Mr John Emerson AM
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Review of the tax arrangements applying to
collective investment vehicles
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28 February 2011

Dear John

**Review of the tax arrangements applying to collective investment vehicles**

Thank you for the opportunity to provide the industry's views on the tax arrangements applying to collective investment vehicles (CIVs).

The Property Council is the peak body representing the interests of owners and investors in Australia's $320 billion property investment sector.

The industry supports simplifying and modernising the tax arrangements applying to CIVs.

In line with our discussions, we have kept our comments at a high level. There are a number of key considerations that must be addressed as part of any CIV tax regime:

1) the CIV regime should adopt the elements in the Managed Investment Trust (MIT) regime that work well, being flow-through tax treatment and the deemed CGT treatment for investments;

2) CIV eligibility should focus on satisfying an activity-based test, rather than an entity-based assessment which distorts business transactions;

3) both the eligibility criteria and tax treatment should be clear and certain so that risk-averse foreign investors are encouraged to invest in or through Australia;

4) a simple corporate governance framework to appropriately regulate the structure and operation of CIVs – without a practical framework, industry is unlikely to use the tax regime; and

5) where necessary, the CIV regime needs to provide transitional relief and ensure there is appropriate stamp duty and capital gains tax relief to allow resettlement/restructuring of CIVs.

The attached submission outlines our recommendations for appropriately dealing with these issues. We are keen to discuss them with you further at your convenience.

Please do not hesitate to contact Elaine Abery on (02) 9033 1929 or myself if you have any queries.

Yours sincerely

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# Review of the Tax Arrangements Applying to Collective Investment Vehicles

*Property Council of Australia*

*February, 2011*

# One CIV regime to cover all CIVs

The Property Council of Australia supports a Collective Investment Vehicle (CIV) regime.

We note that Treasury is currently conducting separate consultations settle the Managed Investment Trust (MIT) regime and necessary changes to the trust provisions. The MIT process and outcomes provide important lessons for any CIV regime.

Our comments are high level as it is vital to get the policy and process settings right before delving into the detailed tax issues.

Importantly, a number of key policy issues are not income tax related. These include corporate governance and associated taxes, like stamp duty and capital gains tax. Failure to deal with these issues will make it difficult, if not impossible, for many funds to access a CIV tax regime.

There should be one single CIV regime. There are several design considerations for this regime.

**1) The Australian funds management industry is not uniform but the investment principles are similar**

Investment focus and activities differ:

- equity funds generally invest in portfolio interests in other entities and related financial instruments,
- debt funds generally invest in debt instruments, and
- property funds primarily invest in real estate and also other financial instruments.

Investment locations differ:

- some funds invest solely in Australian assets,
- some funds invest solely in foreign assets, and
- many funds invest both in Australian assets as well as foreign assets.

Despite these differences, the principles underlying these investments are similar.

It makes sense to have one set of common core rules as the basis for the CIV regime to reflect the shared principles. Additional special rules could be used to deal with the peculiarities of sectors within the funds management industry.

**2) The CIV regime should be based on the nature of the CIV's activities (or the income arising from those activities) not the nature of the entity**

Which legal entity a CIV uses will depend on a number of considerations, including the type of investors and where they are based. In line with revenue principles, this choice should be tax neutral.

For example, income of any widely held entity which satisfies Division 6C should be entitled to access the MIT regime. This includes companies and Limited Partnerships (LPs).

**3) Balancing integrity with functionality and simplicity**

The MIT regime has too many existing and proposed integrity rules which limit its practical usefulness.

Australia's attractiveness as a funds management hub relies on a simple, functional CIV regime. Currently, Australia is not a natural conduit country. We have significant local investment source and residency based issues because a large number of Australians and Australian CIVs are themselves investors (ie Luxembourg, Ireland or the Caymans). Whilst these issues result in valid integrity concerns, it is imperative that these issues are resolved in a way that does not deter foreign investors.

**4) A flexible corporate governance framework**

A key attribute of successful conduit countries is a simple and workable corporate governance framework. The corporate governance framework outlines the structure and operations of CIVs. It is the way that the corporations and related law apply to CIVs. It includes ASIC, ACCC and other related regulation.

It is difficult to justify a best practice tax model without a similar corporate governance framework.

