Tax–Aware Investment Management by Public Offer Superannuation Funds in Australia: Attitudes, Practices and Expectations

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Abstract

The Superannuation Industry Supervision Act 1993 (Cth) (the SIS Act) has been amended from 1 July 2013 to require the trustees of Australian superannuation funds to have regard and consider the taxation consequences of their investment strategy. In spite of the literature strongly supporting the benefits of taking tax into account when investing (Tax Aware Investment Management, TAIM) by funds, the extent to which negative perceptions existed about TAIM were unclear. This study was directed at exploring the

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attitudes, practices and expectations of Chief Investment Officers (CIOs) of public offer superannuation funds in respect of TAIM and in the context of the recent reform. Semi–structured interviews were conducted with 22 CIOs. It was found that they rejected all negative reasons for not utilising TAIM. More importantly, the CIOs were supportive of TAIM and felt that any views to the contrary were not theirs. The CIOs did already practice limited TAIM methods with respect to Capital Gains Tax and imputation credits, and they expected little change in the way that they manage their funds from 1 July 2013.

1 Introduction

The Australian superannuation system is the fourth largest in the world with funds held amounting to AUD1.6trn as at 30 June 2013. Further, net investment income in Australian superannuation funds now equals net contributions made.[1] A consequence of the increasing importance of the Australian superannuation system to both the economy and the population as a whole is an elevated interest in the way that superannuation is taxed and the underlying policy decisions that have been taken.

In Australia, income tax is paid by the trustees of superannuation funds on firstly, a specific type of contribution received by the fund and, secondly, on earnings from the investment of those contributions.[2] Taxes on contributions are solely a function of the type of contribution that has been made to the fund over which the trustee has no control.[3] In contrast, taxes paid by the fund on investment earnings are, to a certain extent, within the control of the trustee. Given the growth of funds invested, the ability of the trustee to manage those taxes by incorporating tax considerations into the investment process has become a significant issue.[4]

There is conclusive evidence in the literature[5] that value can be added to investors' returns where trustees manage income taxes by incorporating tax considerations into the investment process (generically called TAIM). There is also an abundance of technical guidance about how this can be achieved.

Further, industry bodies for investment funds in Australia, both superannuation and non-superannuation, have recommended reporting returns after tax to investors, implicitly requiring trustees to actively manage the tax of the fund. The representative body for the collective investments industry, the Financial Services Council (formerly the Investment and Financial Services Association) and, that for large superannuation funds, the Association of Superannuation Funds of Australia (ASFA), have both

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1 Dynamics of the Australian Superannuation System: The Next Twenty Years: 2013-2033, Deloitte Actuaries and Consultants September 2013 available at www.deloitte.com/au/super-dynamics.

2 A superannuation fund pays tax only on contributions within the meaning in Item 1 of the table in section 295-160 and in Item 1 of the table in section 295-190 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The trustee of a superannuation fund is liable to pay tax on the investment earnings of the fund pursuant to section 295-10 ITAA97.

3 Ibid.

4 Taxes on investment earnings can be the largest expense of superannuation funds. Excluding pension funds, which have zero tax, the nominal rates of tax on the income of a superannuation fund are 15% on normal income and 10% on capital gains from assets that have been owned for at least twelve months, which are multiples of other expenses of the funds, such as investment management fees.

5 See the discussion in part 2. Also, this is both with respect to collective investment funds and individually managed portfolios.

recommended reporting returns after tax to investors in, respectively, collective investments generally and in certain superannuation funds.[6]

More significantly with respect to superannuation funds, The Cooper Review[7] discussed the importance of taxation to superannuation funds and recommended that the SIS Act be amended to include 'the taxation consequences of the investment strategy, in light of the circumstances of the fund' as one of the factors to which regulated superannuation fund trustees must "have regard", and, also, "to ensure that trustees consider those taxation consequences when giving instructions in mandates to investment managers".[8] These recommendations were subsequently accepted and now have legislative effect as an obligation on trustees of superannuation funds to consider "the expected tax consequences for the (fund) in relation to the investments…" that are covered by the investment strategy, commencing from 1 July 2013.[9]

Notwithstanding the demonstrated benefits of TAIM, the support of industry bodies and this newly introduced legal obligation for superannuation fund trustees to use TAIM, there may be some reluctance to adopt it, with perceptions that it is difficult and complex to use.[10] The purpose of this article is to report on a study undertaken into the attitudes, practices and expectations of CIO of public offer superannuation funds to TAIM.[11] In terms of attitudes, the study set out to ascertain if reluctance to adopt TAIM does exist and if so, the underlying causes. In terms of practices, the study set out to also ascertain if these funds currently take tax into account when making investment decisions and, if so, how exactly it is done. Finally, the study investigates the expectations of the CIOs about how their function may or may not change given the legal obligation placed on trustees to take tax into account when investing from 1 July 2013. The data that forms the basis of this study was collected

6 IFSA Guidance Note no. 25.00, Product Performance- Calculation of After-Tax Returns, June 2008. Effect of Tax on Superannuation Fund Investment Returns, ASFA Background Paper April 2008. *www.superannuation.asn.au/.../116/ASFA-BP0804-effectoftax.pdf.aspx* "ASFA supports the disclosure of post-tax returns of investment managers' portfolios and seeks to have the practice increasingly adopted throughout the superannuation industry."

7 Cooper, J. (Chair), Super System Review Panel Final Report to Government, 30 June 2010 available at http://www.supersystemreview.gov.au.

8 (Recommendations 2.1 and 3.4) Super System Review, Final Report, Part One, Overview and Recommendations available at http://www.supersystemreview.gov.au.

9 Section 52(6)(a)(vi) of the SIS Act .

10 Heddle, I.A., Quick Guide to Tax Efficient Investment, ITG Research, 1 November 2005.

11 In this context a public offer superannuation fund is defined as a class of superannuation fund that stands in the market and invites contributions from members of the public. Broadly, unions and their corresponding employers in a specific industry establish industry superannuation funds for employees in that industry. Retail superannuation funds are established by commercial organisations such as banks and financial institutions. Retail funds are set up to make a profit for the sponsor. That is not necessarily the case for industry superannuation funds.

via in-depth semi-structured telephone interviews conducted with 22 CIOs of public offer superannuation funds in mid 2013.

The article is presented in five parts. Following on from this introduction, the second part of the article is a review of the literature on TAIM including its benefits and the methods by which it can be implemented. The third part of the article explains the design, methodology and method used in the study and describes its conduct. The fourth part presents the findings, with concluding comments and areas for further research presented in the final part.

2 Tax Aware Investment Management (TAIM)

Broadly then TAIM can be said to be active management of taxes of a fund by incorporating tax consequences into the investment process. By way of introduction to put that in context as it is more extensively canvassed below, that includes such practices as not disposing of assets within twelve months of acquisition in order to access the discounted CGT gains, selecting shares that pay dividends with imputation credits and accounting for member specific deductions, such as for insurance premiums, at the member account level.

The seminal study of the benefits of TAIM was undertaken by Jeffrey and Arnott in 1993 in the USA.[12] This was a largely theoretical work that argued that managing a fund by taking tax into account when investing was beneficial to investors. It concluded that asset turnover in the fund, in particular, advanced taxes thus reducing after-tax returns. The reduction in after-tax returns was greater than the economic benefits that were achieved from the increased turnover.

The benefits of TAIM have also been clearly demonstrated in other studies. For example, when various investment management strategies were compared against a pre-tax benchmark, a pre-liquidation post-tax benchmark and a post liquidation post-tax benchmark, the results indicated that, in general, TAIM investment strategies underperformed tax unaware investment strategies when measured against a pre-tax benchmark.[13] However, when measured against a post-tax benchmark, the tax aware investment strategies outperformed those that were tax unaware. The magnitude of the outperformance was striking. The tax aware investment strategies underperformed the tax unaware strategies measured on a pre-tax basis by 0.30 per cent (30 bps). Yet, when measured on an after-tax basis, the tax aware strategies outperformed the tax unaware strategies by over 2 per cent (200bps) thereby demonstrating that managers

12 Jeffrey, R.H. and Arnott, R.D., Is Your Alpha Big enough to cover its taxes?, *Journal of Portfolio Management*, Spring 1993 pp15-25. Of course, as the Australian and US tax systems differ significantly in a number of regards with respect to investment, necessarily the specifics of what tax aware is differs between the two. Nevertheless, the principle is consistent across both.

