Investment & Financial Services Association Ltd

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19 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

Re: Review of the Tax Arrangements Applying to Managed Investment Trusts

The Investment and Financial Services Association Limited (IFSA) welcomes the opportunity to comment on your Discussion Paper *Review of the Tax Arrangements Applying to Managed Investment Trusts.*

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

IFSA has provided, in the following pages, detailed reasons to issues raised in the Discussion Paper. IFSA's response is structured in chapters which correspond to the chapters in the Discussion Paper. IFSA has previously provided a response to Chapter 7 - Capital versus Revenue Treatment of Gains and Losses Made On Disposal of Investment Assets by Managed Investment Trusts.

The sheer scope of the issues canvassed in the Discussion Paper emphasises the need for reform to this area of taxation law, and in particular the introduction of a separate taxation regime for Managed Investment Trusts.

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IFSA looks forward to continuing to work with the Board of Tax on this important review. 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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CHAPTER 4

Introduction

4.1 In Chapter 4 the Board of Tax sets out various options for determining tax liabilities for an MIT.

4.2 As has been mentioned in the Consultation Paper and at consultation meetings between industry participants and the Board, this issue is particularly important to MITs due to the uncertainty associated with the concept of present entitlement. It is difficult to promote MITs as globally competitive products when uncertainties exist in relation to such fundamental aspects of MITs. We believe that removing these uncertainties will translate directly into an improved understanding of and confidence in MITs in the domestic and international markets. In order to be seen as a hub for financial services, it is imperative that uncertainties such as those around present entitlement be dealt with clearly and concisely.

4.3 Further, the overarching policy principles in the Board's Terms of Reference should always be kept in mind when attempting to frame a solution to this uncertainty.

IFSA recommendations

Option 2 in the Discussion Paper is a good foundation for a statutory rule for determining tax liabilities of an MIT.

The MIT would be legally bound to 'distribute' at least the Virtual Taxable Income each year. To ensure integrity, there would be a statutory condition requiring the trust to show such an intention to do this.

The concept of distribution should be defined as widely as possible.

The simple carry forward approach as currently applied by MITs is the most appropriate mechanism for dealing with under- and over-distributions.

Detailed responses to specific 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 current issues and in that case, what modifications would be desirable; and

(c) any other options for change. (Question 4.1)

IFSA's Proposal

4.4 IFSA's proposal is based on the following premises:

a) The uncertainty of present entitlement needs to be resolved;

b) Should the MIT intend to distribute its 'taxable' income then the beneficiary should bear the tax liability;

c) The uncertainty as to how to determine the share of income (however defined) needs to be addressed;

d) A simple solution to the uncertainty can be reached by adopting a statutory model (however formulated);

e) Australia seeks to be a financial services hub that attracts overseas investment.

4.5 IFSA propose that Option 2 in the Discussion Paper is a good foundation for a statutory rule for determining tax liabilities of a MIT. Broadly, the Option is in line with the philosophy that the MIT is a conduit investment vehicle for the investor and that investor should bear the tax on the income derived by the trust.

4.6 The strength of IFSA's proposal is that it institutes in the legislation the efficient methodology that MITs have developed over the years. MITs have a tried and true way of doing things that has only one problem which is that the legislation does not clearly support it. IFSA's proposal would require very little implementation because we would be continuing our current practices. MITs would just be able to do them without the threat of the legislation being interpreted in a different way.

4.7 This methodology has evolved over the years because it is the best balance between simplicity and equity. In the process of writing this submission IFSA have considered all the alternative methods in detail and have concluded that none of them work better than what MITs do now.

4.8 Under this Option, the concept of 'taxable income' of a trust is a hypothetical concept. That is, theoretically, if the trust is exempt from tax there is no taxable income. IFSA submit, therefore, that the trust will be required to calculate the virtual taxable income (VTI) which will form the basis of the tax liability allocation mechanism.

4.9 For this proposal to be effective there must be an intention by the trustee to distribute at least the VTI each year, with the concept of 'distribution' being defined very widely as described in IFSA's response to question 4.2 below. This intention can be evidenced in the Trust Deed/Constitution, a distribution policy adopted by the trustee, minutes of trustee meetings and/or the product disclosure statement (PDS) required under the *Corporations Act 2001*. That is, the MIT would be legally bound to make distributions each year (unless there is no income). To ensure integrity, IFSA propose this would be a statutory condition requiring the trust to show such an intention.

4.10 This serves two purposes: it ensures that the trustee will statutorily be exempt from tax, and secondly it will alert the unit holder that they will be subject to the tax on the VTI each year. This also ensures that the concept of present entitlement is no longer required.

4.11 Indeed, this is how present entitlement broadly works at the present. In practice, PDSs already contain statements like this in response to the current trust regime. A matter like this is required to be disclosed to investors under the *Corporations Act 2001*. Such a statutory condition would therefore be no additional burden. The trustees already notify the unit holders that they are subject to tax on the income of the trust even though they may not physically receive the income during that year.

4.12 Statements in a PDS are a binding contract between the trustee and the investors as well as the investors having statutory protection against misleading statements. This approach therefore has a high level of integrity and is easy for the ATO to monitor.

4.13 If there is no intention by the trustee to distribute the VTI then, IFSA submit, that the trust should not qualify to be within the new MIT rules and should remain in Division 6 or whatever replaces it for trusts other than MITs. In practice, it would be very unlikely that an MIT would not have an intention to distribute its VTI. This is the broad industry understanding of how the current regime works and this requirement will not be seen as a change. Those who have chosen to operate MITs have already chosen to be bound by such a requirement.

4.14 It is important to understand this intention in the context of the fiduciary and statutory duty of the trustee to act in the best interests of all unitholders. At paragraphs 6.26 et seq of this submission we deal with the examples on pages 37 and 38 of the Discussion Paper. Using these examples we demonstrate why it is already the practice to distribute cash equal to the VTI. This should not be understated as it is at the core of how the trustee functions in an MIT.

De-linking Tax Allocation from Cash Distributions

4.15 On the issue of whether a cash distribution should necessarily be linked to a tax liability on behalf of investors, IFSA submit that there is a continuum of investors needs in this regard, from the 'mums and dads' that require the cash distribution to fund their tax liability, through to the institutional investor that is able to fund its tax liability separately from the distribution and is therefore not reliant on physical cash being distributed.

4.16 That is, while most retail investors take distributions from MITs in cash, the majority of distributions made by institutional fund managers are automatically reinvested by investors through the crediting of additional units in the MIT rather than the payment of cash – this is effectively a constructive receipt of the distribution and full reinvestment back into the MIT.

4.17 Each MIT's distribution practices will be dictated by investor preferences so that the product is competitive and attractive to the retail or institutional investors to which the MIT is marketed. Each fund manager will manage their investors such that if the investors are reliant on a cash distribution, then they must distribute cash. Each fund manager will, in their fiduciary capacity be disclosing the fund's cash distribution policy to allow potential investors the opportunity to decide whether to invest based on this profile. IFSA considers that this is a matter that each fund

manager should address separately on a fund by fund basis and that it is not a technical matter that the Board of Tax should be concerned with.

The Other Options in the Discussion Paper

4.18 As mentioned above, as long as the trust discloses the intention to distribute VTI, then the cash distribution policy can be de-linked from the tax allocation calculation. Therefore there would be no requirement to distribute a minimum amount as per Option 3. This is one of the key advantages of Option 2 over Option 3. Further, Option 3 contemplates a 90% distribution requirement combined with a potential de minimus under/over requirement of 2% which in our view would cause more uncertainty. Option 3 attempts to bring simplicity but instead merely changes the distribution target and means the MIT can leave 10% in the trust to accumulate, which would impact the fund by increasing the unit price and creating potential capital gains implications for investors – this is inconsistent with Policy Principle 4 that 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.

4.19 Broadly Option 1 should produce the same result as Option 2. However, for this to occur the distribution would need to be 100% of the assessable income of the MIT. This has the potential to cause confusion, make the definition of 'distribution' critical and require rules as to whether non-cash items such as franking credits should be included in the calculation of the income. Option 2 provides the certainty that the policy principle of the beneficiary being the one bearing the tax liability is applied.

4.20 Further, under Option 1 if a cash distribution is required in order to obtain the deduction, the Fund may need to borrow monies to fund the distribution or otherwise sell down investments. This funding issue is exacerbated under Option 1 for MITs which elect into TOFA and subject gains to tax on an unrealised basis. Under Option 2, this requirement is nullified by the attribution of the tax liability to the underlying beneficiaries, and in effect may simply allow the trustee to issue further units in the MIT.

4.21 A further alternative put forward in the paper is to modify the existing Division 6 legislation and redefine key terms. However, what is required is certainty around the tax liability of trusts. A patch over the problems with the current law may do no more than create further uncertainty, and if this Option is ultimately chosen, then industry must work closely with Treasury and 'road-test' the patched legislation to ensure it meets the requirements that can be obtained via one of the other Options.

4.22 However, should a trust not satisfy the definition of a MIT, and subsequently falls out of Option 2, potentially the trust should come within the ambit of Division 6. On this basis, to ensure certainty for these trusts, perhaps Division 6 could be modified for these non-MIT vehicles. This would further ensure integrity within the tax system that all trusts are being captured.

Allocation of Tax Liability

4.23 An important consideration under Option 2 is the method by which the VTI is allocated to beneficiaries. This has been a point of uncertainty and contention for

MITs for many years. The current legislation lacks the appropriate clear mechanism to state who gets what share of income.

4.24 IFSA submit the most appropriate method of allocating the tax liability should be on the basis of the amount of 'distributions' allocated to each investor under the rules of the trust or applied for an investor's benefit. This would ensure that the distribution matches the tax liability being allocated. In a typical unit trust context, this allocation would be based on each investor's share of units held as a proportion of the trust's total units issued at the end of each distribution period.

4.25 The basis of our trustee exemption model is that the trustee has an intention to distribute at least the VTI each year with 'distribution' defined as described in IFSA's response to question 4.2 below. The way in which the trustee actually divides the VTI between investors in giving effect to this intention provides the best basis for allocating the tax liability. The trustee will communicate these amounts to the investors, as it does now, and will report these amounts to the Tax Office in the Annual Investment Income Report, as it does now. For example:

A fund has taxable income/VTI for the year of $10,000. Investors have received distributions during the year as follows:

	Quarter 1	Quarter 2	Quarter 3	Final
Investor A	500	500	500	1000
Investor B	1000	-	-	-
Investor C	-	-	500	1000
Investor D	1000	1000	1000	2000

Note in this example that Investor B has left the fund (redeemed) after quarter 1 and Investor C has joined the fund after quarter 2.

The taxable income from the trust that investors will include in their personal tax returns will be:

Investor	Taxable Income
A	2500
B	1000
C	1500
D	5000
TOTAL	10,000

4.26 A problem with the current rules is where a large investor (Investor B in this example) leaves the trust, and the MIT is required to sell assets to fund the redemption. This can cause large taxable gains to be triggered in the MIT, however, there is inherent uncertainty under the current rules as to the extent to which such an investor can be presently entitled to net income and what, if any, gains and/or income can be attributed to the redeeming investor. Please refer to our elaboration of this issue in Chapter 6.

4.27 A further advantage of Option 2 is that it can resolve this issue without complexity: Effectively, it would implement a simple statutory rule, as opposed to relying on special distributions and other clauses in the trust deeds, which states that the tax liability follows a special distribution to a redeeming investor, to ensure this uncertainty is dealt with.

The Board seeks stakeholder comment on a definition of distribution that would provide clarity and ensure appropriate tax outcomes. (Question 4.2)

What constitutes a distribution?

4.28 To provide the maximum flexibility for product providers to respond to clients needs, the concept of distribution should be defined as widely as possible. Any explicit allocation of value from the trust fund to the investors should constitute a 'distribution' for these purposes.

4.29 IFSA see three main ways in which an MIT may distribute an amount, all of which should be acceptable. As circumstances change, other methods of distribution may be required and it would be better if the concept was defined in general terms to allow for this. The three main ways IFSA see are:

- *Cash Distributions with Voluntary Reinvestment:* As soon as practicable after the end of the distribution period the trustee transfers cash to the investors. Investors have a power to nominate that this cash be immediately reinvested in the MIT rather than transferred but there is no compulsion for them to do so. The unit price reduces by the amount transferred. This is the in essence the way distributions generally currently work. Occasionally, the trustee will transfer assets other than cash but this does not need to be thought of as a different way of distributing.

- *Distributions Declared but Not Paid:* It is quite rare for MITs to have an obligation to transfer cash but to delay meeting that obligation. It is common though with family trusts. There is no reason to prevent MITs from doing this if the appropriate circumstances arise. Any power to do this would be clear in the trust deed and PDS and investors would only invest in the MIT if they understood the effect of this possibility.

- *Compulsory Reinvestment:* A small proportion of MITs work better if cash is kept within the fund rather than transferred. As noted above, there are some investors who anticipate meeting their tax liability from other sources of cash and are willing to invest under these conditions. Under the current 'present entitlement' system the only way to get this outcome is for the trustee to only accept applications from investors who agree upfront to reinvest distributions and for the trustee to expel from the MIT any investor who revokes this agreement. It would be simpler for these MITs if the trust deed could identify amounts as being compulsorily reinvested distributions.

4.30 Each of these methods would be effected by a reduction in the unit price when the distribution happens and an issue of new units if and when the distribution is reinvested.

4.31 Distributions would require a communication from the trustee to the investor advising them of the amounts they need to include in their tax return. This already happens.

4.32 One important implication of our description above of distributions is that IFSA are making no connection whatsoever between the amount distributed and the income of the MIT calculated under accounting rules or calculated on any basis other than as VTI. Breaking this connection will overcome many of the problems that currently exist.

4.33 IFSA's vision of a distribution is an allocation of value whose primary purpose is to make the tax system produce the correct outcome. In practice it will coincide with many clients' desire for cash flow. The fact that the clients' cash flow will be governed by the VTI is no different to the current system. There will be flexibility for the product providers to produce different cash outcomes if the circumstances justify. There will be flexibility to make connections to accounting income if that is what the clients want. In most cases though it will be better for all parties to keep the product design as simple as possible.

4.34 The distributions may be volatile and they will sometimes in effect include amounts of capital. There is no way of avoiding this without making the products very complicated. The tax system should not lead to the design of complicated products. It should provide the scope for both simple and complicated products to exist, as the circumstances warrant.

4.35 In any case, there needs to be specific provisions to deal with what are referred to as "gross-ups" in respect of franked dividends. Section 207-20 of the *Income Tax Assessment Act 1997* includes an additional amount in the assessable income of a taxpayer that receives a franked dividend. The gross-up represents the pre-tax income of the company that paid the franked dividend. It has only been transmitted to the recipient of the dividend in the form of franking credits.

4.36 IFSA's recommendation is that VTI should not include this gross-up as it does not represent anything received by the MIT. Instead the trustee communicates the amount of franking credits flowing through the MIT and only the ultimate investor includes the gross-up in assessable income and claims the franking credit tax offset. This is what in effect happens now.

4.37 A similar issue arises when foreign income has been subject to foreign tax. The MIT only receives a net amount, that has been reduced by the foreign tax. Only the reduced amount should be included in VTI and the ultimate investor should gross-up in conjunction with claiming the foreign tax offset.

The Board seeks 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. (Question 4.3)**

4.38 Section 99A was brought into the legislation in 1964. Since then the investment landscape has changed markedly, and as such section 99A is no longer an appropriate punitive regime given the modern MITs that currently exist.

4.39 It is understood that there must be an appropriate balance between integrity and equity considerations combined with a view that the options must be neutral or near revenue-neutral.

4.40 The reality of the MIT system is a conduit and collective investment vehicle that is marketed to the public, will calculate its taxable income and attempt to distribute the full amount of this income to its investors. The undistributed taxable income, if any, will arise from estimates, rounding, errors and very occasionally differing interpretations of the law. A rate of the highest marginal tax rate plus Medicare levy does not allow for undistributed taxable income that is essentially an unintended error in the calculation.

