11 March 2014

General Manager
Tax System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Via Email thirdpartyreporting@treasury.gov.au

Attention: Nicholas Backhouse

Dear Sir,

Improving tax compliance – enhanced third party reporting, pre-filling and data matching

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

We write in relation to the Treasury Discussion Paper entitled "Improving tax compliance – enhanced third party reporting, pre-filling and data matching" (**the Discussion Paper**). The Discussion Paper addresses the creation of new third party reporting regimes in relation to:

- Sales of real property;
- Sale of shares and units in unit trusts;
- Sales through merchant debit and credit services; and
- Taxable government grants and other payments.

The ambit of our submission relates primarily to the proposed reporting regime in respect of the sale of shares and units in unit trusts.

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At the outset, our view is that the proposal with respect to shares and units will impose significant compliance costs on industry, costs which are, in AFMA's view, not commensurate with any perceived benefits that may accrue. Further, for the reasons set out below, it is our submission that there are cogent reasons as to why the policy objectives underpinning the proposal are incapable of being satisfied, regardless of the costs.

Accordingly, it is our submission that the entire proposal be re-evaluated to acknowledge the disproportionate impacts of the proposal. In the event that the Government does wish to proceed with the proposal notwithstanding our submission, it is clear that timeframes for commencement will need to be significantly revised.

The Government's deregulation agenda

Prior to making specific points in respect of the Government's proposal, it would appear timely to review the Government's statements with respect to pursuing a deregulation agenda subsequent to the 2013 Federal election. As articulated as early as November 2012 in a Press Release from the now Prime Minister:

> "Deregulation reform is part of the Coalition's plan to free up Australia's businesses so that they can create more jobs and opportunities for all Australians…(t)he Coalition will cut the regulatory burden on business and community groups by $1 billion a year and curtail the growth of regulation that is impeding the capacity of Australia to grow and succeed."

More specifically, comments contained in the Coalition's "Deregulation Reform Discussion Paper" appear particularly pertinent to the current proposal. Under the Deregulation Policy Principles, the Paper states that:

> "Regulation can, however, easily exceed the point at which the costs of further rules or reporting requirements outweigh the benefits. This is especially so since those groups advocating for or formulating additional regulations – including the bureaucracy – are typically not those who must directly bear the costs of these additional regulations."

In AFMA's view, the appropriateness of the proposed mandatory reporting requirements in respect of listed instruments needs to be considered through the lens of the Government's deregulation agenda. For the reasons set out below, it is AFMA's submission that the costs of compliance for industry with the proposed mandatory reporting requirements vastly outweigh the public benefits that accrue. That is, in AFMA's view, this proposal is one that is completely at odds with the Government's deregulation agenda.

The regulatory burden on participants in the financial services industry

In addition to the comments from the Government in relation to its deregulation agenda, it is appropriate to acknowledge that the financial services industry, to whom the specific measures are targeted, has been and continues to be subject to significant regulatory and reporting requirements, requiring the expending of significant amounts. These measures include the Foreign Account Tax Compliance Act (**FATCA**) measures emanating from the United States, which are proposed to be adopted globally through

the endorsement by the G-20 and the OECD of the Common Reporting Standard, to together with the trade reporting aspects of the OTC Derivative reforms, committed to by the G-20, that operate simultaneously with the move towards central clearing of OTC derivatives. These measures, and the responses from financial services industry participants, continue to be refined and will not be fully implemented in the short to medium term. Adding an additional burden to the same participants which imposes significant costs and yields zero benefit to the participant, is particularly concerning to AFMA and its membership, which is already struggling to implement and finance compliance with these measures.

AFMA urges the Government to consider the local and global moves towards reporting uncleared OTC derivatives to central repositories as part of the G-20 commitment to OTC derivative reform. There may be some synergies between this process and the ability for third parties to report information to the ATO, at least in terms of the adaption of systems to allow for the reporting of information. It would make no sense, in AFMA's view, to compel institutions to develop reporting systems in parallel based on different requirements.

