Level 2
95 Pitt Street Sydney, NSW 2000
Telephone 02 8223 0000
Facsimile 02 8223 0077
Email tia@taxinstitute.com.au
Website www.taxinstitute.com.au
ABN 45 008 392 372

23 December 2008

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

Email: taxboard@treasury.gov.au

Dear Sir

Submission on Tax Arrangements Applying to Managed Investment Trusts ('MITs')

The Taxation Institute of Australia ('Taxation Institute') is please to provide it comments in response to the Board of Taxation's *Review of the Tax Arrangements Applying to Managed Investment Trusts* ('Discussion Paper') issued on 29 October 2008.

In addition to our comments set out below, the Taxation Institute lodged an interim submission on 5 December 2008 in response to the issues raised in Chapter 7 of the Discussion Paper, "Capital Versus Revenue Account Treatment of Gains and Losses Made on the Disposal of Investment Assets by MITs." That submission is attached as an Appendix to this document.

In our submission below, we have not attempted to address comprehensively the remainder of the issues raised in the Discussion Paper. Rather, we address what we see as key threshold issues raised in the Discussion Paper, namely:

- the requirements to qualify for an MIT regime (Chapter 11 of the Discussion Paper);
- the need for effective "flow through" treatment (Chapter 6 of the Discussion Paper); and
- how different models could appropriately address the need for "flow through" treatment (Chapter 4 of the Discussion Paper).

The Taxation Institute is happy to work in further consultation with the Board in resolving these threshold issues and the other issues raised in the Discussion Paper.

Executive Summary

Our main submissions are as follows:

- The qualification requirements to qualify for an MIT regime should be set in a way that:
  - provides certainty of application; and
  - does not distort efficient portfolio construction (e.g. distortions which hinder the use of wholesale funds).

- In order not to discourage investments in professionally managed portfolios (implicitly with higher returns for lower risk), there should not be distortions which advantage direct investment. This requires a high degree of flow through treatment (including of underlying "tax preferred" amounts such as franking credits and discount capital gains).

- Although it is theoretically possible to achieve these results under any of the options suggested in the paper, a dividend deduction model would involve considerable complexity as compared with the existing flow through treatment of Division 6 *Income Tax Assessment Act 1936* ('ITAA 1936') trusts. If a dividend deduction model were to be introduced, it would be necessary to consider ways to minimise the number of "components".

Set out below are our detailed comments in relation to the above submissions.

The requirements to qualify for an MIT regime

In Chapter 11 of the Discussion Paper, the Board has sought comment on the following questions:

11.1

(a) what is an appropriate approach to defining "widely held" for the purpose of any new MIT regime;
(b) should rights attaching to interests in an MIT be uniform;
(c) should an MIT be able to make an irrevocable election to be governed by the new MIT regime; and
(d) what compliance burden might arise if some trusts are within the new MIT regime and others are outside and there are crossing-holdings in funds.

The Board's terms of reference are to review the income tax arrangements for widely held collective investment vehicles.[1] The approach of the above questions presupposes that there is a need to define "widely held" for the purposes of completing this review. It is submitted that this may not be the best starting point.

There are several criteria that could be used to define the type of entity that should be capable of being subject to a new MIT regime that incorporates all widely held collective investment vehicles:

(a) a trust to which CGT event E4 can apply in respect of the whole of the fund of assets, thus excluding trusts with discretionary objects;

(b) a managed investment scheme for the purposes of the Corporations Act, registered or unregistered, perhaps limited to those managed investment schemes that are trusts;

(c) the concept of "managed fund" used in Subdivision 12-H of the *Taxation Administration Act 1953* ('TAA 1953'), which includes a concept of "widely held"); or

(d) some other test that involves the potential for interests in the trust being offered to the public.

However, we note that even amongst these formulations there is the potential for certain types of wholesale trusts not to satisfy the requirements of one of those options. Accordingly, if one such option is adopted it would be necessary to expand the definition to ensure that such trusts are capable of being subject to the regime.

The quantitative tests that are currently used[2] create very high compliance costs, partly through the work involved in doing the calculations and partly through the uncertainties that arise. Similarly, the current use of "fixed trust" creates a lot of uncertainty as MITs are totally dependent on the

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[1] paragraph 1.5 of the Discussion Paper
[2] set out in Appendix G of the Discussion Paper

exercise of the Commissioner’s discretion. A qualitative approach like those set out in (a), (b) and (d) above will work more efficiently.