4.41 Should IFSA's version of Option 2 be adopted, the section would effectively no longer be required, as there is an intention by the trust to distribute its VTI, and for the beneficiaries to be taxed on the VTI.

4.42 Alternatively, section 99A could be repealed and a new section inserted which would give rise to a rate of tax on under-distributions at the same rates as the withholding tax rates in Subdivision 12H. A further penalty regime as an integrity measure, based on the nature of the breach which may be in line with current ATO practice.

The Board seeks 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. (Question 4.4)**

4.43 IFSA considers our version of Option 2 described above is more appropriate than either receipts basis or a present entitlement basis. The exempting tax model would seek to tax the unitholder on their share of their VTI in the same year as it has been calculated by the MIT, and therefore would not result in any deferral of tax.

The Board seeks 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 minimus rule of say up to 2 per cent of the net income and if yes, what should be the consequences of breaching the de minimus rule; and

(d) Whether the Commissioner of Taxation should have the discretion to increase the de minimus in special circumstances, and if so, what circumstances. (Question 4.5)

Background

4.44 It is important to consider IFSA's responses to the above questions in the context of typical arrangements applied by an MIT.

4.45 MITs will typically determine their annual taxable income and distribution components within several days of their tax year end due to a range of commercial and statutory requirements.

4.46 Firstly, MITs generally issue daily application and redemption unit prices for investors entering and exiting funds. MITs must determine the amount of the annual cash distribution and the associated tax components as soon as possible after year-end so as to not prolong the unit pricing freeze that normally occurs for several business days after year-end.

4.47 During this time investor applications and redemptions are suspended. The amount of cash distribution will result in a decrease in the fund's cash and therefore its net asset value that is the basis upon which application and redemption prices are struck. Until the taxable income can be calculated and its component break down is established a fund cannot be properly unit priced.

4.48 Secondly, due to commercial and statutory considerations, MITs will generally seek to issue annual tax statements to unitholders within tight timeframes. For example, this is necessary in order to ensure that appropriate withholding tax is deducted from distributions to non-residents. Further, it is necessary so that unitholders who rely on these statements for preparation of their own income tax returns can satisfy their requisite lodgment requirements.

4.49 Finally, there is a high degree of cross investment in the funds management industry that has resulted in the need for timely reporting of tax components so that other MITs that invest across the funds management industry can determine their own taxable income and the tax components that must be reported to their own investors in a timely manner. For example, wholesale and sector funds are required to report distribution components to retail fund unitholders to enable the retail fund's investors to determine their own tax position. This process is repeated at each tier

of the investment process and will ultimately be reflected in the tax returns that will be lodged by investors (individuals, superannuation entities and companies).

4.50 The calculation of taxable income of the MIT for the purposes of the MIT's income tax return is generally completed many months after the end of the financial year. For example, most MITs with a 30 June year-end have until the following 15 January to lodge their tax return. By such time further information becomes available that is not available in the days immediately following the end of the financial year. Also, a detailed review of income and expense items can be undertaken to ascertain the appropriate tax treatment. Understandably, such a high degree of accuracy cannot be achieved within the tight timeframe within which the distribution components are required to be determined for the issue of the MIT's annual tax statements.

4.51 The difficulty in achieving 100% accuracy in determining tax component information in annual tax statements issued by MITs arises because:

- It is increasingly common for many MITs to invest in complex unit trusts that are in turn invested in alternative asset classes such as infrastructure funds or hedge funds in order to obtain investment diversification. Unfortunately, as many of these funds are invested in foreign funds and assets, it is not always possible to obtain accurate tax data in respect of the underlying investments until some weeks or months after the end of each financial year;

- In recent years many MIT operators have established 'multi-manager' funds which invest in trusts managed by other arm's length investment managers (often called boutique fund managers) on whom the MIT operator is dependent for tax information. Sometimes these boutique fund managers are unable to provide timely, accurate tax distribution component information until some time well after the end of the financial year;

- Many listed property and infrastructure trusts are unable to provide final details of tax distribution components to trusts typically until late August or September after each year end; and

- Custodians who hold legal title to assets of trusts (and on whom trusts are dependent for correct transaction processing in respect of investment assets, some of which are held in foreign jurisdictions) sometimes make errors in processing transactions close to year-end. This results in adjustments to tax details provided to trusts after trusts have finalised data used in preparing annual tax statements.

4.52 Accordingly, upon reconciling the sum of taxable distributions made to investors and the net taxable income of the trust as calculated for its income tax return, it is sometimes the case that a shortfall ('under-distribution') or excess ('over-distribution') will have occurred. It should be noted that under-distributions and over-distributions do not arise because of any deliberate action or failing on the part of the trustee and usually will not arise because an error has been made in the calculation of the distribution. Rather, they may arise because the precise income, expense or other amount may not be known by the trustee at the time the

distribution is made and the trustee will therefore determine its distributable taxable income after having regard to:

- prior year experience/actuals;
- estimates released to the market by the security issuer; or
- a combination of different estimation methods.

4.53 In most cases, however, additional information that affects taxable income of the MIT emerges after the distribution is made.

4.54 The existence of under- and over-distributions is not contemplated in the taxation legislation. The treatment of them has been subject to industry practice over many years.

4.55 In general, the long-held practice of the industry for under-distributions is as follows. If the quantum of the under-distribution is considered material, then a 'special distribution' may be made to unitholders presently entitled at the preceding distribution date. What is considered 'material' is at the discretion of the trustee (and the auditors of the trust), and is normally governed by the trustees overriding fiduciary obligation to act impartially and even-handedly between beneficiaries and groups of beneficiaries.

4.56 If the quantum of the under-distribution is not considered to be material, the full amount of the under-distribution is carried forward and corrected in the next distribution made after discovery of the difference. In other words, the next distribution would be increased by the amount of the preceding period's under-distribution.

4.57 The long-held practice of the industry for generally applied for over-distributions is that the amount of the over-distribution is carried forward and corrected in the next distribution made after discovery of the difference. In other words, the next distribution would be decreased by the amount of the preceding period's over-distribution.

Responses to Questions

4.58 As a practical matter, as distributions must be made, and tax statements issued, well before finalisation of the trust's income tax return for a financial year, the quantum of distributed net income and that reflected in the trust's income tax return will rarely be equal. This is simply due to the fact that the distribution is based upon information and estimates available at the time of the distribution, rather than the more complete information which becomes available by the time of lodgement of the trust's income tax return. These differences are not the result of any deliberate action or failing by the trustee.

4.59 IFSA consider that the simple carry forward approach as currently applied by MITs (and described above) is the most appropriate mechanism for dealing with under- and over-distributions.

4.60 It is important to note that the differences that arise are both under- and over-distributions. The debate on this matter often centres upon the potential tax deferral that results from under-distributions, but fails to recognise the effective pre-payment of tax that arises when over-distributions are made. In our experience, it is just as likely for an over-distribution to arise as an under-distribution, and therefore the importance attached to the potential for tax deferral is over emphasised.

4.61 In any event, we submit that the concerns that the simple carry forward mechanism results in a significant deferral or avoidance of tax when a trust under-distributes is unfounded, for the following reasons:

- Trustees are subject to overriding fiduciary obligations to obey the terms of a trust (which will include its distribution requirements) and to act with a high degree of probity and impartiality between beneficiaries. The majority of trust deeds will require a minimum distribution of the net taxable income of the trust. To this end, the trustee is legally obliged to distribute the distributable income of the fund. As noted above, in those cases where an amount distributed is significantly less than the net taxable income of the trust, trustees will ordinarily consider making a special distribution to correct the under-distribution rather than simply carry that amount forward. Accordingly, any carried forward under-distributions are likely to be small in amount.

- It is ordinary practice in the industry to correct the under-distributions at the time of the first distribution after the difference is discovered. As most MITs distribute quarterly or half-yearly, it is often the case that these under-distributions are corrected prior to the final distribution of the trust for the financial year succeeding the year of under-distribution. In such an event, unitholders subject to the Pay As You Go (PAYG) system will be obliged to include these amounts in their instalment income in the quarter of receipt, with the result that tax is paid on these amounts at that time.

4.62 The carry forward approach does involve a degree of inequity between redeeming and remaining unitholders where these redemptions occur between the distribution date and the date of correction of the under- or over- distribution. However, it must be recognised that such inequities are an unavoidable consequence of investment via a pooled vehicle, and trusts in particular. It has long been recognised that unitholders' capital can be 'converted' to income and vice versa dependant upon their time of application and redemption. This 'conversion' aspect continues to exist despite the attempts to eliminate or minimise it via 'full-equalisation' pricing methodologies or via special distribution clauses triggered by "large" redemptions.

4.63 In any event, the alternative 'deduction/credit' approach discussed in the Consultation Paper does nothing to alleviate this inequity. In essence, any tax paid by the trustee on 'undistributed' income is attached (together with the relevant income) as a tax credit to the subsequent distribution. Similarly, any over-distribution is a deduction in the subsequent financial year. This would continue to involve distribution to unitholders at the subsequent distribution date

irrespective of redemptions from the last distribution date at which the under- or over-distribution arose, thus ingraining the perceived generational inequity.

4.64 IFSA considers a de minimus rule is unnecessary and may create a potential distortion in the operation of the industry. The Board of Taxation's suggested de minimus threshold of 2% is far too small having regard to the nature of matters which can give rise to the under-and over-distribution, as discussed above. Also, it is difficult to reconcile a 2% de minimus rule with the minimum level of annual distribution (90%) suggested under Option 3 of the Board's Alternatives to the Present Regime.

4.65 As discussed above, trustees are subject to a strict fiduciary regime that will provide an overriding legal restriction as to the quantum of any under-distribution that will be carried forward. IFSA consider that these fiduciary requirements will provide a sufficient incentive to ensure that a statutorily imposed de minimus rule is unnecessary.

4.66 Further, the imposition of a de minimus rule may encourage trustees to include a 'buffer' in their calculations of distributable income, effectively including an additional amount to ensure that they reach the designated 'minimum' distribution. The inclusion of this 'buffer' would reduce the risk of under-distribution, but would increase the risk of over-distribution. Any such statutorily imposed incentive to over-distribute should be discouraged as it will disadvantage unitholders by effectively requiring them to pre-pay tax, and will impact long term savings by encouraging the return of 'capital' to unitholders that would otherwise remain as 'savings' in the trust.

CHAPTER 5

Introduction

5.1 IFSA is strongly of the view that Australia has a significant opportunity to attract non-resident investors to access global and regional investment markets by investing through Australian resident collective investment schemes.

5.2 Australia has a well established, well regulated and well run funds management industry. Our same time zone advantage means that Australian fund managers should also be able to provide better quality service to Asian investors than can the more traditional international funds centres such as Luxembourg and Dublin.

5.3 Historically, however, the Australian tax system has been a significant barrier to the flow of funds from Asian investors into Australian domiciled schemes.

5.4 If Australia is to compete with the other major international fund centres it is imperative that there is certainty about the operation of Australia's tax laws as they impact upon non-resident investors and equally crucial that non-resident investors suffer no additional tax impost by reason of investing through an Australian resident fund than would have been the case had they invested in the underlying assets directly or through one of the other international fund centres.

IFSA recommendations

An investment management exemption be introduced.

The tax law be amended such that non-resident investors in an Australian trust would not be subject to tax on hedging gains which relate to Australian or foreign assets irrespective of where they are sourced.

Relax the investment restrictions in the Offshore Banking Unit provisions of the *Income Tax Assessment Act 1936*.

The new MIT regime should not be limited to unit trusts. Instead any legal entity that meets the prescribed prerequisite conditions would be eligible to elect, irrevocably, into the new regime.

Detailed responses to specific questions

What issues are currently experienced under Australian domestic law and treaties with the operation of international rules for MITs. (Questions 5.1(a))

5.5 One of the fundamental tenets of Australia's income taxation system is that non-residents should not be subject to Australian tax on foreign income and gains. However, the funds management industry continues to encounter difficulty in exporting its services due to a number of factors including:

- the inadvertent application of withholding taxes to profits and gains from foreign sources which are treated as Australian source income under Australian tax law;

- foreign funds investing in shares and similar securities which wish to appoint a local manager to assist in managing the Australian (and to some extent the foreign) assets in doing so may cause the foreign fund to be exposed to Australian tax because the CGT exemption no longer applies (as the fund may have a permanent establishment in Australia);

- foreign funds which invest directly and are dealing in Australian listed stocks, if they were to be considered to hold the assets on revenue account (contrary to the views expressed in the separate IFSA submission regarding issues dealt with in Chapter 7 of the Discussion Paper), and so be exposed to Australian taxation where there is no Double Tax Agreement exemption. Their preference in those circumstances would be to invest in non-Australian securities as most non-Australian tax jurisdictions exempt such investments from local tax (whether the assets are held on revenue or capital account);

- foreign funds which invest in a local fund may be disadvantaged where the local fund is deemed to hold assets on revenue account as the local fund will withhold tax from Australian sourced gains (from 1 July 2010) at 7.5%. Whereas a direct investment or an investment in a non-Australian fund would not give rise to such taxation.

5.6 Most of the above issues have been overcome in foreign jurisdictions by specific legislation. For example in the US a foreign investor investing or dealing in US stocks is not as a general rule exposed to US tax on the profits - even where the foreign investor has a fund manager or agent in the US managing the stocks.

5.7 Other examples of the inadvertent application of Australian tax laws can be found in the rules for the taxation of foreign exchange (FX) gains, bond profits and the taxing of hedge funds due to Australian management and control of the managed fund. In the case of FX gains and losses, fund managers often execute hedge contracts offshore in order to give the gain a foreign source so as to ensure that non-resident investors are not disadvantaged. Indeed in some cases, global fund managers have established a full trading desk (satellite office) elsewhere in the Asia-Pacific region because of these tax issues, resulting in the generation of jobs, skills and the like occurring offshore rather than in Australia. This is an example of the inefficient practices that have developed as a result of the often uncertain application of our tax laws to everyday fund transactions. Some global fund managers have unfortunately drawn the conclusion from real-life examples of this kind that our Asian competitors (e.g. Hong Kong) are easier jurisdictions than Australia in which to establish and progress global product and process initiatives.

5.8 In addition to these issues, Australian tax can apply to a non-resident's share of income attributed under the Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) attribution rules due to an ATO interpretation of Australian tax law (refer ATOID 2005/200).

5.9 Non-residents are unwilling to invest through jurisdictions where the taxation regime is uncertain. This is especially the case where the allocation of assets to the jurisdiction is small but the risk of being taxed extends to all assets. For instance a foreign fund with managers in Australia may risk being seen as centrally managed here which would expose the entire fund to Australian tax. Hence measures to overcome the above issues can only enhance Australia's opportunity to become an international financial centre.

5.10 It has become quite clear that Australia is out of step with most financial centres overseas in terms of the treatment of foreign investors. This risks Australia becoming a 'back water' in terms of foreign investment and will mean the huge flows of capital particularly in Asia remain outside Australia with a detrimental impact for employment and economic growth. This is especially frustrating where Australian managers are technically considered some of the best in the world yet often end up having to go overseas to apply their expertise. The issue has become even more important given the current global financial crisis.

5.11 As such it is important that Australia provide tax treatment and exemptions at least equivalent to those offered overseas, so that our tax regime does not operate as a disincentive to foreign investment.

What suggestions are there for dealing with the issues. (Question 5.1(b))

Investment Manager Exemption

5.12 The United Kingdom has an investment management exemption (IME) which allows a manager acting for a non-resident to be exempt from tax on behalf of its non-resident client, including offshore funds. The tax exemption was introduced to encourage non-residents to invest through British institutions.

5.13 In the United States, as noted above, the tax exemption for foreign investors trading in United States' stocks, even where a local agent or manager is present in the United States, has been around for many years.

