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Mr Richard Warburton AO
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Dear Mr Warburton

AUSTRALIAN CUSTODIAL SERVICES ASSOCIATION

SUBMISSION ON THE REVIEW OF THE TAX ARRANGEMENTS APPLYING TO MANAGED INVESTMENT TRUSTS

The members of the Australian Custodial Services Association (ACSA) would like to thank the Board of Taxation for the opportunity to provide this submission on its review of the tax arrangements applying to Managed Investment Trusts.

ACSA represents the interests of the custodial industry in Australia. ACSA currently represents members holding securities totalling more than $1.3 trillion in custody and under administration. One of ACSA's main objectives is to encourage the adoption of standardised practices and procedures in custodial services between members.

The review of Australia's Managed Investment Trust regime will have a direct impact on the members of ACSA as they will be required to administer and apply the regime on behalf of their clients being Managed Investment Trusts. ACSA members recommend the Board of Taxation consider a regime that:

- Is simple and practical to administer;
- Will provide a legal framework that is robust and clear; and
- Will enable Australia to compete internationally and become the financial services centre for Australasia.

On this note, ACSA has set out in the attached submission its views and recommendations in relation to the Managed Investment Trust regime.

ACSA would be more than pleased to answer any questions or provide further comments to the Board of Taxation if required. In this regard, all requests should be directed to Elly Grace on (03) 8641 0898.

Yours faithfully

Bryan Gray
Chairman, ACSA

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1. Introduction

The Australian Custodial Services Association (ACSA) currently represents members holding securities in excess of $1.3 trillion in custody and employing in excess of 3,000 people. ACSA welcomes this opportunity to provide the Board of Taxation (BoT) with their ideas regarding the potential redesign of the taxation rules applicable to the managed funds industry. As a key stakeholder, ACSA not only has an obligation to its members to ensure that it fulfils its primary aim of representing the custodial industry and is part of the BoT's consultation process, but it also has an obligation to its client base, to ensure that it highlights the practical difficulties existing within the current taxation regime, so as to facilitate the development of efficient custodial services.

ACSA feels it is crucial to emphasise the administrative and systems difficulties faced by the custodial industry as a result of the complexities of the current taxation rules for trusts. It is often difficult to obtain comfort that the rules are being fully complied with and the time and cost involved in seeking to ensure compliance is enormous.

ACSA has worked closely with the Australian Taxation Office (ATO) in the past in highlighting the problems with the existing rules and on the development of the withholding tax provisions of Subdivision 12-H in Schedule 1 of the Taxation Administration Act 1953 (Subdivision 12-H). Of concern is that despite this close consultation, the resultant Subdivision 12-H remains difficult to administer. This highlights the importance of close consultation with the industry, in particular ACSA, and the allowance of sufficient legislative drafts and time to ensure that simple, workable rules are introduced.

Whatever form the final MIT regime will ultimately take, it would fall upon the members of ACSA to apply the rules and to explain the same to foreign investors and foreign sub-custodians. This is because the vast majority of foreign investments into Australian MITs are under the custody of ACSA members.

For this reason, ACSA feels it critical that it is represented in the consultation group that will be responsible for development of the new rules.

It is also important that once any new rules are introduced, sufficient time is provided before the start date to enable the funds management and custodian industries to alter their systems and processes to fully comply with the new regime. Also importantly, time is needed to explain the new rules and their implications to foreign investors and foreign sub-custodians. As such, it is imperative that the commencement date of the new MIT regime be flagged sufficient ahead of time to avoid the confusion presently experienced by foreign stakeholders in relation to the Subdivision 12-H rules.

2. Chapter 4 – Options for Determining Tax Liabilities

Chapter 4 of the BoT's discussion paper on its review of the tax arrangements for Managed Investment Trusts (MITs) outlines various problems with how the current trust rules of Division 6 of the Income Tax Assessment Act 1936 (Division 6) operate to determine tax liabilities in respect of MITs.