Another approach is to have no distinction whatsoever. That is to say that any trust could be subject to an MIT regime. When one considers the particular benefits that are intended to accrue to an entity that would be subject to an MIT regime, it would appear that there are 3 possible categories:

- capital gains tax treatment;
- the application of the rules in subdivision 12-H; and
- reduced complexity and reduced compliance costs.

In relation to an application of a statutory CGT rule, there are probably only a few situations that a non-MIT would be subject to revenue taxation as opposed to capital taxation in respect of the disposal of its asset. For example, a small closely held fund is likely to have CGT treatment apply under normal rules. While there might be certain exceptions, the Taxation Institute questions if it is appropriate to design a regime just to deal with those exceptions. In relation to the application of subdivision 12-H, it is submitted that from the MIT’s point of view this imposes obligations on an MIT as much as it provides benefits to investors. Finally, to the extent which there are reduced compliance costs as a result of the adoption of a new MIT regime, to the extent that entities that might not otherwise satisfy one of the above tests (or even a widely held test), a reduction in compliance costs and complexity can only be a good thing.

To the extent that any rules are created to distinguish between an MIT and other kinds of trusts, there will be issues around times of testing (including intra year), dealing with start-up and wind-down phases and tracing problems when such rules are adopted. Such requirements will only go to increase compliance costs.

It is submitted that:

- there should be no requirement that interests in an MIT be uniform. There are a significant variety of managed investment trusts currently on offer that provide different classes of units to meet different commercial requirements. Often, for example, differential fees between wholesale, mezzanine and retail unitholders are necessary to reflect the costs associated with those types of unitholders. This necessitates different classes of units to reflect those different fees and the subsequent interest in the underlying assets that a unitholder will benefit from. Further, as greater sophistication is achievable in the system design supporting MITs, it will be possible that a greater number of trusts will allow for differential asset election within a single trust. This will necessitate differential unit classes. There is no fundamental integrity issue that should necessitate uniformity of the interest in order for a trust to qualify for an MIT regime and

- it would provide a certain degree of flexibility for an MIT to be “opted in” to the regime. It is accepted that, for integrity reasons, such an option should be irrevocable.

In relation to the compliance burden that might arise where certain trusts are within the new MIT regime and others outside it, we agree that where cross-holdings exist it would be likely that significant costs would arise. In many cases, such trusts would exist within the same platform offered by an Australian financial service licence holder.

This would mean that a dual systems would need to be maintained thereby effectively doubling the costs associated with an MIT regime.

Even where an AFSL holder only offered an MIT-regime trust or non MIT-regime trust, it is likely, given the connection between the different managers within the industry, that such cross-holdings will still occur. Accordingly, there will still be a need to maintain the dual systems regimes to deal with the fact that distributions will be received from or made to a non-MIT by an MIT.

The need for effective "flow through" treatment

Paragraphs 6.19 (and those following) of the Discussion Paper raise the issue of the character of amounts in the hands of the trustee flowing through to the beneficiaries entitled to those amounts.

The Principles That Are Needed

The Board's terms of reference provide a number of policy principles. The first of these is that the tax treatment for trust beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly.[3]

In addition to these policy principles, there is an objective of enhancing the international competitiveness of Australian managed funds to help ensure the future prosperity of the Australian economy.[4]

MITs hold such a large proportion of investment assets that any aspect of the income tax system that is designed to influence the behaviour of investors needs to flow through MITs or it will be ineffective.

For the design of the income tax system to be effective and to meet the Board's policy principle and objective noted above, a number of significant characteristics need to flow through to beneficiaries. Each of these significant characteristics are dealt with below, followed by a consideration of characteristics that are currently preserved that perhaps do not need to be preserved in a new regime.

Characteristics that need to be preserved

This section deals with the characteristics of the income in the hands of the trustee that need to be preserved.

- Capital Gains Tax Discounts

Capital gains tax discounts make a significant difference to the amount of tax payable by the beneficiary. If investors cannot get the benefit of capital gains tax discounts investing via an MIT then the majority would bypass MITs and invest directly. This would be a major breach of the policy principle identified above. Because the discounts are at different rates for different taxpayers, the MIT has to identify to the beneficiary whether a capital gain has been reduced by the discount or not. If it has and the beneficiary is not entitled to a 50% discount then the beneficiary has to adjust the outcome.

