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Managed Investment Trusts Review
Board of Taxation
c/ - The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir

Review of the Tax Arrangements Applying to Managed Investment Trusts

The Taxation Institute of Australia (Taxation Institute) welcomes the opportunity to provide its comments in response to the issues raised by the Board of Taxation in Chapter 7 of the Review of the Tax Arrangements Applying to Managed Investment Trusts (MITs). The Taxation Institute reserves the right to further clarify aspects of this submission, particularly in respect of the Australian Taxation Office's (ATO) Listed Investment Company Ruling.

Our Proposal

Legislative provision modelled after s 295-85

It is proposed that a legislative provision be inserted into the current Tax Law, which provides the current CGT rules as the primary code for all asset profits generated by MITs that qualify for the regime. We propose that such a provision be modelled after s 295-85 that currently applies to superannuation entities.

This approach is considered to be simple to administer, and that it would significantly reduce compliance costs.

Applying such a legislative provision also provides certainty in application in making the CGT rules the first port of call in any consideration of tax on an MIT's asset profits. The approach is consistent with the Review of Business Taxation's Policy Principles in that:

- Policy Principle 1: from the perspective of a large proportion of individual taxpayers, investments in assets are likely to be subject to the CGT rules, and in many cases the CGT discount rules. Applying the CGT rules to MITs retains this character; and

- Policy Principle 2: flow-through taxation of income can still be applied.

Further, it is consistent with the Review of Business Taxation's recommendation that gains from all shares and all real estate be subject to the CGT rules.

A legislative provision that applies the CGT rules as a primary taxing code makes use of law that is both current and familiar, and further eschews the necessity of a raft of new and complex operational and definitional provisions. Further, due to its current use and ease of application, s 295-85 provides an ideal model for the proposed legislative provision. Whilst variations to the model are required to limit its application, such variations should be kept to a minimum in order to retain simplicity.

Legislative provision defining capital / revenue

Alternatively, it is proposed that a legislative provision could be inserted into the current Tax Law that specifies a fixed time beyond which a relevant asset holding will be considered capital in nature – e.g. an asset continuously held by the same person for a period of 12 months, excluding situations where an agreement as to the disposal of the asset has been entered into within the 12 month period (i.e. similar to the discount capital gains rules).

This approach retains the current CGT system as well as the application of the general revenue provisions of ss 6-5 and 8-1, again bypassing the need for new and complex CGT-based legislation applying only to MITs. It also deals directly with the complexity of the capital / revenue distinction by providing a definitive answer in all situations as to whether a gain or loss is on revenue or capital account.

Although relatively simple to administer, it is considered that this approach may have given rise to subsequent issues relating to intangible assets, beneficial entitlements, asset rollovers and other concessional treatment. Additionally, the application of an arbitrary 12 month (or other similar) period may not cater to all particular circumstances. There is also the additional difficulty of characterising assets that are held for the purposes of hedging, although it is noted that this may be dealt with under the new TOFA legislation.

However, the approach is still sound in providing consistency in its approach, whilst the fixed period reflects a practical reality for most situations involving the capital/revenue distinction when holding an asset. The approach also corresponds to the familiar use of the CGT discount.

Direct responses to Q7.1

a) How the case law principles apply to and/or are applied by MITs, and whether the principles are applied consistently across the different industry sectors

This question relates to the principles applied by TR 2005/23 in interpreting the rules arising from, in particular, the *London Australia* case and the *Myer Emporium* case.

Paragraph 9 of the Ruling briefly summarises the Commissioner's perspective on the revenue-capital dichotomy:

> *"If on the facts the disposals of investments on a listed investment company are undertaken as part of carrying on a business of investment, the gains or losses on such disposals of investments will be on revenue account…On the other hand, where the disposal of investments amounts to no more than a mere realisation or change of investments, i.e. the disposals have not been made as part of a business or investment, the gains or losses will be on capital account."*

In light of *London Australia* and *Myer Emporium*, the Commissioner has formed the view that:

- investment strategies which do not envisage an "exit point" for some investments are an indicator that the portfolio is on capital account; and
- where the sale of stock is a mere realisation or change of investment, the proceeds are recognised as capital gains or losses.

