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The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

by e-mail: taxboard@treasury.gov.au

19 December 2008
Our Ref: AMK

Dear Sir/Madam,

Re: Review of the taxation arrangements for managed investment trusts

Deloitte welcomes the opportunity to assist in the consultation on the Board of Taxation's (Board) discussion paper "Review of the tax arrangements applying to managed investment trusts" (the Discussion Paper).

We appreciate the efforts of the Board that have gone into developing the Discussion Paper and commend the Board for appropriately identifying the many issues and uncertainties currently faced by the managed investment trust (MIT) industry.

Our responses to the Board's questions are contained in the attachment to this letter. We trust that the Board's recommendations will go a long way towards improving the system for trust taxation of MITs in Australia and achieve the objective of developing Australia as the financial services hub of Asia. Importantly, in our view, the Board should ensure that recommendations are focused on progressing Australia's standing as the fourth largest onshore managed funds market in the world and that recommendations will not have any negative effect on this crucial Australian industry.

If you have any queries or would like to discuss any aspect of our submission further, please contact Alexis Kokkinos on +61 (0) 3 9208 7127.

Yours sincerely

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Submission on the "Review of the Tax Arrangements Applying to Managed Investment Trusts"

1 Executive summary

The review of the taxation provisions for MITs provides us with a fantastic once in a life-time opportunity to review and correct the significant taxation issues and uncertainties currently faced by the industry.

The MIT industry in Australia is significant. As outlined by the Board in paragraph 2.2 of the Discussion Paper, Australia had A$1,319 billion in consolidated funds under management at the end of June 2008. We note that this has been the case when there has been significant taxation uncertainty.

Accordingly, we believe that addressing the taxation issues and uncertainties can only be positive. Such changes will help to improve investor confidence in the industry and will go a long way towards helping to make Australia a true financial services hub of Asia (if not beyond).

In addressing the Board's specific questions contained in the Discussion Paper, we have sought to highlight what we believe to be the main issues in those areas and, where appropriate, have suggested potential recommendations for consideration by the Board. We have also ensured, to the greatest extent possible, that our responses to the Board's questions are consistent with the policy principles outlined in the Discussion Paper. A summary of our recommendations follows.

Recommendation 1

We recommend that a specific tax regime or set of provisions for the MIT industry is developed in isolation from any changes to be considered for other forms of trusts. It is our preference that an MIT be defined based on the Subdivision 12-H definition of an MIT, with appropriate changes. Due to the significant fiduciary requirements imposed on a responsible entity under the CA 2001, we believe that there are lower tax integrity threshold requirements that would need to be considered by the Board if such provisions or recommendations were to be applied solely by MITs and no other forms of trusts.

Recommendation 2

A provision, similar to section 106-50, should be enacted as a broad principle of the Tax Act, whereby the beneficiary of a bare trust type relationship is deemed to be both the legal and economic owner of the relevant assets (or liabilities) for tax purposes.

Recommendation 3

Legislative clarification should be provided so that MITs are deemed to continue to exist as the original trust if the deed or constitution is modified by the responsible entity of an

MIT in accordance with section 601GC of the CA 2001 (or in a manner consistent with section 601GC if such a provision were applicable to the MIT). As with other law developments requiring trust deed changes, similar concessions may need to be supported by the relevant states for stamp duty purposes.

Recommendation 4

We highlight the administrative advantages with proceeding with a patch approach to Division 6. We highlight that the TEM approach is sufficiently similar to the current approach in Division 6 and may also be one of the easier models to implement. While the other

Recommendation 5

The definition of distribution would depend on whether the Board proposes a TADM, TEM or MDM model, or alternatively if the Board recommends the retention of the current system with a patch model. In the first case, we believe that a distribution linked to cash distributions would be workable. Under a patch mode, we believe that present entitlement appears to be more appropriate. Under either approach, appropriate amendments would be required to CGT event E4 to remove the instances of double taxation.

Recommendation 6

We believe that it is inappropriate to tax MITs at a penalty rate of 46.5%. We recommend consideration of a marginal tax rate for MITs (based on percentage of undistributed income). Alternatively, we request consideration of a 30% flat rate for MITs. Whichever mechanism is chosen, there should be a credit passed to beneficiaries similar to imputation.

Recommendation 7

We highlight that there are various issues that would need to be practically worked through if the Board was to recommend a change to a receipts-based approach for investors or alternatively move to a 31 March year end.

Recommendation 8

The Board should recommend a formal overs and unders system in the MIT regime, with sufficient flexibility to ensure investor confidence. We have recommended a threshold higher than 2%, an ability to use some form of averaging, a Commissioner's discretion, and an appropriate fixed dollar *de minimis* amount.

Recommendation 9

There are various international taxation issues associated with trusts, including treaty issues, conduit interactions, interactions with CGT, functional currency election technical issues, CFC and FIF interaction issues, TFN withholding uncertainties, interaction with Subdivision 12-H and issues associated with residency and the management of foreign funds. We recommend that the Board considers targeted consultation aimed at identifying and working through the large number of international taxation issues associated with trusts, with a view to providing recommendations that would increase the certainty and competitiveness for MITs investing abroad through Australia.

Recommendation 10

The Board should recommend that a statutory provision be inserted to remove any doubt about the assessability of a tax deferred or tax-free distribution received by a beneficiary of an MIT. Appropriate amendments should also be made to remove double taxation.

Recommendations 11

We believe that the flow-through provisions contained in section 6B and 115-215 could be re-written to provide greater certainty and some additional flexibility with MIT distributions. We also request the Board to consider whether a flexible statutory provision should be introduced regarding the allocation of expenses by MITs in order to provide certainty on the matter.

Recommendation 12

We recommend that a statutory elective provision allowing for a deemed capital treatment be introduced promptly to provide certainty to the industry on this issue. We recommend that the Board considers the additional consequential issues that may arise in deemed capital treatment, as highlighted in our submission.

Recommendation 13

We recommend that an MIT be deemed to be a fixed trust for the relevant provisions of the Tax Act. As the term is used differently in different parts of the Act, a deeming rule may require appropriate links to the relevant parts of the Act, (i.e. Schedule 2F, Subdivision 124-M, etc).

Recommendation 14

We ask the Board to articulate the reasons for retaining an integrity provision such as Division 6C before recommending that it continues.

Recommendation 15

Section 102M should be amended so that an MIT is deemed to carry on an eligible investment business, unless it carries on activities that are 'ineligible'. This, coupled with a ring fencing provision, would provide greater certainty and flexibility compared with the current test.

Recommendation 16

The 20% exempt entity rule should not be retained for superannuation funds as the policy rationale for bringing superannuation funds within this rule no longer exists.

Recommendation 17

The control test should be abolished. Ring fencing should be considered for non-compliance with the eligible investment rules.

Recommendation 18

We believe that the Australian REIT industry would benefit from a specific REIT regime, if the general MIT recommendations are insufficient to cater for all of the property-specific issues.

Recommendation 19

The policy rationale for Division 6B no longer exists and is properly catered for by Division 6C. Accordingly, Division 6B should not be retained.

Recommendation 20

As MITs are significantly different from other forms of trusts, (i.e. due to the fiduciary responsibilities imposed by the Corporations Act), we believe that the Board should consider recommendations for MITs in isolation. We consider the policy issues for other trusts to be fundamentally different to those with MITs. We recommend a separate review to be undertaken of other forms of trusts (non-MITs) with a view to correcting the anomalies in the operation of the taxation law for such trusts.

Recommendation 21

We highlight a number of additional technical issues in relation to MITs and request that the Board considers these additional issues in making its final recommendations to Government.

2 Scope of the proposed regime (Chapter 11)

2.1 Definition of an MIT (Question 11.1)

2.1.1 Limiting the proposed regime to MITs

One of the more significant problems with the current taxation regime for trusts is that there is effectively one set of provisions for all types of trusts, both MITs and non-MITs. We believe that this fact alone has made it very difficult for the ATO to administer the law in a practical manner for MITs.

MITs or their responsible entities are generally covered by the requirements of the *Corporations Act 2001* (Cth). MITs are generally governed by the requirements of Chapter 5C of the *Corporations Act 2001* (Cth) (CA 2001) as managed investment schemes (MIS). The operators of MITs are holders of financial services licensee who are also governed by the requirements of Chapter 7 of the CA 2001. These provisions impose a significantly higher level of fiduciary responsibility on the responsible entity over and above that of a trustee of a privately owned trust. For this reason alone, there is a much lower threshold of integrity concern with MITs compared to other forms or categories of trusts.

Accordingly, we are of the view that MITs should not be governed by the same set of tax principles that apply to non-MITs. While non-MITs could effectively benefit from the proposals and recommendations to be made by the Board, we are concerned that perceived tax integrity concerns that relate to non-MITs would potentially undermine significant developments and reform to the taxation regime applying to MITs. The priority of the Board should be seen as correcting the taxation regime for MITs, and restoring certainty to the industry. With this objective in mind, we believe that recommendations on issues such as attributing tax liabilities, covered in section 3.1.1 of this submission, will be easier to develop.

As outlined in section 10 of this submission, however, there are also significant issues with the application of the trust provisions to non-MITs. We believe that these issues should be addressed by a separate review by the Board for trust arrangements for non-MITs.

2.1.2 Using the Schedule 12-H definition

We believe that an appropriate gateway to the MIT provisions would be through a test based on that contained in section 12-400 of Schedule 1 to the *Taxation Administration Act 1953* (Cth).

In summary, the test in section 12-400 appropriately balances integrity with simple compliance. The test would also limit any special provisions to MITs that are subject to the significant fiduciary responsibilities contained in Chapter 5C and Chapter 7 of the CA 2001, adding a significant overlay of integrity to the new provisions.

The responsibilities imposed on an MIS and a financial services licencee are significant. An MIS is required to have a public company as the responsible entity, that responsible entity must hold an Australian financial services licence from ASIC to operate the scheme[1], the MIT must have a legally enforceable constitution that meets certain minimum content requirements, must have a specified compliance plan and must appoint an auditor to audit compliance with the plan, the officers and employees of the responsible entity must meet statutory duties of care, loyalty and honesty, and act in the best interests of the members[2], must treat the members who hold interests of the same class equally and members who hold interests of different classes fairly[3], and also provides enforceable civil penalties where there is a contravention against a member[4].

A financial service licensee also has general obligations imposed under section 912A(1) of the CA 2001, which are aimed at promoting consumer confidence in financial services and the provision of efficient, honest and fair financial services by all licensees and their representatives. ASIC may take administrative action where it has any reason to believe that licensees are not complying with their obligations. This could include suspending or cancelling a licence under section 915C(1) or imposing additional licence conditions under section 914A(1).

These requirements of section 12-400 will help ensure any proposed provisions that will apply to MITs will not be undermined by the entities utilising such provisions, acting as an automatic integrity measure for the revenue.

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[1] Section 601FA

[2] Section 601FC(1)(c)

[3] Section 601FC(1)(d)

[4] Section 601MA

2.1.3 Defining 'widely held'

The section 12-400 definition of an MIT currently contains a definition of a widely-held entity for the purpose of the proposed MIT provisions. While the current provisions use a test of 50 members to define an MIT, we question if this threshold is appropriate. The definition of a registered MIS in the CA 2001 only has a 20 member requirement under section 601ED. It would appear appropriate to include such trusts within the new MIT provisions, as they are also subject to the same fiduciary responsibilities as MITs currently within section 12-400.

