Review of the Tax Arrangements Applying to Managed Investment Trusts

Discussion Paper

The Board of Taxation

October 2008

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FOREWORD

Australia's managed funds industry is an important and dynamic part of Australia's economy and one of the largest in the world. In order for the Australian managed funds industry to be able to continue to grow and develop its export potential, it is important that Australia's tax arrangements do not create unnecessary or unintended barriers to investment in Australian managed funds.

Australia's taxation law does not contain a specific regime for the taxation of managed investment trusts. Rather, the original legislation for taxing trusts contained in the tax law continues to apply. To date, there has been no systematic approach to adapt the law to align it with modern practice and the use of trusts as commercial investment vehicles.

In this context, the Board welcomes the opportunity to review the tax arrangements applying to managed investment trusts and assess options for introducing a specific tax regime that would reduce complexity, increase certainty and minimise compliance costs.

Consultations with industry and submissions from interested parties will play a crucial role in shaping the Board's recommendations to Government.

Richard Warburton AO	John Emerson AM
Chairman, Board of Taxation	Member, Board of Taxation

CHAPTER 1: INTRODUCTION

1.1 On 22 February 2008 the Government asked the Board of Taxation to undertake a review of the tax arrangements applying to managed investment trusts[1] and to complete its review by the middle of 2009. The corresponding terms of reference are reproduced in the next section.

1.2 As requested by the Minister the objective of the review is to provide advice on revenue neutral or near revenue neutral options for introducing a specific tax regime for managed investment trusts which would reduce complexity, increase certainty and minimise compliance costs.

1.3 The current taxation legislation does not encode a single coherent policy for the taxation of trusts. There has been no systemic approach to adapt the taxation legislation to align with modern practice and the use of trusts as commercial vehicles. The result is taxation legislation that is piecemeal and often uncertain in its application.[2]

1.4 As noted by the Government, the review is a key part of the Government's commitment to make Australia the financial services hub of Asia. The Government wishes to implement reforms to enhance the international competitiveness of Australian managed funds to help ensure the future prosperity of the Australian economy.

TERMS OF REFERENCE

1.5 The Board of Taxation is requested to review the current income tax arrangements applying to managed funds that operate as managed investment trusts (**MITs**). That is, managed funds that are widely held collective investment vehicles undertaking primarily passive investments.

1.6 The broad policy framework for the taxation of trusts is to tax the beneficiary on its share of the net income of the trust, so that the trustee is only taxed on income that

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1 Managed investment trusts are collective investment vehicles that allow investors to pool together their capital to enable investment in larger and more diversified assets than would otherwise be the case.

2 As noted by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs in his address to the Investment and Financial Services Association (IFSA) Member Luncheon in Sydney on 22 February 2008.

is not taxable in the hands of beneficiaries. Within this framework, the Board should ideally develop options for reform with taxation outcomes that are broadly consistent with five key policy principles:

Policy Principle 1

1.7 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.

Policy Principle 2

1.8 In recognition of the tax advantages available to trusts that are not available to companies deriving business income, flow through taxation of income from widely held trusts, such as managed investment trusts, should be limited to trusts undertaking activity that is primarily passive investment.

Policy Principle 3

Beneficiaries should be assessable on their share of the net income of a trust whether it is paid or applied for their benefit, or they have a present right to call for immediate payment.

Policy Principle 4

1.9 The trustee should be liable to tax on the net income of the trust that is not assessable to beneficiaries in a particular income year.

Policy Principle 5

1.10 Trust losses should generally be trapped in the trust subject to limited special rules for their utilisation.

1.11 The objective of the review is to provide advice on options for introducing a specific tax regime for MITs which would reduce complexity, increase certainty and minimise compliance costs. The Board is to have regard to the policy framework and principles outlined above, as well as the following:

- the current taxation treatment for trusts relies on the use of *present entitlement* to determine the income tax liability as between beneficiaries and trustees. The Board should explore alternatives that provide broadly similar taxation outcomes for beneficiaries, having regard to the costs and benefits of those options; and
- international developments in this area, especially those in the US, UK and Canada.

1.12 The Board should also examine potential reforms to the eligible investment business rules in Division 6C of the *Income Tax Assessment Act 1936* that, while not compromising the integrity of the corporate revenue tax base, would enhance:

- the international competitiveness of Australia's real estate investment trusts (REITs);[3] and
- the capacity of Australia's managed funds industry to attract funds under management from other countries.

1.13 The Board should also examine:

- whether there is a continuing need for the tax integrity rules in Division 6B of the *Income Tax Assessment Act 1936,* in light of the operation of the capital gains tax regime, dividend imputation and Division 6C;
- the costs and benefits of establishing a separate taxing regime for REITs; and
- the desirability of extending relevant aspects of the recommended changes to the tax arrangements for other trusts.

1.14 The Board should complete its review by the middle of 2009.

Board's approach and policy benchmarks for assessing options

1.15 The Board is mindful of the need to ensure that any options for reform are consistent with the five key policy principles outlined in the terms of reference and also that any recommendations for tax reform have regard to economic efficiency, equity and simplicity considerations.

1.16 In the context of the review, the efficiency objective would require that the investment choices for investors in MITs and other investment options, and the level of risk that they are prepared to bear in making those investments is not driven by taxation outcomes. Consistent with *Policy Principle 1*, the tax outcome for a beneficiary in an MIT should largely replicate the tax treatment as if the beneficiary had derived the income directly.

1.17 The equity consideration would require that those liable for tax on the income of a trust are entitled to that income and there are no double taxation outcomes, timing mismatches or revenue leakages. Furthermore, the income should be subject to the

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3 REITs are collective investment vehicles that allow investors to pool together their capital to enable investment in real estate assets. In some jurisdictions, such as the USA, they are structured as companies whereas in others, such as in Australia, they are structured as trusts.

beneficiary's marginal income tax rate as if the income were derived directly by the beneficiary.

1.18 The simplicity objective would require that the beneficiary and the trustee can both establish with ease and certainty the amount of their respective tax liabilities.

1.19 The Board acknowledges that the extent to which each benchmark is achieved needs to have regard to the competition among objectives and that there might be some trade-offs between these objectives. For example, under some options there might be a specific departure in the tax treatment of a beneficiary in an MIT compared with the tax treatment that would fall on an individual deriving income directly, but the simplicity benefits of doing so could outweigh the costs arising from not fully meeting the efficiency benchmark.

1.20 The Board is also mindful of the objective of making Australia the financial services hub of Asia. This involves comparison with major competitors and ensuring that Australia's taxation regime for MITs reduces barriers to competition for funds in the region. The comparisons also provide useful background to the examination of options for reform.

THE REVIEW TEAM

1.21 The Board has appointed a Working Group of its members comprising John Emerson AM (Chairman), Keith James, Chris Jordan AO and Dick Warburton AO to oversee its review. The Working Group is being assisted by members of the Board's Secretariat and staff from the Treasury and the Australian Taxation Office (**ATO**).

1.22 The Board has received assistance from Professor Richard Vann (The University of Sydney) in the consideration of technical issues relevant to the review. In addition, the Board has asked two members from its Advisory Panel, Teresa Dyson and Ken Schurgott, to assist as members of the Working Group. It has also benefited from the assistance of a panel of experts comprising Michael Brown, David Cominos, Michael Hennessey, Alexis Kokkinos, Andrew Mills, Tony Mulveney, Karen Payne and Karen Rooke.

REVIEW PROCESSES

Consultation

1.23 The Board has conducted targeted consultations with a range of stakeholders who expressed an interest in the issues raised by the review. These consultations have assisted the Board in the development of this discussion paper.

Submissions

1.24 The Board is inviting written submissions to assist with its review. Submissions should address the terms of reference set out in paragraphs 1.5 to 1.10 and the issues and questions outlined in this discussion paper (a full list of issues/questions is at Appendix A). It is not expected that each submission will necessarily address all of the issues and questions raised in the discussion paper. The closing date for submissions is 19 December 2008. Submissions can be sent by:

Mail to: The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Fax to: 02 6263 4471
Email to: taxboard@treasury.gov.au

1.25 The Board understands there is considerable stakeholder interest in the issues raised in Chapter 7: Capital Versus Revenue Account Treatment of Gains and Losses made on Disposal of Investment Assets by MITs and accordingly requests submissions on these issues as soon as possible.

1.26 The Board intends to publish submissions on its website, unless the submitter has requested that the submission remain confidential.

Board's report

1.27 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board's report and its recommendations will reflect the Board's independent judgment. The Board has been requested to provide its report to the Government by June 2009.

1.28 It is expected that the Board's report will be published in conjunction with the Government's response to the report.

Chapter 2: Background on the managed funds industry in Australia

The managed funds industry in Australia

2.1 Australia has the fourth largest onshore managed funds market in the world (behind the USA, Luxembourg and France) and the largest in Asia.[4] In terms of REITs, Australia is the second largest market after the USA.[5]

2.2 At the end of June 2008, Australia had A$1,319 billion in consolidated funds under management,[6] with the following composition:

- around 74 per cent (A$982 billion) was invested in the superannuation and life insurance environment;
- around 24 per cent (A$322 billion) was invested in public unit trusts and cash management trusts, which are in the main the MITs subject of this review; and
- the balance (A$16 billion) was invested in other funds such as common funds and friendly societies.

2.3 Assets placed with investment managers reached a total of A$1,181 billion as at the end of June 2008, up from A$791 billion in June 2004.[7]

2.4 Of the total assets placed with investment managers in Australia, only 4 per cent (A$48 billion) were sourced from overseas.[8]

2.5 There are close to 120 significant fund managers operating in Australia, including 17 of the 20 largest global asset managers. In June 2007 the 10 largest investment

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4 Investment Company Institute global survey of mutual funds conducted in March 2007, reported in Department of Innovation, Industry, Science and Research (DIISR), Managed Funds in Australia, February 2008.

5 Ernst & Young, Global REIT report, REIT Market Review 2007.

6 Managed funds, Australian Bureau of Statistics (ABS), June quarter 2008. Estimates of consolidated assets of managed funds are derived by eliminating any cross-investments that take place between the various type of funds. For example, investments by superannuation funds in public unit trusts are excluded from the assets of superannuation funds in a consolidated presentation.

7 ABS, ibid.

8 ABS, ibid. This figure is the level of unintermediated investment by foreign residents in Australian managed funds and does not include investments held by Australian nominees on behalf of foreign investors ($10 billion at 30 June 2008, ABS unpublished).

managers (ranked by assets under management) accounted for 48 per cent of the market, and the 30 largest accounted for around 80 per cent.[9]

2.6 Wholesale or institutional sources of MIT funds, including in particular superannuation funds, accounted for around 75 per cent of aggregate funds under management in June 2007. Wholesale assets are assuming an increasing share of managers' total assets.[10]

2.7 In a report commissioned by IFSA from Lateral Economics,[11] it was estimated that the funds management industry may account for as much as 40 per cent of the contribution that the finance and insurance industry as a whole makes to the Australian economy, which would put its share of gross domestic product at around 3.4 per cent, higher than agriculture's share of 3.1 per cent.

Public unit trusts

2.8 As defined by the ABS, a public unit trust is a trust which issues units to the general public within Australia for the purpose of investing the pooled monies. It must have registered a product disclosure statement with ASIC and be governed by a trust deed. The units may or may not be listed on the ASX (around 57 per cent of them are listed). With respect to the total of A$307 billion of unconsolidated assets invested in public unit trusts as of June 2008, the following breakdown is reported by the ABS:[12]

- property trusts (that is, real estate investment trusts) account for A$132 billion, of which almost all are listed property trusts representing A$125 billion;
- equity trusts account for A$151 billion, of which unlisted equity trusts are the majority, representing A$101 billion; and
- other unit trusts, including mortgage trusts, account for A$24 billion.

2.9 In terms of destination of investments by public unit trusts as of the end of June 2008, close to 18 per cent is held in overseas assets (A$54 billion). Of the remaining A$253 billion invested in Australia, the major holdings are in equities and units in trusts (A$103 billion) and in land and buildings (A$93 billion).

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9 DIISR, ibid.

10 DISSR, ibid.

11 Lateral Economics, Other people's money: A snapshot of Australia's funds management industry and its export potential, June 2007.

12 ABS, ibid.

REAL ESTATE INVESTMENT TRUSTS

2.10 As noted in the 2007 edition of the Ernst & Young Global Real Estate Investment Trust Report, total global capitalisation for the REIT market at 30 June 2007 was US$764 billion, with the US having a 50 per cent share and Australia ranking as the second largest REIT market with US$112 billion (15 per cent share).[13]

2.11 Other observations made in the Ernst & Young Report about the REIT market in Australia (**A-REITS**) during the year ended on 30 June 2007 include:

- A-REITS had an average yield of 7.05 per cent, up from 6.5 per cent in 2006 and the second highest of all REIT countries globally;
- gearing for the average A-REIT increased to 43.93 per cent from 34.09 per cent in 2006. Trusts with foreign property have gearing levels in excess of 50 per cent in most cases; and
- capitalisation rates have tightened further, from levels that were considered low in 2006. Capitalisation rates between 5 and 6 per cent are commonplace for quality properties.

13 As reported by Ernst & Young at the 6th Annual Property Intensive conference held in Sydney on 27 August 2008, the 2008 edition of their Global REIT report, will show that Australia remained at 30 June 2008 the second largest REIT market after the US, but will also show that Australia ranked last out of 16 countries in terms of total rate of return (capital and income) in the year to 30 June 2008.

CHAPTER 3: CURRENT INCOME TAX ARRANGEMENTS FOR MANAGED INVESTMENT TRUSTS

OVERVIEW

3.1 MITs are widely held collective investment vehicles which allow individuals to pool together their capital to enable investment in larger and more diversified assets than would otherwise be the case. They also provide an easy way to invest as the investment decisions and everyday management of the trust are undertaken by investment managers. Most MITs in Australia are unit trusts taxed under the general trust provisions of Division 6 of Part III of the *Income Tax Assessment Act 1936* (**ITAA 1936**) and related provisions, however, certain widely held trusts (corporate unit trusts and public trading trusts) are taxed in a similar manner to companies under Divisions 6B or 6C of Part III of the ITAA 1936.

3.2 This Chapter outlines the current taxation arrangements applying to MITs and identifies areas where issues and uncertainties can arise.

TAXATION OF TRUSTS GENERALLY

3.3 The key general provisions for the taxation of trusts are found in Division 6 of the ITAA 1936. These provisions operate in conjunction with the general taxation provisions located elsewhere in the legislation; in particular they work with the ordinary income, general deduction, capital gains tax (**CGT),** dividend imputation and withholding tax rules contained in the ITAA 1936 and the *Income Tax Assessment Act 1997* (**ITAA 1997**).

Determining liability to taxation

3.4 Division 6 of the ITAA 1936 uses both trust law concepts and tax law concepts as the basis for determining whether tax liabilities are imposed on beneficiaries or on trustees. In general terms, a beneficiary is taxable on a share of the net income[14] of the trust estate for tax purposes having regard to the share of the income of the trust to which they are presently entitled.

14 Defined in subsection 95(1) of the ITAA 1936.

3.5 The net income of a trust estate (a tax law concept) is the taxable income of the trust calculated as if the trustee is a resident taxpayer. The trust income may differ from the net income.

3.6 A beneficiary will generally have a present entitlement to a share of the trust income if they have been paid or received that share of trust income, or have a present right to demand payment of that trust income or a 'vested and indefeasible' interest in that income.[15] Whether a beneficiary is presently entitled to a share of the trust income can depend on the nature of a beneficiary's interest in the trust, the type of trust or whether there are different classes of beneficiary with varying entitlements to trust income or capital.

3.7 The broad principles underlying the general trust provisions are that:

- a beneficiary's assessable income for a year should include a share of the net income of the trust estate where the beneficiary is presently entitled to a share of the income of the trust estate;[16]
- if a beneficiary is presently entitled to a share of the trust income, they will be subject to taxation on that share of the net income of the trust regardless of whether it is actually distributed and regardless of whether it is different in amount to the share of the trust income;
- the beneficiary is then taxed on their total taxable income (including the share of the net income); and
- the trustee is taxed on that part of the net income of the trust which is not assessable to a beneficiary or to the trustee on behalf of a beneficiary.[17] In these circumstances, the trustee is generally taxed at a flat rate at the highest marginal tax rate plus the Medicare levy, currently 46.5 per cent.

3.8 The taxation law requires that a beneficiary's present entitlement to trust income be determined as at the end of the trust's income year, usually 30 June.

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15 Subsection 95A(2) ITAA 1936. The expression 'vested and indefeasible' is not defined in the tax law and its meaning is determined having regard to case law. A vested interest is one that has taken effect in possession, or is bound to take effect in possession at some time and is not contingent upon any event occurring that may or may not take place. An interest will be defeasible if it is a vested interest that can be brought to an end or defeated, in whole or in part, by the operation of a condition subsequent or a conditional limitation.

16 Under section 97 of the ITAA 1936 where the beneficiary is not under a legal disability or section 98 of the ITAA 1936 where the beneficiary is under a legal disability (for example, a minor), or a non-resident at year end.

17 Sections 99 and 99A of the ITAA 1936.

Concept of present entitlement, trust income and share of trust income

3.9 In the legislation there is no clear definition of, or concept of, trust income, present entitlement or share of the trust income. Accordingly, some stakeholders are of the view that there can be uncertainty as to:

- whether trust income refers to net accounting profit, distributable income or gross ordinary income; or whether it can vary depending on the circumstances and the terms of the trust deed;
- the meaning of the expression 'share';
- the circumstances in which present entitlement exists; and
- how beneficiaries and trustees are to be taxed where trust income differs from the net income of the trust for tax purposes.

3.10 The issues associated with the current operation of Division 6 when determining tax liabilities and potential options for addressing them are covered in more detail in Chapter 4.

THE TREATMENT OF TRUST DISTRIBUTIONS

3.11 The taxation treatment of distributions to beneficiaries is dependent on a number of factors such as the individual circumstances of the beneficiary, the nature of their interest in the trust and the type of the distribution.

The nature of a beneficiary's interest in the trust property

3.12 An important factor for determining the taxation consequences to a beneficiary is the nature of that beneficiary's interest in the trust and specifically, the nature of the beneficiary's interest in the trust property or, in certain instances, entitlement to income and capital. Where a beneficiary is taken to have a sufficient proprietary interest in the trust property certain tax consequences follow. For example, some taxation consequences arise as a result of a beneficiary being taken to have an 'absolute entitlement'[18] to the trust property.[19] Others arise as a result of the beneficiary being

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18 The ATO takes the view in draft Taxation Ruling TR 2004/D25 *Income tax: capital gains: meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the Income Tax Assessment Act 1997* that a beneficiary will be absolutely entitled to an asset of the trust if the beneficiary has a vested and indefeasible interest in the asset as well as the ability to call for the trustee to transfer the asset to the beneficiary or at its direction. See also *Kafataris v Deputy Commissioner of Taxation* [2008] FCA 1454 (*Kafataris*).

19 For example, as a result of section 106-50 of the ITAA 1997, acts of the trustee are regarded as acts of the beneficiary for the purposes of applying the CGT provisions.

taken to have a 'vested and indefeasible'[20] interest in the trust property or in the share of income and capital.[21] These concepts are not specifically defined in the legislation.

3.13 Where MITs are established as unit trusts, unit holders would normally not have a specific interest in any particular asset of the trust. Rather, a unit is usually taken to represent a proportional interest in the whole of the trust property net of any liabilities.

3.14 Recent High Court and Federal Court decisions have raised some uncertainty for MITs and investors in applying provisions which require a beneficiary to have a specific interest in the trust property.[22] To the extent that there is uncertainty for MITs and investors, compliance costs are increased.

Character of income

3.15 The taxation treatment of a distribution to a beneficiary will depend on the character of the income in the beneficiary's hands, for example, different consequences arise for beneficiaries in an MIT if the distribution is taken to be:

- dividends — non-resident beneficiaries will be subject to a final gross withholding tax on the unfranked part of the distribution and resident beneficiaries may be entitled to a proportionate share of franking credits attached to distributions received by the trustee;
- interest/royalties — non-resident beneficiaries will be subject to a final gross withholding tax on the distribution;
- other Australian sourced income — non-resident beneficiaries will be subject to final withholding tax on the 'fund payment' amount;
- foreign source income — non-residents beneficiaries will not be subject to tax on the distribution; and
- capital gains — qualifying beneficiaries can benefit from the CGT discount.

3.16 In the context of MITs, one of the widely perceived consequences of the use of a trust is that the character of amounts in the hands of the trustee will generally

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20 As discussed above, there is no legislative definition of the term but it is generally said to mean one that has taken effect in possession, or is bound to take effect in possession at some time (that is, is not contingent upon any event occurring that may or may not take place) and cannot be defeated.

21 For example the existence of vested and indefeasible entitlements to income and capital is relevant in determining whether a trust is considered to be a fixed trust under section 272-65 of Schedule 2F to the ITAA 1936.

22 See for example the High Court decision in *CPT Custodian Ltd v Commissioner of State Revenue* (2005) 222 ALR 286, [2005] HCA 53 (*CPT Custodian*). In that case the court decided, inter alia, that the nature of a beneficiary's interest in the trust property can only be determined in accordance with the terms of the trust instrument. These decisions have raised doubt as to whether beneficiaries in many modern MITs can establish an interest in any particular trust property.

flow-through the trust and be retained in the hands of beneficiaries. The current law specifically provides this outcome in some circumstances. For example, there are provisions which provide for the flow-through of exempt and non-assessable non-exempt income[23] and in some circumstances a beneficiary may be deemed to have made a capital gain that has been realised by the trustee.[24] Beneficiaries may also be deemed to have derived income attributable to, for example, dividends and interest.[25] Also, where qualifying conditions are met, certain tax attributes such as franking credits[26] and foreign income tax offsets[27] may flow-though to the beneficiary.

