

## Tax Brief

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### **CGT Treatment for MITs – Draft Legislation**

The Government has taken another step on the long road to reform of the tax rules for managed investment trusts ('MITs'). On 10 December, Exposure Draft legislation was released giving a first glimpse of the rules that are intended to make the capital gains tax regime ('CGT') the principal provisions for taxing gains and losses made by MITs. The text contains a few surprises that were not previously foreshadowed either in the recommendations or consultations so far. Moreover, the new measures add some confusion about the range of entities that will qualify for CGT treatment, which may render the entire project rather less useful than originally promised. This Tax Brief examines the Exposure Draft.

#### **1. Background**

Even by Australian standards, this proposal has had a longish gestation.

It stems originally from the review by the Board of Taxation of the tax arrangements applying to MITs, a project that was an election promise made by the Labor party during its campaign for the 2007 election. In February 2008, the newly-elected Government formally referred the matter to the Board of Taxation. (See our Tax Brief at [http://www.gf.com.au/477\\_624.htm](http://www.gf.com.au/477_624.htm) )

While the Board's final report on the MIT project has still not been released, in late 2008 the Board made interim recommendations to the Government that MITs should be able to elect to apply CGT treatment exclusively to gains and losses made on certain types of trust assets. The Government announced in the May 2009 Budget that it had accepted the Board's recommendation, and delivered the proposal into Treasury's care for further design and implementation. (See our Tax Brief at [http://www.gf.com.au/477\\_753.htm](http://www.gf.com.au/477_753.htm) )

In June 2009, Treasury released a Discussion Paper giving some further detail on the proposal and identifying the issues on which it wanted to receive submissions. (See our Tax Brief at [http://www.gf.com.au/477\\_768.htm](http://www.gf.com.au/477_768.htm) )

The Exposure Draft legislation released on 10 December is the result of those consultations. However, it appears Treasury also took the opportunity to make a few significant, unannounced and not always welcome changes to the June Discussion Paper.

The significance of this project can be seen at two levels. The effect of confirming CGT treatment for the MIT would flow through to qualifying resident investors – who will enjoy CGT discount on trust gains – and non-resident investors – who may be able to benefit from the CGT exemption for non-residents. The election can also have second order implications for the MIT itself – 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 so that a MIT may be able to reorganise its affairs with less exposure to tax than would otherwise be the case.

## 2. CGT treatment ... and revenue treatment

The announcement by the Treasurer in May 2009 was relatively clear and unambiguous. It referred to –

‘... an irrevocable election to apply the capital gains tax (CGT) regime to disposals of eligible assets (generally shares, units and real property).’

This is largely repeated in the Exposure Draft. A MIT will be able to elect CGT treatment for certain types of assets – namely, shares, units, land and options over these assets. In particular, CGT treatment will not extend to financial arrangements (as defined under the financial arrangement provisions) or debt interests (as defined in the debt-equity rules). This limitation had been foreshadowed in the Treasurer’s press release and in Treasury’s June Consultation Paper and has survived despite submissions arguing for a more nuanced approach.

**Revenue treatment.** However, and this is aired for the first time in the Exposure Draft, there will be a statutory consequence for MITs that are eligible to elect CGT treatment but decide not to. They will receive mandatory revenue treatment on all assets they hold (other than land). This seems to recast the Treasurer’s policy fundamentally – the proposal is no longer just a safe harbour for MITs. It may be more accurate to say the policy has now changed to: MITs are subject to revenue account treatment on all their assets (except land) unless they make an election.

The addition of a special provision for MITs that are eligible to elect CGT treatment but decide not to, changes the dynamics of this regime quite substantially:

- share trusts will be obliged to make the election if they are to avoid revenue treatment on their entire portfolio – the option of arguing about the character of their assets under existing law is effectively taken away from them; and
- property trusts might have thought it unnecessary to make the election because it is usually much clearer that their assets are already held on capital account. It now seems that they too will be obliged to make the election in order to avoid mandatory revenue treatment on appreciated residual (ie, non-land) assets. Shares in a land-rich company, for example, would be exposed to revenue treatment if the election is not made.

Of course, whether mandatory revenue treatment turns out to be a penalty or a concession, compared to CGT treatment, depends on whether the asset in question would be realised for a gain or loss.