Furthermore, where a trust is operated in a similar manner to an MIT (as defined in section 12-400), we believe that there should be some scope to have such trusts qualify as an MIT. For example, there are cases where 'boutique' funds are operated by financial service licensees in the same manner as MITs, yet do not technically meet the requirements to be classified as a registered MIS or MIT as defined. In these cases, we believe that it is warranted to consider an alternative fallback test. Such a test could allow trusts that are operated by a financial services licensee to qualify as an MIT. This alternative test may or may not be subject to a Commissioner's discretion. While this is only a suggested alternative fallback test, we ask the Board to consider a possible broadening or flexible definition that includes other appropriate forms of trusts.

We believe that there are a number of advantages of using the 12-400 definition as opposed to the 'widely held' definitions contained elsewhere in the Tax Act. Section 12-400 does not require specific tracing through tiers of entities and contains a deemed member rule where the interests of the MIT are held by a widely-held entity. Accordingly, the definition more appropriately deal with different types of MITs, including retail funds, wholesale funds, listed funds, and unlisted funds.

Furthermore, the section 12-H definition already caters for start-up entities and exits under sections 12-400(4) and (5). We note, however, that 100% subsidiary trusts may not always satisfy the financial services licensing requirement contained in section 12-400(1) item 2. This could mean that the head trust could be defined as an MIT, while its subsidiary entities may be defined as non-MITs. We ask that the Board considers making recommendations to correct this anomaly for subsidiary trust arrangements.

2.1.4 Unit trust requirement and single class of units

If the section 12-400 definition of an MIT is recommended by the Board, then we don't believe there would be any need to restrict the regime to unit trusts, or trusts with a single class of units on issue.

As outlined earlier, an MIT that is governed by CA 2001 is subject to either or both Chapter 5C and Chapter 7 of the CA 2001. This imposes significant requirements on the licensee, as well as a requirement on the responsible entity to treat all members who hold interests of the same class equally and members who hold interests of different classes fairly[5].

Due to the integrity requirements placed on responsible entities by the CA 2001, there appears to be little or no integrity risk in allowing for different classes of interests, or interests based on something other than a unit in a unit trust. The application of the law to those different interests would need to be done in a reasonable manner by the responsible entity.

2.1.5 Irrevocable election

While we believe that it may be appropriate to require an MIT to make an irrevocable election to be an MIT, we note that there will be instances where a trust may stop meeting the definition of being an MIT (for example, where it is simply acquired by a single entity and thus becomes closely held). Accordingly, in certain circumstances, it may no longer be appropriate for a trust to apply the MIT regime.

Accordingly we ask the Board to consider recommending limited exceptions to a proposed irrevocable election. We also recommend that special entry and exit rules are appropriately considered for an MIT transitioning in or out of the regime, (i.e. to ensure that no amounts of assessable income or allowable deduction are taken into account twice).

2.1.6 Amendments to Schedule 12-H

While we have proposed that the section 12-400 definition be considered as a basis for the definition of an MIT, we highlight that there are a number of technical issues with the current definition.

For example, there is an issue with the types of foreign entities covered by section 12-400(2)(d). For example US REITS are not trust entities and it is questionable whether they are ‘recognised, under a foreign law relating to corporate regulation, as an entity with a similar status to a managed investment scheme’.

Tracing issues may also occur where investments are held through investment structures that are broadly similar to a trust (such as a UK and German LP). While trusts are

[5] Section 601FC(1)(d)

structures found in many common law countries, the concept of a trust is s foreign to a number of jurisdictions with which Australia deals. Accordingly, we believe there should be some scope to examine amendments to section 12-400(2)(e).

Finally, section 12-400(2) does not allow tracing through a number of similar entities, such as wrap providers. When a wrap provider invests in an MIT, the MIT would generally not have access to who is investing via the wrap provider. Accordingly, we believe that the exception list in section 12-400(2) should be reviewed and possibly extended to cover this type of investor, as well as any other forms of investors that have similar characteristics to those already contained in that section.

As one of the objectives of the review is to enhance the international competitiveness of Australian MITs, we believe it is imperative that non-resident investors are adequately dealt with in any reform undertaken.

Accordingly, if the Board agrees to use a current definition of an MIT in the act, (e.g. section 12-400), we would request that the Board recommend some form of consultation on the proposed definition to iron out any anomalies.

2.1.7 Cross holding of funds

We acknowledge the many issues associated with cross holdings of funds, and understand that they will be difficult issues to resolve.

We believe, however, that an appropriate mechanism that could be used for dealing with errors, which may arise due to cross holdings, is to have an appropriate unders and overs provision for MITs. This will reduce the possibility of errors and thus amendments of amounts reported to beneficiaries. Our recommendations about overs and unders is covered in section 3.5 of this submission.

2.1.8 Recommendations

A summary of our recommendations related to the Board's questions on the definition of an MIT, as per Question 11.1, follows.

Recommendation 1
We recommend that a specific tax regime or set of provisions for the MIT industry is developed in isolation from any changes to be considered for other forms of trusts. It is our preference that an MIT be defined based on the Subdivision 12-H definition of an MIT, with appropriate changes. Due to the significant fiduciary requirements imposed on a responsible entity under the CA 2001, we believe that there are lower tax integrity threshold requirements that would need to be considered by the Board if such provisions or recommendations were to be applied solely by MITs and no other forms of trusts.

2.2 Treatment of IDPS and bare trusts (Question 11.2)

In a number of instances, the ATO has taken the view that bare trust relationships result in a Division 6 trust relationship for tax purposes. This view has resulted in a substantial number of anomalies with the operation of our current tax provisions.

As an example, the ATO recently concluded that section 23AJ does not apply to an entity that holds shares through a bare trust for another company (refer to TD 2008/24 and TD 2008/25). The result is, in our view, unintended. While section 23AJ does not apply to MITs, the ruling is indicative of how the ATO would seek to apply the tax provisions to revenue assets held on a bare trust relationship.

This ATO view, if extended further, could result in more anomalies when applying other provisions of the Tax Act. For example, the controlled foreign company (CFC) provisions could operate inappropriately to the extent that a CFC holds active shares or carries on active business operations through a bare trust relationship. If this holding is considered a Division 6 trust, this could result in an inappropriate attribution of income under sections 384(2)(c) and 385(2)(c) of the 1936 Act.

Furthermore, if an investment in a foreign investment fund (FIF), as defined in Part XI of the 1936 Act, is held through a bare trust, complications may arise under the ATO view as to whether the bare trust is (in itself) a FIF interest, and whether certain exemptions (such as that contained in section 497) can be applied to an entity holding a FIF interest through a bare trust. This issue is touched on in ATO IDs 2008/36 and 2007/182, which deal with US investment retirement account assets (IRAs), relating to self-directed investments, established and managed by a custodian on behalf of an individual for the exclusive benefit of the individual and his/her nominated beneficiaries.

We note that the treatment of IDPS and bare trust arrangements appears to be inappropriately dealt with under the Tax Act, except for under the CGT provisions. We believe that the rule in section 106-50 needs to be broader, and should apply to all provisions of the Tax Act. Unlike the majority of issues outlined in the Discussion Paper, this issue is not specific to the MIT industry and is a systemic issue with our Tax Act.

Recommendation 2
A provision, similar to section 106-50, should be enacted as a broad principle of the Tax Act, whereby the beneficiary of a bare trust type relationship is deemed to be both the legal and economic owner of the relevant assets (or liabilities) for tax purposes.

2.3 Trust deed amendments (Question 11.3)

The issue of resettlements is a significant industry issue that concerns MITs when an amendment is required to be made to a trust deed. In 2005, the introduction of AIFRS resulted in uncertainty for MITs about whether units in the trust should be classified as a financial liability under AASB 132: *Financial Instruments: Presentation*. While amendments to the relevant trust deed could have avoided this issue, the concern of the application of a resettlement to the MIT (and the tax consequences associated with a resettlement) was a major impediment to MITs making such changes to their trust deeds.

While the ATO subsequently produced administrative and workable guidance on this issue (in the form of the fact sheet “Trust resettlements - AIFRS related amendments to trust deeds”), this document was not released until 2007. Essentially the ATO stated that certain amendments to the trust deeds were not to be considered a resettlement. While the guidance the ATO provided is to be commended for its practicality, we believe the time lag in addressing the issue resulted in a significant degree of unnecessary uncertainty for the MIT industry.

We believe that similar issues may arise if MITs are required to amend their trust deeds to fit within a proposed MIT regime. In our view, it is crucial that a legislative amendment be introduced to provide certainty that deed amendments of an MIT in certain situations, such as these, are not to be considered a resettlement for the purposes of the Tax Act.

Furthermore, as highlighted in section 2.1.2 of this submission, if the Board recommends that a definition of an MIT be consistent with section 12-400 of the TAA 1953, we highlight that the constitution of many trusts governed by the CA 2001 can generally only be amended in certain limited circumstances, either by way of a special resolution of the members of the scheme, or by the responsible entity if the responsible entity reasonably considers the change will not adversely affect members' rights[6]. Accordingly, we do not believe that there are tax integrity concerns associated with deed amendments by MITs. We believe that such a change is not different to a change to a company's constitution where that company is governed by the CA 2001. We highlight that such companies have a degree of certainty that such changes will not trigger a tax liability to either the company or its members.

We therefore believe that it is appropriate to have a blanket exception from resettlements where the trust deed is modified by the responsible entity of an MIT in accordance with section 601GC of the CA 2001 (or in a manner consistent with section 601GC if such a provision were applicable to the MIT). As with other law developments requiring trust deed changes, similar concessions may need to be supported by the relevant states for stamp duty purposes.

Recommendation 3
Legislative clarification should be provided so that MITs are deemed to continue to exist as the original trust if the deed or constitution is modified by the responsible entity of an MIT in accordance with section 601GC of the CA 2001 (or in a manner consistent with section 601GC if such a provision were applicable to the MIT). As with other law developments requiring trust deed changes, similar concessions may need to be supported by the relevant states for stamp duty purposes.

3 Determining tax liabilities (Chapter 4)

3.1 Attribution of tax liabilities (Question 4.1)

3.1.1 Overview

Before providing specific comments on each of the four models proposed by the Board in Chapter 4 of its Discussion Paper, we believe that it is first important to identify the main reasons for the significant number of issues with Division 6 of the 1936 Act, which is currently applied to MITs.

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[6] Section 601GC of the Corporations Act 2001

Many practitioners would argue that the current system itself could be made to work if the ATO were to administer the law using a practical interpretation of the legislation. We understand, however, that a significant impediment to doing this is the fact Division 6 applies to all forms of trusts. This makes it difficult to administer the same law differently for two separate classes of taxpayers. Accordingly, we believe that there are two fundamental issues that need to be addressed by the Board in making its recommendations about determining tax liabilities.

