage through tax

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<sup>53</sup> Establishing an after tax benchmark is not easy and has raised controversial issues, see: Stein, David. 1998. “Measuring and Evaluating Portfolio Performance After Taxes”. *The Journal of Portfolio Management*, Winter pp 117-124; and Brunel, Jean. L. P. 2000. “An Approach to After-Tax Performance Benchmarking.” *The Journal of Wealth Management*, Winter pp 61-67.

<sup>54</sup> See the incredible similarity to average Australian active turnover rates in the sample in this paper.

- Minimising turnover, which is so essential to good after-tax performance, requires just as much – and conceivably more – management attention as a high turnover, non-taxable portfolio.

For the past decade the US debate has developed, and research has intensified. However, the principles established by Jeffrey and Arnott (1993) have not been impugned; rather, they have been corroborated by others. Much of this work has centred upon how to introduce tax management into the mutual fund product, and hence the concept of “tax-managed investing” or “tax aware” funds has evolved. The debate has largely been championed by the passive managers, for the simple reason that they generally start on firmer ground, and it suits their commercial interests. With this caveat, the arguments propounded by the likes of Dr Joel Dickson of Vanguard<sup>55</sup> do appear to be compelling. They make the point that in the market run up, an average 2.5% of performance was lost to taxes by high MTR investors in US mutuals in the five years to 2000, and a similar number for the past ten years. That value leakage is greater than both the average expense ratio of funds and the estimated transaction costs associated with portfolio turnover among funds.<sup>56</sup> As noted above, tax take from fund investing is likely to have greater impact than fees and costs – which places the current debate on fee disclosure (important as it is) into context.

Dickson hones in on particular problem areas, where tax management has greater potential significance; for example, with small caps, due to the need of the manager to sell down when a stock rises in value to leave the small cap index. Thus, if the fund has a wider mandate or philosophy, and is not constraining itself to one limiting benchmark, it may be naturally easier to tax manage – easier, than for example, a small cap index fund where the fund has to periodically re-constitute to match the changing index composition. In the US an example of a tax benign mandate might be the Wilshire 5000, where small caps can migrate to mid and then to large without the manager being constrained to sell. However, when looking at attempts to be tax efficient, and whether the manager is active or passive, the common issue is that gains are not realised at the discretion of the investor<sup>57</sup> – and there is simply no way of avoiding this, save, theoretically (the SMA promoters might say) with a SMA having overlay or intervention facilities: see Section 5B below, and as to certain disadvantages SMAs have over funds. Funds are not all bad, when it comes to tax efficiencies, the principal advantage being due to cash in-flows, and the potential these bring for optimal accounting treatment.

Acceptance of the tax issues, and the quest for tax efficiency has resulted in analysis of the following issues, which have been adapted to Australian conditions:

### **Investment strategy**

The confinement of a mandate to small caps is mentioned above, but there can be several other strategic issues that will bear upon tax efficiency. Given that negative fund cashflows are more of a problem for a manager than positive cashflows (the forced redemption issue) the risks are greater in high Alpha funds, than with a passive fund – for the reason that manager disappointment may surface with the active high alpha manager if underperformance surfaces.

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<sup>55</sup> Dickson, Joel. M. 2000. “Tax-Efficient Mutual Funds”. *Association for Investment Management and Research*, pp 39-49.

<sup>56</sup> *Ibid*, p 39.

<sup>57</sup> *Ibid*, p 39.

On a similar point, it is probable that a growth manager will be less efficient than a value manager, for several reasons: lower franking levels (notwithstanding lower dividend yields); higher stock turnover (the quest for growth winners); and the need to sell overpriced winners.

### **Custodial lot data**

As pointed out with private accounts in Section 1B above, it is essential that the manager have access to accurate lot data, and in the case of funds, the custodian must be able to accommodate this, for the application of different accounting strategies.

### **Turnover**

This is a complex issue, where it can be dangerous to apply the simplistic proposition that low turnover equals tax efficiency. This caveat is certainly the case in the US where one can have “good” turnover, generated from tax loss harvesting, as against “bad”<sup>58</sup> turnover generated by the quest for alpha, irrespective of the tax impact. There is a large body of US literature on this issue, and the picture can be clouded. These two types of turnover have been labelled: “tax-inefficient turnover” which is associated with realising gains; and “tax-efficient turnover” which is associated with realising losses.<sup>59</sup>

The first issue is to apply a common test for establishing turnover rates, and that generally applied in the US is a ratio derived from the lesser of purchases or sales for a period divided by average net asset value. But applying this test to these funds illustrates an issue<sup>60</sup>:

Fund A – every day \$1m million in cash flows into the fund, and the fund buys stock with great wisdom, and never sells = zero turnover and highly tax efficient.

Fund B – cash outflow of \$1m every day, and to manage this, zero purchases and \$1m in sales each day to manager cashflow = zero turnover and massive tax inefficiency.

Disclosure of directional turnover would reveal this difference, but this is seldom disclosed in the US – and nothing is disclosed in Australia: see below. Even with disclosure of turnover levels, there is a degree of opacity in the US due to the fact that, often, one does not know of the accounting treatment used by the manager, and as is noted below, this can have a significant bearing upon tax efficiency.

However, weighing all these qualifications on the scales against the current Australian backdrop, it does appear that turnover is highly correlated to tax inefficiency, certainly for active managers, due to the fact that: most use standard FIFO accounting;<sup>61</sup> there is little active loss harvesting (no incentive for the manager to do this under our reporting rules), and hence no “good” turnover; generally no other tax aware strategies are applied, for example to hold for 12 months to halve the capital gains tax rate. This conclusion is backed by the sample below. Bergstresser and Poterba (2002)<sup>62</sup> found that current turnover of US mutuals is an important predictor of a funds tax burden. Their empirical findings suggested that turnover is not typically directed at tax-minimisation – and this is believed to be the current Australian position, from anecdotal inquiries.

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<sup>58</sup> See discussion of this concept: Arnott, Robert D., Andrew L. Berkin., and Jia Ye. 2001. “Loss Harvesting: What’s It Worth to the Taxable Investor?” *The Journal of Wealth Management*, Spring p 10 – 18.

<sup>59</sup> Poterba, James. 1999. “Unrealized Capital Gains and the Measurement of After-Tax Portfolio Performance.” *The Journal of Private Portfolio Management*, Spring, pp 23 – 34.

<sup>60</sup> Provided to the author in conference by Dr Joel Dickson.

<sup>61</sup> First in First Out, which results in lower cost base holdings (lots) being sold (accounted for) first, which is probably tax inefficient in a rising market over time.

<sup>62</sup> *Ibid.*

As will be seen below, turnover rates in some Australian equity funds can be surprisingly high. US studies have divulged that the average rate of turnover of US domestic funds is around 70 percent and of actively managed funds it is 77 percent.<sup>63</sup>

### **Accounting treatment/policy**

Most mainstream Australian equity funds, apply standard FIFO accounting. In the US there is a move towards LIFO (last in first out) or more prevalent in tax aware funds, to HIFO – highest in first out. As discussed in Section 1B above, the ATO and our tax laws, do permit such accounting provided that shares are specifically identifiable in lots (dates, cost etc) with an accounting system that maintains the integrity of such data.<sup>64</sup>

The choice of accounting treatment is likely to have a major impact upon tax efficiency for passive funds,<sup>65</sup> for the reason that they have multiple lots of one stock due to index replication, and similar activity. However, for aggressive active funds, adoption of HIFO accounting will probably have a minor impact for the reason that they do not have the multiplicity of parcels/lots, but rather take large positions which will be liquidated *en bloc*, at their trading will, with little if any difference to consequential tax treatment under FIFO or HIFO. And, of course, the higher the “bad” turnover, the greater the need for some ameliorative tax planning; but this accounting rule will not provide it – rather, for active funds, loss harvesting is likely to produce more meaningful results. Conversely, Vanguard applies passive HIFO to its US funds, with positive after-tax impact.

HIFO accounting does however raise equity issues between different investors, as it is good for old unitholders in the fund (it defers realisation of capital gains); but is arguably bad for new investors due to the unrealised “overhang” – see below. The answer to this is effective disclosure, and confidence in the on-going performance of the manager (equals, low redemption prospects), and as noted above, this confidence level is probably easier to achieve with passive managers than for active – and the more active and higher the alpha objective, the greater the risk of falling off the perch, with concomitant implications for hedge funds. HIFO accounting is not generally invoked on its own, but is coupled with loss harvesting and other strategies.

### **Loss harvesting**

Loss harvesting is the practice of selling shares which have declined in value, thereby crystallising losses on capital account, which may – at some indeterminate future date – be set-off against realised capital gains. Contrary to comment in the financial press, loss harvesting should be pro-actively practiced throughout the year, and not simply applied in mid June – for the simple reason, that opportunities might be lost throughout the year. There are many nuances to loss harvesting that are outside the scope of this paper<sup>66</sup>, but one salient issue for the Australian investor/manager, is that of the ATO practice and tax law position on contemporaneous sell/buy transactions.

