19 December 2008

Attention: Christine Brown
Managed Investment Trust Review
The Board of Taxation
c/ Treasury
Langton Crescent
CANBERRA ACT 2600

To the Board

Review of the tax arrangements applying to managed investment trusts Ernst & Young submission

Ernst & Young is pleased to make this submission in response to the questions and discussion in the Board of Taxation's discussion paper "Review of the Tax Arrangements applying to Managed Investment Trusts" (the Discussion Paper). Our submission, detailed in Appendix 1, follows our interim submission concerning the treatment of gains and losses made on the disposal of assets by managed investment trusts (MITs) dated 9 December 2008. The interim submission is attached as Appendix 2.

We have also provided input into other professional body and industry body submissions.

Our submission is based on our experiences and discussions with Ernst & Young clients in the managed funds and investment industry.

Our submission recognises the key objectives that the review should result in reduced complexity and increased certainty for the taxation of MITs and their investors and also minimise compliance costs to both.

We agree with Policy Principle 1 which provides that the review should result in legislative change which ensures that the tax treatment for trust beneficiaries in MITs, who derive income from the trust, should largely replicate the tax treatment that would arise if they had derived that income directly. The suggestions submitted below are consistent with this Policy Principle.

We submit:

- A taxation regime for MITs should be introduced, based preferably on the "Option 2" trustee exemption model
- The MIT regime should confirm the flow-through taxation of MITs for their investors
- The MIT regime should be available to all funds that collectively manage funds for investors where such funds are listed, "widely held" or owned 10% or more indirectly by one or more listed and/or widely held funds
- The MIT regime should allow funds to manage their issues of "overs and unders", "last man standing" and part year redemption income allocation
- The MIT regime should be an exclusive taxation code for MITs if the MIT elects to apply the regime
- The Division 6B Corporate Unit Trust rules should be removed
- If the Division 6C Public Trading Trust rules are to be retained then their application must be restrained and modified
- Amendments are required to clarify the interaction of the recently introduced final MIT withholding tax rules with other withholding tax rules
- A MIT should be deemed to be a "fixed trust" for the application of the rules which rely on this term

► Section 51AAA of the ITAA 1936 should not apply to MITs.

We support the Government's policy to promote Australia as a financial hub and believe the measures we suggest in this submission will be positive in respect of increasing the attractiveness of Australia for the investment of international funds.

However, given that the overwhelming majority of funds invested in Australian MITs are sourced from Australian residents and Australian entities, including notably superannuation funds, it is important that the MIT regime also operate in the most efficient manner in respect of the taxation of those Australian investors.

Our submission supports, as far as possible, our understanding of the general approach of Australian managed funds to deal with many of the gaps and uncertainty in the law. We believe that legislating many aspects of this approach should ensure that costs of compliance from changes to the law should be kept to a minimum and that investors should be able to understand the changes better than if a completely new taxation regime is implemented.

We do not believe a regime based on foreign jurisdiction regimes for property and other funds, including real estate investment trusts (REITs) is required. The modification of the current law in line with Option 2 and the confirmation of the flow-through nature of funds, in conjunction with deemed capital treatment for the disposal of assets, should address the majority of concerns of funds and investors.

We note the terms of reference of the Board's review include that the options presented to the Government should be revenue neutral or near revenue neutral. Although it is difficult for us to gauge the revenue impact of our submission proposals, we believe they should be largely revenue neutral on our understanding that our approach would generally conform to the current practice of the majority of managed funds and their investors. We also believe that the implementation of a MIT regime will have an efficiency dividend for the Australian economy which should offset any minor revenue leakage in respect of any of the particular elements of the regime.

Further detail on our submission is set out in Appendix 1 under the following headings:

► Definition of MIT – application of the measures
► Determining tax liabilities – proposed taxation system for MITs and their investors
► Division 6B Corporate Unit Trust and Division 6C Public Trading Trust rules
► Non-resident withholding tax
► Fixed trust and other issues.

If you would like to discuss this submission in more detail please contact in the first instance Dale Judd on 03 9655 2769, Daryl Choo on 02 9248 4472, Paula Houvardas on 02 9248 4726 or Tony Stolarek on 03 8650 7654.

