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Dear Raph,

A New System for Managed Investment Trusts

We welcome the opportunity to comment on the Discussion Paper regarding the implementation of a new tax system for managed investment trusts released by the Treasury on 18 October 2010.

In the time available we have provided below information, comments and answers on the most important points.

There is one point on which we strongly recommend that a proposal in the Discussion Paper not be adopted. The requirement to reissue tax statements for overs above the de minimis amount would be very costly for the ATO, the investors and the MIT. Yet would provide little benefit. This is discussed more fully below.

1. Background and the Concept of a MIT

The discussion paper asks whether it is appropriate to take the existing concept of a MIT in Division 275 and incorporate it more generally in the income tax treatment of MITs.

It would simplify the law if there was a core concept of a MIT which was then applied broadly, being modified when necessary. For example, some provisions could apply as follows

> This Division applies to MITs that meet the following conditions …

or

> This Division applies to MITs and entities that would be MITs if …

We would see this core definition being applied very broadly. For example, in the loss rules in Schedule 2F of the Income Tax Assessment Act 1936 we would expect that MITs would all fit into a particular category rather than having to work through the various tests to find what category they are in.

2. Attribution Method of Taxation

Background Information on the Role of Distributions

At all times the investor's have a right to redeem their share of the value of the portfolio through the unit pricing mechanism. Intermittently, all investors on the register at a particular point in time have part of the value of the right to redeem transformed into a right to a distribution. The distribution and the part of the redemption right that has been transformed are worth the same in pre-tax dollars.

Distributions only exist to smooth the application of the tax laws. In the absence of income tax, managed funds would not distribute. Investors would simply withdraw money whenever they needed it, like they do with a bank account. If they wanted to they could set up a regular withdrawal amount to produce the cash stream that they need.

In order to have the incidence of tax at the investor level, which is what the investors and the product providers want, the current system requires the investors to be presently entitled to the income of the trust. This in itself forces a distribution because having created a present entitlement that entitlement has to be satisfied.

The controversy of having to deal with differences between accounting income and tax income only arises as a by-product of the present entitlement system. There is no commercial reason to distribute accounting income. The controversy only arises because section 97[1] arguably requires there to be a present entitlement to accounting income whereas the tax is payable on the tax income. If it were not for section 97, accounting income would be a trivial number that is calculated only because the Corporations Act requires registered managed investment schemes to publish financial statements that comply with accounting standards.

The traditional legal distinction between income and capital that features so heavily in case law on trusts plays no role in MITs. A MIT will never have income beneficiaries and capital beneficiaries in the traditional sense. Investment return drifts between income and capital too much for it to be possible to sell these things separately. For example, as a company approaches its dividend date whether the accrued profits are enjoyed as a capital gain on sale or a dividend depends on the vagaries of the cash flow in and out of the fund as well as the vagaries of the sharemarket. Income and capital units are too random an outcome to be the basis of a commercial product.

There was a period of time in the 1980s and early 1990s when a bull market in commercial property lead to property trusts having income units and capital units but these were based on a formula rather than the traditional distinction. The income units typically gave the right to the net rental income up to a limit whereas the capital units gave the right to everything else. In nearly all cases these separate classes were merged into ordinary units before any properties were sold.

Examples 3, 4 and 5 in the Discussion Paper suffer from a misunderstanding of the role of accounting income.

Under the attribution method the role of distributions will be thought of differently. Only the following three scenarios will arise with any sort of regularity.

The most common future scenario

Under the attribution method the MIT will calculate its tax income and will attribute it. It will pay an amount of cash equal to the amount required so that no cost base adjustments will be required. This is what most MITs are currently trying to achieve. The accounting income will play no role. The traditional distinction between income and capital will play no role. All that will matter is the calculation of tax income under the income tax legislation.

The most common future scenario for property trusts

The property MIT will calculate its tax income and will attribute it. It will pay an amount of cash equal to the net rental income, which will be a higher number than the tax income because net rental income is reduced for tax purposes by depreciation and capital allowances. There will therefore be a downward

[1] All references to the legislation are to the Income Tax Assessment Act 1936 or the Income Tax Assessment Act 1997 unless otherwise specified

cost base adjustment. This is done because investors in property trusts traditionally want to see a high yield. This is how property trusts currently operate and how they will continue to do so.