13 Apelfeld, R., Fowler, G.B. and Gordon. J.P., Tax Aware equity Investing, *Journal of Portfolio Management*, Winter 1996 pp 18-28.

who incorporate the impact of taxes into their investment process significantly improve investors wealth when compared with managers who do not.[14]

Since 2001 the US Securities and Exchange Commission has required mutual funds to disclose after-tax returns (based on a standardised formula) in their prospectuses. The policy intent behind this requirement is to improve disclosure to investors of the effect of taxes on the performance of the funds.[15]

In terms of actual practices and methods for implementing TAIM, managing asset turnover is regarded as the practice or method which adds the most value when investing on an after tax basis.[16] Other methods thought to be commonly used include the active management of the fund's imputation credits by either including imputation credits generated by the fund in the investment manager's performance reports and/or reporting imputation credits generated by the fund according to investment managers.[17]

Australian studies have demonstrated empirically that, in certain circumstances, funds do care about capital gains tax efficiency.[18] Actively managing the fund's Capital Gains Tax ("CGT") position by taking into account the 12-month holding period to get the CGT discount by either or both of using tax lot selection in managing the CGT position or managing turnover appears to be regarded as a method which adds high value.[19]

More theoretical and possibly less widely used methods include using a tax optimisation model where expected returns net of taxes (CGT in particular) are traded off against risk measured as a tracking error;[20] using the long term capital gains tax rate plus synthetic dividends;[21] shorting a stock (or equivalently buying a put option) even when it has no embedded gain, to manage tax on realisation;[22] managing dividends and deferring capital gains to harvesting losses;[23] deferring gains by selling asset

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14 Ibid.

15 Final Rule: Disclosure of Mutual Fund After-Tax Returns, http:/www.sec.gov/rules/final/33-7941.htm.

16 See Note 13.

17 Cooper, J., Superannuation and Tax Considerations, *Taxation in Australia* Vol 46(8) pp 343-349.

18 Fong, K., Gallagher, D., Lau, S., and Swan, P., Do Active Managers Care About Capital Gains Tax Efficiency?, available at http://ssrn.com/abstract=968871; and Faff, R., Gallagher, D. R. and Wu, E., Technical Asset Allocation: Australian Evidence. Australian Journal of Management Vol30 No2 December 2005 pp 1-35.

19 Ibid.

20 Apelfeld, R., Fowler, G.B. and Gordon. J P., Tax Aware equity Investing, *Journal of Portfolio Management,* Winter 1996 pp18-28.

21 Chincarini, L. and Kim, D. The advantages of tax managed investing, *Journal of Portfolio Managemen*t Fall 2011.

22 Grinblatt, M. Keloharju, M., Tax Loss Trading and Wash Sales, *Journal of Financial Economics* 71(2004) 51-76.

23 Luck, C.G., 2003, Capturing Tax Alpha in the Long Run available at www.aimrpubs.org.

classes that have lost momentum;[24] using active strategies that incorporate security selection, portfolio construction and risk management;[25] avoiding realising gains to enhance and preserve long-term wealth;[26] and altering the timing of the execution decision with derivatives.[27]

Yet, notwithstanding the benefits of TAIM as evidenced in the literature and the availability of methods by which to implement it, TAIM is still considered "difficult and complex, requiring special expertise, integration into operational procedures and the determination of tax assumptions about investors."[28] TAIM has also been described as "unrewarding in that investment managers can ignore the tax impact where their performance is measured and rewarded by reference to pre-tax benchmarks."[29]

There is some support in the literature for the existence of general difficulties and complexities in using TAIM including in controlling the tax liability of the fund and managing it for efficient tax outcomes, which may be inconsistent with the pursuit of economic returns.[30] Other difficulties and complexities include reconciling accrual based performance measurement with the cash basis by which most taxes are calculated, managing CGT differential tax rates and accounting for imputation credits.[31] More generally and as already noted, there may possibly be other reasons for any reluctance to adopt TAIM including that investment managers are be rewarded for pre-tax investment performance so they are not be interested in taking tax into account in making investment decisions;[32] investment managers perceive it to be too difficult to implement; where there are multiple third party investment managers no one manager has visibility of the tax position of the fund as a whole; [33] there is a lack of after-tax indices by which to measure the performance of investment managers;[34] the cash flows of individual fund members are too varied or difficult to track to give any meaningful measure of after-tax return;[35] measures of investment performance

24 King, M., Guo, B., Tax–efficient Passive Momentum Asset Allocation, *The Journal of Wealth Management*, Summer 2003 pp 68-72.

25 Brunel, J.L., Tax Aware Equity Investing, Association of Investment Management and Research, CFA Investment Counselling for Private Clients II, 2000.

26 Jeffrey, R.H., and Arnott, R.D., Is Your Alpha Big Enough To Cover Your Taxes?, *The Journal of Portfolio Management* Spring 1993, pp 15-25.

27 Brunel, J L., Improving Tax Efficiency with Derivatives, 2002 AIMR.

28 See Note 10. Although, of course, the later is not relevant in the case of superannuation funds as they are paying at a known fixed rate.

29 Ibid.

30 See Note 9.

31 See Notes 17 and 10.

32 Ibid.

33 Ibid.

34 Ibid.

35 Ibid

use accrual accounting whereas calculating the tax liability uses cash accounting;[36] the consequences of TAIM may not yet be fully appreciated by fund members;[37] or there may be risks (including tax penalties and reputational damage) to the fund.[38] These eight likely causes identified above were considered to be within the direct knowledge or experience of the CIO and they therefore informed the design of the semi-structured interviews used in this study.

From a review of the literature it was apparent that there were other possible causes of any reluctance to adopt TAIM, but it was felt that they may either be beyond the direct knowledge of the CIO, specific to a particular class of public offer superannuation fund, or not significant in terms of the value that they could contribute to after-tax returns. Whilst it was still possible that these causes could arise during the interviews (given their semi-structured nature), the interviewees were not directly questioned about them. These other possible causes include the recognition of Deferred Tax Assets ("DTA") (either those that are accrued revenue tax losses or from capital tax losses) in the members' unit price;[39] the determination of how DTAs are accounted for if the fund is, subsequent to generating them from capital losses, investing in revenue assets so that the capital losses can never be used;[40] the netting of a tax deduction to the member's account, such as a tax deduction for insurance premiums, against the contribution taxes of the member;[41] the reporting of imputation credits in the performance reports of investment managers;[42] the management of the CGT position of the fund, with respect to the differential tax rates depending on length of time that the asset has been held, either by use of tax lot selection or the use of propagation;[43] the recognition of withholding tax leakage when a fund is in pension mode (where Foreign Tax Credits from foreign equities are lost because the fund is not taxpaying);[44] the value of a member's units is net of any provision for deferred tax, which value is then applied towards pension units when a member transitions

36 Although, reconciling that difference can be achieved by hypothecating a realisation of the fund assets at an assumed tax rate or, alternatively, by deducting the tax liability from pre tax investment performance measurement.

37 See Note 26.

38 Williams, R., Russell Investments, June 2012, Does propagation meet your after tax investment needs? Available at http://www.russell.com/au/institutions/our-research/russell-research/.

39 Suggested methods to resolve this include recognising deferred tax assets (as recommended by the Australian Prudential Regulation Authority), assuming long-term capital losses will be realised at the long term capital gains rate (10 per cent), assuming that long term capital losses will be realised at the short-term capital gains tax rate (15 per cent) or assumes a discount of the value of the deferred tax assets base.