A best practice corporate governance framework must appropriately distinguish between the protection required for retail investors and sophisticated investors. Similarly, if there is a difference between disclosure regimes for companies and trusts, this must be adequately explained. Current differences between disclosure regimes have no obvious rationale. They cause additional complexity for fund managers and confusion for investors.

**5) Clear, modern and well defined tax rules**

Division 6C is outdated and requires urgent modernisation. We have previously provided detailed comments on this provision as it applies to property. Those views are extracted in Appendix 1.

We applaud government's efforts to create an attractive MIT regime. However, to attract new investors to Australia, we need to offer them a stable tax and corporate governance regime. This means we need to reform these rules quickly, once and for all to give industry a practical and reliable regime. For example:

- the "connected with Australia" tests are difficult for new investors to satisfy, and
- undefined general terms like "investment management" create uncertainty, deterring new investors.

There is a perception that the Australian MIT rules are also becoming so complex that they impede investment into existing funds.

**6) Appropriate restructure relief**

It is important to remember that income tax interacts with corporations law, stamp duty and other taxes, such as capital gains tax. In the property space, stamp duty is a significant cost of doing business. Stamp duty involves additional complications for funds that invest in property, through:

- State based differences in approach;
- continued differences in the treatment of listed and non-listed widely held structures;
- different treatment of company, trust and partnership structures; and

- limited restructure relief, particularly from one form of structure to another.

Unless there is simple, practical rules that make it easier for industry to restructure, many existing property entities will be effectively excluded from any benefits flowing from the CIV regime.

# What is a CIV?

A CIV is any entity or arrangement (as defined). We believe that the definition should be inclusive of all entity types, including companies, trust, LPs etc.

The focus of a CIV regime should not be on the type of entity, but rather on the nature of the activity and income arising from that activity. Corporate and LP CIVs are common internationally. It is important that eligible CIVs include all internationally recognised and accepted CIV entities.

A CIV should have the following characteristics.

**1) Widely held**

This test should be the same for all CIVs.

It is common for one CIV to invest in or through a second CIV. It is important that clear, simple tracing rules recognize this. The current trust-based rules in the MIT provisions should be expanded to include corporate entities and LPs.

The international funds markets are constantly evolving. It is important that the CIV regime is flexible enough to deal with the continued growth of new sources of investment and the difficulties this creates for assessing whether a fund is widely held. For example, sovereign-related investment can be made through a sovereign fund or a government pension plan.

It is also important that the definition of widely held be flexible enough to deal with overseas regimes. For example, "investors" in pension and CIV funds in various jurisdictions may not have legal interests in the fund as they do in Australia.

The widely held rules need to be flexible, simple and certain so that a proper assessment of the status of a CIV can be made at any time without conducting a costly and time consuming tracing exercise.

**2) Satisfy clear, simple corporate governance requirements**

Successful conduit regimes overseas:

- have a simple and effective system of corporate governance, and
- recognise all commonly used legal structures as eligible CIVs, including companies and LPs.

**3) Satisfy the connection with Australia test**

In a MIT context, the trust must:

- be Australian resident,
- have an appropriate qualified responsible entity or manager, and
- satisfy the investment management test.

This requires a significant connection with Australia which may be more justified in the context of investment in real property.

The policy emphasis seems to be on attracting people to use Australian managers rather than foreign ownership of Australian assets. This appears to reflect concerns around corporate governance and integrity.

For MITs, uncertainty around interpreting the investment management test is a significant barrier to global managers setting up operations within Australia. The connection test should be simple and clear.

It is critical to bear in mind that Australia is a high tax country compared to most of the conduit countries in which foreign funds currently operate.

We are concerned that integrity measures are appropriately balanced against the primary aim of making Australia a more attractive investment destination. It is also important however to ensure that the regime does not provide offshore managers with an advantage over local managers.

The design of the entity based rules should carefully consider the impact on manager activity.

**4) Involved in passive investment activity**

This test should apply to all CIVs and should be based on an appropriately modernised Division 6C.

It is critical that reform deals with the core investment issues under Division 6C. To date, these reform issues have not been prioritised. The outcomes so far appear to focus on revenue protection (the arms length rule and the retention of the control test). Industry needs a practical framework that is modern, simple and clear, addressing issues such as REIT subsidiaries and eligible investment.