### 3. Scope of the new measures – types of trust

Much of the detail in the Exposure Draft is devoted to defining the range of trusts that are eligible to make the election – the definition runs to three pages. This part of the Exposure Draft may have much greater importance than appears at first sight if, as seems to be the case, it will become the basis of the MIT definition in the new MIT regime expected to result from the Board of Taxation's final report.

The rules for withholding tax from distributions made by MITs already contain a definition of MIT. That definition is built around 3 ideas – a residence test, a registration test (which appears intended to serve as the basis for demonstrating that the trust is being actively and externally managed), and a test based on the nature and identity of the investors (which appears intended to serve as the basis for demonstrating that the trust represents, directly or indirectly, a pool of collective funds). More specifically, the definition of MIT in these rules requires:

- the trustee to be an Australian resident or that central management and control of the trust is in Australia (condition 1);
- the trust to be a managed investment scheme (MIS) under the *Corporations Act* and operated by a financial services licensee under that Act whose licence covers operating such a MIS (condition 2); and
- the trust to be directly or indirectly widely held under any one of the following tests (condition 3):
  - the trust is listed on an approved stock exchange in Australia; or
  - it has at least 50 members; or
  - it has at least *one* member which is:
    - a life insurance company;
    - a complying superannuation fund, complying ADF or foreign superannuation fund, with at least 50 members;
    - a MIT that is itself listed or has 50 members;
    - a foreign trust that is equivalent to a MIS with at least 50 members; or
    - a trust (including through a chain of trusts) where interests in the trust are held by at least one of the preceding types of entities and the trust or each trust in the chain meets conditions 1 and 2 above (this part of the definition is meant mainly to cater for wholesale funds).

The main problems experienced with this definition have been in relation to the MIS and registration conditions (condition 2). The variations to the MIT definition in the Exposure Draft are, apparently, meant to address some of these problems, but they add other conditions that may create new difficulties. Indeed, they may cast some doubt on the accepted meaning of the existing rules – some of the changes only appear necessary if the existing rules are read narrowly.

The extensions in the Exposure Draft create four different additional ways to be a MIT. They are based in large part on the current MIT definition, with variations. (This means that a trust may be a MIT for the CGT rules but not the MIT withholding rules.)

**Variation 1.** The first variation in the Exposure Draft requires condition 1 to be met, and a slightly modified version of condition 2 – the trust does not need to be a MIS, but must still be operated by a financial services licensee. However, with regard to condition 3, the new version would require *all* members of the trust (not just one) to be life insurance companies, complying superannuation funds, ADFs or foreign superannuation funds with at least 50 members, or another MIT (as defined under the withholding definition or one of the variations in the Exposure Draft).

The omission of the requirement for the trust to be a MIS is the important difference here, but the change comes at the cost of tighter membership requirements. It is mainly directed at wholesale funds.

**Variation 2.** The second variation is similar to the first – ie, condition 1 and the modified version of condition 2 must be met. The membership condition (condition 3) is changed so that the trust must have at least 50 members (ignoring objects of a trust and individuals). It is not clear exactly what is intended here – the explanatory material accompanying the Draft refers to a wholesale trust but the 50 member test is usually associated with widely held retail trusts. It looks like what is intended is a widely held fund designed for institutional investors.

**Variation 3.** The third variation relaxes the financial services licensee requirement (condition 2). The trust must be a MIS as defined under the *Corporations Act*, but the requirement for a financial services license can be ignored if a licence is not required because the trust is operated by a Crown entity or a person with an ASIC exemption.

**Variation 4.** The fourth variation requires that condition 1 be met and that *every* member of the trust be a MIT (under the withholding definition or any of the variations above). In this case there is thus no requirement that the trust be a MIS or be operated by a financial services licensee.

A special disqualifying rule says that the trust will not be a MIT under any of the four extensions if ownership of the trust is closely held – that is, 20 or fewer individuals hold directly or indirectly at least 75% of the issued units. This reinforces the basic idea that the trust must ultimately be widely held, even if it is a wholesale trust. The definition of MIT in the withholding rules

has a slightly different exception, although with similar intent – that 10% or more of the trust cannot be held directly or indirectly by one foreign resident individual.