Yours sincerely,

Dale Judd
Partner

Appendix 1

Definition of a MIT

The terms of reference of the Board's review include consideration of the current income tax arrangements applying to managed investment trusts (MITs), being managed funds that are widely held collective investment vehicles undertaking primarily passive investments (paragraph 1.5 of the Discussion Paper).

In our view, a MIT should be defined widely to include all non-closely held entities that operate as collective investment vehicles. The definition should not be overly prescriptive other than to ensure that the regime does not apply to family and wholly private trust arrangements.

The MIT regime should therefore apply equally to retail funds, wholesale funds, private equity funds, sub-funds of these and other similar funds (for example incubation funds) whether listed or unlisted.

In our view, there is no current definition of a MIT that will satisfy this requirement. We set out below some suggestions for how the elements of a definition could be constructed in order to ensure the simple determination of whether the rules apply to an entity or not. However, in making these comments we note the law should avoid using strict definitions which may inappropriately restrict the use of the measures, as well as avoiding undefined terms which would result in significant uncertainty in the application of the law and which could potentially result in disputes with the Australian Taxation Office (ATO).

"Collective investment" should be defined widely so as to encompass current and future investment activities. The definition of managed investment scheme in the Corporations Act has some wording that may assist in building this concept in the MIT definition:

> *"managed investment scheme" means:*
> *(a) a scheme that has the following features:*
> *(i) people contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);*
> *(ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);*
> *(iii) the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).*

In respect of the widely held requirement we submit that a MIT should include all of the following:

- Entities listed on an approved Australian or foreign stock exchange
- "Widely held" entities including:
  - A trust with at least 50 members;
  - A trust where at least one of the members is a listed entity or an entity in which at least one member is, a MIT, a life insurance company, superannuation or approved deposit fund, including foreign equivalents, where the fund has at least 50 members (as listed in paragraphs 12-400(2)(a),(b) and (d) of the TAA 1953, MIT definition); and
- Entities with interests owned indirectly (through a company, partnership or trust) at least 10% by one or more listed and/or other widely held entities, as defined above.

Special rules for the year of commencement of a fund and the final year will be required.

Entities with multiple classes of interests or units should be eligible to be a MIT. Issues which arise with the taxation of the income of such entities are separate to eligibility issues and are discussed below.

The MIT regime should apply to both Australian resident trusts and foreign equivalent collective investment vehicles that operate in Australia via a permanent establishment.

Determining tax liabilities – proposed taxation system for MITs and their investors

As noted in the Discussion Paper, the reliance on the problematic law in Division 6 of the Income Tax Assessment Act 1936 (ITAA 1936) for fund and investor purposes does not in many cases deliver an outcome consistent with Policy Principle 1.

We submit that a separate regime for the taxation of MITs and their investors should be introduced. Our preference is that this regime should essentially follow the Option 2 trustee exemption model suggested in the Discussion Paper.

Option 1 would require substantial new law and would add to the compliance costs of funds and investors without, in our view, any perceived major advantage. Option 3 is unnecessary as it is the general practice of funds to distribute their income on an annual basis and the outcome from a modified Option 2 would mean that such requirement is unnecessary to deal with the net income of the MIT in most cases.

The default position for a MIT with a single class of units or interests could be that it must allocate its net income based on the percentage of units or interests held by each investor. The timing and frequency for measuring the proportionate unit/interest holding for a year would be determined by each fund, as required by its trust deed.

For funds with multiple classes of units or interests, the mechanism for allocating the net income will be more complex. In these cases, the allocation of net income might be based on the share of distributions (in cash or property) made in respect of the income year (including distributions made within 3 months of year end) for each investor. This "distribution allocation" approach might also be attractive to MITs with a single class of units or interests and should also be available to them as an option.

The above approach should result in all MIT net income being taxable to the MIT investors. This would remove the requirement for section 99A to tax the trustee of the MIT on any income of its net income. However the rules might provide that if the fund does not deal with the net income of the MIT in an effective way to include that net income in the investor's assessable income that the trustee rule would apply. This might occur for MITs with multiple classes of interests where no distribution is made in a year where there is net (taxable) income in the MIT. Alternatively, taxation of the trustee might be appropriate for funds that fail to report the allocation of taxable net income to investors in time for them to lodge their income tax returns.

We submit that the appropriate rate of tax to the trustee should be 30% or less to be better aligned with the rates of the majority of investors in MITs (superannuation funds and Australian resident individuals) as a proxy rate for those investors.

