Investment & Financial Services Association Ltd
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01 December 2008

Mr Dick Warburton AO
Managed Investment Trusts Review
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Mr Warburton Dick

Re: Capital versus Revenue Treatment of Gains and Losses Made On Disposal of Investment Assets by Managed Investment Trust (MITs)

Thank you for giving priority to the above issue.

IFSA recommends this issue be resolved by legislating a statutory rule which deems the gains and losses made on disposal of investment assets by MITs to be on capital account.

IFSA has provided, in the following pages, detailed reasons as to why MITs should receive statutory deemed capital account treatment.

Our submission is consistent with your Review's terms of reference *to reduce complexity, increase certainty and minimise compliance costs.* The uncertainty will not be resolved without a statutory rule because the case law precedents are unclear.

If you would like to discuss any aspect of IFSA's please contact myself or Daniel Caruso on 02 9299 3022.

Yours sincerely

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Chief Executive Officer

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Chapter 7

> One of the principal reasons for the widespread dissatisfaction with the current system is that it is not based on a coherent set of principles. The 1936 Act was developed in an Australian economy very different from today's. This Act has been added to and patched largely in an ad hoc manner until it is no longer coherent and is not easily comprehended.
>
> If we are to avoid perpetuating this situation we need to establish a sound foundation and a framework of coherent principles capable of adaptation to meet changing needs and policies without sacrificing the integrity of the system.
>
> *A Strong Foundation: Discussion Paper*, Review of Business Taxation, November 1998[1]

7.1. Introduction

7.1. This is the Investment and Financial Services Association's (IFSA's) response to Chapter 7 of the October 2008 Discussion Paper *Review of the Tax Arrangements Applying to Managed Investment Trusts* ('the Discussion Paper') issued by the Board of Taxation ('the Board').

7.2. This chapter raises the most important issue in the whole of the Discussion Paper. If the tax outcomes of investment through managed investment trusts ('MITs') is not consistent with the tax outcomes of economically similar forms of investing then MITs will not be commercially viable. Investors would refuse to invest via MITs leading to:

- reduced savings;
- less sophisticated investment markets and so an increased cost of capital particularly for higher risk ventures;
- disruption of investment by superannuation funds;
- the use of more costly direct investment structures; and
- the upset of any plan for Australia to be a regional financial centre.

7.3. This behavioural response is discussed in more detail in section 7.8 below.

7.4. The Review of Business Taxation identified in 1998 "the lack of a coherent framework for taxing investment income" as one of the three "key problem areas" within its mandate.[2] The Review was critical of the fact that under Australia's current tax system "transactions which are identical, or very similar in their economic substance, are taxed differently because of differences in form"[3] and that "(v)arious inequities and inefficiencies stem from the tax rates applied to different forms of income".[4]

7.5. The Review developed an appropriate and coherent solution for taxing investment income but the Government of the day only implemented some of the Review's recommendations. The gap that they left is the one that the Board of Taxation is now being asked to consider. In particular, the availability of a capital gains tax discount to only some investors is an inequity in tax rates for transactions which are very similar in

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[1] page iii

[2] *A Strong Foundation*, Review of Business Taxation, November 1998, page xi

[3] page xii

[4] ibid

their economic substance and is an outcome that the Review of Business Taxation sought to address.

7.6. Any recommendation that the Board of Taxation makes needs to progress the work of the Review of Business Taxation. The solution needs to be part of a coherent framework and needs to deliver a system that is equitable and efficient in meeting the Government's objectives.

7.7. In section 7.2 we explain the Review of Business Taxation's solution. In sections 7.3 to 7.6 we propose a solution consistent with that solution. Section 7.6 in particular addresses the characteristics of investment and the characteristics of MITs to demonstrate the flaws in an argument that MITs should be on revenue account. In section 7.8 we describe the behavioural consequences of not adopting our proposal and in section 7.5 we address the cost of our proposal.

7.2. The Review of Business Taxation's Solution

7.8. The Review proposed that the objectives in designing the tax system are:

- optimising economic growth;
- ensuring equity; and
- facilitating simplification.[5]

7.9. The aspect of equity identified by the Review that is most relevant to the taxation of the asset profits of MITs is horizontal equity: taxpayers in similar circumstances being treated in a similar way.[6] Horizontal equity is the core issue for Chapter 7. It is central to our proposal in section 7.3.

7.10. The Review also suggested a set of principles for designing tax policy. The ones relevant to the issue under consideration are:

- where practical, the tax base is to be adjusted for inflation;
- entities should be considered as extensions of their ultimate owners;
- all income should be taxed comparably, measured from the point of view of the natural person who is the ultimate owner of the income;
- in order not to distort the cost of capital, avoid differentially taxing types of investments or types of entities;
- taxation of inbound investment should be consistent with Australia's national interest including its competitiveness;
- taxation measures should be designed on the basis of their actual behavioural impacts, not simply their formal or legal impacts; and
- economic transactions having the same economic substance should be taxed similarly, irrespective of their form.[7]

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[5] page 62

[6] page 63

[7] Principles 3, 4, 6, 7, 9 and 11, pages 69 and 70

7.11. The principle of not differentially taxing investments was expanded on as follows:

> Income taxation drives a wedge between the before-tax return earned by an entity and the after-tax return obtained by the individual investor. Where that proportional wedge is the same across all types of investments, whether held directly by the investor or indirectly through different types of entity, the pattern of investment and hence the allocation of scarce economic resources will be unaffected by income taxation.
>
> Where that proportional wedge varies with the type of investment, the type of entity, the choice of financing adopted by an entity or an entity's distribution policy, investment neutrality will be absent. In general, the more skewed and uneven the pattern of tax wedges is, the larger are the likely costs of resource misallocation: with tax-favoured sectors or investments over-expanded relative to other sectors or investments.
>
> The more even this pattern of tax wedges, the greater the degree of investment neutrality in the business tax system, and the more likely is it that business taxation minimises impediments to productivity growth.[8]

7.12. The Review applied these objectives and principles to recommend the capital gains tax ('CGT') discount that we now have.[9] They introduced this recommendation as follows

> The Review's recommendations for capital gains taxation are designed to enliven and invigorate the Australian equities market, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources.[10]

7.13. We revisit this quote in section 7.3 below.

7.14. This introduction included the following comment that has particular importance in the current debate

> Even in the medium to longer term, the Review expects a heightened level of realisations activity amongst individual shareholders and CIVs.[11]

7.15. In other words, the Review of Business Taxation expected investment portfolios to have high turnover and did not see this a reason for denying the CGT discount.

7.16. Linked to this recommendation was a recommendation that the CGT rules be the rules for taxing gains from all shares and other membership interests and all real estate.[12]

7.3. Our Proposal

7.17. Our proposal is for a statutory rule providing that the CGT rules be the primary code for all asset profits generated by all MITs that qualify for the regime. The issue of whether the rule should be restricted to only some MITs is addressed in section 7.6 below.

7.18. Such a rule is simple and would significantly lower compliance costs. Currently MITs spend significant amounts of time and direct expenditure on tax advice and on risk management meetings to discuss responses to the uncertainty. Ultimately this will impact on management fees. None of this actually eliminates the uncertainty but it is an inevitable consequence of modern corporate governance practices.