The first is that we believe that there is a strong case that the model chosen for MITs needs to be drafted specifically for the use of MITs only. We believe that this will allow the ATO to interpret the law based solely on its effect on the MIT industry, without taking into account other forms of trust vehicles and integrity concerns associated with such vehicles.

Secondly, we believe that the Board should consider recommending that the drafting of the provisions should be done in a way that provides some commercial flexibility for responsible entities and MITs. Due to the CA 2001 requirements for MITs, the responsible entity must meet statutory duties of care, loyalty and honesty, must act in the best interests of the members[7], treat members who hold interests of the same class equally and must treat members who hold interests of different classes fairly[8]. A responsible entity must therefore act with utmost integrity in making decisions that affect the treatment of a member of the MIT, which we believe would include the imposition of unfair or unreasonable tax liabilities on beneficiaries when compared to other beneficiaries. We see few, if any, integrity concerns with providing the responsible entity with commercial flexibility under the proposed MIT provisions. As discussed in section 3.1.2 below, flexibility is needed to deal with issues such as the determination of expenses and income of the trust, the allocation of expenses to classes of income, the determination of the character of income, and the treatment of overs and unders.

These issues will occur irrespective of the approach adopted by the Board. Our recommendations below on dealing with these issues therefore require the Board to take into account this fundamental principle applicable to MITs.

3.1.2 Dealing with common issues associated with all models

We see that there will be a number of common issues associated with all models proposed by the Board. We highlight these issues and our suggested recommendations for dealing with them.

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[7] Section 601FC(1)(c)

[8] Section 601FC(1)(d)

a *Determination of income and expenses*

If concepts such as income or classes of income are to be used in the proposed regime, we believe it will be imperative to provide responsible entities with some degree of flexibility in determining such amounts. We see no tax integrity concerns with allowing a responsible entity of an MIT to determine income of a trust, classes of net income of a trust, or character of income in accordance with the constitution or trust deed of an MIT, provided that it is done on a reasonable basis. For example, the treatment of a capital receipt as income of the trust under the deed poses no integrity concerns for an MIT or its beneficiaries, given that tax will always be paid on the total of the taxable income of an MIT, and that MITs do not use such classifications to stream income to advantaged beneficiaries.

b *Allocation of deductions to income classes*

With the repeal of section 50 of the 1936 Act, there is some uncertainty about the allocation of deductions and expenses to different classes of income, especially about whether amounts need to be allocated to net capital gains distributed to beneficiaries. We understand that the ATO is planning to release some form of guidance on the treatment of expenditure under the current law (potentially in the form of a practice statement).

To avoid interpretational issues under any of the proposed regimes, we believe that it will be important for the Board to consider and recommend a manner in which expenses or deductions could be allocated by an MIT to different classes of income. As outlined earlier, it is our view that it should be acceptable to allow some commercial flexibility when it comes to expense allocation. A responsible entity should be allowed to determine such an allocation, provided it is done on a reasonable basis. We believe that this will help to increase certainty that there will be no disputes over the net amount of different classes of income distributed to beneficiaries of an MIT.

c *Attribution of character to income*

The proposed TADM, TEM and MDM are significant departures from Division 6 of the 1936 Act. Accordingly, section 6B of the 1936 Act, section 855-40 and Subdivision 115-C of the 1997 Act may not deal with character attribution under such models appropriately.

Once a responsible entity determines a net amount of a certain class of taxable income to be attributed to a beneficiary, we believe that a statutory rule similar to section 6B of the 1936 should be provided to MITs to allow a reasonable allocation of the amount. Again, due to the CA 2001 requirements, we do not believe that such a proposition will result in tax integrity issues for the revenue. A power to make such a determination (provided it is reasonable) will reduce the uncertainty about character issues associated with distributions by MITs.

d *Non-taxable distributions*

All models need to interact with CGT event E4 appropriately, which is the treatment of non-taxable payments made to beneficiaries. The Board will need to consider amendments to this provision to take into account taxable and non-taxable distributions received by a beneficiary. While CGT event E4 creates a compliance issue, if the Board was to recommend that this provision should continue to operate, then we believe that appropriate legislative adjustments would be required.

In the first instance, we believe that there should at least be a 'reverse CGT event E4' that results in an increase in the cost base of shares in cases where taxable income attributed to a beneficiary exceeds the payment received. A mechanism to allow for appropriate adjustments under CGT event E4 would be to reduce the cost base of units for payments made, and to increase the cost base for taxable income attributed to the beneficiary. Furthermore, we recommend an adjustment to CGT event E4 to re-insert Division 43 deductions as tax-exempt distributions.

We believe that these amendments would help to correct the majority of double taxation issues identified by the Board in relation to CGT event E4.

e *Allocation of a redemption between income and capital*

The treatment of incoming and outgoing beneficiaries could be dealt with more appropriately if there were specific rules for such situations. For example, a statutory rule (similar to the method accepted in PBR 71884) allowing a redemption to be treated partly as a distribution of income and partly as capital could overcome the technical issues identified at paragraph 4.7 of the Discussion Paper.

Whichever model is ultimately adopted by the Board, the rules should include the flexibility for the trustee to include in redemption proceeds a distribution of income or capital, if the deed allows. We believe that it would be appropriate for the treatment to be similar to the share-buy-back provisions, where the capital component of the buy-back would expressly exclude the amount that is treated as an income distribution[9]. A specific provision that allows an allocation, similar to the share buy-back provisions, would seem to help overcome some of the uncertainty in this area.

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[9] Refer to section 159GZZZQ and the definition of reduction amount.

f *Systems changes and administration*

The TADM, TEM and MDM represent significant changes to the current system of taxation of trusts. Accordingly, it is expected that these models would require systems changes to be made by MITs. The Board should take into consideration the effect that this would have on (a) the time frame required to implement any new system, (b) guidance provided by Treasury and ATO on all aspects of the new system including the requirement for distribution statements to members, and (c) the tax deductibility of costs of implementing the new system.

3.1.3 Applying the recommendations to Appendix H

To demonstrate some of the issues identified in section 3.1.2 of this submission, we refer to the examples contained in Appendix H.

In the two examples, the Board accepts the trustee's allocation of expenses and the determination of the classes of income. In both examples, the administration expense of $20 is solely allocated to net rental income, rather than to any other forms of income. This may be considered a reasonable approach and may reflect the true nature of the expenses incurred. The arbitrary allocation of administration expenses could give rise to uncertainty, however, if the ATO considered this unreasonable. That is, the ATO could argue that such expenses are to be allocated over all classes of income.

To further complicate this issue, under the TADM or TEM approach it is unlikely that section 6 of the 1936 Act or *Charles v FC of T (1954) 90 CLR 598* would be relevant in determining the character of income attributed to the beneficiaries. On one view, this is because attribution under both of these new approaches would be independent of income derived by the trustee of the MIT. That is, under the TADM approach, a distribution of cash (not income) made to the beneficiary would result in attribution, (i.e. which may be sourced from a borrowed sum), while under the TEM approach, attribution would occur without the beneficiary having a vested and indefeasible interest in the income distributed, (i.e. via automatic statutory attribution).

Taking into account these issues, it seems reasonable to allow MITs to allocate expenses and character on a reasonable basis. This appears to be the basis used by the Board in those examples. Accordingly, we would request that the Board make a more formal recommendation that statutory provisions allow such reasonable determinations to be made by the trustee of an MIT.

3.1.4 The patch model

It is our view that the patch model offers the greatest number of advantages for MITs, provided the definition of ‘patch’ is consistent with the theme that the law should be amended to apply in a manner that is currently being applied by MITs. If this were to occur, the patch model would result in the fewest issues for MITs, including reduced compliance, systems, administrative and educational issues.

We believe that the biggest impediment to this approach is that the amendments would also apply to other trusts outside the MIT regime if the patches were made directly to Division 6. We understand that there are integrity concerns in allowing this to occur and accordingly, it is not our view that a patch should occur in this fashion. For example, two possible amendments to Division 6 would be to deem capital gains to be income of the trust or to deem the income of the trust to be determined in accordance with the trust deed.

To overcome any integrity concerns with amending Division 6 directly, the patch system could be done outside Division 6. For example, a new Division could be inserted into the 1997 Act to modify the operation of Division 6 for MITs only (the MIT Patch Division). The MIT Patch Division could, among other things, modify Division 6 so that it includes capital gains in the calculation of income of the trust, allows for the calculation of income of the trust in accordance with the deed and accounting principles as determined by the trustee, provides clarity about the proportionate approach, provides clarity about the allocation of expenses and the determination of expenses, and provides clarity about the allocation of character to distributions by a trustee. Furthermore, the MIT Patch Division could also allow for regulation-making power to address industry concerns as and when they occur.

Coupled with additional amendments such as an unders or overs model, we believe that the patch approach provides significant benefits for the MIT industry and will not produce the same level of uncertainty and risks that a brand new system may bring with it. Our comments are subject to obtaining an appropriate treatment of trusts for treaty purposes in Australia, however, which may remain a significant issue for MITs under a patch approach depending on the Board’s conclusions on that issue.

3.1.5 The tax assessment and deduction model (TADM)

We highlight some issues with the TADM approach that would need to be considered by the Board in determining its workability.

a *Fundamentally different approach*

We note that the TADM approach is fundamentally different to the current Division 6 approach to allocating tax liabilities. As this is perhaps a significant departure, we recommend appropriate comprehensive road testing of examples before any recommendation to use this approach is made by the Board.

b *Treatment of excess distributions made by the trustee*

In Appendix H, the examples state that "under the trustee assessment model, the trustee can only claim a deduction for deductible distributions up to the value of the net income". Accordingly, excessive distributions would not result in a carry forward deduction to the trustee and the trustee would instead be assessable on such amounts.

While we understand that Appendix H is for demonstrative purposes only and is not meant to be a statement of accepted principles, we highlight the importance of the issue of the treatment of excessive distributions in the TADM approach. If the TADM approach was suggested by the Board, we believe that the treatment of excessive distributions would be a significant issue that would require specific industry consultation in determining the correct treatment of such distributions.

To demonstrate the practical issues associated with the treatment of excessive distributions, we request that the Board considers the following example. Assume that an MIT derives $100 of taxable income in year one, and $200 of taxable income in year two. Assume the trustee derives $300 of cash in both years, but distributes $150 in year one, and $150 in year two. In this example, there is only one beneficiary and the beneficiary acquired its unit in the MIT for $100 (representing the corpus of the trust). It is assumed there are no tax/accounting differences in this example.

Under the Board's approach as outlined in Appendix H, the beneficiary would be taxable on $100 in year one and $150 in year two. It is assumed that the excess $50 non-taxable distribution in year one would result in a reduction of cost base under CGT event E4. The trustee would further be taxable on $50 in year two (the undistributed amount) and would need to fund this out of corpus of the trust, (e.g. say $23 at 46.5%). If the MIT were to be liquidated and a further distribution of $77 were to be made out of the remaining corpus, the beneficiary would be further taxable on $27; the excess of the distribution over its cost base of $50. The taxation of this additional amount would be considered double taxation. The tax payable of 46.5% by the trustee on the amount in year two would also be considered inappropriate in this example, particularly if the beneficiaries had a significantly lower effective tax rate.