3.17 This flow-through treatment is also said to arise more generally under a general law 'conduit theory' of trusts,[28] although, there is a view that case law has raised doubts as to whether the 'conduit theory' is a principle of general operation.[29] As a result of the same cases, there is also doubt about whether specific flow-though provisions in the tax law which require a beneficiary to have a sufficient interest in the trust property are capable of applying in the context of a beneficiary's interest in an MIT.

3.18 The flow-through taxation treatment of trusts and character retention is dealt with in more detail in Chapter 6.

Where trust distributions differ from the net income of the trust

3.19 Where distributions from a trust exceed the net income of the trust, Division 6 does not itself operate to include any of the distributed excess in the assessable income of the beneficiary.[30] However, in the case of MITs, such amounts will generally result in a CGT cost base adjustment to the beneficiary's unit.[31] The excess of distributions over the net income is commonly referred to as tax deferred distribution.

3.20 Trust distributions may exceed the net income of the trust for a number of reasons, either of a timing or permanent nature. For example, a timing difference arises where revenue may be recognised in an earlier income period for trust purposes than it is recognised for tax purposes. An example of a permanent difference is where a deduction is not allowable for tax purposes but the outgoing is recognised as an expense in the accounts of the trust.

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23 See for example subparagraphs 97(1)(b) and 97(1)(c) of the ITAA 1936.

24 See for example Subdivision 115-C of the ITAA 1997.

25 See section 6B of the ITAA 1936.

26 Subdivision 207-B of the ITAA 1997 together with the Division 1A of the former Pt IIIAA of the ITAA 1936.

27 Section 6BA of the ITAA 1936 together with Division 770 of the ITAA 1997.

28 See *Syme v C of T* (Vic) (1914) 18 CLR 519 (Privy Council) and *FC of T v. Tadcaster Pty. Ltd* (1982) 13 ATR 245 at 249, and *Charles v FC of T* (1954) 90 CLR 598.

29 See *CPT Custodian* and *Webb v Syme* (1910) 10 CLR 482 (High Court).

30 It is understood that the Commissioner's practice is not to apply section 99B of the ITAA 1936 in these circumstances.

31 A capital gain will arise under CGT event E4 if the non-assessable amount exceeds the cost base of the unit.

3.21 There is a view that one of the issues with the current taxation treatment of tax deferred distributions in relation to MITs is whether Division 6 is an exclusive code for the taxation treatment of such distributions, or whether they can be included in the assessable income of a beneficiary[32] if they otherwise have the character of ordinary income in the hands of the beneficiary.

3.22 The treatment of tax deferred distributions is discussed in more detail in Chapter 6.

CAPITAL GAINS TAX

3.23 There are several CGT provisions which apply specifically to trusts. The CGT treatment of a trust's assets and of beneficiaries' interests and entitlements can depend on a number of factors including the nature of the trust. For example, under the CGT provisions, there is a distinction made between deceased estates, unit trusts and other types of trusts. For CGT purposes, a different treatment applies where the beneficiary is taken to be absolutely entitled to the trust property. Acts of the trustee in relation to the assets are ignored and the beneficiary is taken to have done the acts for CGT purposes.[33] In the context of MITs and other unit trusts, CGT applies separately to the disposal of trust assets by the trustee and the disposal of a beneficiary's unit in the trust.

Trustee level

3.24 Gains on the disposal of trust assets by MITs are generally included in the net income of the trust on the same basis as if the trustee were an individual taxpayer. For MITs this treatment is important because where the assets are held by the trustee on capital account and certain qualifying conditions are met, the CGT discount will be available to the trustee in determining its net income.[34] However, where assets are held by the trustee on revenue account or for less than twelve months then the full amount of any gain on disposal of the asset will be included in the taxable income of the trust.

3.25 Some stakeholders have suggested there should be an amendment to the law to make the CGT provisions the primary code for calculating gains and losses in respect of investments by MITs in shares, units in unit trusts and real property.

3.26 The treatment of gains made on disposal of MIT assets is dealt with in more detail in Chapter 7.

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32 Under section 6-5 of the ITAA 1997. See *FC of T v Belford* (1952) 88 CLR 589 and *Union Fidelity Trustee Co. v. FC. of T* (1969) 119 CLR 177.

33 Section 106-50 of the ITAA 1997; also see *Kafataris*.

34 Subdivision 115-C of the ITAA 1997.

Beneficiary level

3.27 Where a beneficiary is assessable on a share of the net income of an MIT that is attributable, in whole or in part, to a discount capital gain, the beneficiary is deemed to have made a capital gain equal in amount to the gain grossed up for the 50 per cent CGT discount in the hands of the trustee.[35] Eligible beneficiaries then offset their own capital losses against the grossed up capital gain before applying the CGT discount to determine their individual capital gains.[36]

3.28 Where a beneficiary receives certain tax deferred distributions from an MIT, the cost base of their interest in the trust is, in certain circumstances, adjusted to reflect the distribution. If the non-assessable distribution exceeds the CGT cost base of the beneficiary's interest, the excess is taxable to the beneficiary in the year in which the distribution is made. If the non-assessable distribution does not exceed the CGT cost base, it will be applied to reduce the cost base for the purposes of determining any capital gain or loss in future income years.

3.29 A current issue for MITs is that effective double taxation of capital gains can arise for beneficiaries where the trustee makes a tax deferred distribution sourced from trust gains which are not included in the net income of the MIT until the gains are realised for tax purposes in a later income period.

3.30 Tax deferred distributions and cost base adjustments are dealt with in greater detail in Chapter 6.

Fixed trusts

3.31 Certain widely held trusts such as MITs may be provided with more flexible rules in some areas of the taxation laws. For example, under the trust loss rules[37] less onerous tests apply to determine when losses can be recouped by the trust. Another example is where beneficiaries are able to access special rules when determining whether they satisfy the 45 day holding period rule for the purposes of being eligible to receive a share of the franking credits attributed to a dividend distribution received by the trustee.[38]

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35 The discount is only available to individuals and superannuation funds. However, all beneficiaries have extra capital gains deemed and it is only after the gross up and offset of losses that the discount is applied to the beneficiaries entitled to it.

36 However, if there is no beneficiary entitled to trust income then the trustee is taxed on the capital gain. A trustee assessed under subsection 98(3) or section 99A is not entitled to the CGT discount.

37 Schedule 2F to the ITAA 1936.

38 Division 1A of former Pt IIIAA of the ITAA 1936.

3.32 Eligibility for a number of these special rules is limited by the requirement that the MIT be a 'fixed trust'. The definition of fixed trust[39] depends on whether persons have a 'fixed entitlement'[40] to all of the income and capital of the trust.

3.33 These provisions use the general law concept of a 'vested and indefeasible interest' to determine whether a person has a fixed entitlement to the income and capital of the MIT. The operation of these provisions in the context of MITs has been a concern of industry and questions have arisen as to whether, in many unit trusts, investors have interests in the income and capital that could be described as 'vested and indefeasible' interests. If not, then many MITs will need to rely on an exercise of the Commissioner's discretion in order to satisfy the definition of a fixed trust.

3.34 Fixed trusts are discussed in more detail in Chapter 8.

Divisions 6B and 6C

3.35 Corporate unit trusts and public trading trusts are Australian resident public unit trusts which are taxed like companies under Division 6B or 6C of the ITAA 1936.

3.36 Division 6B was introduced in 1981 to discourage the reorganisation of companies involving the transfer of assets and businesses into a public unit trust in which the shareholders would take equity in order to avoid continued company tax and shareholder treatment and to attract trust tax treatment instead. It was introduced when the (then) classical system of taxation applied. This system did not provide franking credits to shareholders for the tax paid by a company so that distributed company profits were effectively taxed twice, once at the company level and also when the net amount was distributed to shareholders by dividend.

3.37 Division 6C was introduced in 1985 to ensure that any public unit trust (publicly listed, publicly offered or widely held) would be taxed in a similar way to a publicly listed, publicly offered or widely held company, unless its activities were confined to certain listed activities, generally investment in property primarily for rent or involving trade or investment in certain kinds of financial assets. The intention was to discourage trusts being used to provide a tax alternative to conducting any activity other than the listed activities in a company. The equity holders in the public unit trust would correspondingly be taxed like shareholders for the same reason. Provided widely held trusts limit their investments to eligible investments and trading in certain financial instruments, they retain trust taxation. The intention was to protect revenue and ensure competitive neutrality between listed and publicly offered or widely held companies and trading trusts. One particular concern at the time was that superannuation funds, which did not benefit from imputation credits until 1988 (so

39 Section 272-65 of Schedule 2F to the ITAA 1936.
40 Section 272-5 of Schedule 2F to the ITAA 1936.

that the classical system of company taxation initially applied to them), would prefer to receive business income through trusts rather than companies. As a result Division 6C extends the concept of a public unit trust to any unit trust in which superannuation funds hold 20 per cent or more of the trust, even though the unit trust is not otherwise listed, publicly offered or widely held.

3.38 In light of the changes to the tax law involving the treatment of capital gains, the imputation system and the taxation of superannuation funds which occurred at the time and subsequently to the introduction of Division 6B, questions arise as to whether it is appropriate that Division 6B remains in the legislation.

3.39 The current operation of Division 6C and Division 6B and the issues which arise for MITs are discussed in more detail in Chapters 9 and 10 respectively.

TAXATION OF NON-RESIDENT BENEFICIARIES

Distributions to non-Residents

3.40 Where a non-resident beneficiary is presently entitled to a share of income of a trust which reflects dividends, interest or royalties (with a relevant Australian connection) derived by the trustee and included in the income of the trust estate, the trustee (in their capacity as the relevant Australian payer) will generally be required to withhold and remit tax to the ATO at the following rates:

- Unfranked Dividends — 30 per cent
- Interest — 10 per cent
- Royalties — 30 per cent

3.41 These rates are generally reduced by Australia's tax treaties for dividends and royalties. Fully franked dividends are not subject to withholding. As the tax withheld is a final tax, this income is not subject to assessment by lodgement of a return of income.

3.42 Since 1 July 2007 distributions attributable to Australian source net income (other than dividend, interest and royalty income and capital gains on assets that are not taxable Australian property) from MITs to non-resident beneficiaries are subject to a uniform, non-final withholding tax of 30 per cent. Amounts of net income (corresponding to income of the trust to which a non-resident is presently entitled) not distributed within a 3 month timeframe are subject to tax in the hands of the trustee at the top marginal rate. However, effective from 1 July 2008, legislation has replaced this regime with a final withholding tax which phases down the rate of 30 per cent to 7.5 per cent over 3 years for beneficiaries from countries which have an effective

exchange of information agreement with Australia. For other countries, a 30 per cent final withholding rate applies.[41]

3.43 Non-resident beneficiaries are not assessable on amounts attributable to distributions subject to final withholding tax. In the 2008-2009 financial year, an interim arrangement enables non-resident beneficiaries to claim deductions for expenses associated with their investments (such as interest expenses), and receive a credit for withholding tax paid.

3.44 Distributions to non-resident beneficiaries which are not attributable to dividends, interest, royalties or Australian sourced net income (excluding taxable gains on non-taxable Australian property) are not otherwise subject to withholding tax.

Non-residents and capital gains tax

3.45 Non-residents, including beneficiaries of trusts and trustees of foreign trusts, are subject to capital gains tax on certain Australian assets.[42] One of the main changes made to the CGT treatment of non-residents in 2006 was to reduce the categories of assets which give rise to a CGT liability. As a result of these changes, units held on capital account by most foreign beneficiaries in MITs are not subject to CGT on disposal. Non-residents are also generally not subject to capital gains from the disposal of non taxable Australian real property when the gains are distributed through a fixed trust.

3.46 The taxation arrangements which apply to non-resident beneficiaries are discussed in more detail in Chapter 5.

41 See Division 840 of the ITAA 1997.
42 Division 855 of the ITAA 1997.

CHAPTER 4: OPTIONS FOR DETERMINING TAX LIABILITIES

UNCERTAINTIES WITH THE CURRENT OPERATION OF DIVISION 6

4.1 The terms of reference require the Board to have regard to the current taxation treatment of trusts which relies on the use of present entitlement to determine the income liability as between beneficiaries and trustees. The terms of reference also require the Board to explore alternatives that provide broadly similar taxation outcomes for beneficiaries, having regards to the costs and benefits of those options.

Trust income

4.2 There is no definition of, or clear concept of, trust income in the legislation. The ATO takes the view that trust income is to be determined by reference to ordinary concepts[43] whilst others take the view that what is trust income can be determined by the trust deed or by the trustee acting under authority of the deed.[44]

4.3 The trust income is likely to differ from the trust's net income for tax purposes. When trust income differs from the trust's net income, it can create inappropriate taxation outcomes. For example, income beneficiaries may be liable to tax on capital gains, even though the capital gains are retained by the trust or are entitlements of, or paid to, other beneficiaries (such as a capital beneficiary). That is because a capital gain is statutory income for tax purposes and may not be trust income.

Share of trust income

4.4 There is also no definition of 'share' of trust income in the legislation. There are essentially two approaches that can be used to determine the share of trust income: (a) the proportionate approach (that is, share is taken to mean proportion); and (b) he quantum approach (that is, when share is taken to mean amount).

4.5 Neither approach produces a satisfactory outcome in all cases. For example, under the proportionate approach, a beneficiary may be taxed in respect of an amount

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43 Refer ATO Decision Impact Statement concerning the decision of the Full Federal Court in *Cajkusic & Ors v Commissioner of Taxation* [2006] FCAFC 164.

44 The case of *Bamford & Ors v FC of T* [2008] AATA 322 (*Bamford*) (on appeal to the full Federal Court) is the most recent case to consider this issue.

which they will not receive. The weight of judicial authority lies with the proportionate approach.[45]

Present entitlement

4.6 The term 'present entitlement' is not defined in tax legislation. Generally, present entitlement to income is established if a beneficiary has an interest in the income which is both vested in interest and in possession and has a present right to demand and receive payment of trust income, whether or not the precise entitlement can be ascertained before the end of the year of income, and whether or not the trustee has funds available for immediate payment.[46] In the context of discretionary trusts, section 101 of the ITAA 1936 deems a beneficiary to be presently entitled to an amount paid to them or applied for their benefit.

4.7 A problem with the use of present entitlement in the context of MITs is where an MIT sells assets to obtain funding for redemptions of units (that is, to pay out beneficiaries withdrawing from the trust). Whilst a gain on the disposal of the assets may be in whole or in part the source of the redemption payment, there is an issue as to whether the redeeming unit holder can be characterised as a beneficiary presently entitled to the income of the trust estate in respect of the relevant year of income. If they cannot be so characterised, then the liability for tax payable on the gain (whether it be revenue or capital in nature), would fall on the trustee and/or ongoing beneficiaries. This may lead to MITs increasing the end of year distributions to match the gain which Division 6 includes in the assessable income of the ongoing beneficiaries.

ALTERNATIVES TO THE PRESENT REGIME

4.8 At a high level, there are a number of alternative approaches to the current system that can be used as a basis for determining the tax liabilities. For example:

Option 1: the trustee could be assessed on the net income after allowing a deduction for certain distributions made to beneficiaries. This option is referred to as the trustee assessment and deduction model;

Option 2: the trustee is exempt from taxation and instead tax on the net income of the trust is always assessable to beneficiaries, irrespective of the level of actual distributions made to them. This option is referred to as the trustee exemption model; and

45 Recently, the AAT case *Bamford* has affirmed the use of the proportionate approach.

46 *Harmer v FC of T* (1991) 173 CLR 264.

Option 3: the trustee is exempt from taxation and instead tax on the net income of the trust is always assessable to beneficiaries provided a substantial minimum level of annual distributions (for example 90 per cent) of income is made to them within a specified period.

4.9 In each of these options the trustee would be required to calculate the net income on the same basis as the current section 95 of the ITAA 1936.[47] Examples using numeric values of the operation of options 1 and 2 are contained in Appendix H.

4.10 Alternatively to the above options, it may be possible to retain the basic structure of Division 6 but modify it to clarify or redefine the meaning of key terms such as present entitlement, income of the trust and share of that income.

4.11 Each option would have different impacts for MITs and beneficiaries, including on compliance costs, and international implications.

4.12 Under Option 1, the liability of the beneficiary would depend on the extent to which the trustee makes deductible distributions to the beneficiary. Options 2 and 3 would ensure the income of an MIT is taxed to beneficiaries although they may give rise to situations where a beneficiary may be taxed on amounts to which they have no immediate entitlement.

4.13 Option 1 ensures beneficiaries will have sufficient funds to pay the tax liability associated with the receipt of income because actual distributions must be made for the MIT to claim a deduction.

4.14 An issue with Option 1 is that the MIT may have accrual (foreign or other) income included in its assessable income, and will not be in receipt of the actual funds to make a distribution in respect of that income. It may need to borrow to make the distribution, or pay tax at the trustee level on the undistributed net income.

4.15 Option 2 provides a very high degree of certainty about where the tax liability will fall as the beneficiary is taxed on the net income and not the trustee. An issue under this option is that distributions of income need not be made to beneficiaries and therefore there is more scope for beneficiaries to have a tax liability without the receipt of funds from which to pay it. However, it is noted that beneficiaries may choose an investment vehicle that does not provide cash distributions annually and be willing to fund their tax liabilities from other sources.

4.16 Option 3 reduces the extent to which beneficiaries are liable for tax on amounts they do not receive. There may be some additional compliance costs for trustees as they must ensure that they make the required minimum level of distributions. If the trustee does not make minimum distributions, they would be subject to tax.

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47 This requires that the taxable income of the trust be calculated as if the trustee is a resident taxpayer.

4.17 If under Option 3 the minimum level of distributions is not made, the trust could fall out of the regime entirely and Division 6 would instead apply. Alternatively, the Commissioner could be given discretion based on certain criteria to permit the trust to continue to be taxed as an MIT or the trustee could be taxed on the undistributed amount possibly at penal rates.

4.18 The Board notes that other countries have specific taxation regimes for managed funds and/or real estate investment trusts (refer to Appendix E and Appendix F).

Q 4.1 Issues/Questions

The Board seeks stakeholder comment on:

(a) the high level Options outlined above including comment on any issues that affect their workability as alternative models;

(b) the alternative that the current arrangements, which rely on Division 6 concepts such as trust income, share of trust income and present entitlement, could be modified to overcome the current issues and in that case, what modifications would be desirable; and

(c) any other options for change.

What are distributions?

4.19 In any taxation regime for MITs, there will be a requirement to calculate the net income of the MIT. If the net income of the MIT always falls to be assessable to beneficiaries (Option 2), then there may not be a need to define a distribution unless there are special conditions, such as minimum distribution rules for the MIT (as in Option 3). However, if (as in Option 1) the mechanism for determining whether a beneficiary is liable to taxation is payment of a distribution that is deductible to the MIT, then a definition of distribution is essential.

4.20 A deductible distribution could be defined to include a payment or application of money or property to or on behalf of a beneficiary. In a model that requires minimum annual distributions, the minimum could be calculated by reference to the net income amount or the trust income amount.

Q 4.2 Issues/Questions

The Board seeks stakeholder comment on a definition of distribution that would provide clarity and ensure appropriate tax outcomes.

Character flow-through

4.21 The discussion of character flow-through is relevant to the operation of any potential options for determining taxation liability. This is discussed separately in

Chapter 6, which contains a discussion of possible methods of ensuring that the character of amounts received by the trustee are able to flow-through to beneficiaries entitled to the amounts.

Tax rate for undistributed/unallocated income

4.22 Option 1 will result in the trustee being taxed on any undistributed net income. An important consideration for this option is the tax rate applicable to that income. The current section 99A rate of tax applied to the net income that is not otherwise assessable in the hands of beneficiaries or trustees is the top personal marginal rate, plus the Medicare levy (currently 46.5 per cent).

4.23 In determining the appropriate rate to apply, consideration should be given to the integrity concerns which underlie the current tax rate which is applied to trustees on undistributed net income. The current rate is not intended to represent a proxy for a beneficiary's individual tax rate but was originally designed to remove the cost to tax revenue of trusts accumulating income.

4.24 In the context of MITs the rate of tax to apply should reflect an appropriate balance between equity and integrity.

Q 4.3 Issues/Questions

The Board seeks stakeholder comment on whether:

(a) applying the current section 99A tax rate on the undistributed taxable income of a trust would reflect an appropriate balance between integrity and equity considerations; and

(b) there are means, other than applying the top marginal rate, for preserving integrity.

When is tax liability determined

4.25 Under the current approach, a beneficiary's tax liability arises in the same year that income is derived by the trust, even though an amount of the income may not be distributed to the beneficiary until the following income year.

4.26 The current treatment is consistent with *Policy Principle 1* and *Policy Principle 3* of the terms of reference which require 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 and that beneficiaries should be assessable on their share of the net income of a trust whether it is paid or applied for their benefit, or they have a present right to call for immediate payment.

4.27 Under Option 2 (the trustee exemption model), the net income of the trust is taxable to beneficiaries in the same year that the income is derived.

4.28 However, under Option 1 (the trustee assessment and deduction model), there are two approaches that can be taken to determine when liability arises:

- the trustee could be given, for example, three months after the end of the income year to make distributions that it can claim as deductions for that income year, and resident beneficiaries would include the taxable distribution in their tax return for that same income year; or
- taxable distributions could be assessable in the income year that they are actually received by beneficiaries. Under this receipts based approach the trustee would claim a deduction for the distribution of the taxable amount in one year (say 2007-08) even though it makes the distribution on, for example, 29 August 2008, in the 2008-09 income year and the beneficiaries include it in their 2008-09 tax return rather than their 2007-08 tax return as would apply under the first approach.