An unusual but possible future scenario

Some investments produce tax income but do not produce cash. An example might be a discounted security that produces tax income under the Taxation of Financial Arrangements regime but does not pay coupon interest. If the MIT only held investments like this and they were not liquid, there would be tax income to be attributed but no cash to match. The current solution is to compel the investors to reinvest the distributions that they are presently entitled to. Then there is no requirement for cash flow. An alternative under the attribution method, which would have the same economic outcome, would be to attribute the tax income but not pay any cash. There would then be an upward cost base adjustment.

Background Information on Distribution Methodologies

There are various methodologies currently used for dividing tax components between investors. No one method is clearly better than the others.

Most organisations have a methodology forced on them by their choice of accounting and registry software. Each system has just one way of doing things. The developers of the systems have attempted to program the correct methodology but different developers have received different advice on what is correct.

A simple example arises when the MIT makes quarterly distributions and there have been large capital gains in the first half of the year and large capital losses in the second half of the year netting out to a small capital gain for the year as a whole. There will be large distributions in the first half of the year and small distributions in the second half. In most MITs there will be some investors who only participate in some of the distributions. Either because they acquired their units after the first distribution or because they redeemed their units before the last distribution.

In respect of this example, some advisers in the past have directed that it is technically correct to calculate the components only on an annual basis and to apply the same components to each of the four distributions even though the tax characteristics did not arise smoothly over the year. This method gives a small net capital gain component to the investors who were in the fund only in the first half of the year , when in fact this is when large capital gains arose. The investors who were only in the fund in the second half of the year when the large capital losses arose also get a small net capital gain component even though there was a net capital loss during their time in the MIT.

Some advisers have directed that the opposite approach is technically correct. Each quarter’s distribution is said to have its own components that are summed at the end of the year. In our example, the investors who were only in the fund in the first half of the year would at first have been believed to have a large capital gains component to go with their large distributions. As the capital losses arise it becomes necessary to reduce the capital gains component of the earlier distributions. It is often the case in an example like this that the early distributions exceed the net income of the fund for the year so those earlier distributions end up having a non-assessable component. At other times all that is required is to reduce the capital gains component as far as can be done. In those cases there will be small distributions in the second half of the year but they will not have a capital gains tax component.

It is difficulties like this that lead to Division 12-H of the Taxation Administration Act being based on estimates.

The other constraint on choice of methodology is that this is a bulk process. Most MIT providers are doing all their distributions at the same time so expert resources are stretched. Most MITs also have a very large number of investors so the methodology has to be based on algorithms rather than judgment.

The methodologies are not chosen to allow for tax streaming benefits. The industry does not expect to be allowed to stream for tax minimisation benefits. We do expect to be able to stream occasionally for equitable reasons. For example, when a large investor redeems, causing the MIT to crystallise significant capital gains, the trustee may make an ad hoc distribution just to this investor of the net income generated by these capital gains. This is done for equitable reasons. It reduces the impact on the remaining investors. The trustee may want to allocate the capital gain characteristic wholly to the redeeming investor's distribution on the basis that this more correctly reflects what actually happened.

The attribution method has a strong transitional benefit in that it allows MITs to continue with their current methodologies without having to change their systems, if that is what they choose to do. This is very important. It minimises the cost of implementing the new regime.

Background Information on Constituent Documents

The Discussion Paper states that a precondition for a MIT to use the attribution method will be that the constituent documents of the MIT clearly establish at all times the investors' rights to income and capital, including the character of the income.

For this purpose the constituent documents are taken to include the trust deed, the product disclosure statement and minutes of decisions taken by the trustee.

Trust Deeds

The interaction of the unit pricing mechanism and the distribution mechanism in MIT trust deeds ensures that the dollar value of each investor's interest is economically equitable. That is, over any given period of time, each investor's redemption value plus distributions received will be proportional to the amount they have invested. This is a fundamental rule for widely-held vehicles because they would not have commercial integrity any other way.

This is a strong mechanism to ensure pre-tax equity but does not in itself necessarily deliver post-tax equity. Nor does it necessarily protect the revenue from inappropriate streaming of tax characteristics.