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[8] pages 75 and 76

[9] *A Tax System Redesigned*, July 1999, Chapter 18

[10] page 598

[11] ibid. The expression 'CIV' was the Review's term for what we are now calling a 'MIT'. See their Chapter 16.

[12] As well as a few other assets not relevant to MITs. See Recommendation 4.10, page 178 et seq.

7.19. It would be a further embodiment of the Review of Business Taxation's recommendation that gains from all shares and all real estate be subject to the CGT rules. Its adoption by the Board would fully deliver on the Board's terms of reference. We would encourage the Board to highlight to the current Government that the Review's recommendation could be implemented even further by extending this rule to all investors. We are making the same point to the Australia's Future Tax System review.

7.20. If, contrary to our proposal, the asset profits of a large number of MITs were to be treated as being on revenue account then the policy behind the introduction of the CGT discount is not going to be met. MITs are key intermediaries in a very large proportion of the total equities market and of individuals' interests in the equities market. Repeating the quote from the Review extracted above

> The Review's recommendations for capital gains taxation are designed to enliven and invigorate the Australian equities market, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources.[13]

7.21. If asset profits of MITs do not qualify for the benefit of the CGT discount then the intended stimulus to the equities markets will be severely undermined and the participation by individuals will be severely reduced. The optimum allocation of capital resources is driven by sophisticated investors. If MIT's role in the equities markets is adversely impacted then a significant part of the sophisticated investment in these markets is being excluded.

7.22. Excluding asset profits of MITs from the CGT discount would also offend the Review's principles cited above about taxing similar economic transactions in a similar way. The sophisticated high turnover portfolios held by MITs do not have a different economic substance to any less sophisticated investments. This is discussed further in section 7.6 below.

7.23. We propose a statutory CGT rule modelled on the current section 295-85[14] that applies to superannuation entities. The only difference to section 295-85 would be to allow for the fact that rules for the taxation of financial arrangements will shortly be introduced. This is discussed in section 7.4.1 below. The statutory rule would be as follows:

CGT to be primary code for calculating gains or losses

(1) The modifications in subsection (2) apply if a CGT event happens involving a CGT asset that was owned by a MIT just before the time of the event;

(2) These provisions do not apply to the CGT event:

(a) sections 6-5 (about ordinary income), 8-1 (about amounts you can deduct) and 15-15 and 25-40 (about profit-making undertakings or plans);

(b) sections 25A and 52 of the *Income Tax Assessment Act 1936* (about profit-making undertakings or schemes).

(3) The provisions in subsection (2) can apply to a CGT event if a capital gain or loss from the event is disregarded because of one of the provisions in this table:

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[13] See footnote 10.

[14] *Income Tax Assessment Act 1997*

Where gain or loss disregarded because of CGT provision		
Item	Provision	Brief description
1	Paragraph 104-15(4)(a)	Title in a CGT asset does not pass when a hire purchase or similar agreement ends
2	Section 118-5	Cars, motor cycles and valour decorations
3	Section 118-10	Collectables and personal use assets
4	Section 118-13	Shares in a PDF
5	Section 118-25	Trading stock
6	Section 118-30	Film copyright
7	Section 118-35	Research and development
8	Section 118-55	Foreign currency hedging gains and losses
9	Section 118-60	Certain gifts
10	Section 118-300	Insurance policies
11	Section 118-305	Superannuation
12	Section 118-310	CGT event happens to right to, or part of, RSA

7.24. Keeping the rule as similar as possible to section 295-85 avoids unnecessary complexity. Neither the industry nor the ATO has found section 295-85 difficult to apply in practice.

7.25. The table in the proposed subsection (3) above is the same as that used in the current section 295-85 even though a number of the entries in this table are not relevant to MITs. For example, item 3 'collectables and personal use assets' cannot apply because a MIT cannot have any 'personal use' of an asset. Nevertheless, our proposal is to keep the rule consistent with section 295-85 and with any similar rule that the Government may introduce to apply to investors other than MITs. Keeping a statutory rule for MITs in this standard form would make it easier to introduce a broader rule in the future.

7.4. How the Statutory Rule Would Work

7.26. It is easiest to understand this proposal by running through the different types of assets that a MIT could own.

7.4.1. Financial arrangements other than equities

7.27. We are assuming that the proposed Division 230 to be introduced by the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 ('ToFA') will be introduced substantially in the form currently set out in the Exposure Draft Legislation.

7.28. Our proposed rule will not displace the ToFA rules. Effectively the income recognition ordering provisions in the legislation are as follows:[15]

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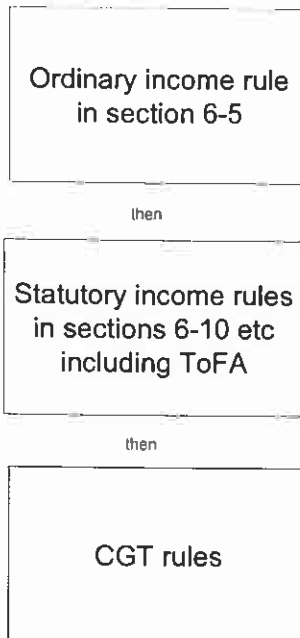
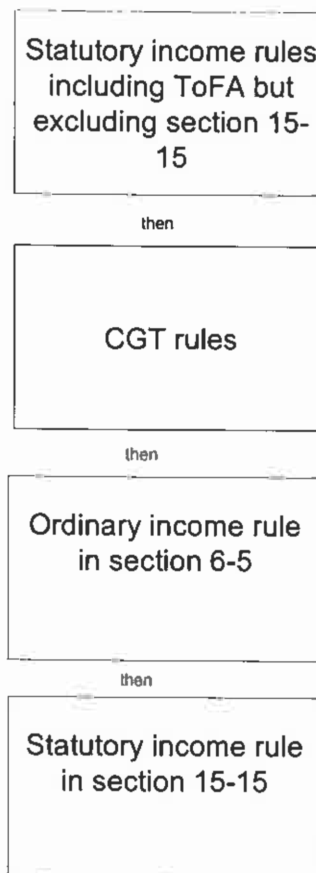
[15] See sections 6-10(2) of the *Income Tax Assessment Act 1936* and section 118-20.



7.29. The consequence of section 295-85 is, and the consequence of our proposed statutory rule would be, to reorder this as follows:[16]



[16] See the proposed 118-27 of the *Income Tax Assessment Act 1997*.

7.30. ToFA will put the taxation of financial arrangements as defined in that Division, other than equity interests, on revenue account. This is being done in part specifically to remove the what the Draft Explanatory Memorandum calls "the complex capital/revenue distinction".[17] Our proposed rule therefore would have no effect on financial arrangements other than equity interests.

7.31. ToFA makes subsections (3) of the current section 295-85 redundant. It has therefore not been replicated in our proposal above.

7.4.2. Equity interests

7.32. Our proposed statutory rule will have its biggest impact on the taxation of gains and losses from the disposal of equity interests. For MITs, this is the asset type where the greatest uncertainty exists. Our proposed statutory rule would make all equity interests held by MITs subject to the CGT rules except when those interests are subject to the ToFA rules.