Summary of the settlement system for listed securities

Prior to the making of specific comments regarding the issues associated with the reporting of transactions in respect of listed shares and units to the ATO, AFMA thought it useful to include a brief summary of the settlement process in relation to listed shares and units. This summary assumes that investors hold their investments through the Clearing House Electronic Subregister System (**CHESS**) as opposed to via an issuer-sponsored registry. We note at the outset that the choice for an investor holding through CHESS or through an issuer-sponsored registry generates significant complications with respect to the reporting of appropriate information, and we elaborate upon these complications further below.

CHESS operates on a DVP (delivery versus payment) basis, meaning that at a period of time after a transaction occurs, there is a simultaneous and irrevocable electronic transfer of legal title to the securities against the consideration paid. Presently, the time for transfer is three business days after the transaction (i.e. settlement happens on a T+3 basis). This settlement must be handled by an authorised market participant, i.e. a broker. The legal title to the securities is held on CHESS in electronic form, meaning that there are no paper certificates issued. The title to the securities is recorded in a specific Holder Identification Number (**HIN**) for an investor on a per-broker basis.

As at September 2013, CHESS held more than $1.45 trillion of securities with more than 11 million holdings. The value of trades executed daily on the two approved securities exchanges in Australia (the ASX and Chi-X) is around $4 billion, with approximately another $1 billion per day of securities transacted off-market.

Perceived benefits arising from the reporting requirement

The announcement in the 2013-14 Federal Budget, which was committed to by the incoming Government in an announcement from the Treasurer/Assistant Treasurer on 6 November 2013, sets out the stated rationale for the current proposal. The primary rationale for the proposal appears to be to improve compliance through data matching,

with a stated ancillary benefit of improving the pre-filling of tax returns, thereby making tax time simpler. In aggregate, the four categories of reporting are expected to generate, in underlying cash terms, $431.7 million over the forward estimates period. The costs of compliance are also included in the Budget announcement, estimated as being $77.8 million over the forward estimates period. AFMA makes three comments in relation to these figures.

Firstly, the revenue projections over the forward estimates period are not broken down by each category of reporting. In evaluating whether the Government should proceed with the mandatory reporting of acquisitions and disposals of listed shares and units, it would be necessary for a specific articulation of the revenue expected to be generated over the forward estimates period with respect to data matching taxable gains arising from the disposal of listed securities. We ask the Government to provide this estimate so as to properly facilitate an evaluation of the proposal.

Secondly, AFMA submits that the revenue generated from data-matching under-reported sales of listed shares and units will be *de minimis,* insofar as it is restricted to retail investors that generally hold such securities on capital account. Institutional investors (such as banks and other proprietary traders) who would represent a considerable amount of the turnover on Australia's securities exchanges, will have gains arising from the acquisition and disposal of such securities under Division 230 of the *Income Tax Assessment Act* 1997 (**the 1997 Act)** such that the taxable gain is determined with reference to the accounting profits disclosed in the audited financial statements. Accordingly, we submit that for such taxpayers, the level of scrutiny and verification as to the taxable gains reported is robust and will not be incrementally enhanced through the adoption of the reporting requirement. Similarly, other wholesale investors that hold their investments on capital account, such as Managed Investment Trusts (**MITs**), have heightened tax reporting obligations and regulatory requirements that impose increased integrity and transparency regarding the calculation and reporting of any CGT liability. Consequently, in AFMA's view the reporting of trades for such investors would not incrementally add to the integrity of the tax system.

For retail investors that hold their investments on capital account, AFMA would anticipate that such holdings are more often than not for a duration of in excess of twelve months and hence any gains would be eligible for the CGT discount, thereby further reducing any revenue accretion arising from the proposal.