5.14 Hong Kong has also implemented such a tax exemption clarifying that offshore funds with Hong Kong fund managers and investment advisors are not subject to tax in Hong Kong on profits derived in Hong Kong.

5.15 More specifically, we understand that the Hong Kong IME is granted to non-resident persons (including natural persons, corporations, trustees and partnerships) in respect of profits from certain types of 'specified transactions' including: transactions in securities, transactions in futures contracts, transactions in foreign exchange contracts, transactions involving the making of deposits other than by way of a money lending business, transactions in foreign currencies and transactions in exchange traded commodities.

5.16 Japan has also introduced an IME.

5.17 IFSA recommends that a similar tax exemption be introduced in Australia to address situations in which Australian and foreign source income flowing through to non-residents is taken to be Australian source income under Australian tax law

because the management and control function is performed by an Australian fund manager or because the securities involved are traded in Australia. This simple tax exemption would provide a significant boost to the export activities of the funds management industry. Other advantages, including increased depth and liquidity in Australia's trading markets, would further promote Australia as a regional financial hub.

5.18 Fees derived by Australian fund managers from this activity would be subject to tax at the normal corporate tax rate. If, as expected, this measure resulted in Australian fund managers increasing their funds under management by attracting more non-resident investor funds, tax collections from fund managers' fee income would correspondingly increase.

5.19 IFSA notes that given that most foreign funds would currently be exempt from Australian tax under the CGT regime and may be treaty protected in any case the expansion of the exemption would we submit not result in any loss of revenue but generate additional revenue in Australia as greater investment would occur with the subsequent flow on effect to related Australian industries such as stockbroking.

5.20 A more detailed argument in favour of an investment manager exemption relates to the lack of a statutory rule for determining source in Australia.

5.21 The general scheme of the trust provisions in the Australian tax law is that non-resident beneficiaries in an Australian trust will only be subject to tax on income and gains having a source in Australia. However, there are no statutory rules for determining source.

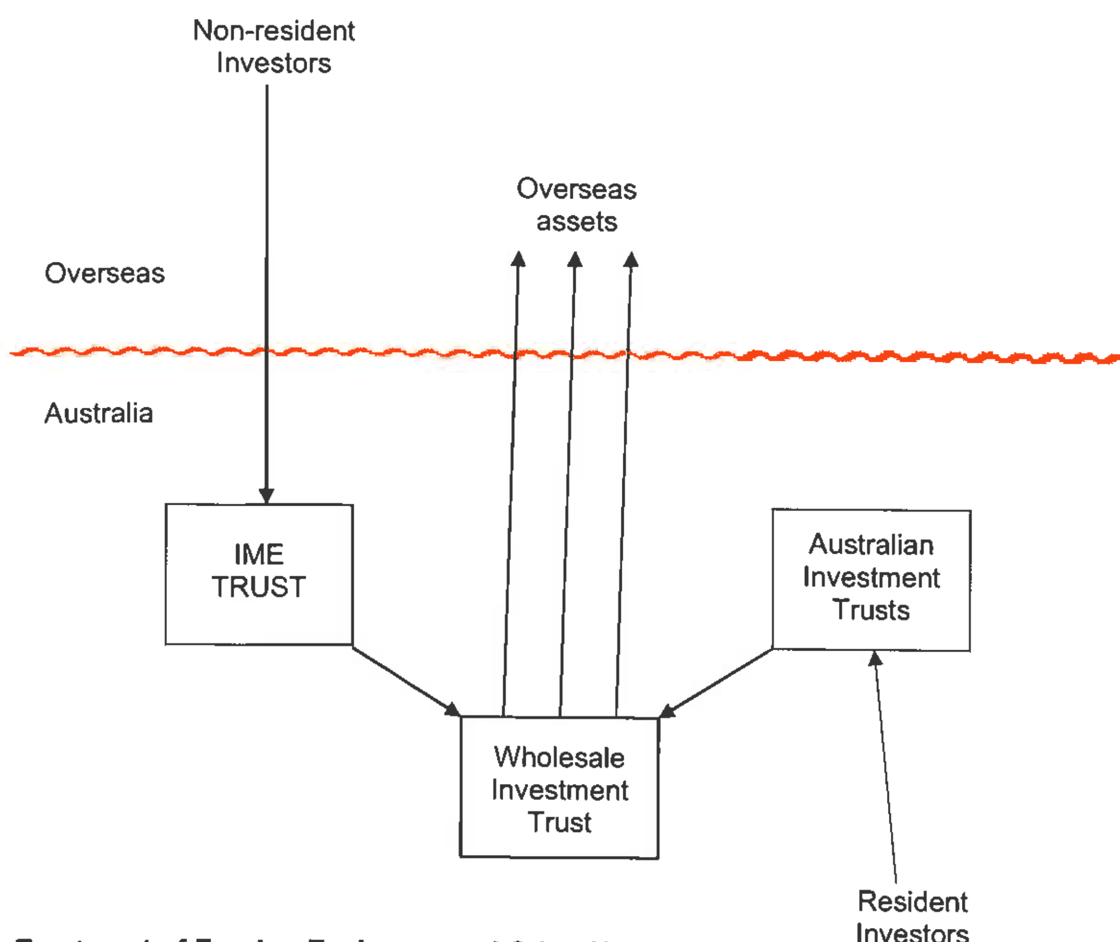
5.22 There are two schools of thought in relation to the determination of the source, for tax purposes, of an item of income or a gain. The first and preferred view is known as the 'transactions test' which provides that a gain on the disposal of securities will be sourced at the place where the contract giving rise to the acquisition and disposal of the securities is executed. Consequently, if securities are purchased and sold on a foreign stock exchange the source will be taken to be outside Australia.

5.23 The alternative view is known as the 'operations test' and provides that the source of a gain will be the place where the decision making as to which security to buy and sell takes place. For an Australian resident trust which is managed from Australia this test may give rise to an Australian source notwithstanding that the securities are traded outside Australia.

5.24 Whilst it is generally believed that the ATO supports the transaction test in determining source on disposal of securities, the position is not beyond doubt and clarification in this area would be welcome.

5.25 Other jurisdictions have dealt with similar issues by introducing an IME to ensure that non-resident investors do not create a taxable presence in these jurisdictions merely by virtue of having appointed a local fund manager to manage their inestments.

5.26 Such an exemption should operate in two ways. Firstly, it should apply to mandates requested by non-residents and managed by Australian managers. Secondly it should apply to Australian investment vehicles which are wholly owned by non-residents. In this instance the IME should continue to apply where the MIT invests into another Australian MIT that actually holds the investments. In this way domestic and foreign investors would have their investments pooled thus achieving greater efficiency. The following diagram shows how this would operate:



Treatment of Foreign Exchange and Other Hedging Gains

5.27 Related to the issue of source as outlined above, the treatment of FX gains and losses can be problematic. FX hedging contracts are typically used by fund managers to offer investments in asset classes denominated in a foreign currency without the concomitant exposure to the currency fluctuations. That is, the investor will always get exposure to both currency movements and the underlying asset class unless the fund manager strips away the FX exposure using hedging contracts.

5.28 Often, the non-resident investor does not want the FX exposure, just the pure asset class returns, and will be less likely to invest with the fund manager unless the manager offers FX hedging. The tax law treats FX gains as statutory income rather than capital gains and where those gains have an Australian source an Australian tax liability may arise in respect of a non-resident unitholder's share of the gains.

Whereas, currently fund managers may seek to execute hedge contracts offshore to give the FX gain a foreign source in order to ensure that non-resident investors are not disadvantaged, in practice that may be difficult to control and is an unnecessary administrative burden.

5.29 Similar issues arise in relation to other hedging contracts such as futures and forwards.

5.30 IFSA recommends that the tax law be amended such that non-resident investors in an Australian trust would not be subject to tax on hedging gains which relate to Australian or foreign assets irrespective of where the hedging gains are sourced. This would also be consistent with the fact that the underlying Australian assets are most often not Taxable Australian Property as defined in section 855-15 of the *Income Tax Assessment Act 1997*.

5.31 IFSA considers that such an exemption would not be detrimental to Australian Government revenue given that little tax would currently be collected on such gains and, given the innate volatility of currency, losses are equally as likely to be generated as gains. If the measure allowed Australian fund managers to increase their funds under management by attracting more non-resident investors, tax collections from funds managers' fee income would increase.

Modification of Eligibility Criteria for Trust Exemption in Offshore Banking Unit (OBU) Provisions

5.32 A manner of addressing the source issues referred to above would be to modify the OBU rules contained in Division 9A of the *Income Tax Assessment Act 1936*.

5.33 The OBU provisions of Australia's tax law currently provide for an exemption from tax for the income of a trust of which an OBU is a trustee or the central manager and controller, where all of the investors in the trust are non-residents and the investment activities are limited to those prescribed within the OBU provisions. See section 121EL of the *Income Tax Assessment Act 1936*.

5.34 Unfortunately, those investment restrictions are extremely onerous and difficult to comply with in practice. Consequently very few funds qualify for the exemption and the Government's intention of encouraging the management of ex-Australian assets on behalf of non-residents is unfulfilled.

5.35 IFSA recommends minor relaxation of the investment restrictions which could improve this position. In particular it is suggested that:

i. the requirement in section 121D(6A)(d) that 'the currency in which the investment is made is not Australian currency' be deleted;
ii. foreign exchange and other hedging contracts be excluded from the definition of 'Australian thing' in section 121DA(5) for the purpose of determining the average Australian asset percentage which must not exceed 10%; and
iii. that the provisions be modified to accommodate the position where the '121EL Trust' has a trustee which is independent of the OBU manager of the trust. This could be achieved by inserting the following words at the end of paragraphs (a)

and (b) of subsection 121DA(6): 'or the trustee of a trust which satisfies each of subparagraphs 121EL(1)(a), (b) and (c)'.

5.36 Also, the position could be further improved if the requirement for all investors to be non-residents was eased. Currently an Australian fund manager must set-up two extra trusts, one trust managed exclusively for non-resident investors and a separate trust for resident investors. It would be more efficient to allow both resident and non-resident investors in the same trust but apply the OBU exemption to the share of income and gains accruing to the trust for the benefit of non-residents.

Multiple classes

5.37 Consistent with IFSA's recommendations in response to Question 11.1(b), consideration should be given to allowing unit trusts with multiple classes to fall within the new regime. An example of such multi-class structures would be one where classes are denominated in different foreign currencies. Such flexibility is important to ensuring Australian MITs remain adaptable and attractive to a variety of foreign investors.

Would there be advantages in having a deemed corporate flow-through CIV regime for international reasons. (Question 5.1(c))

5.38 For Australia to develop into an international financial services centre, it will be necessary to be cognisant of the preferences of international investors.

5.39 Many foreign investors do not come from a common law jurisdiction. Consequently, these investors are not familiar with trusts and often prefer to invest in a vehicle which has either a contractual basis such as an Irish common contractual fund, or is a corporate entity such as a Luxembourg SICAV.

5.40 In order to allow Australian based fund managers to service these clients from Australia, as opposed to them establishing an offshore vehicle for these clients, serious consideration needs to be given to the establishment of alternative flow through vehicles, particularly for non-resident investors.

5.41 IFSA recommends that the new provisions that apply to MITs should not be limited to unit trusts. Instead any legal entity that meets the prescribed prerequisite conditions would be eligible to elect, irrevocably, into the new regime. Once such an entity has elected into the regime the features normally associated with MITs such as transparency, flow through and deemed capital status would apply, regardless of how that type of entity might normally be treated for tax purposes.

5.42 By allowing such flexibility Australian managers would be able to develop products that suited particular overseas jurisdictions. In Appendix E of the Discussion Paper the Board has correctly identified that the preferred style of Collective Investment Vehicle may differ from country to country and, indeed, may even vary within a country depending upon the type of investment. Such flexibility provides a degree of protection against future developments that may result in unit trusts falling out of favour with investors.

5.43 Additionally by allowing other types of entity within the MIT regime it may be possible to overcome the deficiency that many Double Tax Agreements do not afford protection to trusts that are not taxpayers.

CHAPTER 6

Introduction

6.1 Chapter 6 of the Discussion Paper deals with trusts as flow-through vehicles. This is an area where IFSA considers the current legislative and administrative arrangements, while not perfect, are operating well.

IFSA recommendations

No change be made to the current arrangements where there are differences between the net income of the MIT and the actual distributions made to beneficiaries.

There should be a legislative basis for the required character retention rather than relying on a general law principle.

The existing statutory flow through mechanisms work appropriately and should not be changed.

MITs be entitled to a cash refund of imputation credits.

The current treatment of MITs and foreign tax credits be retained.

In the absence of amendments to the withholding tax rates applicable to the various components of MIT distributions, wholesale simplification to the current flow-through of character may not be possible.

Flow through of character continue to operate as per current practices under IFSA's preferred method of determining the tax liability on the net income of the MIT (which is a version of a trustee exemption model (Option 2)).

Non-resident and resident and portfolio and non-portfolio investors should not be treated differently for character retention purposes.

Detailed responses to specific 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. (Question 6.1)

6.2 The modern unit trust emerged in the early 80s and initial offerings were typically simple cash management trusts. As the range of underlying investments expanded two practical aspects became more evident.

6.3 Firstly, the need to prepare formal annual accounts for unitholders meant that accounting / trust income became the focus of trustees and beneficiaries. Previously such income figures were academic. In many instances the divergence

between accounting and tax income is minimal. However, in the case of property and infrastructure assets accelerated depreciation regimes and other tax write offs means that for the initial years accounting income typically exceeds tax income.

6.4 It is suggested that the need to examine both trust income and tax income should be discontinued for entities falling within the new MIT regime. Instead the liability of beneficiaries should be based upon the proportion of tax income which is distributed to them. By adopting such an approach the problems of deciding between the proportionate model and quantum model [*Zeta Force Pty Ltd* 98 ATC 4681] are eliminated.

6.5 For example a unit trust has taxable income for the year of $10,000. The beneficiaries have received distributions as follows:

	Quarter 1	Quarter 2	Quarter 3	Final
Investor A	500	500	500	1000
Investor B	1000	-	-	-
Investor C	-	-	500	1000
Investor D	1000	1000	1000	2000

6.6 The taxable income from the trust that investors will include in their personal tax returns will be:

Investor	Taxable Income
A	2500
B	1000
C	1500
D	5000
TOTAL	10,000*

(*The $10,000 is based upon distributions being made equal to the taxable income. IFSA's suggested treatment of under distributions and over distributions is contained in the comments in respect of chapter 4.)

6.7 The second issue is that the beneficiaries of a modern unit trust constantly change due to the trust being open to redemptions and investment. This change means that the investors who receive distributions are not necessarily the economic recipients. For example:

A fund has 10,000 units at the start of the year. Net tangible assets are $10,000 thus the unit price is $1.00.

As at 30 November the fund has received taxable income of $1,000 which has not yet been distributed, thus the unit price has risen to $1.10.

An investor, A, redeems 1000 units for $1.10 and new investor, B, invests $1,100.

Investor A derives a realised capital gain of $100 (=1100 – 1000) which will be taxable to A.

Investor B is issued 1000 units @ $1.10.

The fund receives no further income in the remainder of the year and distributes its taxable income of $1,000 at year end ($0.10 per unit). After this distribution the unit price falls to $1.00 (= [11,000- 1000]/10,000)

Investor B receives a taxable distribution of $100 and now holds 1000 units @ $1.00. Investor B now has an unrealised capital loss of $100.

Thus Investor B has taxable income of $100 and an unrealised capital loss of $100 despite being in a neutral position from an economic perspective.

6.8 MIT managers seek to deal with this disadvantage in a number of ways including:

- More regular distributions (quarterly / monthly).
- Daily accruals.