The Ruling considers further cases and attempts to formulate "indicia which would contribute to a capital account conclusion".

"80. The absence of an investment style which envisages an exit point is one indicator that the portfolio would be held on capital account, so that any disposals from that portfolio would be mere realisations of investments. The 'buy and hold' philosophy is an example of such a style. The relevant case law discloses other indicia which would contribute to a capital account conclusion.

These may include:

- *a low average annual turnover (that is, less than London Australia, where the average turnover had been in the order of 10%);*
- *a lack of regularity in sale activity (AGC (Investments) Limited v. FC of T 92 ATC 4239 (AGC (Investments)); Trent Investments Pty Ltd v. FC of T 76 ATC 4105);*
- *a high proportion of stocks sold have been held for a significant number of years (see AGC (Investments) - 75% of stocks sold held more than 5 years). However, if a high proportion of the remainder are turned over, this tends to the opposite conclusion;*
- *a low level of sales transactions compared to the number of stocks in the portfolio (see Milton Corporation v. FCT 85 ATC 4243);*
- *profits on sale normally constitute a small percentage of total income; and*
- *significant percentage of 'aged' stocks remain in the portfolio (AGC (Investments) - nearly 60% of stocks held more than 10 years)."*

The Taxation Institute do not accept the Commissioner's views for the following reasons.

Indicia of capital

The Ruling briefly refers to *AGC Investments*[1] and *Milton Corporation*[2] and identifies factors in which proceeds are on capital account when an investment is sold. These factors, or "indicia" of capital fail to distinguish between the ratio of each of these cases and the particular circumstances of the taxpayers in these cases. Indicia which would contribute to a capital account conclusion should directly reflect the judicial tests employed in all these cases.

Paragraph 80 of the Ruling states that a low average turnover ratio in the case of *London Australia* is an indicia of proceeds on capital account. However, the turnover proposition in *London Australia* was not the ratio of the case. The test in this case was whether the realisation or conversion of the securities "is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business."[3]

The taxpayer in *London Australia* systematically sold shares at a profit for the purpose of increasing the dividend yield of its investments such that the sale of the shares was a normal operation in the course of carrying on the business of investing for profit. Accordingly, it was held the proceeds from the sale of the shares were business profits of the investment company.

The Court considered that a large part of the taxpayer's activities centred around the collation and assessment of materials and the making of decisions about share disposals, retentions, and purchases with a view to maintaining the optimum capital base or dividend return.[4]

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[1] *AGC Investments Limited v FC of T* 92 ATC 4239.
[2] *Milton Corporation v FCT* 85 ATC 4243.
[3] *London Australia Investment Co Ltd v Federal Commissioner of Taxation* (1977) 15 ALR 203 as per Gibbs J.
[4] *London Australia* as per Jacobs J on p. 217.

Hence, it is clear that the Court gave broad consideration to the taxpayer's investment policy and its conclusion was not largely based on the taxpayer's annual turnover of shares. The "low average annual turnover" indicia fails to reflect the important test of whether the sale of the shares was a normal operation in the course of carrying on the business of investing for a profit.

Ruling fails to address recent and early decisions in respect of the revenue-capital distinction

While the Ruling briefly discusses the decision in *London Australia* and *Myer*[5], limited references were made to subsequent cases which deal with the revenue-capital distinction issue in relation to capital gains derived from the disposal of investments.

The Ruling should also consider the following cases which deal with profits or gains made from the disposal of investments (including shares and property); and whether such gains should be kept on revenue or capital account.

Australasian Catholic Assurance[6]

The taxpayer company sold 14 blocks of flats at a substantial profit. These flats were bought as good investments over the long-term and were expected to generate a 10% annual return through rental income over approximately 30 years.

