

## Tax Brief

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### **New definition of managed investment trust**

#### **1. Introduction**

The ongoing story of the project to reform the taxation of managed investment trusts ('MITs') has yet another chapter. On 24 June, Parliament passed a Bill which made significant amendments to the definition of a MIT, broadening the former provision in some respects but also adding important new restrictions. The Bill has received Royal Assent and is now law. This Tax Brief examines the new definition and how it has changed the range of trusts that are eligible to access the MIT withholding tax and CGT election concessions.

#### **2. Background**

The definition of a MIT was introduced into Australian tax law in 2007 but has been the subject of much tinkering since then during the ongoing reforms to the taxation of MITs – for example, the decision to change the tax system for non-resident investors in MITs to a final withholding tax, the decision to reduce the applicable tax rate for non-residents to 7.5% and the decision to allow MITs to elect capital gain and loss treatment for certain types of assets.

The impetus for these changes has been the Government's policy:

... to increase Australia's funds management export earnings by increasing Australia's attractiveness as an investment destination.

But Treasury has been unhappy with key aspects of the definition. Treasury took the view that the MIT definition was not effectively achieving its purpose because a MIT might be operated by a non-resident with minimal input from a local licence-holder or by a manager that was not operating in Australia. The Government wanted 'closer alignment' between the MIT definition for withholding tax and the definition of MIT that would apply for the purposes of the CGT election concession. In April 2010, Treasury proposed changes which would exclude trusts conducting or controlling a trading business. Taxpayers had other concerns with the definition.

In May, the Government introduced a Bill into Parliament making further changes to the definition of MIT, changes which were themselves amended as the Bill made its way through Parliament.

The position that has now been reached represents a substantial change from the former definition of a MIT. It is broader in some respects but also subject to important new restrictions. As will be seen below, some of the new tests are still

more than a little arcane, the evidence being that it now takes 9 pages of tax legislation to define a MIT. Nevertheless, the final version represents a significant improvement and should satisfy a number of the industry's concerns.

### 3. Key changes

Some of the key changes introduced by the new definition include:

- a 'local management' test which requires that Australian trust assets be substantially managed in Australia;
- having separate MIT criteria according to whether the trust operates at a retail or wholesale level;
- adjusting the licensing requirements for fund managers;
- changing the rules which operate when a MIT is owned in part by another type of collective investment vehicle (such as a life insurance company, superannuation fund or other MIT) and expanding the range of vehicles considered to be collective investment vehicles; and
- re-stating the ownership rules to exclude trusts with concentrated ownership.

### 4. The MIT definition – general requirements

The new definition contains a number of general conditions that must be met by all trusts and some further conditions that vary for particular types of trust.

1. All trusts must satisfy a **residency test**: either the trustee must be a resident of Australia or else the central management and control of the trust must be located in Australia. This test must be met at the first time during an income year that the trust makes a distribution (or at an earlier time in that year). This test is the same as the former definition.

2. The trust must not be engaged in active **trade or business**. There are two ways that a trust might fail this test:

- First, a trust will fail this test if it carried on trading business using the definition in Division 6C of the *Income Tax Assessment Act 1936*. The Division 6C test requires a trust to conduct only 'eligible investment business' – that is, invest in land primarily for the purpose of deriving rent, or invest or trade in certain kinds of securities. Where a trust earns income from activities other than eligible investment business (subject to a small *de minimis* exception) it conducts a trading business and will not be able to be a MIT under this test.
- Secondly, a trust will fail this test if it controls, or is able to control, the affairs or operations of another entity which earns income from activities other than eligible investment business.

This test makes explicit a view that Treasury asserts was always the intended scope of the MIT regime – that it is only relevant for trusts which derive passive

income. The test should not come as a surprise to trustees, fund managers or investors.

3. The trust must be a '**managed investment scheme**' as defined in the *Corporations Act*. The definition in the *Corporations Act* defines a MIS by reference to the pooling of funds to generate financial benefits for people who do not have day-to-day control over the operations of the fund.

This formulation represents an improvement to the former law which aggregated the idea of a MIS with another test – that the fund is operated by a person with an appropriate Australian Financial Services Licence ('**AFSL**'). Licensing requirements are now dealt with separately.

4. A substantial proportion of the '**investment management activities**' are carried out in Australia in respect of:

- the assets of the trust that are situated in Australia;
- the assets of the trust that are 'taxable Australian property'; and
- the assets of the trust that are listed on an approved stock exchange in Australia.

