Tax Provision for Unit Pricing Policy

Changes to the policy were made by the Policy owner in July 2019 and reported to the Board.

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1 Executive Summary

1.1 Introduction

This policy outlines the process and principles to provide for tax in the calculation of unit prices for Rest. It is a supporting policy to the 'Rest Unit Pricing Policy'. The principles have been developed in conjunction with Rest's custodian (State Street). This policy also considers specific tax considerations in determining the appropriateness of the methodology employed regarding items raised in the ASIC/APRA Unit pricing – Guide to Good Practice (the Guide). This policy will be formally reviewed on an annual basis. It may also be updated from time to time to enhance the method of tax provisioning in unit pricing.

1.2 Overview

The tax provision in the unit price is an estimate of the tax liability at a point in time. Rest uses the accounting profit or loss at the asset class level and applies a tax rate which varies depending on the type of security generating the gains or losses. There is a process to check the accuracy of the estimate and adjust where it is outside a set tolerance each month.

A tax true-up is done each year between the tax in the unit price and the tax provision per the final tax return. Any permanent adjustments are made to the tax in the unit price. Historically the amount of the true-up adjustment has been small, which shows that the methodology is reasonably accurate.

This process is relatively simple to administer which reduces the risk of calculation error yet provides an estimate that is reasonably accurate and a method for adjustment in a timely manner.

Rest's General Manager Finance (GM-F) considers that the methodology is appropriate for Rest.

1.3 Who needs to know

This is a technical policy so is not required knowledge for all staff.

The Rest Investment and Finance teams who are responsible for unit pricing and the controls around tax provisioning need to understand the policy in detail and assist the GM-F in ensuring processes are followed in line with the policy.

The Tax Planning Committee and Board need to know that Rest has a Tax Provision for Unit Pricing Policy and be comfortable that the processes and controls are appropriate.

1.4 What has changed

There have been no substantive changes made to the policy. This policy has been updated for organisational changes at Rest and some discussion which is more process than policy has been removed to a procedures document maintained by Rest Finance.

Rest

2 Tax provision process

2.1 Overview

Rest maintains a single pool of assets for the whole Fund including both superannuation and pension assets. State Street maintains individual manager portfolios which hold the underlying securities and produces a trial balance and net asset value at the individual portfolio and the asset class level (e.g. Australian equities).

To cater for the different tax treatments between superannuation and pension, the asset class level is valued on a "pre-tax" basis. However, an exception to this is that imputation credits are also recognised as an asset at this level, since both the superannuation and pension members are entitled to the benefit of imputation credits. This is referred to as the "pre-tax sector".

Pension options hold notional units directly in the "pre-tax sector" (or "Pension Sector").

The tax provision for superannuation is calculated by reference to the "pre-tax sector", but only posted at the "taxed sector" based on its proportion of ownership in the "pre-tax sector" at the beginning of the year and at the most recent month end. The "taxed sector" holds notional units in the "pre-tax sector" plus a provision for tax[1].

Superannuation Options hold notional units in the "taxed sector". The tax provision for the Superannuation Options is calculated based on the accounting profit and loss at the "pre-tax sector". Tax is applied at different rates depending on the nature of the gains and losses. For example, gains and losses on capital investments such as equities are taxed at 10% as Rest generally holds assets for more than 12 months and so is entitled to the CGT discount. Gains and losses on traditional securities such as bonds and short-term securities are taxed at 15%. Income and expense items such as interest and dividends are also taxed at 15% on the gross amount. The benefit of franking credits is included in the valuation of the "pre-tax sector" and foreign income tax offsets are only recognised at the taxed sector level.

The tax rate for capital investments such as equities can be changed. The appropriateness of the tax rate and the likelihood of Rest realising short term capital gains in the next 12 months is reviewed annually. It may be that a new rate somewhere between 10% and 15% may be more appropriate to recognise that a proportion of capital gains may be taxed at the higher rate of 15%.

Rest considers that the above approach provides a good estimate for all tax liabilities applicable to the gains and losses inherent in the unit price. The tax liability for Unit pricing purposes takes in to account all accounting income and gains. There

[1] An exception to this is the Australian share sector where the pension option invests directly with managers whose investment style is suited to those in pension phase. Refer Appendix for explanation of the Australian equities sector for accumulation and pension members.

is no split between current or deferred liabilities or realised/unrealised income or gains.