The trust deeds do not currently deal at all with the character for tax purposes. The character is often a by-product of the provisions of the deed but the deed does not itself address it. For example, the deed provides that a investor may redeem units for a unit price that equals the net asset value of the fund divided by the number of units on issue. It is the tax law that treats this is a capital gain or revenue gain for tax purposes.

Another example is that the deed will provide for distributions to be paid. The deed may draw on the tax law to determine the quantum of the distribution but does not in itself attempt to describe how tax components are allocated between investors.

There would be resistance to having to put more detailed rules in deeds. Deeds are inflexible and hard to amend. Like legislation, words that seem clear at the time they are drafted can end up being interpreted in unexpected ways. The desire to keep deeds at a high level and deal with detail elsewhere is analogous to wanting to use principles based drafting for legislation and leaving the detail for regulations or administrative determinations.

Product Disclosure Statements

The statutory purpose of product disclosure statements is to provide investors with the information they require in order to decide whether or not to use the product. The legal requirement is that they be clear, concise and effective. The pressure is to keep them as short as possible. Information on how tax components will be allocated between investors is not information that investors seek when deciding whether to invest or not, so it is not currently provided in these documents.

There is some scope to add this information to the product disclosure statements but it is limited. There will be a lot of resistance from lawyers and marketers to including technical detail that does not directly inform the decision to invest or not.

Product disclosure statements are typically updated every 12 months. This updating is an expensive but necessary process. If the attribution methodology were contained in the product disclosure statement it would be easy to make changes if the changes could be timed with the scheduled update. It would be prohibitively expensive to make changes at other times.

Using the product disclosure statement is therefore more flexible than using the deed but still rather inflexible.

Minutes

It is good practice for the MIT provider to document the methodology that they use, although this is often not done. When it is done, it is done by operational staff or external tax experts, not by the board of the trustee.

It would not be onerous to expect this documentation to be created to support the attribution system. It would not be onerous to expect the board of the trustee to formally adopt the methodology as set out in the document. Perpetual, for example, has a ‘distribution policy’ that the board of the trustee has adopted. In its current form it deals with the more difficult issues such as unders and overs rather than recording the detail of the methodology, but it could be easily adapted.

Inevitably, a documented policy cannot foresee every contingency. There will need to be a delegation of authority to someone to make on-the-spot judgments. Board members will not themselves have the expertise to make judgments without the full analysis being set out for them. They therefore cannot be expected to deal with minor unexpected issues that arise and will need to authorise appropriate people to make these smaller decisions.

It would be relatively easy to make appropriate changes to a methodology that is adopted in this way. At the same time, any board-approved changes will have integrity because directors have a duty to act lawfully.

Investors’ Entitlements not Discretionary

It is proposed that the condition to use the attribution method will be that the investors’ rights and entitlements, as found in the constituent documents, not be discretionary.

There are two possible things that could be offensive about a discretionary trust: the ability to stream the quantum of tax income to lower marginal rate investors (‘quantum streaming’) and the ability to stream the tax characteristics of assessable income to those investors who can get the most value out of them (‘characteristic streaming’).

The Discussion Paper’s First Suggestion

The Discussion Paper’s first suggestion on how to implement this concept is that the ‘no material discretionary elements’ test from Subdivision 126-G be adopted.

We recommend two modifications to this test.

The first recommendation is that the test be expressed more concisely than it is in Subdivision 126-G.

> the value of an investor's interest in the MIT cannot be significantly altered by the exercise or non-exercise of a power

The second recommendation addresses the problem that no-one can ever agree on what 'significantly' means. Some interpret it to mean 'not immaterial' while others interpret it to mean 'more than 50%'.

We recommend that the following definition be included.

> value is *significantly altered* if it is altered in a way that would not be commercially acceptable between parties operating at arm's length

These two parts can be combined into a single proposition.

> the value of an investor's interest in the MIT cannot be altered by the exercise or non-exercise of a power in a way that would not be commercially acceptable between parties operating at arm's length

However this test is expressed, it will deal with quantum streaming but will not completely deal with character streaming because tax character is not considered in determining the value of the interest.

The Discussion Paper's Second Suggestion

The Discussion Paper's alternative suggestion on how to implement the concept of investors' entitlements not being discretionary has two limbs.

The first limb is that it be possible to determine at any point in time what the investors' entitlements to income and capital are and the character of these amounts.