7.33. ToFA includes equity interests in the definition of 'financial arrangement' but excludes them from the accruals and realisation methods, therefore excluding them from compulsory revenue account treatment.[18]

7.34. The reason for this approach is to allow taxpayers to choose to use one of the elective methods for their equity interests. One consequence of choosing either the fair value method or the financial reports method for equity interests would be to effectively put them on revenue account.

7.35. Therefore the effect of our proposed statutory rule would be to have equity interests held by MITs taxed under the CGT rules subject to the trust's right to treat them on revenue account using one of the elective ToFA methods.

7.36. Note that if the MIT does not use a ToFA election and does not hold assets for more than 12 months, our proposed statutory rule is detrimental rather than a benefit. It prevents the MIT offsetting their losses against other income without the compensation of a discount for their gains. The statutory rule would therefore not be providing any benefits to those who hold assets for only short periods of time. This is discussed further in section 7.4.9

7.4.3. Real estate

7.37. Our statutory rule would make real estate assets held by MITs subject to the CGT rules in all cases. Given the pattern of buying and selling properties by MITs and the fact that Division 6C[19] prevents MITs engaging in property development, there is general agreement that this is the outcome under the current law.

7.38. Our proposed rule therefore provides a little extra certainty without significantly changing the tax outcomes.

7.4.4. Commodities

7.39. MITs do not hold commodities directly. It would be impractical to do so. Given the size of the investments that a MIT needs to hold to be economical to manage, the storage costs for holding actual commodities would be prohibitive.

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[17] paragraph 1.38

[18] section 230-45(2)(e)

[19] *Income Tax Assessment Act 1936*

7.40. Funds with a commodity theme use derivatives. Even if they use derivatives under which commodities are deliverable, they would have a practice of settling these derivatives in cash before maturity. These commodity derivatives are therefore within the definition of 'financial arrangement' for the purposes of ToFA.[20] They would therefore be on revenue account as described above even if our proposed statutory rule was introduced.

7.4.5. Depreciating assets

7.41. There would be no change to the tax treatment of depreciating and amortising assets under our proposed statutory rule. Division 40 would continue to apply to these assets and in the unusual circumstance of the asset being sold at a profit the profit would continue to be taxed as statutory income under section 40-285.[21]

7.4.6. Trading stock

7.42. The effect of subsection (3) of the proposed provision would be to maintain the current treatment of assets that are trading stock. It is not common for MITs to treat their assets as trading stock.

7.4.7. Foreign currency

7.43. Foreign currency is a 'financial arrangement for ToFA purposes[22] so will be on revenue account as described above.

7.4.8. Other assets that are not financial arrangements

7.44. ToFA excludes a list of things from the definition of 'financial arrangement'.[23] The only items on that list not dealt with above that a MIT could reasonably be expected to hold are infrastructure borrowings and forestry interests in forestry managed investment schemes.

7.45. These assets have their own schemes for taxing profits on disposal and so would be unaffected by our proposed rule.

7.46. Profits on the infrastructure borrowings excluded from the definition of 'financial arrangement' are exempt from tax.[24] Our proposed statutory rule would not change this.

7.47. Forestry interests have their own statutory income rule and our proposed statutory rule would not change its application.[25]

7.4.9. Electing in to the statutory CGT rule

7.48. There are two approaches that can be taken to applying the proposed statutory rule. The first is that it be a choice available to the MIT. Under this approach, if the MIT would prefer to hold their assets on revenue account they can do this through an irrevocable election they make.

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[20] section 230-50(2)(d)

[21] *Income Tax Assessment Act 1997*

[22] section 230-445(1)

[23] See sections 230-400, 230-410 and 230-425.

[24] Section 159GZZZZE *Income Tax Assessment Act 1936*

[25] sections 394-25 and 394-30

7.49. The second approach that can be taken is to rely on the elections that will already exist in the ToFA rules.

7.50. IFSA recommends the second approach on the basis that it creates a simpler overall regime.

7.5. The Cost of Our Proposal

7.51. The Board is required to provide the Government advice on "revenue neutral or near revenue neutral options".[26]

7.52. There is no significant cost to revenue of our proposal. The vast majority of MITs already treat equities and real estate on capital account. We do not accept that the costing of our proposal should be done as though the current law was that MITs treat equities on revenue account. We do not accept that this is the correct interpretation of the current law. This is discussed in the section 7.6.3.

7.6. Should The Statutory CGT Rule Apply To All MITs Or Just Some?

7.53. It is our proposal that the statutory rule described in section 7.3 above apply to all MITs.

7.54. We have demonstrated above the purpose behind the introduction of the CGT discount. There is nothing in that purpose that would justify excluding some MITs from the rule. Nor is there anything in that purpose that could be used as a logical basis for such a distinction.

7.55. The most commonly heard view is that MITs with high turnover are the ones more likely to hold equities on revenue account for tax purposes. Such an outcome would be most counterproductive. In recommending the introduction of the CGT discount the Review of Business Taxation was explicitly seeking to encourage sophisticated investment. The link between high turnover and sophisticated investment is discussed in section 7.6.1 below.

7.56. Division 6C[27] or a variation thereof will exclude any fund that carries on a business from the MIT regime so all the funds in the regime will be investors of a type that were targeted by the Review of Business Taxation to benefit from the CGT discount.

7.57. One source of confusion in this debate is that many people do not understand what investment is and how it differs to the carrying on of a business. To assist the Board of Taxation in understanding the issue before them we explain what investment is in section 7.6.1. In section 7.6.2 we then compare this understanding of the term investment to the activities of MITs to show that what MITs do is investment. In section 7.6.3 we look at the current tax law to see that the confusion does not stem from the case law precedents but with how people have misunderstood the principles to be discerned from the precedents.

7.6.1. What investment is

7.58. Investment stands in contradiction to business. This is explicit in the tax law as demonstrated in 7.6.3 below but it is also a feature of ordinary language.

7.59. A simple exercise of taking finance books randomly off a library shelf leads the reader to the following meaning of 'investment':

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[26] paragraph 1.2 of the Discussion Paper

[27] *Income Tax Assessment Act 1936*

> Investing is simply the means of converting present sums into future values.[28]

and the following meaning of 'business':

> Businesses come in all shapes and sizes, but, despite the variations in size and activity, each is what we call a business because each is an organization engaged in producing and selling, at a profit, goods and services that consumers want.[29]

7.60. From further reading on these two topics the difference that emerges is a subtle one. The books on investment are about how to generate a return on capital. The books on business are about how to execute a profit-making idea. The discussion of capital in the business books is about sensibly minimising the amount of capital employed so as to maximise the profit.

7.61. Investment is what you do when you have capital and you want to grow it. The capital is the raison d'être for the investment activity. Business is what you do when you have an idea for making a profit. The need for capital reduces the profitability of the idea.

7.62. For business, capital is no more than a costly input.

7.63. With an investment, assets are acquired because that is the only way to generate a return. With a business, assets are only acquired where they increase the profitability of the business. Investing is seeking returns on capital as the sole factor of production. Business applies various factors of production, including capital, in the optimal quantities to generate a profit.