40 See Note 17.

41 Ibid.

42 Ibid.

43 Berkin, A. L., Ye, J. Tax Management Loss Harvesting and HIFO Accounting, *Financial Analysts Journal* Vol. 3 July/August 2003. See also Notes 17 and 38.

44 Williams, R. After tax perspectives, 2012 Long-Term Investing Report, Russell Investing available at http://www.russell.com/au/institutions/our-research/russell-research/.

to pension mode;[45] having efficient structures in place between the fund's tax administrators and fund investment managers to manage such tax issues as the 45 day holding rule and the CGT 12 month rule;[46] and the efficient management of tax information relevant to members after tax returns flows from the tax administrators to the investment decision makers.[47]

In summary, in spite of the evidence of the benefits of TAIM, there appear to be potentially many impediments to its adoption and, as a result, there appeared to be merit in investigating further the attitudes, practices and expectations of the CIOs of public offer superannuation funds, particularly in the context of Australia and at this point in time given the legislative reforms that have taken place from 1 July 2013.

3 Design, methodology, method and conduct

In terms of design, the study was limited to the public offer superannuation funds regulated by the Australian Prudential Regulation Authority (APRA). That was because they are a class of superannuation fund that stands in the market and invites contributions from members of the public. That should be compared with other superannuation funds where the membership is limited to individuals who can only become members in terms of the trust deed. It was considered that as these funds (i.e. public offer superannuation funds) therefore compete for membership, it was more likely than not that tax efficiency of investment of the fund would be important. Primarily because that would enhance after tax returns to members and, consequently, be useful in attracting members.

While the ultimate responsibility for investment decisions in respect of a fund is with the Board of the trustee company and, indeed, the legal obligation, from 1 July 2013, on funds to take tax into account when investing is also with that Board, invariably those Boards rely on recommendations about investment of the fund. Equally any tax issues in respect of that, from individuals within the organisation. Usually the person responsible for these recommendations is designated the title CIO.

In practice therefore, the function of a CIO is to make recommendations to the trustees of their superannuation funds about investment by the fund and, if necessary, to appoint third party investment managers to invest the funds through formal investment mandates. Consequently, this suggests that the person who should be interviewed about the issues being studied should be the CIOs of public offer superannuation funds.

The methodological approach adopted in this study is best described as critical realism as the researchers sought to understand the 'real' reality and expected that, in the pursuit of answers to both 'how' and 'why' type questions, they could be dealing

45 Ibid. Also, pers com discussions with Mr. R Clare, Research Director, Association of Superannuation Funds of Australia, Sydney Australia December 2012.

46 See Notes 17 and 10.

47 Ibid.

with complex relationships and issues.[48] Critical realism is usually regarded as a non-positivist paradigm, and its adoption typically allows the research design to be driven by what is wanted to be learnt rather than to be preordained.[49] In this case, the reality was that there were only 83 public offer superannuation funds listed on APRA's website and the CIO could only be identified for 74 of these funds.[50] Thus a structured postal survey, assuming a 35 per cent response rate, would not generate sufficient responses to enable inferential statistical analysis to be performed with reliability. Moreover, the likely response rate to a postal survey could in fact be lower if the survey instrument did not get directly to the appropriate person in the first instance. More importantly, a structured survey was unlikely to give the researchers the richer and deeper knowledge that they were seeking and precluded the asking of follow up questions.

As a result, the method adopted was a semi-structured telephone interview,[51] which, as a method, has elements of both the quantitative and qualitative research paradigms. Whilst no inferential statistical analyses were undertaken, the descriptive statistics of responses to closed questions are reported herein, as is the qualitative comparative analyses[52] of responses to open-ended questions that were organised thematically. Thus the descriptive statistics are objective, whereas the qualitative analyses are based on the researchers' interpretation of the interviewees' responses, and by nature, are both interpretive and subjective, and do not necessarily provide hard and fast explanations from which hypotheses can be tested or predictions made.[53] That is, the explanations derived from the qualitative component of this study were expected to be 'messy and open-ended' rather than 'nice, neat and complete'.[54]

In the first instance a letter of invitation was posted to each of the 74 CIOs identified. The letter explained the purpose of the research and explained that a follow up phone call would shortly follow. Twenty eight (38 per cent) of the sample population responded to the request for interview, though 6 did subsequently decline to

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48 McKerchar, M, 2010, *Design and Conduct of Research in Tax, Law and Accounting*, Thomson Reuters, Sydney, p77.

49 Grix, J. 2004, *The Foundations of Research*, Palgrave, Basingstoke, p.85.

50 Per http://www.apra.gov.au/RSE/Pages/POE.aspx?dtype=POL as at 28th January. Some funds on the register had merged and other funds were, in effect, duplicated on the register but under different names. The letters were addressed to the CIO of the relevant fund who was identified from either information on the APRA data base, through investigation of the fund's publicly available information on their website or through enquiries made by phone using publicly available information. In those letters the CIOs were invited to be interviewed by a telephone interview at a time arranged at their convenience.

51 A copy of the instrument is available from the corresponding author.

52 The technique of comparative analysis uses method of difference or method of agreement, or both, to identify examples on which to focus when seeking findings and building theories. See Neuman, W., 2006, *Social Research Methods*, 6th ed, Pearson Education, Boston.

53 See Note 48.

54 Denscombe M., 2002, *Ground Rules for Good Research: A Ten-Point Guide for Social Researchers*, Open University Press, Buckingham, pp.21-22.

participate.[55] The remaining 22 (30 per cent) were interviewed by telephone, with all interviews conducted by the one researcher.[56] At the outset of each interview various background details were collected including confirmation that the interviewee was in fact the CIO; and that the Board acted on recommendations of the CIO with respect to investment of the fund and appointment of any investment managers. The classification of the fund (industry fund or otherwise); the amount of assets under management of the fund; and the number of members in the fund were ascertained. Details were also sought about whether or not all investment decisions about the fund were ultimately made by the Board of the trustee company or if any decisions were delegated to the CIO.

Of the 22 interviewees, 13 were from industry funds (IF) and the remaining 9 were from non industry funds (NIF). Of the 13 industry funds, 8 were small (IFS) in that they had less than AUD$5B in assets under management and had less than 20K members. The remaining 5 industry funds were large (IFL) and had more than AUD$5B in assets under management and over 20K members. Of the 9 non industry funds, 3 were small (NIFS) (assets <AUD$1B and <20K members); 3 were medium (NIFM) (assets >AUD$1B but <AUD$20B and members >20K but < 100K) and the remaining 3 were large (NIFL) (assets >AUD$20B and >100K members) in size.

A semi-structured interview usually then begins by outlining a set of issues to be explored. In this study the issues were the eight most likely causes (Part 1 Attitudes, Table 1) identified from the literature that could explain why TAIM may be considered complex and difficult.[57] The CIOs attitudes to each of these eight negative views about TAIM were gauged on a scale from "strongly agree" to "strongly disagree". Interviewees were also invited to comment otherwise outside that scale in respect of each of them. The second part of the study sought details from the interviewees about use by them currently of any TAIM methods or practices. Interviewees were asked directly only about methods and practices with respect to imputation credits and CGT management, but were also invited to report any other TAIM methods and practices.

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55 It is most likely that the balance of enquiries of CIOs (n=46, or 62%) did not result in interviews (or formal declines) due to the difficulty in directing the letters requesting participation to the correct person. In other words, the name of the CIO of some public offer superannuation funds could not be found using any of the three methods mentioned above. Most likely this was a result of the difficulty in accessing senior executives' personal information using publicly available information, not all of which publicly available information provided this level of detail. In accordance with university ethics requirements participation was voluntary and confidentiality assured.

56 The interviews were not recorded other than by notes taken by hand by the researcher, each of which took between 20 to 30 minutes to conduct.

57 The issues to be explored in the interviews served simply as a check to make sure all issues (from the perspective of the researcher) were covered in each interview; it was not a constraint on the wording and spontaneity of the questions asked or of any issues raised by the interviewees themselves with respect to TAIM.