4.29 The first approach is largely consistent with the current administrative arrangements in respect of discretionary trusts, whereby the Commissioner allows trustees two months from the end of the income to establish present entitlement[48]. However, three months aligns with the period allowed for withholding by MITs from distributions to foreign residents under the withholding tax provisions for MITs in the *Taxation Administration Act 1953.*

4.30 The second approach will lead to a deferral of tax revenue. The cost to revenue would need to be balanced against the simplicity of resident beneficiaries being taxed on a distribution receipts basis.

4.31 Another approach which has been suggested by some stakeholders for simplifying the tax arrangements for beneficiaries is to change the tax year for all MITs to 1 April to 31 March so as to allow them more time to prepare distribution statements before 30 June.

48 Refer Taxation Ruling IT 328 *Trusts: interpretation of section 101 in relation to sections 99 and 99A under 1964 amending legislation*.

Q 4.4 Issues/Questions

The Board seeks stakeholder comment on:

(a) the scope to move to a receipts based approach under a model that allows trustees a deduction for their distributions;

(b) the feasibility of other options to simplify arrangements for beneficiaries including changing the tax year for MITs; and

(c) whether, under the trustee assessment and deduction model, resident individuals should be the only class of beneficiaries assessable on a receipts basis.

Correcting errors in calculating net income — treatment of ‘unders’ and ‘overs’

Overview

4.32 As a result of complexity and time constraints, trustees of MITs can experience difficulty in obtaining ‘final’ information to allow them to calculate within a reasonable time of the end of each financial year, the income of the trust and the net income of the trust. Revisions may be required at a later time to ensure that the correct amounts are reported to the ATO and beneficiaries.

4.33 In some cases, trustees may not be able to obtain all of the relevant information to provide to beneficiaries in a timely fashion. For example, this may be due to the complex investment arrangements entered into by the MIT.

4.34 If a revision occurs, the amounts initially reported to beneficiaries may overstate or understate the correct amount of their share of the net income of the trust. Before the error is identified to them, beneficiaries may have already included the incorrect amounts in their income tax returns.

4.35 If there is an ‘under’, that is the trustee initially under-reported net income to beneficiaries, issues arise in determining where liability to tax in relation to this amount of the MIT’s net income falls. If beneficiaries are presently entitled to all of the trust income, then under the proportionate view the beneficiaries of the trust will be liable for the tax shortfall. The tax law would require the beneficiary to request an amendment to their assessment.

4.36 If there is an ‘over’, that is the trustee initially over-reported net income to beneficiaries, the beneficiaries are entitled to request an amendment to their assessment and obtain a tax refund.

4.37 The issue is further complicated where beneficiaries redeem or sell their units prior to the rectification of any 'unders' and 'overs'.

4.38 Some stakeholders have indicated that adjustments to 'unders' and 'overs' are made in the subsequent year of income to avoid the costs and complexity involved with the reissuing of distribution statements. However, there is no ATO endorsed practice to accept under and over adjustments for one year of income to be rolled forward into the calculation of the following year's net income and beneficiaries' entitlements.

4.39 There would be significant compliance costs for MITs and beneficiaries and administration costs for the ATO in requiring trustees to reissue distribution statements to beneficiaries and for beneficiaries to seek amendments to their assessments, potentially for very small amounts.

Options for dealing with 'unders' and 'overs'

4.40 There are a number of potential approaches to dealing with this issue. These may include:

- the carry forward approach — MITs would be able to carry forward an under or over into the following income year (that is, as an increase or decrease to net income); or
- credit/deduction approach — MITs pay tax and be subject to General Interest Charge on an under and attach a tax credit to the subsequent after-tax distribution. MITs can claim a deduction for an over in the following year.

4.41 In order to preserve integrity (that is, avoid the undue deferral of tax liabilities on unders) and to ensure that there is still an incentive to calculate net income accurately, a de minimis rule may be necessary. For example, the relevant approach would only apply if the under or over amounts were less than 2 per cent of net income. If the under or over amount was greater than the de minimis, the MIT or the beneficiary (as relevant) would be liable in accordance with the ordinary operation of the law.

Q 4.5 Issues/Questions

The Board seeks stakeholder comment on:

(a) the desirability of adopting either a simple carry forward approach or a deduction/credit approach for correcting errors in calculating the net income of the trust. The Board also requests comments on how these approaches would interact with the Options for determining tax liabilities outlined in paragraph 4.8;

(b) how any approach adopted could address the inequities in the allocation of tax liabilities which can arise when unit holders redeem or sell their units before errors in the calculation of the net income of the trust have been identified;

(c) under either approach to correcting errors in the calculation of net income of the trust, whether there is a need for a de minimis rule of up to say 2 per cent of the net income and if yes, what should be the consequences of breaching the de minimis rule; and

(d) whether the Commissioner of Taxation should have discretion to increase the de minimis in special circumstances, and if so, what circumstances.

CHAPTER 5: INTERNATIONAL CONSIDERATIONS

BACKGROUND

5.1 International taxation is based on residence and source. Resident taxpayers are taxed on worldwide income and non-residents on income sourced in that country. It follows that where a resident of one country derives income sourced in another country there will be double taxation of the income. Bilateral tax treaty models have been developed to deal with this double taxation.

5.2 These models operate on the basis that the source country reduces or gives up its unrestricted taxing rights over passive income. To the extent that passive income is taxed at source, withholding taxes are generally applied based on the gross amount of the income and on a final basis. Tax treaty limits on source taxation of passive income are also expressed in terms of the gross income (such as 10 per cent of an interest payment).

5.3 Under these models, the country of residence agrees to eliminate or reduce its taxation on income of its residents which is taxed at source in another country. This outcome may be achieved by giving a tax credit for the foreign tax paid against its own tax (for passive income and in some countries for all income) or exempting the foreign source income from tax (for business, employment and in many countries real property income). Most countries have replicated these relief mechanisms in their domestic law.

5.4 Australia follows these international norms in its domestic law and tax treaty practice. Income is taxed on a residence and source basis.[49] Final gross withholding taxes are applied to dividends, interest and royalties. A final withholding tax also applies to distributions to non-residents by MITs. Other Australian sourced income received by non-residents is taxed on a net basis.

International taxation of MITs

5.5 The international tax treatment of MITs and trusts generally builds on the above framework. If beneficiaries are presently entitled to trust law income, the rules are

49 Sections 6-5 and 6-10 of the ITAA 1997.

applied to them more or less directly. For example, in respect of interest derived by an MIT:[50]

- if a non-resident beneficiary receives a distribution which includes interest derived from an Australian borrower, interest withholding tax is applied; or

- if, as part of a distribution, an Australian resident beneficiary in an MIT receives foreign source interest income which has been taxed at source, the beneficiary is entitled to a foreign income tax offset for the foreign tax. Moreover, if the beneficiary in the MIT is non-resident and the income foreign source, Australia does not tax the income.

5.6 If the MIT has income to which no beneficiary is presently entitled, then the trustee is taxed on that share of the net income under usual residence and source rules with some modifications. The extent of taxation depends on whether the MIT is resident in Australia.

5.7 If the MIT is resident in Australia the worldwide income of the MIT is taxed to the trustee though the tax is refunded on later distribution to a non-resident beneficiary if it is out of foreign source income.

5.8 If the MIT is a non-resident, it is taxed only on Australian source income to the extent no beneficiary is presently entitled. A later distribution of any foreign source income of the non-resident MIT to a resident beneficiary is taxed at that point with a foreign income tax offset and an interest charge to reflect the fact that the income was not taxed in Australia when derived by the MIT. There are additional rules in this case which may tax the settlor or the beneficiary of the MIT as income is derived by the MIT and effectively exempt the beneficiary on receipt of its distribution.

Taxation of non-resident beneficiaries

5.9 For MITs investing in bonds and shares, interest income and unfranked dividends are generally subject to final withholding tax for non-resident beneficiaries. Also, any gains made on the disposal of shares held by the MITs on capital account are not subject to tax in the hands of non-resident beneficiaries unless the shares are taxable Australian property. Domestic gains on the sale of assets held on revenue account are subject to withholding on distribution to non-residents.

5.10 As noted above, since 1 July 2007 distributions attributable to Australian source net income (other than dividend, interest and royalty income and capital gains on assets that are not taxable Australian property) from MITs to non-resident beneficiaries are subject to a uniform, non-final withholding tax of 30 per cent. Amounts of net income (corresponding to income of the trust to which a non-resident is presently

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50 Analogous principles apply in relation to unfranked dividends and royalty payments.

entitled) not distributed within a 3 month timeframe are subject to tax in the hands of the trustee at the top marginal rate. Since 1 July 2008 distributions attributable to Australian source net income (other than dividend, interest, royalty income and capital gains on assets that are not taxable Australian property) from MITs to non-resident beneficiaries are subject to a final withholding tax which phases down the rate of 30 per cent to 7.5 per cent over 3 years for beneficiaries in countries which have an effective exchange of information agreement with Australia. For residents of other countries a 30 per cent withholding rate applies.

THE INTERNATIONAL TAX TREATMENT OF MITS AND CORPORATE COLLECTIVE INVESTMENT VEHICLES COMPARED

5.11 In other countries many forms of corporate collective investment vehicles (**CIVs**) are technically companies for tax purposes even though they are not generally subject to tax (see Appendix E for REITs and Appendix F for other international managed investment fund regimes). Distributions by corporate CIVs are usually treated as dividends under domestic law and are subject to dividend withholding tax in the usual way if distributed to non-residents. Therefore, only one form of withholding tax is generally applicable.

Taxation treatment of MITs

5.12 Countries with corporate CIVs generally need special rules to pass foreign tax credits for the foreign taxes levied on the company through to shareholders. This is because any foreign withholding tax on the income derived by the corporate CIV is generally levied on the corporate CIV rather than the shareholders. This is in contrast to the treatment of MITs and their beneficiaries.

5.13 Many countries, including Australia, have special reductions in withholding tax for certain distributions made to foreign pension funds. If a pension fund invests in a corporate CIV, it may not benefit from the foreign withholding tax reduction in the foreign country as the foreign country will regard the tax as levied on the corporate CIV. In principle, the special rules for corporate CIVs should overcome this problem.

5.14 Corporate CIV countries will generally levy dividend withholding tax on distributions to non-resident beneficiaries even if the income which is being distributed is foreign source, although some countries do not levy withholding tax on dividends paid to non-residents (for example UK and Singapore). By contrast, in the MIT case, non-residents are not subject to withholding tax on foreign source income.

Tax treaty treatment of corporate CIVs

5.15 When tax treaties are considered, corporate CIVs in principle seem advantaged. Because corporate CIVs qualify for treaty benefits in their own right, source tax

reductions effected by the treaty are directly available to the CIV. On the other hand, judging by recent work of the Organisation for Economic Cooperation and Development (**OECD**) in relation to REITs[51] and on-going work on collective investment generally, it is likely that MITs are not entitled to treaty benefits in their own right. Therefore, the benefits have to be claimed on the basis of the residence of the beneficiaries in the MIT, a more complex undertaking.

5.16 The OECD recognises[52] that it is desirable for MITs to be able to claim treaty benefits on behalf of beneficiaries, and also that income derived by corporate CIVs should be recognised as flow through for treaty purposes so that investors in them (like pension funds) would be entitled to more generous treaty benefits than other investors. The OECD has suggested language that will simplify the operation of tax treaties for MITs in the form of property trusts with non-resident beneficiaries. Australia has adopted a variant in its very recent tax treaty with Japan.

5.17 There are also possible problems with corporate CIVs under existing treaties. As the dividend article of many existing treaties would be applicable to any newly introduced corporate CIV regimes and that article typically has a very low withholding tax rate of 5 per cent or 0 per cent rate for non-portfolio investment by a foreign company in a local company, the source country may be prevented by treaty from taxing non-resident corporate (including corporate CIV) investors in local corporate CIVs to the extent it wishes.

Q 5.1 Issues/Questions

The Board seeks stakeholder comment on:

(a) what issues are currently experienced under Australian domestic law and treaties with the operation of international rules for MITs;

(b) what suggestions are there for dealing with the issues; and

(c) would there be advantages in having a deemed corporate flow-through CIV regime for international reasons.

51 OECD, Tax Treaty Issues Related to REITs: Public Discussion Draft available at http://www.oecd.org/dataoecd/23/44/39554788.pdf and OECD, 2008 Update to the OECD Model Tax Convention available at http://www.oecd.org/dataoecd/20/34/41032078.pdf pp 43-44, 49-50.

52 OECD, Update on the work of the informal consultative group on the taxation of Collective Investment Vehicles and procedures for tax relief for cross-border investors, 18 July 2008, available at http://www.oecd.org/document/49/0,3343,en_2649_33747_41030513_1_1_1_1,00.html.

CHAPTER 6: TRUSTS AS FLOW-THROUGH VEHICLES

OUTLINE

6.1 The Board has been asked to develop options for reform that generate taxation outcomes that are broadly consistent with, amongst others, the policy principles that:

- 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;
- beneficiaries should be assessable on their share of the net income of the trust whether it is applied for their benefit or they have a present right to call for immediate payment; and
- the trustee should be liable to tax on the net income of the trust that is not assessable to beneficiaries in a particular year.

6.2 These policy principles suggest that the nature and extent of the character of the amounts derived by the trustee should, in broad terms, flow through directly to beneficiaries entitled to those amounts. They also indicate that the net income of the trust should only be taxable once, either to the beneficiaries who are entitled to a share of the net income or, where no such beneficiaries exist, to the trustee.

ADDRESSING POTENTIAL DISTORTIONS

6.3 As outlined in Chapter 3, MITs will often be established where unit holders do not have any specific interest in any particular assets of the MIT. Rather, typically a unit is a separately transmissible interest which is taken to represent a defined interest in the whole of the trust property net of any liabilities.

6.4 Because beneficiaries in an MIT are not generally regarded as the owners of the underlying MIT property, potential distortions can result where there are differences between the net income of the MIT and the distributions made to beneficiaries. In particular, some gains may be taxed twice, including to beneficiaries who are not entitled to the underlying gain.

Where MIT distributions exceed the net income of the trust

6.5 MIT distributions may exceed the net income of the MIT for a number of reasons either of a timing or permanent nature, including:

- the trustee claiming tax deductions which are not an expense in the accounts of the trust (for example, building allowance write-offs);
- the trustee distributing gains that are recognised for trust purposes in a particular case but which are not recognised for tax purposes (for example, unrealised gains); and
- the trustee returning contributed capital.

6.6 Where MIT distributions exceed the net income of the MIT, Division 6 does not generally operate to include the excess in the beneficiaries' assessable income. Such amounts generally give rise to a CGT cost base adjustment to the beneficiaries' units. If a non-assessable distribution exceeds the CGT cost base of a beneficiary's units, the excess will be taxable to the beneficiary as a capital gain in the year in which the distribution is made.

6.7 If a non-assessable distribution does not exceed the CGT cost base of the beneficiary's unit, it will be applied to reduce the cost base for the purposes of determining any capital gain or loss in future income years. However, if the beneficiary is a non-resident who holds their units on capital account or a superannuation fund in the pension phase, they will not generally be subject to Australian tax on any capital gains arising from the sale of their units.

6.8 Effective double taxation of capital gains can arise for beneficiaries where the trustee makes a tax deferred distribution sourced from trust gains which are not included in the net income of the MIT until the gains are realised for tax purposes in a later income period. This is because the initial untaxed distribution has a tax impact for beneficiaries as a reduction of the cost base of their units or an actual capital gain (if the untaxed part of the distribution exceeds the cost base of the beneficiaries' interest in the MIT) and the subsequent inclusion of the relevant amount in the MIT's net income (as income or a capital gain) will then also be subject to tax (usually in the hands of beneficiaries who are presently entitled to that income in the year in which it is included in net income).

6.9 The following example illustrates how distortions can arise where trust distributions differ from the net income of the trust. The example also illustrates the distortions that can occur when units in the MIT change ownership.

Example

Beneficiary A subscribes for $10,000,000 units in PropTrust (assumed for the purpose of this example to be an MIT even though reference is made to a single investor). The trustee uses the subscription price to acquire office accommodation for rent.

In its first year, the income of the trust is $1,250,000 and the net income of the trust is $1,000,000 (which includes a reduction for a building allowance of $250,000).

The trustee distributes $1,250,000 to Beneficiary A. As a result, Beneficiary A receives a tax deferred amount of $250,000 and accordingly the cost base of its units is reduced to $9,750,000.

In the second year, the trust disposes of the building for $10 million. After adjusting the cost base of the building, it makes a gain of $250,000 which for the purpose of this example is assumed to be a capital gain which is included in the net income of the trust. The trust also has some net rental income.

The gain is not included in the trust law income. Assume that there is no distribution of an equivalent amount to Beneficiary A.

Before the end of the second year, Beneficiary A sells its units in PropTrust to Beneficiary B for $10,000,000 (for the purposes of the example it is assumed that any tax liabilities which, in practice, may be factored into the price paid for the units are ignored). Beneficiary A makes a capital gain of $250,000 ($10,000,000 capital proceeds less $9,750,000 cost base).

At the end of the year, Beneficiary B is presently entitled to the rental income of the trust for the year. Assume the only amount distributed is rent. Beneficiary B includes the $250,000 as a capital gain in its assessable income for the year, even though it has not received a distribution to cover this amount.

As a result of these transactions, a single economic gain of $250,000 is taxed twice — once to Beneficiary A and once to Beneficiary B. This occurs because the gain is recognised and distributed to Beneficiary A for trust purposes (that is, in year 1) before it is recognised and attributed to Beneficiary B for tax purposes (that is, in year 2).

Where MIT distributions are less than the net income of the trust

6.10 Where MIT distributions are less than the net income of the trust, for example where the MIT makes a capital gain which is included in the MIT's net income but which is not included in the distributable MIT income, distortions may also occur.

6.11 The following example illustrates the potential problems which arise where an MIT makes a capital gain that is included in the net income of the MIT for tax purposes but does not form part of the distributable trust income for trust law purposes.

Example

Beneficiary A subscribes for $10,000,000 units in PropTrust (assumed for the purpose of this example to be an MIT even though reference is made to a single investor). The trustee uses the subscription price to acquire office accommodation for rent.

In its first year, the income of the trust is $1,250,000 and the net income of the trust is $1,000,000 (which includes a reduction for a building allowance of $250,000).

Beneficiary A is presently entitled to all of the income of the trust and is taxable on $1,000,000. The trustee distributes $250,000 to Beneficiary A. As Beneficiary A receives a tax deferred amount of $250,000, the cost base of Beneficiary A's units is reduced by $250,000.

In its second year, the trust disposes of the building for $10 million. After adjusting the cost base of the building, the trust makes a gain of $250,000 (which, for the purposes of this example, is a capital gain which is included in the net income of the trust). The gain is not included in the trust law income. Assume that there is no distribution of an equivalent amount to Beneficiary A.

Because Beneficiary A is presently entitled to all of the income of the trust, it is taxable on the capital gain of $250,000, even though it has not received a distribution for this amount (although they did receive a tax deferred amount in the earlier year).

At the beginning of year 3, the value of the trust's assets is $10,000,000.

Beneficiary A then sells its units in PropTrust for $10,000,000 and makes a capital gain for tax purposes of $250,000 (as the cost base of its units is $9,750,000).

As a result of these transactions, Beneficiary A is taxed twice on the same economic gain.

Treatment of tax deferred distributions

6.12 Division 6 does not operate to include a tax deferred distribution in a beneficiary's assessable income. However, such amounts generally give rise to a CGT cost base adjustment to the beneficiary's units. Beneficiaries may be required to maintain records of these transactions for up to five years after they dispose of their units in the trust.

6.13 A concern with the current arrangements for tax deferred distributions is that they add significant complexity and compliance costs for beneficiaries. If cost base adjustment records or data are not maintained, or errors are made by beneficiaries, capital gains can be under or overstated at the time of disposal in the income tax returns of individual investors.

6.14 In Chapter 3 it was noted that another issue for MITs is whether Division 6 is an exclusive code for the taxation treatment of tax deferred distributions, or whether they may be included in the assessable income of a beneficiary if they otherwise have the character of ordinary income in the hands of the beneficiary.

6.15 It is the ATO's view, as per Taxation Ruling No IT 2512, that Division 6 does not operate as an exclusive code for the taxation of beneficiaries in all circumstances and that, for example, distributions out of trust capital may be assessed as ordinary income if the distributions have the character of income in the hands of a beneficiary.[53] Further detail on this issue is included at Appendix C.

Options for change

6.16 An option for dealing with tax deferred distributions would be to recognise that, to the extent to which a tax deferred distribution is not attributable to contributed capital, it is attributable to an underlying trust gain and, therefore, those distributions should be taxed in the hands of the unit holders as and when the gains are realised by the unit holders (that is, instead of merely requiring a cost base adjustment). Adjustments may be required to reflect the extent to which the unit holder would not be taxable in full on the underlying trust gain (for example, for capital gains). It should be noted, however, that depending on its design, this option could be a departure from *Policy Principle 1* which requires that 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.

6.17 In order to avoid taxing the gain a second time, however, corresponding adjustments would be required at the trust level to remove the underlying gain from any subsequent calculations of the net income of the trust.

6.18 Another option, in cases where trust distributions are lower than net income, would be to require a corresponding uplift in the cost base of the units to avoid double taxation.

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53 See *Ewing v C of T* (1928) ALJR 246 (High Court) and *Tindal v Federal Commissioner of Taxation* (1946) 72 CLR 608 (High Court).

Q 6.1 Issues/Questions

The Board seeks stakeholder comment on any options for addressing the uncertainties and potential distortions, including double taxation, which can result where there are differences between the net income of the MIT and the actual distributions made to beneficiaries.

The Board requests that stakeholders consider their comments in the context of both listed and unlisted MITs and in the context of the alternative approaches for determining tax liabilities discussed in Chapter 4.