Australian Custodial Services Association

Some of the problems in relation to Division 6 stem from the lack of definitions of various terms in Division 6 and the need to rely on legal interpretations of various court cases. As a result, this causes uncertainty and complexity in the application of Division 6 to MITs.

The BoT suggests 3 options for determining tax liabilities of MITs, being the trustee assessment and deduction model, the trustee exemption model and the 90% distribution threshold model.

The BoT also notes that other countries have specific taxation regimes for MITs and / or real estate investment trusts (REITs) and provides a summary of some of these regimes in Appendices E and F to their paper. Many of these regimes involve a MIT being deemed for tax purposes to be a tax free company where the distribution is taxable as a dividend in the hands of the investor. Where the distribution is made to a non-resident, dividend withholding tax applies. However, flow through treatment is provided for certain components, mainly being capital gains.

In order to address the uncertainties and complexities in Australia's current taxation rules for trusts, ACSA recommends the BoT consider adopting a corporate flow-through Corporate Investment Vehicles (CIV) regime similar to that adopted in some other countries. More details of the proposed regime are provided below. You will note that this recommendation adopts certain aspects of each of the 3 abovementioned options put forward by the BoT as alternatives to the present regime.

ACSA recommendations

ACSA recommends a new Division be introduced into the Income Tax Assessment Act 1997 to deal with the taxation of MITs.

Structure of the new regime

- The new regime should only apply to trusts that operate within the MIT industry. This will require an appropriate definition to ensure the desired outcome (refer Section 7 below).

- Trusts that are not within the MIT industry, as defined by the new regime, should continue to be subject to the present Division 6. The new Division and Division 6 should operate mutually exclusively.

- The preferred terminology for trusts that fall within this new Division is "Collective Investment Vehicles". This terminology is more widely recognised by foreigners within the global investment industry. (The rest of this submission will refer to the corporate CIV regime).

- The new Division should clearly outline how the corporate CIV regime is to operate and, in respect of taxation matters, place less reliance on constituent documents and legal interpretation of terms.

How should a CIV and its investors determine their tax liabilities?

ACSA recommends that CIVs and their investors determine their tax liabilities as follows:

- CIVs should be treated as non-tax paying corporate entities with a certain level of flow through treatment.

- CIVs should calculate their taxable income in accordance with the general provisions with the Income Tax Assessment Acts. For example, the general rules governing assessable income and allowable deductions should be applicable.

- The cash distribution of CIVs should be required to be, as a minimum, their taxable income on a yearly basis, excluding tax gross ups for credits/offsets

- CIVs should not be entitled to the CGT discount. Therefore, the taxable income of a CIV will include the undiscounted capital gain. Upon distribution of the taxable income, the investors will be entitled to claim the relevant CGT discount that applies to them.

- Investors in CIVs should be assessed on the distributions received on a "receipt basis". This would remove the problems with the term "present entitlement". This possibility is addressed in paragraph 4.28 of the BoT paper. Notwithstanding that paragraph 4.28 relates to the trustee assessment and deduction model referred to above, a similar approach could be adopted in the context of a non-tax paying corporate CIV.

- The components of a CIV distribution should be kept to a minimum. Unlike the current regime which requires trusts to keep track of many different types of income, the proposed CIV regime will have less components. ACSA recommends that the components of a distribution from a corporate CIV should be limited to:

  Cash items
  - Australian sourced income
  - Foreign sourced income
  - Capital gains
  - Return of capital

  Non-cash items
  - Franking credits
  - Foreign Tax Credits

- As the cash component to a distribution would only consist of taxable income and capital, the concept of tax deferred distributions would be removed.

- The distribution entitlement of each investor should be determined based on the units held as a proportion to total units on issue as at declaration date.

