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Dear Raphael

**Implementation of a new tax system for Managed Investment Trusts –
Discussion Paper October 2010 (MIT paper)**

Thank you for the opportunity to provide our comments on the MIT paper.

The Property Council of Australia is the peak body representing the interests of owners and investors in Australia's \$400bn property investment sector. The Property Council serves the interests of companies across all four quadrants of property investment debt, equity, public and private.

The Property Council is a strong supporter of all MIT reforms that will bolster the property industry's ability to compete effectively in this sophisticated, global market.

Importantly, the Government's policy commitment has been aimed at reform to enhance and support the MIT industry for the future.

The MIT Paper correctly identifies a range of issues that need to be resolved. However, the discussion paper does not provide sufficient detail for us to meaningfully comment on issues as they affect property trusts. The proposals all require significant development and some are simply not acceptable to the property industry in their current form.

We are concerned that the consultation is being rushed and will be deficient given there are no proposed solutions and Treasury is looking to go from a conceptual discussion to solutions/ drafting instructions within 4 days without further detailed consultation.

There needs to be a substantial revision of the consultation timetable and start date or we will end up with draft legislation that the property industry cannot support.

Industry is also concerned the discussion paper suggests concepts that appear to be moving away from the spirit, intent and in some cases the actual recommendations made by Board of Tax and accepted by Government.

The process risks imposing draft legislation that is unworkable and a step backwards rather than a best practice regime for industry and the economy.

We understand that the MIT Paper is designed to test ideas, however we are concerned that implementing solutions based on many of the proposed concepts will hold back or cripple parts of the industry because established property MITs:

- 1) will face additional unnecessary hurdles to access yet "another" MIT regime;.
- 2) may not be able to access critical provisions that are key to managing capital;

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- 3) will be subject to wide ranging anti-avoidance rules which substantially widen the ambit and operation of Division 6C; and
- 4) will be forced to undertake impractical and cost prohibitive compliance activities for marginal benefit..

The Issue for Property Trusts

Widely held property trusts are a unique category of MITS, because unlike most equity investment or funds management MITs, they are not simply an aggregator of cash.

Property trusts run passive investment activities managing property portfolios that require gearing, and working- capital functions to (for instance), make foreign exchange transactions, loan repayments on property assets and engage in capital maintenance of those assets.

This creates significantly different and complex problems for property trusts which are not adequately addressed by the current proposals.

The key issues that must be addressed for the property industry are:

- 1) all Property MITs must satisfy the "clearly defined rights or entitlements" rule;
- 2) the attribution rules must apply to all Property MITs irrespective of the level of distribution;
- 3) the unders and overs rules must be redesigned to prevent massive compliance costs for the industry, investors and the ATO;
- 4) any arms length rule must be specifically targeted without impacting existing Division 6C rules;
- 5) all Property MITs must be treated as fixed trusts;
- 6) CGT and stamp duty relief must be available if changes to trust constitutions are required.

We are keen to work with Treasury to resolve all these issues as quickly as possible to ensure we can support a best practise regime for industry and the economy.

We would like to organise workshop discussions with you to address these issues.

We strongly urge Government to delay providing legislative instructions and, seriously consider deferring the start date for the regime.

Please do not hesitate to contact me on 0406 45 45 49 if you have any queries or to set up a time to meet.

Yours sincerely



Andrew Mihno
Executive Director International & Capital Markets
Property Council of Australia

***Treasury Discussion
Paper: A New Tax
System for Managed
Investment Trusts***

Submission

*Property Council of Australia
November, 2010*



A New Tax System for MITs

A Introduction

The Property Council is a strong supporter of the MIT reform process.

The Treasury MIT paper has correctly identified a range of issues that need to be resolved and raises many of the questions that need to be answered.

The discussion paper does not however provide suitable and/or sufficient detail for us to meaningfully comment on issues affecting property trusts.

This is because:

- Some of the questions are not appropriate. The industry considers that some of the proposed concepts extend beyond the recommended positions adopted by the Board of Tax and agreed by Government.
- Where we do agree with the questions, we do not have sufficient detail to meaningfully comment on Treasury's proposed outcomes.

Taking these factors in account, the 15 November consultation deadline is too short for us to provide a considered and comprehensive response.