Income character flow-through recognition should be legislated for all types of income, building on the current rules for capital gains and dividends. This should include source flow-through. Deductible expenses and prior year tax losses should be allowed to be allocated on a reasonable basis against each class of income except imputation gross ups and foreign tax credits which would follow the dividend and foreign income amounts.

The law should make clear that the MIT regime is the exclusive code for the treatment of income from investments in MITs and that is there is no residual operation of section 6-5 in respect of the elements of MIT income for investors.

Overs and unders

Overs and unders should be dealt with in accordance with current industry practice to use a carry-forward approach, as an adjustment to the calculation of taxable income of the next year. This should apply for all adjustments.

A breach of the de minimis rule should result in a penalty only to the MIT. It should not require the amendment to assessments of investors, which is impractical, or taxing the trustee of the MIT on this amount, which creates inequities in the absence of complex rules to manage the allocation of the tax paid.

However the de minimis level suggested is likely to be too low for many funds and a 5% rate would be a more appropriate measure for what is a reasonable level of adjustment. Possible de minimis alternatives include a per investor dollar amount or percentage of funds under management.

The alternative suggested in the discussion paper is complex and would require the drafting of significant new law for a minor benefit.

Last man standing and redemption issues

The unlisted MIT practice of dealing with last man standing and redemption issues for MITs that exit the fund during the year should be accorded legislative support. That is, the method by which the particular MIT's trustee deals with investors that leave the MIT during the year to allocate to them their appropriate share of the income and net income of the MIT should be confirmed. The replacement of section 97 with more flexible rules discussed above should allow this outcome.

CGT cost base adjustments

Taking into account Policy Principle 1, there would appear to be no reason for continuing to adjust the cost base of units held in MITs (under CGT event E4, ITAA 1997) if the trustee exemption model is adopted. Investors will be taxed on the income of the MIT in accordance with Policy Principle 1 and any further taxation consequences arsing from distributions would be outside the policy. This proposal would obviate the need to track cost base reductions.

If cost base adjustments are to continue then an amendment is required to increase the cost base where the amount of net income of the trust taxed to an investor is more that the cash distributions received for a year. A simple adjustment could be required to account for both increases and reductions, by adding the share of taxable income to the cost base and subtracting the cash received. MITs may be able to provide details of this adjustment to investors in annual distribution statements.

MIT regime should be optional

Trusts that satisfy the definition for an MIT should be able to irrevocably elect into the MIT regime. In this way any compliance burden of having different rules apply to MITs and non-MIT trusts should be able to be managed.

The MIT regime election should be separate to the election for revenue treatment on the disposal of investment assets, included in our earlier submission. That is, a managed fund in the MIT regime should be allowed to decide whether its investment assets are taxed on capital or revenue account.

The capital rule should also be drafted so that it can be applied to other specified entities. We submit that listed investment companies (LICs) should also be entitled to access the capital "bright line" rule in order to overcome the current interpretative issues raised by the ATO (in TR 2005/23) and to address any issues of competitive disadvantage compared to MITs that might arise.

Division 6B Corporate Unit Trust and Division 6C Public Trading Trust rules

The Division 6B corporate unit trust rules should be removed.

These rules were introduced in 1981 to address issues that are no longer relevant following the introduction of capital gains tax and the dividend imputation system.

Policy Principle 2 and other comments in the Board's terms of reference assume that the policy of the Division 6C public trading trust rules should continue. We note that these rules were introduced in 1985 to address particular issues and that there have also been changes to the law since that time which are relevant to the policy outcome of the provisions, including for example the introduction of refundable franking credits. We therefore submit that the policy of Division 6C should be reconsidered.

The Division 6C rules are complex and their potential application is problematic. They impede Australian superannuation funds' and managed funds' participation in infrastructure investment and global investment. The rules also restrict the ability of Australian funds to attract international capital.

If Division 6C is to remain then its application must be significantly restrained and modified.

Although the interim changes to Division 6C made by Tax Laws Amendment (2008 Measures No.5) Act 2008 may assist some managed funds to determine whether their activities could fall within the provisions, the changes made are largely incremental and many core issues with the provisions remain. In particular we believe that the range of investments permitted as an 'eligible investment business' should be re-examined. Ernst & Young has previously provided suggestions to Treasury in relation to such changes.