CHARACTER RETENTION AND FLOW THROUGH

6.19 It has been long understood that under the general law, the character of amounts in the hands of the trustee can flow through to the beneficiaries entitled to those amounts. However, the decision in *CPT Custodian* has created uncertainty about the principle of flow-through in all but simple trusts.

6.20 It is the case however, as noted in Chapter 3, that there are specific provisions in the tax law that seek to ensure that the character of exempt income, non-assessable non-exempt income and capital gains flow through to beneficiaries together with tax attributes on other types of income, such as franking credits and foreign tax credits. There are nevertheless uncertainties regarding how these provisions operate:

- for example, there is uncertainty about how the general deductions of the trust should be allocated when calculating the separate components of the trust's net income. It is not clear whether the trustee has discretion to allocate prior year tax losses or general administrative expenses to particular categories of income (rent, dividends, capital gains etc) or whether it must allocate the expenses rateably across all income types; and

- uncertainty also arises in determining amounts that are 'attributable to' or 'taken into account in working out amounts' included in beneficiaries' assessable income under specific mechanisms existing in the income tax law.

6.21 A related issue with character retention and flow-through tax treatment is complexity and compliance costs for beneficiaries, MITs, and the ATO in regards to reporting and recordkeeping. See for example, the ATO's standard distribution statement for resident unit holders at Appendix B, which details the extent of reporting MITs are required to provide, having regard to the current design of the law, to individual resident beneficiaries.

OPTIONS FOR INCREASING CERTAINTY AND MINIMISING COMPLIANCE COSTS

6.22 There are a number of options that could potentially apply to reduce the current uncertainty and compliance costs associated with character flow-through.

6.23 One option could be to create specific legislation to ensure the flow-through of character which is said to result under the general law.

6.24 Another option could be to treat all MIT distributions in a similar manner to company dividends and enact special rules which would preserve character flow-through in specific instances. Under this option it might be possible to attach a tax credit to the dividend-like distribution in a similar manner to a franking credit.

6.25 Consideration could also be given to whether distributions to foreign residents could have different character retention arrangements. This could, for example, be dependent on the size of their investment in the MIT. For example, the OECD has suggested that a different approach could apply to portfolio and non-portfolio foreign beneficiaries in domestic REITs. It suggests that REIT distributions to portfolio investors be at the lower rate of tax as a final withholding tax (15 per cent maximum under the usual tax treaty) in the same manner as applies to portfolio equity investment. This limited rate of tax would not apply where a beneficiary holds a non-portfolio investment in a REIT (in which case the domestic law withholding rates would apply unaffected by the treaty, for example, 30 per cent gross in the case of US REIT distributions).

6.26 This approach may reduce compliance costs and increase simplicity by extinguishing any character associated with foreign portfolio investment. However, this would require the trustee to determine the size of the unit holdings of individual beneficiaries which could be difficult or impossible where units are held by beneficiaries through a custodian arrangement.

Q 6.2 Issues/Questions

The Board seeks stakeholder comment on:

(a) how current uncertainty as to the applicability of a general law principle of flow-through of character should be addressed;

(b) whether the existing statutory flow-through mechanisms (for example, CGT, franking credits and foreign tax credits) work satisfactorily and, if not, why not;

(c) whether flow-through of character can be maintained while reducing compliance costs and complexity and, if so, by which means;

(d) whether flow-through of character needs to be maintained in general or, alternatively, needs only to be maintained in specific circumstances;

(e) how flow-through of character might work under any options considered for changing the way tax liability should be determined (as discussed in Chapter 4);

(f) whether non-residents can be treated differently in order to reduce complexity (for example, possible consolidation of the base from which amounts are to be withheld); and

(g) whether character retention should be concerned with whether investors are portfolio or non-portfolio investors.

CHAPTER 7: CAPITAL VERSUS REVENUE ACCOUNT TREATMENT OF GAINS AND LOSSES MADE ON DISPOSAL OF INVESTMENT ASSETS BY MITS

OVERVIEW

7.1 The Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen, has confirmed that the treatment of gains and losses made on disposal of assets by MITs is an issue that the Board should consider as part of this review.

7.2 During initial stakeholder consultations this issue has been raised with the Board as an important issue for the MIT industry.

OPERATION OF THE EXISTING LAW

7.3 There are no statutory rules for determining whether gains and losses on the disposal by MITs of shares, units in unit trusts and real property should be on capital or revenue account.

7.4 Gains on the disposal of assets can be on revenue account or capital account. The tax law provides special treatment for capital gains on the disposal of assets held on capital account for more than 12 months by individuals, trusts and superannuation funds. It also provides special treatment for non-resident investors.

7.5 Revenue losses made by a trust on the disposal of assets can be claimed against current income. Capital losses are however quarantined in the trust and may only be offset against capital gains.

Determining what is capital and what is revenue

7.6 Taxation Ruling TR 2005/23[54] paragraphs 73 to 76 set out below provides comment on this issue:

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54 TR 2005/23 deals with capital gains and Listed Investment Companies (LICs) referred to in Subdivision 115-D of the ITAA 1997. The principles discussed in the ruling are relevant to MITs.

Whether gains or losses on the disposal of investments are on capital account is a factual matter to be determined by reference to case law. If disposals take place as part of a business operation, carried out in the course of the business of profit making, the profit arising on the sale will be income according to ordinary concepts: *California Copper Syndicate v. Harris* (1904) 5 TC 159. To determine this question it has been said that: 'It is necessary to make both a wide survey and an exact scrutiny of the taxpayer's activities': *Western Gold Mines NL v. C of T (WA)* (1938) 59 CLR 729 at 740; 1 AITR 248 at 255.

In *London Australia Investment Co. Ltd* (1977) 138 CLR 106; 7 ATR 757; 77 ATC 4398 (*London Australia*), Gibbs J, in finding that the relevant gains were on revenue account, stated at CLR 117, ATR 763, ATC 4403-4404:

> The sale of shares was a <u>normal operation</u> in the course of carrying on the business of investing for a profit. (emphasis added)

It is likely that all listed investment companies would be considered to be carrying on an investment business. However it does not follow that the sale of shares would be a normal operation in the course of carrying on that business. The intermittent nature of share sales may lead to the conclusion that such sales are mere adjustments to the dividend earning structure of the business.

In *London Australia*, the taxpayer gave consideration to selling certain shares if the dividend yield fell below a certain level. This 'exit point' was far from automatic, as was illustrated by the presence of low yielding blue chip stocks in the portfolio and an average annual turnover of around 10 per cent (after converting the portfolio value to market value rather than the historical cost used at the time). Nonetheless, the fact that the investment process envisaged an 'exit point' for some shares appeared to be critical to the finding that the taxpayer held shares on revenue account.

7.7 The following extracts from *FC of T v. Myer Emporium Ltd* (1987) 163 CLR 199 at 213 again highlight the factual nature of the necessary inquiry and the scope for different outcomes based on the individual circumstances of each case:

> … over the years this Court, as well as the Privy Council, has accepted that profits derived in a business operation or commercial transaction carrying out any profit-making scheme are income, whereas the proceeds of a mere realisation or change of investment or from an enhancement of capital are not income ...
>
> The proposition that a mere realization or change of investment is not income requires some elaboration. First, the emphasis is on the adjective 'mere': *Whitfords Beach* ((1982) 150 CLR at p 383). Secondly, profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the profit arising from their expected increase in value: see the

discussion by Gibbs J in *London Australia* ((1977) 138 CLR, at pp 116-118). 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 realization. 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.[55]

IMPLICATIONS FOR MITS

7.8 The characterisation of gains and losses made on the disposal of MIT assets as on capital or revenue account has a number of implications:

- where a gain is made on capital account, then in certain circumstances the CGT discount will be available to the trustee in determining the net income of the MIT. Where a resident beneficiary is assessable on a share of the MIT's net income that is attributable in whole or in part to a discount capital gain, the beneficiary will be deemed to have made a capital gain equal in amount to the gain grossed up for the 50 per cent CGT discount. Eligible beneficiaries are then able to apply the CGT discount (50 per cent for individuals and 33 per cent for superannuation funds) in determining their net capital gains; and
- where a non-resident investor receives a distribution of capital gains which are not sourced from taxable Australian property, Australia does not tax the distribution. Domestic gains on the sale of assets held on revenue account are subject to withholding on distribution to non-residents.

7.9 Furthermore, CGT is the primary code for calculating gains and losses made on assets held directly by superannuation funds. Therefore, to the extent that this capital treatment is not available to superannuation funds who invest in MITs, there may be an incentive for them to seek to invest directly or through pooled superannuation trusts.

7.10 Some stakeholders have suggested to the Board that there should be an amendment to the law to allow the CGT provisions to be the primary code for

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55 Based on the relevant principles derived from case law, it is the ATO view that a profit or gain from a transaction will be income if the trustee entered into the transaction to make a profit or gain and the transaction was entered into, and the profit was made, either outside the normal course of the taxpayer's business, or in the carrying out of an isolated or one-off business operation or commercial transaction. See Taxation Ruling TR 92/3 *Income Tax: whether profits on isolated transactions are income*.

calculating gains and losses in respect of investments by MITs in shares, units in unit trusts and real property. It is claimed that this would benefit the MIT industry by:

- enhancing the competitiveness of Australian MITs as part of the Government's objective of making Australia the financial services hub of Asia; and
- reducing significant compliance costs for MITs.

7.11 Reduced compliance costs and certainty could be achieved through statutory rules that provide for either capital or revenue account treatment for gains and losses made on the disposal of MIT assets in certain circumstances.

7.12 A comparison of the mechanisms for determining capital and revenue in a number of jurisdictions is contained in Appendix D.

Q 7.1 Issues/Questions

The Board seeks stakeholder comment on the following:

(a) how the case law principles described in paragraphs 7.6 and 7.7 apply to and/or are applied by MITs and whether the principles are applied consistently across the different industry sectors;

(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;

(c) what considerations would support a statutory rule treating gains and losses made on the disposal by MITs of certain investment assets (shares, units in unit trusts and real property) as being on capital account. Alternatively, what considerations would support a statutory rule treating gains and losses made on disposal of these assets by MITs as being on revenue account;

(d) whether MITs should be given an irrevocable election to have this treatment applied to them;

(e) if statutory capital or revenue account treatment were to apply to MITs, how could specific rules be structured;

(f) should statutory capital or revenue account treatment be extended to other collective investment vehicles (including LICs);

(g) the desirability of a statutory rule treating MIT gains distributed to particular kinds of investors (for example, complying superannuation funds) as being on capital account; and

(h) should different considerations apply for MITs that are Private Equity funds.

CHAPTER 8: IMPLICATIONS OF THE DEFINITION OF FIXED TRUST

BACKGROUND

8.1 The tax law provides 'widely held' or 'pooled' investment vehicles such as MITs with more flexible rules in a number of areas in recognition of their differences from other entities and to streamline and reduce compliance costs, for example, the trust loss rules, simplified franking credit rules and CGT scrip-for-scrip rollover relief.

8.2 Eligibility for a number of these concessions is limited by the requirement that the investment vehicle is a fixed trust. The definition of fixed trust relies on the concept of the beneficiaries/investors having a fixed entitlement to income and capital of the trust. The terms fixed trust and fixed entitlement are also used elsewhere in the legislation and the issues presented by the use of these terms are not unique to MITs.

FIXED TRUSTS AND FIXED ENTITLEMENT

8.3 The definition of a fixed trust[56] turns on whether one or more persons have a fixed entitlement to all of the income and capital of the trust. Whether a person has a fixed entitlement is determined with reference to the legal concept of 'vested and indefeasible' interest.[57]

8.4 There is some uncertainty surrounding whether unit holders in some MITs do have a fixed entitlement to trust income or capital as they may not have an indefeasible interest in the income and/or capital of the trust due, among other matters, to the trustee having the power to issue and redeem units and the possibility that unit holders' entitlements may be varied by amendments to the trust deed.

8.5 Subsection 272-5(2) provides that if a person has invested in a unit trust, the mere fact that the units are redeemable, or that further units are able to be issued, does not mean that the person's interest, as a unit holder, in the income or capital of the unit trust is defeasible, providing certain circumstances are satisfied. Essentially these conditions require that the issue or redemption be at full value.

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56 Section 272-65 of Schedule 2F to the ITAA 1936.
57 Section 272-5 of Schedule 2F to the ITAA 1936.

8.6 The Commissioner has a limited discretion to treat certain interests as being vested and indefeasible that would not otherwise be so considered. In exercising the discretion, the Commissioner is obliged to consider the circumstances in which entitlement is capable of not vesting or being defeased, the likelihood of the entitlement not vesting or being defeased and the nature of the trust.

8.7 Having regard to the meaning of vested and indefeasible (as outlined in Chapter 3) and given the limited nature of the Commissioner's discretion, it is possible under the existing law that some MITs may not be able to qualify as fixed trusts.

TRUST LOSS RULES

8.8 Losses incurred by a trust remain trapped in the trust and cannot be distributed to beneficiaries. Such losses may be used by the trust in working out its net income for the purpose of Division 6.

8.9 The trust loss provisions[58] determine when trusts can deduct current year and prior year losses against their income and are designed to prevent the tax benefits that arise from the recoupment of trust losses being transferred to persons who did not bear the economic effect of the loss when it was incurred.

8.10 The trust loss measures achieve this by imposing a number of tests that must be met before losses can be claimed. Broadly, the tests examine whether there has been a change in underlying ownership or control of a trust or whether certain schemes have been entered into in order to take advantage of losses. The trust loss provisions do not, however, contain any rules to prevent the benefits that arise from the recoupment of capital losses being transferred.

8.11 Generally fixed trusts are only required to satisfy the 50 per cent stake test and the income injection test to be able to utilise losses. Non-fixed trusts are subject to more onerous rules; for example, they are required to satisfy the control test and the income injection test before they are able to utilise losses. In some circumstances non-fixed trusts will also have to satisfy the pattern of distributions test (which requires calculations in respect of income or capital distributions, if any, going back six years) and the 50 per cent stake test.

QUALIFIED PERSON RULES AND FRANKING CREDIT FLOW-THROUGH

8.12 The Australian imputation system largely restricts the usage of franking credits to persons who are owners of shares. In order to ensure that this restriction is maintained, the imputation system incorporates a holding period rule (or certain

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58 Schedule 2F to the ITAA 1936.

alternative rules) having the effect that a beneficiary in receipt of a trust distribution attributable to a franked dividend received by the trustee is not able to access a portion of the franking credits attached to the dividend, unless the beneficiary is a 'qualified person'.

8.13 In determining whether a beneficiary is a qualified person, there are special rules which may apply to beneficiaries in a 'widely held' trust. These beneficiaries are only required to satisfy the 45 day rule in relation to their interest in the trust as a whole, rather than in relation to each dividend which flows to the beneficiary. The provisions do not look through the 'widely held' trust to see whether the beneficiary has had an interest for 45 days in each of the underlying shares of the trust estate.

OPTIONS FOR CLARIFYING THE TREATMENT OF FIXED TRUSTS

8.14 Potential options for clarifying the treatment of fixed trusts include:

- introducing a rule whereby certain MITs will be deemed to be fixed trusts; or
- altering the definition of the term 'fixed trust' to ensure that the term does not rely on the concept of 'vested and indefeasible' interest.

Q 8.1 Issues/Questions

The Board seeks stakeholder comments on:

(a) the advantages and disadvantages of the potential options for clarifying the treatment of fixed trusts outlined above; and

(b) any other options for clarifying the treatment of fixed trusts.

CHAPTER 9: ELIGIBLE INVESTMENT BUSINESS RULES IN DIVISION 6C OF THE *INCOME TAX ASSESSMENT ACT 1936*

OVERVIEW

9.1 The terms of reference for the review ask the Board to develop options for reform with taxation outcomes that are broadly consistent with five key policy principles. The key policy principle in relation to the operation of Division 6C is *Policy Principle 2*:

> *'In recognition of the tax advantages available to trusts that are not available to companies deriving business income, flow through taxation of income from widely held trusts, such as managed investment trusts, should be limited to trusts undertaking activity that is primarily passive investment.'*

9.2 The Board has been asked to consider reforms to Division 6C that, while not compromising the integrity of the corporate revenue tax base, would enhance the international competitiveness of Australia's REITs and the capacity of Australia's MITs to attract funds under management from other countries.

9.3 An issue for the Board to consider is what approaches can be taken to develop principles to distinguish between when the activity of a listed, publicly offered, or widely held trust should be subject to company taxation and their holders will be taxed like shareholders, rather than flow-through trust taxation.

BACKGROUND TO DIVISION 6C AND THE ELIGIBLE INVESTMENT BUSINESS RULES

9.4 MITs must limit their activities in a year to eligible investment business (**EIB**) in order to retain trust taxation treatment under Division 6. Otherwise, they will be public trading trusts and be taxed like companies for the year, and their holders will be taxed like shareholders.

9.5 Division 6C defines EIB as either or both of:

- investing in land for the purpose, or primarily for the purpose, of deriving rent; and

- investing or trading in certain financial instruments, including shares in a company and units in a unit trust.

9.6 Division 6C was introduced in 1985 to tax a public unit trust like a company unless it was carrying on only EIB activities. Division 6C was designed to address concerns that trusts were being used to provide an alternative to company tax arrangements for listed, publicly offered or widely held vehicles.

9.7 Under the classical system of taxation, trusts were tax advantaged compared to companies. The introduction of dividend imputation that provides resident shareholders with a tax credit for company tax paid removed some, but not all, of the tax advantages arising through the use of trusts. The dividend imputation system was announced on the same day as Division 6C on 19 September 1985. The Government of the day recognised that the introduction of dividend imputation would reduce the incentive to use trusts. The statement 'Reform of the Australian Taxation System', September 1985, notes:

> *'Although the decision to introduce a full imputation system for companies will reduce the incentive to use trusts, there would still be advantage for tax-exempt institutional investors in the trust form because it is not proposed that imputation credits be refundable.*
>
> *To ameliorate that bias, it has been decided to extend company tax arrangements to those public trusts which operate a trade or business. Private trusts, and public unit trusts of the more traditional kind which invest in property, equities or securities will not be affected.'*[59]

9.8 As noted earlier in this discussion paper, a particular concern at the time involved superannuation funds preferring trusts over companies as they originally did not benefit from the imputation system and the corporate tax system remained a classical system so far as they were concerned. This concern appears to have been addressed in 1988 when superannuation funds were made taxable and became able to access imputation benefits.

9.9 This particular concern may have affected the drafting of the definition of public unit trust. Subsection 102P(2) of Division 6C of the ITAA 1936 will cause a non-widely held trust to be a public unit trust if an exempt entity or entities hold twenty per cent or more of the beneficial interest in the unit trust. An example of when this can occur is when a superannuation fund owns twenty per cent of a unit trust as a complying superannuation fund meets the Division 6C definition of exempt entity. If that trust then carries out activities not limited by the EIB rules, the trust will become a public trading trust.

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59 'Reform of the Australian Taxation System', September 1985, p 65.

9.10 Some stakeholders have noted that superannuation funds have their own prudential requirements under the *Superannuation Industry (Supervision) Act 1993*.

Q 9.1 Issues/Questions

The Board seeks comment on whether it is still appropriate to have the 20 per cent rule for complying superannuation funds.

The control test

9.11 Under Division 6C, a managed fund is not able to carry on a trading business (which is defined to mean a business that does not consist wholly of EIB), or control (directly or indirectly, or be able to control) another person or entity in its carrying on of trading business — including owning a controlling interest in a domestic or foreign trading company. The control test was introduced to prevent the indirect circumvention of Division 6C.

9.12 The existing control test does not extend to a business entity structure where the same investors hold their equity interest in a trust and company, the interests can only be traded, issued and redeemed together and the company carries out trading activities using (that is, renting land and other) assets owned by the trust. These arrangements are referred to as stapled entities.

9.13 In 2007, Division 6C was amended[60] to allow a public unit trust to acquire a controlling interest in, or control, foreign entities whose principal business consists of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent. Provided that the foreign REIT is principally investing in land outside Australia for the primary purpose of deriving rent, 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.

9.14 At the same time, Division 6C was amended[61] to allow a stapled group of entities to restructure with an interposed head trust inserted without triggering certain taxation consequences. In particular, after the restructure, the interposed head trust would not be taxed like a company under Division 6C merely because of its control of the active businesses of the formerly stapled entities so long as those activities are subject to company taxation (specific CGT rollover relief must be applicable to these restructures if the Division 6C exclusion is to apply). The effect of this amendment is to allow a public unit trust to own or control a previously stapled company, or trust taxed like a company. Furthermore, after the restructure the public unit trust may control the trading business activities of any entities that are controlled by the previously stapled companies or trusts taxed like companies.

60 *Tax Laws Amendment (2007 Measures No. 5) Act 2007*.
61 ibid.

9.15 These amendments were made to enable Australian listed property trusts to restructure into a single entity for the purpose of certain overseas acquisitions and improve their capacity to acquire property and property holding entities offshore. The amendments were driven by international competitiveness concerns. To acquire overseas assets in another country, such as the US, it is now often necessary for listed property trusts to consist of just the one entity. For example, only a single entity can acquire a US REIT and obtain CGT scrip for scrip roll-over in the US. In this respect, a stapled Australian listed property trust would be at a competitive disadvantage to a single entity US REIT seeking to acquire assets in the US such as control of another REIT.

DIVISION 6C ISSUES FOR REVIEW

Overview

9.16 The Board is aware of industry concerns that the existing EIB rules in Division 6C are overly restrictive and unduly impede commercial practice, especially in respect of REITs. The Board notes that Australia does not have a separate tax regime for REITs, whereas other countries have created specialised taxation regimes for these vehicles.