Benefits of proposed corporate CIV regime

The proposed corporate CIV regime will provide many benefits to the funds management industry and assist in addressing many of the current problems. The benefits will include:

- Similar to the current rules, tax is payable in the hands of the investors but there are fewer components making the treatment less complex. This is consistent with Policy Principle 1 referred to in the BoT's paper as one of the terms of reference for the BoT's review. That is, the tax treatment for investors who derive income from the MIT should largely replicate the tax treatment for taxpayers as if they had derived the income directly.

- The distribution of fewer components will simplify the withholding requirements for distributions made to foreign investors (see further comments under Section 3 below).

- No tax deferred distributions would mean no revenue deferral to the Government as all amounts of distributions are assessable upon receipt.

- Any return of capital would give rise to an adjustment to the cost base of units in the CIV, as per the current rules.

- As CIVs would be treated as corporates for Double Tax Agreement (DTA) purposes, this would ensure the CIVs are recognised for treaty purposes thereby removing the current problems of units trusts not being recognised.

- The corporate CIV regime would be easier to understand globally thereby making Australia more internationally competitive.

Correcting Errors in Calculating Net Income – treatment of 'unders' and 'overs'

Chapter 4, paragraphs 4.32 – 4.39, of the BoT paper discusses the problems CIVs face as a result of complexity of the existing rules and time constraints, commonly referred to as the 'unders and overs' problem. The BoT poses 2 possible solutions to the 'unders and overs' problem referred to as the carry forward approach and the credit/deduction approach.

If the corporate CIV regime outlined above were to be adopted, the prevalence of the 'unders and overs' problem would be reduced. The reasons for this are:

- CIV's would not be receiving distributions from other CIV's with a multitude of components, making it easier for a CIV to more accurately determine the components of taxable income to be distributed to investors; and

- the cash component to the distribution would only consist of income and capital.

However, as the 'unders and overs' problem would not be eliminated entirely, ACSA recommends introducing a specific rule to address it, as outlined below.

ACSA recommendations

- ACSA recommends adopting the carry forward approach outlined in the BoT paper. Under this approach, CIVs would be able to carry forward an under or over into the following income year (that is, as an increase or decrease to net income).

- ACSA acknowledges that a de minimis rule would be appropriate. However, the de minimus example given by the BoT of 2% of net income is too low and would be administratively onerous both to CIVs and the Australian Taxation Office.

- ACSA recommends a de minimus threshold of 5% of the net income of the CIV. That is, if the taxable income (excluding gross ups) distributed to investors is more than 5% lower that the actual taxable income (excluding gross ups), then a special distribution would be required to be made to investors.

- ACSA recommends that no amendment be made for an over distribution from a CIV, irrespective of whether it is greater than the 5% de minimus threshold. This means that tax will be paid by investors earlier than required. However, a specific rule should be legislated allowing the CIV to reduce its taxable income in the following year to reflect the over payment of tax in the prior year.

- ACSA recommends that consideration be given to the inclusion of integrity measures in the regime to deal with the unders and overs matter.

- ACSA acknowledges that this approach would not rectify the inequities in the allocation of liabilities which can arise when investors redeem or sell their units before errors in the calculation of the net income of the CIV have been identified. However, in ACSA's view, any possible solutions to this problem would be too administratively onerous.

3. Chapter 5 – International Considerations

Chapter 5 of the BoT paper outlines the current international tax treatment of MITs. The BoT highlights that where a MIT distributes income to a non-resident, 2 separate sets of tax rules are applicable (i.e. Division 11A and Subdivision 12-H) and that the rules are very complex and cause administrative difficulties. It also highlights the fact that double tax agreements (DTAs) are difficult to administer where trusts are involved. However, the paper neglects to mention the following additional problems in respect of the current withholding rules for Australian trusts distributing to non-residents:

- The withholding provisions under the general trust tax rules can also apply in addition to the 2 abovementioned sets of tax rules (i.e. Section 98 of Division 6).