Due to rent control and rising maintenance costs during WWII, the taxpayer decided to sell the flats. The profit from the sale of the flats was treated as assessable income as Menzies J of the High Court held that:

> *"the taxpayer, as part of its ordinary investment business, bought real estate to obtain a high return and sold it profitably when it was found to be producing a low return, and so made a profit upon its buying and selling which I regard as income according to ordinary concepts, because in the ordinary course of carrying on a business, the taxpayer must from time to time change its investments to use its funds to the best advantage."*

However, as subsequent cases demonstrate, there are other instances where entities dispose of their investments so they can use the funds to their best advantage, yet such gains can still be treated as capital gain (see *National Bank, AGC Insurance* and *Equitable Life*).

As noted in the Ruling, the *Myer*[7] case is authority for the proposition that where the sale of stocks is merely a realisation or change of investment, the proceeds are recognised as capital gains or losses.

> "*It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realisation. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction"*

National Bank[8]

The taxpayer agreed to merge with a Queensland bank in 1948 and agreed to acquire from it particular shares owned by the bank in a pastoral company. It was found that the purpose of the acquisition of the shares was, in part, to retain the pastoral company as its customer and persons who engaged in business with it; partly, a desire to be associated with rural interests in Queensland; and partly, a desire to receive dividends from its investments. However the governing factor was the taxpayer's desire to merge with the Queensland bank with as little

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[5] *FC of T v Myer Emporium Ltd* (1986-1987) 163 CLR 199 at 213.
[6] *Australasian Catholic Assurance Co v FCT* (1959) 100 CLR 502.
[7] *FC of T v Myer Emporium Ltd* (1986-1987) 163 CLR 199 at 213 at para 4369
[8] *National Bank of Australasia Limited v FC of T* 69 ATC 4042 as per Kitto J

disturbance of existing relations with the public and public authorities as possible and to facilitate the continuity of the business.

Kitto J considered the issue of whether the profit on the sale should be considered as being an income receipt:

> *"The purchase of the shares bore no resemblance to an investment of banking funds, made to earn income pending a need for their deployment in the making of advances and the like; it bore no resemblance to an investment by way or erecting a second or third line of defence against a time of stringency or emergency. It was an acquisition, not of the kind that might be repeated in the course of the profit-earning process, but made once and for all for the sake of enhancing, even if only for the time being, the profit-earning potential of the enterprise as a whole … the acquisition of shares did not follow any pattern of investment that the National Bank had followed; it is to be accounted for solely as part and parcel of the takeover of the Queensland National Bank's whole undertaking."*

Kitto J concluded that the expenditure for the shares was akin to a purchase of goodwill rather than a purchase of property to be turned over in the course of business. Accordingly, the profits derived from the sale of the shares was held to be on capital account.

AGC Investment[9]

The taxpayer was a wholly owned subsidiary of an insurance company, which was used as a vehicle for investing the excess funds of its parent. The taxpayer claimed that it acquired the securities with a view to their long-term capital growth. In September 1987, the taxpayer believed the share market was overvalued and instructed the manager of its portfolio to start selling shares in listed companies and to reinvest the proceeds in fixed-interest securities.

The taxpayer made a resulting profit of $45 million which the Commissioner included in the taxpayer's assessable income.

The taxpayer in *AGC Insurance* was distinguished from the case of an insurance company, or a bank. Ordinarily, where insurance companies and banks need to buy and sell securities on a regular basis to maintain liquidity, these activities are considered to be a normal step in carrying on a banking or insurance business, with the consequence that the profits so earned are regarded as income. Upon evidence presented before the Full Federal Court, it was held that there was no necessity for the taxpayer to buy the securities in question in order to maintain the liquidity of AGC Insurances. Hence the gains from the disposal of securities in this instance were held to be on capital account.