- Capital Gains Tax Treatment for Non-Residents

Aligning Australia's treatment of capital gains made by non-residents with international practice is an evolution that is still in progress. This has been a fundamental aspect of moving towards the objective of Australia becoming a regional financial centre.

Section 855-40 *Income Tax Assessment Act 1997* ('ITAA 1997') was explicitly introduced to provide comparable taxation treatment between direct ownership and indirect ownership through MITs (see section 855-40(1)). This is fundamental to the international competitiveness of MITs.

- Capital Gains Tax Character

The consequence of a capital gain maintaining its character is the ability to offset capital losses from against it. This includes capital losses from redeeming units in the MIT as well as capital

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[3] paragraph 1.7 of the Discussion Paper
[4] paragraph 1.4 of the Discussion Paper

losses from other sources. This former facility is particularly important in increasing the equity between the beneficiaries of the trust as can be demonstrated with the examples on pages 37 and 38 of the Discussion Paper.

The flaw in these examples as they are written is that the trustee in each example does not distribute cash to match the $250,000 capital gain being included in assessable income. If the trustees did this, then the beneficiary would have an increase in their capital loss or reduction in their capital gain on redemption of their units. This would balance the $250,000 that the examples show as being taxed a second time.

This is not a perfect offset. It will often occur in a later year and if it is a capital loss it will only be of value if there is a capital gain in that or a subsequent year. Nevertheless, the distortion would be even greater if capital gains made by the trustee were not treated as capital gains in the hands of the beneficiary. This at least significantly increases the chances of having capital gains to offset a capital loss against.

Because distributing cash to match the assessable capital gain maximises the beneficiary's position, the trustee would be in breach of their duty if they did not do so. They would also be in a breach of their duty if they did not inform themselves sufficiently of the tax law to know this. It is a standard technique used in the industry to distribute cash in these circumstances.

A tangential point to make about these examples is that it is better to rely on the trustees to meet their duties in this way than to introduce a complicated mechanism such as cost base adjustments to address these distortions. Trustees are generally getting this matter right. Adding complexity to the system is not warranted.

- Foreign Income for Non-Residents

The primary requirement for any jurisdiction around the world to play a role in the global funds management industry is that the jurisdiction not tax income sourced outside of the jurisdiction that belongs to people outside of the jurisdiction. This is the central principle in the funds management regimes in places like Luxembourg and Ireland.

It is therefore necessary that MIT income that is foreign sourced not be taxed when the beneficiary is a non-resident. This requires tracking the source of the MIT's income.

- Conduit Foreign Income

The conduit foreign income regime preserves the character of foreign income as it passes through Australian resident companies. The consequence is that no withholding tax is paid on an unfranked dividend to the extent it is conduit foreign income. This is the equivalent for businesses of the principle in the previous dot point for MITs. It removes a distortion for global businesses based in Australia they way the principle in the previous dot point removes a distortion for global investing MITs based in Australia.

These two systems come together when an MIT holds Australian shares that pay conduit foreign income. To enable both the MIT and the conduit foreign income regimes to be effective, conduit foreign income has to be tracked as it passes through an MIT.

- Franked Dividends for Non-Residents

It is a principle of our income tax system that company tax is a sufficient impost on non-residents. Consequently, similar to conduit foreign income, no withholding tax is paid on franked dividends paid to non-residents.

This treatment needs to be maintained as explained above in respect of conduit foreign income.

- Foreign Income for Residents and Foreign Tax Offsets

The foreign tax offset system limits the offset to the amount of Australian tax payable on foreign income. To maintain this principle for foreign tax paid by MITs the character of the foreign income needs to be retained in the hands of the beneficiary.

The proper way for this to work is for the beneficiary's share of the foreign tax and foreign income to be added to any other foreign tax paid and foreign income derived by the beneficiary before the calculation of Australian tax payable is done.

- Interest, Dividend and Royalty Income for Non-Residents

If the Board is required to make revenue neutral recommendations to the Government[5] then it will be necessary to recommend that Australian sourced interest, unfranked dividends and royalties be tracked separately to each other and separately to other Australian sourced income. This will be necessary to apply the different withholding tax rates.

