

Tax Brief

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CGT treatment for MITs – New draft legislation

The *Tax Laws Amendment (2010 Measures No 1) Bill 2010* was introduced into Parliament on 10 February 2010 and contains the proposed final form of the measures that permit eligible managed investment trusts to elect to apply the capital gains tax regime as the primary measure for taxing gains and losses on assets.

The Bill incorporates a number of changes from the Exposure Draft released last December that should extend the range of trusts that will be eligible to make the election. This Tax Brief examines these changes in detail. Other aspects of the new measures were considered in detail in our earlier Tax Brief covering the Exposure Draft:

http://www.gf.com.au/Tax_Brief_CGT_Treatment_for_MITs_Draft_Legislation.pdf

Scope of the new measures – changes to the categories of trust that will be eligible to make the election

In order to make the election, a trust must be a MIT either under the current definition of MIT (which is contained in rules that apply to withholding tax from MIT distributions) or under the extended definition of MIT contained in the Bill.

Much of the detail in the earlier Exposure Draft was devoted to the extended definition of MIT, which is further broadened under the Bill. The provisions that apply to extend the definition of MIT incorporate some of the requirements that apply under the current MIT definition and so this current definition will remain relevant in applying the new rules in practice.

The current MIT definition is built around 3 ideas – a residence test, a licensing test and certain membership requirements. As to the purpose of these requirements, the residence test is aimed at testing the trust's connection with Australia, the licensing requirements test appears intended to serve as the basis for demonstrating that the trust is being actively or externally managed and the membership test appears intended to serve as the basis for demonstrating that the trust represents, directly or indirectly, a pool of collective funds.

More specifically, the current definition of MIT for withholding tax purposes requires:

- the trustee to be an Australian resident or, that central management and control of the trust is in Australia (Condition 1);

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- the trust to be a managed investment scheme (MIS) under the *Corporations Act 2001* and operated by a financial services licensee 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 interposed trusts) where interests in the trust are held by at least one of the preceding types of entities.

The main problems experienced with the current MIT definition have been in relation to the application of the MIS and registration and licensing requirements in Condition 2. The Exposure Draft contained a number of variations to the definition of MIT that were apparently intended to deal with some of these problems. The main changes in the Bill are to broaden the range of entities that will be able to access the MIT election to certain wholesale and retail funds as outlined below.

Variation 1: trusts operated or managed by financial services licensees

The first variation to the existing MIT definition created by the Bill relates to trusts that are not MIS's but which are operated or managed by a financial services licensee (FSL).

Specifically, under this variation, Condition 1 must be satisfied but Conditions 2 and 3 are modified (note these modifications are broader than the comparable modifications that were included in the Exposure Draft).

With regard to the modification to Condition 2, the trust must be operated or managed by a FSL whose licence covers providing financial services to wholesale clients or by an authorised representative of a FSL. The inclusion of trusts managed by a FSL will allow a broader range of trusts to qualify than had previously been contemplated by the equivalent modification to Condition 2 in the Exposure Draft, which was limited to trusts operated by a FSL.

The modified Condition 3 will be satisfied if any of the following apply:

- Every member of the trust is a MIT (including under the extended definition contained in the Bill), life insurance company or one of the

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following superannuation entities with at least 50 members: a complying superannuation fund, complying ADF, or foreign superannuation fund.

- 75% or more of the interests (determined by value) in the trust, rights to control the trust and rights to distribution are owned by one or more of the following:
 - a life insurance company;
 - a complying superannuation fund, complying ADF or foreign superannuation fund, in each case 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
- The trust has at least 50 members; or
- The trust was created during the income year, or ceased to exist during the income year and was a MIT in the previous income year.

Private equity funds usually provide for the manager to have a 20% carried interest which applies once a threshold IRR has been satisfied. Accordingly, the '75% test' in bullet point 2 above may be difficult to be satisfied for such funds, especially when the fund is in 'catch up' mode where a large percentage of the distribution of the fund for a particular period may be made to the manager.

In relation to the 50 members test referred to in the third bullet point above, it is possible to trace through interposed trusts to non-trust members. However, individuals who acquired their interest through a retail offering of interests in the interposed trust are not counted for this purpose. Accordingly, it will not be possible for a trust to rely on passing this condition by counting the members of an interposed superannuation fund.

As a result it is difficult to see how some funds with only a small number of institutional investors, such as private equity funds, will meet these conditions.

Variation 2: No FSL requirement

The second variation modifies Condition 2 by relaxing the FSL requirement. Specifically, the trust must be a MIS under the *Corporations Act* but the FSL requirement can be ignored if a licence is not required because the trust is operated by a crown entity or an entity or person with an ASIC exemption.

This second variation is the same as the equivalent variation included in the Exposure Draft.

Variation 3: Every member of the trust if a MIT

The third variation requires that Condition 1 be satisfied and that every member of the trust is a MIT. This variation is the same as the equivalent variation included in the Exposure Draft.

Exception if MIT closely held

The Bill is consistent with the Exposure Draft in that a special disqualifying rule provides that the trust will not be a MIT under the extended MIT definition (i.e. the

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three variations outlined above) 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 current definition of MIT in the withholding tax 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.