- Subdivision12-H has been drafted without knowledge of the intricacies of the funds management industry and systems requirements and is therefore administratively difficult to comply with and will often lead to double taxation.

- Subdivision12-H applies withholding tax to a 'fund payment' as defined. The definition is complex and is not a term that is used outside Australia such that it is not recognised internationally.

- Subdivision12-H was drafted without consideration of the recent changes to the taxation of foreign income rules, generally applicable from 1 July 2008. For example, the quarantining of foreign loss rules were removed from the general tax loss rules. However, technically foreign losses need to be quarantined for the purposes of the Subdivision12-H withholding rules. The practical implication of this is that it gives rise to the need for 2 registry systems to be maintained.

- The fact that foreign losses and Non-taxable Australian property (NTAP) capital losses must be disregarded when calculating the Subdivision 12-H withholding tax payable can lead to the amount of withholding tax payable being greater than the cash distribution from the MIT.

- Subdivision 12-H imposes withholding obligations on MITs, custodians and any other entity that passes a fund payment on to a non-resident. The wide range of entities covered by Subdivision 12-H imposes an additional administrative burden on non-MIT/custodian entities.

- Information on the components of a distribution is not generally available at the time withholding tax is payable and therefore it is not possible to determine the correct amount of withholding tax payable. The rules do not cater for later adjustments to pay extra or obtain refunds for incorrect withholdings.

- The complexity in the rules is an impediment to foreign investors.

The above problems would be substantially reduced should the corporate CIV regime recommended by ACSA be introduced. The reasons for this are that:

- Corporate CIVs would qualify for treaty benefits in their own right. The BoT paper at paragraph 5.16 states that the OECD considers it desirable for MITs to be able to claim treaty benefits on behalf of beneficiaries, and also that income derived by corporate CIVs should be recognised as flow-through for treaty purposes.

- There would be fewer components for the CIV to calculate withholding tax on.

Additional ACSA recommendations

In addition to the features of ACSA's recommended corporate CIV regime outlined above, the following changes are recommended to the withholding rules for corporate CIVs:

- Subdivision12-H should be reworked with close consultation with the funds management and custodian industries. The rules should be very prescriptive, clear, simple and use terminology consistent with the OECD guidelines.

- The application of Subdivision 12-H should be restricted to MITs and custodians.

- The Australian sourced income component of a CIV distribution should form part of the "fund payment" for the purposes of Subdivision 12-H. This, together with capital gains related to Australian real property, would be the only components subject to Subdivision 12-H withholding tax.

- It should be made clear that the only withholding rules that can apply to corporate CIVs are those in Subdivision12-H. Division 11A and the withholding provisions under the general trust tax rules (Section 98 of Division 6) should be specifically precluded from applying.

- The distinction between Exchange of Information (EOI) and non-EOI should be removed from Subdivision12-H. Instead, there should be one set of withholding rates for treaty countries and one for non-treaty countries.

4. Chapter 6 – Trusts as Flow Through Vehicles

Chapter 6 of the BoT paper outlines the fact that under the existing rules double tax and other distortions can arise where trust distributions differ from the net income of a trust. The BoT also states that tax deferred distributions are administratively onerous and give rise to risk of errors.

Other problems highlighted in Chapter 6 are as follows:

- Under existing rules flow through treatment of trusts is not specifically legislated and recent case law has raised uncertainty as to its applicability.
- There are currently no specific rules for allocating expenses and tax losses to the different categories of trust income.
- The complexities of the rules lead to high compliance costs, as demonstrated by the detail required in the ATO's standard distribution statement.

A further problem not highlighted is the uncertainty under the current rules as to whether foreign tax credits (FTCs) can be distributed if a trust does not distribute any foreign income, and the fact that at least $1 of net income needs to be distributed to enable franking credits to pass to investors.