Finally, with respect to the costs of compliance, the costs in the Budget announcement are merely those for the ATO and fail to factor in the costs for the industry. This is, in AFMA's view, both inappropriate and in stark contrast to the Government's deregulation agenda, which specifically requires the costs for industry to be factored in. AFMA submits that the cost that would need to be incurred by participants in the Australian financial markets industry to comply with the third party reporting requirements are considerably in excess of any benefits that may arise.

Addressing questions arising from the Discussion Paper

In this section of the Submission, we provide input in respect of the particular questions posed in the Discussion Paper in relation to the costs of compliance. We have sought to

approach these questions from the perspective of the market participant, although they are applicable to whichever participant in the trade execution and settlement process was required to undertake the reporting liability to the ATO.

Over-arching comments

As noted above, AFMA believes that the implementation of reporting systems to adhere to the requirements set out in the Discussion Paper will impose a significant cost on industry, a cost that will outweigh considerable the benefits arising. In particular, as set out in more detail below, market participants do not currently report the information as requested in the Discussion Paper to any regulator on a systemic basis. Accordingly, in order to adhere to the requirements of the Discussion Paper, a systems build would be required across the industry.

While this is difficult to quantify, based on the current experiences of participants in the financial markets developing systems to address FATCA, Dodd-Frank and AIIR requirements, AFMA estimates that the costs of compliance would exceed $100 million across the industry. As has been exhibited by the AIIR experiences, ongoing changes to the reporting systems would cause these costs to be exacerbated.

In terms of timing, the consistent feedback from the AFMA membership is that once the final specifications for a system are known, the lead-time on development is at least eighteen months and may stretch to two years. Importantly in terms of implementation, this will be the time required before the information can begin to be captured, not just reported. Consequently the lead time should be evaluated as the time that the regime could commence from a data collection perspective, not a reporting perspective.

Information currently obtained at the market participant level

From the perspective of the market participant (i.e. broker) in respect of CHESS holdings, the information collected from the client is generally limited to that necessary for compliance with Anti-Money Laundering and Know-Your-Customer requirements. Specifically, the participant will collect the name, address and tax file number (or ABN in lieu) at the time that the customer registers with CHESS at the time that the participant signs a CHESS Sponsorship Agreement. Apart from this initial requirement, there is no ongoing reporting obligation for the market participant. To the extent that an enquiry is made by a regulator (such as the Australian Securities and Investments Commission) regarding specific transactions then the market participant will be obliged to provide this information on a bespoke basis.

To the extent that a particular investor’s holding in listed securities is registered in CHESS, statements will be periodically provided to the investor to the extent that there is a change in the holding. However, this change will only include details of the holding, as opposed to the acquisition price/disposal price, i.e. it will only disclose quantities of securities acquired and sold and a running balance.

Inconsistency between CHESS holdings and issuer sponsored holdings

One particular concern regarding the provision of information to the ATO by third parties with respect to acquisitions and disposals of securities is the lack of necessity

that holdings are registered and held in a central repository, such as CHESS. Shareholders and holders of other listed securities have the choice to have their holdings of listed securities held in an issuer-sponsored sub-register, which is essentially a register maintained by the company that issued the securities. This function may be outsourced to a share registry but can be performed by the company itself.

This volition by security-holders as to whether to have their holdings registered through CHESS (via a market participant acting as sponsor) or through the issuer sponsored register means that there is no central source of all information regarding securities held. That is, reporting only in respect of the CHESS holdings would not capture all transactions.

This is further complicated by the fact that holders can convert their holdings in and out of CHESS. Consequently, a transfer of a holding from an issuer-sponsored register to CHESS may appear to be a disposal, notwithstanding there is no change in beneficial ownership of the underlying security.

Ability for investors to use more than one broker

Where an investor chooses to hold securities via CHESS, it is possible for the investor to do so through more than one market participant (i.e. CHESS sponsor). In this case, the investor will have a separate HIN for each parcel of securities held by each market participant. This creates the opportunity for securities to be transferred between HINs without crystallising a change of ownership, e.g. in the circumstance where an investor transfers all holdings from one market participant to another, there will be a transfer from one HIN to another without any change of ownership.