The following changes to Division 6C are also required:

- The rule which results in a fund being a 'public unit trust' where it is owned 20% or more by superannuation funds and tax exempt entities should be removed
- The control rule should not apply to controlled companies
- Funds should be allowed to rectify inadvertent breaches of the rules
- The consequences of the division to tax the fund at the company tax rate should only apply to the ineligible income.

The 20% limitation on unitholdings by complying superannuation funds and tax exempt entities is no longer appropriate following the introduction of refundable franking credits. We also note that this restriction was introduced at a time when superannuation funds were not taxable and funds are now generally taxed.

As a matter of taxation policy we see no reason why ineligible activities could not be conducted in a controlled subsidiary company of a MIT that is taxed at 30%. This structure would seem to meet the objectives of the Division to apply the company tax system to non-passive activities.

Any type of control test that is required (for example, it may be required to retain a control test in respect of trusts) must apply to Australian activities only: that is, it should have a "waters edge" limit. Control of foreign entities that may carry on activities considered to be trading should not cause an Australian trust to become a trading trust.

As Australian property trusts and infrastructure trusts have expanded offshore, the current restrictions have caused significant concern and compliance costs. Generally, there seems no Australian tax revenue at risk. Part of the difficulty arises from the style of operation and customary activities varying significantly from country to country, and as compared to Australia. For an Australian trust to monitor whether an underlying entity owning rental property overseas is carrying on any activities which could constitute trading is unrealistic. The recent amendments to "rent" in this regard do not address this issue.

The consequences for breach of the rules is inequitable and inefficient, particularly if the breach might occur for a short time and might be rectified. Notwithstanding recent amendments the risk of the rules applying following an inadvertent breach of allowed activities remains a real risk for funds.

In our view, Division 6C should provide that, if a breach of a unit trust's permissible range of investment activities is identified by the trust or the Commissioner, the trust should not be treated as a trading trust provided that:

- The breach is due to inadvertence rather than deliberate or reckless disregard of the requirements of Division 6C; and
- The relevant trust takes steps to rectify the breach as soon as the breach is identified.

A ring-fencing rule could be introduced to apply the consequences of the Division 6C (see section 102S and the modifications in section 102T) only in relation to the non-EIB income of the trust. The trustee would then be required to perform calculations to determine the EIB and non-EIB income of the trust.

We recognise that this ring-fencing concept might involve substantial drafting and systems issues for the Australian Tax Office.

We note that the "corporate" characterisation of Division 6C trusts is incomplete as public trading trusts continue to be treated as "trusts" for many purposes of the law (for example the trust loss rules, CGT scrip for scrip rollover relief and the Section 23AH and 23AJ exemptions). If the consequences of the Division applying are to remain then these inconsistencies in application should be reviewed and removed if appropriate.

Non-resident withholding tax

There is some uncertainty concerning how the recently introduced MIT final withholding tax rules (Schedule 12-H of the TAA 1953) apply in relation to the other withholding tax rules, in particular the TFN withholding tax rules (schedule 12-E of TAA 1953). The legislation and accompanying explanatory material for these amendments did not discuss such interaction issues. We submit that this review provides an opportunity to clarify the application of the rules to remove any uncertainty.

We submit that the law should clarify that the schedule 12-H rules apply as the exclusive code for withholding for all non-interest, dividend and royalty distributions by an eligible MIT (as defined for those provisions). The law should in particular clarify that the TFN withholding tax rules do not apply to any part of a distribution made by an eligible MIT to a non-resident investor, including tax deferred and foreign source income distributions.

Fixed trust and other issues

Fixed trust definition

The definition of 'fixed trust' (in Schedule 2F of the ITAA 1936) should be amended to specifically include an entity that is a MIT, as defined for the new regime.

This will resolve the significant uncertainty around this term and its use in various provisions including the trust loss, dividend imputation and capital gains tax (rollovers) provisions. The more flexible rules for widely held investment vehicles, as noted in the Discussion Paper, will then be able to operate.

This amendment will assist the effective application of Policy Principle 5 that trust losses should be trapped and subject to limited special rules for utilisation.

The trust loss rules for testing changes of ownership are over prescriptive and difficult to apply in practice. For example, the requirement to trace through interposed entities to ultimate individual investors. We submit that testing and tracing concessions should be introduced to assist MITs, in a similar way that the modifications and tracing concessions in Division 166 of the ITAA apply to widely held and 'eligible Division 166' companies (including to replace the current 'abnormal trading rules, which have been replaced for company testing).