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<sup>63</sup> Chincarini, L., and Daehwan Kim. 2001. “The Advantages of Tax-Managed Investing.” *The Journal of Portfolio Management*, Fall, p 56 – 72.

<sup>64</sup> See TD 33 for capital account, and TR 96/4 for revenue account, trading stock and conformation of the approach for investment shares on capital account under TD 33; eg para 37 et seq dealing with differences after introduction of CHESS.

<sup>65</sup> *Ibid*, Dickson conference – who estimated to 80% of tax efficiency.

<sup>66</sup> For example, the interaction of US long term gains against short term losses: Zivney, T. L., James Hoban., and John Ledbetter. 2002. “Taxes and the investment horizon.” *Journal of Financial Planning*, p 84

In the US there is a specific “wash-sale” rule<sup>67</sup>, which incorporates timing restrictions, whereas in Australia the position is less clear, as there are no precise timing rules (as there are, for example under the 45 day rule for franking credits), but rather the ATO has the power to apply the general anti-avoidance provisions of Part IV(A). Suffice to say, that for the proactive tax adroit manager, there are strategies that can be applied to optimise after tax return, and yet fit with the designated investment philosophy of the manager.

In combination with FIFO accounting, loss harvesting has been proven to add after tax value, and the theory underlying the practice is unimpeachable. Berkin and Jia (2003)<sup>68</sup> have quantified the benefits of loss harvesting and FIFO accounting by using Monte Carlo simulations, and they investigated the robustness of these strategies in various markets and with various cashflows and tax rates. They concluded that: “a market with high stock-specific risk, low average return, and high dividend yield provides more opportunities to harvest losses. In addition, a steady stream of contributions refreshes a portfolio and allows the benefits of loss harvesting to remain strong over time. Conversely, withdrawals reduce the advantages of realising losses.” This paper is replete with many of the observations made above, and it is perhaps instructive to note the author’s grateful acknowledgement of the contributions of Robert Arnott (see above). They start with the observation that the cost of taxes were overshadowed by “the long-lasting bull market and by investors’ zealous quest for active alphas ... But the alpha for a taxable portfolio consists of a pre-tax alpha, which is highly uncertain, and a ‘tax alpha’ (the tax consequences of active management), which may be managed with precision.” Earlier studies are cited<sup>69</sup> to build the contention that the open-ended fund is “endogenously more tax efficient than a closed end fund” due to the ability to raise cost basis with incoming cashflows. This, coupled with FIFO account and loss harvesting had previously shown, that the tax benefits for FIFO accounting was 65-95 bps, with only 5-8 bps added by loss harvesting.

For their simulations, Berkin and Jia applied realistic assumptions in the US context, including a modest 35% MTR, when, as they observe, US top MTRs can often hover around 50% when federal, state and local taxes are combined. They generated three portfolios, for buy-and-hold, buy-and-hold with FIFO accounting, and a tax-advantaged portfolio incorporating loss harvesting and FIFO. They found that using the tax-advantaged portfolio, median cumulative value added was 122% over a 25 year period – ie. over double the cumulative return. Interestingly, from an Australian perspective, they varied the rates of dividend yield, for as they noted; “dividend yields of stockmarket-wide, have dropped sharply in the past 20 years – from more than 5 percent a year in 1982 to 1.5% in 2002.” They found that high dividend yields should have mixed effect on the benefits of a tax-efficient strategy relative to a naïve buy-and-hold strategy, and the impact may well be negligible once franking credits are allowed for. In short, their findings on this point, as with others, have relevance for Australia.

In relation to MTRs, they found that for their 35% base case the tax-advantaged strategy yielded an annualised impressive “tax alpha” of 73 bps p/a over 25 years before liquidation, and 56 bps after liquidation. For an investor on a 50% MTR the improvement leaps to 115 bps and 74 bps P/A respectively. And, if this does appear inconsequential, it is worth considering a pertinent observation they make:

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<sup>67</sup> Prohibits the re-purchase of securities sold at a loss within 31 days of sale.

<sup>68</sup> Berkin, Andrew., and Ye, Jia. 2003. “Tax management, loss harvesting and FIFO accounting.” *Financial Analysts Journal*, Volume 59, Issue 59, pp 91 – 101.

<sup>69</sup> Dickson, Joel. M., and John, B. Shoven. 1993. “Ranking Mutual Funds on an After-Tax Basis.” *National Bureau of Economic Research (NBER)*, working paper No. 4393.

“Keep in mind that to achieve that 74 bps benefit with conventional active investing, one would have to earn a 148 bps alpha with no capital gains taxes on those trades, which most observers of active investing would consider nearly impossible. In ‘How Well Have Taxable Investors Been Served in the 1980’ and 1990’?’ (Arnott, Berkin and Ye 2000)<sup>70</sup>, we found that only 5 percent of all funds outpaced the S&P 500 on an after-tax basis, with an average margin of victory of a scant 74 bps; so a 148 bps after-tax alpha is not a plausible target for most active managers – unless they place tax management at the very top of their asset management priorities. Surprisingly, even for the investor in a modest 20 percent tax bracket ... the average annual alpha of loss harvesting and FIFO accounting over 25 years is still a lofty 40 bps before liquidation and 31 bps after liquidation.”

This study was based on buy-and-hold, with minimal turnover, due only to index changes, and illustrates the power of sophisticated tax managed investing. It does not illustrate the converse, namely the detriment caused by active management with high turnover rates – for which some authority is cited above. It is reasonable to expect that a large divergence of after-tax efficiency will be delivered by the two ends of the spectrum: passive buy and hold with tax-advantaged strategies at one end (per the Monte Carlo simulations referred to above); and highly active tax oblivious managers at the other. In a US Joint Economic Committee Study “Providing Tax Equity for Mutual Fund Investors: Changing the Taxation of Capital Gain Distributions” attached to a bill (H. R. 496) introduced into Congress, April 2004, by Vice Chairman Jim Saxton, it was contended by the authors that taxes can be the most significant cost of investing in a mutual fund, and the paper cited with approval the findings of a 2000 study by KPMG. This concluded that taxes on distributions from mutual funds decreased the performance by up to 61% or 7.7% per year for ten years. The median loss due to taxes was 16.5% or 2.5% per year over ten years.

As the debate matures there are more claims to enhanced tax efficiency, for example by the application of a “proprietary quadratic optimization program”<sup>71</sup>, and how this can be applied to “Active” indexing – which merely illustrates the complexity, if not obscurity, of the debate. This approach enshrines faith in “selection alpha” for re-investing the proceeds from loss harvesting, and applies this to the decision process for selecting what losses to harvest. Thus, instead of “forcing the realisation of all losses, it only takes losses where they can be useful in offsetting gains that are already realised.”

### **Unrealised capital gains in unit prices**

It is impossible to comment meaningfully on this issue in the Australian context without access to data – and data is not readily available. In the US Joint Economic Committee Study cited immediately above, there is considerable discussion of this aspect of US mutual funds, and the most revealing statistic is that prior to the market downturn in early 2000, unrealised gains in US mutuals, as a proportion of total assets, peaked in 1999 at 33%, after building progressively from 1% in 1990.

There are several departures from the Australian position that make any comparative view no more than a guess. Firstly, the far higher dividend yields in Australia have lead to a greater

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<sup>70</sup> And see prior: Arnott, Robert D., Andrew L. Berkin., and Jia Ye. 2001. “Loss harvesting: What’s It Worth to the Taxable Investor?” *The Journal of Wealth Management*, Spring, pp 10 – 18; which notes that 2% to 3% of pre-tax alpha for active funds is needed to match the after tax return of index funds, and that tax-advantaged investing can consistently add roughly 60 bps of after-tax alpha per year, without stock selection skills.

<sup>71</sup> Discussed in: Chance, R. B., Susan Hirshman., and Gordon Fowler. 2003. “Is tax-loss harvesting worth it? Greater after-tax returns through active selection.” *Journal of Financial Planning*, p 74.

proportion of the total return from equities being distributed by way of dividend, thereby diluting accretion of capital. Further, we have not had the same steepness of run-up to 2000, as enjoyed by the US market. And thirdly, the absence of any tax management in Australian funds, and hefty turnover rates (see below) may have resulted in tax inefficiencies and high distribution levels, and hence this would militate against tax efficient “back-ending”.