7.64. The acquisition of assets by a business can be referred to as 'investing'. For example, the Australia's Future Tax System review does this in Architecture of Australia's Tax and Transfer System ('the Architecture Paper').[30] For clarity we refer to 'capital investing' to mean pure investment and 'business investing' to mean the acquisition of assets by a business.

7.65. Business investing is dependent on capital investing as set out in Figure 7.1.

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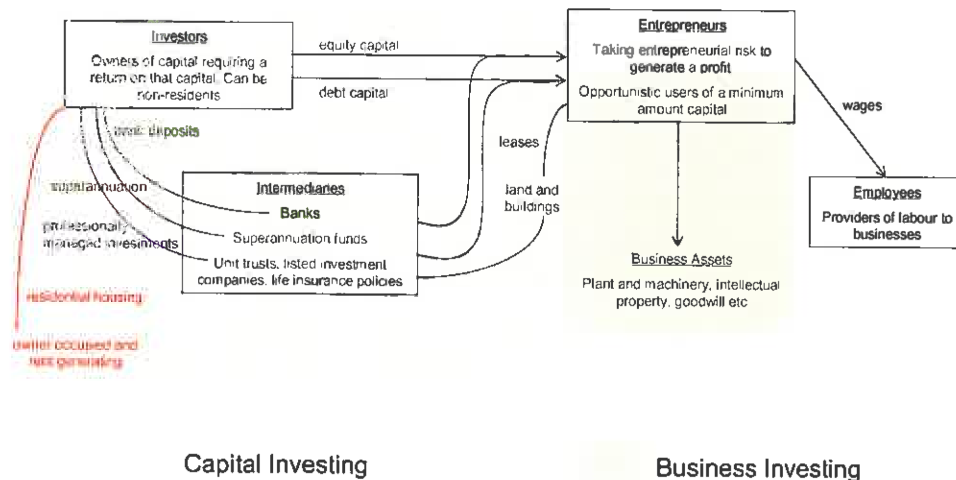
[28] *Investments: Theory and Application*, Mark Hirschey, Thomson Learning, 2001, page 3

[29] *Introduction to Business*, 5th edition, Joseph Straub and Raymond Attner, Wadsworth Publishing Company, 1994, page 8

[30] Australian Treasury, August 2008. See Chapter 8.

Figure 7.1: Flow of Capital in the Economy



Capital Investing

Business Investing

This diagram is necessarily simplified. In reality, there is much more interconnection. For example, banks are both intermediaries and entrepreneurs. Employees can be investors and entrepreneurs at the same time. The diagram also leaves out various financial markets like the futures market that to some extent functions as capital investment and to some extent as business assets

7.66. One source of confusion in the tax system is the role of intermediaries. A great deal of capital investing is done via the common intermediaries shown in Figure 7.1. Economically this does not change the nature of the activity. It is still capital investing. Yet our tax system so often changes the tax treatment when an intermediary is used.

7.67. The Architecture Paper notes that ultimately individuals (rather than business) own factors of production, including capital, and therefore when you remove the veil of these intermediaries it is ultimately individuals who bear the burden of taxation.

7.68. The entrepreneurs carrying on businesses represented on the right hand side of Figure 7.1 can be individuals or groups of individuals operating in partnership. Often they will operate the activity through a company. When the entrepreneur has their own capital they can take on the role of equity investor in the company while the company takes on the role of entrepreneur. Many of these companies grow large taking on diversified equity investors. These diversified equity investments are then often listed on a stock exchange to allow the investors to transfer them easily.

7.69. Entrepreneurial activities take many different forms. They are a combination of know-how, risk-taking, labour, reputation, assets and many other factors with these factors existing in very many different combinations. It is the combination of these factors that generates the profit.

7.70. In contrast, capital investing is no more than the selection of assets. When done properly it is a complicated and sophisticated process requiring expertise, but it is still no more than asset selection.

7.71. Investment is the use of existing capital to produce a return over a sustained period of time. The hallmarks of investment are:

- the existence of capital being the raison d'être for the activity
- a long term objective of sustained returns

- the key operational transactions are buying and selling assets, often through an organised market with anonymous counterparties
- returns are generated merely by owning the assets, not by applying any work to the assets[31]
- diversification of assets
- the key risk is failing to produce appropriate returns through not selecting the right portfolio of assets
- the value of the investment portfolio is only ever the net value of the assets
- the application of expertise, systemisation and intense activity.

7.72. The hallmarks of business are:

- a profit-making idea being the raison d'être for the activity
- minimising the amount of capital used
- an ability to cease activities that are not profitable and return capital
- the key operational transactions are selling goods and services to customers
- asset returns are generated by applying work to assets such as manufacture or distribution[32]
- the key risk is insufficient customer demand for the goods and services being offered
- successful businesses have goodwill meaning that the value of the business is greater than the net value of the assets
- the application of expertise, systemisation and intense activity.

7.73. There is a popular misconception that one difference between investment and business is that business is a sophisticated and intense activity whereas investment is not. Returning to our investment text books shows this to be untrue. Investment is an extensive academic discipline replete with theories, theses and empirical studies. The detail is unrestrained and the mathematics is perplexing.

7.74. Even individuals with relatively small portfolios have access to popular books, magazines and 24 hour television channels dedicated to providing the information necessary for successful investment. It is an activity that is anything but simple.

7.75. While there is a continuing academic debate over the relative merits of 'active asset management' versus 'passive asset management' there are many who believe that the high turnover that results from reacting to new information produces the best trade off between risk and reward. That is, there are many proponents of the idea that high turnover is the best way to meet the investment objective.

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[31] We will be expanding on this notion in our next submission in the context of Division 6C *Income Tax Assessment Act 1936*.

[32] See the previous footnote.

7.76. It is relevant to look at what the opponents of this position believe. Proponents of passive asset management argue that it is too difficult to beat the average performance so it is better to target an average return because it is cheaper to do so. Beating the average performance is usually referred to as 'beating the index' because the average is measured by an index. Targeting an index return is a very complex problem which requires a very sophisticated solution. Complicated software is used to cause the portfolio to always match the stocks that make up the index in the ever-changing proportions that they contribute to the index. Passive asset management is a very intense and sophisticated activity.

7.6.2. What MITs do

7.77. Managed investment trusts are commercial products created by parties who are able to offer professional investment management services. That is, the offerors have the professional expertise to design, maintain and operate a portfolio of assets to generate a return within pre-agreed parameters. The products are marketed to and acquired by people who have capital that needs to be invested.

7.78. The offerors use staff with academic and professional qualifications in investment management, as well as elaborate technology, to research and collate relevant information that is applied in making optimal investment decisions in respect of the capital that the clients have entrusted to them.

7.79. We are not denying that this is an intense and sophisticated activity but that does not stop the MITs' activity being an investment activity.

7.80. The amount of capital invested is the amount that the clients require to be invested. There is no notion of minimising the capital as a business would do. The capital is the raison d'être. It is not a cost.

7.81. The returns are generated merely by owning the assets. There is no work applied to the assets as there would be in a business. There is no manufacture. There is no distribution to customers. There are in fact no customers. The assets are sold in a market where the buyers are generally not known to the seller.

7.82. The portfolios are no more than the sum of the assets. There is no goodwill. There is no brand that attracts the buyers of the assets.