Unfortunately, without a simple, modern regime, some existing property trusts are likely to become non-viable. Further, it limits our ability to become involved in important new markets including residential accommodation and retirement living. All of these new markets require significant investment in land.

To the extent a control test is necessary, it should be revised to recognise situations where the essential character of the income is passive but some associated activities might otherwise cause the entity to fail the Division 6C test. An example of this is REIT subsidiaries.

There needs to be a renewed focus on creating workable rules, moving past integrity concerns that can be outdated.

# How is a CIV taxed?

The usual Australian tax rules should apply to CIVs with the following modifications.

- Deemed CGT account treatment for all assets on a similar basis to the existing MIT rules.
- Consolidation of all Australian resident wholly owned entities that are also involved in passive activities.

  This would exclude entities such as Taxable REIT Subsidiaries (TRSs) and taxpayer controlled entities which are subject to Australian corporate tax.
- Flow through treatment.

  Taxable income of the CIV group should be attributed to investors.

  Again, this would exclude entities such as TRSs and taxpayer controlled entities which are subject to Australian corporate tax. Dividends from these entities would flow through the CIV to investors.

  This approach is designed to overcome integrity concerns about the accumulation of income while giving the CIV flexibility over its capital management.

This approach works well where the income is attributed to Australian residents who include it in their assessable income.

The approach is more challenged when the trustee (or a custodian) is required to withhold tax on monies attributed (but not paid) to a non-resident. There are a variety of models available to deal with this issue which should be reviewed. It is important to avoid adopting a "one size fits all" solution. Depending on the composition and nature of their investors, some vehicles may more readily be able to adjust current and prior withholding rates.

This approach is unlikely to work without a relaxation of the integrity concerns evident in the MIT debate.

- Income (and tax attributes) retain their character when attributed to investors.
- Losses are retained at the CIV level on a consolidated basis.
- Distributions are not taxed

  However, any distribution in excess of a previously attributed amount reduces the investors cost base in the CIV.

# Investment Manager Regime (IMR)

The framework outlined in the proposed IMR does not directly impact the Australian property trust industry.

However, "foreign managed funds" represent a significant portion of the investor base into Australian listed and unlisted property trusts.

We are keen to ensure that any exemption to Australian tax provided to "foreign managed funds" with respect to portfolio interests in Australian securities includes interests in MITs. This should encompass portfolio interests in both listed and unlisted property vehicles.

We are keen to discuss or expand on any of the above comments.

# Appendix 1: Activities Test and Control

(Extracts from Section 4 of the Property Council of Australia's submission to the Board of Taxations review on tax arrangements applying to managed investment trusts

**Issues**

Clearly, the main issue of concern to MITs in the property sector in Australia has been the restrictions placed on their activities by Division 6C ITAA 1936. These concerns remain despite the amendments to Division 6C made in 2007 and those contained in Tax Laws Amendment Act (No 5) 2008 which, while welcome, go only part of the way to solving this difficulty.

<u>4.1 A first best solution [question 9.2]</u>

We noted at the outset of this submission that the argument for activity limitations is unconvincing in 2008. There are many reasons supporting the PCA's view that both Division 6B and 6C ITAA 1936 should simply be repealed:

- The argument that imposing corporate tax is intended to counter tax advantages available to trusts is incomplete – companies enjoy tax advantages that are not available to trusts – and the argument is unconvincing – the imposition of the corporate tax paradigm on trusts is not a sensible way to address the implications of discrepancies that do not share a single underlying driver.
- While activity restrictions may be common in the REIT and CIV regimes of other countries, the restrictions are usually the price to be paid for enjoying a concession – being taken outside the classical system of corporate tax that would otherwise operate. That is not the case in Australia where the trust regime – and even the corporate tax regime – aspire to transparency. The international experience is thus inapt as a lesson for Australia.
- The historical justification for activity restrictions – the need to protect the corporate tax base – has long since ceased to be relevant with the enactment of the imputation system (1987) and refundable imputation credits (2000). For resident investors, these measures make the corporate tax principally a withholding tax regime against an ultimate tax liability imposed and computed at the investor level.
- So far as resident investors are concerned, the introduction of the PAYG regime means there is little practical difference for the government between applying the current trust regime and the corporate regime, and the differences that do exist could be removed if MITs made (or simply reported) more frequent distributions to investors and few of them paid an annual PAYG instalment.