However, this does not deny the seriousness of the issue, the need for disclosure (see below) and fund constitution terms to deal with the “last man standing” problem – ie, massive fund redemptions, triggering gain crystallisation, leaving those investors not redeeming with the forced gain crystallisation issue and its tax consequences. This issue has been referred to as the “classic externality”, in that the after tax return of investors in mutual funds depends upon the behaviour of others.<sup>72</sup>

The reluctance of Australian managers to divulge or even to discuss the “overhang” issue of unrealised capital gains, is perhaps explicable when one considers the findings of Bergstresser and Poterba (2002).<sup>73</sup> This comprehensive study found that, based on a large sample of retail equity funds over the period 1993 to 1999, after tax returns have more explanatory power than pre-tax returns in explaining fund inflows. Moreover, funds with large “overhangs” of unrealised capital gains, experience smaller inflows – all else equal – than funds without such overhangs. Their weighted results imply that a 10% increase in the share of unrealised capital gains, relative to fund assets, is associated with a reduction of between 1.7 and 2.3% in fund inflows – overhangs count in US business development. They considered this to support the earlier findings of Khorana and Servaes (1999), that new funds are more likely to be created in parts of the mutual fund marketplace that are occupied by established funds with substantial capital gain overhangs. The gross outflow effect is consistent with taxable investors being reluctant to sell shares in, and realise gains in, funds that have large embedded capital gains.

### **An Australian sample of tax efficiency**

After examining the US position, a study was implemented to see if the US conclusions hold good in Australia, particularly in relation to turnover. Twelve Australian managers were approached to provide data, five declined the invitation, and seven provided complete data in most areas, although all declined to divulge unrealised capital gains within current unit prices. Those who declined to provide any data were mostly major, mainstream, managers with large asset pools.

In the request for data, an unqualified undertaking as to confidentiality was given in writing, and it was stressed that the analysis would be disclosed in such a way that data will only be disclosed in “generic terms – ie, anonymously, so that it would not be identifiable as relating to your fund. There will be no reference to your name ... My intention is to produce a meaningful industry sample, rather than a comprehensive survey ...”. A standard template was developed and provided to the fund managers, which made it obvious what the research was trying to do – as did the text of the letter requesting data. After the first approach to a manager, who did co-operate, it was made clear that no information as to unrealised capital gains would be divulged by any manager. Then, the request was limited to two areas: firstly all that information which was already in the public domain, namely unit prices, pre-tax return

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<sup>72</sup> Dickson, Joel M., John Shoven., and Clemens Sialm. 1999. “Tax Externalities of Equity Mutual Funds.”

<sup>73</sup> Bergstresser, Daniel., and James Poterba. 2002. “Do after-tax returns affect mutual fund inflows?” *Journal of financial Economics*, 63 p 381 – 414.

numbers, and the tax composition of distributions – all of which is available to unit holders; and secondly, levels of fund turnover.

The five managers who declined gave various reasons, including not wishing to divulge the “sensitive and confidential nature of some information”, and, from one of the big four banks, that they were “unfortunately unable to allocate the resources to compile the information at this time.” Interestingly, in one case, the declining manager made reference to the need for focus on after tax returns in their public promotional material. No conclusion may be drawn from these denials, save perhaps, that disclosure is not a priority for these managers, which is a point addressed below. It is possible that these managers are high turnover tax-inefficient managers, but such a view is not necessary to reach the conclusions made below. The analysis resulting from the seven managers who did co-operate is ample.

Each of the managers who did provide data, is a mainstream institution who has issued a Product Disclosure Statement, and its Australian equity fund is available (eg, through “WRAP” accounts or directly) in both the retail and institutional markets in Australia. Four are major international institutions, the remaining three being domestic. They provided five years of data (2003 back to 1999, but four years in once case) that enabled the following model to be constructed for each:

A – unit price at July 1, post distribution

B – cash distributions, cpu, for the year to June 30

C – capital gain 50% discount reduction component

D – tax-free or tax-deferred component

E – franking credits, cpu

F – taxable cpu distribution in hands of unitholder:  $B - C - D + E$

G – total pre-tax return % per manager

H – total net (post MER) pre-tax return cpu:  $A \times G$

I – retained capital return/gain cpu:  $H - B$

J – tax at 48.5% MTR cpu:  $F \times 48.5\% - E = \text{net}$

K – post tax (48.5%) total return:  $H - J \div A/100\%$

T – annual fund turnover

From this data tax efficiency was calculated as: after tax return (K), divided by pre-tax return (G)  $\times 100 = \%$ . Thus, if efficiency was, for any year, 90%, then 90% of the pre-tax return was retained by the top MTR investor. This approach is perhaps rudimentary, in that it does not account for the time value of mid year cash distributions (etc), but this was sacrificed in the quest for simplicity. The tax efficiency for each year was averaged over the sample period.

The results were:

Fund	Tax efficiency %	Turnover %
A	99	20
B	94	44
C	91	Low
D	91	23
E	87	High
F	85	72
G	81	86

Notes: Fund “C” did not provide its turnover, but due to its style and investment mandate/strategy, it is likely to be low. It does target a very low number. Fund “E” did not provide its turnover, and due to re-structuring issues, may be quite high, perhaps comparable to Funds “F” and “G”.

This result is consistent with the US theory and analysis. As noted above, turnover levels do not tell all, in terms of tax efficiency, but for the reasons already stated (and see below), they are likely to say a good deal in the Australian context – and it appears that they do. Low turnover funds are the most tax efficient, and by a considerable margin. Other comments that may be derived from the analysis, which – for reasons of confidentiality cannot be fully disclosed – are that:

- There is little correlation between tax efficiency and the absolute (pre or post-tax) return. Thus, the best performing fund, pre and post-tax, was “F”; it is an active fund, and perhaps its turnover generating alpha was the cause of greater tax inefficiency – it may be an ideal candidate for a form of tax-advantaged strategy
- Fund “A” rated highly, both in terms of tax efficiency (best) and absolute (pre and post-tax) return (near top)
- In all cases, the years 1999, 2000 and 2001 were consistently good for returns, and 2002 and 2003 were dreadful, and negative in some cases. The degree of tax inefficiency may thus be understated, and it is considered that for this year, the 2004 data might well produce more polarised results
- There does not appear to be correlation between the actual level (cpu) or proportion of retained capital gains, in “I” and tax efficiency, and this may be due to differing cashflows into the funds, and the differing impact such cashflows have on the fund due to size, etc
- The bottom three funds did not apply any tax efficient accounting (eg, no FIFO) and nor did they use active tax management by loss harvesting. The top Fund A, applied both and was the only fund to use loss harvesting, and three of the top four used FIFO accounting for sales. This, again, corroborates that turnover in Australia does tell the investor something, as save for Fund A, all turnover was “bad”.

Net, net, the findings corroborate the US experience.

### **Disclosure and buying a pig in a poke**

Whilst all the issues and the net commercial effect for after tax returns seem to be the same for US and for Australian investors, there is one stark difference: disclosure. In the US, as noted above, a politician entered the disclosure fray upon learning of the seemingly obscure tax injustice of investment into a mutual fund: the investment lost value, but a taxable distribution added insult to injury. Legislative hearings ensued, and eventually resulted in the US *Mutual Fund Tax Awareness Act* 1999,<sup>74</sup> which was not, in the event, signed into law. However, whilst this process was underway, the SEC joined the debate and in 2000 initiated moves itself to placate the public and the legislature. SEC Chairman Arthur Levitt Jr., spoke out on the tax implications of mutual fund investing. Many investors “lack a clear understanding of the impact taxes have on their mutual fund returns” he was quoted as saying.<sup>75</sup> He cited the US\$34 billion that stock and bond investors paid in taxes on fund distributions in 1997, and in March 2000 the SEC issued proposed rules requiring disclosure of after-tax returns in prospectuses.

The industry did not fight the SEC on this point, as it could be seen which way the political wind was blowing, and through legislation, the industry could have been worse off. Since 2001, prospectuses show pre and post-tax annual returns for prior years (one, five and ten years, or since inception), with the post-tax numbers based on the highest Federal MTR for the relevant year of distribution. There are two separate calculations: pre-liquidation, ie assuming no sale of shares/units in the fund; and post-liquidation, which assumes disposal – which therefore captures the unrealised capital gains at the end of the year. Broadly, these are the best case and worst case tax scenarios.

The SEC has issued guidance on how the calculations should be made, and for the loss years of 2000 – 2002, there were instances of after-tax returns being higher than pre-tax returns due to netting of losses, etc. Thus, the SEC has implemented a *de facto* solution. Interestingly, unrealised capital gains are not disclosed prominently, but the data is buried in the public accounts, and can be determined by analysis<sup>76</sup> – see below re Morningstar. Rates of turnover for prior years are also now in US prospectuses.

As well as disclosure in public offering documents, the US has data available from the rating agencies, eg: Morningstar and Lipper. These organisations have free web site data, which tell a great deal as to the tax attributes of each fund. In the case of Morningstar, there is information on turnover, plus a “Tax Analysis”, which includes: pre-tax return; a “tax-adjusted return”; % rank in category on post tax basis; a “tax cost ratio” (which is a tax efficiency rating by reference to a percentage point reduction in return lost to taxes, and thus, like a MER, the smaller the better – contra the approach in the table above); a “potential capital gains exposure”, which captures unrealised capital gains and realised gains pending distribution.