The final part of the study explored the CIOs expectations about how their duties and functions may change from 1 July 2013 as a result of the reforms to the SIS Act. Again, there were a range of closed and open questions asked and interviewees were invited to comment throughout as they saw fit. These issues explored are summarised in the following table.

Part 1: Attitudes
1. Investment managers are rewarded on investment performance on a pre-tax basis so they are not interested in taking tax into account in making investment decisions.
2. Investment managers find it too difficult to take tax into account in making investment decisions.
3. It is too difficult to take tax into account where there are multiple third party fund managers as no one manager has visibility of the tax position of the fund as a whole.
4. There is a lack of investment-grade after-tax indices by which to measure the performance of fund managers.
5. The cash flow of individual fund members is too varied to give any meaningful measure of after-tax return.
6. Measures of investment performance use accrual accounting whereas tax uses cash accounting and these are too difficult to reconcile.
7. The consequences of tax-aware investment management are not yet fully appreciated by fund members.
8. The risks (including penalties and reputational damage) to the fund for tax-aware investment management are unacceptable.

Part 2: Practices
We actively manage the fund's imputation credits.
Imputation credits generated by the fund are included in the investment manager's performance reports.
Imputation credits generated by the fund are reported gross by investment managers
We actively manage the fund's CGT position by taking into account the 12 month holding period to get the CGT discount.
We use tax lot selection in managing our CGT position.
In addition to managing imputation credits and/or CGT, we use other practices to manage our investments in terms of tax.

Part 3: Expectations
We already take the tax consequences into account when making investment decisions for Australian equities.
We are not aware of that we will have to take tax consequences into account from July 2013.

We are aware that we will have to take tax consequences into account from July 2013 and expect that we can implement it without too much disruption.
We are aware that we will have to take tax consequences into account from July 2013 and would value guidance on its implementation from the regulator.
We expect that our IT systems will need extensive changes when we have to take tax consequences into account.
We expect to use external advisors to help us comply with how to take tax consequences into account.
We do not expect to change any of our external investment management mandates as a result of having to take tax consequences into account.
We expect that our tax reporting and decisions will be more closely integrated into our investment management decisions once we have to take tax consequences into account.
We will change our fund external investment management mandates so that performance is measured against after-tax indices once we have to take tax consequences into account.
We will change the way that we report returns to members once we have to take tax consequences into account.

Table 1: Issues explored in interviews

4 Findings

The findings are presented in three parts, namely attitudes, practices and expectations. Within each part findings from both quantitative and qualitative analysis are presented.

4.1 Attitudes

Attitudes to the 8 most likely issues (based on the literature review) and as summarised in Table 1 were explored; the aim being to determine the extent to which they could be a cause of reluctance to adopt TAIM.

Issue 1 was that as investment managers were rewarded on investment performance on a pre-tax basis, they would not be interested in taking tax into account in making investment decisions. That is, using TAIM could give rise to a misalignment between how investment managers are rewarded, which is on their performance measured against pre tax indices, and the objective of the fund being to maximise after tax returns to members.

The responses were fairly evenly divided (58% disagreed and this was consistent across both IFs and NIFs) and fell into one of two broad categories. Interviewees in the first category recognised the misalignment between the way that investment

managers were rewarded and the objectives of the fund for which they were engaged, but did not accept that it was a reason TAIM should not be employed:

> "Agree. But we do not think that it is correct." (IFS)
>
> "Agree. Not black and white –but we encourage them to take tax into account." (NIFM)

Interviewees that disagreed recognised the misalignment but proffered a way of mitigating the problem, such as appointing only low turnover managers:

> "Disagree. All mandates are pre-tax and fees but we appoint managers with low turnover." (IFL)
>
> "Disagree. In theory it is correct but we discuss taxation, extent of transactions (turnover) –not high turnover-tax is a consideration but risk is put ahead of tax." (NIFS)

Of course, several funds mandated investment managers on post tax indices as the measure of investment manager performance, thereby resolving the problem entirely:

> "Disagree. More mandates [are] taking tax into account -75% have tax awareness built into them." (NIFM)

Based on these responses, it was concluded that from the perspective of the CIOs interviewed, issue 1 was not an impediment to the implementation of TAIM.

Issue 2 was that investment managers found it too difficult to take tax into account in making investment decisions. The majority (66 per cent) of interviewees disagreed with this view and this percentage was reasonably consistent across both IFs and NIFs.

> "Disagree. We expect them to do so. It is a requirement of our selection process." (IFS)

Some interviewees conceded the difficulty of TAIM, but not to the extent that it would preclude its use:

> "Disagree. More difficult but not too difficult." (NIFS)
>
> "Disagree that it is too difficult. Some do and some don't -we use boutique funds that do take tax into account." (NIFS)
>
> " Disagree. Franking credits easy to calculate." (NIFL)

Some responses suggested it was the investment managers (rather than the CIO) who were the ones who considered it to be difficult:

> "Agree. Might have been the case but they have systems to manage it." (NIFM)

Overall the responses indicated that there may have been a general perception on the part of the CIOs interviewed that investment managers thought TAIM was difficult but it was not considered to be a tangible reason for not employing it. Indeed, a significant number of responses indicated that any perceived difficulty may have been an "excuse" by investment managers in the past, but that CIOs no longer accept it as a valid reason for not implementing TAIM.

Issue 3 was that where there are multiple third party investment managers no one manager has visibility of the tax position of the fund as a whole. That is, managing a fund for tax can be difficult where there is more than one investment manager. The majority of interviewees (61 per cent) agreed that this impediment existed and this result was reasonably consistent across NIFs and IFs.

It is not uncommon for a public offer superannuation fund (or, indeed, any pooled superannuation fund for that matter) to appoint more than one investment manager. There can be a number of reasons for doing so including appointing investment managers who have different investment styles, such as active or passive. Practically speaking, this means that more than one investment manager may have responsibility for investing the same class of assets, such as Australian equities, which, potentially, could create difficulties with tax being taken into account. The point of this question was to test whether that was the case when a fund had multiple investment managers.

The responses indicated that CIOs accept (61 per cent agreed) that having multiple investment managers can create hurdles in implementing TAIM. This can be the case from circumstances such as 'redundancy', which is where two investment managers hold the same asset, such as equities in the same company.

> "Agree. [Difficult] because of 'redundancy" (which is an overlap of stock between investment managers) -can manage that at Custodian level-propagation." (IFS)
>
> "Disagree. It is difficult but not a reason not to take tax into account." (NIFM)

However, the dominant message was that any hurdle in this regard was surmountable, primarily by either or both of it being managed at the fund level or through management by the fund's custodian:

> "Neutral. Can still manage portfolio in a tax efficient way." (NIFL)
>
> "Agree. [CIO's] job to look after portfolio." (IFS)
>
> "Disagree. Not their role to take tax into account. It is done at the fund level." (IFS)
>
> "Disagree. Assets pooled at custodian level and looking at tax parcel optimisation." (NIFM)

Interestingly again, responses attributed any perceived difficulty when multiple investment managers are involved as being the perception of (and excuse offered by) the investment manager, not the CIO:

> "Agree. Excuses." (NIFL)

Issue 4 was that there was a lack of investment-grade after-tax indices by which to measure the investment managers' performance. Overall the views on this issue were fairly neutral, though there was a difference according to type of fund (63 per cent of NIFs disagreed; 36 per cent (mainly IFLs) of IFs agreed). The responses indicated that there was indeed a lack of investment grade post tax indices but that was not considered a significant issue in terms of an impediment to using TAIM. Other views

discerned were, first, that the bigger public offer funds can arrange for specifically designed ("bespoke") after tax indices to mitigate any lack of publicly available ones; and secondly, that any publically available post tax indices that are currently available do not yet have much visibility or importance amongst this cohort of superannuation funds:

> "Neutral. Some do not but it can be done. So use main stream indices (do not see [after tax indices] in newspapers." (IFL)
>
> "Agree. Do not accept that they are prominent." (NIFL)
>
> "Disagree. Benchmarks have after tax indices-FTSE." (NIFS)

What can be concluded in this regard is that this cohort considers that there is a lack of post tax indices but, to the extent that some do exist, they are not yet considered to be viable.