The first difficulty with this is that, as discussed above, the concepts of income and capital do not feature in the design or operation of MITs. It would add complexity to add these ideas. It would be better to express this as it being possible to determine the investors' entitlements to redemption and distribution proceeds.

The second difficulty, which is addressed in the first suggestion discussed above, is that there will always be a small but inoffensive element of judgment which on a literal interpretation would mean that this test would never be met.

The third difficulty is that redemption proceeds do not have any inherent character.

The second limb is that it is highly unlikely that the trustee would exercise a power to materially affect the beneficiaries' entitlements to amounts or to character.

This second suggestion does not have any advantages over the first suggestion.

Allocation of Expenses

It is important that the rules on expense allocation be flexible and the requirement be no more restrictive than that the allocation be reasonable.

The main reason for this is that there are so many different situations that arise in allocating expenses that it will not be possible to deal with all of them in detail.

The second reason is there will be significant transition cost if some of the current diverse methods can no longer be used.

Determining What Is Fair and Reasonable

The factor that the Discussion Paper leaves out of the determination of fair and reasonable is that the distribution methodology has to be efficient and cost effective. It is easy to increase equity through increasing operating costs but this is not in the investors' interests.

The Current 'Fixed Trust' Requirement

We support the conclusion that the clearly defined rights approach is better than the existing fixed trust approach.

Answers to the Specific Questions in Chapter 2

Question 2

We do not see any advantage in automatically treating some MITs as meeting the requirements. We would prefer that the tests are clear and effective enough to be easily applied.

We do not see how certain MITs are higher risk than others.

Question 3

Powers to accumulate income are not relevant to MITs. See the background information on distributions above.

Issuing interests at a discount should be allowed within the confines of the limits on the discretionary elements of the MIT discussed above.

Question 4

A problem with the expression 'constituent documents' is that the Corporations Act calls the trust deed "the constitution". People could be easily confuse themselves into thinking that only the trust deed was a constituent document. Some sort of definition would be required.

We recommend something like

> The 'constituent documents' are the documents that set out the investors' rights and entitlements including the trust deed, the product disclosure statement and minutes of meetings of the board of the trustee.

This is more of a general principle than a set of rules but is specific enough to be clear.

Question 5

It is important to leave the flexibility to allow the trustee to decide how they want to treat investors who redeem part way through the year.

In most cases MITs will maintain the current approach and will only attribute to investors who are on the register at the end of the quarter. To do otherwise would be very expensive, including significant transitional costs.

What MITs want is the right to set for themselves the parameters for the minority of circumstances when they consider it appropriate to attribute to a redeeming investor. A typical parameter will be that the investor held more than 5% of the units on issue. In most funds this level is never reached. Even when it is, it is a product design issue as to whether the trustee and potential investor consider it important enough to include.

Question 6

The problem with the proposal in Question 6 is that the concept of 'class of units' is not specific. See *Re Equitiloan Pty Ltd v Australian Securities and Investments Commission* (2003) AATA 367 where the parties disputed whether there was more than one class of units. You could not introduce the proposed rule without defining 'class of units'.

In some situations separate classes of units are accounted for as multiple separate portfolios of assets and then consolidated. In such a situation the proposed rule would not impose significant compliance costs.

In other situations separate classes of units are accounted for as a single portfolio. In such a situation the proposed rule would impose significant compliance costs.

Question 7

No. The attribution method is flexible enough to deal with all situations.

Question 8

The anti-streaming rule needs to work like Part IVA.

Question 9

See the answer to question 2 above.

3. Unders and Overs

Under Exceeds the De Minimis Amount

There is not a clear consensus in the industry whether the non-assessable-non-exempt approach is better than taxing the under at 30% and allowing a credit.

Each requires an amendment to the existing tax statements.

The advantages of the non-assessable-non-exempt approach are simplicity and a more sensible outcome if the trustee chooses to pay the tax personally rather than out of fund assets.

The advantage of the credit approach is that it allows the tax to be payable at investor marginal tax rates, although a slightly different generation of investors to the one that took the original distribution.

Over Exceeds the De Minimis Amount

The Discussion Paper's Recommendation

The Discussion Paper proposes that where the trustee becomes aware that there is an over greater than the de minimis amount, the trustee will be required to reissue distribution statements.