Consequently, a transfer of securities from one HIN to another may also inadvertently be reported as a disposal, notwithstanding there is no change in beneficial ownership of the underlying security.

The inability to pre-fill capital gains tax information

As described in the Discussion Paper, the started policy objectives from the requirement for third parties to report transactions in shares and units are:

- To allow the ATO to offer an enhanced pre-filling service to taxpayers; and
- To better address areas of risk to revenue.

Implicit in these policy objectives is that the ATO will be able to take the information, as reported by the third parties and calculate the capital gains tax liability arising for a retail investor from any disposals during a particular income year. For the reasons set out below, AFMA's view is that regardless of the quality of the information reported, this objective cannot be met and any attempt by the ATO to calculate the quantum of the gain will be necessarily flawed.

Disposal of a sub-set of a particular parcel

Where an investor holds a number of shares/units and the acquisition of those shares/units did not happen simultaneously, the investor will need to make an assumption as to which securities are being sold when a sub-set is disposed of.

By way of example, if an investor acquires 100 XYZ shares on 1 January 2014 at a price of $4.00 and a further 100 XYZ shares on 1 February 2014 for $5.00, and then disposes of 150 XYZ shares on 1 June 2014 for $6.00, an issue arises as to which shares were the ones that were sold in determining the capital gain, given that the shares are essentially fungible.

This issue was considered by the ATO in CGT Determination Number 33, entitled "how do you identify individual shares within a holding of identical shares." In this determination, the ATO takes the view that:

- Where the shares are able to be individually distinguished, e.g. by reference to share numbers or other distinctive rights or obligations, those shares are identifiable;
- Where it is not possible to individually identify the shares that have been sold, the Commissioner has accepted a "first in, first out" methodology.

Taking the above example, where the investor was able to specifically identify the XYZ shares that were being sold were all of the 1 February shares and 50 of the 1 January shares, the capital gain arising would be $2,000. However, if the "first in, first out" methodology was applied, then the capital gain would be $2,500.

Whether the shares/units that have been disposed of are capable of specific identification is ultimately a matter for the investor through the self-assessment process. Accordingly, any attempt to pre-ordain the quantum of the capital gain will be inherently incorrect.

CGT Rollover – scrip for scrip rollover example

There are a number of potential provisions within the 1997 Act that allow for an investor that holds a parcel of shares to obtain a rollover in respect of certain transactions undertaken with respect to those shares. The commentary below focusses on the "scrip-for-scrip" rollover available in Subdivision 124-M of the 1997 Act; however the comments should be relevant to other rollover provisions.

Where an investor holds shares in a company that is the subject of a proposed transaction whereby the shareholder in the target company is offered to sell those shares in exchange for shares in the acquiring company, such a disposal may qualify for rollover relief. This means that no CGT liability is crystallised on the sale of the initial shares and the investor's cost base in the new shares mirrors the cost base in the initial shares.

Consequently, the disposal of the shares/units by an investor would not give rise to a CGT liability and hence any disclosure thereof in the pre-filled tax return will be incorrect. Importantly, the ability to elect CGT rollover is generally optional, and the reporting entity will have no way of determining whether the investor makes the election or not.

Inherited shares

In a similar vein, where an investor passes away and leaves shares or units to a beneficiary under a will, this transfer will not trigger a capital gains tax liability.

Accordingly, any such transfer which would *prima facie* infer a taxable disposal for data-matching and pre-fill purposes would be incorrect.

Gifts

Listed share/units which are gifted by an investor to an associate for no consideration will crystallise a CGT event for the investor and the application of the market-value substitution rule to determine the quantum of the gain. Given the report will reflect that the transfer occurred for no consideration then the pre-filled capital loss from the investor's perspective will be incorrect.