9.17 The Government has announced interim changes to the EIB rules that are scheduled to be implemented before the Board's review is finalised. The changes are limited and involve:

- clarifying the scope and meaning of investment in land for the purpose of deriving rent;
- providing a 25 per cent safe-harbour allowance for non-rental income (excluding capital gains) from investments in land;
- expanding the range of financial instruments included in the definition of eligible investment business that a trust may invest in or trade; and
- providing a 2 per cent safe harbour allowance at the whole of trust level for non-trading income.

9.18 The amendments were introduced into Parliament on 25 September 2008 in Tax Laws Amendment Act (2008 Measures No.5) Bill 2008.

Other income from investment in land

9.19 The current EIB rules for investments in land are restricted to those that are made for primarily rental purposes. However, both the current law and the proposed 25 per cent safe harbour allow limited other non-rental income from the land. The Bill

provides that income from the carrying on of a business that is not incidental and relevant to the renting of land is not within the scope of the safe harbour.

9.20 A number of issues have been brought to the attention of the Board by stakeholders, these include:

- investing in residential real estate for the substantial purpose of making capital gains may not meet the current EIB rules, as the investment may not pass the test of investing in land for the purpose, or primarily for the purpose, of deriving rent;
- certain retirement village arrangements that choose to operate on a deferred management fee (DMF) basis may not meet the current test of investing in land for rent, as a DMF is not rent;
- licence fees for rights to occupy, signage fees, etc may be so substantial that an investment in land may not pass the test of investing in land for the purpose or primarily for the purpose of deriving rent; and
- the appropriateness of turnover and profit based rents of particular kinds being treated as rent.

9.21 Whereas traditional rent income from land is unambiguously passive, the case for regarding all other income from land as passive may not be as clear cut.

Relevance of the control test

9.22 Some stakeholders have suggested that the control test is unnecessary in respect of entities that are subject to company taxation. That is, if an MIT owns a controlling interest in a trading company, all it can receive by way of distributions from the company are franked or unfranked dividends. Others have suggested that protection could be provided instead by provisions ensuring that an MIT would be limited to gains by distributions or earnings of a trading company.

9.23 The 2007 amendments referred to above provided more scope for MITs to own and control trading activity. In this context, relevant issues are whether:

- managed funds should be able to establish themselves as controllers of companies with active businesses and trading activities without the need for stapling;
- another MIT should be able to own or control the interposed trust created as a result of the restructure; and
- whether an MIT should be able to own or control any foreign entity carrying on a foreign trading activity or business.

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

Non-EIB income

9.25 Non-compliance with the EIB rules means that the trust is subject to company-like taxation on all of its income in the relevant year. Other countries adopt various approaches to non-compliance, including safe harbours (see Appendix E). In some countries, the so-called 'tainted income' is subject to company taxation, but the other eligible income is treated as transparent.

International comparisons

9.26 The Terms of Reference require that any policy framework is to have regard to international developments in the managed fund sector — and, in particular, in the US, United Kingdom and Canada.

Real Estate Investment Trusts (REITs)

9.27 There is no internationally consistent definition of a REIT, because the framework both for governance and taxation of their income, and of acquisition, holding and disposal of equity in them, is not internationally consistent or comparable. Both the definition and scope of 'real estate investment' and 'eligible investment' vary substantially across the different REIT regimes. The applicable taxation consequences also differ from country to country. Some REIT regimes do however have some common attributes. These include:

- a number of jurisdictions provide for corporate REITs with deductible distributions whilst others provide for transparent REITs or for transparent income and gains of certain kinds;
- eligible entities are required to have a predominant focus on real estate investment, excluding real estate development, measured by either income or asset tests, or a combination of both. Generally, at least between 70 to 90 per cent of income or assets (or both income and assets) are expected to come from rent derived from investments in real estate;
- a number of countries expressly exclude certain income from the definition of rent. Examples include rents based on profits and payments for non ancillary/non customary services;
- de minimis rules may be included to accommodate non-real estate income earned from certain permitted investments. Some countries allow a certain amount of income to be earned from 'residual activities', which are not restricted to passive sources of income;
- some REITs are taxed like companies but effectively exempted from tax at the entity level on eligible income distributed to investors. These amounts are then taxed at the beneficiary level at the applicable rates of tax; and

- some REITs are required to distribute all but a minimal level of income each year to be eligible to participate within the regime.

Other collective investment vehicles/managed funds (non-REIT)

9.28 A number of countries have established specific taxation regimes for non-REIT managed funds that meet certain eligibility requirements. For example, in some jurisdictions there are specific regimes for special flow-through entities, collective investment funds, and mutual funds. In addition, some jurisdictions — such as the United Kingdom — provide for a number of specific types of collective investment vehicles for limited purposes.

9.29 Taxation rules differ from country to country, however, a number of regimes have similarities including:

- an emphasis on activities of a passive nature (for example, investing in shares and securities);
- the entity must be widely held or listed;
- the entity must distribute a minimum amount of income each year;
- many jurisdictions effectively exempt the entity from tax on distributed income. These amounts are then taxed at the beneficiary level at the applicable rates of tax. Some jurisdictions provide for character retention of some capital gains as they flow from the entity to the beneficiary;
- some jurisdictions, for example the United Kingdom, assess eligible income at a lower tax rate; and
- some jurisdictions provide for both corporate and trust collective investment vehicles (in most jurisdictions, taxed on the same corporate basis).

9.30 Detailed information of other countries REIT regimes and non-REIT collective investment regimes are in Appendix E and Appendix F respectively.

Defining primarily passive investment

9.31 Policy principle two provides that in recognition of the tax advantages available to trusts that are not available to companies deriving business income, flow through taxation of income from widely held trusts, such as managed investment trusts, should be limited to trusts undertaking activity that is primarily passive investment.

9.32 There are various approaches that can be adopted to define primarily passive investment. Approaches include:

- Use of broad principles: under this approach the law would outline in broad terms the types of activity and/or income that are permitted investments or trading. For example:
  - investing in real property for rent or other passive income return could be a high level principle; and
  - investments in any trading entity could be permitted up to a limit (depending on the relevance of the control test).
- A specified list of non-eligible activities: Where any investment and trading is allowed, but there is a list of non-eligible investments, trading and/or income. For example, identify those areas of business that should remain subject to company like taxation, for example, all retail operations, mining, building construction for sale, airline operations, etc.

9.33 Each of the approaches requires a detailed consideration of the types of activities that may be regarded as 'primarily passive investment'.

9.34 Another approach would be to retain the existing framework but provide more scope for non-passive trading activities to be included to address specific industry concerns. For example:

- in addition to rent, income from investing in land could be extended to include all forms of rent like income;
- the trust could derive a limited percentage of income from any activity which is not directly connected to its investments in land;
- the control test could be either abolished (perhaps being replaced with an arm's length terms rule for controlled activities) or relaxed by prescribing a limit before it is activated; and
- the trust could own a taxable subsidiary, analogous to a US REIT taxable subsidiary.

Q 9.2 Issues/Questions

The Board seeks stakeholder comment on the following:

(a) what approaches can be taken to changing the eligible investment rules that would reduce compliance costs for managed funds and enhance their international competitiveness;

(b) should the control test be abolished or replaced with a requirement that investments in companies or other entities carrying on trading businesses be limited to a particular percentage or with an arm's length terms requirement; and

(c) should non-compliance with the eligible investment rules result in taxation only on the 'tainted' income and how could this be achieved.

COSTS AND BENEFITS OF A SEPARATE REIT REGIME

Approaches in other countries

9.35 As noted above other countries have developed specific REIT regimes, purposely designed to provide an economic equivalent to transparent tax treatment that effectively taxes the net profit of the REIT to investors. The REIT is generally a corporation with special tax arrangements to give effect to taxation at the beneficiary level only.

9.36 A common feature of some REIT regimes involves the REIT being either exempt from taxation and the investors paying tax on the net profit (assume this to be the taxable income of the REIT), or the REIT being assessable on its net profit, but it being able to claim a tax deduction for distributions of the net profit to shareholders/unit holders. Provided the REIT meets specific requirements, such as investment in real estate and income and other criteria, it retains taxation treatment as a REIT. Otherwise, it is likely to be subject to the general company taxation in the relevant jurisdiction. Investors pay tax on the REIT distribution/dividend received.

Issues for consideration

9.37 The tax treatment of any trust, whether an MIT or not, and whether a REIT or non-REIT managed fund, is currently the same. This raises the issue of the likely benefits versus costs of having a separate taxation regime for REITs.

9.38 The benefits that could arise from a separate taxation regime for REITs include:

- Australian REITs may be more recognised internationally and such a regime would provide more scope to harmonise REIT requirements internationally for tax treaty purposes:
  - this may enhance Australia's ability to attract overseas funds into its REITs.
- specific tax rules can be developed to deal with any special tax characteristics of REITs, if that were desirable from a policy perspective. For example:
  - the concept of a REIT dividend could be incorporated into the law and taxed at different rates for non-resident withholding tax purposes;
  - different distribution requirements or different treatment of trust assets for CGT purposes could be established; and
  - it may easier to define eligible investment rules in the taxation law for property investments or towards active business.

9.39 On the other hand, if Australian REITs do not have different taxation features compared to non-REIT managed funds, a separate regime for REITs may impose tax system complexity and additional compliance costs for the industry, ATO and investors:

- the greater the number of collective investment regimes available the greater the complexity for investors; and
- providing for a separate REIT regime, as opposed to one general MIT regime, could make it difficult for participating funds to move away from property investment towards other passive investments.

Q 9.3 Issues/Questions

The Board seeks stakeholder comment on the costs and benefits of establishing a separate REIT regime.

CHAPTER 10: DIVISION 6B OF THE *INCOME TAX ASSESSMENT ACT 1936*

BACKGROUND

10.1 Division 6B was introduced in 1981 to discourage the reorganisation of companies involving the transfer of assets or businesses into a resident public unit trust in which the shareholders would take equity, in order to avoid continued company tax and shareholder treatment and to attract trust tax treatment instead. It was introduced when the (then) classical system of taxation applied.

10.2 Under the classical taxation system, corporate profits were subject to double taxation. They were taxed both at the company level and at the shareholder level when the net amount was distributed, without any credit given to shareholders for the corporate tax already paid. Because unit trusts are not taxed as companies, there was an incentive for companies to avoid corporate tax by transferring assets into a trust with the unit holders being the same as the shareholders of the company.

10.3 The policy rationale for the introduction of Division 6B in 1981 was to protect the corporate tax base on the basis that there were tax advantages for investors in trusts compared to investors in companies under the classical taxation system. At the time, assets could be transferred by a company to a trust without capital gains on disposal, and distributions of tax deferred income by trusts generally had no taxation implications.

ISSUES FOR THE REVIEW

10.4 Some stakeholders argue that, from a policy perspective, Division 6B is no longer necessary because of the introduction of capital gains tax, Division 6C for public trading trusts, dividend imputation for companies, and the inclusion of resident superannuation funds and most tax exempt investors in the imputation system in 1988 and 2000 respectively.

10.5 In addition, given that there may be sound commercial reasons why a company may want to transfer assets to a trust, some stakeholders are concerned that Division 6B inhibits commercial arrangements and reorganisations. For example, a company carrying on a property development and construction business may seek to transfer its assets to a commonly owned unit trust for the purpose of holding the assets

for rental to third parties. Under the current arrangements, Division 6B will apply to the trust if the assets are not sold for full value but are transferred for scrip.

10.6 While the 2007 changes to Division 6C do allow a stapled group to restructure with an interposed trust, Division 6B inhibits the creation of stapled entity structures by existing corporate trading entities if business assets or business undertakings are to be transferred to a trust for scrip rather than for other consideration.

Q 10.1 Issues/Questions

The Board seeks stakeholder comment on:

(a) whether Division 6B should be retained; and

(b) if Division 6B rules were retained in some form, what changes should be made to them and should they be integrated within any specific tax regime for MITs.

Chapter 11: Defining the scope of a managed investment trust

Overview

11.1 The terms of reference for this review refer amongst other things to options for a specific taxation regime to cover managed funds that operate as MITs that:

- are widely held vehicles; and
- undertake primarily passive investments (refer Chapter 9).

11.2 This chapter discusses the concept of 'widely held' for the purposes of any new MIT regime and, in general terms, the potential scope of an MIT regime.

Widely held

11.3 The taxation laws do not contain a universal definition of a widely held (public) trust. Instead there are a range of definitions that focus on the 'pooling' or 'widely held' aspects of these vehicles. A more detailed discussion of these legislative definitions can be found in Appendix G.

11.4 The definitions in the tax law which seek to define the concept of 'widely held' trusts incorporate two common features. These features are:

- that the trust is a unit trust; and
- that the trust meets either a stipulated regulatory or membership requirement.

Unit trust requirement

11.5 The first requirement for a trust to be considered 'widely held' is that it is a unit trust. There is an exception to this general rule in the withholding tax regime for managed funds. The difference between the unit trust requirement in Division 6C and the withholding tax requirement can be partly explained by the different purposes they serve.

11.6 An issue with the current rules in Division 6B and Division 6C is that they give rise to some uncertainty about what is a 'unit trust' for the purpose of those Divisions. The ambiguity arises through the definition in section 102D for Division 6B and section

102M for Division 6C of 'unit', which, in relation to a prescribed estate, includes a beneficial interest, however described, in any of the income or property of the trust estate'. This creates some uncertainty in the case of some trusts where the interests of the beneficiaries in the trust fund are measured on a proportionate basis but not described in terms of units.

11.7 If a unit requirement is retained it will practically limit the types of trusts that will be able to fall within any new MIT regime. Any unit trust requirement should address the uncertainties in the current rules referred to above.

11.8 Another issue for consideration in a new MIT regime is whether the rights attaching to the units of an eligible MIT need to be uniform. This might be a particular issue for certain private equity trusts which have different classes of beneficiaries entitled to returns calculated in different ways — especially where some beneficiaries invest capital or other services.

Membership requirements

11.9 The second requirement for a trust to be considered 'widely held' is that the trust must meet a membership requirement.

11.10 Two approaches have been adopted in relation to this membership requirement. Typically, to satisfy this requirement, the fund must satisfy either:

- a simple minimum membership level; for example, in defining the term public unit trust, the Divisions 6B and 6C tests include a requirement that units are held by 50 or more persons; or
- a two stage test, which involves meeting a minimum membership level, but provides a carve-out if a small number of the members hold a significant interest in the trust.

11.11 An issue that arises in relation to membership requirements is whether 'look through' treatment is applied to the beneficiaries in the investment vehicle. If for example a complying superannuation fund with thousands of members invests in a trust that is not otherwise widely held, should the trust be treated as widely held?

Special circumstances

11.12 In recognition of the fact that at the beginning and end stages of an MIT's life it may be difficult for the MIT to meet the necessary 'widely held' or listing requirements, consideration will need to be given to whether any new MIT regime should include allowances for these types of special circumstances.

Q 11.1 Issues/Questions

The Board seeks stakeholder comment on the following questions:

(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 cross holding in funds.

INVESTOR DIRECTED PORTFOLIO SERVICES AND ABSOLUTE ENTITLEMENT

11.13 In the managed funds industry, investor directed portfolio services (**IDPS**) are services for acquiring, holding, and disposing of investment assets marketed to investors. Arrangements typically marketed as master funds and wrap accounts are likely to be an IDPS and a managed investment scheme.

11.14 An issue for consideration with respect to IDPS and similar arrangements is whether the tax law recognises one or multiple trusts or looks through to the investor as the relevant taxpayer. A question also arises as to whether any trusts recognised in an IDPS or similar arrangement for tax law purposes should be looked through.

11.15 In summary, with an IDPS typically:

- investment assets are required to be held on trust for the investor such that someone other than the investor is the legal owner;
- investors are given a list of investment opportunities. Each investor has the discretion to make investment decisions and, in particular, sole discretion to decide what assets will be acquired. Further, subject to prior directions given by the IDPS (for example, minimum holding requirements), investors may direct the custodian to transfer assets or realise assets and pay over the proceeds;
- the operator is able to give effect to standing directions previously given by the investor such as to rebalance the portfolio by buying and selling specified securities or realise assets to maintain an agreed minimum balance in a cash account or pay fees associated with the service; and

- the assets in which an investor has an economic interest are held by a custodian who is not the operator. Each investor is provided with consolidated reporting about their interests in assets acquired through or held under the IDPS.

11.16 Some stakeholders take the view that IDPS do not fall within Division 6 and that capital and revenue gains and losses from the investment are taken to be have been made by the investor directly. This view is based on the premise that the trust arrangement in an IDPS is a bare trust and/or that investors are absolutely entitled to the assets of the trust.

Bare trusts and absolute entitlement

11.17 Absolute entitlement provides the basis for determining whether it is the beneficiary, or the trust, that is the relevant taxpayer in respect of capital gains and losses made in respect of trust assets. Specifically, if the beneficiary is absolutely entitled to a CGT asset as against the trustee, the acts of the trustee in relation to an asset are ignored and the beneficiary is taken to have done the acts for CGT purposes. If the beneficiary is not absolutely entitled to the asset, then the trustee is the taxpayer in respect of the asset for CGT purposes and the taxation of the gain will follow the ordinary operation of Division 6.

11.18 There is, however, no legislative definition of absolute entitlement in the taxation law. The ATO, in Draft Taxation Ruling (TR 2004/D25), has taken the view that a beneficiary will be absolutely entitled to an asset of a trust if the beneficiary has a vested and indefeasible interest in the asset as well as an ability to call for the trustee to transfer the asset to the beneficiary or at its direction.[62] The ATO further takes the view that absolute entitlement can only be established by a single beneficiary. That is, it is the ATO's view that, if two or more beneficiaries have an interest in a trust asset, no beneficiary can be absolutely entitled to that asset.

11.19 As a result, there may be uncertainty as to whether individual beneficiaries can claim to have a vested and indefeasible interest in any particular assets held through the IDPS arrangement. Each IDPS must be examined on its own terms.

11.20 In any case, there is no express legislative backing to ignore, for the purposes of Division 6, trusts in which beneficiaries have an absolute entitlement to the assets of the trust. This gives rise to other issues. Losses incurred by the trustee from the disposal of assets held on revenue account would only be available for offset against future net income of the trust. However, they would not be available for offset against other current year income derived by the beneficiary. Similar difficulties arise for arrangements described as nominee and custodian arrangements where assets are held on trust for the beneficial owner. These arrangements are widespread throughout the financial services industry.

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62 See also the recent decision of the Federal Court in *Kafataris*.

11.21 The ATO approach to these issues is to examine the arrangements case by case. If the rights and obligations created are such that it can be concluded that the investments are held on a trust, then Division 6 would generally be taken to apply, irrespective of the nature of that trust.

Q 11.2 Issues/Questions

The Board seeks stakeholder comment on whether:

(a) in designing a new taxation regime for MITs, it would be appropriate to carve-out certain classes of arrangement and, if so, what classes of arrangement would it be desirable to carve out (for example, IDPSs, and arrangements where the investors have an absolute entitlement to specific assets and, accordingly, an entitlement to the income or gain from those assets);

(b) if IDPS arrangement were to fall within an MIT regime and in substance comprise many single transparent trusts, whether it would be appropriate to provide special rules for them and, if so, what should they be; and

(c) there should be a provision for revenue assets which is equivalent to the CGT provision that applies to treat a beneficiary as the relevant taxpayer for CGT purposes where the beneficiary is absolutely entitled to the asset as against the trustee.

CREATING A NEW TRUSTS BY AMENDING THE TERMS OF A DEED

11.22 Another area of uncertainty in relation to the application of the taxation law to MITs concerns the tax consequences of amendments to constituent trust instruments. An amendment to a trust instrument may result in the creation of a new trust estate and/or in an alteration to the nature of the beneficiary's interests in the trust. Either outcome can have income tax consequences. For example, from the trustee's perspective, questions may arise as to whether prior year losses can be carried forward or (as another example) whether the trust property has been settled on the terms of a new trust, which may trigger a CGT event. From a beneficiary perspective, amendments to the trust instrument may so change the essential nature and character of the beneficiary's interest in the trust estate that they effect a cancellation of the whole or part of the original interest and the acquisition of a new interest.

11.23 The question of whether amendments to a trust instrument create a new trust is very much a question of fact and degree. The answer can only be determined by reference to the trust instrument, the nature and extent of the changes and their impact on the trust estate, the fiduciary obligations of the trustee and the beneficiary's interest in the trust. These determinations are not easily made and can be the source of considerable uncertainty.

Q 11.3 Issues/Questions

The Board seeks stakeholder comment on:

(a) any approaches, including potential legislative amendments, for addressing these issues; and

(b) whether the extent of the relief that could be provided would depend on how a MIT is defined for tax purposes? For example, would it depend on whether an MIT is defined to include trusts with multiple classes of beneficiaries and/or whether MITs are required to be registered as managed investment schemes for the purposes of the *Corporations Act 2001*.

CHAPTER 12: IMPLICATIONS FOR OTHER TRUSTS OPTIONS FOR THE DESIGN OF A MIT REGIME

12.1 The terms of reference require the Board to examine the desirability of extending relevant aspects of the recommended changes for MITs to the tax arrangements for other trusts. The Board understands that this is because many issues that create problems for MITs are also issues of concern for other trusts, such as deceased estates, testamentary trusts, discretionary trusts, hybrid trusts, unit trusts that are not MITs and fixed trusts that are not MITs.

12.2 The current taxation policy framework for trusts assumes character of income flows through to the trust beneficiaries. However, as discussed in Chapter 6 there may be some doubts and it can not be assumed that flow through is a universal principle that always applies to trusts.

12.3 Uncertainty about the meaning or application of present entitlement, income of the trust estate and share of the net income of the trust estate may also create issues for other trusts.

12.4 The concept of fixed entitlement for the purposes of the trust loss rules, CGT scrip-for-scrip rollover, and passing through of franking credits to beneficiaries are also relevant to all trusts assumed to be fixed trusts, not just to MITs.