Section 51AAA denial of deductions

Section 51AAA of the ITAA 1936 may deny deductions broadly in circumstances where the only reason for the deduction is because a net capital gain is included in assessable income. The potential application of this section creates unnecessary uncertainty and complexity in the law and should not apply to MITs.

The view has been expressed that section 51AAA should not apply to leveraged MITs in any case (as they would be entitled to deductions under the section 8-1 ITAA 1997 limb of 'carrying on a business'). However the matter is not free from doubt and this uncertainty should be removed. This amendment would also avoid any potential future disputes with the ATO based on arguments by them, for example, that the provision could apply to MITs because of the (proposed) statutory capital treatment of MIT gains and losses.

Appendix 2

9 December 2008

Managed Investment Trusts Review
The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

To the Board

Review of the Tax Arrangements Applying to Managed Investment Trusts
Interim submission: Treatment of gains and losses on disposal of assets

Ernst & Young is pleased to make this interim submission in response to the questions and discussions in the Board of Taxation's discussion paper "Review of the Tax Arrangements Applying to Managed Investment Trusts" (the discussion paper) concerning the treatment of gains and losses made on the disposal of assets by managed investment trusts (MITs).

We will lodge a further submission on the balance of the discussion paper by the 19 December due date.

Our submission has been informed by input received from Ernst & Young clients in the managed funds and investment industry.

We submit:

- The characterisation of gains and losses on the disposal of CGT assets of a MIT should be addressed by a statutory rule at the fund level, for all managed funds
- The statutory rule should provide that the capital gains tax (CGT) provisions are the primary code for calculating the gains and losses of a fund broadly in the same way the rule in Section 295-85 of the *Income Tax Assessment Act 1997* (ITAA 1997) applies to a superannuation fund, which includes designated exceptions to the capital treatment
- The characterisation of the gains of the MIT as capital gains should 'flow through' to all investors in the managed fund so that the distribution of these gains are also treated as capital gains to the investor
- Funds should be allowed an optional election not to apply the statutory rule to their assets
- The CGT discount requirements including the 12 month holding rule should remain, subject to amendment to address certain technical issues. The taxation treatment on the disposal of units in funds should also remain unchanged
- These rules should be applicable not only to MITs as currently defined but should apply to wholesale funds, private equity funds and other funds used to collect savings (particularly those used as collectors of superannuation funds' monies). Otherwise the resulting horizontal inequity will have severe consequences for the managed funds sector.

We submit that a single statutory capital rule, with flow through to investors, will deliver significant benefits to the managed funds industry:

- It will provide certainty to the taxation of MITs
- It will provide certainty to the taxation of investors in MITs
- It will avoid significant complexity and costs of compliance compared to MITs having to undertake a detailed analysis of individual assets to determine their capital or revenue characterisation.

Such reforms must be implemented soon, either in a permanent form or in an interim manner pending the completion of the review of MITs by the Board. Otherwise:

- MITs may instead continue to face significant uncertainty, being required to self assess their transactions and asset disposals as giving rise to either revenue or capital gains in an uncertain environment, perhaps using a detailed analysis of individual assets or classes of assets, perhaps along the lines of the ATO approach in taxation ruling TR 2005/23 for Listed Investment Companies (LICs). In any event the discussion in TR 2005/23 is not appropriate for unlisted funds which must dispose of assets to provide liquidity for redemptions of investments; the application of that ruling would have the potential to adversely affect the managed funds industry in respect of both domestic and non-resident investment.
- Australian investors will face uncertainty concerning the potential characterisation of any gains they receive from the MIT.

  The expected responses of superannuation funds and wealthy and well-advised investors would be to move to direct investment models, including through partnerships and joint ventures and wrap accounts and similar techniques. Given that the majority of funds held in managed funds represent the investments of superannuation funds this likely action of investors has the potential to at least significantly curtail the growth of the industry and, at worst, would result in a significant contraction in or disturbance to the funds management industry.
- Non-residents are also concerned that the treatment of their income from Australian investments is certain and that they can access the concessional tax treatments introduced to encourage investment in Australian funds. These expectations are supported by the Government's 'Australia as a regional financial hub' policy. A vital element for non-resident investors is the CGT exemptions in Division 855 including for distributions of gains by funds.