Issue 5 was that the cash flow of individual fund members were too varied to give any meaningful measure of after-tax return. That is, that tax cannot be managed at the member's account level. An example of the relevance of this issue would be debits to a member's account for life insurance premiums and, as that is a tax deduction to the fund, did the fund recognise that tax deduction in the value of the member's account? The majority of interviewees (72 per cent) disagreed with this view, particularly the IFLs (86 per cent).

> "Agree. Tax assessed at fund level." (IFL)

Some interviewees indicated that either the fund had an inability to account for tax at the member level because of the way that the fund was structured or that they could do it anyway, but chose not to, but in any case that was not a cogent reason for not using TAIM:

> "Disagree. [Accounting for tax at the member level is] contrary to the way industry is structured-which is pooled. Pooling gives advantages of scale and diversification." (IFS)
>
> "Disagree. Can make it happen." (NIFM)

Clearly, some interviewees did not consider that managing for tax at the member account level added value in any case:

> "Agree. Why worry about it–[superannuation is] concessionally taxed already." (NIFS)

It seems that funds of this type, where investments are not hypothecated to a member's account (generically called "pooling" of investments), can have difficulty in recognising tax attributes specific to members at the member account level. Nevertheless, it was considered that any inability in that regard was offset by the benefits of pooling, such as investment diversification, and, in any case, certainly was not considered to be a valid reason for not using TAIM.

Issue 6 was that measures of investment performance use accrual accounting whereas tax uses cash accounting and these were too difficult to reconcile. The majority of interviewees (61 per cent) disagreed, particularly the IFL (75 per cent).

In very broad terms Australian income taxation is calculated on a realisation basis. That is, with limited exceptions in this context, a public offer superannuation fund will only have a liability for income tax when an asset is realised by, say, disposal. On the other hand, investment accounting and performance measures are, again with exceptions, calculated on an accruals basis.

This difference in methodology has most significance in respect of unrealised gains on the assets in the fund because those unrealised gain may be recognised in investment accounting and performance measures but not recognised for tax until the assets are disposed of. More specifically, the value of a members account may be calculated in investment performance terms by reference to unrealised gains on assets in the fund. However, any income tax in respect of that member's account in respect of these unrealised gains cannot be calculated with certainty until those assets are sold. That difference can give rise to a potential mismatch, which can have intergenerational issues.

In terms of TAIM usage, the question then is if investment returns credited to the members' accounts (importantly, unrealized gains on these investments) are calculated using accruals methods, why manage the fund to mitigate tax on unrealised gains?

It appears that, while in theory there is a mismatch in the methods by which investment performance is measured and income tax is calculated, the majority did not consider that to be an impediment to managing a fund with tax in mind primarily because any potential tax liability, in respect of unrealised gains in particular, can be estimated and reflected in the member's account:

> "Agree. Done over a year but difficult on a daily basis." (IFL)
>
> "Disagree. Can't be perfect but calculate unit pricing using estimate of tax liability." (NIFS)
>
> "Disagree. Can be explained so no problem." (NIFS)
>
> "Disagree. Imputation Credits important to members in pension mode." (NIFM)

Again, a theme emerged that this issue was an 'excuse' by the investment managers:

> "Strongly disagree. Excuse –tax calc. can be estimated –estimate adjusted from actual on a daily basis." (NIFL)
>
> "Disagree. Excuses." (NIFL)

The distinction in the way that other types of superannuation funds, Self Managed Superannuation Funds (SMSF) in particular, account of tax at the member level was noted by some. This was in the context that these other types of funds found it easier to manage this mismatch but the funds that were the subject of the study managed it through the member's unit prices:

> " SMSFs are on a realisation basis but public offer superannuation funds units [value] reflects the tax." (IFS)

Yet there was a minority who considered this issue to be problematic but not to the point of it being a reason not to use TAIM:

> "Agree. Causes headaches with deferred tax–it is a problem." (NIFM)

It was concluded that this cohort of funds, where investments are pooled rather than hypothecated, can estimate any potential tax lability, particularly with respect to unrealised gains, and account for that in the unit price used to measure the value of the member's account. Thereby addressing any issues with respect to any mismatch in methodology.

Issue 7 was that the consequences of TAIM are not yet fully appreciated by fund members. This question sought the view about the relevance to members of investments being made after taking into account the taxation consequences of that investment. The majority of interviewees (58 per cent) agreed that this was the case, accepting that tax management of the fund, whether done efficiently or at all, was not visible to fund members. However, notwithstanding this lack of visibility to members the responses indicated that CIOs nevertheless considered it to be an important part of their function:

> "Disagree. Lots of things that members do not appreciate/understand-young members or [others who are] not engaged." (IFL)
>
> "Disagree. After tax is what they see-is what they ultimately get." (NIFS)
>
> "Disagree. It is important to members in pension mode." (NIFM)
>
> "Disagree. [It is our] fiduciary duty to manage and also engage better." (IFL)
>
> "Disagree. Even though they don't see it but they get after tax returns." (IFL)
>
> "Disagree. Should be appreciated as it is after tax." (IFS)
>
> "Agree. [Invisibility to members is] probably true." (NIFM)
>
> "Disagree. All members reporting is after tax members, returns are after tax eg. Compare term deposit with effect tax free interest [on after tax basis]." (NIFL)

One notable exception was a fund where members actually enquired of the CIO about how the fund managed its taxes:

> "Disagree. Get queries from members about how we manage tax." (NIFM)

Overall, even though the consensus was that tax at the fund level was not within the purview of members, what came through very strongly was that the CIO's nevertheless considered that its management was a very important part of their function.

Issue 8 was that the risks (including tax penalties and reputational damage) to the fund from TAIM practices were unacceptable. This statement sought to explore any sensitivity to risk to the fund from managing its taxation. Interestingly, the majority

of interviewees (58 per cent) agreed that managing the tax on investments could give rise to those types of risks in hypothetical cases, such as for private equity investment or aggressive tax planning. For example:

> "Agree. Aggressive tax planning could result from that- tax minimisation, dividend washes. Takes vast amount of tax advice to manage this." (IFC)
>
> "Agree. Loss trading can be reputational [risk]." (IFC)
>
> "Neutral. Could be a reason but not really sure." (NIFS)
>
> "Agree. Need to be sensitive to it for indirect investments." (NIFS)
>
> "Agree. Reputational risk- industry funds are risk averse and ideological." (NIL)

However, there were some contrary views about such risks, and, also, about the size of that risk:

> "Disagree. Not really a risk." (NIFS)
>
> "Agree. Possibly, but not a big risk." (NIM)
>
> "Disagree. Not a big risk because not aggressively tax managed." (NIM)

Again, one notable exception was a disclaimer that a CIO would even know or consider what these risks were:

> "Disagree. Investment professionals aren't taught to think like we are "tax risk" –don't even know what it means." (IFS)

It was concluded that sensitivity to tax risk does seem to be a consideration in embracing TAIM, albeit hypothetical and of an indeterminate size. Nevertheless, it was not considered to be a reason not to adopt and implement TAIM.

In summary, none of the eight issues explored with the CIOs was considered a valid or cogent reason not to use TAIM. To the extent that any of the eight may have ever been a valid reason for not using it, that no longer seems to be the case, at least in the eyes of the professionals who are the gatekeepers on these issues. Indeed, to the extent that there is any residual view that any of these eight may be cogent reasons for not adopting TAIM, the CIOs seemed to attribute that attitude to the investment managers.

4.2 Practices

From Table 1 it can be seen that whilst there were six issues regarding practices explored in the interviews, they in effect relate to two major aspects of practice – the management of imputation credits and of CGT.

