Greenwoods & Freehills

Secretary,
Board of Taxation
c- The Treasury
Langton Crescent
CANBERRA ACT 2600

taxboard@treasury.gov.au

5 December 2008
Matter 14085
By email

Dear Sir

Re: Interim Submission on Tax Arrangements Applying to Managed Investment Trusts – Response to Chapter 7 of MIT review

Greenwoods & Freehills is Australia's largest advisory firm practising exclusively in revenue law. Its clients include many of Australia's largest managed funds.

This interim submission is made in response to the request in paragraph 1.25 of the Board of Taxation's Discussion Paper ('the Paper') for early responses on the issues raised in Chapter 7, "Capital Versus Revenue Account Treatment of Gains and Losses Made on the Disposal of Investment Assets by MITs." A further submission on other aspects of the Paper will be lodged with the Board shortly.

Executive summary

(1) In our submission, the statutory codification of the revenue v. capital distinction will represent a very significant improvement to the Australian tax system. This single change would make the tax law simpler to administer, significantly reduce compliance costs and provide greater certainty to taxpayers, all of which would enhance the competitiveness of Australia's managed funds industry.

(2) An appropriate solution to the revenue / capital distinction would be achieved by inserting a legislative provision to make the current CGT rules the primary code for all profits generated by MITs from dealings with assets. Section 295-85 ITAA 1997, which currently applies to superannuation funds, is a suitable model for such a provision.

(3) If this proposal is not acceptable, the working of the revenue / capital distinction could be greatly enhanced by inserting a legislative definition based on a holding period – that an asset is treated as capital in nature if it has been continuously held by the same person for a period of (say) 12 months.

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(4) Any new regime should apply to events occurring after the commencement date but with the option for a trustee to make an irrevocable designation with respect to assets held on that date to treat those assets as being held on revenue account.

1 The need for a statutory rule

Chapter 7 of the Paper Notes that, "there are no statutory rules for determining whether gains and losses on the disposal by MITs of shares, units in unit trusts and real property should be on capital or revenue account" and asks whether the law on the capital v. income dichotomy "causes significant compliance costs to MITs."

In our view, the answers to question 7.1 varies significantly, depending largely on the industry sector involved:

- for MITs in the property sector and for bond and cash funds, the revenue v. capital distinction does not represent a serious source of difficulty;
- for MITs in the equities sector, the revenue v. capital distinction can represent a serious source of difficulty, largely because of the scope for disagreements with the ATO about the meaning and application of the appropriate law.

It is certainly true that many funds do not regard the Commissioner's views in TR 2005/23 as an appropriate summation of the current law, especially the implications to be drawn from the decisions in *London Australia* and *Myer Emporium*. While TR 2005/23 is helpful in that it lists a number of criteria which the Commissioner regards as indicating that assets are held on capital account:

- the taxpayer's investment policy does not envisage 'an exit point';
- there is a low average annual turnover of assets;
- sales are infrequent;
- sales proceeds represent a small percentage of total income; and
- the fund has a significant percentage of 'aged' stocks;

we share the scepticism expressed in other submissions about how accurately these factors reflect current law.

However, even if TR 2005/23 were an accurate statement of current law, its terms are so nebulous that it is incapable of simple and direct application. It is in many places just as Delphic as the law which it is meant to clarify for taxpayers.

Hence, in our submission, there is potentially great benefit for funds in some industry sectors from having a clear statutory rule to determine whether gains or losses made by a trustee on the

disposal, surrender or other realisation of trust assets are on revenue or capital account. For other types of funds, while there may be rather less benefit, there should not be any significant detriment to having a codified rule. A statutory rule should:

- greatly increase certainty for taxpayers and potential for dispute with the ATO;
- significantly reduce compliance costs for funds in certain industry sectors, as well as for the ATO (as the current law is as difficult for the ATO to apply as it is for taxpayers); and
- have little or no revenue cost for funds operating in many industry sectors.

Therefore, in our submission, any statutory rule should apply to all MITs (subject to the transitional application mentioned in paragraph 4 of section 1 above).

2 Defining the capital v. income border

2.1 Option A – the superannuation regime

The experience of the superannuation industry shows that having a single statutory rule for policing the capital v. revenue boundary – in that case, the CGT regime – as the exclusive regime for taxing gains and losses made on fund assets has removed significant areas of uncertainty for fund managers, and eliminated the kinds of dispute with the ATO that exist in parts of the managed funds industry.

In our submission, that model is appropriate for MITs as well because:

- it is a well understood system and so should greatly ease compliance and administration;
- it is regarded as simple and easy to apply;
- it matches the treatment that most investors in managed funds would expect to receive had they invested directly instead;
- it would not represent a change to the current law for most managed funds;
- it would not involve any danger of significant revenue leakage;
- it is unlikely to lead to changes in the behaviour of fund managers.

It may be that this rule would represent a change for funds in some industry sectors, but if that is so, there would still be great benefit from having such a rule just for those sectors where CGT treatment is already the norm.

2.2 Option B – A holding period rule

We noted above the possibility of an alternative holding period rule for determining the capital v. revenue distinction. The proposal would be for the holding period rule to operate as a safe harbour:

- CGT treatment would apply to assets held by an MIT for, say, 12 months or more;
- the current law (CGT or ss. 6-5 and 8-1) would apply to assets held for less than 12 months.

This proposal has the same benefits as any statutory rule:

- a clear demarcation greatly increases certainty and reduce compliance costs;
- because use of a statutory period mirrors the CGT-discount rule approach, it is familiar and well understood;
- it also matches the treatment that most investors in managed funds would expect to receive had they invested directly instead;
- as a matter of economic policy it more accurately rewards patient capital than the general law rule, which is largely dependent on intention at the time of acquisition rather the length of holding period;
- it does not involve any danger of significant revenue leakage; and
- it is unlikely to lead to changes in the behaviour of fund managers.

However, in our view, while representing a major improvement to current law, a holding period rule is inferior to Option A (the superannuation fund-style CGT rule). Although it should be relatively simple to administer, it will raise significant consequential issues such as handling rollovers, the treatment of successor assets (where no rollover occurs), the problem of asset stuffing (akin to s. 115-45) and significant improvements to existing assets. It would also have higher compliance costs than Option A as it would still be necessary to track dates of acquisition and disposal and for system functionality to calculate different potential outcomes.

3 Transition

In our submission, the new regime should apply to all CGT events occurring after the commencement date but with the option for a trustee to make an irrevocable designation with respect to assets (or classes of assets) held at that date, that those assets are to be treated as being held on revenue account.

Yours sincerely

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