We are concerned that the consultation will be rushed and will be deficient given there are no proposed solutions and Treasury is looking to go from a conceptual discussion to solutions/drafting instructions within 4 days without further detailed consultation.

However, we are committed to making this regime work in a way which delivers the industry based reform that was the original aim of the process.

We acknowledge that the implementation of these proposals will be difficult. We do not consider that Treasury can do the work properly without more time and input from industry in the form of workshopping various matters. We are keen to work with Treasury and the ATO to facilitate this.

B Summary

The Property Council remains a strong supporter of the MIT reform process.

We look forward to the eventual extension of this process to include the modernisation of the "REIT provisions" in Division 6C. We believe this reform can be delivered at no net cost to revenue but with significant benefits for the industry. However, we do not accept any attempts to amend the operation of the Division 6C provisions ahead of a full and proper consideration of these provisions as foreshadowed in the Government's announcements.

In the meantime, we are focussed on making the announced changes workable. As noted before, the MIT Paper correctly identifies a range of issues which require resolution and raises many of the questions that need to be answered.

The following proposals outlined in the discussion MIT Paper will have a significant adverse impact on the property industry if not implemented correctly, or in some cases if implemented at all:

- **The start date:** 1 July 2011 does not give enough time to develop well constructed legislation and allow MITs to make appropriate changes to comply with the rules.
- Attribution rules should apply to MITs irrespective of distributions.
- The rules should clearly indicate that all MITs satisfy the "clearly defined rights or entitlements" criteria.

- The proposals for unders and overs will not work for property trusts, investors and the ATO.
- The proposed arm's length test is inappropriate, inconsistent with the BOT recommendations and will adversely impact most MITs.
- The uncertainty surrounding the current definition of a fixed trust must be addressed For example, all MITs should be deemed to be fixed trusts.
- The MIT definition is not complete. In particular, the list of qualified investors in subsection 12-402(3) does not include a wholly owned subsidiary of a qualified investor. We understand that this is supposed to be revisited.
- CGT and stamp duty rollovers are required where any changes to trust deeds arising from the new rules would otherwise result in a resettlement.

In the timeframe available for comment, we have not been able to work through and fully resolve all of these issues. Therefore, our submission identifies where the property industry stands on each of the major issues. We agree with Treasury's assessment that there is a lot of work to do to come to an appropriate landing on these provisions.

Given the importance of these changes and the potential adverse impact to the property sector, we would like to workshop each of the major issues with Treasury (and the ATO) to co-develop the necessary solutions.

We think such a process is necessary and appropriate for the property industry given the disproportionate impact of these provisions on this industry – see Section C below.

Further, the proposed changes will have a systemic impact on industry (and the ATO) which should not be under-estimated and this needs to be reflected in the careful introduction of these provisions.

C Why Property is disproportionately affected by these rules

There are a range of reasons why the proposed MIT changes are particularly significant for the property industry. These include:

- the definition of eligible investment business in Division 6C is more restrictive for property investments (investing in land to derive rent) as opposed to other affected investments (investing or trading in a wide range of financial assets);
- this has resulted in the development of stapled and other structures to allow trusts to invest in all real estate assets classes without falling foul of Division 6C;
- the nature of the transactions involved in real estate - building, developing and running large scale, multi-faceted property assets, depreciation, lumpy and irregular capital gains and relationships with tenants means there are a greater range of differences between tax, trust law and accounting income than in other trusts subject to Division 6C;
- this increased structural complexity and greater range of outcomes has two results:
 - a range of industry practises which to one extent or another have been signed-off, accepted, acknowledged or tolerated by the ATO; and
 - significant potential for the proposed amendments to impact the property industry on a disproportionate basis.

For better or worse, the impact of the various industry practises is reflected in the value of participants in the property industry be it via a listed price on the ASX or an NTA for wholesale funds. To the extent the proposals result in changes to these industry practises there is the possibility of a price impact for investors.

We suggest there are three propositions which should underlie the development of the detailed rules:

- 1) implementation of the changes should not fundamentally change the tax outcomes for industry participants;
- 2) industry participants should be given all necessary rollover and transitional relief to allow them to fully implement these changes; and
- 3) protection should be provided against any adverse impacts affecting pricing (and therefore investors) whether by way of rollover or transitional relief in relation to affected arrangements.