Note that the equities accounting gains contributing to unit pricing is calculated on a weighted average basis. This methodology differs to the taxation propagation methodology based on highest cost held for 12 months basis.

The Funds tax liabilities for accounting purposes comprises a current tax liability that relates to realised gains and income recognised in the current period, plus a deferred tax liability relating to unrealised gains and income yet to be recognised. The equities recognition methodology differences will give rise to difference in current liabilities and tax payable for the current period.

Each month, Rest Finance reviews the year to date tax expense in the unit prices to the year to date tax expense in the monthly accounts at a whole of Fund level. Differences are classified into known methodology variances, and other differences. The sizes of the differences are reviewed for reasonableness and materiality.

Each month, Rest Finance reviews the tax provision in the unit prices to the tax provision in the monthly accounts at the sector level and investigates any significant difference. Where the difference causes more than a 10-basis point impact at an option level (3 basis points for Cash and Basic Cash), Rest may instruct State Street to adjust the tax provision in the unit prices to align more closely with the tax provision in the monthly accounts.

2.3 Annual clear out of tax provision

Upon finalisation of the tax return, Rest Finance carries out a 3-way reconciliation of the tax in the unit prices to the tax in the annual financial statements to the tax in the tax return. The GM-F will then review the reconciliation and provide an instruction to the custodian to take up any permanent differences and clear out any remaining tax balances. The franking credits are cleared out of the untaxed sector.

3 Specific tax considerations

Whilst the Joint ASIC and APRA Unit Pricing Guide to good practice (RG 94) ("the Guide") was published in August 2008, it remains the most relevant reference point for unit pricing methodology. Section 5.2 of the Guide specifically relates to determining tax in unit price. The specific tax considerations outlined below refer to points outlined in the Guide and explains Rest's methodology and how it is in accordance with the Guide.

3.1 Tax provision estimate

The Guide states that a reasonable estimate of the tax provision must be used each time a unit price is struck. This estimate must be reconciled with the tax provision in the accounts from time to time.

a) Rest uses an estimated tax provision each time a unit price is struck which approximates to the tax provision in the accounts by applying different rates to different types of income.

b) Franking credits are recognised as an asset in the individual portfolios, and therefore form part of the “pre-tax sector” valuation. Income tax, including foreign income tax offsets is provided for at the taxed sector level, based on the average proportion of Super to the total fund holdings for each sector. This then flows through to the different options.

c) The tax provision included in the unit price is reconciled to the accounts each month for reasonableness.

Rest’s methodology is aligned to the Guide.

3.2 Treatment of imputation credits and foreign tax offsets

The Guide states that unit holders present in a product at the time an amount accrues should receive the benefit of that amount in the unit price, even if legal entitlement arises later. This principle should be reflected in the policy for imputation credits to the extent possible.

a) Imputation credits from dividends are recognised on an ex-date basis, and therefore are immediately reflected in the unit prices.

b) No adjustment is made for denial of imputation credits from the 45-day holding period rule on the basis that the denial of franking credits is not material to unit prices. This difference is identified as part of the tax return preparation and forms part of the annual reconciliation of tax provision in the unit prices to the tax return.

c) Rest invests in several unit trusts that it does not control which distribute taxable income and provide distribution statements. Generally, the components of the distributions are not finalised until after the year end. However, for tax provision purposes, an estimate of the distribution components is used based on information available at the time of distribution (usually based on the prior year’s actual). The difference between the estimate and the actual is adjusted in the unit price as part of the annual reconciliation and true-up.

d) Foreign income tax offsets on dividends are recognised on an ex-date basis and therefore are immediately reflected in the unit prices.