Thus the Property Council submits the optimal position is that there should be no limit on the range of activities that an MIT is permitted to undertake.

<u>4.2 A second-best solution [question 9.2]</u>

The history of the negotiations surrounding the amendments made by Tax Laws Amendment Act (No 5) 2008 suggest that Treasury's current thinking still seems to be that it is necessary to insist upon some notion of "investment" remaining in the legislation to create and enforce the corporate tax paradigm for public trusts (though not for private trusts). Hence, we consider next a second-best solution: what changes would need to be made to Division 6C ITAA 1936 so that it can be made less burdensome in practice for MITs.

We set out below a series of seriatim observations about how some of the difficulties presented by Divisions 6B and 6C might be ameliorated so that any ongoing restrictions do not defeat industry's desire and the Government's goal "to make Australia the financial services hub of Asia … [and] enhance the international competitiveness of Australian managed funds" [para 1.4].

*i) Creating a more workable test.*

We examine how such a distinction might be drawn so that it caused the least possible detriment. There are many elements to this process:

- deciding whether to set a hard number or an order of magnitude – ie, how to describe the bar;
- setting the level – ie, deciding where to set the bar; and
- deciding what is measured – ie, deciding what the bar looks like.

*ii) A hard number v. a fuzzy line.*

The Property Council submits that any activities test to be enacted should be drafted as a test that is a combination of a bright-line numerical test (as a safe harbour) and a qualitative test. An example of such a formulation would be:

> 1. An MIT must derive 'the preponderance of its income ...' / 'hold the majority of its assets ...'
>
> 2. An MIT will satisfy test 1. if X% of its income / assets are ...

A test which is a combination of a "fuzzy" test and a "hard" safe harbour allows MITs an appropriate but not excessive degree of flexibility. For example:

- An MIT which derives say 82% of its income as rent would satisfy the safe harbour test and need to inquire no further.
- An MIT which derives say 72% of its income as rent might not satisfy the safe harbour test, but the MIT would be permitted to avoid the consequences of triggering the corporate tax paradigm if the offending 28% was represented by, say, 7 amounts each of which represented 4% of the gross income. The rental income is clearly dominant and the MIT should be allowed to retain its MIT status despite the incidental classes of non-rental income.

*iii) Income or assets test.*

That number or measure must then be applied to something. Many countries employ both an income and an assets test in the design of their REIT regime – that is, they apply numeric tests to both the amount and type of the REIT's income and its assets. In our view, an active v. passive distinction would be less onerous if the test were based on amounts of gross assessable income rather than the use or application of assets. For example, the formulation:

- An MIT must derive at least X% of its income in the form of rent, other amounts of income commonly generated from providing the use of land and other types of passive income is a more workable test than an assets-based test:
- At least X% of the assets of the MIT (by cost or value) must be used for the purpose of generating rent, interest, dividends, etc.

*iv) Setting an appropriate level.*

The next issue is the appropriate level at which this test should be set. 75% of gross income is common as an income test and this would seem to be an

appropriate level to alleviate much of the pressure that currently surrounds the test in Division 6C ITAA 1936.

Whatever level is chosen, there is a separate issues about the strictness involved in counting to that number. For example,

- there would still be a need for a de minimis test – ie, in counting up to 75%, ignore any amounts of (forbidden) assessable income that are insignificant (say, up to 2% of gross income);
- there would still be a need to remove lumpy transactions from the calculation because they are unrepresentative of passive investment – ie, in counting up to 75%, ignore the proceeds of sales of capital assets (if a capital v. revenue dichotomy survives), insurance recoveries, sales of subsidiaries etc; and
- if the test were based on income rather than assessable income, there would be a need to remove the effect of accounting income or ordinary income that will not be taxable – ie, in counting up to 75%, remove the effect of asset revaluations and the derivation of exempt or NANE income.

*v) Frequency.*

The next issue is how often the test is to be applied – that is, is it an annual snapshot, a quarterly test or a test applied any point in time? Further, if the test is failed, does that failure trigger the prescribed consequences for that single year or for all succeeding income years?