Alternatively, a trustee could be given an option to carry forward deductions for additional distributions under the TADM approach, which would then be attributed to beneficiaries in the year that such a deduction is applied by the trustee to net income of the trust. Furthermore, excess allocations of taxable income over and above cash distributions to beneficiaries should result in an increase in cost base to unit holders' units (under a reverse CGT event E4 type event). If these broad alternative principles were applied, the beneficiary would be attributed $100 of taxable income in year one and would also adjust its cost base in units held by $50 under CGT event E4. In year two, the trustee would apply a carry forward deduction of $50 to reduce its taxable income to nil. The beneficiary would be taken to receive a $200 distribution that would taxable in its hand, and would increase its cost base in its units by $50 (due to the excess of distribution over cash under a reverse CGT event E4). In summary, this alternative example does not result in tax payable by the trustee and would also not result in double taxation paid by the beneficiary. This alternative is comparable to the scenario of having the trustee pay only an amount equal to the taxable income in both years under question, (i.e. if distributions were limited to $100 and $200 for years one and two respectively).

Whether this alternative is acceptable, however, would again depend on the facts. The outcomes become more complicated in situations where beneficiaries enter and leave during an income year. Accordingly, it is our view that, if the TADM approach was to be adopted, the treatment of excessive distributions would be a significant issue that would need to be consulted on appropriately in order to determine the industry preferred approach to the treatment of such amounts.

c *Treatment of tax paid by the trustee*

As the TADM approach uses a quantum method for allocating tax liabilities, rather than a proportionate method, the model will result in a shift of tax being paid to the trustee in many cases. As demonstrated by the previous example, payments of tax by a trustee can result in instances of double taxation where the beneficiary is not provided with a credit or benefit for the tax paid.

We ask that the Board considers whether a method of providing a credit to beneficiaries would help to alleviate the instances of double taxation where a trustee pays tax under a TADM approach.

The previous example can be used to demonstrate how a credit system could alleviate double taxation under a TADM approach. In the example, the additional tax ($23) paid by the trustee could be allocated to a beneficiary on a subsequent distribution. The gross up of a distribution of $27 to $50 (together with a $23 credit for trustee tax paid) would help to ensure that the $27 distribution is not taxed for a second time where the credit is a refundable tax offset (similar to imputation). This issue is significantly important for beneficiaries that are superannuation funds that pay tax at a rate of 15%.

3.1.6 The trustee exemption model (TEM)

We highlight some issues with the TEM approach that would need to be considered by the Board in determining its workability.

a *Overview comments*

We emphasise upfront that the TEM approach is not a significant departure from the commercial application of Division 6 currently being applied by MITs. We therefore believe that this model would be an an attractive option to fund managers because of its similarities to existing practice and the potentially low cost of implementation (as compared to the other options). For this reason, this model may be more attractive to funds managers than the TADM approach.

b *Interaction with section 104-70*

As the TEM is not dependent on distributions to be made to beneficiaries, there is a significant question about how CGT event E4 would interact with the TEM approach. It would appear that the break in nexus between a distribution and attribution would require some fundamental changes to the current section 104-70. Our views on proposed amendments to CGT event E4 are outlined at section 3.1.2d of this submission. Those views could be consistently applied to a TEM approach.

c *Beneficiary funding issues*

As correctly identified in the Discussion Paper, a significant issue with the TEM approach is that it will attribute tax liabilities to beneficiaries irrespective of cash distributions made to them. Accordingly, beneficiaries may be required to fund their own tax liabilities where the MIT does not make distributions to the beneficiary.

While newly-created trusts may be able to cater for this issue by disclosing distribution policies in their product disclosure statements, this issue may not be appropriately dealt with where the regime is made available to existing MITs that elect into the new regime.

We note that this issue could be overcome by a minimum distribution model (MDM) and that consideration of the MDM approach may be seen as a means for overcoming this issue. We have also highlighted concerns about the MDM approach that the Board would need to consider appropriately.

d *Method of attributing tax liabilities to beneficiaries*

One difficulty with applying the TEM approach is with attributing tax liabilities to beneficiaries. A statutory rule, requiring precise attribution, could result in interpretational difficulties where the MIT has more than one class of beneficiaries, or where beneficiaries enter or leave an MIT part way through an income year.

As outlined earlier, the responsible entity of an MIT must meet statutory duties of care, loyalty and honesty, must act in the best interests of the members, and treat members who hold interests of the same class equally and members who hold interests of different classes fairly under Chapter 5C of the CA 2001.

Accordingly, it would appear reasonable to allow trustees of MITs to allocate tax attribution to beneficiaries on a fair and reasonable basis with regard to their relative interest in the MIT and their period of membership. We recommend that the Board considers a practical method of allocation if the TEM approach is to be considered.

3.1.7 The minimum distribution model (MDM)

a *Overview*

The MDM approach seems to overcome the funding issues associated with the TEM approach. As correctly identified by the Board, however, the requirement of having a minimum distribution will result in further complexities and administrative issues that would need to be dealt with appropriately.

b *Appropriate threshold*

The Board has put forward a potential 90% threshold for minimum distributions. We question whether such a high threshold is required. If the main reason for minimum distributions is to help beneficiaries fund their tax liabilities, we would consider that the maximum amount that would need to be distributed to a beneficiary in any year of income would not need to be greater than 46.5% of the taxable income of the trust. Accordingly, we question why 50% would not be an appropriate threshold. It would seem that MITs would find it easier to satisfy this lower percentage threshold, and it would reduce concerns about inadvertent breaches of the minimum distribution threshold.

c *Interaction with CGT event E4*

We highlight our previous comments on a proposed CGT event E4 for the TEM approach in section 3.1.2d of this submission. When considered in relation to incoming and outgoing beneficiaries, we believe that a minimum distribution model of 50% would not result in inequitable outcomes for such beneficiaries.

To demonstrate this, assume that an MIT derives $100 of taxable income in year one and $200 of taxable income in year two. Assume that there are no tax accounting differences and that it distributes $50 in year one and $100 in year two, (i.e. 50%). Furthermore, assume that beneficiary A is the sole unit holder of the MIT, whereby the units were acquired for $100 at the start of year one (being as consideration for its contribution to corpus of the trust). Assume that its units are sold to beneficiary B on the first day of year two for $150, equal to the market value of the units held by beneficiary A at that time.

In this example, beneficiary A would be assessable on $100 of taxable income in year one, and would receive an uplift in cost base of $50 under the reverse CGT event E4. Its disposal of its units for $150 would not trigger a capital gain or loss. In year two, beneficiary B would be taxable on $200 of taxable income and would receive an increase in its cost base to $250. A subsequent distribution of the remaining $250 of capital would not result in a taxable gain or loss to beneficiary B.

d *Amendment assessment effects on the MDM*

We believe that the Board would need to consider the effect that an amended assessment may have on the MDM threshold. In our view, there need to be exceptions to the MDM threshold that cater for such adjustments in certain circumstances.

For example, assume that the MIT derives $200 of taxable income and distributes the minimum amount to its beneficiaries, (e.g. $100 if a 50% threshold was accepted). Assume that the trustee is incorrect about the deductibility of certain expenses, and that the Commissioner denies a $20 deduction. As the minimum distribution threshold would not be satisfied in the example, one would need to consider whether it is appropriate to treat this instance as a breach of the threshold.

We note that the amended assessment may occur some time after the year of distribution, (e.g. four years later), and the effect of the breach on the subsequent four years would also need to be considered. We would request that the Board considers whether (in circumstances that the trustee has taken reasonable care) the percentage should be compared to the unadjusted level of taxable income prior to any amended assessments. Alternatively, we would request a Commissioner’s discretion to cater for the situation.

e *Consequences for breaching the threshold*

The Board’s discussion paper highlights that the consequences of a breach in the minimum distribution percentage could be substantial, including the potential for the trust to “fall out of the regime entirely and Division 6 would instead apply”.

We recommend that the Board more appropriately consider the ramifications. The move to an MDM requires a fundamental change to systems and processes for an MIT as compared to Division 6. It would be considered inappropriate for an MIT to move between two systems, especially where liabilities need to be reported to its beneficiaries, which may number in the thousands.

The Board could consider other, more appropriate, consequences, such as applying a penalty to the MIT. Alternatively, the Board could consider whether in such a case the liability should partially fall to the beneficiaries and partially fall to the trustee. The percentage allocated to the trustee could be based on the shortfall percentage not distributed to beneficiaries.

3.1.8 Company flow-through model (CFTM)

A company flow-through model could also be considered by the Board. Essentially, this would be similar to a CIV type regime or an LIC regime currently contained in Subdivision 115-C. The benefit of such a regime is that it may provide a degree of certainty about whether outbound investments would attract treaty benefits. It would seem that to make this model work, it would need to be coupled with a TADM type approach, like similar vehicles in foreign jurisdictions.

While providing clarity for overseas investors, it is equally important to ensure that the after-tax investment returns to resident beneficiaries should not be different to the after-tax returns that the beneficiaries would have otherwise received if the company flow-through model had not been adopted. As company taxation may have consequences to the returns for superannuation fund investors, we recommend that such a model be considered as a regime in addition to, rather than as a replacement of, an MIT regime.

Recommendation 4
We highlight the administrative advantages with proceeding with a patch approach to Division 6. We highlight that the TEM approach is sufficiently similar to the current approach in Division 6 and may also be one of the easier models to implement. While the other models proposed by the Board have significant merit, those models would require a large amount of testing by the Board and potentially large systems changes by MITs. The Board could consider a corporate model as an alternative to an MIT regime to create flexibility for managers.

3.2 Definition of distribution (Question 4.2)

3.2.1 Distributions based on payments under the three proposed models

The Board has requested comment on the definition of distribution. At paragraph 4.20, the Discussion Paper states:

> A deductible distribution could be defined to include a payment or application of money or property to or on behalf of a beneficiary. In a model that required minimum annual distributions, the minimum could be calculated by reference to the net income amount or the trust income amount.

In our view, while the definition of distribution could be based on a concept of net income or trust income, we believe that reference to payments made to a beneficiary (adjusted appropriately for net capital gains and other non-cash amounts such as the franking credit gross-up), would seem to work for all the three alternative models proposed by the Board.

That is, under the TADM approach, the concept of a distribution being a cash amount appears to work appropriately in the example provided in Appendix H. The concept of distribution is not generally required, however, for amounts attributed under the TEM approach.

We believe that if a concept of cash is used for distributions, then the Board will need to ensure that the definition of distribution appropriately covers the creation of a present entitlement that is reinvested back into the trust. Under common law, such a reinvestment would result in an ‘offset’ and thus a legal payment. As this may result in uncertainty, however, it would be helpful to ensure that this is the treatment if such a mechanism was to be recommended by the Board.

While distributions are required under the MDM approach to determine whether minimum distributions have been made, the base for testing the percentage would need to be taxable income. A distribution determined by way of cash amounts would be compared to this base amount, (i.e. as it should be used as a basis for determining whether the beneficiaries have appropriately received distributions to fund their tax liability). For example, if the net income of the trust is $200, an MDM could still work appropriately if it required cash distributions of at least (say) 50% or $100 of the base amount of $200.