Overall, the legislation must provide a high level of certainty for the industry.

D Treasury MIT Paper

We have set out below our comments on the Treasury MIT Paper.

Consistent with the approach adopted by Treasury, we have restricted our comments to establishing the relevant principles because we consider that legislation can only be drafted when these principles have been agreed.

We reiterate that many of the proposals will have a significant adverse impact on the property industry if not implemented correctly, or in some cases if implemented at all. We are keen to work with Treasury and the ATO to come up with an appropriate and workable MIT regime.

1 Concept of Managed Investment Trust

Other than some relatively minor changes to correct issues arising out of the MIT definition under Division 275, (for example, to correct the position in relation to sub-trusts which are wholly owned by one or more MIT's and do not have a licensed trustee), we are satisfied that the definition should apply for the purposes of the proposed changes.

We note that, although not raised directly by the Board of Taxation, consideration should be given to introducing the definition of a MIT into other parts of the tax law that provide a concession for widely held trusts. For example:

- s.128FA – at present, some MITs may not qualify as “eligible unit trusts” for the purposes of the withholding exempt exemption of publicly offered debt and are therefore at a commercial disadvantage to their competitors; and
- the trust loss rules – at present only listed trusts may rely on the same business test and only trusts with more than 1,000 direct unitholders are entitled to relief from the 50% stake test during a start-up phase.

We consider that having slightly different concepts of “widely held” in different part of the tax laws is inequitable and inefficient.

2 Clearly defined rights or entitlements.

In our view, whilst this test is necessary, it should not be another substantive test for trusts which are already:

- MIS's;
- MIT's;
- subject to corporations law regulation; and
- can only amend their constitutions in accordance with the corporations law.

Beyond that, we note that many of the alternatives proposed by Treasury suffer from the problems which beset the fixed trust and other existing provisions within the ITAA and would create unnecessary complexity and uncertainty.

It would be easy to side-step the complexity and approve short-cut rules for listed trusts, and for registered schemes but as argued (and accepted) in the debate on MIT withholding, the industry contains many participants outside these important classes.

It is difficult to see why these trusts should be excluded.

We need to work together to create a base-line test which permits the majority of MIT's to access the attribution regime recognising that the key intent of the Board's process was to simplify matters for the industry and investors therein not to create another set of complex rules leading to a significant compliance burden.

3 Attribution

The industry applauds the introduction of attribution but, attribution must mean attribution and cannot bring with it any echoes of the old present entitlement system.

The question of what cash distribution a MIT decides to distribute is a commercial matter for the trust and its investors. The rules should not be dependent on what distributions are made and what income is retained.

Similarly, the ATO cannot become the arbitrator of what is fair and reasonable as a matter of trust law – there is existing consumer protection legislation designed to protect investors and it would not be appropriate for the ATO to assume an oversight role in this area. To bring the ATO into this arena is to make it the work-horse for every disgruntled investor.

4 Under and Overs

Again the industry applauds the introduction of these rules but considers that more work is required to make them practically workable.

For example, as presently drafted it is hard to see the trustee has any real choice in the event of an amendment outside the 5% threshold but to amend prior distribution statements.

To do otherwise would be to expose current unitholders to a 46.5% tax liability that properly relates to prior periods when they might not have been unitholders.

Even if the unitholders are identical it is difficult to see how a trustee could justify paying tax at 46.5% when the average unitholder rate will almost always be lower.

It might be suggested that this means that there should be many such adjustments under the current system. This is not the case because:

- current unders and overs policies are elastic;
- any adjustments are made in the current years; and
- there has been little ATO activity leading to material adjustment to trusts' taxable income.

This is one example of an area where industry practise (with the knowledge and sometimes approval of the ATO) has to be taken into account when designing the detailed rules.

5 Cost Base Adjustments

Cost Base Adjustments are another positive proposal which requires careful implementation.

While the industry can and does provide information on cash distributions and the taxable amounts referable to those distributions, one should not under-estimate the system impact on the industry in being required to maintain and provide actual cost base information to investors. Indeed, listed vehicles are unlikely to know the actual cost base of individual investors who have acquired their interest on market

At present, there are a range of practises and it will take some time (and cost) for all participants in the funds management industry to satisfy the proposed cost base reporting requirements.