e) Foreign income tax offsets from unit trust distributions are estimated in the tax provision based on information available at the time (usually based on the prior year's actual). The difference between the estimate and the actual are adjusted in the unit price as part of the annual reconciliation and true-up

f) Excess foreign income tax offsets at the end of the financial year will be lost. Rest monitors the level of any excess foreign income tax offset. Should such an excess arise, Rest will assess the likelihood of the position reversing by financial year end to determine whether it is appropriate to continue to recognise the offsets in the unit prices. The procedure for monitoring excess foreign income tax offset is as follows:

    i. The level of excess foreign income tax offsets is monitored on a quarterly basis. The calculation of the cap on foreign income tax offsets (FITOs) that can be claimed is not straight forward. The FITO cap calculation is the subject of a tax ruling TR2014/7(as amended), which addresses the source of foreign currency gains and to what foreign currency hedging losses may reasonably relate. This ruling has been subject to significant industry lobbying and has been amended by the ATO. There is still a significant degree of uncertainty and disagreement between the ATO and tax profession regarding this issue. At a high level, Rest considers that the source of the SIM FX hedges is Australian, since the contracts are formed in Australia. Rest has developed an apportionment methodology based on its interpretation of the ruling for what the foreign currency hedging losses relate to. This apportionment methodology has been reviewed by PwC and considered to be reasonable.
    ii. Where the excess FITO represents more than 10 basis points of the international equities sector, the pricing response team will consider recommending to the CEO to either continue to recognise the FITOs (with the expectation that by the end of the financial year, the position will have reversed) or to exclude the excess FITOs from the unit prices.
    iii. The pricing response team will consider the economic outlook for the rest of the financial year in making its recommendation.
    iv. The decision made by the CEO will be notified to the Investment Committee.
    v. If a decision is made to exclude the FITOs, then this will be subject to the Custodian's ability to implement this change in a robust manner so as not to increase the risk of a unit pricing error.
    vi. If FITOs are de-recognised in the unit prices, they will continue to be monitored monthly in case the markets reverse and the offsets can be utilised. If this happens, the Custodian will be instructed to re-recognise the offsets.
    vii. After year-end rollover FITOs are re-set and will be recognised based on the monitoring procedures outlined above for the new financial year.

Rest's methodology in relation to imputation and FITOs is aligned to the Guide based on materiality.

3.3 Treatment of deferred tax assets (future income tax benefits – FITBs)

The Guide states that FITBs should be included in unit prices to the extent that they have value for present or future unit holders, taking into account the circumstances of the fund, the governing documentation, possible events, and the fund's approach to discounting to allow for the time value of money.

a) Rest will have a deferred tax asset for net capital losses if it has net realised and/or unrealised capital losses that are carried forward for offset against future capital gains. The existence of a deferred tax asset raises a potential issue regarding equity between members, as the value of the asset may only arise sometime in the future.

b) The unit prices recognise the benefit of any net capital loss including realised capital losses carried forward from prior years at 10%. This is considered appropriate as Rest generally holds capital assets for more than 1 year, so when in a net capital gain position, pays tax on its capital gains at 10%.

c) The amount of the deferred tax asset relating to capital losses is reviewed each month from the tax provision calculation. If the deferred tax asset relating to capital losses exceeds 1% of the net assets of the Fund, Rest's GM-F will prepare a paper for the Investment Committee recommending to the Board the level at which to set a cap on the recognition of the deferred tax asset. The following issues will be considered:

   i. Expectations of market movements and their volatility
   ii. Exposure of the Fund to possible significant redemptions
   iii. Potential changes to the applicable tax rate
   iv. The investment timeframe
   v. The extent to which deferred tax assets in one investment option can be applied against gains elsewhere in other investment options.
   vi. Likely inflows and outflows for the Fund.
   vii. Once the level of the cap has been determined by the Board, it will remain in force for a period of 12 months and then be subject to further review if the DTA is still above 1% at that time.

d) The Custodian has developed a report showing the amount of realised and unrealised capital losses (at 10%) as a percentage of total pre-tax assets. Once the level exceeds 1.5% of net assets of the Fund, this is provided to the Rest Finance each time a unit price is struck for monitoring purposes. This report will identify when the DTA exceeds 2% of the net assets of the Fund and the amount of any adjustment required.