3.2.2 Distributions based on present entitlement under the patch model

If the patch model was to be adopted by the Board, then we believe that the present entitlement method may still be an appropriate manner of determining attribution.

Modifications to determining 'income of the trust', and special rules for determining 'present entitlement' would however help to resolve various issues currently faced in relation to distributions.

3.2.3 Interaction with CGT event E4

As noted above, the TEM approach would not require a definition of distribution for the purpose of determining attribution. It may require consideration of the term distribution when considering whether CGT event E4 applies, however. On the current wording of section 104-70, CGT event E4 only applies when there is a payment. Furthermore, there must be a direct link between the payment and the inclusion of the amount in assessable income by the beneficiary. Under the TEM approach (and perhaps the TADM and TEM approaches), there may be a disconnect between the payment and the inclusion of amounts in assessable income, and accordingly CGT event E4 would need to be reconsidered.

We have outlined at section 3.1.2d our views on modifying CGT event E4 under the various approaches.

Recommendation 5
The definition of distribution would depend on whether the Board proposes a TADM, TEM or MDM model, or alternatively if the Board recommends the retention of the current system with a patch model. In the first case, we believe that a distribution linked to cash distributions would be workable. Under a patch mode, we believe that present entitlement appears to be more appropriate. Under either approach, appropriate amendments would be required to CGT event E4 to remove the instances of double taxation.

3.3 Tax rate applicable to trustee (Question 4.3)

3.3.1 Stepped marginal rate for MITs

We question the need for integrity provisions akin to section 99A for MITs, given the new regime is dealing with MITs generally subject to the high level of fiduciary responsibilities contained in Chapter 5C of the CA 2001. In our view, the integrity concerns should be significantly less than those for privately-owned trusts.

Furthermore, per paragraph 2.6 of the Discussion Paper, if superannuation funds account for 74% of investments in MITs, it is our view that it is unnecessary for the section 99A rate to be the top marginal rate, especially where the rate of tax for a complying superannuation fund is only 15% (or 10% on capital gains).

We highlight an alternative to a flat rate of tax for MITs on undistributed income; a stepped marginal rate system for MITs. For example, this rate of tax could be:

- 15% for undistributed amounts that are less than 20% of net income
- 30% for undistributed amounts greater than 20% but less than 50%
- 46.5% for undistributed amounts greater than 50%.

Alternative, if a stepped tax threshold is not acceptable to the Board, we recommend the Board considers a flat rate of 30%, comparable to the rate that applies to companies.

3.3.2 Credit approach for tax paid by a trustee

As indicated at section 3.1.5c of this submission, we recommended that the Board proposes improvements to the treatment of amounts that have previously been taxed to the trustee. As identified earlier, we believe it is appropriate for a credit to be passed to the beneficiaries, especially in circumstances where the trustee is required to pay tax at a rate of 46.5% and the beneficiary is only required to pay tax at a much lower rate, (e.g. at 15% in the case of a superannuation fund).

Recommendation 6
We believe that it is inappropriate to tax MITs at a penalty rate of 46.5%. We recommend consideration of a marginal tax rate for MITs (based on percentage of undistributed income). Alternatively, we request consideration of a 30% flat rate for MITs. Whichever mechanism is chosen, there should be a credit passed to beneficiaries similar to imputation.

3.4 Time of allocating tax liabilities (Question 4.4)

3.4.1 Move to a receipts-based approach

The Board has sought comment on whether there should be a move towards a receipts-based approach under a model that allows trustees a deduction for their distributions. This is designed to overcome the issue where the tax liability arises in the same year the income is derived by the trust, even though an amount of income may not be distributed to the unit holder until the following year.

We believe that there are significant issues associated with the current proposal of using a receipts basis. If there are interim distributions, then the trustee would still be required to determine the character of the interim distribution using some mechanism. We believe that this would be significantly difficult and arbitrary without reference to full-year amounts.

Accordingly, a receipts basis would only appear to work if all distributions derived by a beneficiary for an income year were taxed in the following year of income. This would overcome the predominant compliance issues associated with identifying the correct tax amount being distributed to beneficiaries, including the treatment of cross-holdings in other trusts, unders and overs, etc.

We believe, however, that this approach may result in an unacceptable one time permanent adjustment to the revenue collection from MITs. We do not believe this is consistent with the principles of the review outlined by the Minister, as stated in paragraph 1.2 of the Discussion Paper.

We do highlight that there are significant administrative compliance advantages with this approach under either the TADM or patch model. Accordingly, the Board could consider alternatives to ensure that the proposal is revenue neutral. For example, the revenue effect of the deferral could be equalised by requiring beneficiaries to include an additional amount of statutory interest income in their taxable income, equal to the deferred distribution of taxable income multiplied by the base interest rate. If such an equalisation method were to be introduced, however, we highlight that this approach may be overly complex and thus result in compliance and administrative issues.

3.4.2 Changing the tax year for MITs

The Board has also asked us to consider the alternative of moving to a balance date of 31 March. At first instance, this recommendation appears to have merit. On reflection, however, we are not sure that this recommendation will correct the trust cross-holding issue. This is because MITs would still hold investments in other non-MIT trusts not required to have a 31 March year end or provide tax information until lodgement of their returns.

There are also commercial and compliance issues that would need to be considered. For example, a change to 31 March would likely require a change of year end for accounting and auditing purposes. MITs may need to make many systems changes to deal with the new year end and coordinate with other regulatory parties such as ASIC.

Accordingly, we highlight the impediments to such a significant change and request that these issues be consulted on and considered more broadly by the Board before making any recommendations on this approach.

3.4.3 Class of beneficiaries

The Board has also queried whether, under the TADM, resident individuals should be the only class of beneficiaries assessable on a receipts basis. As the withholding rules are based on payments, we agree that this approach already seem to apply to payments made from MITs to non-residents.

We are not sure, however, why the Board considers it appropriate to restrict the receipts basis to resident individuals, as opposed to resident trusts, companies, superannuation funds or partnerships. We believe the main benefit with the proposed deferral is to ensure that there is a reduced discrepancy, (i.e. a reduced over or under) of the amount reported to the beneficiary as a taxable distribution. Limiting the rule to individuals would not rectify this issue.

Recommendation 7
We highlight that there are various issues that would need to be practically worked through if the Board was to recommend a change to a receipts-based approach for investors or alternatively move to a 31 March year end.

3.5 Unders and overs (Question 4.5)

3.5.1 Simple carry forward approach or a deduction/credit approach

The Board has acknowledged that MITs often have difficulty obtaining final information to allow them to calculate the income and net income of the trust within a reasonable timeframe. It is common for MITs to have unders and overs as a result of late changes to the information they have obtained, and in practice many MITs carry over the amount to the next year.

We believe that the preferred approach is the carry forward approach. We understand that many fund managers would prefer this approach, in line with current industry practice. This would limit the systems changes required to deal with the issue. Any integrity concerns with this approach would be dealt with by having an appropriate limitation to the rule.

3.5.2 Appropriate threshold and tests

While the Board has highlighted that 2% may be considered an appropriate threshold for unders and overs, we believe that this threshold is far too low. The rationale for an appropriate under or over threshold is to reduce the compliance issues associated with errors and resulting amended assessments.

One of the main issues that results in overs and unders is the treatment of trust distributions received by MITs from other trusts, as the MIT may not receive accurate tax information relating to the treatment of such distributions. The over and unders threshold should appropriately ensure that a fund managers best endeavours to estimate such amounts do not result in breaches of the proposed over and unders test.

Accordingly, we believe that an over and unders error percentage can only be determined appropriately by taking into account a sample of the industry and considering the average level of unders or overs for MITs. We also recommend that additional thresholds, discussed below, are also included in the over and unders test for MITs. It is our strong belief that the Board must recommend appropriate thresholds and alternative tests that ensures investor confidence in the tax treatment of their distributions through MITs.

3.5.3 Additional thresholds

We also believe that the Board should consider the appropriateness of an averaging mechanism to smooth out adjustments. For example, an MIT may not breach its under over threshold for two years, but may then have a one-off adjustment of, say, 8% one year. The Board should consider whether an averaging provision could be appropriate in such circumstances.

Furthermore, we believe that a fixed dollar value *de minimis* threshold should also be adopted by the Board. This would alleviate the requirement to make an adjustment where the error is smaller than the compliance cost associated with such an adjustment, (e.g. reprinting of distribution notices). For example, a minimum threshold of $100,000 (CPI indexed) could be considered by the Board. This fixed dollar value should invariably be increased where the size of the fund warrants this to be the case. As MITs generally are required to prepare a NAV at the end of each year, the fixed dollar threshold could be based on the NAV of the fund.

3.5.4 Commissioner's discretion

We believe that it would be appropriate to provide an additional Commissioner's discretion. We believe that the discretion should be applied where it is considered unreasonable to make an adjustment, taking into account the cost of compliance (for both the ATO and the taxpayer), and the magnitude of the error. In certain circumstances, the discretion could be accompanied with a requirement for the trustee to make a compensating adjustment or payment, (e.g. the payment of a penalty or certain interest amounts to the Commissioner).

3.5.5 Impact on unit holders who have redeemed or sold units

If appropriate *de minimis* and safe harbour thresholds are proposed by the Board, we believe that the under or overs approach adopted would appropriately address the inequities in the allocation of tax liabilities that could arise when unit holders redeem or sell their units before errors in the calculation of the net income of the trust have been identified. That is, we would only expect immaterial errors to be borne by incorrect unit holders, which is the generally accepted as industry practice currently.

Recommendation 8
The Board should recommend a formal overs and unders system in the MIT regime, with sufficient flexibility to ensure investor confidence. We have recommended a threshold higher than 2%, an ability to use some form of averaging, a Commissioner's discretion, and an appropriate fixed dollar *de minimis* amount.

4 International considerations (chapter 5)

4.1 Addressing uncertainties (Question 5.1)

4.1.1 Issues under the current tax law and possible solutions

The Board has sought comment on the issues currently experienced under Australian domestic law and treaties. There are a significant number of uncertain international tax issues with MITs. We highlight some of these to be considered by the Board. We believe, however, that the Board should recommend a separate review of the application of international tax provisions to MITs, in an effort to help identify and correct all such issues under a future MIT regime.

a <u>*Treaty application issues*</u>

Accessing treaty benefits is significant issue for Australian MITs investing offshore. We note the comments made by the Board about MITs claiming treaty benefits and reference to the OECD reports on this issue, and we acknowledge the uncertainty about this issue. We question, however, whether the analysis of the treaty issue has been correctly identified in the Board's report. We provide our high level analysis of this issue for the Board's consideration below.

The Board has highlighted the issue with transparent entities that has been subject of OECD reports and amendments to OECD model commentary. We highlight though that these comments are based on the OECD model treaty, which contains a very different definition of 'resident' to the standard Australian model tax treaty.

Per Article 1 of the OECD model treaty, a treaty only applies to persons who are residents of one or both of the Contracting States. Article 4(1), defines a resident taxpayer as being 'liable to tax by reason of domicile, residence, place of management or any other criterion of a similar nature'. The OECD commentary at paragraph 8.7 states:

> Where a state disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that state. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income ad are thus the appropriate person to claim the benefits of the Conventions concluded by the states of which they are residents. This latter result will obtain even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity.