This information provides the investor and their adviser with the information to make an informed decision about a fund. Of course, it is possible to draw erroneous conclusions from one bare number – for example, an investor might see 25% for the unrealised capital gain of

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<sup>74</sup> Fleming, Peter, D., 2000. “A Taxing Problem – When a fund’s manager factors taxes into investment decisions, investors should do better.” *Journal of Accountancy*, online Issues, May 2000, see “Congress Chimes In” where the history is outline. Acknowledgements also to Dr Joel Dickson for conference background points.

<sup>75</sup> Fleming, *Ibid*.

<sup>76</sup> It should also be admitted that the determination of after-tax returns, taking unrealised gains into account, is not without its own complexities: see Poterba, James. 1999. “Unrealized Capital Gains and the Measurement of After-Tax Portfolio Performance.” *The Journal of Private Portfolio Management*, Spring, pp 23 – 34.

an S & P 500 Index fund, and assume that it is less tax efficient than another 8% fund, and yet the latter is less efficient because it has crystallised large capital gains and distributed them. This example itself raises one of the conundrums of tax managed investing: the more efficient a fund is, the more it back-ends the problem and produces large unrealised accretions to capital value, which may only be ameliorated by large inflows. Low unrealised gains, may well only confirm past tax inefficiencies. This is not an area for the uninformed.

This conundrum was recognised early in the US debate, and led to a conclusion that existing US fund shareholders (mutuals are companies in the US) and potential new investors have different preferences concerning the realisation of capital gains.<sup>77</sup> Existing investors would prefer to defer gains as long as possible – but this creates the overhang for new investors. And, as is argued in this paper, if the probability for large net redemptions is sufficiently high, then a large overhang makes the fund undesirable to new investors. There is thus an incentive – where this overhang is disclosed – for the manager to limit the overhang by realising capital gains with turnover<sup>78</sup>. Overhang data has been available in the US through Morningstar since 1993.

Against this US backdrop the **Australian** position is unsatisfactory. Here, the investor knows nothing of: turnover; unrealised capital gains in the unit price; nor the tax efficiency of the fund. Unless something specific is said on tax management in the product disclosure statement (**PDS**), it is safe to assume that the fund is not managed with any concern as to tax. Rather, and at any tax cost, the manager is straining to achieve maximum pre-tax return – for the advertising agency to use.

It does appear in Australia, that there are several equity funds with very high levels of turnover (say, 80 to 100% or more), as there are in the US. If a fund has a 100% turnover, its average holding is 12 months, and by implication it is likely that around one half of its holdings will be for less than 12 months. If this is so, the first issue is loss of the 50% capital gains discount. The second, more problematic if theoretical issue (at least it appears to be theoretical so far) is whether the fund is, in tax parlance, a share trader or a capital investor – as if the former, then no 50% discount will be available, no matter what the holding period of any specific stock/lot. A proper analysis of this legal issue is outside the scope of this paper. Suffice to say, that if a private share investor was tax audited, and it was seen that they consistently had 100% turnover for many years (not one isolated year due to market volatility etc), then the ATO may well contend that they are on revenue account, irrespective of the actual subjective intent of the investor. The revenue/capital account issue is one of the most difficult in tax law, and there is no precise answer to it.

Given the evidence provided in this paper, it would seem reasonable to expect that basic tax related information should be provided in our PDSs. By s 1013D of the *Corporations Act* (Cth) 2001, the main content requirements for a PDS are set out, and the information must include “such of the flowing information as a person would reasonably require for the purpose of making a decision, as a retail client, whether to acquire the financial product: ... (h) general information about **any significant taxation implications** of financial products of that kind;”. Further, in s 1013E there is the catch-all requirement that a PDS must contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as retail client, whether to acquire the product.

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<sup>77</sup> Barclay, Michael J., et al, 1997. “Open-end mutual funds and capital-gains taxes.” *Journal of Financial Economics*, 49 (1998) pp 3 – 43.

<sup>78</sup> *Ibid*, p 12.

Surely, if there is a large unrealised gain in the unit price, that should be disclosed. Equally, if the fund is turning over 90% or 100% per year, and some might consider that it is rather a “share trading” fund than an investment fund, then this should be stated. Clearly, funds with passive strategies and low turnover have a different investment profile than highly active ones shooting for alpha. The absence of any tax-advantaged policy of the manager should also be able to be weighed on the scales. This is not to say that high turnover funds are bad – the evidence cited above gainsays that. There is nothing wrong with investing in a share trading fund, if the investor appreciates the risk and the potential reward – and the possible after tax dilution of such reward. In the end, disclosure is about fairness and economic efficiency, and whilst the analogy to accounting disclosure for listed companies is hardly apposite, the fundamental principal of linkage between financial reporting and economics is relevant.<sup>79</sup>

### **Share trading and tax**

The issue is raised above as to whether certain investment funds might be more accurately categorised as share trading funds, and indeed, some hedge funds in Australia (eg, long short funds) are so categorised for all of their holdings. However, virtually all “long” only funds are on capital account, notwithstanding that some have very high turnover rates. It is now contended that this situation may well be at variance to tax law.

The question as to whether shares are held on capital or revenue account is a vexed one which has delivered a large body of case law over the years. This law will not be fully analysed here, for the reason that much of it may not shed a great deal of light on the current position, now that we have capital gains tax with differential short and long term rates under the 50% discount for individuals – or 33% for super funds in accumulation. Case law has been driven by different taxpayer objectives in prior periods, eg: contending that shares were held on capital account for “long term investment” so as to avoid tax before a capital gains tax was introduced;<sup>80</sup> or contending the opposite where the taxpayer had realised large losses, and wanted to offset these against income.<sup>81</sup> With this caveat of the risks/distortions associated with looking through old spectacles into the current CGT tax scenario, it is still possible to identify principles, that as a matter of precedent, are still applicable today, unless some legislative intention makes them inapplicable to a specific factual matrix. Indicia of share trading include:

- Repetition and regularity
- High turnover
- Whether operating to a plan, setting budgets and targets
- Nature of the activity and whether it has the purpose of profit making
- The complexity and magnitude of the undertaking
- An intention to engage in trade routinely or systematically
- Operating in a businesslike manner and the degree of sophistication involved
- Whether any profit/loss is regarded as arising from a discernable pattern of trading

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<sup>79</sup> See generally: Verrecchia, Robert, E., revised 3 April 2001. “Essays on Disclosure.” *Journal of Accounting and Economics*, pp97 – 179, a somewhat weighty analysis.

<sup>80</sup> Case S33, (1985) 1 ATC 297, where the wife of an accountant was held to be share trading, due to repetitive and regular transacting, system and selection of shares, volume and amount of capital employed.

<sup>81</sup> Case W8 (1989) ATC 171; Case X86 (1990) ATC 621; Case 35/94 (1994) ATC 318; Case 9/94 (1994) ATC 154, where held that viewed objectively, activity could not be characterised as trading in shares, because after being burned in the 1987 crash, the taxpayer had abandoned any intention to engage in share dealing regularly, routinely or systematically.

- The volume of operations and the amount of capital employed.<sup>82</sup>

After a review of case law, it does seem clear that many fund managers may well be categorised as share traders as apposed to passive long term investors on capital account. Sure, if there has been some extraordinary event, that has caused market dislocation and unexpected turnover through unprecedented action (eg, September 11), then this might be explained away, and could be taken as an exception. However, if the manager is regularly turning over 90% or 100% of stock over a multi-year period in relatively stable market conditions (eg, 1999 through 2003), and this turnover was due to the manager's opportunistic active style, and not to fund cash inflows or outflows; then why would the authorities not apply to determine trading?

It is understood that one argument propounded to support the "capital" case, is that of unit trusts being subject to trust law, and the trustee (now responsible entity) being charged with the preservation of capital. This many well be so, but the revenue/capital account issue must turn on the actual facts, and not on what the trust deed (now constitution) implies that they should be. Of course, the facts and commercial implications will determined whether investors are better to have pooled funds on capital or revenue account: revenue is best where losses are incurrent and will not therefore not be quarantined; and capital will be best where assets are held over 12 months and the 50% discount applies.

On the analysis done with the seven Australian equity funds, there was a low proportion of distributed gains attracting the 50% discount. This may be partially due to market conditions, or to our relatively high dividend payout ratios, and it must also be linked to turnover and average holding period. Given the positive long term returns from the ASX, and the after tax investment objectives of private investors, it is clear that investors have a strong interest in increasing the concessional component with a 50% discount – which equates to a saving of 24.25% in tax to top MTR investors.

It may well be that the ATO sees no great value leakage with the current state of affairs, and simply turns a blind eye. Also, if 90% turnover dictates share trading, what of 40%? However, given the potential for disruption, some more certainty appears to be appropriate – for the benefit of both investors and responsible entities, ie fund managers. Fund managers are not paid to take risks arising from tax audits and the potential retrospective unscrambling of years of tax leakage. A similar issue arrises in relation to LICs, discussed in Section 3B below and the choice of tax effective accounting.