7.83. The activity of the MITs has all the hallmarks of investment and none of the hallmarks of a business.

7.84. Division 6C prevents a MIT from carrying on or controlling a business.

7.6.3. This is consistent with the current law

7.85. This section demonstrates that the explanation above of the difference between investment and business is consistent with the tax law cases. We reject the Tax Office's technical analysis as to the circumstances in which a Listed Investment Company will hold its assets on revenue account (and therefore an MIT if it assumed that the same principles apply).

7.86. The first point made is that a profit can still be a capital gain even if there was an intention to resell the asset at a profit. We then analyse the relevant cases and show that they are consistent with the explanation above.

7.6.3.1. Intention to resell at a profit can still result in a capital gain

7.87. It is often believed that there is a tax law principle that if a taxpayer acquires an asset with an intention to resell it at a profit, then the resulting gain is ordinary income rather than a capital gain. This is incorrect.

7.88. An intention to make a profit does not in itself make the profit ordinary income. The High Court said in *Federal Commissioner of Taxation v Whitfords Beach Pty Ltd*

> It has been a long-settled principle of revenue law that, unless a sale of property is made in an operation of business, the resulting profit will not be income according to the ordinary concepts and usages of mankind.[33]

7.89. There is nothing in any other High Court case that questions or contradicts this. London Australia does not contradict this because it took as an undisputed fact that a business was being carried on.

7.90. The principle that an intention to make a profit does not create ordinary income has been acknowledged by the Parliament. Before there was capital gains tax legislation, section 26(a)[34] had to be introduced to make these profits statutory income. The High Court in Whitfords Beach confirmed that this section was an extension of the scope of the legislation

> The profit on the sale of an asset may be assessable income within this provision, even though it would not ordinarily be regarded as income and would not fall within section 25(1) of the Act.[35]

7.91. Section 26(a) became section 25A[36] then section 25-15[37]. When the capital gains tax legislation was introduced, section 25A was amended so that it would not apply profits arising from a sale of property acquired on or after 20 September 1985. This was an explicit decision evidencing that in 1986 the Parliament still held the view it held when section 26(a) was introduced, that it was possible to acquire an asset with an intention of resale at a profit without that profit being ordinary income. This was a decision that the capital gains tax rules were to apply to assets acquired with the intention of resale at a profit, unless the profit arose in the course of a business.

7.92. *Californian Copper Syndicate (Limited and Reduced) v Harris*[38] tells us that an investment activity is not a business. In that case the words:

- ordinary investment;
- merely a realisation in or change of investment; and
- a mere enhancement of value

were contrasted with:

- the carrying on, or carrying out, of a business; and
- an operation of business in carrying out a scheme of profit-making.[39]

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[33] 82 ATC 4031 @ 4040

[34] *Income Tax Assessment Act 1936*

[35] @ 4034

[36] ibid

[37] *Income Tax Assessment Act 1997*

[38] (1904) 5 TC 159

[39] @165-166

7.93. The analysis that follows shows what the Courts have meant by 'investment' in this context and shows that managed investment funds are generally carrying on an investment activity and not a business.

7.94. The exercise is to determine the difference between an investment activity and a business. This difference is widely misunderstood because people do not understand how investment works.

7.95. For example, having an intention to sell an asset at a profit can be a characteristic of carrying on a business but on its own it is not enough for a conclusion that a business is being carried on. Managed investment funds generally intend to sell their investments at a profit. All investors do, even 'mum and dad' investors. It is as much a characteristic of an investment activity as it is of a business.

7.96. A lot of commentary and precedent exists on how to distinguish a business from a hobby and that the proprietor's intention can be one of the differentiating factors. None of that commentary is relevant to the question of whether or not a gain generated from the acquiring an asset with an intention to resell it at a profit is ordinary income. Answering this question requires that a business be distinguished from an investment activity, not that a business be distinguished from a hobby.

7.6.3.2. *Radnor*

7.97. In *Federal Commissioner of Taxation v Radnor Pty Ltd*[40] there was an amount of capital employed to provide for a disabled person over the whole of that person's life. The activity of the company was to produce an appropriate return on the capital. The court held that the profits on sale of assets were not ordinary income.

7.98. This was an employment of existing capital to produce returns over a sustained period of time. That is what made it investment rather than a business. The following extracts from the case show this distinction in action

> ... it would be wrong to characterise Radnor's activities as a business of dealing or trading in shares. Radnor's function was not to trade but to invest. Radnor had the ongoing duty to see to both the derivation of income and the protection of the capital.[41]
>
> ...
>
> ... Radnor was not an investment company carrying on a business for the profit of shareholders. Radnor was the investment arm of a trustee and was under a duty to invest funds to the benefit of beneficiaries.[42]
>
> ... Radnor had a duty to ... maintain the value of the fund.[43]

7.99. This concept of protecting or maintaining the value of the fund is analysed in more detail in a separate section below.

7.100. What made the activity in *Radnor* investment rather than a business was the role that capital played. The activity was to employ the given capital. There was no profit-making idea that existed separately to the capital. Rather than there being a profit opportunity for

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[40] 91 ATC 4689

[41] @ 4650

[42] @ 4651

[43] ibid

which capital was raised, there was an amount of capital that had to be employed profitably. The capital was the raison d'être for the taxpayer's activity.

7.101. It is important to acknowledge that in *Radnor* the company's activities had many hallmarks that are normally associated with a business. This shows that factors such as the frequency of the activity, the sophistication, the systemisation, the significant profits and the employment of experts are not determinative of the distinction between investment and business. The books on investment show that the ordinary meaning of this concept involves a very sophisticated and intensive approach to producing an appropriate return on the capital. These hallmarks associated with business are equally associated with proper investment.

7.6.3.3. *Californian Copper*

7.102. *Californian Copper* itself is the counterexample to *Radnor*. In that case the profit had come from selling copper-bearing land. The company had raised capital which it had expended in acquiring the land, in developing the land, in head office expenses and in the expenses of getting started. It had then sold the land at a profit.

7.103. The Court of Exchequer in Scotland looked at the purposes listed in the company's constituent documents. These purposes identified an idea of making money from some particular copper mines and from copper mines more generally. They added the carrying on of "mercantile, commercial, financing and trading businesses" and more generally "carrying on business deemed conducive to the prosperity of the Company".[44]

7.104. Lord Justice Clerk determined that these purposes pointed to this being a business and that the mode of the company's actual procedure did as well. The words used were

> ... this Company was in its inception a Company endeavouring to make profit by a trade or business, and that the profitable sale of its property was **not truly a substitution of one form of investment for another.**[45] (our emphasis)

7.105. It was noted that the company did not have sufficient capital to work the mineral field.

7.106. Lord Trayner agreed with this conclusion using the following words

> This is not, in my opinion, the case of a company selling part of its property for a higher price than it had paid for it, and keeping that price as part of its capital, nor a case of a company merely **changing the investment** of its capital to pecuniary advantage.[46] (our emphasis)

7.107. The bolded phrases above identify one of the factors that can be observed that truly distinguishes between investment and business. If this had been investment there would have been a need to invest the proceeds of sale into another asset. The capital would still be there and would still need to be invested. Businesses return capital when it is no longer needed. Investment involves an obligation to continue to produce a return on the capital. The company in Californian Copper had an idea that was successfully executed over a short period of time without there being any ongoing activity. The capital was not the raison d'être for the taxpayer's activity. It was an input that was minimised.[47]