GRE Insurance[10]

Unitraders was a wholly owned subsidiary of Union Insurance Society Canton Ltd, another member of the group. In that year, GRE Insurance Limited ("**GRE**") acquired all the shares in Unitraders for $2.5 million. Between October 1980 and January 1982, GRE sold to Unitraders all the equities which it held in its investment portfolio. The sole purpose of the sales were to ensure that the benefit of the rebates on dividends under s.46 the *Income Tax Assessments Act* (Cth) 1936 was preserved.

GRE expected that there may be a period where no assessable income would be earned. In this case, GRE could not obtain the benefit of the rebate of dividends for which s.46 provided, as the rebate was against tax payable.

After the sale of all the equities in its investment portfolio to Unitraders, there was no relevant change in GRE's investment strategies and business operations. Decisions to buy and sell continued to be made by the Investment Department in London.

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[9] *AGC (Investments) Limited v FC of T* 92 ATC 4239.
[10] *GRE Insurance Limited v FC of T* 92 ATC 4089.

The Full Federal Court held that the activities of Unitraders were an integral part of the insurance business conducted by GRE and although the equities were held by the subsidiary, Unitraders, rather than GRE directly:

> *"… the equities indirectly formed part of the funds representing the insurance reserves and part of the circulating capital of the business … the equities were not sold by GRE to Unitraders because it was a prudent time to dispose of or realise the investments. Nevertheless, profits were made on the sales of assets that formed part of the circulating capital .. because these profits arose from equities which had been held as part of the investment portfolio of the insurance business, the profits made were in that sense normal and ordinary profits of the insurance business."*

The Court also found that part of the investment strategy of the company was to hold a proportion of equities, and that varying the proportion of the equities was required if it seemed prudent from an investment point of view.

Westfield[11]

This case dealt with the situation of isolated transactions. It followed the principles from the *Myer* case whereby a profit or gain made from an isolated transaction will be treated as income if circumstances are such as to give rise to the inference that the taxpayer's intention or purpose of entering into the transaction was to make a profit or gain.

In this case, Westfield (the taxpayer) was in the business of designing, constructing, letting and managing shopping centres. In 1978, the taxpayer acquired an option to buy a block of land with the potential of developing a shopping centre. The taxpayer's initial plans were to develop the land itself.

The option was exercised and the land was later sold to AMP at a profit on the agreement that Westfield would be given the contract to design and build a shopping centre on the subject land. Hill J of the Full Federal Court considered that obtaining the contract to construct and manage the shopping centre is not a scheme of profit making per se, but a scheme for deriving income from the performance of work under the agreement. In particular, where a transaction falls outside the ordinary scope of business, an intention or purpose of profit making must be established to point to the conclusion of a revenue receipt.

> *"The judgement, not only in the passage, but in several later passages (at 211-213), emphasises that where a transaction occurs outside the scope of ordinary business activities, it will be necessary to find, not merely that the transaction is "commercial" but also that there was, at the time it was entered into, the intention or purpose of making a relevant profit.*
>
> *What was said in Myer has been applied in a number of cases in this court since. Among them are Moana Sand Pty Ltd v FC of T 88 ATC 4897 and FC of T Cooling 90 ATC 4472; (1990) 22 FCR 42. It does not, however, follow from the judgement in Myer, or for that matter, from the judgements in any later cases, that every profit made by a taxpayer in the course of his business activity will be of an income nature. To so express the proposition is to express it too widely, and to eliminate the distinction between an income and a capital profit."*[12]

The Full Federal Court found that the taxpayer at the time of acquisition had no purpose of reselling the land. There was only the possibility that the land may be resold. In this instance, a profit making intention or purpose of the taxpayer could not be established. Accordingly, the profit from the sale of land was held to be a capital receipt.