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<sup>82</sup> Case X86 *Ibid.*

## Section 3B

### Listed Investment Companies

#### LIC structure and comparison to unit trust

LICs are not managed funds in the mutual fund or Australian unit trust sense, they are listed companies, which happen to invest in (mostly) other listed securities. Unit trusts exhibit a degree of tax neutrality and transparency, in that the tax consequences of what the fund manager does with fund assets inevitably passes through to the investor each tax year – save that realised losses are not distributed. Thus, income and realised capital gains are not taxed within the fund, but flow through to the investor, with the same categorisation as they have within the fund – ie, over/under 12 months for 50% CGT discount, all franking credits etc.

By contrast the LIC is taxed as a company at 30% on all taxable income. Under the imputation system franking credits flow into the LIC through dividends from its investee companies, and it may also generate its own franking credits by incurring tax, eg from realised capital gains. The franking account of a LIC will grow until it is distributed to LIC shareholders. This is another difference, for there is no guarantee with a LIC that all franking credits will be distributed, as this is at the discretion of the manager – see below. Most dividends from the older LICs (eg, AFIC and Argo) are fully franked, but of course, this does not necessarily stop the build up of franking credits.

#### Distributions to investors

LIC shareholders generally only receive one form of distribution: dividends. LICs do not generally use off-market share buy-backs<sup>83</sup> or reductions of capital to return funds to shareholders – they can always find a use for additional capital and the concept of “surplus capital” does really lend itself to a LIC. Thus, subject to one qualification relating to the 50% CGT discount, all distributions to shareholders are on revenue account, and they hold their LIC shares on capital or revenue account, depending upon their personal position and whether they are share traders.<sup>84</sup>

When the new business tax system was introduced there was great controversy over the question as to whether LIC investors should enjoy the CGT 50% discount for investments made within the LIC. The issue being, that the discount was not to be given to companies, and – it was said – why should a LIC be an exception? This controversy caused the shares of old/established LICs (with large unrealised capital gains) to trade at a significant discount to net tangible assets (NTA), pending resolution of the issue. Suffice to say that lobbying by the house of Were (and others) prevailed, and that amendments were introduced to, effectively, pass through the discount.

Since July 2001, certain dividends (sourced from 12 months plus holdings/sales) paid to LIC shareholders may be classified as “eligible capital gains”, which reduce assessable income by the 50% discount component. Thus, the shareholder enjoys the same benefit of reduced assessable income as they would have enjoyed had they held the (12 month plus) asset directly themselves. To claim this deduction, the shareholder must be a resident individual,

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<sup>83</sup> They do however use on-market buy-backs, which seem to be more directed at smoothing trading share prices, where these trade at a premium to NTA, and perhaps for enhancements to EPS, rather than for capital management to correct a “lazy balance sheet”.

<sup>84</sup> See the discussion on this capital/revenue point in Section 2B “Share trading and tax” in relation to fund turnover.

trust/partnership (some flow through applies) or a complying superannuation fund or life company, with the latter two receiving a 33.3% reduction. The LIC dividend statement will contain a statement to separately identify this “LIC capital gain”, and this component may also be franked.

In order to qualify for such dividends, the LIC must hold the relevant assets on capital account,<sup>85</sup> and be a listed company with 90% of the value of its CGT assets consisting of “permitted investments” – broadly, listed securities, financial instruments and assets used in its business to derive income, including shares in other LICs. There is a 10% concentration limit for the LIC investing in another company.

### **Disclosure and commercial issues related to tax**

When viewing these issues it is possible to broadly categorise them as:

#### **Positive**

- There is greater disclosure of the unrealised gain tax position for LICs than with managed funds, due to monthly statements to the ASX (to month end, due 15<sup>th</sup> each month but generally provided earlier) of the NTA position, which is reported on a pre-tax, and post-tax basis, where LICs estimate the tax payable on gains on a full liquidation basis. This is readily observable on the ASX web site under company announcements, and is therefore far more satisfactory than the opaque unrealised capital gain position with unit trusts.<sup>86</sup> This monthly disclosure is analysed by the research departments of institutional broking houses (eg, Goldman Sachs JBWere), and accordingly the information is soon absorbed in trading prices – although this does not result in convergence on trading prices to NTA<sup>87</sup>, and indeed some LICs trade at an incredible premium, eg Platinum Capital 35% over post-tax NTA end May 04. The statutory and half yearly accounts also reveal tax matters, that analysts may examine
- The LIC manager does not have to deal with redemptions or applications, and can manage the pool of assets as one constant discrete pool, unlike a unit trust. One positive to come out of this, is that the LIC is not subject to the “last man standing” risk, outlined in Section 2B above – a run on the fund, triggering crystallisation of capital gains to the detriment of remaining unit holders
- High marginal rate taxpayers (**MTRs**), may well be pleased that the LIC is not forced to distribute realised capital gains, as in a unit trust, as notwithstanding the tax paid by the LIC and the available franking credit, they would be better off to defer distribution and leave this value in the share price

#### **Negative**

- As the LIC is, effectively, a closed-end fund (subject to new issues or on-market buy-backs), the manager does not have the benefit of new funds flowing into the pool of assets, which can be effective for tax management, in that this has the effect of raising the cost base from new buys, and coupled

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<sup>85</sup> This is not always the case: for example it is understood that Platinum Capital had to change to revenue account at the insistence of the ATO, as this company does “short” and engage in other trading-like activities, but in the event this was beneficial to investors as it eliminated quarantining and enabled set-off against derivative trading losses, etc.

<sup>86</sup> See discussion of this point in Section 2B.

<sup>87</sup> As is the case with ETFs – see Section 4B.

with optimal accounting (eg, FIFO), this can have the effect of decreasing realisation of capital gains, which defers tax – see Section 2B above

- LIC managers are paid fees on FUM (funds under management, being the NTA), and hence there is a form of conflict between dividend policy to shareholders and optimisation of the manager's profit and margin. Most major LICs tend to adopt a dividend smoothing policy, which they quite genuinely believe is in the best interests of unit holders – many of whom are simply looking for a stable income flow of fully franked dividends. This can be positive in a LIC, and it can result in a dividend payout ratio of over 100% in poor return years, as LICs can pay dividends out of reserves, unlike unit trust. However, it can also result in the accretion of franking credits, to the detriment of shareholders, as undistributed imputation credits are in reality a form of interest free loan to the Federal Government. Shareholders have no effective control of dividend policy, and simply have to live with what they get – which, to low marginal rate or nil rate taxpayers, means value deferral, as they cannot get the cash refund.

This paper does not address the non-tax commercial issues that arise in relation to LICs, and in particular the premium/discount problem, the difference in regulation of LICs to trusts (LICs are not managed investment schemes), and the recent increase in small LICs with a varying quality/depth of management. From a pure tax perspective, LICs do have attractions for both high and low MTR investors, and perhaps the simplicity of distributions from the large LICs<sup>88</sup> and the consistency in fully franked dividends does serve the interests of most shareholders, notwithstanding any deferral in distribution of franking credits.

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<sup>88</sup> It is understood that the level of 50% discounted gains (eligible capital gains) is very low, and hence this complexity seldom arises, or this has been so historically.

## Section 4B

### Exchange traded funds

#### Origin and structure

As with most financial innovations, Exchange Traded Funds (**ETFs**) originated in North America in the 1980s, with Standard & Poor's introducing the first US ETF<sup>89</sup> in 1993 on the American Stock Exchange. They were able to grow and operate because of the advent of computerised program trading, which enables institutions to trade in numerous stocks within a prescribed "basket".<sup>90</sup> In Australia, this is often called a "blocked trade." This ability to marshal a wide, index based, basket of stocks is essential to operation of the ETF. At the end of April 2004 there were 304 ETFs with assets of US\$227 billion, managed by 35 managers on 28 exchanges around the world.<sup>91</sup> ETFs have become immensely popular for both individuals and institutions. Why is this so?

The answer lies in: low cost, trading close to net asset value (**NAV**), close tracking of a specified benchmark index, transparency, ease of transacting and tax efficiency. In essence, ETFs have many of the attributes of an open ended managed fund, save for one distinguishing feature: rather than applications and redemptions being in cash at NAV, brokers are invited to tender baskets of stocks into the listed ETF in exchange for units/shares of the ETF, and visa versa applies on any redemption – ie, the ETF pays the holder in-kind by the transfer of a basket of stocks. Retail/individual investors may not transact in this way, instead they simply buy/sell the ETF units on market, as with any other traded security, and hence they are concerned with liquidity and a trading price close to NAV. They also have an interest in the costs within the ETF (the term "**MER**", for management expense ratio, is used for ETFs as with managed funds), and in how closely the ETF tracks the given benchmark in its internal stock holdings and its consequential total return relative to the given index – the tracking error.