> **Example:** A distribution statement is sent to a unitholder advising them to include $100 in their assessable income as the amount attributed to them. The trustee pays a $100

> cash distribution to them in order that the unitholder not be required to make any cost base adjustments.
>
> The trustee later discovers that they significantly overestimated certain items and that the correct amount for the unitholder to include in assessable income would have been $90.
>
> The trustee sends an amended distribution statement to the unitholder advising them to seek an amended assessment to reduce their taxable income by $10. Further, as the cash distribution now exceeds the amount of assessable income by $10, the unitholder will be required to reduce the cost base of their units by $10. The excess $10 paid turns into an unintended return of capital.

We are concerned that reissuing distribution statements is inconvenient and costly for the clients, the Tax Office and the trustee of the managed fund. We are concerned that this is not justified by the benefit to the client.

Our Recommendation

We recommend that instead the law require the trustee to carry the over forward no matter its size.

This approach would have integrity because an over only arises through error or the use of estimates. Intentionally using inaccurate numbers would not be allowed. It could be made an offence similar to that of making false or misleading statements to the Commissioner.

The system then becomes one of taxing unitholders on a basis of honest estimates, with payments for excessive unders so that the revenue is protected.

There is nothing improper in basing a system on estimates. Division 12-H of the Taxation Administration Act already does this. Accounting standards recognise that estimation is necessary so company dividends are often based on estimates.

It will be rare that a managed fund will pay cash less than the attributable amount. It is a long-standing practice to pay cash that matches or exceeds the taxable amount. The system could be justified on the basis that it is analogous to the taxation of dividends where the unitholder is taxed on the amounts they receive which are based on estimates.

The law would be expressed as

> The trustee shall attribute an estimate of …

The managed funds product disclosure statements, addressed to potential unitholders, would carry an explanation something like the text below. It is assumed in this example that the trustee pays cash equal to or greater than their estimate of the notional taxable income of the fund. It will be clear from this explanation that there is a risk that the trustee will overestimate the taxable amount and that they unitholder will still be required to pay tax

> Soon after the end of each quarter you will be paid your share of the distributable income of the fund for that quarter. You will be required to include in your tax return for the year, an amount less than or equal to the sum of these payments.
>
> You will be sent a tax statement soon after the end of the year that will show you what amount to include in your tax return and the different components of income that make up this amount. Different components can be taxed differently and will be required to be disclosed separately in your tax return. The tax statement will also show franking credits and other amounts that can be used to reduce the amount of tax you pay. Along with

> the tax statement will be a guide that shows you how to put these amounts in your tax return.
>
> The distributable income for a quarter will be the trustee's estimate of the net income of the fund up to the end of the quarter calculated in accordance with income tax law, less amounts already paid in respect of earlier quarters. The trustee may increase the distributable income above this estimated amount by including additional amounts of income that are not subject to tax.
>
> The Fund itself will not pay income tax unless the trustee's estimate of the net income of the fund is more than 5% below the correct amount. If this happens the Fund will pay 30% tax. This tax will be available as a credit in a future year.

It is assumed in this example that you adopt our recommendation in respect of unders greater than 5%.

Reasons for Our Recommendation

The primary reason for our recommendation is the compliance costs. The amendments will almost always be for relatively small amounts. The cost to the ATO of processing these amendments will be high relative to the benefit being obtained.

Most investors will not understand what it means to amend an assessment. Many are financially unsophisticated and will find the process annoying and stressful. There will be a high level of non-compliance.

It will also increase the cost of administering the managed fund, which may be passed on to the investor.

Investors will use this system as evidence that the tax system is too complicated. We are also concerned that they will use it as evidence that managed funds are too complicated.

One factor that needs to be taken into account is that it is very common for managed funds to invest in other managed funds. The cheapest way to construct a portfolio for a managed fund with the right asset allocation and the right fee level is often to invest in a number of other funds created by the same product provider. This can create a chain of trusts up to six deep. Any solution needs to be tested against the risk that there is a cascading of administrative requirements. We are concerned that reissuing statements will have this problem.

Interaction with Withholding Obligations

No change in legislation is required for fund payment withholding but changes are required for interest and dividend withholding. Interest and dividend withholding should be made consistent with fund payment withholding.