- Franking credits for Residents

Franking credits are one of the main attractions for investing in Australian shares so investors would not use MITs if franking credits were not to flow through.

The current system flows franking credits through MITs to residents without requiring that franked dividend income flow through. In the broader income tax system franking credit offsets are not limited by reference to income the way foreign tax offsets are. The MIT rules therefore do not need to be as restrictive.

The current system does not allow franking credits to flow through MITs if there is no assessable income at all for beneficiaries in that year. There is no logical reason for this. Franking credits should flow through even if the allowable deductions of the MIT exceed its assessable income. This would better reflect the principle of replicating the tax treatment for beneficiaries as if they had derived the income directly.

- Infrastructure Income

Section 159GZZZZG ITAA 1936 provides an election to treat infrastructure borrowing income that would otherwise be exempt to be assessable and subject to a 30% rebate. This is to encourage superannuation funds who have a 15% tax rate to invest in infrastructure.

Section 396-15 ITAA 1997 provides a similar 30% offset for certain income from borrowings in respect of land transport facilities.

As superannuation funds invest a lot of their capital via MITs, the effectiveness of these infrastructure incentives will be reduced if the character of this income does not flow through MITs.

- 'Tax Free' Distribution Components

Distributions from an MIT in excess of its taxable income generally give rise to a cost base adjustment. Industry jargon calls this the 'tax deferred component' of the distribution. Some distributions in excess of taxable income though do not give rise to a cost base adjustment. There is a specific list of these in section 104-71 ITAA 1997.

The ones relevant to MITs are:

  - non-assessable non-exempt income (section 104-71(1)(a));

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[5] See paragraph 1.2 of the Discussion Paper.

- income taxed in the hands of the trustee (section 104-71(1)(c));
- income and gains from pooled development funds (section 104-71(3)(a)(i) and (3)(b));
- income from infrastructure borrowings (section 104-71(3)(a)(ii)); and
- amounts sheltered by the capital gains tax discount (section 104-71(4), Item 1).

These are amounts where a cost base adjustment would impose a further amount of tax that would be inappropriate. Industry jargon calls the sum of these the ‘tax free component’ of the distribution.

It will be an inevitable part of any regime for taxing MITs and MIT investors that there will be both some distribution components that are not assessable but give rise to a cost base adjustment and some distribution components that are not assessable and do not give rise to a cost base adjustment. Any regime will have a ‘tax free component’ of a distribution.

Characteristics that do not need to be preserved

This section deals with the characteristics of the income in the hand of the trustee that do not need to be preserved.

- Capital Gains Tax Indexation

Capital gains tax indexation continues to be a feature of the system. Investors can choose whether the apply indexation or the capital gains tax discount.

The amount of indexation was frozen in September 1999 reducing its usefulness. As companies are not entitled to the discount, indexation continues to provide a small benefit to them for assets acquired before September 1999. The other circumstance where a taxpayer would choose indexation over the discount is where there are capital losses to offset. Capital losses neutralise the discount but do not affect indexation.

Even with both these cases the benefit that investors in MITs are getting from the availability of indexation is relatively small. The choice that exists though makes the capital gains tax rules very complicated for MITs. MITs work on a large scale so it is necessary to program the capital gains tax rules into software. It is extremely complicated to program the many scenarios that arise in trying to optimise this choice.

To remove indexation as a choice in calculating the taxable income of an MIT would remove a small benefit but also a lot of compliance costs. It is something that is likely to be attractive to the industry.

- Attributable Income

The Board recently reviewed the anti-tax deferral rules. One aspect that was controversial was the treatment of interests in a controlled foreign company (CFC) or foreign investment fund (FIF) held via trusts. The controversy was whether the attribution accounts should be kept at the beneficiary level or the trustee level.

Attribution accounting at the beneficiary level is more accurate but more complicated. The nature of MITs is that investors get significant benefits from pooling their capital with other investors and in return accept that the tax outcomes in the short term can be slightly inequitable. Attribution accounting is an area where this trade off would be a positive one.

Tracking attributable income at the level of the MIT investor and the associated attribution accounting requires a very large amount of data. In a typical MIT, investors are coming and going all the time making tracking their interest in each CFC or FIF very time consuming.