12.5 Absolute entitlement is a particular concern to closely held trusts as the ATO holds and applies the view that a beneficiary can not be absolutely entitled to an asset, where there is more than one beneficiary.

Q 12.1 Issues/Questions

The Board seeks comments on whether any options for change that you have commented upon for MITs should be extended to other trusts.

GLOSSARY

Australian Real Estate Investment Trust (A- REIT)

Australian Bureau of Statistics (ABS)

Australian Securities and Investments Commission (ASIC)

Australian Securities Exchange (ASX)

Australian Taxation Office (ATO)

Capital Gains Tax (CGT)

Corporate Collective Investment Vehicles (CIVs)

Department of Innovation, Industry, Science and Research (DIISR)

Eligible Investment Business (EIB)

Investor Directed Portfolio Service (IDPS)

Investment and Financial Services Association (IFSA)

Income Tax Assessment Act 1936 (ITAA 1936)

Income Tax Assessment Act 1997 (ITAA 1997)

Listed Investment Companies (LICs)

Managed Investment Trust (MIT)

Organisation for Economic Cooperation and Development (OECD)

Pay As You Go (PAYG)

Real Estate Investment Trust (REIT)

APPENDIX A: DISCUSSION QUESTIONS

CHAPTER 4: OPTIONS FOR DETERMINING TAX LIABILITIES

Q 4.1

The Board seeks stakeholder comment on:

(a) the high level Options outlined above including comment on any issues that affect their workability as alternative models;

(b) the alternative that the current arrangements, which rely on Division 6 concepts such as trust income, share of trust income and present entitlement, could be modified to overcome the current issues and in that case, what modifications would be desirable; and

(c) any other options for change.

Q 4.2

The Board seeks stakeholder comment on a definition of distribution that would provide clarity and ensure appropriate tax outcomes.

Q 4.3

The Board seeks stakeholder comment on whether:

(a) applying the current section 99A tax rate on the undistributed taxable income of a trust would reflect an appropriate balance between integrity and equity considerations; and

(b) there are means, other than applying the top marginal rate, for preserving integrity.

Q 4.4

The Board seeks stakeholder comment on:

(a) the scope to move to a receipts based approach under a model that allows trustees a deduction for their distributions;

(b) the feasibility of other options to simplify arrangements for beneficiaries including changing the tax year for MITs; and

(c) whether, under the trustee assessment and deduction model, resident individuals should be the only class of beneficiaries assessable on a receipts basis.

Q 4.5

The Board seeks stakeholder comment on:

(a) the desirability of adopting either a simple carry forward approach or a deduction/credit approach for correcting errors in calculating the net income of the trust. The Board also requests comments on how these approaches would interact with the Options for determining tax liabilities outlined in paragraph 4.8;

(b) how any approach adopted could address the inequities in the allocation of tax liabilities which can arise when unit holders redeem or sell their units before errors in the calculation of the net income of the trust have been identified;

(c) under either approach to correcting errors in the calculation of net income of the trust, whether there is a need for a de minimis rule of up to say 2 per cent of the net income and if yes, what should be the consequences of breaching the de minimis rule; and

(d) whether the Commissioner of Taxation should have discretion to increase the de minimis in special circumstances, and if so, what circumstances.

Chapter 5: International considerations

Q 5.1

The Board seeks stakeholder comment on:

(a) what issues are currently experienced under Australian domestic law and treaties with the operation of international rules for MITs;

(b) what suggestions are there for dealing with the issues; and

(c) would there be advantages in having a deemed corporate flow-through CIV regime for international reasons.

CHAPTER 6: TRUSTS AS FLOW-THROUGH VEHICLES

Q 6.1

The Board seeks stakeholder comment on any options for addressing the uncertainties and potential distortions, including double taxation, which can result where there are differences between the net income of the MIT and the actual distributions made to beneficiaries.

The Board requests that stakeholders consider their comments in the context of both listed and unlisted MITs and in the context of the alternative approaches for determining tax liabilities discussed in Chapter 4.

Q 6.2

The Board seeks stakeholder comment on:

(a) how current uncertainty as to the applicability of a general law principle of flow-through of character should be addressed;

(b) whether the existing statutory flow-through mechanisms (for examplem, CGT, franking credits and foreign tax credits) work satisfactorily and, if not, why not;

(c) whether flow-through of character can be maintained while reducing compliance costs and complexity and if so, by which means;

(d) whether flow-through of character needs to be maintained in general or alternatively, needs only to be maintained in specific circumstances;

(e) how flow-through of character might work under any options considered for changing the way tax liability should be determined (as discussed in Chapter 4);

(f) whether non-residents can be treated differently in order to reduce complexity (for example, possible consolidation of the base from which amounts are to be withheld; and

(g) whether character retention should be concerned with whether investors are portfolio or non-portfolio investors.

CHAPTER 7: CAPITAL VERSUS REVENUE ACCOUNT TREATMENT OF GAINS AND LOSSES MADE ON DISPOSAL OF INVESTMENT ASSETS BY MITS

Q 7.1

The Board seeks stakeholder comment on the following:

(a) how the case law principles described in paragraphs 7.6 and 7.7 apply to and/or are applied by MITs and whether the principles are applied consistently across the different industry sectors;

(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;

(c) what considerations would support a statutory rule treating gains and losses made on the disposal by MITs of certain investment assets (shares, units in unit trusts and real property) as being on capital account. Alternatively, what considerations would support a statutory rule treating gains and losses made on disposal of these assets by MITs as being on revenue account;

(d) whether MITs should be given an irrevocable election to have this treatment applied to them;

(e) if statutory capital or revenue account treatment were to apply to MITs, how could specific rules be structured;

(f) should statutory capital or revenue account treatment be extended to other collective investment vehicles (including LICs);

(g) the desirability of a statutory rule treating MIT gains distributed to particular kinds of investors (for example, complying superannuation funds) as being on capital account; and

(h) should different considerations apply for MITs that are Private Equity funds.

Chapter 8: Implications for the definition of fixed trust

Q 8.1

The Board seeks stakeholder comments on:

(a) the advantages and disadvantages of the potential options for clarifying the treatment of fixed trusts outlined above; and

(b) any other options for clarifying the treatment of fixed trusts.

Chapter 9: Eligible investment business rules in Division 6C of the *Income Tax Assessment Act 1936*

Q 9.1

The Board seeks comment on whether it is still appropriate to have the 20 per cent rule for complying superannuation funds.

Q 9.2

The Board seeks stakeholder comment on the following:

(a) what approaches can be taken to changing the eligible investment rules that would reduce compliance costs for managed funds and enhance their international competitiveness;

(b) should the control test be abolished or replaced with a requirement that investments in companies or other entities carrying on trading businesses be limited to a particular percentage or with an arm's length terms requirement; and

(c) should non-compliance with the eligible investment rules result in taxation only on the 'tainted' income and how could this be achieved.

Q 9.3

The Board seeks stakeholder comment on the costs and benefits of establishing a separate REIT regime.

CHAPTER 10: DIVISION 6B OF THE *INCOME TAX ASSESSMENT ACT 1936*

Q 10.1

The Board seeks stakeholder comment on:

(a) whether Division 6B should be retained; and

(b) if Division 6B rules were retained in some form, what changes should be made to them and should they be integrated within any specific tax regime for MITs.

CHAPTER 11: DEFINING THE SCOPE OF A MANAGED INVESTMENT TRUST

Q 11.1

The Board seeks stakeholder comment on the following questions:

(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 cross holding in funds.

Q 11.2

The Board seeks stakeholder comment on whether:

(a) in designing a new taxation regime for MITs, it would be appropriate to carve-out certain classes of arrangement and, if so, what classes of arrangement would it be desirable to carve out (for example, IDPSs, and arrangements where the investors have an absolute entitlement to specific assets and, accordingly, an entitlement to the income or gain from those assets);

(b) if IDPS arrangement were to fall within an MIT regime and in substance comprise many single transparent trusts, whether it would be appropriate to provide special rules for them and, if so, what should they be; and

(c) there should be a provision for revenue assets which is equivalent to the CGT provision that applies to treat a beneficiary as the relevant taxpayer for CGT purpose where the beneficiary is absolutely entitled to the asset as against the trustee.

Q 11.3

The Board seeks stakeholder comment on:

(a) any approaches, including potential legislative amendments, for addressing these issues; and

(b) whether the extent of the relief that could be provided would depend on how a MIT is defined for tax purposes? For example, would it depend on whether an MIT is defined to include trusts with multiple classes of beneficiaries and/or whether MITs are required to be registered as managed investment schemes for the purposes of the *Corporations Act 2001*.

Chapter 12: Implications for other trusts

Q 12.1

The Board seeks comments on whether any options for change that you have commented upon for MITs should be extended to other trusts.

Appendix B: 2008 Standard Distribution Statement

(Referred to in paragraph 6.21)

2008 tax return information: Resident individual unit holder for year ended 30 June 2008

Part A: Summary of 2008 tax return (supplementary section) items

The tax return item labels are the white letters inside coloured boxes on the *Tax return for individuals (supplementary section) 2008*.

Tax return (supplementary section)	Amount	Tax return label
Non-primary production income		13U
Other deductions relating to distributions		13Y
Franking credits		13Q
Credit for tax file number (TFN) amounts withheld		13R
Credit for tax paid by trustee		13S
Total current year capital gains		18H
Net capital gain		18A
Assessable foreign source income		20E
Other net foreign source income		20M

Part B: Foreign tax credit information —additional information for item 20

Foreign income categories:	Amount	Foreign tax paid
Passive income*		
Other income		
*includes foreign net capital gains and attaching foreign tax as follows: • discount capital gains • indexed capital gains • other capital gains		

Part C: Capital gains tax information — additional information for item 18

		Grossed up amount
Capital gains — discounted method		
Capital gains — indexation method		
Capital gains — other method		
Total current year capital gains		

Part D: Components of distribution

	Cash distribution	Tax paid or tax offsets	Taxable amount
Australian income			
Dividends: franked amount			
Dividends: unfranked amount			
Interest			
Other income			
Less other allowable trust deductions			
Non-primary production income			
Capital gains			
Discounted capital gain			
Capital gains tax (CGT) concession amount			
Capital gains: indexation method			
Capital gains: other method			
Distributed capital gains			
Net capital gains			

Part D: Components of distribution (continued)

	Cash distribution	Tax paid or tax offsets	Taxable amount
Foreign income			
Interest income			
Modified passive income			
Other assessable foreign income			
Assessable foreign income			
Other non-assessable amounts			
Tax-exempted amounts			
Tax-free amounts			
Tax-deferred amounts			
Gross cash distribution			
Other deductions from distribution			
TFN amounts withheld			
Other expenses			
Net cash distribution			

APPENDIX C: TAX DEFERRED DISTRIBUTIONS GIVING RISE TO ORDINARY INCOME IN THE HANDS OF BENEFICIARIES

(Referred to in paragraph 6.15)

Under the current law, tax deferred distributions may give rise to ordinary income in the hands of investors — whether they do in a particular case will depend in part, on the extent to which Division 6 is an exclusive code for the taxation of beneficiaries and, in part, on the quality of the receipt in the hands of the particular beneficiary.

When considering whether Division 6 is an exclusive code for the taxation of beneficiaries, a distinction can be made between distributions that are sourced in income or other assessable amounts that have been taken into account in the calculation of the section 95 net income of the trust, and distributions that are sourced in capital. The uncertainty about whether Division 6 is an exclusive code centres largely on distributions sourced in tax sheltered assessable amounts. It has, however, long been acknowledged that distributions sourced out of the capital of a trust can be ordinary income if the distributions have an income quality in the hands of the beneficiary (although it has been unclear when this might be the case, see *Tindal v FCT* [1946] HCA 26 but compare *Charles v FC of T* (1954) 90 CLR 598).

The long standing view of the ATO has been that Division 6 does not operate as an exclusive code for the taxation of beneficiaries and that distributions out of trust capital, and even sheltered income, can be assessed as ordinary income if the distribution has an income quality in the hands of the beneficiary. See, in particular, Taxation Ruling No. IT 2512 which expresses the view that receipts of tax deferred distributions representing a return on commercial activities carried on by a financier who is a unit holder should be assessed as ordinary income.

The question of whether a trust distribution constitutes income in the hands of a particular beneficiary will depend on the circumstances in which the beneficiary receives the distribution. In the case of MITs, there are several possible situations, in addition to those outlined in IT 2512, in which it might be argued that tax deferred distributions could take on the character of ordinary income in the hands of a beneficiary.

For example, the regularity of the return on the investment in the managed trust and the manner in which the investment is marketed to the beneficiary may, in some cases, point strongly to the return on the investment being of an income character. For instance, the investment may be promoted to the beneficiary on the basis that it will yield a specified percentage return. Indeed the return may even be guaranteed by way of a collateral undertaking from the promoter or its associates. Similarly, the distribution may have an income flavour because it is an ordinary incident of the

taxpayer's business to receive such distributions or because the distribution otherwise represents a return from property.

This is a particular issue for banks, insurance companies and hedge funds who would generally be expected to hold their investment assets on revenue account and for whom trust distributions might be considered incidental to their investment activities. If the financial institution is a resident, a failure to bring tax deferred distributions to account as ordinary income may result in a timing difference, where tax is deferred until such time as the cost base of the unit is fully eroded or the unit is sold. But where the taxpayer is a non-resident financial institution, the tax deferral will be permanent as no capital gain will generally arise. In both cases amounts that would have been considered part of the ordinary return on a financial institution's investment activities may be seen as receiving concessionary taxation treatment.

Appendix D: Comparison of the mechanisms for determining capital and revenue

(Referred to in paragraph 7.12)

Country	Distinction between capital and Revenue	Method of distinction	Taxation of capital	Special treatment for CIVs
United Kingdom	Yes	Judicial Interpretation	Capital gains are taxed at 18 per cent.	No
New Zealand	Yes	Judicial Interpretation	The income tax system does not apply tax to capital gains unless there is a specific provision within the Act that brings the relevant capital within the tax net.	No
Canada	Yes	Judicial Interpretation of Statute	Taxed at marginal tax rates dependant on inclusion rate.	No
United States	Yes	Judicial Interpretation of statutory definition	Long-term capital gains are generally subject to a maximum rate of tax of 15 per cent for individuals and 35 per cent for corporations (including REITs). Short term gains of less than 12 months are subject to ordinary marginal tax rates.	No
Singapore	Yes	Judicial Interpretation	The income tax system does not apply tax to capital gains.	No

APPENDIX E: SUMMARY OF KEY FEATURES OF INTERNATIONAL REAL ESTATE INVESTMENT TRUST (REIT) REGIMES

(Referred to in paragraphs 4.18, 5.11, 9.25 and 9.30)

REIT STRUCTURES

United Kingdom

- UK REITs must be structured as companies. A company elects into the UK REIT regime by notice and faces 'entry charge' of 2 per cent of value of 'exempt activity' (property) assets and deemed realisation at entry of all pre-entry assets on which no tax charge arises.

- UK REITs must be:

  - UK resident and not resident elsewhere (treaty tie-break clause may ensure this in some cases);

  - listed (on a 'recognised stock exchange'); and

  - widely held as they cannot be a 'close' company; REITs may not be widely held even if they are majority owned by listed or widely held company.

- UK REITs cannot be 'open-ended investment companies' (OEIC) or have variable capital.

Canada

- Canadian REITs are generally structured as Canadian mutual fund trusts. A mutual fund trust must, *inter* alia, be a Canadian resident unit trust. The principal conditions that must be met for a trust to qualify as a mutual fund trust are:

  - the trust's only undertaking must be: (i) the investing of its funds in property (other than real property or an interest in real property or an immovable or a real right in an immovable); (ii) acquiring, holding, maintaining, improving, leasing or managing real property (or an interest in real property) or any immovable (or real right in immovables) that is capital property of the trust; or (iii) a combination of the activities described in (i) and (ii)

- its units must be widely held and dispersed: there must be at least 150 unit holders each with at least a 'block' of units (as defined) having a fair market value of at least CDN$500;
- no more than 50 per cent of the fair market value of the issued units may be attributable to units held by non-residents of Canada, unless all or substantially all (that is, at least 90 per cent) of its property is not taxable Canadian property; and
- conditions requiring the trust to accept, at the demand of the unitholder, and at prices determined and payable in accordance with the conditions of the trust, the surrender of the units, must be attached to units representing at least 95 per cent of the aggregate fair market value of all issued units (a close-ended mutual fund trust).

• Where the condition relating to the surrender of units described above are not met, the trust must instead meet the following conditions in order to qualify as a (open-ended) mutual fund trust:
  - At least 80 per cent of its property must consist of 'qualified investments' such as: any combination of shares; property convertible into, exchangeable for or conferring a right to acquire shares; cash; bonds, debentures, mortgages, notes and other similar obligations; marketable securities; real property or immovables in Canada and interests in such property; and rights to and interests in any rental or royalty computed by reference to the amount or value of production from a natural accumulation of petroleum or natural gas in Canada, from an oil or gas well in Canada or from a mineral resource in Canada;
  - At least 95 per cent of the REIT's income must be derived from 'qualified investments'; and
  - No more than 10 per cent of its properties may be shares, bonds, or securities of any one corporation or debtor (other than the federal government, a province or a Canadian municipality).

United States

• US REITs can be companies, trusts or associations and must:
  - be managed by one or more trustees or directors;
  - have beneficial ownership which is evidenced by transferable shares, or by transferable certificates of beneficial interest;
  - have beneficial ownership which is held by 100 or more persons; and

  - be ordinarily taxable as a domestic corporation.

Germany

- German REITs are structured as companies and are required to:
  - be listed joint stock companies with a minimum share capital of EUR 15 Million;
  - have a single class of shares; and
  - have their seat and place of management in Germany (producing exclusive German residence under most treaties).
- No shareholder can have more than 10 per cent direct ownership of a REIT.

Singapore

- Singapore REITs are typically structured as unit trusts and must:
  - be managed by an asset manager and administered by a trustee; and
  - be listed on the Singapore stock exchange and thus have tradable units (to be eligible for tax concessions).

Japan

- Japanese REITs can be either companies or trusts. Japanese corporate REITs must meet one of the following requirements:
  - shares must be offered to the public, mainly in the domestic market, with a total issue price of JPY 100 million or more at establishment; or
  - there are at least 50 shareholders at the end of the fiscal period; or
  - qualified institutional investors must hold 100 per cent of the REIT's shares at the end of the fiscal period.
- Japanese REITs cannot own subsidiaries.

Hong Kong

- Hong Kong REITs are unit trusts and must:
  - have their deed approved by the Securities and Futures Commission of Hong Kong (SPC);

- be managed by a management company and administered by a corporate trustee, which are to be independent of each other; and
- be listed on the Hong Kong stock exchange and thus have tradable units.

ACTIVITY RESTRICTIONS

United Kingdom

- UK REITs may carry on 'Exempt activities' and 'residual activities'.
- Property rental activities are 'exempt activities' with distinct tax treatment.
- All other activities — 'residual activities' — attract normal UK company tax treatment.

Canada

- Subject to the requirements described above for a unit trust to qualify as either closed-ended or open-ended mutual fund trusts, Canadian REITs are also subject to the following restrictions:
  - hold no 'non-portfolio property' (a defined term) other than 'qualified REIT property'. Qualified REIT property generally includes real or immovable property situated in Canada, nominee companies, internal management companies that meet certain criteria, and limited ancillary income;
  - 95 per cent of its revenues are derived from rent from real or immovable properties, capital gains from dispositions of real or immovable properties, interest, dividends and royalties;
  - 75 per cent of its revenues are derived from rent from Canadian real or immovable properties, interest from mortgages or hypothecs on Canadian real or immovable properties and capital gains from dispositions of Canadian real or immovable properties; and
  - the fair market value of its Canadian real or immovable property, cash and certain Canadian indebtedness, is not less that 75 per cent of the equity value of the trust.

  (Note that certain amendments proposed to the above legislation would remove the distinction between Canadian and foreign property for purposes of the 75 per cent revenue and property value tests)

- REITS that do not meet these conditions will be subject to the newly enacted distribution tax on income trusts and partnerships, resulting in its income being taxed in a manner similar to a Canadian corporation.

United States

- US REITs may invest in real estate assets for rent and in financial securities.

Germany

- German REITs are restricted to:
  - acquiring, holding, managing and disposing of real estate in Germany and abroad, excluding existing residential property;
  - acquiring, holding, managing and disposing of interests in 'real estate partnerships';
  - wholly owning REIT Service Corporations; and
  - real estate ancillary services in relation to its own properties.
- Trading in real estate is prohibited.

Singapore

- Singapore REITs may invest in real estate properties for rent and are excluded from:
  - property developments and investing in property development securities, unless the REIT is to hold the developed property upon completion subject to the condition that the total contract value of property development activities undertaken and investments in uncompleted property developments should not exceed 10 per cent of the REIT's deposited property;
  - investing in mortgages other than 'mortgage backed securities'; and
  - investment in vacant land.

Japan

- Japanese REITs are asset holding vehicles and must not engage in any business other than asset/investment management.
- The asset management function must be outsourced to an asset manager.

- The custody function for the assets owned by the REIT must be outsourced to a custodian.
- Other administrative functions are in practice outsourced to an outside service provider as a Japanese REIT may not have employees.

Hong Kong

- Hong Kong REITs may only invest in real estate (which should generate rental income).
- Hong Kong REITs may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, but the aggregate contract value of such real estate shall not exceed 10 per cent of the total net asset value of the scheme at the time of acquisition.
- Hong Kong REITs are prohibited from investing in vacant land or engaging or participating in property development activities.