Accordingly, assets flow into and out of the ETF through the primary market, but under the control of the ETF manager. Institutions and individuals can go "long" (including, with external leverage) the ETF by physically holding listed ETF shares/units, or they may short this security on market, which means – depending upon the ETF benchmark – that they are shorting the market or the benchmark/index sub-set of the market on which the ETF is based. Thus, in the US and in Australia, ETFs are used as a substitute for futures.

Experience in the US has shown that ETFs trade with very low spreads relative to fair value and have low tracking error. A 2002 study of US listed "Spiders"<sup>92</sup> being Standard and Poor's Depository Receipts, found that when the price return was compared to the price return of the S&P 500 there was "almost no difference ... On average, the Spider NAV price return and the return on the standard S&P Index are the same. The range is from -6 bps to +8 bps per year, with 4 years positive and 2 years negative. It appears that, against the S&P Price Index, the shortfall is very close to zero. Failure to exactly hold the index is as likely to lead to superior performance as to inferior performance, and over the period the shortfall could be

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<sup>89</sup> Bansal, Vipul K., and A. Somani. 2002. "Exchange Traded Funds: Challenge to Traditional Mutual Funds." *Review of Business* Fall: 40-43.

<sup>90</sup> *Ibid*

<sup>91</sup> Morgan Stanley Institutional Equity, Exchange Traded Fund Strategies, *Global Summary as of April 30, 2004*. London.

<sup>92</sup> Elton, E. J., M. J. Gruber., G. Comer and K. Li. 2002. "Spiders: Where Are the Bugs." *Journal of Business* July, Vol 75 Issue 3: 453-473.

plus or minus. The effect of transaction costs, any missed capital changes by S&P, and mismatching are quite small, and the total effect of all these influences leads to virtually no difference”.<sup>93</sup>

On an accumulation basis, Elton et al found that Spiders underperformed the S&P 500 by an annualised 28 bps, and attributed this to the 18 bps MER charged against the fund, and 10 bps due to the return shortfall, caused by putting dividends in a non-interest bearing account or by not reinvesting dividends, at the time of payment, in the underlying stock – with quarterly payments of dividends and a period annualised total return of 22.2%, it was easy to derive annual value leakage of around 10 bps.

This low or zero tracking error is a consequence of the “true to label” internal management of the fund, and the fact that the professional market is always looking for an arbitrage opportunity to exploit should the trading price of the fund stray far from NAV. If there is a significant difference in the cost/value of a prescribed basket of stocks, which replicate the index, and as specified by the ETF manager and published daily, then the arbitrage traders will exploit that difference by tendering stock or redeeming as the case may be. Where the ETF is trading at a premium, the broker will buy the basket on market at what will be NAV, then tender this stock into the overpriced ETFs of greater market value, and then sell the acquired ETF shares/units for a riskless profit.<sup>94</sup> If trading at a discount, the broker would buy the ETF units on market and then redeem units for a basket of underlying stocks at NAV.

In the US much had been made of the tax efficiency of ETFs<sup>95</sup>, and this may be summarised as being due to:

- Passive management which reduces operating cost and volatility – ETFs are passive funds which track an index, they do not attempt to actively outguess stock valuations through research and stock picking. Rather, their goal is efficient index replication, which results in:
- Very low turnover within the fund – the Spiders analysis observed turnover of 4% P/A, this being due to composition changes to the index. This can vary from year to year, and in Australia is certainly an issue (eg, as currently with NCP), but a minor one overall. This low turnover within the ETF pool results in low realised capital gains, and – of course – low operating costs
- When institutions redeem, and are paid in-kind through what is effectively a “block trade” being a basket of index stocks, the ETF transfers out its lowest cost base stock, thereby protecting the position of current ETF unitholder. This leaves a higher cost basis and reduces the potential for crystallisation of capital gains when/if the ETF does have to sell stock for index tracking.<sup>96</sup> In the US, a redemption is not a tax event for the fund, and therefore there is no capital gains tax. In Australia, the cost base is assigned to the redeeming broker, which in effect transfers the capital gains tax exposure to the broker
- Transacting in the ETF by individuals (ie, buying and selling on market) does not impact the internal pool of assets, as it does in a managed fund, where the cash washes through the fund and causes purchase/sales of underlying stock. This non-institutional activity relating to an ETF, causes no transacting at all

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<sup>93</sup> *Ibid.*

<sup>94</sup> King, S. 2002. “Mutual funds: Investment of Choice for Individual Investors.” *Review of Business* Fall: 35-39.

<sup>95</sup> Bernstein, Phyllis J. 2002. “Investments.” *Journal of Accountancy* (January): 40

<sup>96</sup> *Ibid*

within the ETF, and hence avoids virtually all of the capital gains problems associated with mutual, open-ended, managed funds as discussed in Section 2 above<sup>97</sup>. The only transacting within the ETF pool, is for index replication and applications/redemptions with institutions when stocks flow into or out of the ETF by in-kind transfers

- All dividend distributions pass through the ETF, which in the US is structured to qualify as a Regulated Investment Company under the US Tax Code – and thus, dividends are not taxed within the fund.

### **The Australian experience**

In Australia, ETFs had a rocky start. In 2001 there was considerable industry activity and several of the major global ETF players were muted as being in the process of launching ETFs: Barclays Global Investors; Salomon Smith Barney (as it was then known); BNP Paribas; and State Street Global Advisors (**SSGA**)<sup>98</sup>. In the end, only SSGA was left standing in the Australian ETF market, and it has gradually built three ETFs, each being structured as an Australian unit trust: streetTRACTS S&P/ASX 50; streetTRACTS S&P/ASX 200; and streetTRACTS S&P/ASX Listed Property – all now regulated under the one Product Discloser Statement (**PDS**) of 3 October 2003. Naturally these ETFs track the index in their title.

The PDS and promotional material for these funds does mention tax issues, but this is not featured as a key advantage of the funds, perhaps due to complexities. This paper is however primarily concerned with tax and will therefore ignore the other issues/advantages – which should be assessed by any investor.

The PDS shows that these ETFs have been structured to operate in the same way as their US forebears. This has resulted in the following features/consequences:

- **Tracking** – they closely track the relevant index: take the S&P/ASX 200 fund, to see that as of 30 April 2004<sup>99</sup>, going back to inception on 30 September 2001, the S&P/ASX 200 Accumulation Index returned 5.55% annualised, and the fund returned 5.54% gross of fees and 5.21% net – the 33bps difference is largely attributable to the MER of 29 bps. During this 31 month period the average annual distribution has been 3.06% and the annual price return has been 2.07% (= 5.13 which does not precisely match net 5.21 due to compounding) – and, as one would expect in such a passive fund, the distributions have been stable, unlike many active funds (see Section 2 above)
- **Trading price to NAV** – they have traded at close to NAV: for the S&P/ASX 200 fund on 30 April 2004 the last traded prices was \$34.64, C/F NAV of \$34.67 – a negligible 9 bps discount, C/F the premiums/discounts for Listed Investment Companies discussed above. This result is the direct consequence of fund management by SSGA through the application/redemption process, and the institutional quest for a risk free arbitrage profit, as outlined above. It is this process, which is partially reactive to retail trading in the ETF stock, which ensures pricing close to NAV – and recall, the market can hold a degree

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<sup>97</sup> *Ibid*

<sup>98</sup> Chaplin, David. 2004. “The Track Less Travelled: ETFs make a comeback.” *Independent Financial Advisers* (Issue 218): 32-33 – where a good historical overview is provided

<sup>99</sup> streetTRACTS Detailed Performance Analysis as at 30 April 2004, provided by SSGA, and see [www.streettracts.com.au](http://www.streettracts.com.au)

of confidence that this NAV is relatively “pure” (see below) in the sense that it is not carrying a high embedded tax liability through unrealised capital gains

