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TAXATION INSTITUTE *of* AUSTRALIA
IT'S ESSENTIAL

15 November 2010

General Manager
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The Treasury
Langton Crescent
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Dear Treasury

Managed Investment Trust (MIT): Submission on the Discussion Paper titled "Implementation of a new tax system for managed investment trusts"

The Taxation Institute of Australia ("**Taxation Institute**") is pleased to provide the following comments on the Discussion Paper titled "Implementation of a new tax system for managed investment trusts" which was released for public comment on 18 October 2010.

1. Summary

The Taxation Institute welcomes the Assistant Treasurer's announcement[1] ("**Announcement**") to introduce a new tax system for managed investment trusts (**"MITs"**) and to implement a number of other associated reforms.

In particular, the new regime for the taxation of MITs announced as part of the Announcement has the potential to create greater certainty and flexibility regarding the taxation of MITs.

However, in order for the proposed MIT regime to achieve these objectives, it is important that sufficient certainty is provided with respect to the availability and application of the regime. As currently presented, the Taxation Institute has some concerns regarding whether the proposed MIT regime will fully achieve its objectives.

Our submissions are directed at facilitating the achievement of the stated objectives of the proposed MIT regime. The Taxation Institute's recommendations in relation to certain selected consultation questions are discussed further below.

2. Comments on Consultation Questions

<u>Consultation Question 1</u>

Whether any or all of the rules about trusts treated as MITs for the purposes of the capital account election (Division 275) should be incorporated in the concept of a MIT that applies generally to the treatment of MITs for income tax (but not withholding tax)?

The rules about trusts treated as MITs for the purposes of the capital account election should also be applied for the purposes of determining availability of the attribution regime.

This is on the basis that these modifications are equally appropriate to the attribution regime as they deal with the general Australian domestic taxation of trusts, as opposed to withholding tax on distributions to non-residents.

[1] See Assistant Treasurer's Speeches No. 015 of 7 May 2010

Consultation Question 2

Should the core clearly defined rules be supplemented by tests which would allow some types of MITs (e.g. registered MISs) to automatically satisfy the requirement in situations where rules already operate to prohibit a MIT from acting in a manner inconsistent with the core rules? If yes, in which situations should these tests apply?

Firstly, the Taxation Institute is concerned that some of the suggested proposals for the clearly defined rights rule go much further than was contemplated in either the Board of Tax's report or the Assistant Treasurer's Announcement. Most, if not all, of the suggested approaches will result in no MIT satisfying the primary requirements. Additionally the approaches are likely to increase complexity and compliance costs whereas one of the aims of the Review was to reduce those costs. The Board's report envisaged a much simpler approach of adopting the Corporations Act rules.

Irrespective of what primary approach is adopted, the "clearly defined" gateway to the attribution regime should be supplemented by tests that would allow registered managed investment schemes ("**registered MISs**") to automatically satisfy the requirements. This is likely to reduce compliance costs for registered schemes and is appropriate given the Corporations Act requirements imposed on registered MISs.

However, it is recommended that this test be based simply on a requirement that the MIT is a registered managed investment scheme under the Corporations Act, rather than also satisfying the "listed" requirement that is currently imposed under the "widely-held" test to qualify as a MIT. This is because there is currently a deficiency in the "listed" requirement that will exclude a number of registered MISs.

Under the current MIT definition, a registered MIS will only automatically satisfy the widely held test for MIT purposes in circumstances where its units are "listed for quotation in the official list of an approved stock exchange in Australia" (e.g. ASX). However, a number of registered MISs will generally be "quoted" on the ASX under the AQUA rules rather than being listed for quotation in the official list of the ASX. As such, these registered MISs will not likely be able to rely on their listing under the AQUA rules for the purposes of automatically satisfying the definition of an MIT.

This is an inappropriate outcome given that those registered MISs are, by virtue of their registration under the Corporations Act, subject to the same requirements under the Corporations Act as registered MISs that are also "listed", as discussed in the Discussion Paper.

Further many MITs that are not registered are wholly owned by one or more widely held entities (e.g. the "good list" investors described in 12-402(3) of the Tax Administration Act). As presently drafted, such trusts would not fall within the concessional testing. Such a result seems inappropriate and will clearly lead to increased compliance costs.