ASSET/INCOME REQUIREMENTS

United Kingdom

- An 'exempt activities' property rental business must involve at least 3 properties with no one property representing more than 40 per cent of the total value of the properties involved in the property rental business (condition must be met throughout the accounting period), subject to a 'minor corrected breach' exception.
- Property rental business excludes all owner-occupied property, all property occupied by another entity controlled by the company, and all property owned by a stapled entity.
- Cash awaiting re-investment in property rental assets can be part of 'exempt activities' property for up to two years, but income on that cash is not part of 'exempt activities' income.
- A REIT must derive at least 75 per cent of its total profits (ordinarily using IAS measures, before tax and excluding realised and unrealised gains or losses on real property) from the property rental business (each accounting period).
- Rent from certain specified activities excluded from exempt activities.

Canada

[see under 'Activity restrictions' above]

United States

- At least 75 per cent of the value of a US REIT's total assets must consist of real estate assets, cash items and government securities.
- No more than 25 per cent of the value of a US REIT's total assets can be invested in securities other than those covered by the 75 per cent requirement.
- No more than 25 per cent of the value of a US REIT's total assets can be invested in securities of taxable REIT subsidiaries.
- Except for government securities and securities of taxable REIT subsidiaries, no more than 5 per cent of the value of the REIT's total assets can be invested in the securities of any one issuer and investment in the securities of any one issuer cannot exceed 10 per cent of the total value or voting power of the outstanding securities of that issuer.
- US REITs must derive at least 95 per cent of their gross income from real-property sources (rents and gains from sale or disposal of such property) and from certain other investments if by way of passive income.
  - At least 75 per cent of the REIT's gross income must be from real property sources.
- Rent from certain activities, including profit based rent and related party rent, is excluded.

Germany

- At least 75 per cent of a German REIT's assets must be qualifying real property assets.
- The gross assets of any wholly owned REIT service companies must not exceed 20 per cent of the assets of the parent REIT.
- German REITs must derive at least 75 per cent of their gross receipts from rental, leasing, or sale of such real estate.
  - They cannot qualify if they are a dealer in real estate or if the gross revenue of the REIT's service companies exceeds 20 per cent of the revenue of the parent REIT.

- Leveraging of German REITs is limited to 55 per cent of the fair market value of assets.

Singapore

- At least 75 per cent of a Singapore REIT's 'deposited property' (this means the value of the REIT's total assets based on the latest valuation) should be invested in income-producing real estate. The remainder of the REIT's deposited property must consist of real estate related assets and other permissible investments.

- The total contract value of property development activities undertaken and investments in uncompleted property developments should not, except in limited circumstances, exceed 10 per cent of the REIT's deposited property.

- Singapore REITs' borrowings are generally limited to 35 per cent of value of property but may be higher (up to a maximum of 60 per cent) if a credit rating for the REIT is obtained from one of three specified credit agencies and disclosed to the public.

- Singapore REITs are required to do a full valuation of their real estate assets at least once a year.

- Singapore REITs should not derive more than 10 per cent of their revenue from sources other than:

  – rental payments from the tenants of real estate held by the REIT; or

  – interest, dividends and other similar payments from Special Purpose Vehicles and other permissible investments of the fund.

Japan

- Under the Investment Trust Law a Japanese REIT must invest primarily in 'Qualified Assets' which include securities; real estate; leasehold rights in real estate; surface rights; monetary debts; promissory notes and trust beneficiary rights.

- Under the Tokyo Stock Exchange listing rules, a Japanese REIT cannot own assets not relating to real estate except cash, cash equivalents or certain shares of specified Special Purpose Companies.

- A corporate REIT cannot own more than 50 per cent of shares in another corporation.

- The net asset value of a corporate REIT must be maintained at JPY 50 million or more.

- If a REIT is listed:
  - real estate assets must make up over 70 per cent of the total assets under management (listing requirement);
  - at least 95 per cent of the REIT's total assets must be invested in, or expected to be invested in real estate assets, cash and cash equivalents for 3 months after listing; and
  - the real estate, such as land, building and structures may be located inside or outside Japan.

Hong Kong

- Hong Kong REITs cannot acquire any asset which involves the assumption of an unlimited liability.
- If the name of the Hong Kong REIT indicates a particular type of real estate, the REIT must invest at least 70 per cent of its non-cash assets in the indicated real estate.
- Hong Kong REITs can establish and own special purpose vehicles (SPVs), however, it is expected that these vehicles will be wholly owned by the REIT except in special and limited circumstances, in which case they must be mostly owned by the REIT.
  - Where a REIT invests in hotels, recreation parks or serviced apartments, such investments shall be held by special purpose vehicles.
- REITs may borrow (either directly or through their SPVs) for financing investment or operating purposes but aggregate borrowings shall not at any time exceed 45 per cent of the total gross asset value of the scheme.
- REITs can invest in foreign assets.

TAXATION OF INCOME AND DISTRIBUTIONS

United Kingdom

- Rental profits, and capital gains from disposal of rental property, from 'exempt activities' are exempt from corporate income tax.
  - Gains on developed rental properties sold within 3 years may be taxable.
- Corporate income tax applies to profits from 'residual activities'.

- At least 90 per cent of the rental income from the 'exempt' property rental business (excluding profits from disposal of properties) must be distributed annually in the form of dividends.
- Dividend distributions of profits from exempt activities are treated as property income in hands of resident investors.
  - Withholding tax (20 per cent rate) applies to these distributions to resident individual shareholders and foreign shareholders.
- Distributions of profits from residual activities treated as taxable ordinary dividends.
- Capital gains tax payable on disposal of REIT shares by shareholders.
- Major breach results in disallowance of REIT status.
- Extra tax charged for some minor breaches.

Canada

- A qualifying REIT is not taxed on distributed income and capital gains.
- Income and taxable capital gains (50 per cent of capital gains) of a REIT that are not paid or do not become payable to investors before the end of a taxation year are taxed at the REIT entity level at the highest marginal tax rate applicable to individuals.
- Distributions of REIT income are taxable in the hands of the investors.
  - Withholding tax applies to distributions to foreign investors.
- REITs are not subject to a minimum annual distribution amount.
- Loss of Mutual Fund Trust status by a REIT has a number of negative taxation consequences.

United States

- Corporate income tax applies to taxable income of REIT entity that is not distributed.
  - An excise tax may also be payable on undistributed amounts.
  - A penalty tax may also apply when a REIT and a taxable REIT subsidiary fail to engage in an arms-length transaction.

- Deductions allowed to REIT for dividend distributions of current year income and capital gains.
- REIT distributions to investors taxed as corporate dividends.
- Capital gains distributions taxed at special rate (currently 15 per cent).
- REITs must annually distribute an amount that is at least equal to the sum of 90 per cent of their ordinary taxable income and 90 per cent of their net income from foreclosure property.
- Breach of the rules can lead to the imposition of various penalties, including the payment of corporate taxes on all income from non-qualified assets and a $50,000 penalty for non-asset test failures. Loss of REIT status is also possible.

Germany

- Eligible REIT income is not subject to corporate income tax.
- Distributions (dividends) of REIT income fully taxable at the shareholder level.
- REITs must distribute 90 per cent of their prior year income. This income may be reduced by capital gains from property sales applied to purchase replacement real estate.
- A penalty may be imposed if REIT fails to meet requirements and consistent failure may lead to the loss of REIT status.

Singapore

- Taxable income of a REIT that is not distributed to investors is taxed at the entity level at the corporate tax rate.
- Distributions of taxable income to resident corporate investors are taxed at the prevailing corporate tax rate. Distributions to individuals are generally tax-exempt.
  - A withholding tax applies to distributions of taxable income to foreign non-individual investors.
- REITs must annually distribute at least 90 per cent of their taxable income.
- Breach of rules could lead to the withdrawal of tax transparency status and/or de-listing (resulting in the loss of tax concessions).

Japan

- Corporate income tax applies to income of REIT.
- Distributions of dividends deductible to REIT.
- Dividend income taxed when distributed to investors.
  - Withholding tax applies to distributions to foreign investors.

Hong Kong

- Authorised REITs are exempt from profits tax. However, if the authorised REIT directly owns a Hong Kong property and derives rental income from such property, it will be subject to property tax on the rental income.
- Generally REIT property will be held through a wholly owned REIT subsidiary (Special Purpose Vehicle) which will be subject to profits tax on the rental income. Where the REIT subsidiary is subject to profits tax on the rental income, it can apply for exemption from property tax.
- Dividends distributed from the REIT subsidiary to the REIT will be exempt from profits tax and any distributions made by the REIT to unitholders will not be taxable in the hands of the unitholders.

APPENDIX F: SUMMARY OF KEY FEATURES OF INTERNATIONAL MANAGED INVESTMENT FUND REGIMES

(Referred to in paragraphs 4.18, 5.11 and 9.30)

STRUCTURES AND RESTRICTIONS

United Kingdom

Approved investment trusts:

- structured as UK resident companies and are required to be listed on the London stock exchange;
- must derive their income 'wholly or mainly' (70 per cent) from shares and securities (excluding trading profits relating to transactions in shares and securities);
- memorandum or articles of association must prohibit surpluses arising from the realisation of investments being distributed as dividends;
- must distribute at least 85 per cent of its eligible income each year; and
- Investment Trust status is applied for and, if conditions are met, granted separately for each accounting period of the company.

Venture capital trusts:

- similar to investment trusts but are designed to encourage individuals to invest in non listed trading companies;
- required to be listed on the London stock exchange;
- must derive their income 'wholly or mainly' from shares or securities and at least 70 per cent of its investments must be in 'qualifying holdings' (unlisted companies that carry out certain qualifying trades) and at least 30 per cent of the qualifying holdings must be in eligible shares; and
- Venture Capital Trust status is applied for and, if conditions are met, granted separately for each accounting period of the company.

Authorised Investment Funds (AIF)

- Can be structured as Authorised Unit Trusts or Open-Ended Investment Companies; and

- Open Ended Investment Companies can elect to be treated as a Property Authorised Investment Fund where they derive at least 60 per cent of their net income from a Property Investment Business (carrying on a property rental business, owning shares in UK-REITs, and/or owning shares/units in foreign entities that are equivalent to UK-REITs), and have at least 60 per cent of their assets forming part of the Property Investment Business.
- There are also unauthorised unit trusts which do not fall within the AIF Regime.
- AIF status is obtained by being authorised by the Financial Services Authority.

Canada

Mutual fund

- Can be a resident Canadian unit trust or corporation.
- Its only undertaking must be the investing of its funds in property (other than real property and or acquiring, holding, maintaining, improving, leasing, or managing real property (or interest in real property) that is capital property of the trust; and
- 95 per cent of issued shares/units (based on fair market value) must have conditions attached which require the fund to accept, at the demand of the holder, the surrender of the shares/units at prices determined and payable in accordance with conditions.
- Alternatively for a unit trust, at least 80 per cent of its property must consist of, and not less than 95 per cent of its income is to be derived from, shares, share warrants, bonds, debentures, mortgages, marketable securities or cash, notes or similar instruments, real property located in Canada and interests in such property, or rights to or interests in any rental or royalty from an oil or gas well, or from a mineral resource situated in Canada.

United States

Mutual Funds (Regulated Investment Companies)

- Corporations must be registered under the Investment Company Act of 1940 as a management company, unit investment trust, Business Development Company or as a type of common trust fund, and make an irrevocable election to be treated as a Mutual Fund.
- At least 50 per cent of total assets are to be invested in cash, government securities, securities of other mutual funds and the securities of other issuers of which the RIC owns no more than 10 per cent of the vote nor accounts for more than 5 per cent of the RIC's total assets.

- No more than 25 per cent of total assets can be invested in: (1) the securities of any one issuer (other than government securities or securities of other mutual funds); (2) the securities of two or more issuers controlled by the mutual fund and engaged in a related trade or business; or (3) the securities of one or more qualified publicly traded partnership.

- At least 90 per cent of the entity's gross income must be derived from dividends, interest, payments with respect to certain securities loans, gains from the sale or disposition of stock or securities or foreign currencies, other income derived from the business of investing in stocks, securities, or currencies, and the net income derived from qualified publicly traded partnerships.

- Must distribute to its shareholders at least 90 per cent of its annual investment company taxable income and its net tax-exempt interest income (there is no distribution requirement for net capital gains).

New Zealand

Portfolio Investment Entities ('PIE'):

- both trust and corporate type. A PIE can be a company, unit trust, superannuation fund or group investment fund however a life insurer is specifically excluded. However, an investment linked life fund of a life insurer can become a PIE;

- the entity must use, or have available to use, 90 per cent or more by value of the entity's assets in deriving income from the owning or trading of: (a) an interest in land; (b) a financial arrangement; (debt type arrangements); (c) an excepted financial arrangement; (which includes equities); (d) a right or option concerning property referred to in (a) to (c);

- the entity must derive at least 90 per cent of its income from the property above and it must consist of: (a) dividends; (b) financial arrangement income derived by the entity (like interest); (c) income under a lease of land [Note: this is likely to be amended further to exclude income under a lease of land from an associated person]; (d) proceeds from the disposal of property; (e) foreign investment fund income; (f) portfolio investor allocated income; or (g) distributions from superannuation funds; or (h) replacement payments (under share lending arrangements); and

- The entity must be widely held.

Singapore

Designated Unit Trusts (DUTs)

Qualifying criteria:

- be an authorised collective investment scheme and is open to public for subscription; a restricted authorised scheme; or a scheme that is exempted from authorisation;

- not be a REIT or property trust that invests directly in Singapore immovable properties;

- the trustee is tax resident in Singapore; and

- the investment or fund manager holds a capital markets services licence for fund management under the Securities and Futures Act or is exempt from the requirement to hold such a licence under that Act.

- If the DUT is a restricted authorised scheme or is exempted from authorisation, the following additional conditions apply:

  – not more than 50 per cent of its investments is beneficially held by related parties of the investment or fund manager;

  – investors do not have day-to-day control over the management of the investments, they do not have the right to be consulted or to give management directions and they do not have control or influence over the distribution policy of the unit trust; and

  – assets held under the unit trust were not transferred (other than by way of a sale on market terms and conditions) from a Singapore business which would not have been exempt from tax in the first place.

Japan

Investment trusts:

- both corporate and trust type;

- under the Investment Trust and Investment Corporation Law, are required to invest primarily (more than 50 per cent of the assets) in securities-related derivative instruments, real estate, rights of lease of real estate, rights of superficies, monetary receivables, promissory notes, rights related to financial futures and other derivative transactions, equities in investment partnerships, and beneficiary rights in trust of money, securities, monetary receivables, real estate and rights of superficies and of leases of land; and

- the asset management function must be outsourced to an asset manger.

Hong Kong

Collective Investment Scheme:

- can be either Unit Trusts or Mutual Fund Corporations;
- require authorisation from the Securities and Futures Commission as either a non specialised scheme or specialised scheme;
- specialised schemes cannot have as their primary objective investment in equities and/or bonds and include unit portfolio management funds, money market/cash management funds, warrant funds, leveraged funds, futures and options funds, guaranteed funds, index funds and hedge funds;
- in relation to securities of a single issuer, non specialised schemes cannot hold an amount greater than 10 per cent of the schemes net asset value A waiver of this limitation may apply in the case of a scheme whose sole objective is to track an index with constituent stocks exceeding 10 per cent (for example, index tracking fund). Also, non-specialised schemes cannot hold more than 10 per cent of any ordinary shares issued by any single issuer. However, up to 30 per cent of a scheme's total net asset value may be invested in Government and other public securities of the same issue;
- a non specialised scheme's holding of unlisted or unquoted securities cannot exceed 15 per cent of its total net asset value; it may not invest in any type of real estate or interests in real estate (but can invest in shares in real estate companies and interests in REITs that are listed on a stock exchange); and if the name of the scheme indicates a particular objective, geographic region or market, at least 70 per cent of its non cash assets must reflect this;
- non specialised schemes may invest through a wholly owned subsidiary company where direct investment in a market is not in the best interests of investors as long as the subsidiary is established solely for the purpose of making direct investments in such a market (the underlying investments of the subsidiary, together with direct investments made by the scheme, must in aggregate comply with the requirements); and
- it is accepted that some collective investment schemes may have gained prior authorisation in an overseas regulated jurisdiction — the so called recognised jurisdiction schemes. In such cases, the SFC may grant authorisation to these schemes provided certain conditions are met.

TAXATION

United Kingdom

Approved Investment Trusts:

- subject to corporation tax on its income in the normal way; and
- exempt from corporation tax on capital gains on disposal of investments for each period in which they obtain investment trust status. Other companies are liable to pay corporate tax on such gains.

Venture Capital Trusts:

- exempt from corporation tax on capital gains on disposal of investments. Other companies are liable to pay corporate tax on such gains;
- gains or losses accruing to an individual on a qualifying disposal of any ordinary shares in a Venture Capital Trust is not a chargeable gain or allowable loss;
- if certain conditions are met no income tax arises in respect of dividends paid in respect of venture capital trust shares; and
- if certain conditions are met, an individual can obtain tax relief for investments of up to £200,000 per annum made in newly issued shares of a Venture Capital Trust.

Authorised Investment Funds:

- exempt from corporation tax on capital gains on disposal of investments. Other companies are liable to pay corporate tax on such gains;
- such gains cannot be distributed to investors except on a liquidation of the units in the fund;
- special tax rules exist for investments in loan relationships and derivative contracts that aim to preserve the exemption from tax on chargeable gains to returns from these investments;
- there is a deemed full payout of fund income using an attribution mechanism based on investor entitlements;
- although treated as companies for tax purposes, a lower rate of tax is applied to the taxable income of the funds (20 per cent for the fiscal year 2008/2009 as compared to 28 per cent for companies);

- if investment requirements are met a fund may distinguish in its accounts whether amounts are to be paid out wholly as dividends or wholly as yearly interest;
- interest distributions paid by an authorised investment fund (AIF) are deductible for UK tax purposes in calculating the funds taxable income;
- the fund must withhold tax at the basic rate of tax (20 per cent) from the distribution (not applicable to certain distributions including UK companies);
- in the hands of investors the interest distribution is subject to income tax in the same way as normal interest income and investors are allowed a credit for tax withheld at entity level;
- if investment requirements are not met then the Tax Acts shall have effect as if the total amount were dividends on shares paid on the distribution date by the authorised investment fund to the participants in proportion to their rights;
- for UK resident recipients, the tax rules attempt to put the investor in the same position had it invested directly in the underlying investments (allowed a credit for tax withheld at entity level);
- distributions from a Property Authorised Investment Fund are 'streamed' into three components:
  - income from the fund's property business is exempt from tax at the fund level and distributed to investors as property income dividends (liable to withholding tax for certain investors) and taxed at the investor level as profits of UK property business); and
  - interest and dividend distributions which receive similar tax treatment to that applicable to other Authorised Investment Funds.
- unauthorised unit trusts are subject to income tax and capital gains tax at the rate of 20 per cent;
- there is no automatic exemption from tax on capital gains and the trust will only be exempt if all of its investors are themselves exempt for reasons other than residence; and
- all distributions are deemed to be post tax and investors will be given credit for this against their own tax liability (or can reclaim it if exempt).

Canada

- A Mutual Fund is not exempt from tax but is entitled to deduct in a year all income and capital paid, or due and payable as a distribution to investors in the

year so it may reduce its net taxable income to nil (provided appropriate designations are made).

- Mutual Fund Corporations can only flow through Canadian dividend and capital gains, with other income being taxed at the entity level.
- Both capital gains and income distributions are subject to regular tax rates in the hands of investors.
- If the Mutual Fund trust is a Canadian resident and listed or traded on a stock exchange or other public market, and the trust holds one or more non-portfolio properties, it will be considered a specified investment flow-through trust ('SIFT'). It will, therefore, not be able to deduct any amount of its non-portfolio income that it has distributed and it will be liable to pay tax on this at a rate approximating the corporate rate.

United States

Mutual funds (Regulated Investment Companies)

Fund Level:

- subject to taxation at regular corporate income tax rates but are allowed a deduction for any ordinary dividends paid (not eligible if one class of shareholders, or one or more members of a class of shareholders, is singled out, unless such treatment was originally intended when the dividend rights were created);
- may avoid corporate level taxation on its net capital gains by distributing such gains to shareholders. If it elects to retain some of its net capital gains then it will be subject to taxation at regular corporate capital gains rates on the amount retained; and
- a non-deductible excise tax is generally imposed on a mutual fund that does not satisfy minimum distribution requirements on a calendar-year basis (regardless of the fiscal year of the fund).

Shareholder Level:

- ordinary dividends are generally taxed to the shareholder as ordinary income (however, the shareholder may be eligible to be taxed at the lower capital gains rate for distributions from certain dividends received by the fund);
- tax-exempt interest may generally be excluded from the shareholder's gross income (however, exempt-interest dividends derived from private activity bonds constitute a tax preference item for alternative minimum tax purposes);

- for capital gain distributions shareholders are entitled to a credit or refund for their portion of any capital gain tax paid by the mutual fund. Shareholders may increase the cost basis of their shares by the difference between the undistributed capital gains and their deemed portion of taxes paid;
- a distribution that is not out of a mutual fund's earnings and profits is a return of the shareholder's investment and is not generally subject to tax but reduces the shareholder's basis in their mutual fund shares; and
- the sale, exchange or redemption of shares in a mutual fund is treated as the sale of a capital asset.

New Zealand

Portfolio investment entities

- Portfolio investment entities are generally not taxed on any realised gains from the disposal of shares in New Zealand companies or certain Australian resident listed companies.

Portfolio investment entities other than listed companies or unit trusts:

- entity income is notionally allocated to its respective investors and income tax is paid by the entity on behalf of those investors based on their individual income allocations and at the investor's elected rate of either 30 per cent, 19.5 per cent or 0 per cent; (Only certain entities can elect a rate of 0 per cent — a natural person cannot elect a 0 per cent rate);
- for investors on the 30 per cent or 19.5 per cent rates who have notified the PIE of their correct rate, this entity level tax is a final tax; and
- income that is unable to be allocated to an investor is treated as the income of the entity and is taxed at the corporate tax rate.