Status as a MIT for the purpose of making an election for CGT treatment exists (or is failed) in relation to an entire income year. However, special rules provide that certain of these tests need to be met at discrete points of time – either when the first fund payment is made for an income year, or if no payment is made, then on both the first and last days of the income year.

It was noted above that the election into the regime has effects, but so too does the implicit election not to adopt the new regime. This may well create an interesting dynamic where a trustee concludes that a trust is not within the definition of MIT, and so ineligible to make the election, but the ATO wants to assert that the entity was eligible in order to invoke revenue treatment for certain gains.

#### **4. Scope of the new measures – type of asset**

As noted above, the election to invoke CGT treatment does not have universal effect. Some assets held by a MIT are expressly included; some are expressly excluded; some are left unaffected.

So, where a MIT is eligible and does elect into the new regime:

- CGT treatment will automatically follow for certain kinds of assets; and
- CGT treatment may still follow for other kinds assets. (That is, mandatory revenue treatment is only prescribed for assets held by MITs that are eligible but *do not elect* into the new regime.)

**Shares, units and options.** Mandatory CGT treatment is available for a 'share in a company' and 'a unit in a unit trust.' Mandatory CGT treatment also follows for an option to acquire or to dispose of a share or a unit.

This formulation means that CGT treatment will not automatically extend to transactions involving:

- interests in companies that might be considered 'equity interests' under the debt-equity rules, but which are not in the form of shares. The obvious examples would be certain types of participating or perpetual loans;
- interests in fixed trusts that are not 'unit trusts;' and
- many other forms of derivative.

**Land, options over land, etc.** Mandatory CGT treatment is also available for 'land,' an 'interest in land,' and an option to acquire or dispose of land or an interest in land.

Again, despite the beguiling simplicity of the language, there will be some difficulties at the margin. The notion of 'land' may seem clear enough, but the idea of 'an interest in land' may prove problematic in many industries. For example, there may well be difficulties for transactions involving:

- a short term, or even a 99-year, lease;
- a right of pre-emption;
- an interest in an infrastructure project that is contractual;
- rights to airspace or transferable floor space;
- rights of entry or use created by contract or covenant;
- assets that may be fixtures on land or fittings within buildings;
- assigning the benefit of a contract to purchase land; and
- development agreements and management rights which are inherently bound up with land.

Notice that there is no geographical limit on this provision – the land can be situated anywhere. It is also worth noting that this provision does not extend to shares in land-rich companies – the shares are not 'land' for the purposes of this provision – although they would usually be covered by the provisions dealing with shares.

**Debt and debt-like assets.** The Exposure Draft specifically excludes two types of debt-like assets. CGT treatment is removed for

- most financial arrangements (as defined under the regime for taxing financial arrangements ('TOFA')); and
- debt interests (as defined in the debt-equity rules).

This rule is consistent with the parallel regime for complying superannuation funds, where gains and losses made on various kinds of debt-like investments are, for the most part, dealt with under the rules dealing with qualifying securities, traditional securities, and, for large funds (or small funds which have made the relevant election), the TOFA rules. The effect of the exclusion for debt and debt-like assets is that these rules remain in play for MITs as well.

The entitlement to enjoy CGT treatment is given to assets which are 'shares' but is then removed for assets which are a 'Division 230 financial arrangement.' This formula might seem to create a difficulty – every share is a 'financial arrangement' under the financial arrangement rules. However, a share is a 'Division 230 financial arrangement' only if the TOFA regime is actually being applied to the share by the taxpayer. Hence, a taxpayer which has elected to apply the TOFA rules to its holdings of shares (that is, it has made the fair value or financial reports elections) will continue to be subject to TOFA treatment for these shares.

**The rest.** For funds that elect into the new regime, the rules are silent about the tax treatment of everything else. Hence the treatment of all other assets remains subject to the operation of the capital v. income doctrines in current law.

**MITs that are eligible, but do not elect.** The discussion so far has focussed on the position of MITs that are eligible to elect CGT treatment and decide to do so. But as was noted above, revenue treatment is now to be attached to most of the assets of MITs that are eligible to elect CGT

treatment but decide not to. For example, shares and units in land-rich entities would be affected if they were considered to be held on capital account under current law.