The majority of Australian tax treaties do not use this concept of 'liable to tax' in Article 4, but instead use a test of residency on its own. For example, Article 4(1) of the double tax agreement with the United Kingdom applies to a person who is a resident of a Contracting State where:

> (a) in the case of the United Kingdom, if the person is a resident of the United Kingdom for the purposes of United Kingdom tax; and (b) in the case of Australia, if the person is a resident of Australia for the purposes of Australian tax.

As Australia does not generally have a 'liable to tax' provision in our treaties, the 'conduit' concern highlighted in the OECD commentary may not apply to Australian trusts that are resident of Australia.

If the Board agrees with this proposition, then we believe that the real issue in applying Australian tax treaties to Australian trusts is whether the definition of a 'person' for the purpose of Article 1 and Article 4(1) of Australian taxation treaties includes a trust.

While a trustee may be considered a person, a trust is generally not a person under Australia's domestic laws (although it is an 'entity' under Australia's domestic laws). It may be arguable that the relevant person to be considered in the case of a trust is the trustee. This has some support in section 960-100, which states that:

> (3) A legal person can have a number of different capacities in which the person does things. In each of those capacities, the person is taken to be a different entity.
>
> Example: In addition to his or her personal capacity, an individual may be:
>
> - sole trustee of one or more trusts; and
> - one of a number of trustees of a further trust.
>
> In his or her personal capacity, he or she is one entity. As trustee of each trust, he or she is a different entity. The trustees of the further trust are a different entity again, of which the individual is a member.
>
> (4) If a provision refers to an entity of a particular kind, it refers to the entity in its capacity as that kind of entity, not to that entity in any other capacity.
>
> Example: A provision that refers to a company does not cover a company in a capacity as trustee, unless it also refers to a trustee.

Accordingly, it is accepted that the legal person, being the trustee, can be a person for domestic law purposes. The term 'person' is generally defined in an inclusive manner in Article 3(1). Per Article 3(2), it may be appropriate to import the domestic law definition of a person, where the context does not otherwise require a domestic definition to be used. We believe that it is therefore possible that Australian trusts investing outside Australia could arguably be entitled to treaty benefits under most of our current tax treaties.

This issue is, however, subject to significant debate and uncertainty. We note that the ATO originally took the view that a trust was not a person for the purpose of the New Zealand double tax agreement in paragraph 54 of draft ruling TR 2004/D24. This view was omitted, however, from the final ruling TR 2005/14.

It appears, therefore, that one of the more significant issues that should be resolved is whether an Australian trust is a 'person' that would obtain treaty benefits under a typical Australian treaty. It is our view that this issue should be clarified by the ATO and indeed Treasury.

If ATO and Treasury were to accept that this were the threshold issue for Australian trusts investing offshore, then one method that could help to clarify this issue would be to define a trust as a person in the Australian domestic income tax law, which would have effect for treaty purposes by virtue of Article 3(2) of most treaties (the internal definition provision that takes on domestic law meanings)[10]. While this would possibly give rise to the issue of static versus ambulatory interpretation of treaties, this issue could also possibly be overcome by a treaty override provision contained in the *International Tax Agreements Act 1953* (Cth).

We understand that the Board would need to seek the views of the Treasury and the ATO on whether they agree that such a change to the domestic law would overcome the treaty benefits issue for Australian trusts. On this point, we note that recently, in the Australian/Japan tax treaty, the negotiators chose to introduce Article 7(9) where a resident of a Contracting State is beneficially entitled, whether directly or through one or more interposed trusts, to a share of the profits derived from business carried on in the other Contracting State by the trustee of a trust (other than a trust that is treated as a company for tax purposes) in its capacity as trustee. This new clause simply attributes the business of the trust to the beneficiary when these conditions are satisfied. We are not convinced that this new Article clarifies this issue for all income derived by an Australian MIT from investments offshore where another Article of the treaty otherwise applies.

In conclusion, it is our view that the Board should recommend that the ATO and Treasury advise their view as to whether treaty benefits extend to Australian resident trusts on an amendment to the domestic taxation law definition of persons in the *International Tax Agreements Act 1953 or Income Tax Assessment Act 1997*. If, on their view, such an amendment would not correct this issue, we recommend that the Board considers broader changes to the Australian treaty model dealing with trusts and MITs, in particular to address this issue in our treaties in future.

b <u>*Conduit treatment of MITs*</u>

We believe that it is important for Australian MITs to be seen as complete conduit vehicles in instances where they invest in foreign assets and distribute income to foreign investors. In these cases, we believe the tax law should operate as if the investors were deriving such income directly.

The obvious concern with the current tax treatment is the lack of rules allowing for appropriate conduit treatment. For example, ATO ID 2005/200 highlighted the conduit issue for trusts deriving FIF income that would otherwise be non-assessable income to a non-resident beneficiary. The lack of appropriate conduit principles resulted in the income in this ATO ID being taxable to the trustee.

[10] Article 3(3) of the Australian-UK treaty

Furthermore, section 855-40 provides for a conduit treatment of capital gains provided that the trust is a fixed trust. While this overcomes the issue of streaming for privately-owned trusts, we see no reason why a conduit treatment is not automatically provided to MITs that otherwise would not be a fixed trust per the strict test contained in Schedule 2F of the 1936 Act.

Any uncertainty related to the taxation of non-residents should be removed completely in order for Australian funds to compete seriously for the operation and administration of global funds in Australia. Currently, we believe that uncertainty about the tax outcomes for non-residents results in managers choosing to establish global funds offshore. Consequently, the flow of benefits from having funds managed in Australia, the potential for Australian fund managers to earn income from providing services and any subsequent economic benefits are lost.

c *Taxable Australian property versus source*

The capital gains provisions tax non-residents on their taxable Australian property interests, while the statutory and ordinary income provisions generally tax on source.

This difference creates an anomaly in relation to the link between Division 6 and the capital gains tax provisions. This is because section 855-10 applies to a trustee of a foreign trust for CGT purposes, while section 95 deems the trustee to be resident for the purpose of Division 6. This would mean that a capital gain that was Australian sourced (but non-TARP) could still be considered Australian source income for Division 6 purposes. This is clearly inappropriate where a non-resident trust has derived a gain on a non-TARP asset.

While ATO ID 2003/99 seems to provide a practical solution to this issue, it is not certain whether this ATO ID extends to Division 855 capital gains. While the EM to section 160L stated that the term ‘taxable Australian asset’ was drafted as a source rule, there is no statutory rule that deems such gains to be Australian source income:

> By sub-section 160L(2), and subject to other provisions of section 160L, Part IIIA is also to apply to every disposal on or after 20 September 1985 of a taxable Australian asset (a term defined in section 160T) which was owned immediately before the disposal by a person who was not a resident of Australia or by a trustee of a trust estate or of a unit trust that was not a resident trust estate or a resident unit trust respectively, where the asset was acquired by that person on or after 20 September 1985. This also corresponds, generally, with the position under the Principal Act that non-residents of Australia are subject to income tax on income from sources in Australia.

We understand that this issue has been raised in NTLG meetings with the ATO and is listed as an outstanding issue. It is recommended that this issue should be addressed and clarified so that Division 855 gains are treated as foreign source income for our domestic laws for the purpose of applying Division 6.

d *Functional currency election*

We understand that Treasury is currently considering amendments to Subdivision 960-D to allow MITs to make functional currency elections. We believe that this technical issue and anomaly needs to be resolved to provide certainty for MITs that prepare their accounts primarily in a functional currency.

The issue is whether item 1 of section 960-60 of the 1997 Act applies to an MIT. An MIT generally would meet the criteria for preparing accounts in accordance with section 292 of the CA 2001 (being a registered scheme). As an MIT applies Division 6 of the 1936 Act, it is required to determine its net income as opposed to its taxable income or tax loss. We believe that this issue could easily be corrected by a minor technical amendment.

e *Attribution accounts for MITs*

Under the CFC provisions, a beneficiary of a trust is required to maintain an attribution account under Division 4 of Part X of the 1936 Act. While this may be manageable for privately-owned trusts, this practice is administratively impossible for MITs. We ask that the Board consider addressing this administrative issue if it is not otherwise addressed by Board in their final report to Government on the anti-tax deferral provisions.

f *FIF attribution*

Currently, complying superannuation funds are entitled to a FIF exemption. We highlight, however, the issue raised in ATO ID 2008/99, which holds that a FIF exemption is not available to complying superannuation funds that invests via a foreign hybrid. It is noted that this view overturns a previous ATO ID 2006/40 which held that the exemption does apply.

We believe the right policy outcome is provided by ATO ID 2006/40. However, the ATO ID raises a broader question about applying FIF exemptions where the interest is held through another entity (e.g. a foreign hybrid or bare trust). If the ATO ID were extended to MITs, similar unacceptable outcomes would also occur for MITs applying exemptions under the FIF provisions. We understand that this issue may be addressed by the Board 's recommendations on the anti-tax deferral regime. However, if this issue is not addressed, we recommend that it be considered as part of this review on MITs.

g *Application of the TFN provisions*

The ATO recently prepared a draft paper on the application of the various withholding provisions contained in Division 12 of Schedule 1 to the TAA 1953. We note that there are some apparent technical deficiencies with such provisions, which may result in an inappropriate application of certain withholding provisions to payments made by an MIT. We request that the Board recommends that Treasury corrects any such issues for MITs and that there is certainty about the withholding requirements of MITs under a proposed new regime. Uncertainty about the withholding arrangements applying to non-residents would undermine Australia's ability to be seen as a financial services hub of Asia.

h *Treatment of entities such as US REITs, UK LLPs, etc*

As discussed in section 2.1.6, section 12-400 of Subdivision 12-H may not appropriately recognise certain entities such as US REITs or German closed-end funds, even though they have a similar status to an MIS under a foreign law. We ask that this technical issue be addressed.

i *Multi-class multi-denominated funds*

Foreign exchange movements present a significant issue when marketing Australian trusts to non-resident funds (or where a non-resident manager wishes to use an Australian trust as a regional investment vehicle). This is because many non-residents do not wish to have currency exposure to Australian dollar units (even if the underlying investments are international, for example). Moreover, few non-residents (especially at the retail level) would have the inclination to hedge an Australian dollar investment into their own currency. Accordingly, we understand that there is a real demand for trust vehicles that have multi-denominated classes of units, (e.g. AUD, HKD, USD, Euro, etc) and believe that the Board should recommend that this be considered an option for MITs in Australia.

If this recommendation was to be accepted by the Board, however, we note that they would also need to consider the importance of allowing for a mechanism to remove foreign currency exchange risk in relation to such units. This would require, for example, the ability to remove certain foreign currency gains and losses derived in relation to the portion of income attributed to beneficiaries of a class of income, (e.g. by calculating the amount of taxable income of the class on the basis of a functional currency). Such multi-denominated classes are common in financial hubs such as Luxemburg, which are the real barrier to making Australia an international financial services centre of Asia.