Portfolio investment entities which are listed companies or unit trusts:

- income is taxed at the entity level at a rate of 30 per cent;
- full imputation credits must be attached to distributions;
- dividend income is exempt in the hands of certain resident portfolio investors; but
- the investor can chose to treat the distribution as taxable income to utilise any excess imputation credits on fully imputed dividends.

Additional comments

On entry into the PIE regime, a notional sale and reacquisition of NZ and Australian listed shares is required. Any tax liability arising from this can be spread over three years and any losses can be carried forward.

Singapore

- Gains on the sale of securities, interest income (other than interest for which Singapore tax has been deducted at source by the payer), and dividends derived from outside Singapore and received in Singapore and other specified income does not form part of a DUT's statutory income and is therefore not taxed at the trust level (this is regardless of whether or not the DUT distributes its income).

- This income is deemed to be the income of the unit holder unless they qualify as non-residents or individuals, in which case it is free from further tax in Singapore.

Japan

Investment trusts:

- under the tax law, investment trusts are categorised either as a taxable trust or as a non-taxable trust;

- out of 'trust type' investment trusts, income of a security investment trust and an investment trust has its units mainly offered in the domestic public market is not subject to Corporate Income Tax. Distribution is subject to withholding tax when distribute to investors; and

- income of 'corporate type' investment trust and 'trust type' investment trust other than above is subject to Corporate Income Tax. If a certain investment trust meets all requirements such as 90 per cent of taxable income distribution requirement, the distribution may be deductible from their taxable income. Distribution is subject to withholding tax when distribute to investors.

Hong Kong

- HK profits tax applies to Hong Kong sourced profits derived by any person carrying on a trade, profession or business in Hong Kong.

- Profits derived by an authorised collective investment scheme or a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime are exempt from HK profits tax.

- Foreign sourced income is not subject to taxation in Hong Kong.

- Gains from the sale of capital assets are not liable to profits tax.
- Dividend and other distributions from an entity liable to HK profits tax are generally not taxable in the hands of unitholders/shareholders.
- Fund management companies carrying on business in HK and deriving HK sourced profits are subject to HK profits tax.
- Offshore funds are exempt from HK profits tax on profits derived from specified transactions and transactions incidental to the carrying out of the specified transactions. However, the tax exemption on profits derived from the incidental transactions is subject to a 5 per cent threshold. If the 5 per cent threshold is exceeded, the whole trading receipts from the incidental transactions including the 5 per cent will be chargeable to HK profits tax. Profits from the specified transactions will continue to be fully exempt from tax.

Appendix G: Current tax law definitions of widely held trusts

(Referred to in paragraph 11.3)

The tax laws do not currently contain a universal definition of a widely held (public) trust. Instead there are a range of definitions that focus on the 'pooling' or 'widely held' aspect of these vehicles.

Definitions are contained in Divisions 6B and 6C, the trust loss rules (Schedule 2F to the ITAA 1936) and the withholding tax regime for managed funds in subdivision 12-H of Schedule 1 to the *Tax Administration Act 1953*. The issue of defining 'widely held' was also touched upon in the Review of Business Taxation (the RBT).

Division 6B and Division 6C

Certain widely held trusts (corporate unit trusts and public trading trusts) are taxed like companies under Divisions 6B or 6C of Part III of the ITAA 1936. Division 6B and Division 6C use the concept of 'public unit trust' to label the pooled or widely held investment vehicle that are the target of these provisions.

Division 6B defines the term 'public unit trust' in section 102G. For the purposes of Division 6B, broadly a trust is a public unit trust where:

- any of the units are listed for quotation on a stock exchange;
- the units are held by 50 or more persons; or
- any units are offered to the public (but not where the offer was merely to secure public status under Division 6B).

A unit trust is not a public trust if 20 or fewer persons hold or have the right to acquire 75 per cent or more of the beneficial interests in the income or property of the trust. In applying this test a person and his relatives and nominees are deemed to be a single person. Special rules allow for the tracing of beneficial interests through layers of trusts.

Division 6C also defines the term public unit trust in section 102P. The definition is broadly similar to that appearing in 102G. One difference is that 102P provides an alternative test which, if passed, leads to characterisation of a trust as a public unit trust for Div 6C purposes. This alternative test is relevant where exempt entities are (including complying superannuation funds) are unitholders of the trust.

Trust loss rules

The trust loss provisions in Schedule 2F to the ITAA 1936 are designed to prevent the tax benefits that arise from the recoupment of trust losses and debt deductions being transferred to persons who did not bear the economic effect of the loss when it was incurred. Widely held (fixed) trusts are subject to less onerous compliance obligations to assess whether they can utilise losses and debt deductions.

These rules do not use the concept of a public unit trust to convey the widely held (public) nature of a trust. Instead Division 272 of Schedule 2F utilises the concept of a widely held trust. The concept of a widely held unit trust is defined in section 272-105 of Schedule 2F as a fixed trust that is a unit trust and is not closely held that is, more than 20 individuals beneficially hold directly or indirectly, 75 per cent or more of the fixed entitlements to income or capital of the trust.

There are four specific types of widely held trusts identified in Division 272 of Schedule 2F:

- an *unlisted widely held trust* which is a widely held unit trust where the units are not listed on an approved stock exchange, section 272-110 of Schedule 2F;
- a *listed widely held trust* which is a widely held unit trust where the units are listed on an approved stock exchange section;
- an *unlisted very widely held trust* which is an unlisted widely held trust with at least 1,000 unit holders where the units carry the same rights, section 272-120 of Schedule 2F; and
- a *wholesale widely held trust* which is an unlisted widely held trust where at least 75 per cent of the units in the trust are held by certain bodies (that is, a listed widely held trust, an unlisted very widely held trust, a life insurance company etc), the initial amount subscribed was at least $500,000 and all the units carry the same rights.

Withholding tax regime for managed funds

The most recent addition to the range of definitions for a widely held (public) trust is 'managed investment trust' which is contained in the withholding tax regime in section 12-400 of Schedule 1 to the TAA 1953. This definition was introduced in *Tax Laws Amendment (2007 Measures No. 3) Act 2007* and applies to certain distributions to foreign residents from managed investment trusts. The definition lists three requirements that must be satisfied at the time the first fund payment is made for the trust to qualify as a managed investment trust.

- The trust must have a relevant connection with Australia;

  - The relevant connection can be established by a trustee of the trust being an Australian resident at a relevant time, or can be established by the trust's central management and control being in Australia at a relevant time.

- The trust must satisfy certain *Corporations Act 2001* requirements pertaining to the management of investments; and

  - To meet this requirement the trust must be a 'managed investment scheme' (MIS) at the time the first fund payment is made for the income year and be operated by a 'financial services licensee' (FSL) whose licence covers operating such a managed investment scheme. The terms MIS and FSL are both defined in the *Corporations Act 2001*.

- The trust is either listed or is widely held.

  - The trust must be listed or widely held in the sense that the trust has at least 50 members at the time it makes the first fund payment for the income year. The provisions allow look through so that the 50 member requirement is met if at least one specified entity in subsection 12-400(2) of Schedule 1 to the TAA 1953 is a member of the trust and has at least 50 members itself.

The law contains two refinements to these three general rules.

- In order to prevent the ownership of the units in a managed investment scheme being concentrated in a few foreign members, despite the 50 member test being satisfied a trust will not be considered to be widely held if one or more foreign resident individual members have, directly or indirectly, a 10 per cent or more interest in the trust.

- In recognition that funds have a 'life cycle' that is, a beginning and an end and that this may make it difficult to satisfy the widely held or listing requirements, the provisions also incorporate a mechanism which allows these requirements, in certain circumstances, to be relaxed in the income year in which the trust is created or wound up.

This definition of MIT only applies to the withholding regime for managed funds.

Managed investment scheme

Under section 601ED of the *Corporations Act 2001* a managed investment scheme must be registered with the Australian Securities and Investments Commission (ASIC) where:

- the scheme has 20 or more members;

- the scheme is promoted by a person who was in the business of promoting managed investment schemes; or

- where ASIC issues a determination that a number of schemes are closely related and should be separately registered.

A managed investment scheme does not need to be registered if all the issues of interests in the scheme would not have required the giving of a Product Disclosure Statement under Division 2 of Part 7.9 if the scheme had been registered when the issues were made.

A number of conditions must be satisfied in order for a managed investment scheme to be registered. Broadly under Part 5C.1 of the *Corporations Act 2001* the scheme needs to lodge a constitution[63] and compliance plan[64] with ASIC and appoint a responsible entity to operate the scheme and hold the property of the scheme as a trustee.

Division 855 – CGT and foreign residents

Division 855 of the *Income Tax Assessment Act 1997* (ITAA 1997) narrows the range of assets on which foreign residents are subject to Australian CGT to primarily Australian real property and the business assets (other than Australian real property) of a foreign resident's Australian permanent establishment.

Division 855 uses the term fixed trust. The term fixed trust is defined in section 995-1 of the ITAA 1997. A trust is a fixed trust if entities have 'fixed entitlements' to all of the income and capital of the trust. An entity is deemed to have a fixed entitlement to a share of the income or capital of a trust under section 995-1 if the entity has a fixed entitlement to that share within the meaning of the trust loss provisions in Schedule 2F to the ITAA 1936.

Under Division 855 a membership interest in another entity (for example, an MIT) will be taxable Australian property only if the underlying value of that entity is principally derived from Australian real property and a non-portfolio test is passed.

Real Estate Investment Trusts (REIT)

REITs are an important part of this review. The tax laws do not contain a specific definition of a REIT except as a component of eligible investment business in Division 6C.

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63 Each registered managed investment scheme must have a Constitution. A scheme's Constitution is similar to a trust deed and must cover the matters prescribed by the Act and the policy statements of ASIC.

64 A Compliance Plan is a detailed document that sets out measures to ensure that the Responsible Entity complies with the law and the scheme's Constitution. Where the board of directors of the Responsible Entity does not consist of at least half 'external' directors, section 601JA of the *Corporations Act 2001* requires that the scheme has a Compliance Committee. The role of the committee is to monitor the extent to which the Responsible Entity complies with the scheme's Constitution, the Law and the scheme's Compliance Plan.

The Review of Business Taxation (the RBT) and Collective Investment Vehicles

The taxation of MIT-like vehicles has been touched upon in previous reform processes. Chapter 16 of the Review's *Discussion paper 2, Building on a strong foundation*[65] for example discussed the possibility of provision in the tax law for flow through taxation of collective investment vehicles (CIVs).

CIVs for this purpose were widely held vehicles undertaking investments delivering a full flow through of annual profits to participants, namely investments less of an active business nature and much more of a passive portfolio, or intermediate nature not involving control of business operations.

The RBT recognised that it would be necessary to define such widely held entities. It noted that:

> Under the current tax law, a public unit trust is a unit trust where any of the units are listed for quotation on a stock exchange, the units are held by 50 or more persons, or any of the units are offered to the public. A unit trust where 20 or fewer persons hold 75 per cent or more of the beneficial interests in the income or property of the trust is specifically excluded from being a public unit trust. (For the purposes of special tax treatment it would also be necessary for the trust to be a resident unit trust.) This definition, suitably modified if applying to entities other than unit trusts, may be an appropriate way of defining widely held vehicles.
>
> The definition of 'widely held' would need to be cognisant of the interest withholding tax arrangements — that, for example, provide related exemptions for widely distributed bonds.

The RBT's final report, *A Tax System Redesigned, More certain, equitable and durable*[66] made two key recommendations about the scope of the concept of widely held and its application to collective investment vehicles.

Recommendation 6.21 sought to put forward an acceptable definition of 'widely held'. The definition was as follows:

> *That a 'widely held' entity subject to entity taxation be defined as an entity where:*
>
> *(i) the membership interests (for example, units or shares) are held by not fewer than 300 persons; and*
>
> *(ii) 20 or fewer individuals do not hold, directly or indirectly, 75 per cent or more of:*

65 Commonwealth of Australia 1999, *Review of Business Taxation: A Platform for Consultation Discussion Paper 2; Building on a strong foundation*, February 1999, Commonwealth of Australia, Canberra.

66 Commonwealth of Australia 1999, *Review of Business Taxation: A tax system redesigned*, July 1999, Commonwealth of Australia, Canberra.

- the interests in the profits or capital; or
- the voting rights.

The RBT noted that this definition of 'widely held' is broadly based on the standard definition used in the trust loss provisions, which taxpayers are familiar with and is easy to apply to trusts.

The additional requirement that the membership interests in the entity are held by not fewer than 300 persons was thought to be important in guaranteeing that the entity had a genuinely broad based membership.

Recommendation 16.8 sought to put forward an acceptable definition of 'widely held' for a CIV. The definition was as follows:

> *That a 'widely held' entity for purposes of defining a CIV be an entity satisfying one of the following three conditions:*
>
> ***Standard definition***
>
> *(i) an entity meeting the standard definition of 'widely held' provided by Recommendation 6.21; (as above)*
>
> ***Where CIV interests held by pooled investment entities, governments or non-resident entities***
>
> *(ii) an entity where all of the interests are collectively held at all times by:*
>
> - pooled investment entities — comprising CIVs, complying superannuation funds (other than excluded funds), approved deposit funds, pooled superannuation trusts, statutory funds of life insurance companies, or life insurance business of friendly societies;
> - governments and government bodies that are exempt from income tax; or
> - non-residents (other than individuals).
>
> ***Where the CIV is a registered managed investment scheme mainly held by pooled investment entities***
>
> *(iii) the CIV is a registered managed investment scheme and at least 75 per cent of CIV interests are held at all times by pooled investment entities.*

The RBT noted that the first part of the 'widely held' definition ensures that only genuinely broadly based funds receive CIV treatment. The second and third parts were designed to make the CIV regime available to 'wholesale' vehicles primarily used by CIVs and by superannuation and life insurance vehicles to obtain specialised investment services.

Appendix H: Example of the operation of a trustee assessment and deduction model and a trustee exemption model

(Referred to in paragraph 4.9)

Example A: Income of the trust exceeds net income

The following examples A and B demonstrate the possible application of a trustee assessment and deduction model and a trustee exemption model. The mechanics of such models would be dependent on the consideration of issues such as the treatment of distributions as (covered by question 4.2). Accordingly, these models are provided for indicative purposes only.

For the purposes of these examples, the capital gain is not included in the trust law income however the trustee has a discretion to distribute such amounts.

Furthermore, under the trustee assessment model, the trustee can only claim a deduction for deductible distributions up to the value of the net income, including a gross up for franking credits and other tax offsets distributed to the beneficiaries.

The MIT unit trust return for the 2007-08 was as follows:

Income year 2007-08	Income of the trust ($million)	Net Income for tax purposes ($million)
Rent from properties	300	300
Investment property expenses (deductible)[(a)]	-100	-100
Management, marketing and administration expenses	-20	-20
Interest expense	-20	-20
Building Allowance / Depreciation	0	-80
Net Rent	**160**	**80**
Dividend received	70	70
Franking credits	0	30
Total Dividends	**70**	**100**
Interest received	20	20
Capital gain from sale of land[(b)]		10
Trust income/Net income	**250**	**210**

(a) The amount incurred by the trust in relation to investment property expenses was for a repair to an existing property rather than a capital improvement.
(b) The gross capital gain from the sale of land was $20 million and the net capital gain was $10 million (which reflects the 50 per cent capital gains discount).

Income of the trust and net income for tax purposes

The income of the trust for the 2007-08 income year was $250 million and its net income for tax purposes was $210 million. The difference in these amounts was attributable to the different treatment of depreciation, franking credits and capital gains for tax purposes.

The trustee decided to distribute cash equal to the amount of the income of the trust and a further $20 million for the gross amount of the capital gain from the sale of land. The amount distributed to the beneficiary of the trust is therefore $270 million.

Deductible distributions under a trustee and assessment deduction model

Under the trustee and assessment deduction model the trustee is taken to distribute $210 million to investors to avoid being assessed on the income of the trust (being $180 million in cash and $30 million a deemed distribution representing the franking credits). See table below:

	($million)
Deduction for distribution of net income	180
(Including gross up for franking credits)	30
Grossed up deductible distribution	210
Deduction distribution amounts	
Net Capital Gain	10
Dividends	70
Franking Credits	30
Interest	20
Rent	80
	210

Tax deferred distribution

As the trustee decided to distribute all of the income of the trust for the 2007-08 income year, and the income of the trust exceeded net income for tax purposes, the trust made a tax deferred distribution to investors. The tax deferred distribution was calculated by determining the difference between the income of the trust (including the gross capital gain) and the deduction recognised under the trustee and assessment deduction model. As illustrated below the tax deferred amount for the 2007-08 income year was $80 million.

Cash reconciliation	($million)
Cash amount paid to investors	270
Less: Cash representing distributions of net income amounts (including $10 million re the net capital gain)	180
Less: Balance of the capital gains amount paid	10
Less: Tax preferred amount – Excess over net income – CGT E4 amount (sourced from building allowance/depreciation)	80
Balance to zero	0

Investors' tax return amounts

Under the trustee and assessment deduction model the investors in MIT unit trust would include the following information in their 2007-08 income tax returns.

Investors tax return (assume one unit holder)	($million)
Rent	80
Dividends	70
Franking credit	30
Interest income	20
Net capital gain	10
	210
Gross capital gain	20
E4 cost base adjustment	80

Distributions under an exemption model

Under an exemption model, the net income of the trust is attributed to unit holders in accordance with their entitlement under the trust deed.

Investors' tax return amounts

Under an exemption model, the investors in the MIT unit trust would need to have included the following information in their 2007-08 income tax returns.

Investors tax return (assume one unit holder)	($million)
Rent	80
Dividends	70
Franking credit	30
Interest income	20
Net capital gain	10
	210
Gross capital gain	20
E4 cost base adjustment	80

Example B: The net income of the trust exceeds the trust income

The MIT unit trust return for the 2007-08 was as follows:

Income year 2007-08	Income of the trust ($million)	Net Income for tax purposes ($million)
Rent from properties	300	300
Investment property expenses (deductible)[(a)]	-100	0
Management, marketing and administration expenses	-20	-20
Interest expense	-20	-20
Building Allowance/Depreciation	0	-80
Net Rent	**160**	**180**
Dividend received	70	70
Franking credits	0	30
Total Dividends	**70**	**100**
Interest received	20	20
Capital gain from sale of land[(b)]	0	10
Trust income/Net income	**250**	**310**

(a) The amount incurred by the trust in relation to investment property expenses was for a capital improvement rather than for a repair to an existing property and is therefore not a deductible expense.
(b) The gross capital gain is $20 million and the net capital gain is $10 million (which reflects the 50 per cent capital gains tax discount).

Income of the trust and net income for tax purposes

The income of the trust for the 2007-08 income year was $250 million and its net income for tax purposes was $310 million. The difference in these amounts was attributable to the different treatment of improvement expenses, depreciation, franking credits and capital gains for tax purposes.

The trustee decided to distribute an amount equal to the sum of income of the trust and the $20 million gross capital gain from the sale of land. The amount distributed to the beneficiary of the trust is therefore $270 million.

Deductible distributions under a trustee and assessment deduction model

Under the trustee and assessment deduction model the trustee would need deductible distributions of $310 million (including a deemed distribution of $30 million for franking credits) to investors to avoid being assessed on any of the net income of the

trust. However, to do this the trustee would need to borrow $20 million to fund the shortfall.

In this example the trustee does not borrow to fund the shortfall and therefore the trustee would be liable to tax as follows:

	($million)
Net income	310
Less: Deduction for distribution of net income	260
(Including gross up for franking credits)	30
Grossed up deductible distribution	290
Amount taxable to trustee	20
Deduction distribution amounts	
Net Capital Gain	10
Dividends	70
Franking Credits	30
Interest	20
Rent	160
	290
Shortfall of net income — taxable to trustee unless it borrows to pay it out	**20**

Tax deferred distribution

The trustee decided to distribute all of the income of the trust for the 2007-08 income year. However, as the income of the trust for the income year did not exceed the trust's net income for tax purposes for the income year, no tax deferred distribution can be made to investors.

Cash reconciliation	($million)
Cash amount paid to investors	270
Less: Cash representing distributions of net income amounts (including $10 million re the net capital gain)	260
Less: Balance of the capital gains amount paid	10
Less: Tax preferred amount (Building allowance/Depreciation)	Not taken to be paid
Balance	0

As demonstrated by the cash reconciliation, there was a $20 million shortfall in the distribution to investors that was not covered by the trustee through borrowings.

The shortfall is represented by the difference between the net income of the trust ($310 million) less the deductible distributions ($290 million).

Under the trustee and assessment deduction model the trustee is assessed on the $20 million shortfall in this example.

Investors' tax return amounts

Under the trustee and assessment deduction model the investors in MIT unit trust would need to include the following information in their 2007-08 income tax returns.

Investors tax return (assume one unit holder)	($million)
Rent[(a)]	160
Dividends	70
Franking credit	30
Interest income	20
Net capital gain	10
	290
Gross capital gain	20
E4 cost base adjustment	0

(a) In this example, as the trustee does not borrow to make deductible distributions. There is a shortfall of $20 million. Based on the calculation of income of the trust and the net income of the trust, the difference has been attributed to a shortfall of net rental income distributed to beneficiaries. Accordingly, the amount of net rent that has been taken to flow through to beneficiaries has been limited to the amount paid to the beneficiaries (that is, the trust income amount of $160 million).

Distributions under an exemption model

Under an exemption model the net income of the trust is attributed to unit holders in accordance with their entitlement under the trust deed.

Investors' tax return amounts

Under an exemption model, the investors in the MIT unit trust would need to have included the following information in their 2007-08 income tax returns.

Investors tax return (assume one unit holder)	**($million)**
Rent	180
Dividends	70
Franking credit	30
Interest income	20
Net capital gain	10
	310
Gross capital gain	20
E4 cost base adjustment	0