

Tax Brief

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CGT Rules for Managed Investment Trusts

In the May 2009 Budget, the Government announced that it had accepted one of the interim recommendations made by the Board of Taxation as part of its current review of the tax arrangements applying to managed investments trusts (“MITs”) – namely, that MITs would be able to elect to apply capital gains tax (“CGT”) treatment exclusively to gains and losses made on certain types of trust assets. Treasury has released a brief Discussion Paper giving some further detail on the Budget announcement and identifying the issues on which it is seeking submissions. This Tax Brief examines the design features of the new proposal and the kinds of qualifications that are going to constrain its scope and operation. This is a very welcome policy development, but as will be seen, the promise of implementing it in a regime that would prove to be simple, neat and elegant is now looking less likely.

1. The effects of the proposal

The Paper outlines a proposal for an election for a qualifying MIT to “allow the capital gains tax to be the primary code for disposals of shares, units and real property.”

The regime will be elective – MITs can elect the safe harbour of CGT treatment or remain under current law, which might afford capital or revenue treatment. While the Paper does not mention it expressly, it is implicit in other aspects of the Paper that the election will extend to existing assets held by the trustee that makes an election, as well as newly-acquired assets. It also appears that the effect of the election will extend to all relevant assets – MITs will not be able to dissect their portfolio into those assets under the CGT regime and those outside it (though not all assets are meant to be within the proposal as discussed below). However, it may be that some selectivity might be achieved by holding assets in different MITs, only some of which make the relevant election. Having said that, there will undoubtedly be some close scrutiny by the Australian Taxation Office of arrangements designed to secure unintended tax advantages from this measure – to bring inappropriate trusts into this regime or to quarantine the effects of what is meant to be an all-encompassing election, for example.

The immediate object of the proposal is to offer a safe harbour for those MITs holding assets where there might be uncertainty whether gains and losses are on revenue account. The intended impact of the safe harbour will then flow through to qualifying investors who will enjoy CGT discount on

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trust gains. This safe harbour may be attractive to share funds with some exposure to the possibility of unexpected (and unwelcome) revenue treatment, and perhaps less attractive for property funds where this possibility is typically much less likely. From this perspective, property trusts may see less to be gained from making the election.

Even so, the election will also have some second order implications that may make it attractive to all. For example, the CGT rules typically have more, and more developed, rollover rules than is the case for assets held as trading stock or revenue assets – MITs may now be able to undertake various re-organisations without triggering gains or losses. Similarly, non-residents may now be able to invest in ways that will benefit from the CGT exemption offered to non-residents – without CGT treatment, a similar investment might give rise to taxable Australian-source income.

There is already a comparable (though, mandatory) regime in the tax legislation which applies to certain gains and losses made by superannuation entities. The Paper refers to those rules at one point suggesting that they may be a model for the MIT regime. Those rules work in this manner:

- if a CGT event happens to a CGT asset, certain tax provisions are switched off – namely the rules which would otherwise trigger an ordinary revenue gain or loss, the rules about gains and losses from a profit-making scheme or undertaking and the rules about the taxation of financial arrangements;
- however, those provisions can remain operative for foreign currency gains and losses made on certain kinds of assets; and
- the provisions also remain operative where (certain) capital gains and losses would not arise because of an exception in the CGT rules.

If the regime proposed for MITs is designed along these lines, there are several interesting features worth noting:

- the revenue gain or loss rules are only switched off where a CGT event occurs. Not every transaction that generates a gain or loss which can give rise to a tricky characterisation issue necessarily involves a CGT event, but unless there is a CGT event, the safe harbour is unavailable;
- the provision does not switch off every rule which attaches revenue treatment to gains and losses arising from sales or redemptions. In particular, the rules dealing with gains and losses made on the sale of traditional securities, discounted securities and depreciating assets (such as the items of plant within a building) are left unaffected; and
- where no capital gain or loss arises because the gain or loss is disregarded under the CGT rules, the possibility of taxation as ordinary or statutory income is often reinstated. In other words, the CGT rule is not a true “code” in the sense of an exhaustive statement because other law remains operative as a fall-back.

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2. Eligibility

2.1 Trusts that are MIT

Much of the detail of the Paper is taken up with a discussion of the kinds of entities that will be eligible to make the election for CGT treatment. The key concept is that the relevant trust must be an “Australian MIT.” The discussion in the Paper suggests that this concept will be almost identical to that used in the current MIT withholding rules.

There are to be three elements to the test of an “Australian MIT”:

- a jurisdictional test – the trustee (or one of several trustees) must be a resident or the central management and control of the trust must be in Australia;
- a management test – the trust must be a “managed investment scheme” as defined in the *Corporations Act* operated by a “financial services licensee;” and
- a collective investment test – the trust must be either listed on an Australian stock exchange or else be “widely held” as defined.

Widely-held. A MIT can be “widely held” if it meets either of two tests:

- the MIT has at least 50 members; or
- the MIT has less than 50 members but at least one of its members is:
 - a complying superannuation fund, approved deposit fund (though not a pooled superannuation trust), or foreign superannuation fund, in each case with more than 50 members;
 - another MIT that is either listed or has 50 members; or
 - an entity that is recognised under foreign law as having similar status to an Australian MIT, with at least 50 members.

This concept will be almost identical to that used in the current MIT withholding rules except for the removal of life insurance companies from the list of relevant members. The rationale for this position offered in the Paper is that life insurance companies typically hold their assets on revenue account. Whether or not this is true for their own assets, APRA statistics indicate, “superannuation business made up 90 per cent of life insurance office assets (backing Australian policyholder liabilities) and also accounted for 90 per cent of premiums.” Excluding life insurance companies does seem odd in the face of such a situation. Presumably the trustees of every MIT with insurance company investors will now be exceedingly keen to attract a superannuation fund as a member; their life insurance company investors may well thank them for it.