6.9 However, these are mechanisms for reducing the problem not eliminating it.

6.10 The problem is even more pronounced when capital gains are considered. For example:

A unit trust is established with 10 members each contributing $1,000 in exchange for 1000 units @ $1. The $10,000 is invested into 10,000 shares in Australian companies @ $1. Three years later the shares are worth $1.20 each, the fund has assets of $12,000 and the unit price is $1.20. Investor A redeems 1000 units and receives $1,200. In so doing the investor realises a capital gain of $200.

However, in order to fund the redemption the trust had to sell 1,000 shares. This sale generates a second capital gain in the fund itself of $200. This realised capital gain will form part of the net income of the fund for tax purposes and will need to be distributed to the remaining 9 unitholders. Thus each of the 9 remaining unitholders will have a taxable capital gain of $22 (= 200/ 9) under section 97 of the Income Tax Assessment Act 1936 despite the fact that the activities of investor A generated, in an economic sense, the capital gain <u>and</u> that A also has to include $200 of capital gain in taxable income.

6.11 This 'double up' has resulted in a trend for institutional investors and high net worth individuals to seek mandate arrangements, individually managed accounts or wrap / IDPS investments rather than investing into an MIT.

6.12 For most investors in MITs the existence or size of these double ups is not readily apparent. Hence MITs are often criticised for their lack of 'transparency'.

6.13 A number of MIT providers have started to institute arrangements where 'special distributions' are made to redeeming unitholders in order to ensure that the correct

unitholder receives relevant income. Normally such arrangements take the form of identifying a portion of what would otherwise be redemption proceeds as actually being a distribution to that unitholder of either capital gains or income as appropriate.

6.14 In the above example investor A would be considered to have received a $200 distribution of capital gain and the redemption proceeds would be $1,000. The remaining unitholders would not receive any additional distribution in respect of this amount.

6.15 It is suggested that such special distributions to specific unitholders should be considered as part of distributions made in determining the allocation of 'tax income' amongst unitholders.

6.16 Tax deferred distributions, distributions in excess of taxable income, occur must commonly in distributions from property trusts (listed or unlisted) and infrastructure trusts. Typically, but not exclusively the underlying cause of the tax deferred distribution is the availability of tax incentives or accelerated depreciation. The usual reason in the property sector is the building allowance provided in Division 43 of the *Income Tax Assessment Act 1997.* For example:

A trust has the following financial outcome for the year.

Rent	*10,000,000*
Manager expenses	*(1,000,000)*
Accounting profit	*9,000,000*
Division 43 Building allowance	*(500,000)*
Taxable income	*8,500,000*
Taxable distribution	*8,500,000*
Tax deferred distribution	*500,000*
Total distribution	*9,000,000*

6.17 For non-property trusts over distributions are occasionally made but are much less significant. In the property sector there is an expectation that part of any distribution will not be taxable.

6.18 Tax deferred distributions reduce the CGT cost base of units held by the investor. Thus a greater capital gain normally results from any redemption / disposal. This process of cost base adjustment is not widely understood in the general community. The providers of unlisted MITs and REITs, typically, but not always, provide redeeming investors with an estimate of CGT liability. Such estimates take into account the relevant cost base adjustments.

6.19 Listed REIT providers typically do not provide such an estimate as the initial on market purchase cost is not known to the provider.

6.20 It is suggested that if the allocation of tax income is changed to a mechanism solely focused upon 'tax income' (as discussed in the preceding paragraphs) the complexities arising from tax deferred distributions would be substantially reduced for non-property trusts. This is because such trusts will seek to only distribute trust income. (Small over distributions will arise from time to time but these are best dealt with in the manner suggested in the comments in chapter 4).

6.21 In the case of property and infrastructure trusts the divergence between cash flow and tax income means that tax deferred distributions are inevitable. The only means of simplifying tax deferred distributions for such funds will be to either:

1. Discourage funds from making such distributions by requiring investors to treat them as immediately taxable; or
2. Eliminating the reduction in the CGT cost base of units.

6.22 The first option is not practical as it detracts from a policy tool of the Australian Government. That is it diminishes the attractiveness of accelerated write offs and investment incentives.

6.23 The second option whilst simple and effective would have a revenue cost to the Government.

6.24 This approach is not perfectly equitable but investors accept that. The nature of MITs is that investors get significant benefits from pooling their capital with other investors and in return accept that the tax outcomes in the short term can be slightly inequitable. These short term effects balance out over time.

6.25 Consequently, IFSA recommends that no change be made to the tax treatment of tax deferred distributions by MITs.

6.26 The Discussion Paper has its own examples on pages 37 and 38. The flaw in the examples is that the trustee in each example does not distribute cash to match the $250,000 capital gain being included in assessable income. If the trustee did this, then the beneficiary would have an increase in their capital loss or reduction in their capital gain on redemption of their units. This would balance the $250,000 that the examples show as being taxed a second time.

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

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

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

How current uncertainty as to the applicability of a general law principle of flow-through character should be addressed. (Question 6.2(a))

6.30 IFSA supports the need to provide more certainty in respect of character retention and the flow through nature of distributions by MITs.

6.31 Retention and flow through of particular tax characteristics is in our view the best means by which Policy Principle 1 can be satisfied, that the tax treatment for trust beneficiaries who derive income from an MIT should largely replicate the tax treatment for taxpayers who derived the income directly.[1]

6.32 IFSA recommends there should be a legislative basis for the required character retention rather than relying on a general law principle that may be open to question. IFSA's conclusion below is that the legislation already provides for all the character retention that is required.

Whether the existing statutory flow-through mechanisms (for example, CGT, franking credits and foreign tax credits) work satisfactorily and, if not, why not. (Question 6.2(b))

6.33 IFSA considers that the existing statutory flow through mechanisms work appropriately and align outcomes for investment via MITs with those of investing directly except in relation to the flow through of franking credits.

6.34 The flow through of franking credits and foreign tax credits is denied when a trust has an income tax loss in any tax year. In such a loss year, the benefit of both franking credits and foreign tax credits is irrevocably lost to investors and the trustee. This is in contrast to the far more favourable treatment of direct investors who receive a cash refund in respect of excess franking credits. This refund is available to resident individuals and superannuation funds which represent over 95% of investors in MITs but not to MITs because they are constituted as trusts.

6.35 Hence a well informed investor in a typical Australian equity MIT, that invests in listed Australian companies which generate significant franked dividends would be better advised to invest directly into shares and not via an MIT due to the risk of franking credits not flowing through to investors. The risk of loss of franking and foreign tax credits is greater in the current falling investment markets and this loss of tax credits to MIT investors is a further penalty to investors at times of poor investment returns.

6.36 The risk of loss of franking and foreign tax credits will be further increased should the outcome of the Board of Tax review of MITs not lead to deemed CGT account for certain MIT assets as argued for in IFSA's separate submission on chapter 7 of

[1] See paragraph 1.7 of the Discussion Paper

the Discussion Paper. It is understood that the ATO is awaiting the outcome of the Board of Taxation review of MITs before issuing a draft determination on the capital/revenue treatment of assets. From our knowledge of the ATO's general views on this matter, we expect that this determination will restate the ATO view that many investment trusts, especially MITs, hold assets on revenue account. If such a determination were to issue, in falling markets the revenue losses realised on disposal of assets will push many MITs into tax loss positions resulting in the denial of franking and foreign tax credits to investors. However, direct investors will continue to obtain the benefits of cash refunds of franking credits.

6.37 Given the cash refund available to resident investors for franking credits but not for foreign tax credits and the Policy Principle, 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, IFSA recommends that MITs be entitled to a cash refund of imputation credits and that the current treatment of MITs and foreign tax credits be retained. Such a cash refund of franking credits would be entirely passed onto investors and this would correct a significant inequity in the tax treatment of MIT investors compared to direct investors. This could be implemented by very simply deleting MITs from the types of trust subject to denial of refundable franking tax offsets at 67-25(1B) of the *Income Tax Assessment Act 1997*.

Whether flow-through of character can be maintained while reducing compliance costs and complexity and, if so, by which means. Whether flow-through of character needs to be maintained in general or, alternatively, needs only to be maintained in specific circumstances. (Question 6.2(c) and (d))

6.38 IFSA recommends that the level of detail that is included in the ATO's standard distribution statement[2] (SDS) should be kept at a minimum to make the investor's tax compliance as easy as possible but that this cannot be at the cost of significant breaches of Policy Principle 1. If there are significant benefits to investing directly rather than via an MIT then investors will be driven away from MITs. On the other hand, IFSA understands that the Board does not want MITs to have significant advantages over direct investment.

6.39 Under the current law and SDS, IFSA's observation is that the level of detail that is reported to unitholders is unnecessary for resident investors. For example, a resident individual unitholder's tax liability is not impacted by whether the distribution comprises unfranked dividends, interest income, rental income, gains on the sale of traditional securities or assets held on revenue account. The individual would merely include the sum of these amounts in the relevant 'trust' section of their tax return.

6.40 The SDS is performing three different functions. As well as providing tax return information to resident investors it provides withholding tax information to non-residents. It also provides information to intermediaries who will pass that information on without knowing whether the final user of the information is a resident or a non-resident.

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[2] See paragraph 6.21 and Appendix B of the Discussion Paper

6.41 A significant level of detail that is maintained by managers and reported on the annual SDS is to ensure compliance with the various non-resident withholding tax obligations that are imposed on the MIT. This is required due to the differing withholding tax that applies to franked dividend, unfranked dividends, interest and the fund payments under Division 12H[3]. In addition, withholding tax may or may not apply to capital gains depending on the nature of the assets.

6.42 In the absence of amendments to the withholding tax rates applicable to the various components of MIT distributions, IFSA considers that wholesale simplification to the current situation may not be possible.

6.43 Any such consideration of this issue should take into account double tax treaty requirements and maintaining parity with direct investments. It is worth noting however that the reduction in withholding tax rates applicable to fund payments under Division 12H was made with the express intention of attracting foreign investment into Australian MITs with a view to making Australia a financial hub of Asia. Such policy considerations could equally apply to the other withholding tax amounts.

6.44 Having an investment in an MIT by a resident investor treated neutrally with direct investment does not require complete character retention. It only requires retention of capital gains tax characteristics, the foreign source of income, entitlement to an infrastructure rebate under section 159GZZZZG[4] and those items distributed in excess of the taxable income of the MIT for which no cost base adjustment is required.[5]

6.45 Character retention in each of these cases is already specifically provided for in the legislation.

6.46 The situation in respect of non-residents is dealt with in IFSA's answer to question 6.2(f) below.

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) (Question 6.2(e))

6.47 As described in chapter 4 of this submission, IFSA recommends that a version of Option 2, a trustee exemption model, be used as the method of determining the tax liability on the net income of the MIT. Under that model the 'virtual taxable income'[6] (VTI) of the MIT is allocated among the investors in proportion to the distributions made to them in respect of that income year. This is a formula for the quantum of each investor's share of the VTI.

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[3] *Taxation Administration Act 1953*
[4] *Income Tax Assessment Act 1936*
[5] See section 104-71 *Income Tax Assessment Act 1997*
[6] That is the taxable income calculated as if the trustee were a taxpayer. Section 95 of the *Income Tax Assessment Act 1936* currently calls this the 'net income'.

6.48 IFSA's proposal above is that the amounts included in the investors' assessable income retain the character that they had in the hands of the trustee. This requires a further formula to allocate these characteristics between the investors.

6.49 This is something that the industry has always done. This method has worked as an efficient balance between compliance costs and equity. IFSA recommend that the industry's approach be maintained.

6.50 As with the discussion above, this approach is not perfectly equitable but investors accept that.

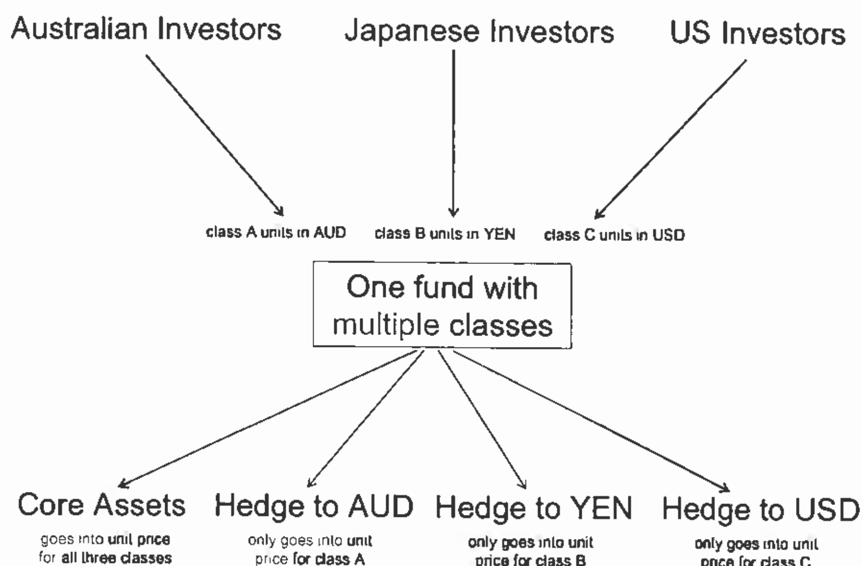
6.51 The industry's method applies two principles. The first principle is subject to the second principle.

6.52 The first principle is that the characteristics are allocated between the investors in proportion to their share of the VTI. For example, if a discounted capital gain makes up 10% of the VTI, then 10% of the assessable amount for each unitholder is treated as being a discounted capital gain.

6.53 The slight inequity is that this does not reflect the parts of the year for which each investor participated in the MIT. For example, even if the discounted capital gain referred to in the example above was a single CGT event that happened in the last quarter of the year, it is still being allocated across all investors even though some of them did not receive the last quarter's distribution or were not in the MIT when the CGT event happened.

6.54 The second principle is that if an MIT has more than one pool of assets then the investor only gets the characteristics that arise from the pools that they participate in. If the investors' interests in the MIT are all uniform then this second principle has no effect.

6.55 This second principle is applied on a bottom up basis. In section 11 of this submission we discuss MITs where the investors' rights are not uniform. One example is as follows:



6.56 The process would be to calculate a VTI for each of the four pools of assets shown at the bottom of the diagram determining both the quantum of VTI and the relevant characteristics that are going to flow through. The class A unitholders get a distribution with the quantum and characteristics based on the AUD hedges and their share of the core assets. The class B unitholders get a distribution with the quantum and characteristics based on the YEN hedges and their share of the core assets. The class C unitholders get a distribution with the quantum and characteristics based on the USD hedges and their share of the core assets.

6.57 Sometimes the sum of the parts does not equal to the target total so reasonable adjustments have to be made to the parts so that the total is correct.

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). (Question 6.2 (f))

6.58 For non-residents the system of imposing withholding tax on only part of the MIT income and at different rates for different parts of the income requires a certain amount of character retention.

6.59 Non-resident investors are sensitive to the rates of withholding tax. This is why Australia recently moved to progressively reduce one of the rates to 7.5%. Reducing the amount of character retention by increasing withholding tax rates would be contrary to the Board's objective of enhancing the international competitiveness of Australian MITs.[7]

[7] See paragraph 1.4 of the Discussion Paper.

6.60 IFSA would support a reduction in character retention through reducing withholding tax rates. The question would be whether this can be done in a 'near revenue neutral' way as required by the Board's Terms of Reference.

Whether character retention should be concerned with whether investors are portfolio or non-portfolio investors. (Question 6.2 (g))

6.61 IFSA sees no basis for treating portfolio investors differently from non-portfolio investors in this regard. Both groups are making decisions whether to invest via MITs or invest directly. They each have the same need for character retention.

CHAPTER 8

Introduction

8.1 Chapter 8 of the Discussion Paper asks for comments as to the advantages and disadvantages of the potential options for clarifying the tax treatment of fixed trusts.

IFSA recommendations

A statutory deeming rule be introduced to provide that all MITs be deemed to qualify as fixed trusts for the purposes of the tax law.

