

Tax Brief

4 November 2008

Review of Managed Investment Trusts: Round 1

The Board of Taxation released its Discussion Paper, *Review of the Tax Arrangements Applying to Managed Investment Trusts ("MITs")* on 29 October 2008. The Paper is very open-ended in raising issues for consultation but does not give any strong indications of the Board's thinking on the issues. Accordingly, this Tax Brief will set out the background to the Review, indicate the main issues that the Board has raised for consultation together with some comments on them, and finally discuss the way forward.

1. Background: Policy principles, terms of reference and importance of MIT industry

In announcing the Review (which was an election commitment, not to mention the subject of much industry lobbying for many years), the Government set out five policy principles as follows:

1. The tax treatment for trust beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly.
2. In recognition of the tax advantages available to trusts that are not available to companies deriving business income, flow through taxation of income from widely held trusts, such as managed investment trusts, should be limited to trusts undertaking activity that is primarily passive investment.
3. Beneficiaries should be assessable on their share of the net income of a trust whether it is paid or applied for their benefit, or they have a present right to call for immediate payment.
4. The trustee should be liable to tax on the net income of the trust that is not assessable to beneficiaries in a particular income year.
5. Trust losses should generally be trapped in the trust, subject to limited special rules for their utilisation.

These principles generally represent the current position. The main focus is the tension between the first two principles. The Board recognises that there will need to be trade-offs among the principles as it does the need for trade-off between the traditional tax policy criteria of efficiency, equity and simplicity.

In the context of the principles, the Board was asked to provide options for introducing a specific tax regime for MITs which would reduce complexity, increase certainty and minimise compliance costs. In doing so the Board was to have regard to:

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- alternatives to the concept of “present entitlement” for allocating income;
- international developments;
- reform of Division 6C to enhance international competitiveness of Australian property trusts (for which the international acronym REIT is used in the Paper) including whether there should be a separate REIT regime;
- possible removal of Division 6B; and
- the possible extension of any new MIT regime to trusts generally.

The importance of the MIT industry is spelt out in statistics in chapter 2 of the Paper. With \$1.3 trillion of funds under management, including over \$300 billion in public MITs, Australia is a significant player on the world collective investment stage. About half of this MIT amount is in equity trusts (two thirds in unlisted MITs) and 45% in REITs (two thirds in listed REITs). The data indicates only a small proportion, \$48 billion, of investment in managed funds is coming from offshore, but MITs probably attract a significant share of this investment (though the Paper does not say so). MITs have over \$50 billion of foreign assets.

2. Issues

After setting out briefly the current tax treatment of MITs, the Paper canvasses the issues raised by the terms of reference.

2.1 Options for determining and allocating tax liabilities

The Board notes uncertainties arising from many of the concepts on which the current law depends: what is trust income (and the problems arising from differences to tax law income), what is a share of trust income (the old chestnut of the proportionate versus the quantum approach) and the concept of present entitlement (including the issues that arise when a trustee sells assets to redeem units)? The Full Federal Court is hearing an appeal in November which may finally resolve the proportionate/quantum issue.

Three possible options are offered for a separate MIT regime:

1. deduction for distributions with the trustee taxable to the extent that taxable income exceeds distributions;
2. beneficiary assessment on the net income of the trust and trustee exempt regardless of the level of distributions;
3. beneficiary assessment on the net income of the trust and trustee exempt provided a significant level of distribution such as 90% of income occurs.

Option 1 overcomes the current possible problem of the beneficiary not having sufficient cash from the MIT to pay any tax liability (if tax law income exceeds trust law income). Conversely option 2 would not seek to solve this issue though, presumably, the market would ensure that investor cash-flow issues were addressed. Option 3 builds on option 2 while potentially addressing the cash-flow issue of unitholders, though not the practical

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problem for the trust in having sufficient cash to fund the required distribution.

Although each option addresses certain issues, there is no single option which addresses all the current problems. Furthermore, each option would involve various subsidiary issues such as:

- what is a distribution;
- would trust income retain its character in the hands of the unitholder (the Paper raises the question whether recent case law throws doubt on character retention);
- what tax rate is to apply if the MIT is taxed, including a possible move away from the current 46.5% top individual rate; and
- when is the unitholder assessed – the time the MIT derives income or when the unitholder receives a distribution?

Alternatively, the Paper raises the possibility of repairing the current rules to deal with the uncertainties noted above.

For the case where there is a revision of the MIT income after distributions or entitlements have arisen, the Paper discusses a carry-forward approach for “under” and “over” cases, and a trustee tax and beneficiary credit approach when additional income is assessed. In either case, there is an important limitation that the variation must not be more than two percent of income.

By way of comment, the emphasis on uncertainty arises to some degree from positions taken by the ATO especially in more recent times. There is no real suggestion in the Paper that the uncertainty should be resolved by sensible cooperation between ATO and industry which would be a possible way forward.

The emphasis on cash flow issues for unitholders seems overdone as this is not a common occurrence with MITs. By contrast, the issue of “unders” and “overs” is an important practical matter but the 2% threshold seems much too small. And just how this fits with a 90% distribution requirement in Option 3 is left unexplained. What is needed is a full solution to the issue.