Imputation credits

The majority (71 per cent) of interviewees agreed that they actively managed imputation credits. Agreement was more apparent with NIFS and NIFM than with NIFL; and with IFL relative to IFS. The vast majority of interviewees reported that they did actively managing the imputation credits of the fund:

> "Yes. [We] look at total return so case to case different per fund manager." (NIFS)
>
> "[We are] putting in place processes to take these into account." (IFS)
>
> "Yes. [We] expect managers to think about because managers are on a post tax performance." (IFL)
>
> "Yes. We record after unit prices to account for that." (IFL)

Several reasons were given by those who responded in the negative to this question including that investment managers are on a best-endeavours basis with respect to this aspect and tax in general because excess return was favoured over tax or because of logistic reasons, such as an inability of the custodian to provide that service:

> "No. Clause in mandates that after tax returns are important and can monitor after tax returns –after tax is important to members because that is what we report but managers are on a best-endeavours rule (45 day/75% delta) and will discuss franking encouragement rather than–same for CGT–[which] is taken into account (holding period and turnover are considered)-excess return from trading is favoured over negative tax effect-balancing outlook before CGT." (NIFM)
>
> "No. Not actively managed. One Quant manager builds tax (CGT and imputation credits) into transaction cost-but only one manager does this." (NIFL)
>
> "No. Issue is the custodian ability to provide that info to fund managers and the fund-will be a key factor in appointment." (IFS)

In exploring more detailed aspects of practices with respect to imputation credits, interviewees were asked if imputation credits were included in the investment manager's performance report per se. The majority (67 per cent) reported in the affirmative and this was reasonably consistent across both NIFs and IFs, irrespective of size:

> "Yes. Custodian manages that." (NIFM)
>
> "Yes. Mandates have been constructed to take tax into account by maximising imputation credits. Post franking credit measurement, [investment managers] are given discretion to do buy-backs. Performance is gross of franking credit, so buy- backs are recognised in performance fees and these are included." (IFL)

Interviewees were also asked if investment managers reported imputation credits gross, with 50 per cent agreeing that this was the case, though there was some uncertainty evident. NIFs (particularly NIFS and NIFM) had stronger agreement than did IF.

Overall, with respect to imputation credit management in general, the responses indicated that it is currently actively undertaken. Further, it is being achieved by imputation credits being included in the investment managers' reports, and these are being reported in gross form.

CGT

To explore the second major aspect of practices, interviewees were asked if they actively managed the CGT position by taking the "12 month rule" into account. The issue in respect of which this question relates is the income tax rule that, with the exception of gains from two particular classes of assets, only 2/3rds of capital gains coming from assets that have been held by a fund for at least twelve months are taxable. In other words, funds that sell those types of assets that have been held for at least twelve months only pay tax on 2/3rds of the gain or, in other words, pay tax at a nominal tax rate of 10 per cent rather than 15 per cent.

The majority of interviewees (65 per cent) reported that they managed funds by reference to the "12 month rule" with respect to CGT. More importantly, the actual method used to manage the 12-month rule was through managing the turnover of the fund because a low turnover implicitly means that more assets are held for a longer period or at least twelve months:

> "[Yes.] 100% turnover in a year [from on Qant manager] but other managers (Australian equities) have low turnover so CGT not an issue but not in mandates but it is tracked just to keep an eye on it." (NIFL)
>
> " Yes. [We are a] low turnover manager (20 per cent) so unusual to sell within 12 months and that is recognised by clients. Some clients are less concerned about CGT (pension phase) but some funds do care. Clients that want to manage CGT- they have system so may hold back because realised gains are too high or sell something to reduce gains." (NIFM)
>
> "[Yes. We track the] FTSE /AFSA indices for Australian equities." (NIFS)
>
> "Yes. Putting it in place now." (IFS)
>
> "Yes. Discrete management on a best endeavours basis, expect that turnover is an issue." (IFS)
>
> "Yes. Hold investments for at least a year." (IFS)
>
> "Yes. Individual fund managers- only see own portfolio-lot selected is used by J P Morgan as Custodian-not perfect alignment." (IFL)
>
> "Yes. In January 2012 [our investment managers] were asked series of questions- do they take tax into account, if so, how do they and active managers have trouble taking tax into account but for passive managers it is easy. Board wanted to know how tax efficient they were – share buy backs are managed tax credit added back by custodian so they do not suffer on pre tax measures- management aware of 45 day rule 45 day rule is measured -lost $145K in 2011 on $1.5bn portfolio." (IFL)
>
> "Yes. Turnover about 15%." (IFL)
>
> "Yes. Ask managers to report positions sold within 12 months so we know what position is." (IFL)

Yet several funds reported putting returns from trading ahead of a negative tax effect from that trading, with one fund reporting difficulties in managing CGT because it was invested in other pooled funds:

> "Same for CGT –is taken into account (only holding period and turnover are considered) in appointment process-excess return from trading is favoured over negative tax effect-balancing outlook before CGT." (NIFM)
>
> "Yes. But no direct mandates, invested in pooled funds. In process of appointing investment managers, no after tax issues are considered, risk/return characteristics are first order and tax is second order. Managing transactions-contributions, withdrawal, and increase benefits by cash flows rather than cash out units- [we] manipulate asset allocation of portfolio to avoid crystallising tax." (NIFS)

Interviewees also reported taking an investment manager's preponderance for turnover into account in due diligence in the appointment process:

> "Yes. Measure turnover of fund manager-during manager selection process and ask asset consultants to report expected turnover." (IFS)
>
> "Yes. Not stipulated in mandate but is part of due diligence when appointing manager." (IFS)

Of those funds that reported not managing the CGT position of the fund one reason given was because they had accumulated tax losses. In that case, better tax management is achieved by selling investments within 12 months of acquisition as 100 per cent of any gain will be taxed at a nominal 15 per cent, thereby maximising the value of the carried forward losses:

> "Yes. Not yet because we have significant crystallised tax losses picked up from ($20B) merger with [another fund] plus [losses incurred during the] GFC. Until tax losses are used up all gains are [at less than 12 months]." (NIFL)

Had they not been in tax loss, they would have managed the "12 month" rule:

> "In 2006/2007 parcels held because of tax cost (too expensive) even though stock over valued would consider holding it." (NIFM)

Another reason given for not managing the CGT position of the fund was that the fund was not taxpaying because it was paying current pensions:

> "Not applicable. Fund is mainly in pension mode." (NIFM)

More detailed aspects of CGT practices were explored by asking interviewees if they used lot selection for managing the fund's CGT liability. "Lot selection" is an (ATO approved) method for managing the 12-month rule in a superannuation fund either in addition to or instead of managing asset turnover. In effect, if a fund has acquired a number of a particular security (such as shares in an Australian company) of different amounts, purchased at different times and at different prices, lot selection is where the trustee chooses the securities that it wishes to sell from the entire holding and that choice is based on the best tax outcome. For example, if a fund has securities purchased within 12 months ago and the same type of securities purchased more than twelve months, it will select those that were purchased more than 12 months ago and at the highest purchase price to sell as only 2/3rds of any gain coming from those will be taxable and, also, the gain will be less.

Whilst this question was not applicable in the case of 2 interviewees, those to whom it had relevance were reasonably evenly divided, with NIFs (66 per cent responded in the affirmative) using lot selection more so than IFs (66 per cent responded in the negative). Interestingly, notwithstanding the tax benefits and accepted nature of this practice, it was not utilised by the majority of funds predominantly because the custodian did not offer that facility:

> "No. But implement it for next year." (IFS)
>
> "No. Have looked at it, would [be good] for equity managers because [we have] no overlap between stock." (IFS)
>
> "No. Do not have system." (NIFL)
>
> "No. Would like to but in hands of custodian who limits how much we can do." (NIFS)

Funds that did report using it indicated that it was their custodian that facilitated it:

> "Yes. (Custodian) NAS is instructed to lot select." (IFL)
>
> "Yes. Rely on custodian." (IFL)
>
> "Yes. But actively choose highest gain to utilise losses but as these are being used…" (NIFL)
>
> "Yes. Individual fund managers- only see own portfolio-lot selected is used by J P Morgan as custodian-not perfect alignment." (IFL)
>
> "Yes. CGT is managed at custodian level-where custodian selects parcels with greatest CGT loss." (IFL)

Clearly, from the responses the management of CGT can be seen to be a "best practice" for industry funds. The preferred practice for achieving that is to manage the turnover of investments in the fund. What is intriguing is that the funds in general were averse to using the ATO approved method of lot selection. It appears that use of this practice is a function of the fund's custodian facilitating it.