Such a rule is simple and would lower compliance costs. Importantly it would greatly reduce uncertainty and the current risk borne by MIT trustees that some of the tax treatments adopted by all MITs (e.g. in relation to carry forward of tax losses, pass through of imputation credits) are contrary to the law.

The changes should be revenue neutral as MITs currently self assess their tax position based on the basis that they qualify as fixed trusts.

Detailed responses to specific questions

The Board seeks stakeholder comments on:

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

(f) **any other option for clarifying the treatment of fixed trusts. (Question 8.1)**

Background

8.2 The definition of fixed trust was introduced into the tax law in 1997-98 as part of Schedule 2F to *Income Tax Assessment act 1936* which contains measures referred to as the trust loss measures. These anti-avoidance measures are designed to restrict the recoupment of prior and current year losses and debt deductions of trusts and to prevent the transfer of the tax benefit of those losses or deductions. The measures restrict the use of losses and the claiming of debt deductions where there has been a change in ownership or control of the trust.

8.3 Unfortunately, the definition of fixed trust which first arose in a tax avoidance context has been used repeatedly in the tax law in a variety of other contexts unrelated to tax avoidance. What may have been an appropriately narrow definition is now used in many places in the tax law where the intention may have been only to refer to widely held or unit trusts generally.

8.4 The concept of a fixed trust is now used in the tax law to limit the availability of tax concessions and in our view, to distinguish between unit trusts and discretionary trusts. A non exhaustive list of the contexts in which fixed trust is used follows:

- Scrip for scrip rollover relief – unitholders in a fixed trust may obtain rollover relief on exchange of their membership interests for comparable interests in the acquiring entity under Subdivision 124-M of ITAA 1997;

- Entitlement to flow through of imputation credits to trust beneficiaries in non-widely held unit trusts uses the same concepts of vested and indefeasible interests as in Sch 2F (refer sections 160 APHL of ITAA 1936);

- To determine non- resident's liability to CGT in Australia on indirect holdings in Australian property via Australian unit trusts – Division 855 ITAA 1997 CGT and Non residents;

- Venture Capital Exemption for non resident investors under Subdivision 118-F of ITAA 1997 (refer sections 118-505 and 118-510(2));

- In defining which entities can be members of a tax consolidated group (refer 703-40 of ITAA 1997).

- The General Value Shifting provisions of Division 727 of the ITAA 1997

8.5 Paragraph 8.7 of the Board of Tax Discussion Paper states that "it is possible under existing law that some MITs may not be able to qualify as fixed trusts." IFSA consider that this understates the difficulties associated with MITs qualifying as fixed trusts and that under the current law it is likely that no MIT currently qualifies as a fixed trust.

8.6 Sections 272-65 and 272-70 of Sch 2F of ITAA 1936 provide that:

> "A trust is a **fixed trust** if persons have fixed entitlements to all of the income or capital of the trust" and
>
> "A trust is a **non-fixed trust** if it is not a fixed trust"

8.7 The term "fixed entitlement" is defined in Section 272-5(1) of Sch 2F of ITAA 1936 as follows:

> "If under a trust instrument, a beneficiary has a vested and indefeasible interest to a share of the income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a fixed entitlement to that share of income or capital."

8.8 As there is no case law on the Section 272-5(1) definition of fixed entitlement, the terms vested and indefeasible interest are understood by reference to the case law relating to the wording of Section 95A(2) of ITAA 1936 and general law on what constitutes a "vested and indefeasible interest".

8.9 Based on this case law, there are at least five reasons why MITs do not qualify as fixed trusts:

1. Power to Amend the Trust Deed

8.10 Under section 601GC of the *Corporations Act 2001* either a majority of unitholders or the trustee may amend the constitution of a trust registered under the Managed Investments Act. Also many MIT trust deeds contain a broad power for the trustee to amend the trust deed in its absolute discretion. It is likely that the existence of such powers results in the beneficiaries' interest being defeasible and thus failing the fixed trust test. Amendment by majority vote could for instance result in an alteration of the rights of minority unitholders against their will.

2. Trustee's Right of Indemnity

8.11 High Court authority has determined that a trustee with a right of indemnity out of trust assets for costs properly incurred in administering the trust is a person beneficially interested under the trust. Furthermore the High Court has determined that the trustee's beneficial interest has priority over the beneficial interests of the other beneficiaries (Chief Commissioner of Stamp Duties v Buckle (1997) 37 ATR 393).

8.12 Given the existence of the trustee's beneficial interest, how can it be said that beneficiaries, who have their interest postponed to that of the trustee, can be said to have a vested and indefeasible interest in income and capital of the trust? This is a common power found in most trust deeds and therefore it is likely that most if not all MITs will not constitute fixed trusts for this reason alone.

3. Redemptions/Disposals of Trust Assets

8.13 The interests of unitholders in income are liable to be defeated in the event a unit is redeemed. This is because most MITs deeds provide that income entitlements are to be calculated by reference to unitholders at a distribution date, and where redemptions occur prior to that date the redeeming unitholder's income interest is defeated. Also an interest in any particular asset may be defeated by the disposal of assets by the trustee to fund the redemption of units held by another unitholder.

4. Power to Issue Units at a Discount

8.14 The trust deeds of many MITs provide the trustee with the power to issue units at a discount. The existence of such a power results in the entitlements of a beneficiary being defeasible, whether or not the trustee actually exercises this power.

8.15 Section 272-5(2) contains saving provisions, which provide that where a trustee has the power to issue further units or redeem units in a trust, that an interest in such a trust is deemed not to be defeasible if units can be issued or redeemed at an amount other than the ASX listed offer price for a listed trust, or the net asset value of the trust for a non-listed trust. Despite these saving provisions, units are commonly issued at a discount to the listed price or net asset value in many circumstances where the parties are acting at arms length. This gives rise to practical problems for trust distribution reinvestment plans, takeovers and issues of new classes of units. Where the units are issued a discount to the offer price, or market value, such trusts do not qualify as fixed trusts under Division 272.

5. Trustee's Power to Determine Income of the Trust

8.16 Most MITs have a provision that permits the trustee to determine the income of the trust. Also many MIT deeds confer the power to satisfy the redemption price of units by income or capital or a mix of income and capital as the trustee sees fit in its absolute discretion. It is difficult to conclude that the unitholders interests in income and capital are vested and indefeasible in such circumstances.

ATO view

8.17 In 2006 the ATO's NTLG Trust Consultation Sub-group considered the current operation and interpretation of the fixed trust provisions. After discussion with group members and the Public Rulings Panel, the Tax Office concluded that, even on a purposive and contextual interpretation of the actual words used in the legislation, it cannot reach an interpretative position that would be aligned with industry expectations. The indefeasibility requirement as interpreted by the Tax Office is significant in that respect.

8.18 In other words, the ATO could not reach an interpretation of the fixed trust provisions that would allow MITs and other common unit trusts to qualify as fixed trusts. The ATO initially proposed to issue a general public ruling on this topic but this has now been deferred pending consideration of fixed trusts by the Board of Taxation. Legislative reform is now necessary.

Response to Questions

8.19 IFSA has listed below two options for the reform of the fixed trust provisions. IFSA prefers Option A over Option B due to it being more certain in its application that Option B. Option B has some residual uncertainty around the meaning of what is a unit trust.

Option A - MITs are deemed to be fixed trusts

8.20 This proposal is simply for a statutory deeming rule to provide that all MITs be deemed to qualify as fixed trusts for the purposes of the tax law.

8.21 Such a rule is simple and would lower compliance costs. Importantly it would greatly reduce uncertainty and the risk borne by MIT trustees that some of the tax treatments adopted by all MITs (e.g. in relation to carry forward of tax losses, pass through of imputation credits) are not supported by the law.

8.22 The changes should be revenue neutral as MITs currently self assess their tax position based on the basis that they qualify as fixed trusts. This option is consistent with the five key policy principles in the Board's Discussion Paper. It is also consistent with the Federal Government's goal of establishing Australia as a regional financial centre for funds management because two CGT concessions available to non-residents depend on the satisfaction of the definition of fixed trust (refer section 3 above).

8.23 The disadvantage of Option A is that other unit trusts which do not qualify as MITs, which operate on an arms length basis will be denied certain tax concessions.

Option B - Replace fixed trust rules with rules applicable to unit trusts

8.24 The concepts used in CGT event E4, section 104-70 and the demerger rules in Division 125 of the *Income Tax Assessment Act 1997* provide a more workable basis to grant tax concessions to certain trusts instead of to the very limited class of fixed trusts.

8.25 That is, the Demerger rollover relief rules apply to a trust if CGT event E4 is capable of applying to all of the units and interests in the trust. These provisions simply apply to beneficiaries who hold units or interests in trusts, without the tax law containing any definition as to what is a unit or interest. Instead the note to section 125-65(2) makes explicit the fact that a discretionary trust cannot be part of a demerger group.

8.26 To our way of thinking these provisions use a more appropriate borderline than that of "vested and indefeasible interest". Because of the fluid nature of beneficiaries' entitlements under discretionary trusts, it is difficult to envisage the application of many of the provisions of the tax law to such discretionary beneficiaries. However they do meaningfully apply to unit trusts or trusts which have defined interests in income and capital of a trust. As most of the provisions which are limited to fixed trusts are not anti-avoidance provisions, it is difficult to see why they should be limited to beneficiaries with vested and indefeasible interests.

8.27 Option B has the same advantages as options A. One disadvantage of Option B is that there is some uncertainty at the margin as to what is exactly meant by the concept unit trust. However the provisions of CGT Event E4 and its predecessor s 160ZM have applied to unit trusts for decades and have given rise to little uncertainty or controversy in the scope of their application. The same could be expected of using these terms in this context.

Should the definition of fixed trust be rewritten?

8.28 An alternative to the above options is the complete rewriting of the definition of fixed trust which must involve the removal of the vested and indefeasible requirements from the definition. The words of the vested and defeasible test being, as Hill J stated in Dwight v FCT 92 ATC 4192, 'technical legal words of limitation' which are not easily applied to modern investment trusts.

8.29 IFSA has previously considered how to completely redefine a fixed trust for tax purposes, but IFSA has not been able to come up with a workable definition which provides a viable alternative. Therefore Options A or B are our preferred outcomes.

CHAPTER 9

Introduction

9.1 Chapter 9 of the Discussion Paper deals with the eligible investment rules in Division 6C of the *Income Tax Assessment Act 1936*.

9.2 As a general observation IFSA believes that the underlying rationale for the introduction of Division 6C no longer exists. The Division was originally intended to extend the corporate tax arrangements to public unit trusts that operated a trade or business. The main advantage of conducting such a trade or business in a unit trust was that the double taxation of company profits that existed under the classical system could be avoided.

9.3 The Board has noted at para 9.7 of the Discussion Paper the statement from "Reform of the Australian Taxation System" September 1985 that:

> "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**" (emphasis added)

9.4 With the introduction of refundable imputation credits this rationale has ceased to exist. Accordingly IFSA's preferred position is that Division 6C be repealed.

9.5 If the Board considers that the Division still has some use, albeit a use that was not intended at implementation, then IFSA has provided detailed responses to the specific questions posed in the discussion paper.

IFSA recommendations

Division 6C of the *Income Tax Assessment Act 1936* be repealed.

The 20% rule for complying superannuation funds be abolished.

The scope of the Eligible Investment Business (EIB) rules needs to be reviewed and redrafted based on broad concepts, such as investment activity and trading activity, rather than detailed lists.

The control test should be abolished.

With regard to non-compliance with the eligible investment rules:

a) there should be a 5% of gross income genuine de minimis threshold; and
b) where the threshold is exceed only the tainted income should be subject to corporate level tax.

Detailed responses to specific questions

The Board seeks comment on whether it is still appropriate to have the 20 per cent rule for complying superannuation funds. (Question 9.1)

9.6 IFSA considers that there is no ongoing rationale to maintain the 20% rule for complying superannuation funds and recommends that the rule be abolished.

9.7 Effectively the 20% rule acts as an investment restriction for superannuation funds. In particular, such investment restrictions on superannuation funds within the tax legislation can:

- Reduce the attractiveness to individuals of saving for their retirement; and
- Restrict the participation of a significant pool of Australian savings in financing important projects including nation building infrastructure.

9.8 With the Board's objectives in mind, IFSA recommends that complying superannuation entities should be excluded from the definition of 'exempt entity' in section 102M and therefore the '20% rule' in section 102P. The inclusion of complying superannuation entities as an 'exempt entity' and application of the '20% rule' imposes an economic growth restriction on an increasing important industry segment, particularly where the concern of the activities of a wholesale or managed investment trust appears to be paramount rather than complying superannuation entities as a type of investor.

9.9 The status and treatment of the complying superannuation entities in the Australian taxation system has undergone significant reform since Division 6C was introduced and with this the concern associated with tax advantages available to trusts and Superannuation entities. Since the introduction of Division 6C in 1985 a number of aspects impacting managed investment scheme and Government policy of compulsory retirement savings have changed the industry and importance of complying superannuation entities with the Australian economy.

	1985 Calendar year	**2008 Calendar year**
	Classical system of company taxation which involved the taxing of profits at the company level and again at the shareholder level.	A dividend imputation system for dividend income forms part of company taxation with both complying superannuation funds and individuals entitled to a refund of excess franking credits.
	Taxation of capital assets had only just been introduced during the year	
	Significant number of Australians rely on Government pensions as the main source of income during	Significant number of Australians make superannuation contributions as part of the compulsory

	retirement	superannuation scheme
	Superannuation and funds management industry were relatively small and with individuals making voluntary contributions	Superannuation and funds management industry have over $1 trillion funds under management
	Superannuation funds had the same tax exempt status (pursuant to section 23F) as other exempt entities listed in section 102P.	Complying superannuation entities are now the only exempt entities listed in section 102P that are subject to tax.

9.10 As complying superannuation entities are now taxable, factors and concerns for the inclusion of complying superannuation entities in the 'exempt entity' list, no longer justify their continued inclusion in the list. Especially since it does not have the same status as others on the list and as a consequence one of the determinants for other trusts having to test for the application of Division 6C. Any concerns associated with trusts that are required to test for Division 6C are suitably dealt with under the other qualifying conditions.

9.11 Alternatively, any concern associated with the activities undertaken by complying superannuation entities would more appropriately be dealt with in the *Superannuation Industry (Supervision) Act 1993* rather than in *Income Tax Assessment Act 1936.*

What approaches can be taken to changing the eligible investment rules that would reduce compliance costs for managed funds and enhance their international competitiveness. (Question 9.2(a))

9.12 IFSA recommends that the scope of the Eligible Investment Business (EIB) rules needs to be reviewed and redrafted based on broad concepts.

9.13 As outlined in depth in IFSA's separate submission on chapter 7, there needs to be a refocus on the difference between an investment activity and trading activity. If EIB rules are to apply to investment activities then allowable activities needs to include all forms of investment and all forms of return on investments should be allowed.

9.14 For example, a right arising under a licence to use intellectual property should be seen as an allowable investment activity. A taxpayer who acquires intellectual property from the original holder in order to derive a royalty stream is investing rather than carrying on a business. Such a position is supported by the approach in the model OECD Double Tax agreement where interest, dividend and royalty income are all treated in a similar manner.

9.15 The distinction being drawn can be best illustrated with an example. A musician writes a song and exploits it for commercial gain. Some years later the musician sells the copyright to a Media Works Fund that has acquired a library of music copyright. The fund derives royalties from the use of the relevant music by radio

stations, advertisers, movie studios etc. The income received is entirely passive in the sense that it is only the use by another that generates income. There is no activity to encourage others to use the copyright. In this example the musician can be said to be carrying on a business however the fund is an investor.

9.16 Hence it is suggested that investing through the acquisition of intellectual property that has been developed by another party should be an activity included in the list of 'eligible investment business'.

9.17 Another example is passive investment in precious metals and commodities. These are alternative investments that fund managers are pooling but are not included in the list of 'eligible investment business'.