CMI Services[13]

This case dealt with the sale of residential properties. The taxpayer was a subsidiary of an insurance company set up to invest surplus funds of the parent company. The funds were used to

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[11] *Westfield Ltd v Commissioner of Taxation* (Cth) 90 ATC 4801
[12] Ibid at 4241
[13] *CMI Services Pty Ltd v FCT* (1990) 90 ATC 4428.

purchase residential properties with the intention of holding them as long as they provided acceptable rental income and did not demand too much management effort.

Two properties were sold when structural faults were discovered. The taxpayer was carrying on a business of investing for the purpose of producing income; but the facts disclosed that the buying and selling of real estate was done as part of the taxpayer's business of investing for the purpose of producing income.

Although the taxpayer's business was to invest in real estate, the conduct of that investment business required that the real estate portfolio be considered and monitored on a regular basis and that real estate should be sold when its market yield dropped to an unacceptable level.

The Full Federal Court held that the sale of residential properties was done as part of the taxpayer's business for the purpose of producing income. The profit made on the sale simply arose according to its investment plan and accordingly, the resulting profit was assessable.

Equitable Life[14]

The taxpayer carried on a life insurance business and decided to abandon the business. The company retained the share portfolio, which was the source of its income. Shares were periodically sold over 7 years until the whole portfolio was sold. The Full Federal Court held that the taxpayer's profits did not derive from any business activity because it lacked a management or investment strategy and accordingly, the profits were not income.

Relevance of these cases to investment entities

In summary, these cases examine the ordinary activities of businesses (including investment companies) in the context of their investment policies and investment patterns to discern, on a case by case basis, whether the gains or profits from the disposal of investments constitute the assessable income or capital gain of the business.

Ordinarily, gains or profits on the sale of investments are treated as ordinary (revenue) income to the taxpayer where the investments are disposed pursuant to the entity's investment strategy that directs the entity's ordinary business activities (*CMI Services, GRE Insurance*). Even in the case of isolated transactions, profits or gains are held to be on revenue account where the sale of an investment (though incidental to a transaction), would constitute the ordinary business activities of the taxpayer when the transaction is viewed as a whole.[15]

However, the above cases also show that there are circumstances where gains or profits were held to be on capital account, especially where:

- the shares were acquired in the context of a takeover of a competing business (*National Bank*);
- there was no pre-determined exit strategy (*Westfield*);
- where the purchase of shares was unnecessary for the liquidity of the business (*AGC Insurance*);
- there is no profit making purpose or intention behind a taxpayer in acquiring an asset (*Westfield*);
- the activities lack a relevant management or investment strategy (*Equitable Life*).

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[14] *FCT v Equitable Life & General Insurance Co Ltd* (1990) 90 ATC 4438.
[15] *Westfield Ltd v Commissioner of Taxation* (Cth) 90 ATC 4801.

Application to trusts

It is important to note that while nearly all these cases deal with investment companies, there are few which deal with investment trusts. The cases of *Charles*[16] and *Radnor*[17] provide guidance on the Court's approach to the treatment of gains and profits derived by trusts on the disposal of an investment.

Charles' case deals with a trustee managing a portfolio of shares in a trust fund. Moneys said to be taxable were received by the beneficiaries of a unit trust and derived from the realisation of investments held by the trustees. Evidence was given that at no time were securities acquired for the express purpose of resale at a profit, and that sales were normally made when the managers anticipated a fall in the value of shares. Consequently, the transactions were effected "in the course of performing a fiduciary duty" to beneficiaries to preserve assets in the trust and any increments in the value of those assets which may be at risk. Hence the gains or losses were not regarded as ordinary (revenue) income or losses of the unit trust.

The decision therefore considered that gains or profits from the sale of investments realised by a trustee managing a portfolio of shares in a trust will be on capital account where the trustee is simply performing his or her fiduciary duty to beneficiaries.