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[44] @ 166

[45] @ 166-167

[46] @ 167

[47] There is a historical context that makes it easier to understand this case. Copper was experiencing a boom at the beginning of the twentieth century. It was at the time held out to be the source of

7.108. This is the same distinction between investment and business that we saw above in the text books and in *Radnor*.

7.6.3.4. Charles

7.109. The next relevant case is Charles v Federal Commissioner of Taxation[48]. The trust in Charles is what we would today call a managed investment fund. The High Court, in analysing the distributions from the trust, started with the general nature of trusts

> The question presents itself at once whether the case is distinguishable in any material respect from a case in which moneys … are distributed amongst beneficiaries by the trustees of a will or settlement, to whose hands the moneys have come in consequence of the exercise of usual powers to invest and to vary investments and to whom the trust instrument gives a discretionary power to make such distributions. The assumption is that in the handling of the investments the trustees of the will or settlement are not carrying on a business. In such a case the character of the moneys in the hands of the trustees is clear: dividends are income, whether the companies concerned have paid them out of income profits or capital profits … and profits realized on sales of securities are necessarily capital.[49]

7.110. The evidence before the Court was that the general policy of the managers of the assets, on behalf of the trustee, was

> to hold the securities as investments, and that their "standard idea" in buying was to buy the best available securities and to hold them unless there appeared to be some very good reason for selling. The factors they had before them in buying … were security, realizability, yield and possibility of capital appreciation, in that order. … it is not the policy of the managers to buy securities with a view to their resale at a profit. … the managers kept themselves closely informed of market trends and wherever they were of the opinion that securities were likely to fall in market value, parcels of shares were sold to avoid a reduction in value of each unit in the trust …[50]

7.111. The Court continued that to treat the profits as ordinary income

> … would be to ignore the evidence already mentioned, which is inconsistent with the notion that the activities of the managers, or of the managers and the trustees together, were different in kind from those in which trustees normally engage who hold a portfolio of shares with power to vary investments from time to time as they consider the interests of beneficiaries require. According to that evidence, the moneys in question arose, not … from transactions forming incidents in the conduct of a business or a profit-making scheme, but from transactions effected in the course of performing a fiduciary duty to preserve for beneficiaries as far as practicable the assets which might appear from time to time to be in jeopardy.[51]

7.112. The difference the Court identified was between the traditional function of a trust, which is to invest the capital that is held on behalf of the beneficiaries, and the possibility that this trust could be carrying on a business.

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potentially extraordinary profits. Speculation in shares in a copper company played a major role in the banking panic of 1907 when the boom ended.

[48] (1954) 90 CLR 598

[49] @ 607-608

[50] @ 610

[51] @ 612

7.113. Having matched the evidence to the traditional function of a trust, the Court concluded that the trustee was not carrying on a business. As with *Radnor* above, and in contrast to *Californian Copper*, the fundamental character of the activity carried on by the trustee in Charles was to produce a return on the capital that had been entrusted to it, within a constraint of preserving the value of that capital. The capital was the raison d'être for the taxpayer's activity. Having capital appreciation, otherwise known as increases in the prices of assets, as a factor in selecting assets did not contradict this conclusion.

7.114. The Court said in the second quote above that the trustee bought securities for capital appreciation but not for resale at a profit. They selected securities because those securities were going to go up in price but this was not the same as buying for resale at a profit. The phrase 'for resale at a profit' has to be dealt with cautiously and not given a meaning that the High Court did not intend. The Court was using it as a metaphor for carrying on a business. It was not using it to identify a characteristic that did not exist in an investment activity. The Court specifically acknowledged that buying for price increases was a characteristic of investment but concluded that there were other characteristics that also needed to be present for the activity to be an investment activity.

7.115. The Court's concept of preserving the value of the capital also appeared in *Radnor* where the phrases used were to 'protect' and 'maintain the value of the fund'. This concept is analysed in more detail in a separate section below.

7.116. The limited circumstances in which the trustees in *Charles* sold shares is dealt with below in a section titled 'The turnover myth'.

7.6.3.5. Trent Investments

7.117. *Trent Investments Pty Ltd v FCT*[52] is often overlooked because it is a Supreme Court case that preceded the High Court decision in *London Australia*. It is actually a very instructive case on a different point to that decided in *London Australia*. *Trent Investments* is a case that distinguishes between investment and business whereas *London Australia* looked at the consequences if a business is being carried on. *Trent Investments* directly addresses the question of whether or not a gain generated from acquiring an asset with an intention to resell it at a profit is ordinary income.

7.118. The Court in *Trent Investments* dealt with an argument by the Commissioner that the taxpayer's profits on disposal of assets were ordinary income because the taxpayer was carrying on a business. The Commissioner said that the taxpayer was not carrying on "the business of share trading"[53] but was carrying on a business nonetheless. The taxpayer owned a portfolio of shares that were managed using "portfolio management principles"[54] and the Commissioner argued that these principles amounted to a business.

7.119. The Court said that the profits would not be ordinary income if

> ... this has been done not by way of trading or in the making of profits by ventures in the nature of trade, but by the purchase of assets to be held ...[55]

7.120. The portfolio management principles used by the taxpayer meant that their activity was "systematic and concerted".[56] Consistent with *Radnor* and *Charles* the taxpayer was "motivated by the purpose of maintaining the capital invested".[57]

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[52] 76 ATC 4105

[53] @ 4107

[54] ibid

[55] @ 4108

7.121. The Court said that investment

> … does not cease to be such merely because it is done systematically and skilfully.[58]

and that

> Persons who "invest" do not, in deciding what to buy and what to sell, confine themselves solely to considerations of income yield; they have regard to the maintenance of their capital. Even in times of a completely static community or stable currency, the acquisition and sale of investments in this sense, may be made by reference to factors other than maintaining or maximising the income yield. … The variation of investments in order to maintain the value of capital is, in my opinion, a normal investment procedure, and this has been recognised by the principles which have been evolved for the taxation of income.
>
> But the principles as to the income tax treatment and the proceeds of investment were not evolved in times of a static community or a stable currency. … It would be, in my opinion, an unreal approach to the principles which have been established governing the taxation of investment income to treat them as assuming that the normal investor, in respect of whose activities the principles have been formulated would not vary the assets held by him by reason of factors such as those to which I have referred. … In a particular case, the facts may warrant a finding that a variation in assets was of a short term nature or otherwise such as to be an adventure in the nature of trade … but this does not mean that, in very case, the variation of assets is to be so categorised.
>
> … It may be accepted that, where share prices are fluctuating …, a systematic investor may see opportunities of employing his skill in buying shares with a view to disposing of them at a profit. But I do not think that this should lead to the conclusion that, in such times, variations to shareholdings, albeit made with an eye to the fluctuations which have occurred or may occur, must cease to be investments in this sense.
>
> It is, in my opinion, consistent with investment principles, e.g., that an asset will be sold and the proceeds invested in another asset because, inter alia, it is seen that the asset purchased is likely to be more valuable than that sold. I do not think that the principles which have been established require that the investor, in considering whether to hold or dispose of an investment, should not have regard to the fact that a prospective investment will become of a greater capital value than the one presently held. The difficulty of drawing the line between a sale and purchase for that purpose and one for the purpose of realisation at a profit does not, in my opinion, mean that the investor must ignore the opportunity to improve as well as maintain the value of his capital.[59]