This requirement is meant to make it clear that a key purpose of the regime is to increase the proportion of investment management services performed in Australia. In the course of consultations, it was pointed out to Treasury that even if the manager of a particular fund is located outside Australia, that manager would usually appoint asset managers, accountants, lawyers and other advisers that would be located in Australia. However, these services were evidently not considered to be sufficient to justify the reduced rates of MIT withholding – it is the investment management sector that is intended to be encouraged.

There will inevitably be a deal of uncertainty surrounding the range of activities associated with managing and operating a fund that are to be considered 'investment management activities.' The Explanatory Memorandum notes that:

The focus of this test is on the investment decisions (and related activities) that are generally undertaken by the manager of the fund. Such decisions relate to the type of, and timing of the purchase of, investment assets.

In determining where such decisions are made, the Explanatory Memorandum indicates that the test should be applied on a substance over form basis. This means that:

- appointing an Australian investment manager which sub-contracts its role to a non-resident manager will not be acceptable; and
- appointing a non-resident manager that purports to make decisions in Australia on a fly-in, fly-out basis will also not be acceptable.

The local management test is applied on an annual basis having regard to the services provided in each year of income. Accordingly, if a non-resident entity is

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involved in the decisions associated with the establishment of a trust, that trust may still become a MIT in subsequent years of income if the ongoing management of the fund is assumed by an entity in Australia.

There are still a number of areas of uncertainty with respect to the local management test. For example, there is no discussion in the Explanatory Memorandum regarding the degree of foreign management that would be permitted while still achieving substantial investment management in Australia. The focus of the discussion in the Explanatory Memorandum is on decisions regarding the selection and acquisition of assets by a trust. While this will produce a relatively straightforward result in the context of open-ended funds, there will be many potential MITs that will be established to acquire a single asset, or portfolio of assets, to be held as passive assets over a particular investment horizon. The nature of the services required to be provided in Australia beyond the initial acquisitions, and the impact of the input on future disposal decisions by the unitholders themselves, is not entirely clear.

The investment management requirement does not apply for the purposes of the CGT election. That is, a trust will not need to satisfy the investment management requirement to access the CGT election provided the other requirements for MIT treatment are satisfied.

5. The trust must be **widely-held** as defined, and not fall within the applicable **closely-held** exclusion. In general terms, what these two requirements demand differs according to whether the trust (i) operates at a wholesale or retail level in the market and (ii) is registered (and whether it needed to be registered) or not as a managed investment scheme under the *Corporations Act*. The rules distinguishes three combinations of these two variables:

- a registered retail MIT (in most cases a MIT that is required to be registered under the Corporations Act, referred to below as a 'compulsorily registered scheme');
- a voluntarily registered wholesale MIT; and
- an unregistered wholesale MIT.

The 'wholesale' and 'retail' labels are not used in the legislation, but the rules are written with these kinds of situations in mind – the test invokes the retail model if the trust has 20 or more retail investors or retail investors own 10% or more of the trust. The terms and implications of the test for each type of trust are examined in more detail below.

It is worth noting that a trust need not satisfy the widely-held requirement during the start-up period (which can be as long as 18 months) or wind-down period (which can last for up to 2 years).

6. **Licensing** test. For retail trusts, no specific licensing test is stipulated because the *Corporations Act* will supply requirements about the MIT being managed by the holder of an appropriate AFSL.

For trusts that are wholesale schemes (whether registered or unregistered), the trust must be operated or managed either by an entity with an AFSL that permits the provision of financial services to wholesale entities or by certain Crown entities (or entities specific by ASIC) that are not required to hold an AFSL.

## 5. The 'widely-held' and 'closely-held' tests

The widely-held requirement and the closely-held exception differ depending on the features of the trust. The tests sometimes involve counting the number of members of the MIT and sometimes counting the size of the interest in the MIT that investors hold, directly or indirectly. Interests in the MIT are measured in percentages by reference to multiple criteria – a method which is not always straightforward where units have different rights.

### ***Compulsorily registered scheme***

The widely-held requirement for a compulsorily registered scheme (typically, a retail fund) will be satisfied if one of the following conditions is satisfied:

- the trust is listed on an approved stock exchange in Australia;
- the trust has at least 50 actual or deemed members; or
- 'qualifying' investors have a direct or indirect interest in the trust of 25% or more and no single non-'qualifying' investor has an interest of more than 60%. (In the Table at the end of this Tax Brief, this alternative is referred to as the 'Keystone Investor' test.)

The closely-held exception will preclude a trust from retaining its MIT status if at any time during the relevant income year:

- 20 or fewer persons (excluding 'qualifying' investors) have an interest in the trust of 75% or more; or
- a single foreign resident individual has an interest in the trust of 10% or more.