Answers to the Specific Questions in Chapter 3

Questions 10 and 11

As distributions are typically calculated to the nearest 0.01 cents per unit, we recommend a de minimis of 0.02 cents per unit to ensure that mere rounding never gives rise to an under or over.

This needs to be an alternative to the 5% of tax income threshold.

In addition we recommend that a total under or over of less than $50,000 be ignored. This rule protects very small trusts which will typically be very new trusts.

Question 12

Estimates and errors are just as much an issue with tax offsets as they are with tax income.

It is necessary for unders and overs to be carried forward for tax offset amounts.

There is no effective de minimis rule for these amounts. The only available system is that they are always carried forward.

As we have said above reissuing tax statements for overs is not in anyone’s interests. In the case of a tax offset, an over is where the offset amount is understated.

Tax cannot be imposed on unders because they are not income and a tax rate cannot be applied to them. In the case of a tax offset, an under is where the offset amount is overstated.

Offset amounts are much smaller than income amounts so the system for dealing with them can be more lenient.

Question 13

The appropriate mechanism is that the amount included in the investor’s assessable income is the amount on the tax statement that the MIT issues.

Unders and overs are then measured by comparing the total of the amounts shown on tax statements to the calculation of tax income under the legislation.

Question 14

Yes. Unders and overs should be calculated at a constituent level, what the industry refers to as the ‘component’ level.

Where, in the following year, a component is not large enough for previous year’s over to be offset against, the excess should be offset proportionally against other components.

Question 15

As we have said above reissuing tax statements for overs is not in anyone’s interests.

Question 16

There should be a significant administrative penalty for intentionally or recklessly issuing an incorrect tax statement. In addition it should be an offence.

4. Cost Base Adjustments

Revenue Account Investors

We do not agree that the current law assesses revenue account investors on tax preferred amounts.

The Comparison Is Cash, Not Income

The problem with the examples in the Discussion Paper is that they compare tax income to accounting income. See the background information on distributions above.

The point of cost base adjustments is to compare the amount assessed to the amount received. Note that section 104-70 turns on the receipt of an amount that is not assessable. This is a cash concept not an accounting income concept. The Discussion Paper assumes these are the same thing but they are not.

Comparing To An Adjusted Amount

It is not possible to simply compare the cash received to the tax income. Adjustments need to be made where cash has left the MIT and a credit is allowable directly to the investor rather than to the MIT. This will be the case for foreign tax payments and TFN withholding.

> **Example:** A MIT issues 10 million $1 units and invests $10 million in a company. The company pays $1 million as an unfranked dividend. The MIT has failed to quote its TFN or ABN. The company withholds $465,000 and pays only $535,000 to the MIT. The investors in the MIT will be entitled to credits adding up to $465,000.
>
> The MIT attributes $1 million to the investors but only pays $535,000 in cash.
>
> The investors immediately redeem all of their units. The MIT sells its shares in the company for the same price it acquired them at so the investor redeems their units for the same amount they acquired them.
>
> If the cost base adjustment rules require a cost base adjustment because the cash paid was less than the tax income, then the investors will have a capital gain for tax purposes even though economically they did not make a capital gain on these units.
>
> If instead the cost base adjustment rules deduct the TFN credits from the tax income before comparing it to the amount of cash paid, then the right outcome will be achieved.

A similar adjustment is required for franking credits which are an artificial amount that the MIT does not receive in cash.

Answers to the Specific Questions in Chapter 4

Questions 17 and 18

The cost base adjustment rules were changed so that the adjustments only have to be made at the end of the year. This was done because the compliance costs otherwise were too high. Nothing has changed since the Government made that decision. Adjustments need to continue to only be required at year end.

The only change that should be made is to include increases to cost bases as well as reductions.

MITs already track these adjustments and communicate them to the investors as ‘tax deferred’ components on the tax statement.

It is not onerous to require differences in the other direction to also be shown on the tax statement. MITs will generally avoid doing this by always paying out cash at least equal to the attributed amount.

Question 19
No.

4. Character and Source Retention

Character and source retention is only required when the tax law treats the character or source differently. These rules already exist in the provisions that require the different treatment.

We do not see how centralising these requirements will make the legislation easier to use.

If you have any questions you can contact me on 02 9229 9931 or michael.brown@perpetual.com.au.

Yours sincerely

Michael Brown

General Manager Group Taxation