2.2 International issues

In the international context, the Paper raises the issue of setting up the regime so that MITs are regarded as companies and distributions are viewed as dividends. This would not require that the legal vehicle used cease to be a trust, just that the trust is treated for tax purposes as some form of company. For example, it could be a company for tax purposes under any three of the options above, but it would not be taxed except in unusual cases.

Other countries are increasingly using this device to attract tax treaty benefits at the MIT level rather than the investor level, though this can have downsides. For example, if tax law has special rules for pension funds (such as Australia’s exemption from withholding tax for foreign superannuation funds) and a pension fund invests in a MIT, the special benefit may not be available if international tax treatment is based on the character of the MIT. There would be problems with this option in relation to some recent

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Australian tax treaties with zero and five percent tax rates on non-portfolio dividends.

The Paper notes that the OECD is working on this issue and may come up with sensible solutions for both corporate-type collective investment vehicles and MITs.

In our view, it is probably best to await the OECD outcome which, although it will not be published until 2010, will be known to the Government well in advance. Submissions on the tax treaty treatment of trusts have also been made by industry in relation to the current treaty policy review so there should be further progress on that issue domestically that will need to be taken into account by the Board.

2.3 Flow-through

Three issues are addressed in this area. First, there is discussion of potential double taxation of gains arising from differences between trust and tax law income and the complexity arising from tax deferred distributions that require continual tracking of a unit's cost base. The possibility is floated of taxing the full amount of distributions as a solution though it is noted that this would contradict the first policy principle of taxing the unitholder as if holding the asset directly. Moreover, overcoming double taxation concerns would require even more complex cost base adjustments for unitholders and adjustments for calculations at the MIT level.

The second issue is character retention. This is seen as giving rise to complexity (the ATO standard distribution statement being regarded as self evident proof). To deal with these various issues, treatment of distributions like dividends is raised. If character retention is to continue, then the suggestion is that it should be made clear by legislation.

The third issue concerns non-residents and whether Australia should adopt the distinction (used by the US and recently discussed by the OECD) of treating non-portfolio investment in MITs by non-residents as direct ownership (especially for land) and treating portfolio investments as equivalent to dividends, similar to the 2006 CGT amendments in Australia for non-residents. Depending on what happens elsewhere, this may mean different character retention rules for residents and non-residents.

Again one wonders whether too much emphasis is being put on issues which arise rarely (such as double taxation) as a reason for remaking the whole regime. Cases of double taxation should be dealt with, but a targeted approach is possible. Further, as appears from the international discussion above, abolishing character retention can create problems in the international sphere, so what is required is an overall balancing of the issues rather than a focus on particular cases and suggesting very large changes to deal with them.

2.4 Capital revenue distinction

The Assistant Treasurer has confirmed to the Board that the capital revenue distinction should be addressed in the MIT Review. The Board quotes from the unhappy ATO ruling on listed investment companies which has been regarded as pushing more and more managed investment situations into the revenue category. There has been talk of a similar ruling exclusively for MITs.

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The Board notes industry concerns with current developments, and suggestions for a statutory rule that gains made by MITs be treated as capital gains, similar to the regime for the superannuation industry.

There is also a discussion about a statutory rule treating gains or losses made on the sale of units by certain kinds of investors (such as complying superannuation funds) as being capital gains or losses. As superannuation funds are a major source of MIT investment, a rule for investors could be an important counter-measure if investments by MITs are increasingly treated by the ATO as on revenue account.

The Board raises the possibility of statutory clarification without suggesting the direction, though the issue of international competitiveness is noted in this regard (foreign managed funds are generally regarded as on capital account in their countries). The Board has asked for submissions on this topic sooner rather than later in view of the current interest in this topic.

In our view, this is an area where the first policy principle and international competitiveness should be the guide. Unitholders in MITs are generally on capital account as they invest for the longer term. To focus on the activity of the trustee rather than the unitholder is not consistent with the first policy principle and is more broadly counter-productive. If investors can get capital treatment for direct investment but not for investment via MITs, the tax system will encourage them into direct investment, whereas the broader policy justification for the MIT industry is to give investors access to professional management and risk-spreading which are not available generally for direct investment.

2.5 Trusts taxed as companies

The Board goes through the history of Division 6C and notes that the concern which led to the special rule for unitholders which are superannuation funds (20% ownership by superannuation funds deems the MIT to be a public unit trust and hence within the scope of Division 6C) was addressed by bringing superannuation funds into the imputation system in 1988. Hence, it is asked if the special rule for superannuation funds should continue.

Similarly, the history of the control test in Division 6C is recounted including the recent relaxation to allow the restructuring of stapled entities. At one extreme, the Board notes industry suggestions for abolition of the control test because the imputation system applied to an entity taxed as a company ensures that no advantages accrue through ownership of the company by an interposed trust, with perhaps a transfer pricing rule to prevent movement of profits out of controlled companies into MITs. On the other hand, various ways of modifying the control test are mentioned so that the exceptions are not so focussed on restructures of stapled entities.