Whatever the rule is for other trusts, attribution accounting for MITs should only happen in calculating the taxable income of the MIT. It is then unnecessary for the character of this income to flow through to the investor, other than to recognise it as foreign income.

- Exempt income

Part of the tax free component of a distribution described above is exempt income in the hands of the beneficiary. This would be the PDF income and the infrastructure income.

A taxpayer is normally required to offset a loss carried forward against exempt income. To maintain this principle would require the character of this part of the distribution as exempt income being retained in the hands of the beneficiary.

It would be quite rare that an MIT would have this type of income at the same time as a beneficiary had losses carried forward. The amounts would be trivial. It is therefore not worth requiring this character to flow through.

- Primary production income

The role of the managed investments scheme industry in agriculture is politically controversial.[6] Nevertheless, agricultural managed investment schemes do not place a high value on the income being treated as primary production income.
The vast majority of MITs do not have primary production income and it would simplify tax return disclosure to treat all income from an MIT as not being primary production income.

Implementing These Principles

It flows from the above that resident investors in MITs will have to distinguish certain characteristics and non-residents will have to distinguish an overlapping set of characteristics.

Intermediaries, such as when one MIT invests in another MIT or when interests in an MIT are held by a custodian, will have to track all of these characteristics because they will be unaware which set of characteristics will eventually be relevant.

The relevant characteristics for the resident investor set out above are:

- capital gain that has been reduced by the discount;
- capital gain that has not been reduced by the discount;
- foreign income;
- infrastructure income subject to rebate;
- other assessable amounts;
- non-assessable amounts that give rise to a cost base adjustment;
- non-assessable amounts that do not give rise to a cost base adjustment;
- franking credits; and
- foreign tax paid.

The relevant characteristics for the non-resident investor are:

- amount subject to the Division 12-H withholding rates;
- amount subject to the interest withholding rate;
- amount subject to the dividend withholding rates;
- amount subject to the royalty withholding rate; and
- amount not subject to withholding.

It is unfortunate that this is so complex but there are no reasonable simplifications available. MITs provide this information to investors accompanied by a guide for individuals that tells them exactly

[6] See for example Media Release No. 062 by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 1 August 2008

where to put these amounts in Tax Pack. It is therefore not as difficult for the investor as it first seems.

The Discussion Paper says it is uncertain whether there is a general law principle that the character of the income is retained in the hands of the beneficiary.[7]

As with every other aspect of a new MIT regime, no uncertainties should be left unaddressed. If this principle is uncertain then it should be made explicit in the new legislation.

The current legislation already does this in some cases. For resident investors section 115-215 ITAA 1997 does this for capital gains, section 6B ITAA 1936 does it for foreign income and section 159GZZZG(3) ITAA 1936 does it for infrastructure income subject to a rebate. Subdivision 207-B ITAA 1997 flows through the franking credits and section 770-130 ITAA 1997 treats the beneficiary as having paid the foreign tax.

For non-resident investors, section 12-405 TAA 1953 provides the tracking for the subdivision 12-H rates. Section 128A(3) ITAA 1936 treats the beneficiary as the person liable for the other withholding taxes and section 128B(3) ITAA 1936 provides the exemptions.

Different models to address the need for “flow through” treatment

Chapter 4 of the Discussion paper raises various alternatives for determining the tax liabilities of trustees and beneficiaries.

As discussed elsewhere, the Board’s terms of reference provide a number of policy principles. The first of these is that the Tax treatment for trust beneficiaries who derive income from the trust should large replicate the tax treatment for taxpayers as if they had derived the income directly.

The requirements to achieve this policy principle are discussed in more detail above.

Each of the models suggested in Chapter 4 of the Discussion Paper can theoretically be tailored to achieve these outcomes, however with different degrees of complexity.

Option 1: Trustee assessment and deduction model

Under the trustee assessment and deduction model, beneficiary tax equivalence can be maintained through some form of “franking” regime.

In other words, different components of the distribution should be able to be identified to investors, with some investor classes obtaining tax preferences in relation to those distributions. A current example of such a regime is the listed investment company capital gain distribution.

Note that this approach can involve the trustee being notionally fully assessable on all amounts, with potential credits for franking credits and foreign tax credits. The key element is that the trustee can identify “tax preferred” amounts to allow particular types of distributions.