- **Liquidity** – any broker registered with the exchange can (effectively) be a market maker, and bids/offers appearing on the screen are not always indicative of the depth of liquidity
- **Distribution pass-through** – all dividends and franking credits (etc) are passed through, although there is some divergence in the distribution rate due to the issuance/redemption process of in-kind transfers with institutions, as the timing and quantum of these can impact upon the actual cash distributions from the ETF pool of assets, and this flows through to impact the franking credit rate
- **Capital gains** – save of the first 9 months to June 2002, the S&P/ASX 200 fund has not distributed any capital gains to December 2003. This ties in with the structure for in-kind institutional applications/redemptions and the passive nature of the fund. As with all other managed funds in Australia<sup>100</sup> there is no published statement as to unrealised capital gains within the unit price, but for the reasons outlined in this Section, one would expect them to be very small as a proportion of the unit price – if any. If FIFO (first in first out accounting) is used for in-kind transfers, then the fund is constantly raising its cost base, and assuming rising markets, this transactional wash-through will diminish the accretion of unrealised capital gains
- **Institutional application/redemption mechanics** – are detailed, transparent, and appear to be designed to minimise performance impact on the fund, with one of the consequential advantages being tax efficiency. Thus, the fund NAV and the “prescribed parcel of securities” required for institutional in-kind applications (ie, tendering stocks into the fund) are published daily on the internet. There are special ASX approved trading and settlement procedures for the in-kind application and redemption facilities. In the case of redemptions, there are mechanics dealing with the tax year end wash-up for matters that cannot be conclusively determined at the time of redemption. “The split between the components of the Withdrawal Amount are not known until after the financial year end because each of the Withdrawal Unit Income Entitlement and the Withdrawal Unit Distribution Entitlement represents a relevant share of the total capital gains and other taxable gains which have been realised by the fund as a result of transferring Index Parcels to redeeming Unitholders during the financial year.”<sup>101</sup> It follows that there is effectively a mechanism for attributing any realised capital gains, caused by a redemption and in specie transfers, to the redeeming party, rather than the fund being forced under the *Tax Assessment Act* to distribute them to other (non-redeeming) ETF unitholders. “Special attribution accounts are maintained by the Responsible Entity in respect of each redeeming Unitholder for each financial year to determine the extent of the capital gains and other taxable gains accrued to the Fund as a result of that Unitholder’s redemption activities.”<sup>102</sup>

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<sup>100</sup> The author has not conducted a survey to verify this statement, but he has never seen it during eight years of investment advising and study.

<sup>101</sup> streetTRACTS Produce Disclosure Statement 3 October 2003, p16

<sup>102</sup> *Ibid* p37

## Conclusions and comments

Australian ETFs would appear to be highly tax efficient for any investor wanting a benchmark return from investment. From the individual's perspective, they do not have the embedded tax problems of managed unit trusts, and they also appear to be more transparent – and hence disclosure is not such an issue as it is for unlisted unit trust funds. They do have different tax dynamics than a passively managed unit trust (ie, an index fund), but whether they are a better investment proposition than such a fund, is a question involving additional non-tax issues, which are outside of the scope of this paper.

Ex facie, they appear to deliver that which they promise.

It might be considered surprising why ETFs have not blossomed in Australia (as they have in the US) and that there is only one provider: SSGA. Perhaps these issues have a bearing:

- Why would a private client stockbroker recommend investing in a listed ETF? Firstly, there is an implicit admission of defeat: the broker is supposed to be able to do better than the market. Further, and after the initial trade on commission<sup>103</sup>, the likelihood is that the client will hold the ETF for a very long time, unless the client is so bold, or the adviser is so bold, that they consider they can outguess the overall direction of the market and trade in and out under such superior foresight – few would be so bold. After the initial purchase of the ETF, there is (absent bold market direction insights) nothing for the broker to advise on. The ETF tracks the index and its trading price is virtually always at NAV. There are limited research insights, and this is evidenced by the dearth of ETF research in Australia
- Many financial planners do not advise on direct listed securities (which ETFs are), and where, under their license authority and educational certification of competency they can, there is no research on which to base a recommendation. There is no research, as there is nothing to research – the ETF is blindingly transparent. Ergo, the adviser, in order to make an investment recommendation, has to achieve a high level of understanding of the ETF so that, as required by the *Corporations Law* the adviser has a reasonable basis for making the recommendation: s 945; and this basis should be set out in a Statement of Advice: s 947(2)(b). As the equity research houses and fund manager rating agencies do not cover ETFs, the dealership group (ie, AFSL holder) would need to conduct its own enquiries and communicate this to the adviser/representative. This might involve, at the least, a thorough reading of the PDS, and an investigation into trading activity of the ETF (eg, by charting the ETF against the relevant index) and checks on liquidity levels.

It is to be hoped that more attention is applied to ETFs in future, as they do appear to provide a tax efficient vehicle for a given investment objective.

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<sup>103</sup> This issue is also addressed in Section 1 above, where there is a contention that divergence of interest can arise, as between broker and client.

## Section 5B

### Separately Managed Accounts

#### **Born in the USA – to solve a problem**

Once again, we look to the US for this financial innovation. Firstly the terminology: “SMA” is the term most used in the US and refers to separately managed accounts. This Section is primarily concerned with these accounts, and their structure is outlined below. Another variation of SMA is the “Individually Managed Account” or IMA, which is generally used to refer to a higher value and tailored mandate, which is managed more intensively on a stand-alone tax managed basis. The industry nomenclature is far from precise, but IMAs are said to be alternatives to tailored non-discretionary broker/adviser accounts; whereas SMAs are used in substitution for managed funds, and are totally driven by the fully discretionary management decisions of an external fund manager – the primary difference being that with the SMA the client has their own pool of assets, whereas with a fund, they own units in the trust and have no indivisible beneficial interest in specific underlying securities.

SMAs started in the US in response to problems that were emerging with mutual funds, principally in relation to tax inefficiencies.<sup>104</sup> These problems are as evident in Australia as they are in the US, and are explained in Section 2B above. Primarily they relate to unrealised capital gains being part of the net asset value (NAV – which is the unit price) of a managed fund, and the lack of any congruity in the after tax objective of the investor and the pre-tax performance objective of the fund manager. The investor wants (or should want) the first, and the manager is solely concerned with the latter. Of course, as the bull market of the nineties bore on, so the tax issues became more evident. Worse, when the market turned in 2000, investors faced the uninviting prospect of making real, pre-tax losses on their investments, and yet having to pay tax on distributions – thereby exacerbating the after tax loss.<sup>105</sup>

Take the simplest example of all: technology fund buys into X stock at \$10 in mid 1999; stock goes to \$25 by Christmas, when Y buys units in the fund; stock falls to \$18 in May 2000 and fund sells out at this price, thereby crystallising a gain of \$8 – inside 12 months, and is therefore a short term hold in the US and is taxed at higher rates, as it is here. Y continues to hold this fund, and has indirectly lost \$7 on this stock (which feeds into NAV), and yet receives a taxable distribution of the \$8 gain. This is no academic issue, and it affected millions of US investors. The March 2000 “tech wreck” and the general market downturn that followed, amplified this phenomenon, as redemptions gathered pace and forced fund managers to sell stocks with large unrealised gains, thereby exacerbating the problem for recent investors who continued to hold their funds.

Also, there was said to be more demand for “control” by the investor (and their adviser, if they had one) over portfolio construction, although this issue is far cloudier, and is of limited relevance in Australia in terms of what is available in the SMA market.

It is for these reasons, and the solution provided through technology (computer processing power), that has enabled SMAs to grow in the US at prodigious rates far in excess of mutual funds in recent years. From 1999 through 1999 SMA annual growth rates are said to be over

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<sup>104</sup> Davidson E. H., and Kevin D. Freeman. 2002. *Investing in Separate Accounts*. New York: McGraw-Hill p 3 et seq.

<sup>105</sup> See the discussion on this point in Section 2B by reference to the US *Mutual Fund Tax Awareness Act*.

31%,<sup>106</sup> and in calendar 2003 the US SMA market grew by 29% with assets over US\$500 billion at year end, with 80% of the market dominated by the major institutions, eg Smith Barney, Merrill Lynch, Morgan Stanley, UBS etc<sup>107</sup> – which is hardly surprising as SMAs require massive computer systems and economies of scale. In essence, they are a technical data/transacting and processing solution to a tax problem, with some investment tailoring spin-off capacity. In September 2003 the average US SMA account size was US\$238,220.<sup>108</sup>

In Australia, SMAs have made miniscule inroads into the personal investment market. This is not a survey, as the focus of this paper is limited to tax. Ergo, the merits of SMA investing are not canvassed here. There appears to be a degree of bifurcation in the Australian market. At one end there are services which apply technology to assist with portfolio management on a pooled basis, in the sense that although each investor holds a separate account of direct securities, the external SMA manager or (perhaps more correctly) the internal IMA manager/adviser, applies investment decisions and discretionary management over numerous accounts at the same time – this being systems enabled, universally contemporaneous, multiple account portfolio management, with separate account reporting etc. Under this approach, there is no external (additional) mainstream fund manager; rather, the IMA/SMA manager is exercising discretion and actively managing the portfolio. At the other end, there is the ASGARD solution, which is more of a vanilla US SMA, whereby ASGARD provide an investment product, being the platform, through which the investor can access a mainstream investment manager, but with a separate account maintained within the platform. Additionally, there are software/systems providers, who encroach into this market, with – they would contend – solutions for brokers and advisers to effectively implement a min-SMA for private clients.