Consultation Question 3

Would it be possible for the clearly defined rights rules to accommodate trustee powers to accumulate income in the trust or issue units at a significant discount without impacting on the integrity of the rules?

We consider that, as currently expressed, the "clearly defined rights and entitlements" gateway to the attribution regime is too narrow and will exclude the vast majority of MITs currently in the market.

Test likely to inappropriately constrain ability of trustees to properly manage MITs

This is on the basis that a vast majority of MITs currently in the market will be constituted under deeds that provide the trustee with flexibility to determine whether amounts are treated as income or capital for the purposes of distribution.

On this basis, the proposed MIT regime will likely become a tax regime of limited application, contrary to the current purpose and intention. This is the case unless the MITs modify their constituent documents to remove the relevant powers and discretions.

The retention of this flexibility is important to ensure that the trustees of the MITs are able to administer the MIT for the benefit of the unitholders. If the amount of income distributed each year was "hard wired", this may disadvantage unitholders and comprise the performance of the investments in the trust. For example, by forcing the MIT to distribute cash where the MIT does not have the cash to do so.

The existence of trustee powers to characterise receipts or expenses as income or capital, accumulate income or issue units at a discount typically does not impact on the integrity of the rules. This is because, as recognised in the Discussion Paper, trustees are, under the general law of trusts as well as the Corporations Act, required to exercise their powers in the best interests of the members of the trust. The proposed attribution regime will provide a stronger link to the right unitholders paying the right amount of tax. Creating high barriers to accessing that regime is counter-productive. Indeed, excluding trusts that have these trustee powers will perpetuate some of the inappropriate outcomes that can arise and interfere with the proper tax result being achieved. The attribution regime is intended to de-link the trust income from the tax income to give effect to such a result. Placing these hurdles on accessing the attribution regime seems inconsistent with that intent.

Proposed exclusion based on "market value" problematic

However, the proposed exclusion in the Discussion Paper that allows such powers to be disregarded where they do not "significantly" affect the "market value" of any of the unitholders' interests in the MIT will be impracticable. It is difficult, if not impossible, to determine with certainty whether and the extent to which a power affects "market value".

For example, given that the power does exist, how is a trustee supposed to know what the "market value" of the interest is if the power did not exist? Further, except where the MIT is listed on a stock exchange, how can a trustee, who is subject to fiduciary duties, definitively conclude whether a particular discretion affects "market value" where there is no secondary market for the interest?

Test inappropriate in context of proposed MIT regime

The discussion surrounding the "clearly defined rights and entitlements" requirement draws heavily on the "no material discretionary elements" requirement imposed under Subdivision 126-G, which provides a CGT roll-over for asset transfers between trusts in certain circumstances.

The purpose of Subdivision 126-G is to provide a concession in the form of a CGT roll-over on an asset transfer between certain trusts with common beneficiaries provided the trust ownership is sufficiently "fixed" such that there is no change in the "effective ownership" of the assets. In contrast, the "clearly defined rights and entitlements" requirement is intended to consist of the gateway to an attribution regime which is intended to have broad application to the majority of MITs, rather than merely operating as a narrowly focused, specifically targeted concession.

In this regard, Subdivision 126-G should not be adopted as the appropriate statutory expression of the "clearly defined rights and entitlements" requirement , but rather a new statutory expression (discussed below) should be developed having regard to the legislative purpose of the attribution model. That is, the development of a model of broad application that is intended to achieve certainty in terms of the ability to determine the tax liability of unitholders.

Test should be based on whether proportionate rights and entitlements clearly defined

We recommend that the "clearly defined rights and entitlements" be expressed to be based on whether the proportionate entitlements of unitholders to the trust income and capital are "clearly defined", in contrast to whether the quantum of each category of right and entitlement is appropriately fixed and determined.

This formulation more appropriately reflects the nature of a unit trust and is more likely to achieve the objectives of the requirements. This is consistent with current market practices and would allow trustees to retain the flexibility they need.

