REVIEW OF THE TAX ARRANGEMENTS APPLYING TO MANAGED INVESTMENT TRUSTS

Consultation Forums

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the board of taxation

www.taxboard.gov.au

Topics

- The Board of Taxation
- Terms of Reference for the managed investment trusts (MIT) review
- Process for the review
- Issues raised in discussion paper
- Comments/questions

The Board

- The Board consists of three ex-officio government members and seven business and community members
- Provides independent advice to the Treasurer and Assistant Treasurer on a variety of tax matters including the effectiveness of tax legislation, tax design, integrity and workability of the legislation, and the functioning of the tax system
- Supported by a Secretariat provided by Treasury

The Board (cont'd)

- The Board is also supported by an advisory panel of about 30 individuals and regularly consults with other business and community sector representatives, legal and accounting practitioners, and academics
- For the MIT review, the Board has:

  - appointed a Working Group of 4 of its members and two practitioners to oversee the review;

  - established an eight person expert panel, and

  - engaged an academic as a consultant.
- Treasury and the ATO are also providing support to the Board

Terms of Reference

- Generally, to review the tax arrangements applying to managed investment trusts
- Specifically, to advise on options for introducing a specific tax regime for MITs to reduce complexity, increase certainty and minimise compliance costs
- Options to be revenue neutral or near revenue neutral

Terms of Reference (cont'd)

Ideally, options should be broadly consistent with five key policy principles:

- tax treatment for beneficiaries should be largely as if they had derived the income directly
- flow through taxation of income should be limited to trusts undertaking activity that is primarily passive investment
- beneficiaries should be assessable on income whether it is paid or applied for their benefit, or they have a present right to call for immediate payment
- the trustee should be liable to tax on income not so assessable; and
- trust losses should generally be trapped in the trust

Terms of Reference (cont’d)

- To explore options other than the current use of present entitlement
- To consider international developments
- To consider reforms to the eligible investment business rules in Division 6C that would enhance:
  - the international competitiveness of Australian real estate investment trusts; and
  - the capacity of the managed funds industry to attract overseas funds

Terms of Reference (cont'd)

- The Board has been asked to also examine:
  - whether there is a continuing need for the tax integrity rules in Division 6B
  - the costs and benefits of establishing a separate tax regime for real estate investment trusts (REITs); and
  - the desirability of extending relevant aspects of the recommended changes to other trusts

Process

- Input from the expert panel and external consultants
- Preliminary targeted consultations with key stakeholders
- Discussion paper released on 29 October 2008. Closing date for submissions is 19 December 2008
- Consultation forums currently being undertaken
- Review to be completed by mid-2009

The Board is focussing on identifying and scoping issues and options, and has at this stage formed no views as to the outcome of the review

Some Key Issues

- Uncertainty in the current law
- Character flow-through retention
- Potential high level options for determining tax liabilities
- Under and overs – errors in calculating net income

Some Key Issues (cont'd)

- International competitiveness
- Capital/revenue treatment of MIT gains and losses
- Division 6C
- Need for Division 6B
- Scope of a MIT regime - which entities/structures should be included

Uncertainty

- Key legislative terms not defined (eg, trust income, ‘share’ of trust income and present entitlement)
- Problems arise when trust income differs from net income
- Potential distortions if amounts included in net income are not distributed (possibly double taxation)
- Leads to complexity and additional compliance costs
- Case authorities may provide little guidance due to specific facts

Character flow-through

- Uncertain application of flow-through taxation treatment for MITs
  - Applicability of a general law flow-through principle uncertain with respect to Division 6
  - Operation of existing statutory flow through mechanisms uncertain (eg. CGT, franking credits and foreign tax credits)

Character flow through (cont'd)

- some options for character retention
  - Creating specific legislation to ensure the flow-through of character
  - Treat all MIT distributions in a similar manner to company dividends and enact special rules which would preserve character flow-through in specific instances

Are different character retention arrangements needed for distributions to foreign residents?

Potential high level options for determining tax liabilities

Alternatives to the present regime

- Trustee assessment and deduction model – investors taxed on distributions received
- Trustee exemption model - investors always taxed on net income of trust
- Trustee exemption model only if minimum distributions made (eg, 90%)
- Current model but with the meaning of key terms clarified

Unders and Overs

- Difficult for MIT trustees to obtain ‘final’ information due to complexity and time constraints
- Amounts initially reported to beneficiaries may overstate or understate the correct amount of their share of the net income of the trust

Unders and Overs

- Options for dealing with ‘unders’ and ‘overs’ include
  - Carry forward approach – MIT would be able to carry forward ‘under’ or ‘over’ into the following income year (increase/decrease net income)
  - Credit/deduction approach – MIT receive a credit or deduction in the following income year

Under either of the above approaches, is a de minimis rule required to preserve integrity and provide incentive to correctly calculate income?

International Considerations

- Internationally, many managed funds are in a corporate form with flow-through taxation
- An issue for the review is whether such an approach is worth pursuing in Australia

Capital v Revenue

- Whether asset disposals should be on capital or revenue account
- Current tax law as interpreted by the ATO suggests many MITs disposals would be on revenue account
- If on revenue account:
  - a CGT discount not available to investors
  - Implications for superannuation funds that hold units in MITs and individuals who are generally on capital account

Board to consider policy arguments for and against capital or revenue account treatment

Division 6C

- Trust/company tax borderline
- Change the eligible investment rules to enhance their international competitiveness?
  - Revenue cost considerations
- Relevance of the control test?

Division 6C (cont'd)

- Is the 20 per cent rule for complying superannuation funds still necessary?
- What should be the tax consequences for breaching the rules?
  - Subject all income to company like taxation or just the 'tainted income'?
- Is a separate REIT regime necessary?

Division 6B

- Company-like taxation applies when assets are transferred from a company to a trust under a scrip for scrip arrangement
  - Is Division 6B still necessary given the changes to the tax law that have occurred since 1981?
  - If retained in some form, what changes should be made and can they be integrated within a specific tax regime for MITs?

Scope of a MIT Regime

- Corporate or trust structure
  - International tax considerations
- Defining widely held
  - Membership requirements
  - Relevance of company law re managed investment schemes
  - Investor directed portfolio services if established as a trust?

Scope of a MIT Regime

- Need or otherwise for uniformity in rights attaching to interests in an MIT (eg, more than one class of beneficiary)
- Irrevocable election?
  - Can two regimes apply at the one time (that is the old and new)
  - Would there be issues because of cross holdings between trusts within the MIT regime and those outside?

Other issues for review

- Special rules for ‘fixed trusts’ may not operate as intended
- Should MITs within the MIT regime be deemed to be fixed trusts or alter definition?
- Trust deed amendments
- Potential to apply changes to other trusts

Submissions by Friday 19 December 2008

COMMENTS/QUESTIONS