The last aspect of practices explored was an open ended question to explore the extent to which any other TAIM practices were used. No positive responses were received to this question, though from further discussion some interviewees did report participation in buy-backs and monitoring turnover.

> "Support buy-backs." (IFS)
>
> "Monitor turnover and buy-backs [we] participate [in them after seeking] tax advice for each deal." (IFL)
>
> "Moving to lot selection." (NIFL)
>
> "No. Apart from buy-backs." (NIFM)
>
> "Tax parcels between investment managers and chose imputation credits." (NIFM)

Again, and consistent with the findings in Part 1 with respect to their attitude to using TAIM, this cohort of funds (as represented by the interviewees) do actively

manage both imputation credits and CGT, primarily through managing the turnover of investments.

4.3 Expectations

The expectations of the interviewees about any changes expected from the rule change commencing on 1 July 2013 were explored using the 10 issues in Table 1 as an interview guide.

Issue 1 was to confirm that tax was already being taken into account when investing, to which 86 per cent of interviewees responded in the affirmative. All NIF were in agreement, although it was clear in the case of IF, that IFLs were in stronger agreement compared to IFS.

> "Our job is to advise trustees about investments so they can take tax into account." (IFS)

As the vast majority of funds reported already taking tax into account, would that mean there was no need for a legal obligation on trustees to do something that they seem already to be doing? Probably not as some funds at least appreciated the legal changes:

> "Think that [rule] changes are appreciated." (IFL)
>
> "Market thinks it too hard so good that SIS Act is changing." (IFL)

Based on responses to this first question, it could be concluded that public offer funds are cognisant of the benefits of taking tax into account in the investment process in any case.

Issue 2 was to determine if interviewees were aware of the changes commencing from 1 July 2013. It appeared that the majority (56 per cent) were unaware, though this seemed to be more apparent in the case of the smaller funds.

> "Dimly aware of it." (IFS)

These results suggest that perhaps there is a need for the regulator and, indeed, service providers to funds, such as asset consultants and financial advisers, to draw the rule change to the fund's attention to ensure compliance. (The interviews were conducted in May 2013, two months prior to its commencement.)

Issue 3 was to explore if the interviewees expected any disruption to current operations as a result of the rule changes. There was strong agreement (93 per cent) that only a slight disruption, if any, was expected, though NIFS and NIFM expected to be less affected. The overwhelming response was that there would not be any disruption current practice:

> "Agree. Already diligent [so] change will just be how we document it." (NIFS)
>
> "Agree. Become more aware." (NIFS)

However, some funds reported that there will be changes:

> "Disagree. Imputation credits will need to be included." (NIFL)

Issue 4 was to explore whether interviewees would welcome some guidance from the regulator about what they expect in practice from this new rule. The majority (79 per cent) expressed a desire for the regulator to give some guidance about what these rules mean in practice, although interviewees were unclear about how the regulator would achieve that:

> "Agree. APRA would need to get it right." (IFL)

> "Agree, but expecting that they won't and will not [be] in detail." (IFL)

> "APRA micromanages so unlikely to add value-also too vague. Fund should work it out first." (IFL)

> "Agree. Would value some guidance and expect that custodian will provide guidance investment managers pushing back on taking tax into account." (IFS)

> "Strongly agree. APRA guidance papers are too confusing not provided with enough guidance-too high level and difficult to interpret." (IFS)

> "Agree. But APRA needs [to] understand at appropriate level rather than macro." (IFS)

Varying reasons were given for why regulatory guidance would be beneficial including that funds may not be aware of the change; were wanting further guidance; or were seeking greater consistency in the current regulation:

> "Agree. Not aware of the change." (NIFM)

> "Disagree. To what degree do they mean? Is it just directing managers?" (NIFM)

> "Agree. Standard risk measure created by industry and endorsed by APRA says that disclosure should be on a pre tax basis (standard risk measure) because not all investment vehicles are taxed so they had it pre tax (this creates a potential conflict with the rule change)." (NIFL)

One fund considered tax too difficult for the regulator to give any meaningful guidance:

> "Disagree. Tax is too difficult. No such thing as generic asset management." (IFS)

Issue 5 explored whether interviewees expected extensive changes to their IT systems after the new rule commences. The majority (88 per cent) of interviewees indicated no expectation of extensive changes to their IT systems from commencement of the new rule. To the extent that there may be a need to change funds, expected that would be done by either asset consultants or the fund's custodian:

> "Strongly disagree. Already doing it." (NIFM)
>
> "Disagree. Make ad hoc calculations but may incorporate tax into account." (IFS)
>
> "Disagree. Asset consultants." (IFS)
>
> "Agree. Custodian (NAS) – yes they will need to change." (IFS)
>
> "Disagree. Collect more info. Thinking about international equities. Board happy that no material tax impact then." (IFL)

Issue 6 explored if interviewees expected to use external advisers to implement this new rule. Views were fairly evenly divided, with 50 per cent disagreeing (2 NIF interviewees strongly disagreed). Of those who did expect to use external advisers, it appeared that they would be either asset consultants or external tax advisers:

> "Agree. Do have tax consultants that we would use." (IFS)
>
> "Agree. PWC [PriceWaterhouseCoopers] to advise." (IFS)
>
> "Agree. Asset consultants." (IFS)
>
> "Agree. Appointed internal tax adviser-internal tax person-assets consultants will be used." (IFS)
>
> "Agree. Asset consultants." (IFL)
>
> "Disagree. Internal tax people and asset consultants to get views." (NIFM)

Where interviewees did not expect to use external advisers, comments included:

> "Not sure." (NIFS)
>
> "Do not need them." (NIFS)
>
> "Disagree. Can't see how they would add value- self interest." (NIFS)

Interestingly one fund did not seem to take the new rules too seriously:

> "Agree. Something that will be done as 'tick a box.'" (IFL)

Issue 7 explored interviewees' expectations that external mandates with investment managers would change after commencement of this new rule. Overall, expectations about changes to investment manager mandates were evenly mixed:

> "Agree. But would be a case by case maybe depending on manager basis." (NIFL)
>
> "Agree. Over time it is a real possibility." (IFS)

"Agree. Will be amended." (IFL)

"Disagree. Fund is considering it at the moment." (NIFS)

"Strongly disagree. Already included." (NIFL)

"Disagree. Will harden up on tax mandate." (IFS)

Issue 8 explored interviewees' expectations as to whether tax reporting and investment decision-making would be more closely aligned after commencement of this new rule. Again, interviewees were evenly matched between those who did expect that tax would be more closely aligned with investment decisions and those who did not:

"Agree. To extent that trying to measure gross of tax and net of tax then maybe. One of the reasons why we are measuring turnover/imputation credits." (IFS)

"Agree. As required." (IFS)

"Disagree. Already ask for that to be done." (NIFM)

"Disagree. No." (NIFL)

Issue 9 explored whether there was an expectation that the mandates with investment managers would incorporate after tax performance measures after commencement of this new rule. The majority (63 per cent) reported that they did not expect investment manager mandates to be changed to incorporate post tax performance measures:

"Disagree. Already considering tax." (NIFM)

"Disagree. Mandates have changed already for large funds. Industry is more developed than people realise. People do not want to spend on customised benchmarks. More moving to post tax funds over time. Industry funds driven by consultants who are more tax aware." (NIFM)

"Looking at income generating products that would include imputation credits and capital side. Aussie equities funds- defensive [product so would be more visible for customers to satisfy demand for yield as fixed income are going down." (NIFL)