This is on the basis that unit trusts are generally understood as trusts where the beneficial interests in the trust property are divided proportionately based on the number of units held. Accordingly, the quantum of each of the unitholder's rights and entitlements are generally not fixed or "clearly defined" as they are determined as a proportionate share of the relevant entitlement for the trust as a whole, the quantum of which will vary depending on the performance of the investments of the trust and the terms of the trust deed. However, the proportionate share will typically be fixed and objectively determinable, to provide unitholders with appropriate certainty.

This is illustrated in the following example.

The Investment Unit Trust holds a portfolio of Australian listed shares and Australian real property. The Constitution for the Investment Unit Trust provides:

- *an objective formula for the issue and redemption price for, based on the Net Asset Value of the Investment Unit Trust divided by the number of units on issue in the trust at the time;*
- *an objective formula for the determination of the income entitlements that arise for the unitholders, based on the Distributable Income of the Investment Unit Trust and the number of units held by the unitholder against the number of units on issue in the trust at the end of the relevant distribution period; and*
- *the trustee with a discretion to classify amounts as Distributable Income or otherwise.Under the "clearly defined rights and entitlements" test discussed in the Discussion Paper, this trust may not classify as an MIT which is eligible for the attribution regime as the trustee is given a discretion to classify amounts as Distributable Income or otherwise.*

This is the case notwithstanding that each unitholder's overall proportionate interest in the trust does not change (i.e. unitholders will continue to be entitled to their respective portions of the amount which is determined to be Distributable Income).

In any case, if an amount is excluded from Distributable Income, the redemption price that the unitholder is entitled to receive on redemption will generally reflect the excluded amount (i.e. the NAV of the trust will generally be increased by a corresponding amount, and vice-versa).

Further, it should not matter for the purposes of the attribution regime that unitholders may also be entitled to different proportions of the Distributable Income, provided that all unitholders, collectively, have "clearly defined rights and entitlements" to the whole of that Distributable Income. This is consistent with the stated purpose of the regime which is to achieve certainty in terms of the ability to determine the tax liability of unitholders.

If the "clearly defined rights and entitlements" test is, as we suggest, determined based on the unitholders' proportionate rights and entitlements, the trust would qualify as an MIT which is eligible for the attribution regime. This is on the basis that the amount of the income entitlements and redemption price are determined based on objective formulae based on the number of units held by the unitholder.

Test should be deemed to be satisfied where trust meets provisions akin to the Corporations Act

The Taxation Institute recommends that provisions be included in the tax legislation which are akin to the Corporations Act requirements in section 601FC and section 601GC which specify the circumstances under which the constitution may be amended and prescribe rules the trustee must follow when dealing with beneficiaries. This approach is consistent with the recommendation in the Board of Tax's report. A MIT that meets these provisions should be deemed to satisfy the "clearly defined rights and entitlements" requirement and, therefore, should be eligible for the attribution regime.

<u>Consultation Question 4</u>

Is it appropriate to describe 'constituent documents' by way of a general principle, similar to the approach adopted by the Board in its Report, or should specific rules which list those documents that form part of a MIT's constituent documents be adopted?

We believe that "constituent documents" should be defined by way of a general principle to provide greater flexibility, but that the legislation should include documents that will always constitute "constituent documents", such as the trust deed and product disclosure statement or offering document. This provides an appropriate balance of flexibility and certainty.

<u>Consultation Question 5</u>

Are specific rules required to ensure that amounts of tax income are appropriately attributed where a unit in a MIT is sold or redeemed during an income year? If so, what rules would be appropriate?

Although we agree, in principle, with the "fair and reasonable" allocation based on the "clearly defined" rights and entitlements approach, it is vital that greater certainty is provided regarding the meaning of "fair and reasonable".

An example of why this is necessary is in the context of determining the amount and character of the taxable income of the trust that should be allocated to a unitholder where they redeem units in a MIT.

Multiple methods may be regarded as "fair and reasonable" in a particular context

In this context, there are numerous ways of allocating taxable income, each of which could be argued to be "fair and reasonable". For example, to prevent "last man standing" issues from arising, the taxable income that is allocated to a unitholder on redemption could be allocated based on, amongst other things:

- the amount of the gain that the unitholder will realise on the redemption of their unit;
- the trust's daily taxable income accrual and the redeeming unitholder's proportionate share in that taxable income; and/or
- the realised (and, in some cases, unrealised) gains that the trust actually realises to satisfy the redemption of the unit.