9.18 One of the difficulties with the existing list of eligible investment businesses is that it is inflexible and is not readily adaptable as different styles and types of investment have emerged. Public Private Partnerships, miscellaneous infrastructure, carbon credit initiatives such as reforestation are all examples of investment that fall within the policy intention of the existing Division 6C eligible investment list yet which do not fit comfortably within the existing definitions.

9.19 This has resulted in either investments not being made through trusts or the creation of complex structures to overcome the impediments. One example of such a structure is the Hills Motorway where a listed company and a trust are stapled together. The company is the tollway operator and the trust the tollway owner. Such structures are expensive to establish and administer and are not well understood by investors.

9.20 The solution would be to have a broader definition of allowable investment based on concepts rather than detailed lists.

9.21 In the context of investment in real property, all forms of return from that investment should be allowable. This would include amounts receivable under leases and licences and capital gains on dealing with interests in real property. Incidental income from providing services including electricity and telecommunications to tenants should be allowable. IFSA accepts that trading in land and development for resale are not forms of investment in land.

Should the control test be abolished or replaced with a requirement that investments in companies or other entities carrying on a trading business be limited to a particular percentage or with an arm's length term requirement? (Question 9.2(b))

9.22 IFSA recommends that the control test should simply be abolished.

9.23 Currently within Division 6C, control by a public unit trust of another person in respect of the carrying on by that other person of the trading business, can cause the unit trust to be classified as a public trading trust.

9.24 The Explanatory Memorandum to the Bill which introduced Division 6C states that section 102N is a safeguarding provision against arrangements to circumvent the operation of Division 6C by having activities that would constitute a trading

business of a public unit trust carried on by an associate. By taking income from an associate in the form of eligible investment income, the trustee could otherwise ensure that the relevant trust did not carry on a trading business and so avoid the operation of Division 6C. Given the changes to Australian tax legislation and the move to offshore investments by Australian property trusts the control rule seems outdated and unnecessary.

9.25 IFSA sees no policy or practical reason to retain the control test currently in Section 102N as it applies to subsidiary or controlled companies in Australia, or to offshore investments.

9.26 Similar to the position for US REITs, an Australian unit trust should be able to control an Australian resident company. Given that Australian resident companies are taxed in their own right, any trading income will automatically be subject to Australian income tax. The Australian company will pay Australian tax on its taxable income and will distribute franked or unfranked dividends. These dividends would be EIB income for the unit trust. In large part the reason for the control test no longer being required for investments in Australian companies is the significant changes to the Australian income tax system since Division 6C was introduced, and in particular the introduction of dividend imputation and refundability of franking credits.

9.27 Where an Australian unit trust has a controlling interest in a subsidiary trust, Division 6C will properly apply at the sub-trust level. The activities and income of the sub trust should not taint the tax status of the head trust. In these circumstances, if the activities of the sub-trust result in it breaching the requirements of Division 6C, then the sub-trust will pay tax on its net income. In such circumstances the head trust will receive 'unit trust dividends' and potentially franking credits from the sub-trust. Such amounts should be EIB income for the purposes of determining whether the head trust passes the tests under Division 6C.

9.28 Further, any control test should have a 'waters edge' limit. That is control of foreign entities that may carry on activities considered to be trading should not cause an Australian trust to become a trading trust provided those entities are not carrying on business in Australia.

9.29 As Australian property trusts have expanded offshore, the current restrictions have caused significant concern and compliance costs. Generally, there seems to be no Australian tax revenue at risk. Part of the difficulty arises from the style of operation and customary activities varying significantly from country to country, and as compared to Australia. For an Australian trust to be required to monitor whether an underlying entity owning rental property in distant lands is carrying on any isolated activities which could constitute trading is unrealistic and impractical.

9.30 The offshore entities themselves would not be subject to Division 6C as, even if they were trusts, they would not satisfy the residency requirements. The income and gains in respect of such offshore investments should be EIB income. This income will be distributed by the Australian unit trust and will be included in the taxable income of Australian resident unitholders of the trust.

9.31 We note that in the corporate context the carrying on of an active business by an overseas company that is owned by an Australia company produces similar Australian tax outcomes to allowing an Australian trust to control the foreign active business.

9.32 Generally the controlled foreign company rules would not apply to foreign active business. Further, distributions from the foreign company to its Australian parent would generally be non-assessable non-exempt income under section 23AJ. Thus the only Australian tax that will apply is tax on the unfranked dividends distributed by the Australian company which may be many years after the Australian company receives the distribution from its foreign subsidiary.

Should non-compliance with the eligible investment rules result in taxation only on the 'tainted' income and how could this be achieved? (Question 9.2(c))

9.33 IFSA recommends that

c) there should be a 5% of gross income genuine de minimis threshold

d) where the threshold is exceed only the tainted income should be subject to corporate level tax.

9.34 The funds management industry has always considered Division 6C to be draconian because one breach, no matter how small, taints all other activities of the trust. For this reason, if Division 6C is retained it is suggested that the corporate tax regime should only apply to the 'tainted income' and that the remaining income and profits should be distributed to unitholders for taxation in the normal manner.

9.35 By adopting a 'tainted income' approach the Division would be able to deal with any partial abuses but at the same time allows a sensible outcome. Such an approach should allow for the proposed de minimis so that corporate taxation only applies to tainted income where the threshold is breached.

9.36 It is also suggested that where such tax is paid by a trust that it should be able to create a franking account and treat a portion of future distributions as if they were a distribution of franked dividends. This is largely the same mechanism that exists through Division 6C at present.

CHAPTER 10

Introduction

10.1 Chapter 10 of the Discussion Paper examines the continued relevance of Division 6B of the *Income Tax Assessment Act 1936*.

IFSA recommendations

Division 6B of the *Income Tax Assessment Act 1936* be abolished.

Detailed responses to specific 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 and specific tax regime for MITs (Question 10.1)

10.2 As identified by the Board of Tax in its discussion paper, since the introduction of Division 6B significant reform to the Australian tax system has taken place. Specifically:

- the classical system of company taxation which involved the taxing of profits at the company level and again at the shareholder level was removed in 1985;
- the exemption from taxation of many institutional investors, and in particular superannuation funds, no longer applied from 1988; and
- the non-refundable nature of excess imputation credits no longer exist as superannuation funds have been able to obtain refunds of any excess imputation credits from 2001.

10.3 In addition, it is worth noting that Division 6C of the *Income Tax Assessment Act 1936* was introduced shortly after Division 6B. Division 6C implements government policy on the circumstances in which a public unit trust is taxed like a company and ensures that there is no tax benefit obtained from moving an active business (as well as many other assets) into public unit trusts. IFSA's position on Division 6C is set out in detail in our response to Chapter 9.

10.4 Given the significant reform to the Australian tax system since the introduction of Division 6B, IFSA considers that the rationale for Division 6B no longer exists.

CHAPTER 11

Introduction

11.1 Chapter 11 of the Discussion Paper deals with the potential scope of an MIT regime and raises three significant sets of issues.

11.2 The majority of the chapter deals with questions relating to the concept of 'widely held' and the effect of amending the terms of a trust deed. This includes the question of whether the rights attaching to interests in an MIT should be uniform. IFSA considers that this specific question is vital as an MIT regime will not be sustainable if rights are required to be uniform. As such, the issue is dealt with separately in Chapter 12 of IFSA's response.

11.3 The chapter also seeks comment on carving out certain classes of arrangement from a new MIT regime or alternatively providing special rules for Investor Directed Portfolio Services (IDPSs).

IFSA recommendations

PART 1 – 'Widely held' and the effect of amending the terms of a trust deed [Questions 11.1(a), (c) and (d) and 11.3(a) and (b)]

'Widely held' should not be defined using a numerical test.

'Widely held' should be defined as:

- A trust which the trustee is providing in the course of financial services operations under the authority of an Australian Financial Services License (AFSL) under the *Corporations Act 2001.*

- Any MIT to which the ASIC may have provided licensing relief, should there be instances where the trustee of a wholesale managed investment trust may not have an AFSL.

- Government owned MITs which are precluded from obtaining an AFSL because they cannot be bound by the Corporations Law.

The question of whether an MIT can make an irrevocable election to be governed by the new MIT regime should be determined at a later stage.

Where the trust deed of an MIT is amended or changed this should not result in there being a creation of a new trust, and that this relief should apply universally across all MITs.

PART 2 – Carving out certain classes of arrangement from a new MIT regime [Questions 11.2(a), (b) and (c)]

IDPSs and other 'simple trusts' should not be classed as an MIT.

A statutory rule for 'simple trusts' should be introduced to recognise the economic substance of what IFSA recommends be called 'simple trusts'.

The concept of a 'simple trust' could be as follows:

- A trust is a simple trust if any income generated by the trust assets is available to the beneficiaries without any modification.
- Legal disability is ignored.
- Security and similar interests in the income are ignored.

The statutory rule would provide that for all income tax purposes it is the beneficiary of the simple trust, rather than the trustee, who derives income and makes capital gains.

The rule could take the following form:

> If an asset is held on trust and the trust is a simple trust then for the purposes of the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*:
>
> (a) all ordinary income and statutory income derived in respect of that asset is taken to be derived by the beneficiary of the trust and not to be derived by the trustee of the trust; and
>
> (b) all capital gains and capital losses made in respect of that asset are taken to be made by the beneficiary of the trust and not to be made by the trustee of the trust.

Detailed responses to specific questions

Part 1 - 'Widely held' and the effect of amending the terms of a trust deed

What is an appropriate approach to defining widely held for the purpose of any new MIT regime? (Question 11.1(a))

11.4 IFSA recommends against defining 'widely held' using a numerical test.

11.5 Rather, IFSA recommends that 'widely held' be defined as a trust which the trustee is providing in the course of financial services operations under the authority of an AFSL under the *Corporations Act 2001* (or equivalent obligations in special circumstances).

11.6 All such trusts should be subject to the same taxation regime. This would be the appropriate manner in which to tax entities which undertake investment activities and undertake to flow through taxable profits to their investors.

11.7 Further, 'widely held' should include any MIT to which the ASIC may have provided licensing relief, should there be instances where the trustee of a wholesale managed investment trust may not have an AFSL. An example of where ASIC has provided such relief has been to certain managed investment schemes which are wholesale equity schemes.

11.8 'Widely held' should also be defined to include Government owned MITs which are precluded from obtaining an AFSL because they cannot be bound by the Corporations Law.

11.9 The benefits arising from such an approach would be to:

- Increase certainty with regards to the types of entities that were subject to a new MIT tax regime;
- Reduce compliance costs in determining whether, and when, an entity was subject to a new MIT regime; and
- Eliminate inconsistencies and anomalies between entities created for the same purposes and which may not be widely held on a numerical basis.

11.10 The most appropriate method to determine whether a proposed MIT regime should extend to an entity should be the purpose for which that entity was established. This can be evidenced by the fact that the trustee for the investment vehicle has been granted an AFSL and consequently has to meet stringent requirements of the Corporations Law.

11.11 Where Government owned MITs cannot obtain an AFSL they should also be included in the same proposed MIT regime given that:

- The operators of these Government owned MITs are required to meet stringent management and reporting requirements akin to those that a trustee with an AFSL is required to meet; and
- Other MITs invest in these Government owned MITs.

11.12 If the MIT was established for the purposes of managing investors' funds and providing those investors with a return on the funds provided, then such investing entities should be subject to the same taxation regime much in the same way they would be subject to the same Corporations Laws and regulations.

11.13 Such a method of determining the extent to which any proposed MIT regime would apply would ensure the following:

- Consistency of treatment between entities which are governed by the corporations laws and investment regulations;
- Certainty as to the tax outcomes which would arise as a result of investing in such investment vehicles; and
- Reduced costs resulting from reduced complexities.

11.14 Appendix G of the Discussion Paper outlines some of the numerous definitions of 'widely held' trusts throughout the Tax Act.

11.15 Each set of 'widely held' rules have further rules governing when a taxpayer is to test whether something is widely held. Irrespective of the governing rules, the timing of testing as to when an entity is 'widely held' creates costs and uncertainty. This is because certain tax laws may vary the treatment of an entity from year to year depending upon where it sits within the various definitions.

11.16 There can also be complex rules that attempt to broaden the definition of 'widely held' where a closely held entity is indirectly held by another widely held entity. However, these rules can create further complexity and uncertainty because often details of the ownership of that other entity are not readily available or easily obtainable, if obtainable at all.

11.17 An example of these problems can be found in Subdivision 12-H of the *Taxation Administration Act 1953* where a closely held trust will be treated as a widely held 'managed investment trust' where an interest in it is held by a superannuation fund which has 50 or more members.[8] Often where IFSA members have to rely on this rule and trace through a superannuation fund, if we can contact the trustees of those superannuation funds they can be unwilling to provide details of the number of members. Consequently IFSA members can be left in a situation where we are unsure as to whether an entity is sufficiently widely held for these purposes.

11.18 Furthermore, situations can arise where an investment trust substantially owned by 3 separate superannuation funds each having 49 members would not necessarily enable that trust to obtain the benefits of Subdivision 12-H. This gives rise to inequitable results where another investment trust has only, say, 51 unit holders in total yet can attain the benefit of the Subdivision 12-H.

11.19 Instances can also arise where a retail MIT may be offered to the public on a 'platform'. In such instances, the operator of that platform as the nominal owner of the interest in the MIT will often not provide details as to the holdings in that MIT. Consequently, information as to the ownership of a publicly offered MIT will not be available thus inhibiting the ability to trace through to the direct owners.

11.20 If a numerical 'widely held' rule were to apply to any MIT regime then such a rule would need to contain tracing rules in order for the taxation treatment under any proposed regime to extend to Wholesale Investment Trusts. For the reasons explained above, we believe that any test which required tracing through the investors in such a trust would give rise to unnecessarily high costs, uncertainties, complexities and above all, anomalies and inconsistencies because of the difficulties caused by tracing. Furthermore, the differences which would result under such rules do not achieve equity.

11.21 This highlights the inconsistencies and anomalies which can arise where a numerical test is used to determine the taxation treatment of entities which undertake the same activities.

11.22 There are also temporal issues which can arise with respect to 'widely held' tests. Certain tests require testing at differing times. These varying tests could occur:

- continuously throughout the year;
- once a year at year end;
- at the time a certain specified event occur; or
- once and for all.

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[8] Subsection 12-400(2) of the *Taxation Administration Act 1953*

11.23 The more times testing is required the greater the associated costs will be.

11.24 The costs associated with testing will be even greater in the managed funds industry where investment managers have numerous investment vehicles. Some fund managers have products ranging in the hundreds. By having a 'widely held' test in order to be taxed under a new MIT regime, each fund would have to be individually tested despite the fact that they would all have been established for an investment purpose and are operating under an AFSL and subject to the *Corporations Act 2001*.

11.25 By examining the operation of Subdivision 12-H it can be seen that subsection 12-400(4) can give rise to inconsistent results between investment trusts despite the fact that each investment trust would have been established for the same purposes. This inconsistency arises where a trust has only one year in order to establish that it is 'widely held'. Consequently, trusts which may have been settled prior to July 2008 must be 'widely held' by the time they make their first fund payment in the 30 June 2009 income year in order to receive the same withholding tax treatment as earlier settled managed investment trusts. However, given the current worldwide economic climate it is proving to be extremely difficult to find investors for some trusts settled in 2008. As a result there will be an inconsistency of treatment between trusts due to factors completely outside the trustee's control.

11.26 As can be seen from the above examples, anomalies and inconsistencies can arise in the taxation treatment of funds which were constituted for substantially similar purposes. Having an MIT regime apply to all trusts governed by the same Corporations Laws will not only eliminate any testing costs, it would further remove tax arbitrage between investment vehicles. Consequently, IFSA consider that those vehicles operating under an AFSL, are exempted by ASIC from obtaining an AFSL or are unable to obtain an AFSL because they are managed by a Government are the appropriate vehicles to fall within the scope of any new MIT regime.