In the case of *Radnor* the taxpayer was a company established by a trustee to hold the investments of three companies set up for the benefit of people with physical and mental disabilities. The members of the families made the investment decisions; however, a professional manager was appointed to manage the portfolio. The manager followed an investment policy which sought dividend income with low capital risk and growth for protection against inflation. The manager instructed the taxpayer company to change the investments, from which profits were realised. Notwithstanding the frequency of the transactions and the appointment of a manager, the Full Federal Court held that the profit was not business income because the company was "obliged to invest to generate income through dividends but also to act to protect capital".

Therefore, the Courts consider that the disposal of investments which give rise to a profit or gain are not assessable as ordinary (revenue) income where the obligation of the trustee is to maintain the trust and protect the capital for its beneficiaries.

Conclusion

The above analysis indicates that the Commissioner's views in TR 2005/23 are inadequate in determining the capital/revenue distinction. Additionally, it also indicates the current case law to be focused primarily on corporate bodies, leaving significant difficulty in applying it to trusts in general. MITs in particular are in an even more unique position, as acknowledged by the MIT review, so that the application of broad "one-size-fits-all" rules becomes inappropriate and inconsistent – a fact made more so apparent by the incongruency of the Commissioner's views with ours.

This further highlights the need for a legislative code applying MITs' asset profits.

b) Is the current requirement to distinguish between capital and revenue treatment on disposal of certain assets one that causes significant compliance costs to MITs, and if so, how?

As noted above, having to determine between capital or revenue treatment on a disposal of assets currently means a great reliance on case law principles. The disparate views and inconsistent interpretation of that case law make it difficult to provide certainty in determining whether revenue or capital treatment ought to apply to a particular set of circumstances – especially where trusts are concerned, and even more so where MITs are concerned.

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[16] *Charles v FCT* (1954) 90 CLR 598.
[17] *FCT v Radnor Pty Ltd* (1991) 91 ATC 4689.

As an accepted principle, this consideration must be applied on a case-by-case basis, ruling out a broad application. Strictly speaking, the determination is to be made on an asset-by-asset basis, thereby significantly increasing the costs of compliance.

The proposals suggested no significant cost, and in fact have potential to reduce the current costs of compliance.

e) If statutory capital or revenue account treatment were to apply to MITs, how could specific rules be structured?

Legislative provision modelled after s295-85

As noted above, it is desirable for new statutory legislation to be as simple and easy to apply as possible. We do not consider any new legislative provision applying capital account treatment to require significant changes to the current CGT provisions, or to require new CGT-based divisions. The legislation need only require the preferential application of the current CGT provisions over the general provisions of s6-5 and s8-1.

It is noted that, as a matter of technicality, the CGT provisions are considered to apply whenever a CGT event occurs, regardless of whether a revenue characterisation applies. As a matter of practice, the CGT provisions are therefore considered whenever there are assets dealings.

Given the successes of the current s295-85, modelling the proposed statutory capital account treatment on s 295-85 would provide familiarity in the way the proposed provision operates, thereby limiting compliance costs. As mentioned above, variations to the model should be kept to a minimum in order to retain the provision's simplicity and ease of operation.

Legislative provision defining capital / revenue

In the alternative, a proposed time-based legislative rule determining the capital / revenue nature of an asset would apply an arbitrary time period for holding an asset (e.g. 12 months) beyond which a capital distinction would be applied. The normal CGT rules would then apply to assets held by an MIT for 12 months or more, whilst the general ss 6-5 and 8-1 provisions would apply to those held for less than 12 months.

Timing of application

An extended issue to any specific rules so legislated would be the time for application and any transitional rules required. Given the timeframe for legislative review and the widespread industry discussions being conducted, we consider it appropriate for the proposed legislative provision to apply to all relevant asset disposal transactions entered into by MITs after a definitive application date, coupled with a notice period. This would provide sufficient time for MITs to make preparations for the provision's application, without the need for grandfathering provisions, and without delaying the provision's application unnecessarily.

If you require any further information or assistance in respect of our submission, please contact the writer on 03 9286 6135 or the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

Sue Williamson
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