Pre-CGT Assets

Any reporting obligation will assume that, for pre-fill and data-matching purposes, that the securities were acquired by the investor after 21 September 1965, being the commencement date for the CGT regime. To the extent that an asset has been continuously held by an investor since prior to the commencement of the CGT provisions, a disposal of that asset will not crystallise a CGT liability and hence the pre-filled return would be incorrect.

Nominee companies

The third party reporting requirement erroneously assumes that the legal owner of the securities will always be the beneficial owner for tax purposes. In many instances, investors will invest via a nominee company, particular where an investor has engaged a custodian to manage the assets of the investor. Nominee companies are regulated under the *Corporations Act* and typically are amongst the largest legal holders of shares in listed companies. Nominee companies are also used in instalment warrant structures, where the issuer holds legal title to the underlying securities as security for the leverage embedded in the warrant.

Any changes to the beneficial owners of securities held via a nominee company will not trigger a change of legal title and hence would not be reported under the current proposal. Similarly, a client may move assets in and out of custody, such that there is a change of legal ownership. Consequently, again, the information provided would be incorrect for data-matching and pre-fill purposes.

Information relevant to the CGT calculation that is not available

In addition to the points made above, the Discussion Paper suggests that the information required by the ATO is more than just the acquisition and disposal dates and amounts, but also information that is held only by the taxpayer but is necessary to determine the cost base of the assets and hence the CGT liability. Specifically, in the context of shares, the Discussion Paper suggests that information that could be reported includes incidental costs and corporate action information, such as capital returns. These amounts are not centrally captured/held and generally are taxpayer specific. Consequently it would appear to AFMA that the inclusion of such information is highly impractical.

In respect of corporate actions, the implications for the investor may differ depending on the specific corporate actions; consider share splits, bonus issues, returns of capital

(both cash and scrip), shares arising on demutualisation, etc. Attempting to standardise the considerable number of different types of corporate actions and implications for investors will, in AFMA's view, cause additional confusion and result in errors from a pre-fill and data matching perspective.

In addition, there are other costs that may have been incurred by an investor which are not deductible and included in cost base for CGT purposes. In particular, this may include non-deductible interest under a capital protected borrowing, where the tax law caps the deductibility to the RBA standard housing rate plus 100bps. The information that is reported to the ATO will not track the amount of non-deductible interest (as this calculation is generally performed by the investor) and hence the CGT information disclosed will be incorrect. Similar issues arise with respect to accountants' fees and financial planner fees.

Specific questions in the Discussion Paper

Based on the comments above, AFMA's responses to the relevant questions posed in the Discussion Paper are set out below:

- **What are your existing share and unit-related reporting obligations?** There is no current regime for market participants for the reporting of transactions in securities to regulators. ASIC does request information from time to time with respect to certain transactions or investors but such enquiries are ad-hoc and bespoke and addressed accordingly. Movements within CHESS will generally trigger a report to the investor (i.e. the holder of the HIN) but for the reasons set out above, such reports are incomplete and will not align to the crystallisation of a CGT event;
- **Do you currently report much of this information to other Government agencies?** As above.
- **How could these obligations be modified to minimise your compliance costs?** Not applicable.
- **Would it be feasible to collect all of the information sought by the ATO?** For the reasons set out above, it is AFMA's view that it would not be feasible for third parties to provide information to the ATO that would allow for the calculation (in the pre-fill context) or verification (in the data matching context) of investors' CGT liability, regardless of the costs involved. Once the costs of compliance are factored in, it is clear to AFMA that this proposal should not be pursued from a cost-benefit perspective.
- **What information do you currently collect?** Refer above.
- **Are there any other entities that collect some, or all, of this information?** The parties that collect the information would be the ASX (in respect of CHESS holdings) and the share registries (in respect of issuer sponsored holdings). However, we reiterate that the information cannot be complete and will give rise, in certain circumstances, to misleading conclusions.