"Strongly disagree. [We already use] post tax for Aussie equities." (NIFL)

"Strongly agree. Because we already do it." (IFS)

"Agree. Have both pre and post tax mandates." (IFS)

Some contrary opinions were expressed:

"Agree. Will be documented more expressly." (NIFS)

"Agree. Expect that it would be more - but it is included at the moment. Again it is a balancing act between performance and CGT and difficulty included in mandate." (NIFM)

"Disagree. Advice was that going post tax benefit was about 6 bps- but could cost $100,000 so not worth it." (IFS)

"Disagree. Cost effective because boutique post tax index-not representative –their fund is too small." (IFS)

One exception in particular is interesting, as it seems to demonstrate the competitive nature of this industry:

> "All looking over shoulder to see what everyone else is doing." (IFL)

Issue 10 explored the expectation that changes would be required to the way that CIOs report to members after 1 July 2013. Given that the regulator already required funds to report to members net of tax, (including any estimation of taxes yet to be paid on unrealised gains) it appears from this study that reporting to members is unlikely to change. Perhaps what is intriguing is that once funds are legally obligated to take tax into account they would not demonstrate to members their enhanced performance (assuming that is the case) as a competitive advantage in winning new members? Then again, given these funds sensitivity to tax risk (see Attitudes: issue 7 above) maybe it is not all that surprising.

The majority of interviews (78 per cent) disagreed with this expectation. Those who did agree were from IFS.

> "Disagree. FIFO basis so unit prices account for tax. Unitise accounts-so members know about it. Aus. equities are tax efficient." (NIFS)
>
> "Disagree. Report after tax now so do not expect to change." (NIFM)
>
> "Disagree. Already report after tax anyway." (NIFM)
>
> "Not at this stage. [Product Disclosure Statement] says it is after tax. Super members and pension members ask that." (IFS)
>
> "Disagree. Already do it." (IFS)
>
> "Agree. Looking at breaking tax amount from members' gross rate-[but] no significant changes." (IFS)
>
> "Neutral. Do that already highlighted." (IFL)

Given the findings in both parts 1 (attitudes) and 2 (practices) of the study, the expectations about likely changes following introduction of the new law were consistent. What was a standout response was the desire of these funds to get some guidance from the regulator about implementation and satisfying the rule. This desire perhaps indicating that the funds need, or are seeking, absolute certainty.

4.4 Intra group differences

The survey differentiated between public offer superannuation funds that were either industry superannuation funds or not and, also, between the size of funds within that differentiation.

It is worthwhile observing that, with three exceptions, there was no significant differences in responses across the three aspects being surveyed, whether between those two types of funds or between fund sizes within each. Those exceptions were, first with respect to managing imputation credits where Non Industry Funds (NIFs) were more strongly in agreement to utilization of imputation credits, secondly that same group were more likely to report imputation credits gross and, finally, again that

same group reported expecting less disruption to what they were presently doing after the law changes.

However, there were subtle differences in responses based on fund type and size with respect to:

- Lack of investment grade indices impeding use of TAIM where IFLs considered that lack more problematic, and
- That cohort (IFLs) also were particularly unconcerned about cash flow at the member account level being difficult.

5 Conclusions

This study set out to explore the attitudes, practices and expectations of CIOs of public offer superannuation funds to TAIM in the light of the legislative reforms effective 1 July 2013. In terms of attitudes, none of the eight negative perceptions (drawn from the literature) about TAIM were accepted by CIOs as cogent reasons not to use it. They conceded that they may well be excuses proffered by investment managers, but that they were largely now “myths that can be consigned to the dustbin of history”. What was interesting and indeed surprising was the attitude to tax risk. Clearly this is a top of mind issue in regard to TAIM. On the other hand, perhaps it just displays non-tax people’s sensitivities about dealing with tax issues, which can have significant negative consequences. Overall it was concluded that based on the views of CIOs interviewed in this study, there was a very positive attitude to TAIM at the CIO level, even if there was some reluctance at investment manager level.

The findings with respect to current TAIM methods and practices were heartening with respect to the limited methods and practices that were investigated in detail - imputation credits and CGT. Managing imputation credits and CGT seem like “low hanging fruit” in terms of tax complexity, capacity to add value and aggressiveness. Nevertheless, the important finding in respect of practices is the simple fact that many of the funds that were studied do, in fact, manage tax on these two aspects almost exclusively. Not as many as would have been expected used lot selection, which was attributed to their custodians, and none of the other ten methods that were identified from the literature featured when CIOs were asked if any other TAIM practices were employed. As to why that may be, as none of those others were put to the CIO, it is largely a matter of speculation. Perhaps, reflecting the identified sensitivities to tax risk, it is that they are considered too aggressive? Alternatively, it may simply be a function that the TAIM market is only developing whereby CIOs have grasped TAIM methods and practices that appear to add value, such as with respect to imputation and CGT management, but have yet to be exposed to the other methods and practices or, indeed, persuaded that they can add value? Why do we think this might be the case? Do we think this might change down the track?

Given that funds reported the use of TAIM to the extent that they did it is not surprising that they do not expect much change following introduction of the law whereby they are obligated to do so. That indeed does beg the question whether there was need for the law in the first place. This leads to several observations. Of course this study was limited to one class of superannuation fund, 74 in number, so that rule may have more relevance in terms of altering trustee behavior to the way that tax is managed with other types of superannuation funds. The second observation is that it could be that in this regard the market, or at least this type of superannuation fund, is ahead of the legal reforms: perhaps a function of having to actively compete for members. It appears from the findings that external advisers will be sought after to assist with implementation but that the IT people will largely be untroubled by the introduction of the new law. However, equally there are indications that these funds at least would like some regulatory guidance about the regulators expectations of how this rule should be implemented.

In conclusion, we found that it appears that perceptions about difficulties with TAIM are certainly not held by the CIOs of these funds. Indeed, they actually use it in limited cases. What the CIOs have also told us throughout this study is that their perception of any negative attitudes towards TAIM resides with the investment managers by them clinging to what, in the view of this study, are outdated views of funds management. One positive outcome of the study is then that, hopefully, it will put to rest any uncertainty about the need for TAIM or the demand for it from those whose role it is to recommend TAIM. Also hopefully, it will ignite a discourse about other practices and methods for achieving TAIM than just imputation credit and CGT management.

This study makes an important contribution to the literature as it is the first qualitative analysis of actual investment management practices incorporating tax of this class of superannuation funds. The study not only gives an insight into their attitude and current practice towards TAIM but also, by corollary, it can be used to determine the prevalence of TAIM in public offer superannuation funds and to indicate how these funds can improve their tax awareness in investing by reference to other TAIM methods and practices.

Of course qualitative research does have its strengths and weaknesses, the main weaknesses being that the findings should not be generalised to the broader population of public offer superannuation funds, but only attributed to the interviewees. However, given the selection process and the number of interviews conducted across the sample population, the findings are considered reasonably robust and the insights gained are meaningful. The interviews have provided a unique opportunity to explore one of the key contemporary issues facing Australia's superannuation industry, now given legislative imprimatur.

Further research is needed in respect of two areas in particular. First, as the appointment of investment managers by CIOs is a two party transaction, this study has the perceptions of the three issues [attitude, practice and expectations] about

TAIM from only one of those parties, the CIOs. To the extent that part of this study was about negative attitudes to TAIM and to a large degree any residual negative attitudes about it were attributed by the CIOs to investment managers, it would seem sensible and, indeed, reasonable, for the investment managers to be asked similar type questions in order to validate or otherwise the views of the CIOs.

Another area of research coming out of this study is with respect to some of the responses, which turned on the structure of these funds. Specifically, these funds pool their investments and that was an issue with respect to some of the aspects that were studied. In particular, with respect to accounting for tax at the member level and the mismatch between measuring investment returns at the member level. It would be interesting, indeed, to study other types of superannuation funds, self-managed superannuation funds in particular, where the funds' investments are directly attributed to the member's account.