Further

> It is not, in my opinion, necessary in order to maintain the status of an investor, that each dollar, once invested, should remain invested in the same stock even though an equivalent stock might be seen as more likely to increase in capital value in the future. … the existence of such a principle as one of the guiding principles of the investment programme does not, in my opinion, conclude the matter …[60]

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[56] ibid

[57] @ 4109

[58] @ 4108

[59] @ 4108-4109

[60] @ 4111

and

> To maintain the status of an investor, I do not think that a taxpayer is required to continue to hold a stock which he believes will fall in price vis-à-vis comparable investment stocks.[61]

7.122. Although there was much activity and a high level of switching of assets the Court's conclusion was

> I do not see what in fact the taxpayer did in this case as taking its activities beyond what a prudent investor, in the financial setting in which the taxpayer was, would do for the purpose of properly husbanding its capital.[62]

7.123. The Court held that the profits were not ordinary income.

7.124. The Court specifically distinguished the banking and insurance cases explaining that

> ... they are such exceptions not because of the systematic and business-like manner in which the investments are made and managed, but because of the relationship of the investment activities to the main business of the taxpayer.[63]

7.6.3.6. *London Australia*, the banking and insurance cases

7.125. *London Australia* and the banking and insurance cases are not relevant to this analysis because they start with the proposition that a business is being carried on and deal with the consequences. They do not in any way attempt to distinguish business from investment.

7.6.3.7. Maintaining the value of the capital

7.126. The Courts in *Radnor*, *Charles* and *Trent Investments* talked about a hallmark of investment being a need to 'maintain', 'preserve' or 'protect' the value of the capital. This idea comes from the case law on a trustee's duties and obligations.

7.127. A trustee has a duty to invest the trust funds in order to produce a return for the beneficiaries.[64] A trustee cannot let the capital sit idle.

7.128. Further, the trustee must produce an appropriate return. The appropriateness of the return will be judged in part by the type of assets the trustee is authorised to invest in under the trust instrument or legislation[65]. The appropriateness of the return is also constrained by a principle of prudence. This principle was expressed in *Learoyd v Whiteley* as follows

> Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to

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[61] @ 4113

[62] ibid

[63] @ 4108

[64] *Jacobs' Law of Trusts in Australia*, 6th edition, R.P. Meagher and W.M.C. Gummow, Butterworths, 1997, paragraph [1801]

[65] ibid

confine himself to the class of investments that are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard.[66]

7.129. In *Re Whiteley* the principle of prudence was expressed as follows

> ... care must be taken not to lose sight of the fact that the business of the trustee, and the business which the ordinary prudent man is supposed to be conducting for himself, is the business of investing money **for the benefit of persons who are to enjoy it at some future time**, and not for the sole benefit of the person entitled to the present income. The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide. That is the kind of business the ordinary prudent man is supposed to be engaged in; and unless this is borne in mind the standard of a trustee's duty will be fixed too low;[67] (our emphasis)

7.130. This principle of prudence is an obligation to ensure that the capital continues to exist and continues to produce a return over time. There cannot be a significant risk of losing the bulk of the capital in the short term. It was common as trusts were developing for there to be income beneficiaries and a separate group of capital beneficiaries. The principle of ensuring that the capital continued to exist was in part a principle of not discriminating against the capital beneficiaries to the advantage of the income beneficiaries.

7.131. The concept of maintaining, preserving and protecting the value of the capital is another way of saying that the capital needs to continue to generate a return over the long term. In *Radnor* it had to continue for the term of a specific person's life. In *Charles* the finding of fact from the evidence was that this is what the unitholders required the trustee to do. In *Trent Investments* it was an undisputed fact. In contrast, in *Californian Copper* there was no ongoing activity once the profit-making idea had been successfully executed.

7.132. What these cases are saying is that the key characteristic of investment is the long term sustainability of the approach to asset selection. The economic owners of the capital expect that capital to continue to produce a return over an extended or indefinite period. It can be said that investment is not 'speculative' but only in the sense that the capital would not be gambled in a way that risks a substantial part of it being permanently lost. It does not mean avoiding asset price fluctuations. It means managing these fluctuations.

7.133. Rules of equity like the principle of prudence adapt with the times. There are some old trust cases where courts were very conservative in their approach to appropriate investments. In *Nestle v National Westminster Bank Plc* though more recently the Court said

> This is an extremely flexible standard capable of adaptation to current economic conditions and contemporary understanding of markets and investments. For example, investments which were imprudent in the days of the gold standard may be sound and sensible in times of high inflation. Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.[68]

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[66] (1887) 12 App. Cas. 727 @ 733

[67] (1886) 33 Ch. D. 347 @ 355

[68] This is an unreported case. The quote can be found in *Principles of the Law of Trusts*, 2nd edition, H.A.J Ford and W.A. Lee, The Law Book Company, 1990, page 397.

7.134. Modern approaches to investment acknowledge that the amount of the capital may go down over short periods of time. Right at the moment the world is experiencing sharp short term drops in equity prices but no-one is suggesting that equities are not an appropriate part of an investment portfolio. On the contrary, these current market conditions are reminding people that equities are very poor instruments for short-term speculation and are only appropriate for a strategy that sustains over the long term.

7.135. Another significant aspect of modern investment theory is the power of diversification. This is alluded to in the quote from *Nestle* above. The risk to individual asset prices or groups of asset prices can be dissipated by combining assets into a portfolio. Acquiring shares in a technology company that has little more than a research program has a high risk. An investor therefore includes these shares in a diversified portfolio of other companies that all have different business risks. Some companies will exceed expectations and others will disappoint. The combined return is subject to much less risk than an investment in any individual company would have been. The combined return is higher relative to the amount of risk taken than an investment in a single company. The higher the risk on individual assets, the more value there is in diversifying.[69] This is called 'modern portfolio theory'.[70] Its purpose is to produce better sustained returns over the long term. It is a hallmark of modern investment.

7.136. Investment in volatile assets like equities will typically involve significant diversification. Investment in less volatile assets like commercial real estate will often involve less diversification. When looking at diversification as a hallmark of investment the riskiness of the individual assets has to be taken into account.

7.6.3.8. The turnover myth

7.137. The turnover of a portfolio is a statistic that is frequently mentioned by commentators but nothing in any of the cases makes it relevant.

7.138. While a high level of activity can be a relevant characteristic in distinguishing a business from a hobby, it is not relevant to a distinguishing a business from investment because a high level of activity is also a characteristic of modern investment practice.

7.139. This statistic is sometimes cited as proving that assets were bought with an intention of resale at a profit but it was shown above that this is not relevant to the question of whether an asset profit is ordinary income.

7.140. In *Trent Investments* the Commissioner was effectively arguing that the systematic turning over of the portfolio made the activity a business and the Court rejected the argument. The Court held that systematic turning over of the portfolio was a characteristic of an investment activity.