Interestingly, while the Paper proposes basing the rules about eligibility for the CGT election on the current MIT withholding rules, it proposes no solutions to the acknowledged uncertainty in those rules – for example, it proposes nothing to resolve the doubts about the status of unregistered managed investment schemes nor the implications of the different kinds of financial services licence that can be issued. Nor does it address the common situation of licence held by a person other than the trustee where

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the trustee is simply an authorised user of the licence. Submissions are being made on these issues, despite the silence of the Paper.

Timing. The Paper proposes that status as an MIT will be determined at the time at which the trust makes its first “fund payment” for the year – typically a distribution other than interest, dividends or royalties.

If the fund makes no such payment during the year, the paper proposes that the test will be applied either when the first distribution of interest, dividend or royalty is made, or, if no payment of this kind is made either, then on both the first and last days of the current year.

The Paper also proposes a special rule for start up and shut-down years.

It is worth noting status as an MIT is determined annually – this is not a “set-and-forget” status – and so funds can be MITs one year and not the next. This may create significant compliance issues for the tracking of gains and losses attributable to periods when the fund was – or was not – a MIT. (These difficulties already exist in the rules about withholding from MIT distributions – the distributions have to be connected to income earned when the fund was, or wasn’t, an MIT.)

Other requirements. Other parts of the Paper imply (though do not state) that there will also be further requirements – namely, that the trust is a unit trust and all membership interests in it that are to be counted have fixed entitlements. Further, the trust must not be subject to tax as if a company.

2.2 Eligibility – trusts owned by MITs

The Budget announcement made it clear that status as an MIT, and hence access to CGT treatment, would be extended to wholesale trusts. This is a welcome announcement because current law does not deal well with trusts that are not themselves listed nor directly widely-held, nor to trusts that are not themselves managed investment schemes (because of the various exceptions in the *Corporations Act*).

The Paper says that a trust can qualify for the CGT election even though it is not a managed investment scheme and managed by a financial services licensee, if two conditions are met:

- the trust must carry on only eligible investment business as defined under current law; and
- any interposed trust (meaning presumably, any trust between the beneficiary who wants to claim the benefit of CGT treatment and the trust which made the gain) must be an Australian resident trust that is a managed investment scheme operated by a financial services licensee.

3. Scope of CGT treatment - assets

It was always anticipated that CGT treatment would not be universal. As was noted above, the rule for superannuation funds leaves the revenue gain and loss rules in play for certain kinds of assets. The MIT rules will apparently do the same.

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The Paper suggests that CGT treatment will only be afforded to “eligible assets”:

- real property and interests in real property; and
- shares and units.

The Paper notes that CGT treatment will not be extended to:

- debt instruments – which may be an issue for certain types of shares;
- financial arrangements. This will require some clarification as all shares are financial arrangements; or
- trading stock.

The trading stock exception may undermine the purpose of the measure as it puts back “on the table” the very issue that the rules are attempting to make redundant – whether the MITs portfolio of investments will generate revenue or capital consequences when realised. The superannuation fund rule discussed above contains no similar limitation and one may also wonder about the need for this exception. If a MIT is carrying on a business and holds land or certain other kinds of assets as trading stock, it may well already have enlivened the rules which tax certain trusts as if companies and those rules will have eliminated this trust and all of its assets from the scope of the current proposal.

It is worth noting that there is no holding period requirement in the proposal – CGT treatment applies to all qualifying assets, even if they are realised within a year of acquisition. However, the CGT discount will presumably remain unavailable for qualifying investors in this case.

4. Scope of CGT treatment - transactions

The Paper contains a cryptic passage indicating that CGT treatment will be applied to “a CGT event arising from the disposal or other realisation of ownership of the asset ...” It is not entirely clear whether this statement is intended to be a further limitation to the scope of CGT treatment, although that seems the most plausible interpretation.

If a limitation is intended, it seems likely that some list will be enacted saying which transactions (CGT events) are affected by these rules and which are not. Some transactions involving complete changes or cessations of ownership will obviously be within the scope of the measure – sales of assets, redemptions of assets, cessation of assets and so on. Other transactions might not be – a premium received on granting a lease, payments for entering restrictive covenants, amounts received for granting an option an over asset, payments where the underlying share or unit remains on issue, and so on.

5. Commencement date

The Paper proposes that the new regime will start from the first day of the trust’s 2008-09 income year – that is, for all existing trusts with a 30 June balance date, the new regime will apply to all eligible disposals which

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occurred on and after 1 July 2008. For trusts that are formed in the future, the provisions will commence from the date of formation of the MIT. Either start date applies regardless of the date on which the trustee decides to make the election.

The reason for backdating the effect of the election appears to be a desire to prevent cherry-picking – to prevent a sudden rush of realisations to retain the benefit of revenue treatment for losses in the run up to the date of making the election.

Back-dating the effect of the election presumably means that some trusts will need to file amended returns if they have made gains or losses on relevant assets in years before the making of the election and treated them as generating revenue gains or losses. Investors too will probably have to file amended returns if they are residents and the position of non-residents may also be affected. This raises the problem of how to deal with completed years – should the MIT be allowed to file an amended return without limit and should the ATO be permitted to amend without limit? The Paper asks for submissions on this issue.

6. Next steps

Treasury is seeking submissions on the Paper by Friday 10 July.

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