The Property Council submits that the test should be an annual snapshot, rather than a point in time test. That snapshot would be taken at the end of the income year when the MIT is in a position to determine its final income position. The test would be determined annually and the consequences of failing the test imposed year-byyear.

4.3 Defining investment; passive operations

Apart from setting the number that is to be used, there is then the much more complex question of classifying various kinds of activities as acceptable or forbidden.

*i) Black list.*

At the moment, Division 6C ITAA 1936 defines passive income and assumes everything else is active. This system has proved cumbersome, restricting the expansion and modernisation of MITs.

Assuming that some form of activity limitation test is to remain, the Property Council has a strong preference that rather than attempting to define passive operations, a "black list" approach be used instead, and that black list should identify forbidden activities – ie, an MIT can do anything as long as it is not on a precise and clearly drafted black list. For example, is an MIT prohibited from operating a farm, coal mine or oil field. An MIT would be permitted to own the farm, but not operate it.

*ii) A third-best option – defining active and passive.*

If an activity-based restriction remains, and the black list option is not taken, then at the very least there needs to be serious revision in classifying various kinds of income or assets as either active or passive income in the hands of an MIT. The categories of "active" and "passive" are not self-defining; they have to be populated with meaningful content. This could be done by defining active or passive or both.

In our submission, the problem of the active v. passive distinction could be reduced somewhat if the test were reversed – defining active, and treating everything else as passive.

If that approach is taken, then the Board should insist that the law clarify several matters. The paradigm type of passive income is obviously rent, but this should extend beyond "rent" in strict sense. An MIT should be permitted to earn without restriction (ie, these kinds of assessable income fall within the 75% permitted income, not the 25% margin of error or the de minimis safe harbour):

- premiums and licence fees received for the non-exclusive use of land – eg, car parks;
- income ancillary to supplying the use of land – eg, income derived from providing the use of fixtures or movable chattels and equipment used in conjunction with the land;
- amounts which are customary in the industry – eg, income collected as a contribution to operating expenses.

We note that the recent amendments in Tax Laws Amendment Act (No 5) 2008 address some of these issues.

But more generally, if an active v. passive distinction is to be maintained, the Property Council would prefer a more open-textured test which permitted an MIT to earn income accruing to the owner of land from managing the land to best advantage. It is intended to be a broad test that would allow an owner to exploit its land in whatever means seem best to it. The formula is trying to capture and express an intended distinction between an owner who derives income (in any form) from owning and exploiting the land, on the one hand, from say,

- an owner who derives income from acquiring land for the purpose of development and sale as trading stock; or
- an owner who derives income from conducting activities that happen to occur on the land – that is, operating a shoe shop is not exploiting the land although the activity occurs on land. The profit is made from selling the shoes.

Such a formulation would permit an MIT to earn income from leasing advertising signage space, charges to fund-raisers for granting access to the land, sales of surplus electricity from solar power collectors, car parks, and so on. These all accrue to the owner of land as the owner of the land, not as a seller of goods or services which could be provided from any location. It is a more suitable notion than attempting to describe active and passive.

There is also a need to clarify the acceptability of profit-based rents or turnoverbased rents. There appears to be a concern that profit-based rents necessarily involve unacceptable forms of profit shifting. The same concern seems also to apply to turnover-based rents, though with less justification. In either case, that view could only be valid if the lease were between associates. There is no profit shifting if an MIT owns a hotel which it leases to a hotel operating company, unless they are associated. If they are not associated, the arrangement is simply one which computes the rent in a particular way. To say that the MIT 'shares the risks and rewards of operating the hotel' under such a lease adds nothing to the analysis; it is akin to saying that a depositor is operating a banking business because it lends at a floating rate.

Hence profit-based rents should be permitted without restriction:

- unless paid by an associate of the MIT (in which case the rent should be recognised at its arm's length amount); and
- even if paid between associates, if the recipient is an entity that is taxed as a company.

4.4 Control issues [question 9.2]

One of the most annoying issues for MITs is the inability to isolate offending actions by putting them into a tax-paying vehicle. The control test in s. 102N(1)(b) ITAA 1936 makes the control of an entity undertaking offending activities just as toxic to the MIT as conducting the activities itself. This means that the MIT is effectively prevented from undertaking the activity altogether or else putting in place expensive and inefficient stapling structures. If it does not abandon the field to others or engage in efficient structruing, it risks putting its entire income stream in jeopardy.