We understand from our discussions with fund managers and responsible entities that this option would significantly enhance the attractiveness of Australian MITs to foreign fund managers and investors. Accordingly, we believe that there is a strong incentive for the Board to consider the use of such funds in Australia in making its recommendations to Government.

j *Management of foreign MITs*

To make Australia a true financial services hub, the Government should also consider making Australia an attractive place to manage foreign resident funds. Managing a foreign resident fund from Australia may change the residency of the fund to Australian, or may result in certain transactions of the fund being considered Australian source income. The Board should consider making a recommendation that would ensure either consequence does not occur for Australian taxation purposes, in order to attract management of MITs to Australia.

Recommendation 9
There are various international taxation issues associated with trusts, including treaty issues, conduit interactions, interactions with CGT, functional currency election technical issues, CFC and FIF interaction issues, TFN withholding uncertainties, interaction with Subdivision 12-H and issues associated with residency and the management of foreign funds. We recommend that the Board considers targeted consultation aimed at identifying and working through the large number of international taxation issues associated with trusts, with a view to providing recommendations that would increase the certainty and competitiveness for MITs investing abroad through Australia.

5 Trusts as flow-through vehicles (Chapter 6)

5.1 Tax-deferred distributions (Question 6.1)

The current tax treatment of tax-deferred distributions raises various issues, in particular whether tax-deferred distributions may be treated as ordinary income and may result in double taxation.

5.1.1 Ordinary income

Appendix C discusses whether tax-deferred distributions can be treated as ordinary income. The Board highlights the long-standing ATO view that Division 6 is not a unique code and that such distributions may be treated as ordinary income in the hands of the investors. We note that the conclusion that tax-deferred distributions are ordinary income is contrary to policy principle one, as it would tax a beneficiary differently than if they hold the investment directly. There are strong policy grounds for the Board to recommend that such distributions be treated as non-assessable non-exempt distributions in the hands of the beneficiary and for this issue to be clarified and corrected.

5.1.2 Double taxation

As correctly identified in the Discussion paper, tax-deferred distributions may result in double taxation, for example where a capital allowance deduction reduces both the cost base of the underlying property and the cost base of the units. Double tax may result if both the underlying property and the units in the trust are disposed of.

This outcome is inconsistent with policy principle one. The issue occurs where there is a timing difference for accounting purposes that is later reversed. Division 43 deductions significantly contribute to this issue, however we note that this has only become an issue recently, due to the amendments to section 104-71(1)(a) from 1 July 2001, where Division 43 amounts were excluded from being 'tax exempted amounts'.

The Board has included a number of options for correcting the proposed problem. We note that it is not possible to be completely consistent with policy principle one, as an MIT will have members entering and exiting during different phases of its life. One approach that would partly deal with the issue would be re-introduce an exception for Division 43 deductions. Alternatively, section 104-70 could be re-written in accordance with our recommendations in section 3.1.2d of this submission.

Recommendation 10
The Board should recommend that a statutory provision be inserted to remove any doubt about the assessability of a tax deferred or tax-free distribution received by a beneficiary of an MIT. Appropriate amendments should also be made to remove double taxation.

5.2 Character flow-through issues (Question 6.2)

5.2.1 Need for a statutory provision

The Discussion Paper highlights that the ATO has a concern about character retention under the existing law. While reference is made to cases such as *CPT Custodian Pty Ltd v Commissioner of State Revenue of the State of Victoria* 2005ATC 4925, we note that section 6B and section 115-215 provide for statutory flow through for beneficiaries of a trust for most categories of income and sources of income.

We have set out our views on this issue in section 3.1.2c of this submission. We believe that the flow-through provisions contained in section 6B and 115-215 could be re-written to provide greater certainty and some additional flexibility with MIT distributions.

5.2.2 Allocation of expenses

With the repeal of section 50, there is currently some uncertainty about how the ATO would require a MIT to allocate expenses and deductions against income. The issue of allocation is further complicated when an MIT derives net capital gains. We have detailed our views on the allocation of expenses in section 3.1.2b of this submission. We ask the Board to consider our submission points on this issue in the case of the ATO providing an uncommercial view on this issue.

Recommendations 11
We believe that the flow-through provisions contained in section 6B and 115-215 could be re-written to provide greater certainty and some additional flexibility with MIT distributions. We also request the Board to consider whether a flexible statutory provision should be introduced regarding the allocation of expenses by MITs in order to provide certainty on the matter.

6 Capital versus revenue (Chapter 7)

6.1 Gains derived by an MIT (Question 7.1)

6.1.1 Providing a statutory rule for MITs

The capital versus revenue issue is without doubt one of the most critical issues for the MIT industry. As the Board is aware, a treatment of assets held by MITs on revenue account would have a significant impact on the future of MITs in Australia. Not only would superannuation funds move to other forms of investment due to their deemed capital treatment under section 295-85, but foreign investors would also find MITs in Australia an unattractive flow-through vehicle without the potential access to section 855-40. Accordingly, we believe that it is imperative that a statutory provision that provides some degree of certainty about the treatment of gains made by MITs on assets be inserted into the Tax Act.

6.1.2 Capital treatment to be elective

We understand the integrity concerns in the current economic climate about the treatment of losses on revenue account. To ensure that the Boards recommendations are revenue neutral, we believe that MITs should be allowed to elect to have a deemed capital statutory provision apply when the following conditions are satisfied:

- that the election be optional, but irrevocable
- that the election be made by a certain time
- that no further opportunity be provided to MITs to make an election, unless the MIT is a new fund (or via a Commissioner's discretion)
- that a new MIT be given until its year end to make an election to apply the deemed capital regime
- that the MIT has consistently treated its gains in the same manner as losses of the same class over the last four years.

We believe that this would create a significant level of integrity and certainty about the application of the deemed capital treatment for MITs. The elective option allows MITs that hold investments on revenue account to continue to treat their investments as such.

6.1.3 Eligible of entities

We see no reason why a deemed capital treatment should not be extended to listed investment companies (LICs). Accordingly, we are of the view that an MIT (to be defined by the Board) and an LIC should both have access to an election to treat gains and losses on the disposal of assets on capital account.

6.1.4 Capital treatment of a class of assets

We understand that a number of approaches could be recommended by the Board in dealing with the capital and revenue distinction for managed funds. We believe that recommendations need to be consistent with these main objectives:

- neutral tax treatment (as far as possible) of assets disposed of by an MIT as compared to its investors
- administrative issues should reduced as much as possible to ensure there are not undue costs associated with complying with the law

- the new provision should be certain for both MITs and investors to enhance industry confidence and to reduce the possibility of errors and the administrative issues associated with correcting such errors.

It is our view that a deemed capital treatment for MITs would help to achieve all of these objectives. If a complete capital treatment is considered a significant cost to revenue, it is our preference that MITs be provided with an option to treat certain assets on capital account, consistent with the treatment afforded to superannuation funds under section 295-85. Adjustments would need to be made to ensure that an equivalent provision would take into account other appropriate asset categories such as real property assets.

While a deemed capital treatment is not completely consistent with policy principle one, (e.g. where unit holders hold investments on revenue account), we believe that the administrative simplicity of this treatment far outweighs this difference. Accordingly, we would propose that ‘eligible assets’ be treated as CGT assets (irrespective of their period of holding) and that ‘ineligible assets’ be treated in accordance with other ordinary and statutory principles.

6.1.5 Dealing with different classes of unit holders

We understand that the Board may have concerns with certain investors obtaining capital treatment through an MIT through the application of section 115-215. For example, revenue investors holding units on revenue account.

If the Board has a concern with providing a flow-through capital treatment for all classes of unit holders in MITs, we believe that this could be catered for by deeming the receipt of a capital gain derived by the ‘class of investor’ as being on revenue account. This could be done by amending section 115-215 so that the ‘trust gain’, as defined in that section, is deemed to be a gain on revenue account.

6.1.6 Present entitlement issues

We highlight the fact that a deemed capital treatment may exacerbate the current present entitlement issues in cases where the capital loss cannot be utilised against other income.

For example, assume an MIT derives $100 of trust income, and derives a capital loss of $100. Depending on whether the capital loss can be applied to the net income (for trust law purposes), there is some uncertainty about whether the trust has ‘income’ to which beneficiaries could be presently entitled.

This could result in a section 99A assessment to the trustee. Accordingly, if the Board proposes a deemed capital treatment prior to recommendations aimed at correcting the present entitlement issues, we believe that it would be imperative to ensure that the proposal is accompanied by a rule that allows trustees the ability to exclude such capital losses when determining present entitlement to income of the trust for section 97 purposes.

Recommendation 12
We recommend that a statutory elective provision allowing for a deemed capital treatment be introduced promptly to provide certainty to the industry on this issue. We recommend that the Board considers the additional consequential issues that may arise in deemed capital treatment, as highlighted in our submission.

7 Definition of fixed trust (Chapter 8)

7.1 MITs and fixed trust definition (Question 8.1)

In our view it is important that MITs are allowed to benefit from the flexible tax concessions available to those trusts that fall within the category of a fixed trust. These tax concessions include the less onerous tests required in order to carry forward and recoup trust losses, simplified access to the 45 day holding-period rules for the purpose of flowing through franking credits, and the ability to access other tax concessions such as the CGT scrip-for-scrip rollover provisions.

The Board has correctly identified that there is considerable uncertainty about determining whether a trust is a fixed trust, and believes that there is merit in altering the definition of a fixed trust to remove the current uncertainty, or deeming MITs to be fixed trusts.

The main benefit of altering the definition of a fixed trust is that this will result in a ‘whole of trust’ solution, not just an MIT solution. The problems associated with the definition of a fixed trust are not limited to MITs, and create issues for all beneficiaries of trusts that rely on the concept of a ‘fixed entitlement to income and capital’ of a trust. This solution may not be simple, however, as it would require the term ‘fixed trust’ to be re-defined and would require extensive consultation with stakeholders and tax professionals. Although this would not be insurmountable, it could be time-consuming and complicated, and would require a close examination of the issues that were explored in 2000 when entity taxation was examined.

On the other hand, a legislative amendment to deem all MITs to be fixed trusts would be a relatively simple solution and would remove uncertainty for all MITs (as defined) about this issue. It would also reduce the compliance costs for MITs of structuring their affairs so that they satisfy the conditions of a fixed trust and of ensuring that they continue to satisfy these conditions.

Accordingly, we recommend that the definition of a fixed trust be extended to deem a MIT to be a fixed trust. The definition of a managed investment trust is discussed in more detail in section 2.1 of this submission.

Recommendation 13
We recommend that an MIT be deemed to be a fixed trust for the relevant provisions of the Tax Act. As the term is used differently in different parts of the Act, a deeming rule may require appropriate links to the relevant parts of the Act, (i.e. Schedule 2F, Subdivision 124-M, etc).

8 Division 6C (Chapter 9)

8.1 Policy of Division 6C

We highlight that the original policy rationale for introducing Division 6C no longer exists in the current taxation climate. While the taxation treatment of trusts, companies, investors and superannuation funds has changed significantly since 1985, Treasury has not properly articulated the exact policy reason for retaining Division 6C. We believe that it is warranted for the Government make a statement about the exact policy reason for retaining Division 6C so that any amendments are made in line with the underlying policy principle. It seems inefficient in our view for a provision to contain an integrity measure where the exact integrity concern has not been properly articulated by the Government.