There is a tension between tax equivalence and minimising the different types of distribution to be identified.

The following key components have been identified above:

- franked distributions;
- capital gains (discount and non-discount);

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[7] See Discussion Paper paragraphs 6.19 et seq.

- foreign income, including conduit foreign income (relevant for non-residents and some corporate residents);
- foreign tax credits for residents;
- infrastructure income;
- domestic interest, (unfranked) dividend and royalty components (for non-residents); and
- non-assessable amounts (returns of corpus / excess of distributable income over taxable income).

This suggests a number of different components to be identified.

An alternative approach would be to move to a simpler approach involving fewer components, albeit resulting in some differences between direct and indirect investment.

One approach would involve the following components:

- Taxed distributions (includes franked distributions, infrastructure income and grossed up foreign tax credits).

  These distributions would allow a 30% rebate to resident investors (non-refundable to corporate investors, refundable to non-corporate investors). These distributions would be tax free to non-residents.

- Discount capital gains.

  The discount capital gain component would be identified. For non-corporate resident investors, this will result in the investor being entitled to a CGT discount. These distributions would be tax free to non-residents.

- Foreign distributions.

  These distributions would include conduit foreign income as well as direct foreign source income. This would exclude amounts included as taxed distributions. These amounts would not be taxed in the hands of non-resident beneficiaries, and would be included in the conduit foreign income calculations of resident corporate beneficiaries. They would also be included in the foreign tax credit calculation of resident beneficiaries.

- Other amounts.

  These distributions would be ordinarily assessable to resident beneficiaries. They would be subject to a single rate of withholding tax for non-resident beneficiaries. Where the beneficiary is resident in an appropriate country, this would be 7.5%. Otherwise, the rate could be set to, say, 30%.

Basketing all these amounts together potentially reduces (but sometimes will increase) the Australian tax payable by non-resident beneficiaries as compared with direct investment. However, the simplicity of the approach should increase the ability of the industry to market to non-resident investors.

Under an “Option 1” model, there will be a requirement for tracking each of the types of distribution, and providing for consequences if there are under or over distributions of any particular component.

If this path is pursued, any tracking regime should have the following design principles:

- the beneficiary’s taxation position should be unaffected (ie they can rely on their distributions); and

- the consequence for the trustee should be based on a simple methodology for estimating the mis-statement of tax at the beneficiary level.

Option 2 & Option 3

Under the Option 2 and Option 3 models, it will continue to be necessary to disclose the components.

Again, there is a tension between the number of components and the equivalence with a direct investment.

Even under these models, it may be possible to create a statutory rule to reduce the number of components as above.

However, any tracking regime should have the design features above:

- the beneficiary's taxation position should be unaffected (ie they can rely on their distributions); and
- the consequence for the trustee (if any) should be based on a simple methodology for estimating the mis-statement of tax at the beneficiary level.

The regime would ideally be an Option 2 "trustee exemption" type regime, but with beneficiaries being entitled to rely on distribution statements prepared in good faith in accordance with trustee duties.

In practice, this equates to the current industry position of "unders & overs" identified in Chapter 4 of the Discussion Paper. The integrity risk of formalising this position is minimal due to the over-riding obligations imposed on trustees.

Other comments

Any regime should be developed so as to be readily updated for other policy initiatives, for example:

- concessional tax treatment of investment income; and
- Facilitation of pre-populated tax returns / exemptions from tax return lodgement.

In relation to the facilitation of pre-populated returns / tax return lodgement exemptions, one approach which might be considered is the refunding of imputation rebates / infrastructure rebates to the MIT fund itself, with the MIT fund simply making a cash distribution to its beneficiaries. In order to be revenue neutral for non-resident investors, there might be a special withholding tax obligation on distributions to non-residents.

The Taxation Institute is happy to meet with the Board to discuss our submission in the context of the Discussion Paper. If you would like to meet with the representatives from the Taxation Institute or 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
President

Level 2
95 Pitt Street Sydney, NSW 2000
Telephone 02 8223 0000
Facsimile 02 8223 0077
Email tia@taxinstitute.com.au
Website www.taxinstitute.com.au
ABN 45 008 392 372

TAXATION INSTITUTE of AUSTRALIA
IT'S ESSENTIAL

5 December 2008

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*).

[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
President