e) The methodology for the apportionment of the cap will be as follows:

i. Each month the total realised and unrealised capital losses are calculated for each sector at 10%.
ii. These flow up to the Accumulation Options to provide a percentage for each option (excluding pension options which are exempt from tax)
iii. Where the total fund percentage < 2% (the current cap) no adjustment is required (and any prior adjustment should be removed)
iv. Where the total fund percentage >2% then the following applies:
    i. A maximum DTA for each option is calculated, by apportioning the overall fund cap over the options using the estimated capital growth rates for each option (provided by JANA). This recognises that due to different weightings to growth assets, the options will have varying capability to generate future capital gains to offset losses. (Note - this provides an overall cap of 2% at the Fund level).
    ii. Only those options above their maximum will be subject to adjustment, on a proportional basis.
    iii. For those options which are above their maximum, the amount above the maximum is calculated in dollar terms.
    iv. This is then expressed as a % of all the options above their maximum.
    v. The apportionment of the adjustment will be based on a proportional basis for any option whose individual percentage is above its maximum DTA. The calculation will be:

$$\frac{\text{Deferred tax asset of option (where option > its max DTA)}}{\text{Total deferred tax asset for all options above their max DTA}}$$

    vi. The Custodian will be notified of the requirement to make an adjustment and will be informed of the apportionment percentages to be used. This allocation will be used until the following month-end calculation is completed and a new allocation provided.
    vii. The dollar amount of the adjustment will be calculated by the Custodian each time a unit price is struck and they will use the apportionment percentages provided by Rest to allocate the total to the individual options. The adjustment amount will be shown separately as an adjustment at the Option level. The post-tax NAV will be calculated as the net assets plus the DTA adjustment.

Rest's methodology in relation to the recognition of deferred tax assets in the unit price is aligned to the Guide and is considered equitable between members.

3.4 Treatment of capital gains

The Guide states that assessing deferred tax on unrealised gains and losses can be complicated because the tax rules are complex, and the assets are likely to have been held for various periods of time.

a) For unit pricing purposes, capital gains are based on the accounting income, being the realised and unrealised gains and losses on equities and options calculated at 10%. This rate of tax is considered appropriate because Rest generally holds assets for more than 12 months and has enough losses to offset short term gains, resulting in all capital gains being assessed at 10%. This assumption is tested and validated each year for both realised and unrealised gains.

b) Whilst it is acknowledged that this will give rise to timing difference between realised and unrealised gains due to different allocation methodology between accounting and tax (accounting is calculated on a weighted average book cost whilst tax parcels are matched using the State Street specific identity method of Highest Cost greater than 12 months. The overall tax expense should not be significantly different.

c) Where Rest invests in wholly owned unit trusts that it controls, Rest seeks an estimate of the distributable income from the investment manager and accrues them in the unit price at year end. This effectively converts an unrealised capital gain (taxed at 10%) to a realised income gain (taxed at 15%) which minimises the difference between the tax in the unit price and the tax per the tax provision.

d) For unit trusts which Rest does not control, no adjustment is made for the capital gains discount on indirect capital gains from trust distributions. This is a conservative approach and is reasonable given the relatively small amount of capital gains distributed from trusts, the frequency of the distributions and the timeliness of the tax information. These adjustments are identified as part of the tax return process and forms part of the annual reconciliation

Rest's methodology in relation to the treatment of capital gains and the tax rate used in the unit price is aligned to the Guide and is appropriate.

3.5 Pooled assets – Accumulation & Pension

The Guide states that a fund may have many types of assets in one taxation pool and there may be interaction of tax effects between multiple investor options which adds to the complexity.

a) Rest maintains a single pool of assets for both the accumulation phase and the pension phase. For tax return purposes, Rest obtains an actuarial

certificate under section 295-390 of the Income Tax Assessment Act 1997 to determine the percentage of the pool relating to current pension liabilities.

b) For monthly accounting purposes, an adjustment is made to the tax provision in the financial statements to account for the pension portion.

c) For unit pricing, both a pension price and a taxed price is calculated at the sector level. The pension price is calculated using the pre-tax net asset value which includes an asset representing the franking credits. The taxed sector includes a provision for tax which is calculated by taking the average of the percentage holding by Super in the sector at the beginning of the year and the most recent month end date, and multiplying by the tax provision of the sector as if it was all taxable.

d) This difference in methodology (i.e. tax in unit price using the % pension holding at the sector level, whereas the tax provision in the accounts uses an average % pension holding at the total fund level) gives rise to a difference in provision which is adjusted as part of the year-end tax true-up.

Rest's methodology in relation to calculation of tax in unit price in a pooled vehicle for both accumulation and pension assets is appropriate and aligned to the Guide. The method of allocating the difference at year-end is equitable.