11.27 If such a regime were to exist it would also prevent small groups of investors combining their funds in a trust in order to obtain the certainty of any MIT regime. This is because those investors would have to meet the stringent requirements of the *Corporations Act 2001* and ASIC in order to fall within an MIT regime. It is likely that even if such investors would be able to meet these requirements they would be unlikely to do so because of the associated costs and reporting obligations.

Australian Financial Services License and Managed Investment Schemes

11.28 The *Corporations Act 2001* requires people who carry on operations of providing financial services to hold an AFSL unless they are covered by an exemption or are authorised to provide those financial services as a representative of another person who holds an AFSL. The process of applying for an AFSL is stringent and licensees have extensive obligations both under the licensing conditions and the governing legislation, particularly where they deal with retail clients.

11.29 ASIC is responsible for administering the *Corporations Act 2001* and maintains a register of licensees.

11.30 An entity will conduct a financial service where they:

- Provide financial product advice;
- Deal in a financial product;
- Make a market for a financial product;
- Operate a registered scheme; or
- Provide a custodial or depository service.

These types of conduct will only be a financial service if they are provided in relation to a financial product.

11.31 Financial service providers need to have their AFSL from the day they start their financial services operations.

11.32 Managed investment schemes are also known as 'managed funds', 'pooled investments' or 'collective investments'. Generally in a managed investment scheme:

- people are brought together to contribute money to get an interest in the scheme ('interests' in a scheme are a type of 'financial product' and are regulated by the *Corporations Act*); and
- money is pooled together with other investors or used in a common enterprise

A 'responsible entity' (RE) operates the scheme (where the scheme is registered).

11.33 Managed investment schemes cover a wide variety of investments including:

- cash management trusts;
- property trusts;
- Australian equity trusts;
- many agricultural schemes;
- international equity trusts;
- some film schemes;
- timeshare schemes;
- some mortgage schemes;
- actively managed strata title schemes.

11.34 New managed investment schemes must be registered with ASIC before they can operate. To register a scheme the proposed trustee must be:

- a registered Australian public company; and
- hold an AFSL authorising the trustee to operate the scheme.

11.35 If the proposed trustee does not hold an AFSL to operate the scheme, an application for an AFSL, or variation of an existing licence, needs to have been submitted to ASIC before applying for registration of the scheme.

11.36 ASIC have granted trustees of certain Wholesale Managed Investment Schemes an exemption from obtaining an AFSL where a licenced related body corporate has accepted responsibility for the provision of financial services by the trustee.

11.37 IFSA also notes that one of the largest institutional fund managers in Australia is a Government owned entity which is technically precluded from obtaining an AFSL, as it cannot be bound by the relevant provisions of the Corporations Act, but is required by its Government owner to comply on an "in principle" basis as if it were a licensed entity.

11.38 Given the above requirements we understand that in almost all instances managed investment schemes will be operating under an AFSL. In the rare instances where a managed investment scheme does not have an AFSL this will usually be because they are being operated by a trustee who is an authorised representatives of another AFSL, or they have been granted relief by ASIC or because the operator is a Government owned entity.

11.39 Consequently, in order to ensure that there is parity of treatment for MITs then any MIT tax regime should apply to all MITs where the trustee is required to have an AFSL.

11.40 Where there are instances that the MIT is able to be operated by a trustee without an AFSL, as in the instances described above, then any MIT tax regime should also extend to these entities. There would be no policy reason to justify the exclusion of these entities from any MIT regime.

Should an MIT be able to make an irrevocable election to be governed by the new MIT regime? (Question 11.1(c))

11.41 IFSA recommends that this question be determined at a later stage through consultation with Treasury, the ATO and the funds management industry.

11.42 There would be both valid reasons for having or not having an irrevocable election available to collective investment vehicles where the Responsible Entity is subject to an AFSL.

11.43 IFSA reiterates that by having an MIT regime apply to collective investment vehicles where the trustee for that entity is subject to an AFSL would create certainty as to the tax treatment of those vehicles. As a consequence, this would ensure certainty and consistency despite insignificant changes in their circumstances.

What compliance burden might arise if some trusts are within the new MIT regime and other are outside and there are cross holding in funds? (Question 11.1(d))

11.44 At this stage IFSA is unable to quantify the compliance burdens that would arise if some trusts are within the new MIT regime and others are outside and there are cross holdings in funds. Much of this would depend upon how the regime was to operate.

11.45 IFSA would realistically expect that there would be significant costs associated with an MIT regime that applied to only some MITs.

Any approaches, including potential legislative amendments, for addressing these issues [creating new trusts be amending the terms of a deed] (Question 11.3(b))

11.46 IFSA recommends that an MIT regime should contain a rule which provides that where the trust deed of an MIT is amended or changed this should not result in there being a creation of a new trust.

11.47 A consequence of such a rule would the certainty that either a change in the trust deed, trustee, investment manager or trust assets would not create a new trust. To do otherwise would cause unfair tax outcomes to arise for investors in MITs from factors that would often be beyond their control.

11.48 Additionally, such a rule would reduce the costs and uncertainty already faced by the trustees of an MIT who already incur considerable expenditure in ascertaining whether changes to the trust deed of an existing MIT will create a new trust. These costs add no value to the investors.

11.49 An example of where such large costs have been ultimately suffered by investors occurred when trust deeds of MITs were amended as a result of the trustees of these trusts adopting the International Financial Reporting Standards ('IFRS'). When this occurred the trustees incurred considerable costs in obtaining advice, including obtaining Private Binding Rulings from the ATO, confirming that the requisite changes in the trust deed did not result in the creation of a new trust.

11.50 IFSA notes that the Direct Value Shifting rules contained in Division 725 can apply where trust deeds are amended and the result is that value shifts between classes of interests in those trusts. Consequently, under the new MIT regime, there should be no creation of a new trust in these circumstances as there are already appropriate rules contained in the Tax Act to deal with these circumstances.

11.51 Further, Part IVA should apply to any schemes which are entered into for the purposes of obtaining a tax benefit. Consequently there should be no creation of a new trust where a trust relationship remains over trust property as there are already appropriate rules contained in the Tax Act to deal with any schemes entered into by a person for the purposes of obtaining a tax benefit.

11.52 IFSA notes, by way of comparison, that corporate entities do not have any adverse tax outcomes which arise where the members of the Board of Directors are changed or where the company's Articles of Association or constitution are changed. Consequently, for the same reason there should be no creation of a new trust where the trust deed of an MIT is amended or changed.

Part 2 - Carving out certain classes of arrangement from a new MIT regime[9]

The Board seeks 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 gain from those assets)

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

11.53 IFSA recommends that certain classes of arrangement which IFSA refer to as 'simple trusts' be carved out from a new taxation regime for MITs.

IDPS

11.54 An MIT is a pool of investment assets held by one party that the law calls a 'trustee' under an obligation to use those assets on agreed terms for the benefit of a group of parties that the law calls 'beneficiaries'. The law calls this relationship a 'trust'.

11.55 The beneficiaries of an MIT have rights in respect of the pool of assets as a whole but have very limited rights in respect of any particular asset on its own. The beneficiaries share, on a periodic basis, the net income that the assets generate. They have very limited rights in respect of any particular item of gross income.

11.56 The IDPS operator provides a service to its clients which is to acquire and hold specific investment assets that the clients have selected from a menu. These investment assets are typically units in MITs but can also be direct shares. The advantage to the client in using this service is that it is a cost effective way of holding investments. They get the execution of the trades, the collection of income, the paying of their financial adviser's fees and accounting and tax reporting.

11.57 The service provider takes legal title to the investment assets because this allows it to perform its tasks in the most efficient way. The client maintains control of the investment assets it has chosen. They have almost unlimited rights to deal with those assets as they choose. They have almost unlimited rights to exactly the income that their chosen investment assets generate. No more and no less. Their right is to the gross income although at the same time they are committing to pay

[9] Some material in this part of the submission is reproduced with the permission of the author from Michael Brown, 'Collective unconscious: It's time to examine collective investment vehicles', *Business Tax Reform – Meet the Critics*, Australian Tax Research Foundation, Conference Series No. 24, 2006.

certain fees and the IDPS operator has a right to divert that income to meet these obligations.

11.58 The investment assets are fungible and the IDPS operator will pool them for the sake of administrative efficiency. Nevertheless the client maintains rights in respect of a specific number of specific investment assets which are distinct from the rights that each of the other clients has.

11.59 The relationship between the IDPS operator and the client is, again, what the law calls a 'trust'. There is one party, the IDPS operator, holding assets under an obligation to use those assets for the benefit of one or more other parties, the clients. Whether this is one trust or many trusts is not relevant to the current discussion.

11.60 Economically, MITs and IDPSs are two quite different relationships. The income the beneficiary receives from an MIT is a net amount that has been produced through the agreed terms on which the assets have been pooled. The gross income received by the trustee does not go to the beneficiaries in the proportions they share the pool at the time the income is received. The sharing of income is based on the proportions at agreed periodic points in time.

11.61 In contrast, the beneficiaries of the IDPS own specific investment assets and receive the income that is generated by those specific assets at the time that it is generated.

11.62 Income tax relies on being able to identify who has derived income. When there is a trustee and beneficiaries there are two possible answers. The proposed new MIT regime is needed to provide clarity to this and other questions in respect of MITs and to produce tax outcomes that match the economic outcomes.

11.63 For IDPSs this issue is much simpler. Taxing the beneficiary on the easily identified income is a straightforward, low compliance cost approach that matches the economic outcomes without any complications.

11.64 The difficult issues that arise with MITs that need to be solved through a specific legislative regime do not arise with IDPSs.

Other arrangements

11.65 A trust exists when one party has an ownership interest in an asset and has an obligation to use that asset for the benefit of another party. It is a much broader concept than merely an investment structure.

11.66 A trust exists when a parent has a bank account in their name which contains money belonging to their child; when a solicitor holds a client's money in their trust account; when a real estate agent takes a deposit on a property; where a capital raising is oversubscribed; where a loan is made for a specific purpose which fails.[10]

[10] *Barclays Bank Limited v Quistclose Investments Limited* (1970) AC 567.

11.67 Trusts also exist in some circumstances as a remedy in equity, where a court sees the existence of a trust as the best way for justice to be done. A 'constructive trust' exists regardless of the intentions of the parties involved and often contrary to at least some of their interests. When a thief takes money they hold it on trust for their victim.[11]

11.68 Most importantly in financial services, a custodian is a trust. Professional custodians are widely used by MITs and superannuation funds and in many other situations because they can perform tasks in an effective and cost efficient manner.

11.69 There are many situations like those above where the income generated by an asset held on trust passes to the beneficiary in a timely and uncomplicated manner without any sort of modification. There is no need for complex legislation to deal with these situations. Trying to apply an MIT regime or the current Division 6[12] to these situations creates unnecessary difficulties. A simple rule that it is the beneficiary who derives the income or makes the capital gain, not the trustee, is all that is required.

(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.

11.70 IFSA considers that many current problems can be solved by introducing a statutory rule that recognises the economic substance of what IFSA recommends be called 'simple trusts'. The statutory rule would provide that for all income tax purposes it is the beneficiary of the simple trust, rather than the trustee, who derives income and makes capital gains.

11.71 IFSA proposes that the trusts to be subject to this statutory rule be called 'simple trusts' as this expression roughly describes the difference between these trusts and other trusts.

11.72 IFSA proposes that the rule take the following form:

If an asset is held on trust and the trust is a simple trust then for the purposes of the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*:

(a) all ordinary income and statutory income derived in respect of that asset is taken to be derived by the beneficiary of the trust and not to be derived by the trustee of the trust; and

(b) all capital gains and capital losses made in respect of that asset are taken to be made by the beneficiary of the trust and not to be made by the trustee of the trust.

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[11] *Black v S. Freedman and Co* (1910) 12 CLR 105, *Zobory v FCT* 95 ATC 4251.

[12] *Income Tax Assessment Act 1936*

11.73 While there are a number of choices that can be made as to the exact words to use, we propose that the concept of a 'simple trust' be as follows:

- A trust is a simple trust if any income generated by the trust assets is available to the beneficiaries without any modification.
- Legal disability is ignored.
- Security and similar interests in the income are ignored.

11.74 This concept would be best communicated through examples in the legislation.

11.75 This proposal for a rule that in the case of these simple trusts it is the beneficiary who derives the income or makes the capital gain, not the trustee, is not a change to the current law, just a clarification.

11.76 Some commentators assume that the legal owner of an asset, for our purposes the trustee, must be the taxpayer who derives the income from that asset. They then look to apply Division 6 to all trust situations. This assumption is not correct. It can be the beneficial owner of the asset rather than the legal owner who derives the income.

11.77 In *MacFarlane v Federal Commissioner of Taxation*[13] two people carried on business together although everything was registered in just one of their names. The Full Federal Court found that this did not stop the other person from being the one who derived half of the income.

11.78 Fisher J said

> ... it would have been open to the appellant to have contended ... that he and Miss Masterman carried on in partnership the service station business ... The fact that the assets of the business and the invested profits thereof were nominally vested in the appellant was immaterial, there being no dispute between the partners. In these circumstances it was strictly unnecessary to determine whether the appellant held the same as express, constructive or resulting trustee thereof ...[14]

11.79 Beaumont J said

> ... the learned judge erred in holding that, for the purposes of this Act, the legal title to income is determinative.[15]

11.80 After finding that the first person held the assets and income on trust for the second person His Honour said

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[13] (1986) 13 FCR 356.

[14] 357.

[15] 367.

> It follows, in my opinion, that for taxation purposes the income in question should be treated as derived by the appellant and Miss Masterman in equal shares.[16]

11.81 The Commissioner, or at least according to the document, a delegate of the Commissioner, takes the same view in ATO Practice Statement Law Administration PS LA 2000/2 which excuses trustees of so-called 'transparent trusts' from lodging tax returns. It says

> Because the beneficiary has an absolute entitlement to the income of the trust, the beneficiary, and not the trustee, will be taxed in respect of that income notwithstanding the existence of the trust.[17]

11.82 Section 106-50[18] provides a specific rule within the capital gains tax rules that where a beneficiary is "absolutely entitled to a CGT asset as against the trustee" then the beneficiary is treated as making the capital gain or loss rather than the trustee. This is similar to the rule we are proposing although it uses a different trigger. There would be a very high overlap between the situations to which our proposed rule would apply and the situations to which this rule applies. The main difference is that IFSA is proposing a form for this rule that IFSA believe will be less controversial in its application than section 106-50 has proved to be. *Draft Taxation Ruling* TR 2004/D25 containing the Tax Office's interpretation of section 106-50 has not been able to be finalised due its lack of acceptance.

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[16] 368.

[17] paragraph 11.

[18] *Income Tax Assessment Act 1997*

CHAPTER 11A

Introduction

11A.1 Question 11.1(b) of the Discussion Paper asks whether a condition for being in the new regime should be that the investors' rights in the MIT be uniform.

11A.2 There are two strong reasons why this cannot be a condition, if the regime is to be effective. The first is that many MITs, over time possibly most MITs, would choose to stay outside of the regime meaning the Board would have achieved very little. The second reason is that a test like this would create a lot of uncertainty and would lead to compliance problems.

11A.3 In addition, there are no benefits from restricting the regime in this way.

IFSA recommendations

There be no requirement that rights attaching to interests in an MIT be uniform.

The Board of Tax should consider recommending that a single MIT be able to be created with multiple classes, where the law protects members of one class from being subject to the liabilities of another class.

Detailed responses to specific questions

Should rights attaching to interests in an MIT be uniform? (Question 11.1(b))

11A.4 Fundamentally MITs are a pool of investment assets shared by a group of investors. MITs are used because this sharing of assets brings benefits to the investors. One major benefit of an MIT is that the investors can access investments that would otherwise be unobtainable with their small amount of capital. These could be large assets like commercial property or infrastructure assets, hard to find assets like private equity investments or simply a well-diversified portfolio of shares. Another major benefit is that by operating on a large scale the MIT can acquire services such as investment expertise and trade execution at a low cost per investor.