The principal exclusion is land. This exclusion means that land held by eligible MITs that decide not to elect, is left untouched – it may generate CGT consequences only or revenue consequences, depending on the operation of the capital v. income doctrines in current law.

**Summary.** The table below summaries the outcomes of the two rules:

	Treatment if MIT <i>elects into</i> new regime	Treatment if MIT <i>does not</i> elect into new regime
Shares, units, etc	Capital	Revenue
Debt-like assets	Unaffected	Revenue
Land, options, etc	Capital	Unaffected
Other assets	Unaffected	Revenue

## 5. Making the election

The Exposure Draft contains a few rules about the procedural requirements for making the election:

- the election must be made in the ‘approved form.’ The common practice, however, is that the ATO will not issue a form for this purpose, and so some other document will be accepted as amounting to the ‘approved form;’
- the date by which the election must be made depends upon whether the trust is an existing MIT at the end of its 2008-09 income year:
  - if the trust was in existence and a MIT at the end of the 2008-09 income year, the election must be made by the latest of 3 dates: the last day of the trust’s 2010 income year, 3 months after the commencement of the provisions, or a later date if the Commissioner exercises a discretion to extend the time; and
  - if the trust is created (or an existing trust becomes a MIT) during or after the 2009-10 income year, the election must be made by the date upon which the trustee is required to lodge the trust’s income tax return for the year in which the trust is formed or becomes a MIT;
- the effects of the election apply to events that occur in the income year in which the election is made (whether before or after the election) and subsequent years; and
- the election is irrevocable.

The Exposure Draft contains a few specific provisions about the consequences of ceasing to be a MIT. The rule noted above – that the

effects of the election apply to all subsequent years – suggests a ‘once-in-always-in’ rule and this is apparently the general presumption. The Draft sets out only two circumstance where access to CGT treatment is quite deliberately switched off:

- where the trust ceases to be a MIT and becomes a trust subject to tax as if a company under Division 6B of the *Income Tax Assessment Act 1936*; and
- where the trust ceases to meet the criteria to be a MIT and becomes a trading trust under Division 6C of the *Income Tax Assessment Act 1936* (although the entitlement to the CGT election may survive where the MIT became a trading trust due to circumstances that are ‘temporary’ and outside the control of the trustee).

## 6. Commencement

In general terms, the effects of the election to attract CGT treatment commence from the start of the income year in respect of which the election was made – that is, the new rules will apply to CGT events occurring from the start of the 2008-09 income year for existing MITs, or from the start of 2009-10 or subsequent income year for new MITs. It is worth noting, therefore, that the new regime will apply to transactions with assets already held by a MIT when an election is made.

While the commencement rule focuses on the date on which CGT events occur, it is also necessary to consider its impact on distributions to unitholders arising from those transactions. Fund managers may need to differentiate distributions that are attributable to gains made before and after the start of the relevant income year (if there are transactions that would have generated revenue gains but now generate capital gains because of making the election). Given that the measure is to be backdated to include the 2008-09 income year, there may well be an impact on distributions already made.

For MITs which have assets that are trading stock (a situation which would seem quite uncommon), but make the election to attract CGT treatment, additional transitional measures exist:

- a special rule preserves ordinary income treatment where a MIT disposes (after invoking the new regime) of land that it held as trading stock or a revenue asset at the end of the previous income year. The rule applies only to land, interests in land and options over land. No rule preserves ordinary income treatment where a MIT disposes of shares or units that it held as trading stock or a revenue asset on entry into the MIT regime; and
- another rule switches off trading stock treatment for all non-land trading stock acquired after the start of the 2008-09 year; and
- the general transitional rule should deal adequately with the consequences of the disposals of subsequently-acquired trading stock.

It is also worth noting the separate transitional rule for MITs which are eligible, but do not elect into the new regime. For these trusts, the effects of *not* making the election commence from the date of commencement of the section, typically the date of the Royal Assent – a good indication that someone accepts this is an unannounced policy change. Again, it is worth noting, the new regime will therefore attach revenue consequences to transactions with (capital) assets already held by an eligible MIT that does not elect. (This is another reason why all eligible MITs may conclude they need to elect into the regime.)