The corporate CIV regime recommended by ACSA would eliminate or reduce these problems for the following reasons:

- On the basis that the corporate CIV regime recommended incorporates a requirement that the cash distribution from a CIV be at least equal to taxable income (excluding tax gross ups for credits/offsets), the prevalence of these distortions would be reduced.
- Removal of tax deferred distributions would eliminate the related administrative burden and would remove the potential for double taxation.
- A distribution from a corporate CIV would comprise fewer components, thereby reducing compliance complexities.
- The flow-through treatment would be specifically provided for in the legislation.

Additional ACSA recommendations

In addition to the features of ACSA's recommended corporate CIV regime outlined above, the following changes are recommended:

- Prescriptive rules should be legislated in relation to the allocation of expenses and losses against components of a corporate CIV distribution.
- Paragraph 6.25 of the BoT paper suggests that distributions to foreign residents could have different character retention arrangements. For example, a different approach could apply to portfolio and non-portfolio foreign beneficiaries. ACSA does not advocate these distinctions on the basis that it would increase complexity and therefore compliance costs.
- Specific rules should be incorporated into the corporate CIV regime to deal with FTCs and franking credits. ACSA recommends that where a CIV has no taxable income in a year, excess FTCs and franking credits should either be allowed to be distributed to investors or carried forward by the CIV.

5. Chapter 8 – Definition of Fixed Trust

Chapter 8 outlines a number of tax concessions that are available to widely held trusts and notes that eligibility for these concessions is dependent upon the trust qualifying as a fixed trust. The definition of 'fixed trust' is not particularly clear and differs for the purposes of different areas of the tax rules. This causes significant compliance costs and uncertainties as to whether a particular MIT qualifies for the various concessions in the tax rules.

One option for clarifying the treatment of fixed trusts put forward in the BoT paper is for a rule to be introduced whereby certain MITs would be deemed to be fixed trusts.

ACSA recommendation

- ACSA endorses this option put forward by the BoT and recommends that all corporate CIVs qualifying for the CIV regime recommended above be legislatively deemed to be fixed trusts for all purposes of the tax rules.

Trust loss rules

One of the tax concessions available to fixed trusts outlined in Chapter 8 is that under the trust loss rules. A problem faced by fixed trusts not referred to in the BoT paper is the 50% stake test applicable to fixed trusts under the trust loss rules.

When determining whether the 50% stake test has been passed, it is necessary to look at individuals holding fixed entitlements, directly or indirectly, in the trust. The indirect holding of fixed entitlements in a fixed trust may be traced through interposed entities (trusts, companies and partnerships) which themselves confer fixed entitlements to their income or capital. It may also be necessary to trace fixed entitlements indirectly through other entities to see if a change in ownership of the trust has occurred. This requirement to trace through indirect entitlements of a fixed trust is administratively onerous for the MIT industry and often it is impossible to accurately apply, leaving MITs with uncertainty as to the availability of their tax losses.

There is a special rule for listed public companies and widely held unit trusts, whereby the Commissioner has discretion to treat the interposed company or trust as an individual holding fixed entitlements for its own benefit. The factors to which the Commissioner will have regard are the practicability of identifying individuals indirectly holding fixed entitlements, changes in the composition of the individuals and other relevant matters, such as abnormal dealings in the listed company's shares.

The fact that the Commissioner must exercise its discretion in this respect is administratively onerous for the funds management industry. In addition, the time constraints of needing to provide investors with distribution statements which rely on the net income of the trust mean it is impracticable to wait for the Commissioner's discretion to be exercised.

ACSA recommendation

- The 50% stake test should be changed to ensure that entities qualifying for the corporate CIV regime recommended by ACSA are not required to trace through indirect interests.

6. Chapter 9 – Eligible Investment Business Rules in Division 6C of the ITAA 1936

Real Estate Investment Trusts (REITs)

Chapter 9 of the BoT paper discusses, inter alia, REITs. It notes that there is no internationally consistent definition of REIT. However, it, together with Appendix E, highlights the fact that REIT is a common internationally recognised term and that a number of countries have separate tax regimes for REITs. The paper outlines some costs and benefits of a separate REIT regime.

