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The Board of Taxation
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By email: taxboard@treasury.gov.au

Dear Sir/Madam,

Submission
Review of the tax arrangements applying to managed investment trusts

We welcome the Board of Taxation's (**Board's**) review of the tax arrangements applying to managed investment trusts, and appreciate the opportunity to make a submission in relation to some of the questions raised in the October 2008 Discussion Paper (**Discussion Paper**).

The current state of the global economy presents new challenges for Australia's funds management industry. Although these challenges are outside the scope of our submission, we consider that they make it even more important than usual, that Australia's tax system does not raise unnecessary or unintended barriers to investment in or through local managed investment trusts.

We are aware that many firms, companies and institutions are likely to make submissions to the Board. We have therefore confined our own submission to one high-level policy issue – specifically, the erosion of any policy justification for Divisions 6B and 6C of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**).

If you have any queries in relation to this submission, please do not hesitate to contact Duncan Baxter (Practice Head – Tax) on (03) 9679 3014 or duncan.baxter@blakedawson.com. We also would be happy to meet with the Board to discuss our comments in further detail (if required).

Yours faithfully

Inconsistency between Policy Principle 1 and Policy Principle 2 and the erosion of policy support for Divisions 6B and 6C of the 1936 Act

Recommendations

That the Board predominantly has regard to Policy Principle 1 in developing options for reform of the tax arrangements applying to managed investment trusts.

That the Board consider repealing Division 6B and Division 6C of the 1936 Act in their entirety.

The terms of reference for the Board's review of the tax arrangements applying to managed investment trusts are (in part) as follows:

TERMS OF REFERENCE

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

1.6 The broad policy framework for the taxation of trusts is to tax the beneficiary on its share of the net income of the trust, so that the trustee is only taxed on income that is not taxable in the hands of beneficiaries. Within this framework, the Board should ideally develop options for reform with taxation outcomes that are broadly consistent with five key policy principles:

Policy Principle 1

1.7 The tax treatment for trust beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly.

Policy Principle 2

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

[etc.]

Policy Principles 1 and 2 are clearly inconsistent inasmuch as Principle 1 supports flow-through taxation for beneficiaries of trusts generally; whereas, in relation to widely-held trusts, Principle 2 would limit flow-through taxation to beneficiaries of trusts that primarily engage in passive investment activities. Or, to put the point another way, Principle 2 sets up an exception to Principle 1 in the case of beneficiaries of widely-held trusts that derive business income (perhaps beyond a *de minimus* level of activity).

One must therefore ask three questions. First, what exactly are the "tax advantages available [only] to trusts"? Second, why are these tax advantages only of concern in relation to **widely-held** trusts? Third, why are these tax advantages only of concern in relation to **business** income?

In our view, the most important question is the first. The unique tax advantages of trusts should reveal clearly why, from a policy perspective, the business income of widely-held trusts is so troubling as to justify denying flow-through taxation. If these advantages do not justify such treatment then we must seriously question the policy basis for Divisions 6B and 6C of the ITAA 1936 (which do just that).

Division 6B – Corporate unit trusts

Division 6B of the 1936 Act was inserted by *Income Tax Laws Amendment Act (No. 3) 1981* (Cth) (**Amendment Act**) as an integrity measure. The Federal government had identified a loophole in the classical system of company taxation, in that a company could transfer an income-producing asset to a trust, thereby avoiding the double taxation of any future income.

This "integrity" nature of Division 6B was made clear in the second reading speech in relation to the Amendment Act:

> The main concern of the Government in this respect is to prevent *ad hoc* erosion of the so-called classical system of company taxation through the use of unit trusts by public companies.
>
> Accordingly, the broad thrust of the amendments is to remove the taxation advantage sought by companies from placing income producing property in the hands of unit trusts.
>
> This is to be achieved basically by treating unit trusts evolving from the practice as if they were companies for tax purposes.

To modern eyes, the government's desire to protect double and multiple taxation of company profits seems quaint. This largely derives from the fact that Australia very emphatically rejected the "classical system of company taxation" in 1987 when it introduced the imputation system. Indeed, the first words of the second reading speech by the Hon. Paul Keating, in relation to the *Taxation Laws Amendment (Company Distributions) Bill 1987*, were:

> This Bill will give effect to the most significant business taxation reform in this country in the post war years - the elimination of the double taxation of company dividends.
>
> It will do this by amending the income tax law to introduce, with effect from 1 July 1987, the full imputation system of company tax announced on 10 December 1986.

See also the explanatory memorandum to the *Taxation Laws Amendment Bill (No. 3) 1987* [Notes on Clause 15]:

> Under the imputation system of company tax, income subject to tax in the corporate sector and distributed to resident individuals will be subject to only a single tier of taxation. The circumstances in which a tax avoidance advantage by way of disguised distributions will arise will therefore be reduced, but not eliminated, relative to the scope for disguised distributions under the classical two-tier system of corporate taxation which the imputation system replaced.

Edmonds J recently took judicial notice of this change in policy in *Hastie Group Ltd & Ors v FC of T* 2008 ATC 8259 (at pp.8259-60):

> In 1987, Australia introduced an imputation system (Pt IIIAA of the ITAA 36) for the taxation of companies and their shareholders in replacement of the classical system which had hitherto existed. Subsequent changes were made to the provisions of Pt IIIAA of the ITAA 36 prior to their embodiment in Pt 3-6 of the *Income Tax Assessment Act 1997* (Cth) ("the ITAA 97"), however I am not aware of any judicial consideration of these provisions as originally enacted or as changed.