- **Is similar information readily available in relation to unlisted shares?** AFMA submits that unlisted shares will not be within the realm of market participants or the settlement system.
- **What would constitute the bulk of your compliance costs (implementation or ongoing) in complying with these regulations?** Given the lack of reporting obligations that currently exist for market participants, the significant costs are the building of systems that would capture the information and report to the ATO. This is an enormous cost, estimated, as noted above, to be in excess of $100 million across the industry.
- **Is the start date of 1 July 2014 feasible? If not, how long would you need to develop any necessary system changes?** As noted above, once final specifications are known, the lead time to build the systems would be at least eighteen months and potentially closer to two years. We reiterate that this is in respect of the capturing of information, not the reporting. Accordingly, the earliest the information could be reported (and we stress that we do not believe there is a compelling case for the information to be reported) is 1 July 2016 with the first reports provided in respect of the 30 June 2017 income year.

Carve-out for wholesale transactions

Following on from the comments above regarding the lack of compliance benefit arising with respect to institutional transactions, AFMA submits that to the extent that the Government chooses to proceed with the requirement for reporting on share and unit acquisition and disposals then such reporting be limited to retail investors only.

While it is not necessarily the case that a retail investor will hold assets on capital account, it will generally be the case that wholesale investors for *Corporations Act* purposes will have their tax returns prepared by a registered Tax Agent, potentially in accordance with Division 230 of the 1997 Act. To that end, AFMA submits that the compliance risk associated with wholesale investors is minimal. Carving out transactions undertaken by institutional investors would also significantly reduce the information that is provided to the ATO, thereby reducing the administrative burden imposed on the revenue authority by ensuring that only the information relevant to the policy objectives of the measure is provided to the office.

In particular, institutions that trade on their own books should be excluded from any reporting regimes. There are AFMA members that undertake purely proprietary business and for efficiency purposes are market participants (i.e. they execute their own transactions). Any reporting undertaken by such enterprises would purely be in respect of their own transactions and consequently add zero from an integrity/data-matching perspective.

Non-application to derivatives and similar instruments

AFMA submits that any proposal to compel reporting of third party acquisitions and disposal be limited to listed shares and units and not be extended to other instruments, such as warrants (including instalment warrants), options and other derivatives.

This is a point of ambiguity between the announcement in the 2013-14 Federal Budget and the Discussion Paper. The Budget Announcement states that "(t)he measure will establish new and strengthen existing reporting systems for…sales of shares (including options and warrants) and units in managed funds." However, the Discussion Paper focusses solely on shares in companies and units in unit trusts, and initially those listed on recognised securities exchanges.

In our view, the inclusion of options, warrants and other derivatives would complicate the information being provided to the ATO and would not incrementally improve either of the policy objectives underpinning the third party reporting measure. The taxation treatment of derivatives and other securities may depend on their structure or the intention of holding by the investor – for example, traditional and qualifying securities will be taxed on revenue account regardless as to the intention of the investor, with the difference being whether the instruments are taxed on a realisation or accruals basis. Similarly, the treatment of options may differ as to whether they are capable of physical delivery.

The tax intricacies of the particular traded securities are not required to be understood by market participants, custodians or the exchanges themselves. Accordingly, reporting by such entities would not appear to enhance either the data-matching within the ATO as to whether an appropriate taxable gain has been disclosed on a tax return, nor would it assist with the pre-fill objectives.

Non-reporting of sales through merchant credit and debit services to institutional transactions

Finally, for completeness, we have assumed that the reporting requirements set out in Section 2.3 of the Discussion Paper regarding merchant sales and purchases does not extend to institutional transactions. We understand the policy intention of the proposals is limited to those financial institutions that provide payment services to merchants; however technically the provision of any banking services that are conducted over an online banking system could fall within the requirements.

We request that the Government make it clear that such institutional transactions are outside the scope of the reporting requirements.

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We would be pleased to discuss any aspect of our submission or the Government's proposal more generally. Please contact me on (02) 9776 7996 if you have any queries or comments.

Yours sincerely,

Rob Colquhoun
Director, Policy