It may be possible to argue that any of the above methodologies are "fair and reasonable" in the context of an ordinary pro rata fund. It is also not appropriate to mandate, in the legislation that will introduce the proposed MIT regime that any particular method automatically apply in any circumstance. This is because there may be circumstances where a particular method is not appropriate given the circumstances of the trust for that year.

Method should be deemed to be "fair and reasonable" where in accordance with constituent documents

Accordingly, we consider that the most appropriate approach would be that a method for allocating taxable income (on redemption of units or otherwise) be deemed to be "fair and reasonable" where the method is undertaken in accordance with a methodology that is prescribed in the constituent documents for the MIT.

This approach provides an appropriate balance of certainty and flexibility. In particular, it provides trustee with the certainty they require regarding whether a particular method of allocation is "fair and reasonable" through the creation of an effective "safe harbour" where the allocation is in accordance with the methodology prescribed in the constituent documents. It also allows sufficient flexibility as it does not prescribe that a particular methodology is used.

We consider that creating a "safe harbour" in this way is important in order to ensure that the proposed MIT regime achieve its stated objectives of certainty and flexibility for the taxation of MITs.

Consultation Question 7

Are any modifications to the proposed attribution rules needed for trustees of trusts where units may be traded on a more regular basis (compared to unlisted trusts), such as listed property trusts or exchange traded funds?

It may be appropriate to have special rules regarding the allocation of taxable income for ETFs.

ETFs are different from ordinary unit trusts in that applications and redemptions from ETFs can be satisfied through the transfer of a basket of securities rather than cash.

As a result, unless the taxable income that arises for a fund on the transfer of the basket of securities to a redeeming unitholder is allocated to that redeeming unitholder, the continuing unitholders of the trust are disadvantaged. It also limits the ability of exchange traded funds to achieve their commercial objective of replicating investment in the underlying portfolio.

Consideration should be given to including rules that provide that where a MIT is an ETF, the taxable income that is to be allocated to a redeeming unitholder includes, at least, the taxable income that arises for the trust on the transfer of securities to the redeeming unitholder on redemption.

This can provide certainty to investors in ETFs regarding the tax treatment of their ETFs that they will not be subject to "last man standing" issues. It will also promote and support the growth of the ETF industry in Australia. The ETF market in Australia is currently small, but has significant potential for growth, particularly given the development of the new AQUA rules by the ASX.

Of course, a specific rule may be unnecessary if a more flexible approach were taken to the allocation on redemption provisions as described above in relation to Consultation Question 5.

Consultation Question 8

What would be an appropriate principle for the proposed anti-streaming provision?

Gateway to anti-streaming rule

We consider that the anti-streaming rule could be designed such that it applies where:

- there is a change in the constituent documents that affects the character of taxable income that is allocated to one unitholder as compared to another unitholder (as suggested in the Discussion Paper); *and*

- the character of the taxable income that is allocated to the unitholders under the change results in a situation where the character for tax purposes of the taxable income allocated to the unitholder is demonstrably inconsistent with how the economic benefits received from the trust are determined under the constituent documents.

We consider that this is an appropriate basis upon which the anti-streaming rule to apply. This is because imposing this gateway for the anti-streaming rule to apply would achieve the objectives of the anti-streaming rule as it would capture contrived arrangements and ensure, that taxpayers are only able to benefit from the receipt of particular types of taxable income where they are also exposed to the commercial risks associated with those types of taxable income.

This principle would also align the anti-streaming rule in the proposed MIT regime with the principle that underlies existing anti-streaming rules in the tax legislation. For example, the 45-day rule prevents taxpayers from obtaining the benefit of franking credits where they have not been exposed to the commercial risks associated with owning the shares in the company on which the relevant franked dividends applies.