  Expected responses by non-resident investors to the uncertain but potential treatment of MIT gains on revenue account would be to withdraw current funds from Australian managed funds and to invest those funds directly or through new funds in a more favourable and/or certain tax jurisdiction.

We set out our reasoning further in the attached Appendix.

If you would like to discuss this submission in more detail please contact in the first instance Dale Judd on (03) 9655 2769, Daryl Choo on (02) 9248 4472, Paula Houvardas on (02) 9248 4726, or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Dale Judd
Partner

Appendix

Capital 'bright-line' rule should be similar to the superannuation fund rule

The characterisation of gains and losses on the disposal of CGT assets of a MIT should be addressed by a statutory rule.

A statutory rule will have significant benefits for the managed funds industry resulting from the certainty that such a rule would provide and from the avoidance of significant complexity and costs of compliance.

Without a clear rule, continued uncertainty, complexity and compliance costs will arise should a case law based analysis be required to be undertaken on an asset by asset or a class of asset basis to characterise gains and losses. These issues would arise in particular for equity funds if the ATO's approach in TR 2005/23 for characterizing gains and losses of LICs is adopted for these MITs.

A statutory rule will also avoid potential disputes with the ATO and the administrative difficulties for the ATO associated with the seeking to amend investor taxpayers' relevant assessments.

The statutory rule should provide that the CGT provisions are the primary code for calculating the gains and losses of a MIT broadly in the same way the rule in Section 295-85 of the ITAA 1997 applies to complying superannuation entities.

Limited exceptions could apply to the rule similar to those in the exceptions to the superannuation rule (sub-sections 295-85(3) and (4)) including for example

- dealing securities; and
- that part of a gain or loss which is attributable to foreign exchange rate fluctuations.

We note that proposed TOFA legislation preserves the CGT rule for superannuation entities (see proposed amendments in Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 at item 80, discussed in the Explanatory Memorandum at paragraph 11.26). Therefore a similar rule can easily be extended to MITs.

So the revenue-capital treatment will require similar rules in relation to MITs.

This capital characterisation should apply to relevant assets without any further requirement for an asset holding period of 12 months or more, because:

- a holding period requirement would introduce a level of complexity and uncertainty, both for the MIT and investors, as it would require analysing the characterisation of gains and losses on an asset by asset basis, which would be unworkable
- any such constraint, which would be more severe than applies for superannuation funds which are the major investors in managed funds, would perpetuate the distortion in funds' tax treatment and would run counter to the intent to equalize the treatment of collective investment vehicles and their investors
- such an approach would increase compliance costs because funds would have to identify, track and report on another income category, i.e. revenue gains and existing CGT systems would need to be changed to extract the short gains and not treat them as capital gains. Further short-term losses would need to be treated as revenue deductions.

The statutory rule should apply for:

- all MIT funds (as defined, to be discussed in our further submission) including property funds, equity funds, private equity funds, wholesale funds and other funds used to collect savings (particularly those used as collectors of superannuation funds' monies)
- funds that are taxed in accordance with Division 6B (corporate unit trusts) or Division 6C (public trading trusts), which should also be included at least for simplicity and recognizing that such funds can move in and out of those provisions on a yearly basis

Private equity funds should not be precluded from this capital treatment. In our view private equity funds, while they may have a finite life, accumulate the savings of superannuation funds and other investors and invest for a medium term. In fact commentators have noted that private equity funds have a longer and more stable investment profile than do many traditional managed funds[1].

The statutory capital rule should be relatively simple to implement for most funds on our understanding that generally property funds and most equity funds currently treat their gains and losses as being on capital account.

Optional election not to apply the statutory capital rule

We note that capital treatment may have adverse implications for some funds and their investors, especially in the current global financial crisis, as losses on CGT assets will be quarantined for off-set only against current year capital gains or for deduction from future year capital gains.

Some managed funds may currently return gains and losses on some of their investment assets on revenue account and that they may want to retain such treatment. We also understand that some investors would have invested in such funds on the understanding that returns would be of a revenue nature and they would therefore likely expect their distributions of fund income to remain on revenue account.

Funds should therefore be allowed an optional election not to apply the statutory capital rule to some or all of its assets but to instead treat all gains and losses on such assets on revenue account.

This election could be irrevocable which would avoid complexity in moving from capital to revenue treatment and vice-versa and would add integrity to the process.