4 Reconciliations

The Guide recommends that reconciliations should be prepared to compare the amounts used in unit pricing with the amounts, separately calculated, which are reported in the financial statements and annual tax returns as follows:

a) compare and resolve difference between the current tax in the unit prices with the provision in the financial statements. Also compare and resolve difference between the current tax in the unit prices with the tax returns.

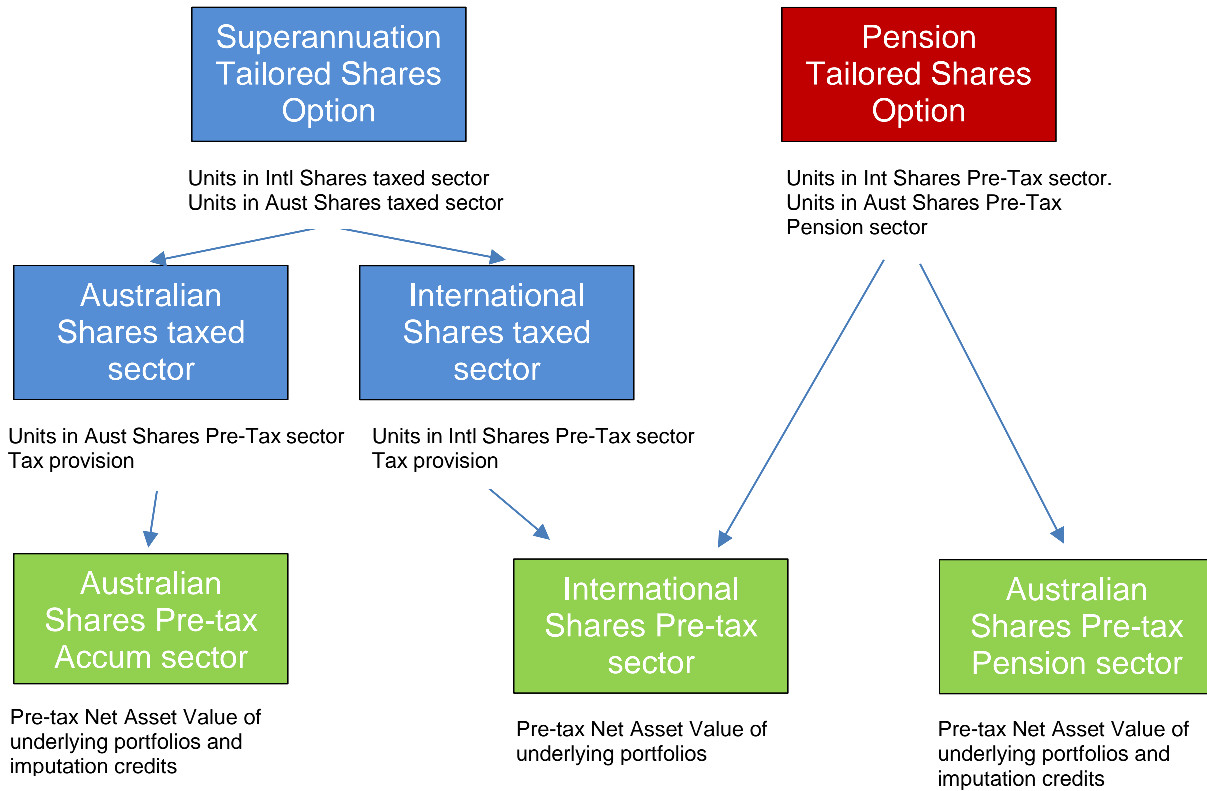
b) compare and resolve difference between the deferred tax in the unit prices with the deferred tax provision in the financial statements.

c) compare and resolve differences between the movement in current tax and the movement in deferred tax.

Rest Finance carries out reconciliations regularly and with a frequency determined by the GM-F in accordance with the Guide and the complexity of Rest Any material differences are investigated by Rest Finance. Currently reconciliations are carried out monthly, quarterly and annually.

APPENDIX

Below is a diagram showing the structure for the Australian Shares Option. This is explained in more detail below.



The Australian Equities sector is different to the other investment sectors maintained by Rest as the Australian pre-tax pension sector has specific investment managers whose investment style is suited to the Pension Option. This includes imputation credits. Therefore, the Australian equities pension options are not identical to the accumulation options and each will have a different performance and unit price.