As we understand it, statements of this type are generally provided by FSC members to clients so they already have systems, people and processes set up to handle reporting so further changes may not be problematic. Property Council members generally will not be in a position to issue CGT statements to investors due to lack of these systems. A 1 July 2011 start-date for detailed reporting of the type proposed is therefore simply not achievable. As noted above such cost base information may not be available.

As a compromise, we propose including a requirement from entry into the MIT regime that the RE/MIT provide (at least) the following information on the annual tax statement to investors:

- where an under or over exceeds the threshold and the MIT chooses to reissue tax statements, details of the under / over amounts broken into tax components on a **per unit** basis so that unit holders can amend prior year tax returns; and
- cost base addition and subtraction items on a **per unit** basis for each income year from commencement of the new regime (without look back) so that investors can determine their CGT liability.

Such information should also be made available on the RE/MIT's website.

This approach is similar to the treatment of fund payment amounts and industry practice with respect to tax deferred adjustments.

6 Character and Source retention

At this stage we are comfortable with the proposed approach.

7 Fixed trusts

Subject to reaching a satisfactory outcome in relation to the question of "clearly defined rights", we are currently comfortable with the proposed approach.

8 Division 6B

At this stage we are comfortable with the proposed approach.

9 Arms length provisions

We consider that until Government reviews the ambit of Division 6C, only a specifically targeted arms length integrity measure should be drafted.

The Board of Tax made six recommendations in relation to Division 6C. They are

- Recommendation 7 – Removing the 20% test for super funds – Government accepted
- Recommendation 8 – redefinition of the scope of EIB – Government rejected this recommendation at this time
- Recommendation 9 - retain control test but allow a single TRS – Government rejected this recommendation at this time
- Recommendation 10 - apply arm's length rules (as trade-off for Recommendation 8 and 9) – Government accepted – even though it rejected 8 and 9
- Recommendation 11 - 6C to apply to all widely held MIT – Government rejected any changes at this time.
- Recommendation 12 - If fail 6C taxed at corporate rate on all income – Government accepted – no change to status quo.

Para 119 of Treasury MIT paper focuses on arm's length test as a specific integrity rule to prevent re-charactering of income from a business as rent from land with no mention of altering expenses incurred by a trust.

Against this background, we submit that:

- Government has clearly deferred a broader consideration of EIB;
- Any arm's length test introduced before the broader consideration of EIB should be a specifically targeted integrity rule which does not adversely effect any existing arrangements.

Consideration of a more widely drafted arm's length test may be appropriate as an integrity measure where there are substantive changes to the operation of Division 6C. However, it is, in our view, inappropriate to introduce a widely based rule in the absence of a such a restatement of

the ambit of Division 6C. To do so, would undo many years of industry and (in many cases) ATO practise on which stapled and other structures are based. This would change the tax outcomes for nearly all participants, changing the pricing of many which is based (at least in part) on their ability to distribute pre-tax income and could cause some to become simply unsustainable.

All of these outcomes are inappropriate without a considered review of the ambit of Division 6C as it applies to property. The Division 6C provision has simply not kept pace with the developments in the securitisation of property, forcing industry and the ATO to find ways to make things work. These practises are reflected in much of the current complexity in the structure of the industry.

So, when the Government has specifically deferred consideration of the operation of Division 6C, the application of any widely based integrity measure should be equally deferred. The integrity measure cannot be one which strips the industry of the benefit of all the structures and practises on which it has relied for its growth.

The detail of what is proposed in the MIT Paper is unclear. Accordingly the industry is very concerned that the proposed operation of the arms length provision is well beyond that required of a specifically targeted integrity measure and therefore has the potential to cause issues under Division 6C and otherwise reprice the sector for investors

For the reasons outlined above, we reject any formulation of this rule which makes it a part of the conditions under Division 6C rather than simply a market value transfer pricing rule restricted in operations to situations where there is a specific integrity issue.

10 Resettlement

Given the uncertain nature of these proposals and therefore whether amendments to trust deeds will be required and the scope of any such amendments, we consider that the Government should immediately commit to:

- providing CGT (and other income tax) rollover relief to allow trusts to amend Deeds so as to satisfy the additional requirements; and
- working to ensure the States provide similar stamp duty relief.

Otherwise we are faced with the prospect of creating a regime which is impossible for the very people it was intended for to access.