7.141. In *Radnor and Charles* the taxpayers emphasised that they only sold investments in extraordinary circumstances but in neither case did the Court use this as the reason the activity was an investment activity. In both cases it may have helped the Court to conclude that the trustees were maintaining, protecting and preserving the capital but it was that approach to capital that was the basis of the decisions, not the level of turnover. *Trent Investments* shows that a Court can reach the same conclusion even if there is turnover. A Court instructed in modern portfolio theory and other modern investment practices would find turnover to be totally irrelevant.

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[69] For example, real estate assets are less volatile than equities so there is typically less diversification.

[70] Modern portfolio theory traces its origins to the work of Harry Markowitz. In particular 'Portfolio Theory' (1952), *Journal of Finance*, 7 (1), 77 and *Portfolio Selection : Efficient Diversification of Investments*, John Wiley & Sons, New Jersey, 1959. It is now a basic topic in investment text books.

7.7. Our Proposal Is Consistent With Ostensible Government Policy

7.142. In treating asset profits of MITs as generally being on capital account for tax purposes MITs have acted consistent with Government policy. This section recounts some of our interactions with Government over many years that have lead us to this view.

7.143. With effect from 1 July 2006 trustees of trusts were no longer required to pay tax under section 98(3) or (4)[71] in respect of the capital gains component of distributions attributable to assets that did not have the 'necessary connection with Australia'. The rationale for this change was that there should be equality of tax outcome between non-residents investing directly and those investing via a MIT. Implicit in this rationale is an acknowledgement that trusts could and often did make capital gains, as against revenue gains, on their investments.

7.144. In 2002 the Government introduced demerger roll-over relief for CGT assets[72] but not for revenue account assets. As MITs are one of the dominant holders of equities that this tax relief applies to, it makes no sense for the Government to only introduce it as a CGT rule unless they believed that MITs held equities on capital account.

7.145. In 2001 section 104–71[73] was inserted into the *Income Tax Assessment Act 1997*. Its purpose was to ensure that there was no need for a CGT event E4 cost base adjustment where an investor received a distribution of a non-assessable amount attributable to a capital gain. Implicit in making this amendment is an acknowledgement that unit trusts could make capital gains.

7.146. In 2001 Subdivision 115-D was added to the *Income Tax Assessment Act 1997*. That subdivision enables listed investment companies ('LICs') to identify part of a dividend to be attributable to any realised capital gains. The attributed part of any such dividend attracts a discount equivalent to the CGT discount in the hands of shareholders. The reason this subdivision was inserted is that LICs had made submissions to the then Government to the effect that investors in LICs were disadvantaged compared to investors in MITs because the latter were entitled to a CGT discount but the former were not. In making this amendment the Government implicitly recognised that asset profits made by MITs could be, and normally were, on capital account.

7.147. In 1999 the Government introduced scrip-for-scrip roll-over relief for CGT assets[74] but not for revenue account assets. As MITs are one of the dominant owners of equities that require this relief, as was the case for the demerger relief, it makes no sense for the Government to only introduce it as a CGT rule unless they believed that MITs held equities on capital account.

7.8. Conclusion

7.148. Without a statutory rule, investors will shun MITs with equity investments in favour of direct equity investments. Investors can react to uncertainty and the risk of uncertain outcomes impetuously. Perception is often more important than substance.

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[71] *Income Tax Assessment Act 1936*

[72] Division 125 *Income Tax Assessment Act 1997*

[73] *Income Tax Assessment Act 1997*

[74] Subdivision 124-M *Income Tax Assessment Act 1997*

7.149. Treasury's Architecture of Australia's Tax and Transfer System[75] says

> All taxes and all transfers affect behaviour in some way. They change how much money people have and the incentives they face.[76]
>
> ...
>
> The level and form of tax affects incentives to save and the level of savings, decisions on the types of investments and how they are financed, and whether investments are made in Australia or overseas.
>
> In Australia the tax system interacts differently across different assets, forms of financing, types of entities and international flows. These different tax treatments can affect savings and investment decisions across the economy, including for housing.[77]

7.150. One of the Review of Business Taxation's principles cited in section 7.2 above was to design taxation measures on the basis of behavioural impacts rather than formal or legal impacts.

7.151. In section 7.1 we briefly listed some of the behavioural impacts of denying the CGT discount to MITs.

7.152. A common reaction from investors who are no longer attracted to MITs with equity investments could be to spend rather than save. It is rational that the higher the effective tax rate on a future increase in wealth, the less attractive that gain is relative to immediate consumption, but the effect is bigger than that. The CGT discount works like a 'sale' sign in a department store. The allure of a bargain gets people to think seriously about investing rather than spending. The CGT discount is a marketing tool for savings.

7.153. Another reaction will be for the investors to acquire equities directly rather than through a MIT. They will do this in a very conservative way. This will create a very big bias towards the larger better-known companies and will mean that smaller companies will have enormous difficulty raising capital. Innovative companies and entrepreneurial start-ups will have no chance. A healthy economy needs a sophisticated and deep market for equity capital so that it gets correctly priced. MITs are the only way to get the bulk of the invested capital into the market in a sophisticated way. Treating MITs consistently with other investment structures is the only way to get this to happen.

7.154. A second poor consequence of people investing directly is increased compliance failure. For a start individuals are far less capable of understanding and dealing with complex corporate actions. They will make a lot more mistakes than MITs would. Further, investment through MITs means that the gains on disposal are reported to the Tax Office through the Annual Investment Income Report.[78] This allows the Tax Office to match the data to individual tax returns. With direct investment there is no reporting of gains to the Tax Office.

7.155. A third poor consequence of people investing directly is that they will generally produce lower returns than they would get through a MIT. A nation of direct investors will have a lower standard of living than a nation of investors using MITs.

7.156. Many superannuation funds, which already have a statutory CGT rule, invest through wholesale MITs. Denying MITs the CGT discount would result in such superannuation

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[75] Commonwealth of Australia, August 2008

[76] page xi

[77] page xviii

[78] See Regulation 56, *Income Tax Regulations 1936*

funds being forced to redeem their MIT investments and invest directly. This transition would be costly and the new arrangements would be less efficient than that currently used which is based on MITs as a hub for collecting investment monies.

7.157. The extra cost would arise because in place of using a MIT superannuation funds would pool through a pooled superannuation trust ('PST'). Investors who are not superannuation entities are not allowed to invest in PSTs so the MITs need to continue to operate for those investors. For every portfolio there would now be both a MIT and a PST, doubling the number of pools in existence. There are fixed costs to running any pool so these costs will have been doubled.

7.158. The Government has designed the CGT rules that apply to non-residents so that investment into Australia is competitive with other markets. They have taken specific steps to make sure that these rules work when the assets are held in a MIT so that Australia can build towards being a regional financial centre for funds management. If the asset profits of MITs are ordinary income rather than capital gains then the tax base for non-residents is much broader and is completely out of step with the rest of the world. Australia will be lose inbound investment and will be a regional outcast rather than a regional centre.

7.159. Giving MITs access to the CGT rules is a crucial issue to the health of the Australian economy. The Government cannot afford to have an investment sector that is shrinking and unsophisticated.