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[1] The president of the Australian Institute of Company Directors, Mr John Story, observed that private equity was prepared to invest for a longer period than some equity investors on the stock markets:

> "They will approach an investment on the basis of a three to five year time span. That's a healthy basis. In recent years in Australia, there's been limited (ability) on the part of our markets to make that type of assessment.
>
> "They've been looking for a return in 12 months, or at the longest two years. If you can't demonstrate a return in that period, then the company is treated harshly in its share price. Private equity is gaining an advantage there because it is more realistic."

(Quoted in "Privateers thrive in over-regulation" by Rowan Callick, China correspondent, The Australian, 10 May 2007)

Short-term gains do not attract CGT discount

We note that the availability of CGT discount is already constrained. The capital gains tax laws provide that the discount capital gain treatment for individuals, superannuation funds and trusts requires a 12 month holding period by the investor (section 115-15). This provides appropriate revenue integrity in relation to short term capital gains.

Commencement date for the capital/revenue rule

The new capital rule should operate as the default position and could apply:

- optionally from the 2008/09 income year and earlier
- mandatorily from the 2009/10 year, in the absence of the making of an opt-out election to be treated on revenue account.

This will ensure funds are not disadvantaged by any new ATO published views but also to allow them sufficient time to adjust systems if necessary and to consider their position for the optional election not to apply the statutory capital rule.

Flow through characterisation for taxation of investors

The characterisation of the gains of the MIT as capital gains should 'flow through' to all investors in the MIT so that these gains are also taxed as capital gains to them.

This treatment would appear to result in all cases from the current operation of Division 115 of the ITAA 1997 and therefore these provisions should be retained. However there are some technical issues with the operation of the CGT discount rules which should be examined at the drafting stage of the above measures.

Investors in managed funds are in almost all cases either superannuation funds or individual or intermediaries for superannuation funds and individuals. Flow through capital treatment will therefore accord with Policy Principle One of the review in respect of almost all investors, that the tax treatment for beneficiaries who derive income from the trust should replicate the tax treatment they would have if they had derived the income directly.

We note that the adoption of a further general principle of flow through, as enshrined in the legislation for capital gains, would ensure that investors have certainty in respect of the taxation of distributions from their fund investments. This proposition is consistent with existing policies supporting the 'flow-through' or consistent characterisation in the hands of the trust and the investor, as mentioned in the Paper at paragraphs. 3.17-3.18, 3.21 and 6.20. However, as noted in para 6.20, those rules are somewhat uncertain and they are scattered throughout the tax law. A clear codification of the rules is therefore necessary. This is particularly important for superannuation funds and non-resident investors.

Limiting the flow through of capital gains treatment of gains made by MITs to particular kinds of investors, for example complying superannuation funds, would introduce further complexity and compliance costs. For example, differential disclosures on distribution statements would be required. Further for the purposes of TFN withholding and MIT withholding the MIT would need to ascertain the type of each investor, which can be difficult where nominees or custodians hold units on behalf of investors, in order to ascertain the correct amount of the distribution to which withholding should apply.

As noted above, Policy Principle One requires alignment of the rules for MITs with the rules for investors investing directly. Any additional rules for MITs over and above the rules applying to investors investing directly would reintroduce the very complexity, uncertainty and costs of compliance that the statutory rule for MITs is seeking to address.

We note that company investors and non-resident investors are not entitled to the CGT discount and so they will not inappropriately benefit from any change in classification from revenue to capital tax treatment in this regard.

The taxation of investors on disposal of their units or other interests in a MIT would not be changed by these new rules.

Revenue cost concerns

The terms of reference of the Board's review include that the options presented to the Government should be revenue neutral or near revenue neutral.

Although it is difficult for us to gauge the revenue impact of our submission proposals we believe that they should be largely revenue neutral on our understanding that a statutory capital rule for all CGT assets of a fund would:

- Align with the current practice of almost all managed funds, including property funds and equity funds
- Align with the current practice of almost all investors in managed funds, including in property and equity funds.

As noted above, capital treatment may have a positive impact on the revenue in respect of some funds as losses on CGT assets will be quarantined for off-set only against current year capital gains or for deduction from future year capital gains. Such revenue positive effects may offset any revenue reductions from what we believe would be the unusual case of a taxpayer changing their treatment of gains distributed by funds from revenue to capital account.