Making the election

The Bill contains the following procedural requirements in terms of making the election, which are the same requirements as those contained in the earlier Exposure Draft:

- The election is irrevocable.
- The election must be in the “approved form”. Typically, 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 the 2009-2010 income year or whether it comes into existence in the 2009-2010 income year.
 - If the trust was in existence and a MIT at the end of the 2008-2009 income year, the election must be made by the latest of the following 3 dates:
 - the last day of the trust’s 2009-2010 income year; or
 - 3 months after the commencement of the provisions; or
 - a later date if the Commissioner exercises a discretion to extend the time.
 - If the trust is created during the 2009-2010 income year, or an existing trust becomes a MIT in that 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.

Consequences of making the election

The consequences of making the election were discussed in detail in our earlier Tax Brief on this topic.

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In summary:

- CGT treatment will automatically apply for “covered assets” which are defined to mean:
 - shares;
 - units;
 - land; or
 - a right or option to acquire or dispose of one of the assets listed above.
- There are two categories of exclusions from the definition of “covered asset” relating to debt-like instruments. The first exclusion is for assets that are “financial arrangements” under the taxation of financial arrangements (TOFA) regime and which are subject to tax under the TOFA regime. The second exclusion relates to assets that are debt interests under the debt-equity rules. For example, redeemable preference shares that are debt interests will not be a “covered asset” and so will be outside the scope of the deemed CGT treatment.
- The taxation treatment of assets other than “covered assets” will continue to be determined in accordance with the usual capital and revenue account principles.
- The deemed CGT treatment will cease to apply if an eligible MIT becomes a “corporate unit trust” within the meaning of Division 6B.
- The deemed CGT treatment will cease to apply if an eligible MIT becomes a “trading trust” within the meaning of Division 6C. It is important to note that a trust will not be a Division 6C trust unless it is both a “public unit trust” and a “trading trust”, meaning that the carve-out for “trading trusts” is broader than a simple exclusion of Division 6C trusts. In other words, an eligible MIT could fall within this exclusion notwithstanding that it may not be a Division 6C trust (i.e. if it was a “trading trust” but not a “public unit trust” for Division 6C purposes).
- Eligible MITs that do not make a CGT election will be subject to deemed revenue treatment for “covered assets” other than land and options over land. The taxation treatment for land and options over land will continue to be determined in accordance with the usual capital v. revenue principles.

Fund managers

The Exposure Draft also contained a new regime relating to the taxation treatment of certain payments made to fund managers. The intention of this new regime is for payments made to fund managers for providing services to MITs to be taxed as ordinary income rather than as a capital gain.

In general terms, this new regime will apply where two principal conditions are met:

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- A taxpayer holds an asset that carried an entitlement to a distribution from a MIT (or an entity that was a MIT in the previous income year), the amount of which is contingent upon the economic performance of the MIT.
- The asset was acquired in connection with providing services to the MIT as a manager of the MIT or an employee of the manager, or where such services were provided by an associate of the taxpayer.

The ambit of this definition is still unclear. In particular, it is not clear whether ordinary units acquired by the manager for fair value will fall within the definition of carried interest.

Where the relevant conditions are met, the new measure will broadly operate as follows:

- Any distribution from the MIT is required to be included in the assessable income of the taxpayer, which means that these amounts will effectively be taxed as income and will no longer be eligible for CGT discount treatment.
- The taxpayer is also required to include in its assessable income the amount of any gain it makes from a transaction with its interest in the MIT (e.g. upon disposal). A corresponding deduction should be allowed to the taxpayer where such a transaction results in a loss.
- Any amount that is included in the assessable income of the taxpayer under this new regime is deemed to have an Australian source. The effect of this deeming is that distributions to non-resident fund managers will also be subject to Australian tax unless the non-resident fund manager is resident in a jurisdiction with which Australia has a double taxation agreement which operates to protect the distribution from Australian taxation.
- 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.

Announcement of further changes to withholding tax definition of MIT

Also on 10 February 2010, the Assistant Treasurer announced that an expansion of the existing definition of MIT that applies for the MIT withholding tax regime will occur so as to achieve a closer alignment to the definition of MIT that will apply for the purposes of making the CGT election as proposed in the Bill.

The press release did not include any specific details of the proposed expansion of the existing MIT definition, other than stating:

“to achieve a closer alignment, the MIT withholding tax definition will be extended to include both wholesale managed investment schemes and government-owned managed investment schemes, subject to appropriate integrity rules”.

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Other important points noted in the press release are:

- The proposed changes will introduce a trading business test for trusts that would otherwise classify as a MIT for withholding tax purposes. Presumably this means that a carve-out will be introduced for trusts that satisfy the “trading trust” tests in Division 6C.
- The proposed changes will also clarify the operation of the MIT definition in circumstances where a trust only has one member.
- The proposed changes will have effect in relation to the income year commencing 1 July 2010.

Action required

Participants in the funds management industry should be preparing for the operation of the new rules now:

- If a fund is not a MIT as defined for withholding tax purposes, it may still be a MIT for these rules and will need to check its status as a MIT under the extensions in the new rules outlined above.
- If a fund is a MIT for the purposes of the new rules, it needs to consider whether to make the election (which most managed funds will wish to do) and put processes in place to ensure that an election is made on a timely basis.
- Fund managers who will be affected by the full taxation of carried interests will need to consider the impacts of this change, including whether remuneration should be restructured.

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