This is especially odd as the impact of Division 6C ITAA 1936 is to treat certain MITs as companies. Yet, were an MIT to establish a company and deliberately attract corporate tax treatment, it gains no comfort from doing so.

In our submission, this rule is nonsensical. Paragraph 9.24 of the Paper seems to imply that MITs should not be able to own or control companies which undertake prohibited activities:

> If the control test were to be abolished, then an MIT could become a holding entity owning subsidiary trading businesses.

But it is hard to see why there is anything untoward in an MIT doing just this. If an MIT is to be prohibited from undertaking certain activities upon pain of triggering corporate tax treatment, then the Government should have no qualms if an MIT voluntarily submits itself to that very treatment, even in part. One could go further and say that an MIT should be encouraged to set up structures that attract corporate tax treatment for the activities that are to be subject to corporate tax treatment.

Indeed, the "top-hatting" amendments in s. 102NA ITAA 1936 enacted in 2007 go most of the way to conceding this issue – they allow a group of stapled entities to restructure by inserting a head trust without triggering CGT at the time of the restructure or invoking Division 6C ITAA 1936 for the head trust thereafter. The logic of these amendments is that a structure in which a trust owns or controls a taxpaying company does not offend sound tax policy. But these measures are unnecessarily constrained – they only apply where the trust is placed on top of an existing stapled structure; they only apply where the rollover under Division 124-Q ITAA 1997 was activated; and so on.

The legislation needs to take the next step – to permit an MIT to own all the shares in a taxable entity which conducts prohibited activities (assuming that activity prohibitions are to remain), regardless of the starting point of the structure.

The next issue is the treatment of the franked dividends in the hands of the MIT. These dividends should be treated in the same way as other dividends – the MIT should pass the franking credits through to its investors in the same way as franking credits on dividends from unrelated companies.

*i) Location restrictions.*

Section 102N(2) ITAA 1936 is also an inefficient restriction on the operations of Australian MITs.

It permits an Australian fund to control a foreign entity provided its principal business consists of investing in land for the purpose of deriving rent. The Paper seems to view this provision as an exception or expansion to the ordinary control rule (probably because of the possibility of aggregating the activities of related controlled foreign entities) and says of this rule:

> there is considered to be minimal risk to the Australian taxation revenue if the foreign REIT owns or controls trading business in the course of its principal business [para 9.13]

If the purpose of the control rule were to protect the Australian revenue then it would seem that there is no risk to the Australian revenue even if the foreign entity were conducting only trading activities. If the test were, does this structure jeopardise any Australian tax, then on that test an Australian MIT should be permitted to acquire and control any offshore entity, trading or not (so long as its operations are conducted exclusively offshore).

The ultimate effect of s. 102N(2) ITAA 1936 is to discourage offshore expansion. The provision should be broadened to allow an Australian MIT to control any offshore subsidiary that operates offshore.

4.5 Consequences [question 9.2]

Question 9.2(c) asks (assuming that activity and location limitations survive), what consequences should follow from undertaking offending activities?

At present the effect of breaching Division 6C is that a trust's entire taxable income is taxed in the hands of the trustee – s. 102S ITAA 1936. If some such outcome is to be imposed, then the Property Council submits that the consequence should be changed so that only the net income generated from the offending activities is subject to corporate taxation in the hands of the trustee. This would obviously require several corollary rules and procedures such as:

- the allocation of expenses between permitted and prohibited activities;
- the ability for the MIT to use franking credits attached to dividends arising from prohibited activities on its own behalf; and
- the ability for the MIT to use foreign income tax offsets arising from prohibited activities on its own behalf;

etc., but there is nothing exceptional involved in making such allocations that requires any special treatment of this situation.

The second question is the franking consequence of the MIT having paid tax as if a company. Again, this should be handled by the usual rules that currently apply where Division 6C ITAA 1936 has been triggered:

- the trustee determines the amount of its offending taxable income for a year of income;
- it files a return for that year of income, pays the appropriate tax and records the tax payment in a specially-created franking account;
- a franking credit can be attached by the trustee to its next income allocation (or distribution) to investors.