### **How SMAs work**

Fundamentally, the standard SMA builds upon the funds management concept of pooled investments, with professional management applying modern portfolio investment philosophy (eg, diversification across sectors/stocks etc), but applies technology to mirror the end result within a single account for the investor – so that the actual legal holding of the investor is not pooled. Thus, the investor does not hold shares (US) or units (Australia) in a mutual/managed fund, but through the SMA the investor has direct beneficial interest/ownership in each small holding (lot) of stock. The management is discretionary, as it is a “managed” fund, but it is possible (in theory) to place overlays, or screens over this discretion; for example to exclude specific stocks or sectors, or to tilt in favour of industries, etc – and the farther one gets out to the IMA end of the spectrum, the more intervention seems to be possible in terms of impacting upon or influencing exercise of the manager’s discretion. Often the investor is said to retain “control”, but this is a misleading concept in relation to SMAs, as total control and vetting would completely defeat the entire management concept: if the Australian manager wants to switch today from BHP to RIO, he wants to be able to implement this immediately, and not call 1,000 SMA clients or their advisers for a chat about it.

Thus, the filters, screens or overlays, have to be mechanistic and susceptible to systems application, and therefore somewhat rudimentary, as otherwise they impact cost, time and efficient management. The greatest advantage of all is said to be tax management, but this is not without its issues either, and this paper is not an analysis of the US position.

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<sup>106</sup> Davidson, *Ibid*, p 3.

<sup>107</sup> Street Talk. 2004. “Managed Accounts grew 29% in 2003.” *On Wall Street* (March 2004): p 28.

<sup>108</sup> *Ibid*.

An ordinary or vanilla SMA, based upon the investment acumen, or otherwise, of an external mainstream investment manager, is therefore a form of surrogate of the mainstream fund – which might hold billions of dollars of assets. Through replication of what the fund manager is doing in his unit trust business (ie, the billion dollar mainstream fund pool) in order to mirror management of that fund, the performance of the SMA, should closely track that of the mainstream managed fund, although the after tax performance will – hopefully – be superior from the SMA. It may be that if the SMA platform manager has placed a ceiling on the number of stock holdings, for reasons of cost (note: this is an exercise in technology/cost trade-off), and the mainstream fund composition is well in excess of this numerical stock limit, then there may be some small variation in tracking from the surrogate SMA to the mainstream fund. It follows from this, that SMAs are only available at the retail end of the market with relatively concentrated active funds, and that index SMAs are not available in Australia, as they would not be cost effective.

### **Australian tax issues and advantages**

#### **Up front**

The main advantage is beyond argument: that when one enters a SMA, one avoids the unrealised capital gain issue – and, the accumulated income/dividend distribution issue. A SMA account is opened either with cash (the ASGARD vanilla approach) or securities are transferred into the account (more IMA tailored approach, with no change of beneficial ownership), and there is no inheritance of unrealised gains or other historical attributes of the mainstream fund or any other pool of assets. If securities are transferred in, then a re-structuring to match the manager's holdings and strategy may well trigger capital gains, but otherwise, the entry is clean and all cost bases are established *do novo* or inherited from the transferred securities.

#### **Operational**

Then there is internal management of the SMA, and doing so in a tax efficient way. There is no clear answer as to whether this is always as efficient and value-enhancing as it is sometimes represented to be. All of the tax issues listed in Sections 1B and 2B above are potentially relevant to SMAs, and in theory they are open to individual and customized management. However, each single SMA product/service has to be examined for its special attributes, and in the Australian market the position is somewhat diffused.

If tax overlays/screens are built into the SMA, this will impact the manager's discretion, and how this is handled in a pure discretionary account is not always straightforward. If this requires consultation with the client and/or adviser, there are clearly cost, time, logistical and liability issues at large. It might be, that the adviser has the capacity to loss harvest<sup>109</sup> in such a way that the discretionary mandate of the manager is not overridden. The only way of doing this, whilst maintaining the integrity/performance of external management, is same day lot sale/buy from/into the same stock. Whatever view might be taken of the general anti-avoidance provisions of Part IVA, guidance provided by the High Court in Hart (2004) and other leading authorities, would appear to raise questions as to the objectively assessed dominant purpose of such action – what possible motivation could there be other than tax minimisation?<sup>110</sup>

It follows, if the transacting intervention is of such a nature that – for example – loss harvesting can only be done in a way that no other dominant purpose can be argued (eg, stock

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<sup>109</sup> See Sections 1B and 2B for a full explanation of this.

<sup>110</sup> See also for “wash sales” ATO Taxation Ruling IT 2643.

selection or sector re-weighting etc), then the scope for such activity might be severely restricted or expunged. Most individual investors wish to avoid audits or disputes with the ATO, and they should certainly try to avoid litigation.

It may well be that the SMA can be structured, and managed in such a way that passive tax efficiencies are optimised, for example by adoption of FIFO (highest in first out) accounting, and similar rules/guidelines.<sup>111</sup> In the case of a personally tailored IMA, it may well be that the governing documents establishing the IMA and the contractual relationships (eg, Investment Policy Statement or Investment Management Agreement,<sup>112</sup>), do stipulate certain guidelines that encourage tax efficiency, such as: no sales within 12 months that generate gains, unless certain prospective performance criteria are satisfied; annual turnover targets/limits; and a bias to value or aggregate franking levels. Over time, this may well have a significantly beneficial impact upon after tax return – but of course, this is not necessarily limited to SMAs, as there is nothing to stop a fund manager adopting such a strategy with a mainstream managed fund, as is the practice in the US with “tax aware” funds – see Section 2B.

However, in terms of the investment dynamics and the discretion bestowed in the active manager, it does seem that the more personalised and tailored a SMA/IMA becomes in relation to tax management, the more costly it will be, and the more difficult it will become to decide with confidence on intervention and the tax/performance trade-off in any precise situation. Where an external mainstream fund manager is used, they generally insist upon a time delay for disclosure of their stock selection positions, and this could further complicate active tax management and timely adviser intervention. The more the intervention, the more the alpha from the mainstream external manager is likely to be diluted. In essence, the older the SMA gets, and the greater the unrealised gains build<sup>113</sup>, the more intractable tax issues will arise of the nature outlined in Section 1B above.

### **Departure**

As the investor beneficially owns the underlying securities in the account, there is a choice on departure: liquidation and an effective redemption, as with a managed fund, save that each security is sold; or transfer out in specie, where there is no tax impact, as there is no change of beneficial ownership.

Ex facie, this appears to be another advantage over managed funds, but in practical terms, is it? For the “professional investor” or for those investing over \$500,000 into a tailored IMA, with a concentrated holding of, say, 15 stocks, it may well be that this investor can take his stock and transfer it into another Chess account, to be directly managed on a non-discretionary basis, or perhaps the assets might be transferred into another IMA.

However, for a smaller sum, where a vanilla SMA is being used as a substitute for a mainstream managed fund, and is within a platform SMA where different fund managers may be selected, the situation is quite different. The investor might have \$150,000 in ABC fund,

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<sup>111</sup> However, accounting strategies are likely to have far less effect with SMAs than with funds, for the reason that SMAs do not, generally, have consistent fund inflows, and hence there are not multiple lots to use for FIFO accounting. See: Dickson, Joel M. 2000. “Tax Efficient Mutual Funds.” *Association for Investment Management and Research*, pp 39 – 49.

<sup>112</sup> Davidson. *Ibid*: Appendix A, p 185.

<sup>113</sup> Dickson. 2000. *Ibid* at page 45 – where the point is made that without the positive effects of fund inflows, SMAs suffer from “paralysed portfolio management” which inhibits re-balancing, just like a private/direct portfolio can.

which is a surrogate mirroring the ABC unit trust, which holds 30 stocks. Does the investor really want the Chess transfer of 30 stocks averaging \$5,000 each, and once transferred what is to be done with their management? The stocks cannot be transferred into another fund/mirror/SMA on the platform, and so if the investor wishes to stay with the SMA platform but switch to the XYZ surrogate fund, then they have to liquidate, as with a managed fund – albeit with no inherited capital gains from prior to their ABC investment date. This could be a less efficient tax outcome.

### **Conclusions**

Overall, the tax efficiencies of SMAs vary greatly and depend upon the flexibility or lack thereof that is built into the SMA structure for intervention, and the nature of the discretionary investment strategy/philosophy adopted by the external manager of the account. At the plain vanilla end, it might be cost effective, but not significantly different to entering a new managed fund – ie, one without the unrealised capital gain baggage. At the bespoke end, it might be relatively expensive, but rewarding with the right expertise applied to investment decisions that can become very difficult indeed. In the absence of portfolio pre-tax outperformance (alpha), it may well be that such a SMA is no better than a passive fund in after tax terms, and it could be more problematic and time consuming than a direct passive personal portfolio, as the manager is constantly trying to re-arrange the deckchairs – and the client might not want this.

Notwithstanding the exceptional American SMA growth, sophistication and processing power, this does not appear to be the one stop shop tax effective silver bullet. The detractors of SMAs<sup>114</sup> often ask: show us the evidence of on-going SMA tax efficiencies. The SMA rejoinder is: we can't, as each account is different. The surrejoinder to that might be: try harder, as all the data is there.

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<sup>114</sup> Generally index managers.