### ***Voluntarily registered wholesale scheme***

The widely-held requirement for a voluntarily registered (wholesale) scheme will be satisfied if one of the following conditions is satisfied:

- the trust has at least 25 actual or deemed members; or
- 'qualifying' investors have a direct or indirect interest in the trust of 25% or more and no single non-'qualifying' investor has an interest of more than 60%.

The closely-held exclusion for a voluntarily registered wholesale scheme will preclude a trust from retaining its MIT status if at any time during the relevant income year:

- 10 or fewer persons (excluding 'qualifying' investors) have an interest in the trust of 75% or more; or

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- a single foreign resident individual has an interest in the trust of 10% or more.

## ***Unregistered wholesale scheme***

The widely-held requirement for an unregistered (wholesale) scheme will be satisfied if the trust has at least 25 actual or deemed members.

The closely-held exclusion for an unregistered wholesale scheme is the same as for a registered wholesale scheme.

## ***'Qualifying' investors (and deemed members)***

The definition retains the approach of having special treatment where membership interests are held by various kinds of collective investment vehicles ('CIVs'). The logic behind the special treatment is that a membership interest held by a CIV should realistically be considered to represent the greater number of individuals who have invested directly into the CIV and so indirectly into the MIT.

Hence, the references above to a 'deemed' member of a MIT reflect a special rule which treats the portion of the MIT held by a single CIV as being held by more than one member. So, for example, if a single life insurance company owns 50% of a MIT, the portion owned by that company would be taken to represent 25 members. (This formula is more strict than the former law which treated a trust as a MIT if a single unit was owned by a relevant CIV.)

For this test, the 'qualifying' investors are life insurance companies, complying superannuation funds with at least 50 members, certain pooled superannuation trusts, another MIT in Australia or similar entity formed abroad with at least 50 members, foreign pension funds, sovereign wealth funds and entities owned by an Australian government agency maintained to meet statutory liabilities (eg, the Australian Future Fund). This list expands slightly the range of entities that were listed in the former law, but the descriptions are highly detailed and the precise characteristics required of each type of CIV will almost certainly prove a source of much ongoing difficulty.

## ***Interests held indirectly***

The new definition contains a series of complex rules dealing with interests in a MIT held indirectly through interposed trusts. These rules can affect the determination whether a trust has a sufficient number of members to be regarded as widely-held and whether there is a concentration of membership which triggers the closely-held test. These rules will require careful examination even for quite ordinary tiered structures.

## **6. Commencement and transition**

For MIT withholding purposes, the new definition of MIT takes effect for the first trust distribution made in relation to a year of income that started after 30 June 2010. In other words, the former definition will continue to apply to pending trust distributions which relate to the 2009-10 income year.

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But because the changes to the definition of a MIT both tighten and relax its scope, special transitional rules are included as part of the Bill. If a trust qualified as a MIT under the definition as it stood in May 2010, a transitional provision is intended to grandfather that MIT until the end of 2016-17 income year.

The amended MIT definition will also apply for the purposes of the CGT election. The special grandfathering rule may also apply to permit trusts which were MITs in May 2010 to make the CGT election.

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## Summary of key requirements

	Options for meeting the 'widely-held' requirement					
	Listing Test	Number of Members Test	Keystone Investor Test	Closely-held Exclusion	Retail Limitation	Licensing
<b>Compulsorily Registered Scheme</b>	Yes	50 or more  'Qualifying' investors can count as several members	'Qualifying' investor(s) has 25% or more and no non-'qualifying' investor has 60%	20 or fewer non-'qualifying' investors have 75% or more  <i>or</i>  1 foreign individual has 10% or more	N/A	Corporations Act requirements
<b>Voluntarily Registered Wholesale Scheme</b>	No	25 or more  'Qualifying' investors can count as several members  Retail investors are not counted	'Qualifying' investor(s) has 25% or more and no non-'qualifying' investor has 60%	10 or fewer non-'qualifying' investors have 75% or more  <i>or</i>  1 foreign individual has 10% or more	20 or more retail investors  <i>or</i>  Retail investors hold more than 10%	Operated or managed by wholesale AFS licensee or certain Crown or ASIC-excluded entities
<b>Unregistered Scheme</b>	No	25 or more  'Qualifying' investors can count as several members  Retail investors are not counted	No	10 or fewer non-'qualifying' investors have 75% or more  <i>or</i>  1 foreign individual has 10% or more	20 or more retail investors  <i>or</i>  Retail investors hold more than 10%	Operated or managed by wholesale AFS licensee or certain Crown or ASIC-excluded entities

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