Application of anti-streaming rule

We also consider that the anti-streaming rule could be formulated such that if the anti-streaming rule applies, the position/treatment that existed immediately before the change in the constituent documents that resulted in the offensive streaming should be restored. Again, this would achieve the objectives of the anti-streaming rule as it ensures that the tax benefits of "streaming" are removed, while not disturbing or distorting the overall tax outcome for beneficiaries more generally.

Exclusion for streaming performed on a "fair and reasonable basis"

As suggested in the Discussion Paper, it is important that the suggested exclusion from any proposed anti-streaming rule be included where the streaming is in accordance with a fair and reasonable allocation of taxable income under the constituent documents.

<u>Consultation Question 9</u>

If certain types of MITs (e.g. registered MISs) were to be treated as automatically eligible for the attribution method, would it be necessary to consider whether the anti-streaming and/or value shifting rules might need to apply beyond changes to a MIT's constituent documents?

As discussed above, it is important that the proposed anti-streaming rule only apply where there is a change in the constituent documents. This should be the case even where the trust qualified for the attribution regime by virtue of being registered.

Just because registered MISs are more restricted in their ability to amend the constituent documents by virtue of the Corporations Act does not mean there is greater potential for "mischief". In fact, there is less chance that inappropriate "streaming" would occur for such trusts due to obligations imposed under law.

In particular, a trustee's duty of care and prudence, as imposed under the Corporations Act (by virtue of being a registered MIS) as well as under the general law, would prohibit inappropriate "streaming". A failure to do so could leave a trustee/responsible entity exposed to claims by beneficiaries/unit holders.

<u>Consultation Questions 10 to 16</u>

The Taxation Institute notes that Consultation Questions 10 to 16 deals with the unders and overs arrangements.

The Taxation Institute further notes the following in relation to these questions:

- There are a number of practical issues regarding unders and overs;
- These issues are best addressed by industry bodies;
- The Taxation Institute would therefore generally support the views of the relevant industry bodies in this regard.

<u>Consultation Question 18</u>

Should the requirement for MITs to notify unit holders of cost base adjustments be an annual requirement, or should MITs be required to notify unit holders more frequently?

Due to the issues stated in our comments to Consultation Question 19 below, we consider that it would be difficult for affected MITs to notify unit holders of cost base adjustments more frequently than annually.

Consultation Question 19

Are any modifications to the proposals warranted for MITs that are Exchange Traded Funds?

It may be appropriate to have special rules regarding ETFs if an amount of taxable income is to be allocated to a redeeming unitholder including an amount referable to the taxable income that arises for the trust as a result of their redemption (also discussed further above). This is because the authorised participants (e.g. brokers etc) who actually redeem units in ETFs are generally assessed on revenue account so the cost base adjustment provisions will not normally apply to them.

Further, for units in a widely held ETF which are listed and could be traded regularly, it may be difficult to track cost base movements, particularly in relation to interim distributions where the net income of the fund (and therefore, the amount of tax income to be allocated to any particularly unitholder) can only generally be determined after year end. These considerations are not isolated to ETFs and would apply to a number of MITs more generally (particularly, those which are listed or regularly traded).

Further guidance may also be necessary to assist trustees in determining whether all or part of any distribution/attribution in respect of a carried interest is attributable to capital subscribed by the carried interest unitholder. Is the intention that this attribution be done on a reasonable basis or will it be self-evident?

Also, the examples in the discussion paper are unclear (and are not consistent with the examples outlined in the report issued by the Board of Taxation). In this regard, the examples in the discussion paper should be clarified to explain why the gain on the sale of land (of $50,000) was not included in trust income for the purposes of the example (e.g. because the trust deed did not give the trustee the power to characterise the gain as income). This can be contrasted with the example in the report issued by the Board of Taxation, where it was so included.

Consultation Question 22

Under the proposed rule about non arm's length transactions in Division 6C:

(a) ***Should the market value treatment apply to transactions where a MIT does not deal at arm's length with another entity, transactions between an entity and its associates or both?***

(b) ***Should the market value treatment also apply to the other party to the transaction?***

(c) ***Are any exemptions from the rule appropriate?***

The proposal that this rule form part of Division 6C and, seemingly, will cause a trust with a non-arm's length transaction to fail Div 6C seems inconsistent with the tenor of the Board's report. Rather it was understood that the Commissioner would have the ability to treat the transaction as having been conducted at market value. Moreover, the proposal for the arm's length rule was made in the context of a broadening of the EIB rules. Given that the government has deferred consideration of such a broadening it seems inconsistent to introduce the arm's length rule and particularly so in the form which it seems is intended.