The change in policy also did not escape the notice of the Commissioner of Taxation, who in IT 2439 *Income Tax: Notification requirements for certain dividends paid by private companies under the phasing-out arrangements for Division 7* commented that:

> With the introduction of the imputation system of company tax, which involves the alignment of the company tax rate with the maximum marginal rate of personal income tax, the additional tax on the undistributed income of private companies will last apply, in its traditional form, to profits of the 1985-86 year. However, to prevent a revenue loss through the retention by private companies of income of 1985-86 and earlier income years that would have been required to have been distributed to shareholders and taxed in their hands, under the previous "classical" system, the abolition of the undistributed profits tax will be subject to certain phasing-out arrangements.

In fact, the income tax consolidation rules carefully preserved the distinction between pre-1987 company profits, which were supposed to be double-taxed; and post-1987 profits, which were not. We therefore see the following observation in the explanatory memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002* [at para.5.84]:

> The purpose of this step is, consistent with the imputation system, to prevent double taxation by allowing a consolidated group a cost for retained taxed or taxable profits that accrued to membership interests when the membership interests were held by the consolidated group (as can occur where there is an incremental acquisition of an entity). The group's allocable cost amount is spread across all of the joining entity's assets at the joining time, including assets that represent earnings whilst the group has held membership interests that have been retained in the entity. Therefore, not to add an amount for these retained earnings in the allocable cost amount would result in double taxation upon the disposal of those assets. The step is not intended to prevent the double taxation of profits derived under the classical system of company taxation that existed before the imputation system was introduced.

The Commissioner of Taxation again acknowledged the underlying policy change in TD 2004/56 *Income tax: consolidation tax cost setting rules: step 3 of the allocable cost amount: how do you work out the paragraph 705-90(6)(b) of the Income Tax Assessment Act 1997 amount where only some of the undistributed profits of a year have recouped losses prior to the joining time?* [at para.3]:

> Step 3 is not intended to prevent the double taxation of profits derived under the classical system of company taxation that existed before the imputation system was introduced (see paragraph 5.84 of the Explanatory Memorandum to the *New Business Tax System (Consolidation) Bill (No. 1) 2002*). That is, even if pre-1987 profits may have been taxed they are not added at step 3 to the extent to which they are represented in the undistributed profits under subsection 705-90(2).

We may therefore readily dismiss Division 6B as an integrity measure whose purpose was to protect a government policy that was abandoned, and actually reversed, more than 21 years ago. Surely it is past time to repeal this artefact of a bygone era?

Division 6C – Public trading trusts

Division 6C is of slightly more recent origin. It was originally announced in the same Ministerial Statement as the imputation system for company dividends (see *Reform of the Australian Taxation System* dated 19 September 1985). At the time, the Hon. Paul Keating said that:

> **INCOME TAX ON PUBLIC UNIT TRUSTS**
>
> The draft White Paper drew attention to the increasing use of trusts to avoid company tax. Although the reforms to the company tax arrangements, which I shall mention shortly, will reduce the incentive to use trusts, there would still be advantages for tax-exempt institutional investors in the trust form. The Government has therefore decided to extend company tax arrangements to public unit trusts but only those which operate a trade or business, as distinct from the great majority which are vehicles for investing in property, equities or securities. These latter public unit trusts, and all private trusts, will be unaffected by this measure. The new arrangements will apply to trusts established after today to operate a trade or business. There will be reasonable transitional arrangements to phase in the new treatment for existing trusts of that kind, with first company tax payments not required before 1988-89.

In other words, the Federal government had identified a loophole in its imputation system of company taxation, in that a tax-exempt entity might hold an income-producing asset through a trust, thereby avoiding the single taxation of any future income. It follows that Division 6C was also an integrity measure of a similar kind to Division 6B although, in this instance, one designed to protect the integrity of single taxation under the imputation system rather than double taxation under the classical system.

If that were the end of the policy changes, Division 6C might still have a role to play today. However, two further legislative changes subsequently cut the policy ground from beneath the Division:

- With effect from 1 July 1988 the Federal government imposed tax on complying superannuation funds, approved deposit funds, pooled superannuation trusts; and on the complying superannuation and rollover annuity income of life assurance companies and registered organisations.[1] This meant that by far the largest category of "tax-exempt institutional investors" was now subject to income tax.

- For dividends paid on or after 1 July 2000, the Federal government has even allowed individuals, complying superannuation entities, and most tax-exempt charities to claim refunds in respect of their surplus imputation credits.[2] This means that almost all tax-exempt and concessionally-taxed institutional investors can now derive full benefit from such credits.

The combined effect of these two changes is that, since 1 July 2000, there has been no need for any integrity measure to protect the single taxation of company profits, because the imputation system now makes the relevant "loophole" a **design feature**.

We may therefore also dismiss Division 6C as an integrity measure whose purpose was to protect a government policy that was reversed more than 8 years ago. Surely it is also time to repeal this artefact of a bygone era?

It is, of course, faintly conceivable that more recently-created "tax advantages" could provide a policy basis for retaining either or both of Divisions 6B and 6C. However, in the modern era, advantages such as access to discount capital gains tax treatment, preservation of the source or character of income, or access to foreign tax credits do not raise the same systemic integrity concerns as those that motivated the introduction of these two Divisions.

It follows that, in our view, both Divisions 6B and 6C should be repealed.

1 Refer to the amendments made by the *Taxation Laws Amendment (Superannuation) Bill 1989* and the *Income Tax Rates Amendment Bill (No. 2) 1989*.

2 Refer to Div.67 of the ITAA 1997 which was inserted by the *New Business Tax System (Miscellaneous) Bill 1999*.