11A.5 MITs are commercial arrangements which the investors are choosing to invest in because it is in their economic interests to do so. Commercially there is no reason why each investor who is sharing the pool of assets has to take exactly the same rights as each other investor. The investors are aware of any differences in rights when they agree to accept the commercial arrangement being offered to them.

11A.6 Having the opportunity to have different rights within an MIT allows this sharing technique to be used in more situations and brings even greater cost savings. The best way to demonstrate this is through the examples below. More and more uses are being found for differing rights. Over time it is quite likely that most MITs will offer some sort of differing rights.

Example 1 – Different Fees

11A.7 A hypothetical fund manager charges three different fee levels based on the economics of different types of investors. Fees are a percentage per annum of the amount invested.

11A.8 For small investors, typically investing amounts measured in tens of thousands of dollars, the fund manager charges 1.5%.

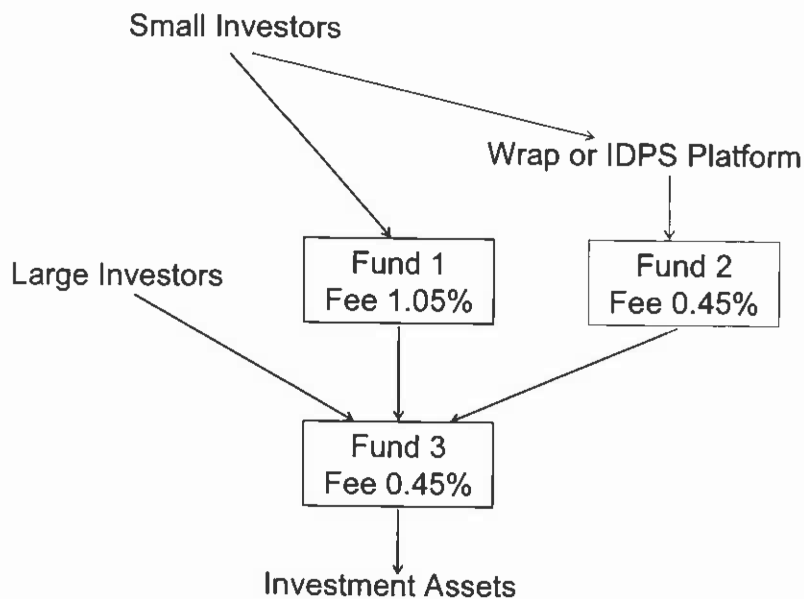
11A.9 Some small investors come to the fund manager through wrap and IDPS platforms. The platform attracts investors which it bundles together investing with the fund manager in larger sums. This reduces distribution and operating costs for the fund manager so they charge a lower fee of 0.9%.

11A.10 Larger investors such as superannuation funds invest even larger sums measured in the tens of millions of dollars. The fund manager has even lower distribution and operating costs in respect of these clients so charges a lower fee of 0.45%.

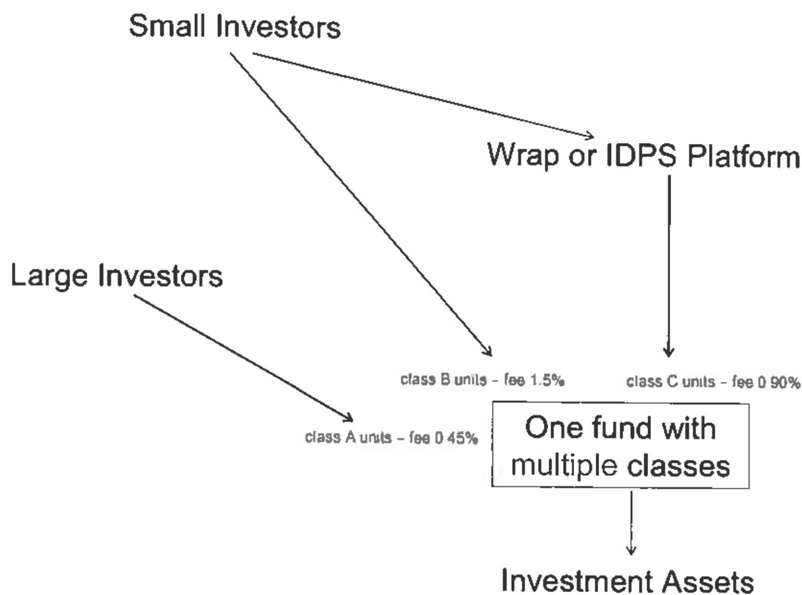
11A.11 The efficient way to charge MIT fees is through the unit price. Unit prices are calculated to allow investors to join and leave an MIT on an equitable basis. The unit price is the net asset value of the MIT divided by the number of units that have been issued. A new investor can join an MIT paying this price or an existing investor can leave an MIT receiving this price and it has no economic effect on any other investor in the MIT. They all maintain the value of their share of the MIT's assets.

11A.12 To maintain this equity, fees are accrued as liabilities, and therefore a reduction in net asset value, each time a unit price is calculated. This ensures that all investors share the fee burden appropriately, even if they join or leave the MIT between fee payments.

11A.13 The hypothetical fund manager in our example would typically have three different MITs for each asset class to allow for the three different fee levels. A typical structure would be something like



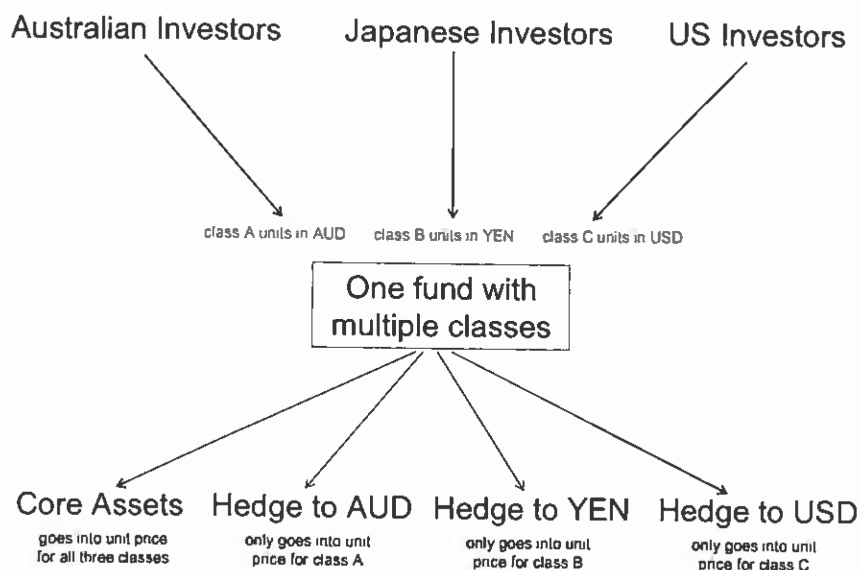
11A.14 A better structure that is slowly being adopted to reduce costs is:



11A.15 In this structure there are three different unit prices. They share a common base being the net asset value of the investment assets but they differ due to the different fees. As the legal and administrative solutions that allow this to work become more widely understood, more and more fund managers will move to this structure. Eventually, most MITs will use this structure.

Example 2 – Different Currencies

11A.16 The following structure is similar to the previous one. It saves costs when clients are investing in different currencies. This will become more important as Australia attracts more offshore clients.



11A.17 Again, this is not a very common structure today but over time will become quite common.

Example 3 – Equity When Investors Join and Leave

11A.18 MITs distribute income periodically. Typically, the income for a quarter is distributed to the investors who are on the register at the end of the quarter. There is an acknowledged slight inequity that arises because some of those investors were not investors for the whole of the quarter. Similarly, there will be some investors who redeemed part way through the quarter without receiving a distribution in respect of the quarter. From a tax point of view, this is shifting amounts between current assessable income and capital gains on redemption.

11A.19 Generally, this slight inequity is tolerated because it is outweighed by the benefits of participating in the MIT. Sometimes a variation in rights can be used to reduce the inequity.

11A.20 One example of this is an MIT listed on a stock exchange that is to have a large capital raising towards the end of a quarter. The MIT could have a provision in its constitution that the units being issued will have no right to that quarter's distribution even though they will be on the register at the end of the quarter. This is something that public companies often do in respect of their dividends when they raise capital.

Example 4 – Separating market returns from outperformance for different investors

11A.21 Broadly, there are two schools of thought in relation to investment management: the 'passive' school which believes that funds cannot outperform the market over time and the 'active' school which believes that some fund managers have the skill to outperform markets over time. The 'active' school of investors is willing to invest in funds which take investment positions which differ from the market index and is willing to pay the fund manager higher fees for this active management skill. Some of these investors prefer a 'market neutral' exposure, meaning they seek only the pure outperformance component of a return. In contrast, 'passive' investors require only market index exposure, which is cheap, and will not pay for active management strategies.

11A.22 Traditionally, fund managers have catered for these two schools of thought by operating separate passive and active funds. Most MITs would fall into one or the other category, however an emerging opportunity is for the fund manager to establish one MIT which pursues a single actively managed strategy with separate 'passive' and 'active' unit classes for investors. This rationalises the MIT operator's product range and introduces economies of scale into the MIT.

11A.23 This is an example of Australia's ability to lead the way in product innovation in managed funds globally. However, this opportunity would not be available to MITs if there were a requirement for investors' rights in the MIT to be uniform.

Example 5 - Charging performance fees inside MITs

11A.24 MITs are also considering ways to respond to the increased demand from some institutional investors for performance-based fees rather than fees based on a flat percentage of funds under management.

11A.25 There are advantages of charging these fees in unit prices – see our discussion in example 1 above. However, new investors in an MIT need an adjustment to performance fees calculated on a whole-of-period basis to exclude the performance of the MIT prior to their investment in the MIT. Similarly, investors who redeem from the MIT prior to period end need a fee charge based on performance up to the time of redemption only.

11A.26 Depending on how often investors are able to enter or leave the MIT, an MIT would need the ability to charge at least three (probably more) different types of performance fees to different investors. This is an emerging area of research for MITs wanting to solve the differential fees problem in a cost-effective and scaleable way – that is, within the fund itself. Again, it is relevant to note that this solution would not be available to MITs if there were a requirement for investors' rights to be uniform.

Example 6 - Discrete Subscription Dates

11A.27 One IFSA member manages a unit trust which was established in 2007, being a $700 million registered managed investment scheme offered to retail investors

which has 62 different unit classes. The commercial rationale for issuing 62 different unit classes in the one unit trust is primarily to facilitate the offer of capital protected investments to investors over a period of time for a range of different investments. Capital protection meaning that the investors are guaranteed to receive back at least the initial amount invested at a set future date. Due to the complicated nature and individually negotiated terms of hedging agreements entered into by capital protected funds, these funds are often offered with a fixed subscription date for a class of investors who wish to invest at one particular time. Later investments are accepted and backed by separate hedging contracts entered into on behalf of another later pool of investors who form another unit class.

11A.28 There are other incidental benefits of having a unit trust with 62 different unit classes including a reduction in compliance costs as only one set of accounts, income tax return and BAS need be prepared rather than 62 of these should the fund have been constituted as individual trusts.

Example 7 - Fixed Returns

11A.29 One fund manager offers a fund that is similar to a menu of term deposits. Investors commit to a particular term, say 12 months, and get a fixed return over that period, say 5.5%. The one MIT offers different periods and over time the return for a given period changes. The investors in the MIT therefore have a right to a variety of different return outcomes.

Example 8 - Capital and Income Beneficiaries

11A.30 There are still many private trusts that have separate capital and income beneficiaries. While currently there may be no MITs targeted directly at this market, the product providers should be able to do so if they choose.

Compliance Problems

11A.31 A condition that the investors' rights in an MIT be uniform would create a lot of uncertainty and would lead to compliance problems.

11A.32 The current system suffers because there is no agreement on what expressions like 'present entitlement' and 'vested and indefeasible interest' mean. A concept of 'uniform rights' is not capable of being defined in a precise way. First there will be disputes on whether something is or is not a right. Then there will be disputes on what sort of characteristics have to match before two things are 'uniform'. Then there will be disputes on the extent to which there is any tolerance for de minimis differences.

11A.33 For example, MIT constitutions often provide the trustee with a discretion to distribute income to a unitholder making a large redemption. This is another technique to reduce the inequity described in example 3 above. This can sometimes provide a significant benefit to the unitholders who are not redeeming. Is this a right? Is it only a right in the years in which there is a large unitholder who redeems? Is this uniform? Analysed before a large unitholder redeems it potentially benefits all unitholders. Can you say that all unitholders could potentially become

large unitholders so this provision applies uniformly to all unitholders or do you have to say that it applies differently to those who currently are large unitholders? Does the analysis change after the trustee exercises the discretion? Does it matter which way the trustee exercises the discretion?

11A.34 Another example is the inability of a unitholder related to the responsible entity to vote on certain resolutions in a unitholders' meeting. Is this a right held by the other unitholders? Can it be uniform given that only some unitholders are related to the responsible entity at any given time? Does it matter whether there are any such unitholders at a given time?

11A.35 A further problem will be that as an MIT changes its constitution over time it could move in and out of being eligible for the regime. Changes to trustee constitutions are often driven by legal imperatives such as changes in the regulatory environment so an MIT will not always have a choice as to whether to accept the change its constitution or not.

No Benefits

11A.36 The Discussion Paper does not provide any arguments in favour of the proposition to limit access to the new regime in this way. It is not apparent that this condition would produce any positive outcomes or avoid any negative outcomes.

11A.37 The Discussion Paper makes a specific reference to private equity funds but only notes that such a condition might be "an issue".[1] Carried interests in private equity funds have been controversial in other jurisdictions. A carried interest is where a service provider to the fund takes an interest in the asset profits rather than a fee. This typically takes the form of an ownership interest in the fund.

11A.38 One controversy in the United States and United Kingdom has been that the share of the asset profits is taxed more lightly than fee income would have been. In an Australian context, a carried interest in an MIT could deliver discounted capital gains whereas the fee income would be fully assessable. If this is an issue that the Board wishes to deal with, there are better solutions than excluding all MITs with varied rights from the new regime.

A further option

11A.39 The Corporations Law in some jurisdictions allow a single entity to be segregated into pools where a particular member only participates in the assets and liabilities of one pool. There is no cross-liability between pools. If one pool becomes insolvent, the members that participate in other pools are protected.

11A.40 In an Australian MIT context this would be a single MIT with multiple classes where the law protected members of one class from being subject to the liabilities of another class.

11A.41 There are administrative and other cost advantages to this structure. The Government may want to consider creating this type of structure in order for the

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[1] paragraph 11.8

Australian funds management industry to compete with other global financial centres that offer it.

CHAPTER 12

Introduction

12.1 Chapter 12 of the Discussion Paper asks whether any of the options for change for MITs should be extended to other trusts.

IFSA recommendations

A specific review of Division 6 be conducted outside of the current review.

Any review of Division 6 should not delay the operation of a new MIT tax regime.

Detailed responses to specific questions

The Board seeks comments on whether any options for change that you have commented upon for MITs should be extended to other trusts? (Question 12.1)

12.2 IFSA acknowledges that the current operation of Division 6 is vague and unclear in certain aspects, affecting its operation in respect of MITs and other trusts such as deceased estates, testamentary trusts, hybrid trusts, and unit and fixed trusts that are not MITs.

12.3 IFSA submits that Division 6 could continue to apply to other trusts such as deceased estates, testamentary trusts, hybrid trusts, and unit and fixed trusts that are not MIT's and recommends a specific review of Division 6 be conducted outside of the current review.

12.4 It may be possible that certain aspects of what IFSA has submitted in the previous chapters could also apply to non-MITs and improve the certainty of the taxation treatment of these trusts.

12.5 IFSA recommends that any review of Division 6 should not delay the operation of a new MIT tax regime.