A problem has been encountered by ACSA members in applying certain DTAs due to the fact that some treaties use REIT terminology that is inconsistent with terminology used in Australia's tax laws. For example, the Australia/Japan treaty.

ACSA recommendations

- Given that REITs have become common investment vehicles internationally, ACSA considers it essential that the term REIT is at least defined in Australia's tax law.

- A disadvantage pointed out by the BoT of a separate REIT regime is tax system complexity and additional compliance costs for the industry, ATO and investors. ACSA agrees and notes that if a sophisticated CIV regime is introduced, there may not be a need for a separate REIT regime.

- If a separate REIT regime were to be introduced, ACSA recommends that the ATO maintain a list of all of the entities that qualify as REITs under the regime.

7. Chapter 11 – Defining the Scope of a MIT

Chapter 11 of the BoT paper addresses the factors that should be considered in determining which entities qualify for any new regime introduced for MITs. The paper notes that the terms of reference for the BoT review were to look at options for introducing a special taxation regime to cover managed funds that operate as MITs that:

- Are widely held; and

- Undertake primarily passive investments.

This implies that these characteristics would be required in any new regime to be introduced.

The paper outlines the requirements under existing rules to qualify as a widely held trust and notes that there are different definitions in different areas of the tax rules. It is inefficient to have different definitions of widely held for the purposes of different areas of tax rules. In addition to this, in ACSA's experience it is the widely held requirement that most commonly gives rise to a fund not qualifying for MIT treatment. In ACSA's view, it is questionable whether there really is a need for a fund to be widely held to qualify for MIT treatment.

Under current rules, a subsidiary fund will generally qualify as widely held provided a certain percentage of units are held by another widely held trust. However, where a non-widely held trust holds units in a widely held trust, the first mentioned trust does not qualify as an MIT. This causes substantial administrative problems for the custodian industry in that firstly it is necessary to determine whether a client is widely held and secondly it is necessary to maintain 2 separate systems to apply 2 separate sets of rules.

ACSA recommendation

- Ideally, there should be no requirement for a fund to be widely held to qualify as a corporate CIV under ACSA's recommended corporate CIV regime. Instead, the only requirement should be that the fund operates in the funds management area. For example, this could incorporate the definition of Managed Investment Scheme under the Corporations Act 2001, as is the case with the existing withholding rules of Subdivision12-H.

- If this recommendation is not accepted, a clearly defined, simple definition of widely held should be incorporated into the new corporate CIV regime and should be made consistent throughout all areas of the tax rules.

- Chapter 11 poses the question of whether a MIT should be able to make an irrevocable election to be governed by the new MIT regime. It is not clear whether this suggestion is envisaging a fund that does not at a particular time meet all of the MIT criteria being entitled to elect to be treated as an MIT. If this is what is envisaged, ACSA would endorse this suggestion as it would give effect to our ideal recommendation that non-widely held funds operating in the managed investment industry should be entitled to MIT treatment.

- It is possible that the suggestion of being able to make an irrevocable election to be governed by the new MIT regime is referring to a fund that at a particular time satisfies the MIT requirements being able to make an irrevocable election to avoid the need for constant monitoring of eligibility. ACSA would also support this election as it would reduce administrative burdens.

- Consideration should be given to providing listed investment companies the option to make an irrevocable election to be governed by the new regime for CIVs and Subdivision 12-H.

- Chapter 11 also poses the question of whether rights attaching to the units of an eligible MIT need to be uniform. ACSA's view is that there should be no such requirement, such that trusts with multiple classes of units should be entitled to qualify for the new regime.

- Any requirements prescribed for qualifying for a new regime should ensure that both listed and unlisted trusts are eligible.