Finally, an interesting provision has been proposed to deal with the fact that the legislation is meant to be available for events that occurred from the start of the 2008-09 income year, but will not be enacted (and elections cannot be made) until well into 2010 – that is, after assessments for the 2008-09 income year have been made. The Exposure Draft contains a special rule to prevent the Commissioner from issuing an amended assessment for the 2008-09 income year to treat a gain as being a revenue gain if the trustee has treated it as capital, has made the relevant election for the 2008-09 year and would have been entitled to CGT treatment if the new regime had been operational when the CGT event occurred or the assessment issued. The benefit of this rule extends to both the trustee and unitholders.

## 7. Fund managers

The second major development that occurred during the consultations on the June Discussion Paper is the introduction of a special regime, apparently intended for fund managers. The Exposure Draft refers to the measure as dealing with ‘carried interests in [a] MIT,’ terminology which might suggest that it is directed to venture capital transactions. It is also written in ways that suggest it could apply to employee equity schemes, particularly in stapled entities.

Whatever its intended scope, the scant level of detail surrounding the measure suggests it may well have been an after-thought. It is a discrete regime which has little connection with the rules about the CGT election which surround it.

In general terms, the Exposure Draft proposes a new and distinct regime where two principal conditions are met:

- a taxpayer holds an asset that carries an entitlement to a distribution from a MIT, the amount of which is contingent upon the economic performance of the MIT; and
- the asset was acquired in connection with providing services to the MIT as a manager of the MIT or an employee of the manager.

Where the relevant conditions are met:

- the taxpayer includes in its assessable income the amount of any distribution from the MIT;

- the taxpayer must also include in its assessable income the amount of any gain it makes from a transaction with its interest in the MIT; and
- additional rules switch off any access to the CGT discount that might otherwise attach to the distribution from the MIT, or transaction with the interest in the MIT.

The obvious intention of the rules is to make fund managers (and their employees) liable to tax on amounts derived from providing services to MITs as ordinary income, rather than as capital gain.

## 8. Final comments

There are several other features of the measure that are worth noting.

In an earlier Tax Brief we noted, '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 Exposure Draft does not solve this problem. Hence, transactions which do not involve a CGT event are unaffected by the measure.

However, the Exposure Draft makes an adjustment in the other direction – narrowing the range of relevant CGT events. In the Exposure Draft, only a CGT event which involves 'a disposal or other realisation of the asset' matters. The obvious assumption seems to be that there would only be an income tax consequence – a consequence which needs to be eliminated – for transactions which involve 'a disposal or other realisation of the asset.' But this assumption may prove incorrect in some cases. Consider, for example, a 99-year lease of real estate. This transaction involves a CGT event (granting the lease is treated as equivalent to a sale of the land for CGT purposes) but it is not obvious that it involves 'a disposal or other realisation' for income tax purposes. Hence the income tax consequences of such a transaction (for example, the treatment of the premium paid for the lease) may survive.

It is also worth noting that the Exposure Draft has rules reinstating taxation as ordinary or statutory income in three cases – hire purchase arrangements, certain gifts and shares in pooled development funds. In these cases, any capital gain or loss is disregarded and so the rule in these new provisions which would ordinarily switch off ordinary income tax is reinstated. However, there is no general proposition in the Exposure Draft that every time a capital gain or loss would be disregarded under the CGT rules, then the ordinary income rules are reinstated.

We noted above that this measure is elective but a MIT cannot choose to bring only some of its assets into the regime; once the election is made its operation is automatic. However, it may be that some selectivity might be achieved by holding assets in different MITs, only some of which make the relevant election. This may be especially relevant for funds with assets that have declined in value.

## 9. Next steps

The Government says it is seeking submissions on the Exposure Draft by 24 December 2009, a day often known as Christmas Eve.

The title of the Exposure Draft suggests that these measures are intended to be part of the first tax Bill of next year, which could be introduced as early as the February sitting of Parliament and passed shortly thereafter.

Whether passage can be achieved quickly and easily must be more than a little doubtful – apart from the well-understood vagaries of the Parliamentary process, there is the 2010 election to consider, not to mention the many issues that the drafting raises. It will not be surprising if there is some slippage to the timetable.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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