If the proposal is to proceed contrary to the above submission, we note that any arm's length rule should only apply to transactions between common interests or related interests of an MIT, including but not limited to subsidiaries and stapled entities (as recommended in the report issued by the Board of Taxation). The market value treatment should generally also apply to the other affected entity in order to achieve a symmetrical tax treatment. However, similar exclusions to those which apply under the value shifting provisions should also apply in these circumstances (e.g. de minimis concession etc).

Consultation Question 23

What are the possible types of amendments to deeds that may be required to be made (in particular, to satisfy the clearly defined rights requirement) and would they likely result in a resettlement?

Whether trustees will be required to amend their trust deeds, and what amendments will be made, will depend on how the “clearly defined rights and entitlements” requirement is expressed.

Consultation Question 24

Are many MITs likely to wish to amend trust deeds?

As currently expressed, it is envisaged that virtually every trustee will be required to amend their trust deeds to qualify to remove discretions regarding determination of distributable income, distributions of capital, ability to issue units at different prices etc. Thus, each MIT will need to make a decision to amend their deed to conform or else not elect into the new regime. Given the amendments are likely to cause trustees to lose considerable flexibility in ensuring that the most equitable result is achieved as between unitholders, it is more likely that trustees will simply not amend their deeds and not opt into the regime. Such an outcome would be contrary to the government’s stated intention of encouraging the international attractiveness of the managed fund industry.

However, if the requirement is as we have suggested, then it is envisaged that minimal amendments will be necessary and only those trusts that have discretionary income entitlements will need to amend their trust deeds to comply.

Consultation Question 25

What would be the appropriate roll-over relief where a resettlement of a trust occurs as a result of a MIT amending its constituent documents so as to be eligible for the attribution method of taxation?

An appropriate roll-over relief in order to avoid a resettlement risk (if any) should be a statutory rule that states that the trust continues to be a trust and that no CGT event occurs upon the making of a qualifying amendment. This is likely to be the simplest method and avoids issues regarding interaction with different rules.

In order to facilitate the implementation of the regime, the Government will also need to be confident that the stamp duty issues can also be managed.

Consultation Question 27

Do some MITs need time before the commencement of the new attribution rules to amend trust deeds and, if so, what would be a reasonable amount of time to allow?

Trustees should be given a period of at least six months to make any necessary changes. This time is necessary to allow trustees to consider their position, ascertain what changes need to be made, instruct lawyers to draft the amendments and then pass the internal processes necessary to implement the changes. However, consultation with industry representatives should be undertaken to determine the most appropriate time to allow for any amendments. Naturally, one would expect that the more substantial the hurdles to meet the new regime the more deed, process and systems changes required.

Consultation Question 28

By what date would industry need to implement changes to its systems and how much time would it be likely to take industry to make those changes?

The changes would need to be in effect by the commencement date of the new regime, that is, 1 July 2011. It would be impracticable for the new attribution regime to come into effect and for amendments to be made subsequently.

Consultation Question 30

What amendments should be made to the withholding tax (and associated PAYG withholding) provisions to ensure that they mesh appropriate?

It will be important for the PAYG withholding rules to be amended to operate such that the amount that the trustee is required to withhold on distributions corresponds with the character of the taxable income that the trustee at that time reasonably anticipates will be allocated to the unitholder in connection with the distribution. Consideration should also be given to whether the TFN Withholding rules will need amendment (together with AIIR reporting regulations) where there are amended statements issued to unitholders.

3. Concluding comments

The Taxation Institute's recommendations are considered necessary in order to ensure that the proposed MIT regime achieves its stated objectives.

If you require any further information or assistance in respect of our submission, please contact David Williams on (02) 9958 3332 or the Taxation Institute's Tax Counsel, Deepti Paton, on (02) 8223 0044.

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Yours sincerely

David Williams
President