Recommendation 14
We ask the Board to articulate the reasons for retaining an integrity provision such as Division 6C before recommending that it continues.

8.2 Eligible investment business

The current test of an eligible investment business contained in section 102M provides a list of acceptable activities. This creates uncertainty in determining whether an activity falls within those parameters and also requires constant refinement where activities are inappropriately excluded from the definition.

In the interest of providing certainty, we believe that section 102M should be amended so that the test accepts all forms of operations as acceptable for MITs, except for those listed specifically as 'ineligible' in that section. This approach would be similar to the mechanism used in the FIF provisions, which define eligible activities in this manner (refer to section 469(1)). We believe that this form of test would provide certainty when it comes to testing whether an investment business is eligible.

Recommendation 15
Section 102M should be amended so that an MIT is deemed to carry on an eligible investment business, unless it carries on activities that are 'ineligible'. This, coupled with a ring fencing provision, would provide greater certainty and flexibility compared with the current test.

8.3 20% threshold for superannuation funds (Question 9.1)

The Board seeks comment on whether the 20% exempt entity rule should be retained for complying superannuation funds. Complying superannuation funds are currently within the definition of an exempt entity for the purposes of this rule, as they previously preferred trusts over companies because they did not benefit from the imputation system. Given that superannuation funds were made taxable in 1988, however, and are now able to access refundable imputation credits, arguably the policy rationale for bringing superannuation funds within the 20% exempt entity rule no longer exists. In light of the current tax treatment of complying superannuation funds, we recommend that the 20% rule be repealed.

Recommendation 16
The 20% exempt entity rule should not be retained for superannuation funds as the policy rationale for bringing superannuation funds within this rule no longer exists.

8.4 Possible amendments to Division 6C (Question 9.2)

We query whether the control test needs to be retained in its current form. Under this test, an MIT is not permitted to control or be able to control another person or entity that carries on a trading business. From a policy perspective, we are unsure about the tax preferences that could be obtained if an MIT were able to have a controlling interest in a company.

This shift in policy appears to be accepted by recent amendments to Division 6C, allowing 'top hat' stapled restructuring have permitted the control of companies in such circumstances. Those amendments have also allowed public unit trusts to acquire controlling interests in entities such as US REITs, even where such entities (or their subsidiaries) carry on some form of minor trading activities.

In light of these changes, we submit that the control test should be amended so that the parameters of its application are more clearly defined. We ask the Board to determine the reasons for retaining a control test as an integrity rule and why such a provision should be retained.

The Board also raises the question of whether non-compliance with the eligible investment rules results in taxation only on the 'tainted' income and how could this be achieved. Our preference is that some form of ring fencing be introduced. There are, however, various compliance issues that the Board would need to consider in applying Division 6C in a ring fenced environment. These include recording and allocating expenses, maintaining franking accounts, etc.

Recommendation 17
The control test should be abolished. Ring fencing should be considered for non-compliance with the eligible investment rules.

8.5 A separate REIT regime (Question 9.3)

There are significant advantages of having a separate REIT regime, like in the United States or the United Kingdom. Such regimes, where properly set up and implemented, can facilitate investment in property, including residential and commercial property investment. such a regime may make Australian property more attractive to foreign investors, which is in line with the Government's commitment to make Australia a regional financial hub.

Division 6C was introduced more than 20 years ago and does not cater for many of the contemporary property investment structures. There are also many issues associated with the trust taxation regime that make it difficult to tax REITs in the same manner as all other trusts. Given the size of Australia's REIT market, it is submitted that a REIT regime is long overdue.

In general, a REIT regime may be similar to the regime that is proposed for all MITs. If a regime for MITs does not cater for property-specific issues, including Division 6C issues, present entitlement issues, tax deferred distribution issues etc, then a separate regime for REITs would definitely need to be implemented by Government.

Recommendation 18
We believe that the Australian REIT industry would benefit from a specific REIT regime, if the general MIT recommendations are insufficient to cater for all of the property-specific issues.

9 Division 6B (Chapter 10)

9.1 Retention of Division 6B (Question 10.1)

The Board seeks stakeholder comment on whether Division 6B should be retained, and if the rules are retained in some form, what changes should be made to them and should whether they should be integrated into any specific tax regime for MITs.

We are of the view that Division 6B should not be retained. There are strong arguments for the removal of Division 6B as it does not seem to be relevant in today's context. Division 6B was introduced in 1981 when assets could be transferred from companies to trusts without any consequences, but CGT may now apply to such transfers. There was also a greater imperative to transfer assets from companies to trusts before the imputation system was introduced in 1988 because the profits of companies were taxed twice – once at the company level, and again at the shareholder level without any credit for corporate tax paid. The comparative tax advantage of trusts over companies has been further narrowed with the introduction of refundable imputation credits.

As we are firmly of the view that Division 6B should not be retained, we have not considered the second question, about whether any changes should be made to Division 6B or if it should be integrated into any specific tax regime for MITs.

Recommendation 19
The policy rationale for Division 6B no longer exists and is properly catered for by Division 6C. Accordingly, Division 6B should not be retained.

10 Implications for other trusts (Chapter 12)

10.1 Extension to other trusts (Question 12.1)

The Board has sought comments on whether the options could be extended to other trusts. As highlighted at section 2.1.1and 3.1.1 of this submission, we believe it is difficult to make recommendations on the basis that they could be extended to other forms of trusts.

Instead, we believe that such recommendations should be made in isolation, with a view to ensuring that the provisions work appropriately for MITs. Once those recommendations are made, we believe a separate review should be undertaken by the Board of the provisions applying to other forms of trusts. Stakeholders could then consider the various recommendations made by the Board in determining solutions to the many issues relating to trust taxation in Australia for non-MITs.

Recommendation 20
As MITs are significantly different from other forms of trusts, (i.e. due to the fiduciary responsibilities imposed by the Corporations Act), we believe that the Board should consider recommendations for MITs in isolation. We consider the policy issues for other trusts to be fundamentally different to those with MITs. We recommend a separate review to be undertaken of other forms of trusts (non-MITs) with a view to correcting the anomalies in the operation of the taxation law for such trusts.

11 Other issues

11.1.1 Overview

There are some other issues that were not identified in the Board's Discussion Paper that we believe should be considered by the Board in their review of MITs.

11.1.2 Lost franking credits

Where a trust has losses and is unable to made a distribution, franking credits can not be passed to the beneficiaries. Accordingly such franking credits are wasted or lost. This outcome is inconsistent with the treatment of individuals and complying superannuation funds, who receive a refund of any excess franking credits. Companies are allowed to convert the excess franking credits to tax losses, which also to some extent provides 'relief' to companies.

Policy principle one states that the tax treatment for trust beneficiaries should largely replicate the tax treatment for taxpayers as if they derived the income directly. We highlight that this issue demonstrates an inconsistency between the treatment of investors and MITs and accordingly we believe that this issue should be considered by the Board.

11.1.3 Lost foreign income tax offsets

Per section 770-10, a foreign income tax offsets (FITOs) are generally available where a gross amount of income that gave rise to the foreign tax is included in the assessable income of the taxpayer. As beneficiaries of MITs receive a share of net income of a trust, this can result in a trapping of FITOs where there are losses in the trust.

The difference between a gross mechanism for persons investing direct as opposed to a net mechanism for persons investing through MITs can act as a deterrent for investment through MITs where the MIT's assets are foreign investments. We ask the Board to consider mechanisms to allow the attribution of FITOs to beneficiaries in circumstances where the MIT derives the credits but has a net loss during the year of income. For example, FITOs could be carried forward and distributed to a beneficiary in a later year of income when the MIT has net income.

11.1.4 The 45-day test and dual layers of testing

Special tracing rules, provided in section 160APHG for widely-held trusts, reduce compliance in relation to the 45-day rule. The term widely-held trust does not necessarily coincide with the definition of an MIT. We recommend that provisions such as the 45-day test are amended so that compliance-saving mechanisms are extended to MITs.

11.1.5 Definition of 'widely held' used by the Act

There are instances where widely held is defined with reference to 300 unit holders, for example in section 115-50. We highlight the anomaly that is caused when certain investors in MITs are treated as one investor rather than as multiple investors.

For example, section 115-45 is an anti-avoidance provision that applies to prevent a unit holder from obtaining a discount gain on their units where more than 50% of the assets of the trust are 'under 12 month' assets. This provision does not apply to trusts where there are at least 300 beneficiaries. An MIT may be substantially owned, however, by a small number of superannuation funds that have (between them) more than 300 members. Effectively the MIT is owned by the beneficiaries of those super funds. As the provision does not allow for a 'trace through' for superannuation funds, or other wholesale or retail MITs, this can result in an inappropriate application of the provision in such circumstances. We recommend that the Board considers references to 'widely held' throughout the Act and consider whether (in a similar fashion to Subdivision 12-H) such provisions should see certain members (such as superannuation funds) as constituting more than one member.

11.1.6 Effects on other industries

We note that beneficiaries such as superannuation funds have significant issues with the timing of the receipt on both accounting and tax information relating to distributions from MITs. This is because they are required to allocate both income and expenses (including income tax) on a fair and reasonable basis to their members under the superannuation industry supervision (SIS) legislation.

Any changes causing delays in the receipt of tax information/deferral of the relevant tax point could can cause significant issues for superannuation funds, including investment structuring issues, and equity issues between current members of the superannuation fund and future members that may be affected.

We believe that any recommended changes to the taxation of MITs should take into consideration the fiduciary issues and equity issues for investor groups, especially superannuation funds.

11.1.7 Product rationalisation

The efficiency of the MIT industry could be enhanced if trusts are allowed to merge without crystallising capital gains, losing tax attributes or triggering other adverse taxation consequences. Existing tax law only allows for a trust to acquire the units in another trust under scrip-for-scrip rollover provisions. When acquired, however, there are limited forms of tax relief that will allow a commercial rationalisation of the trust structures.

We understand that consultation is occurring on financial product rationalisation in relation to the MITs industry. We recommend that the Board considers whether such consultation or recommendations be included within the overall recommendations to be made by the Board.

a *Tax consolidation as a form of product rationalisation*

The tax consolidation regime currently only applies to groups that are 100% owned ultimately by companies (or trusts governed by Division 6B or Division 6C that make an election). We believe that significant efficiencies would be obtained by extending the consolidation regime to MIT groups, where a MIT is a head entity of a consolidatable group. While this option would facilitate the ability of MIT groups to restructure and would remove the double taxation issues associated with holding assets through multiple tiers of trusts, we consider this option to be generally revenue neutral where such transactions would not occur in the alternative (due to the significant tax cost associated with restructuring). Accordingly, we request that the Board considers recommending an extension of tax consolidation to MITs.

b *Extending section 106-50*

Alternatively, we would request an extension of section 106-50 (for all tax purposes and not only CGT), to apply to MITs holding a 100% interest in another trust.

Recommendation 21
We highlight a number of additional technical issues in relation to MITs and request that the Board considers these additional issues in making its final recommendations to Government.