THE INSTITUTE OF ACTUARIES OF AUSTRALIA
A.C.N. 000 423 656

GUIDANCE NOTE 150
TREATMENT OF DEFERRED TAX LIABILITY FOR UNREALISED CAPITAL GAINS

APPLICATION

Actuaries advising organisations which offer unit-linked investment products.

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1. INTRODUCTION

Purpose

The purpose of this "guidance note" is to:

a) Ensure that the investment industry does not ignore the issue, and that some allowance for deferred liabilities is made in pricing all unit-linked investment products.

b) Attempt to encourage a level of uniformity amongst managers, so that the method of reserving becomes as much a "non -issue" as possible for intending investors. Uniformity is also desirable from the point of view of the performance survey industry.

c) Recognise the difficulties involved in establishing a reserving policy when the beneficiaries are subject to varying tax rates. However, it is intended that, where the tax rate to which returns are subject is known (whether paid by the Manager or not), adequate reserves are maintained by all managers.

Scope

The "guidance note" is proposed for all organisations who offer unit -linked investment products of any kind. Non -superannuation products have also been addressed to ensure full coverage, and the problems associated with unitholders paying differing levels of tax has been recognised. This is not intended to be a professional standard for actuaries.

2. GENERAL - DISCLOSURE

The overriding general principle for all unit -linked investment products, where prices are calculated to reflect accrued but unrealised capital gains, is that the amount of unrealised capital gains included in the unit price must be fully disclosed in the various reports described below. In addition, any provisions set aside to meet the future taxation liability attached to these gains, together with the basis used for determining those provisions, must also be disclosed. The requirement for full disclosure should apply to retail unit trust products, insurance bonds, friendly society bonds, Pooled Superannuation Trusts ("PST's") and other unit linked superannuation or life insurance products. The information should be set out in all published accounts, prospectuses and relevant marketing information.

3. TAX PAYING FUNDS AND FUNDS WITH UNIFORM TAX RATE INVESTORS

Provision for tax on unrealised capital gains is required to be reflected in the calculation of unit prices and returns for Pooled Superannuation Trusts. These principles are also to apply for life office superannuation funds, other unit trusts whose investors pay tax at the appropriate superannuation rate, and for non -superannuation products, such as unitised life policies and insurance bonds, on which tax is payable at a uniform rate.

"Mark-to-Market" and "Long-Term Equity" Approaches

By their nature, unit-linked investment vehicles create a timin g mismatch between the declaration of earnings and the time when tax is paid on those earnings. For earnings arising from income or realised capital gains, the time difference is minimal - usually no more than a year. When earnings are declared as a result of changes in the market value of an asset (ie. unrealised gains) the time difference

will depend upon the time at which the asset is eventually sold. For some assets, such as direct property holdings, this time lag could be as long as ten years, or more. If no charge for the future tax liability is made to all of the investors who participate in the growth of the asset, the investors present at the date of sale will usually be unduly penalised. However, precisely how the liability should be shared between investors is not obvious.

There appear to be two alternative approaches to the amount of tax for which any one generation of investors should, in the interests of equity, be charged.

1. "Marking to market" assumes that all assets are realised at the date of valuation. This means that all unitholders bear the cost of tax on (part of) the gain accruing to them in any particular year. The amount of the gain taxable is, of course, calculated with reference to each asset's indexed cost base. This is not necessarily the same as the 'real' gain earned from the unitholder's point of view.

   The appeal of this approach is that it is consistent with the concept of valuing assets at market value. All aspects of the unitholders' returns are calculated on the same basis - ie. that the assets are actually sold at the valuation date. A second advantage is that the method is impartial and relatively incapable of manipulation (by, say, altering assumptions when it suits). Thirdly, it is very easily understood by both fund managers and investors.

2. "Long term equity". The alternative approach is to adopt a reserving process that achieves some form of equity across generations of unitholders by recognising the value of the tax deferral benefit. Such a method would require some recognition of the average holding period of assets and the interest earned on reserves put aside. The calculation of the equitable reserve is not straightforward and several assumptions must be made.

   The appeal of this approach (subject to appropriate assumptions) is that it minimises subsidies between different generations of investors (the classic actuarial definition of equity). It reflects the true nature of different investment vehicles (long term for superannuation funds) and it also

reflects the strategies of different managers. Logically, the reserves held in an index fund versus an active trader should be different to represent the different length of deferral of the tax liability of investors.

Basis for Calculating Provision

The Institute recommends that deferred tax provisions be calculated in a way that provides the greatest degree of equity between different unitholders. Generally, this will involve a reserving method which makes allowance for the type of asset and the style and investment practice of the manager. It is recommended that the basis used be approved by an Actuary (a Fellow or Accredited Member of the Institute of Actuaries of Australia). Actuaries are trained in the determination of such liabilities and will be required to comply with the professional standards of the Institute.

It is considered acceptable to adopt a mark-to-market approach for investment vehicles for which holding periods of assets are generally short. Although not ideal, it is also acceptable to adopt a mark-to-market basis as a conservative estimate of the long term equity approach.

Assets held for less than 12 months

Gains realised on disposal of assets held for less than 12 months are taxed in full (under current capital gains tax legislation). However, provisions set aside in respect of unrealised capital gains accrued on assets purchased less than 12 months before the valuation date, may be calculated on the assumption that the assets will subsequently be held for longer than 12 months if the manager believes this is likely to be the case. Therefore, CPI Indexation up to the valuation date (based on the most recently published statistics) can be used to determine taxable gains in calculating reserves for all assets which would normally be subject to capital gains tax.

This guidance note allows managers some discretion in the basis adopted for maintaining reserves. Managers should be guided by the extent to which the choice of basis has a material effect upon investors' equity. Whilst superannuation funds are taxed at the rate of 15%, much of which may be offset by imputation credits, the effect of a "mark-to-market" versus "long-term equity" approach may be trivial. However, managers should monitor the materiality of the

adopted approach in the light of actual tax -paying experience or in the event that the taxation system applying to their fund alters.

4. OTHER UNIT-LINKED PRODUCTS

Provision for tax on net unrealised capital gains and future tax benefits on net unrealised capital losses are not required to be reflected in the calculation of unit prices and returns for unlisted unit trusts. However, full disclosure is required and, as a result, in a range of circumstances, market forces or fiduciary responsibility may require the Manager to introduce full or partial provisions in order to preserve broad equity between unitholders. The Manager's ability and responsibility to do this would be influenced by the pricing and valuation provisions in the trust deed and its ability to vary them.

Disclosure Requirements

All documents which incorporate the unit price (e.g. accounts, prospectuses, marketing material and communications with unitholders or investment advisors) must disclose, alongside the unit price, the amount of that unit price which represents net taxable but unrealised capital gains or losses, allowing CPI indexation on all assets for which the manager considers it appropriate and allowing for any taxation provisions already incorporated in the unit price.

Equity between Unitholders

In some circumstances, such as when a fund frequently turns over the bulk of its portfolios, pricing with no provisions may produce broad equity between unitholders. However, circumstances in which equity may require that a provision be made, either full or partial, or some alternative action agreed between the trustee and the manager, include:

- Closed funds with high redemption rates.
- Funds open for subscription but with the rate of redemptions significantly exceeding the rate of new sales.
- Funds with single large assets (e.g. major properties) on which substantial capital gains tax could be payable.
- An impending major restructuring of a portfolio.

END OF GUIDANCE NOTE 150