In relation to the definition of eligible investment business, the Board likewise notices the recent "relaxation" of the restrictions (discussed in our Tax Brief http://www.gf.com.au/477_686.htm.) Overseas comparisons are made because of the competitiveness issue. To give effect to policy principle 2 that MITs should be limited to primarily "passive" investment (whatever that means in the 21st century), alternatives to the current approach which are raised are using either broad principles or a list of prohibited rather than a list of permitted activities. Further relaxation of the

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current definition is also discussed. Issues that industry have put before the Board – including residential real estate and retirement villages and the appropriateness of turnover based rents – are also mentioned.

If the test is failed, the issue then arises whether the result should be taxation only of the “bad” part under a company regime, compared to the all-or-nothing current approach.

With regard to Division 6B, the Board notes its origin in the former double taxation system that applied to companies before 1987, commercial reasons why restructures of the kind currently caught by the division may occur and the inhibition it causes for restructures of companies into stapled entities.

Finally, the Board addresses in this context its term of reference relating to a separate REIT regime. On the one hand, the Board notes that such a regime may secure greater international recognition and allow a more tailored approach to property MITs, but on the other, that this may create complexity and cost.

The discussion in this area is particularly tentative except in relation to Division 6B for which no reasons for retention are advanced. Moreover, the concerns discussed are attributed mainly to industry which may indicate that the Board is currently sitting on the fence between industry, Treasury and the ATO. This is an area where international competitiveness is very important. The revenue results of broadening Division 6C are not really addressed but presumably they will be an important factor at the end of the day.

2.6 Definition of fixed trust and MITs

The current very strict definition of fixed trust has significant implications in the rules dealing with trust losses and imputation credits. The issues raised by the definition are briefly set out in the Paper. As possible ways forward, two suggestions floated are:

- deeming MITs to be fixed trusts; or
- replacing the vested and indefeasible test with something else (which is left unspecified).

The former suggestion simply would shift the inquiry to what is a MIT, and depending on what other changes are made to current law, such as a separate MIT regime, a definition of MIT is likely to be necessary. The major issue is the widely-held requirement in the terms of reference. The Paper has an appendix collecting the various definitions in this area at the moment and notes two approaches, a minimum membership requirement with or without the addition of a concentration test (usually expressed in terms of 20 members owning 75%). The question of how to look-through interposed entities under both approaches is raised.

Currently, most definitions have a unit trust requirement which raises issues of what this means and whether it can be dispensed with in future. It is noted that special rules may be required at the establishment and winding up of a MIT to ensure that the widely held test continues to apply. The issue is also raised of whether any definition should require uniformity of rights of investors (ie, one class of unit).

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The current uncertainty of when a trust begins and ends by resettlement is mentioned and suggestions sought on whether legislative amendment might assist in this area.

While a uniform definition and some scope for dealing with special circumstances are desirable, perhaps the greater current concern is the fixed trust issue which certainly should be rectified. If a new MIT regime is created as a result of the Review, then obviously there will need to be a substantial overhaul of the legislation which would open the way for a uniform MIT definition. For more targeted changes, it would depend on the nature of the changes.

One issue that is not addressed directly is the issue of wholesale and retail funds. It would seem desirable that the same kind of rules apply to both which will depend on how the look through issue is treated.

2.7 Other related trusts situations: private equity, IDPS and trusts generally

The Paper also deals with three issues that are important in their own right but are to some extent peripheral to MIT issues. It is asked in relation to the revenue capital issue whether special treatment is necessary for private equity as the nature of the activity is different from the usual MIT (even though private equity cases may satisfy whatever definition of MIT is adopted). More generally (but not mentioned), there may be an issue of coverage of private equity by any new regime.

In the chapter on defining a MIT, the question of how to view investor directed portfolio services (“IDPS”) is raised. Should this be seen as a MIT or rather as separate investments by individual investors? Further, should full transparency be applied which is often adopted in practice although not accepted in full by the ATO?

There is a one page chapter simply raising the question in the terms of reference whether any of the possibilities above should be applied to trusts generally.

It is to be hoped that these issues will be addressed but that they do not adversely affect what happens on the normal MIT front – for example, private equity in a MIT regime should not compromise outcomes for the usual equity trust.

3. The way forward

Since the Review was announced the turmoil in international financial markets which had already affected property trusts has extended much more broadly. This may affect whether industry and the Government have an appetite for extensive change to the current tax arrangements or prefer more targeted changes. The Government, while taking drastic action to deal with the crisis in financial markets, has nonetheless affirmed in several different contexts its objective of making Australia a regional financial centre.

Submission are due on the Paper by 19 December 2008, though, as noted above, earlier submissions on the revenue capital issues are being sought. Greenwoods & Freehills will be making its own submission and will be working closely with industry bodies in preparing their submissions to the

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Board. Greenwoods & Freehills is also ready to assist clients with their issues.

In the meantime, it is likely that the Board will continue to consult with industry as it has done throughout the development of the Paper. After submissions are received, there will be a more formal process of consultation. The Board is due to report to Government by the middle of 2009.

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