The Institute of Chartered Accountants in Australia

18 December 2008

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

By email to: taxboard@treasury.gov.au

Dear Sirs

Review of the tax arrangements applying to managed investment trusts

The Institute of Chartered Accountants in Australia welcomes the review of the tax arrangements applying to managed investment trusts (MITs) to be undertaken by the Board.

The Institute is Australia's premier accounting body which represents over 48,000 members working in the accounting profession providing auditing, accountancy, taxation and business consultancy services or in diverse roles in business, commerce, academia or government.

Given the limited time frame for commenting on the Discussion Paper and the fact that detailed submissions are being made by industry specific bodies, our comments are limited to the following specific issues and questions raised in the Discussion Paper:

- The conflict between the first two Policy Principles in the Terms of Reference
- The desirability of extending relevant aspects of the recommended changes to tax arrangements for other trusts
- Potential reforms to the eligible investment business (EIB) rules in Division 6C of the *Income Tax Assessment Act 1936* (ITAA 1936)
- Whether there is a continuing need for the tax integrity rules in Division 6B of ITAA 1936 and
- The capital versus revenue account treatment of gains and losses made on disposal of investment assets by MITs.

The conflict between the first two Policy Principles in the Terms of Reference

The *Terms of Reference* for the Board's review set an "aspirational" goal of consistency with five key policy principles:

> The broad policy framework for the taxation of trusts is to tax the beneficiaries on their 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:
>
> i. 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;

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ii. 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;

iii. [etc.]

The Institute supports the first of these Policy Principles strongly. It is consistent with considerations of economic efficiency, equity and simplicity that taxpayers who choose to pool their investments through a managed investment trust, should not be taxed any differently as a result.

However, we have considerable difficulty with the second of these Policy Principles, which carves out an exception to the first Policy Principle in the case of widely-held trusts that derive business income. This exception is supposedly justified on the grounds of "the tax advantages available to trusts that are not available to companies". One must therefore enquire as to the nature of these "tax advantages", and ask whether they truly justify an exception from the first Policy Principle.

The Corporate Unit Trust rules in Division 6B were introduced to protect the "classical system" of company taxation, under which the profits of a company were taxed twice (once in the hands of the company, and again when they were distributed to the shareholders as dividends). The second reading speech in relation to the *Income Tax Laws Amendment Bill (No. 3) 1981*, which introduced Division 6B, described its purpose as follows:

> 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.

As is well-known, in 1987 the Federal government abolished the classical system of company taxation and replaced it with the Dividend Imputation rules (see *Hastie Group Ltd. & Ors. v. F.C. of T.* 2008 ATC 8259 per Edmonds J (at pp.8259-60)). It follows that, to the extent the "tax advantages", to which the second Policy Principle refers, were the same as the "taxation advantage" referred to in the second reading speech, it has been more than 20 years since they ceased to be available.

The Public Trading Trust rules in Division 6C were announced in the same *Ministerial Statement*, of 19 September 1985, as the Dividend Imputation rules. The relevant part of the Statement described the purpose of the Public Trading Trust rules as follows:

> 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.

We note that the Statement expressly acknowledged that the Dividend Imputation rules would "reduce the incentive to use trusts" and thus reduce the taxation advantages from structuring an investment through a trust rather than a company. However, the government remained concerned that tax-exempt institutional investors could secure tax advantages by investing through a trust structure. This was, essentially, the ability to apply their own tax-exemption against the relevant income.

Three subsequent changes to the income tax law reduced the significance of this tax advantage:

- In 1989 the Federal government imposed tax on the largest institutional investors – ie. complying superannuation funds, complying approved deposit funds, pooled superannuation trusts; and life assurance companies and friendly societies (in respect of their complying superannuation business).

- From 1 July 2000 the Federal government permitted individuals and complying superannuation entities to claim a refund of their excess imputation credits.

- From 1 July 2000 the Federal government also permitted resident tax-exempt entities, including resident registered charities and gift-deductible organisations, to claim a refund of excess imputation credits. Note that the explanatory memorandum to the *New Business Tax System (Miscellaneous) Bill 1999* stated that (at paras 1.2 and 1.3):

> Under the current law, resident tax-exempt entities, including resident registered charities and gift-deductible organisations, are not able to get a refund of underlying company tax paid on investments in and through companies. This may create a tax-driven distortion away from such investments.
>
> By allowing refundable imputation credits to eligible charities and gift-deductible organisations, the tax-driven distortion is removed because the underlying company tax will be refunded. Given the nature of the organisations eligible for this concession, and the limited cost to the revenue from restricting it to those organisations, refunding underlying company tax in these circumstances is appropriate.

The net result of these three changes was that most tax-exempt institutional investors were either no longer tax-exempt, or were entitled to claim a refund of the underlying company tax. In most cases this meant that there was no longer any significant tax advantage to structuring an investment through a trust rather than a company. Indeed, as the above quote from the explanatory memorandum makes clear, modern tax policy actually justifies flow-through taxation of the income.

There remain a number of other differences between the taxation of trusts and companies. However, differences such as preserving the character or source of income, access to foreign tax credits, or the benefit of capital allowances, do not raise systemic "integrity" issues such as those that led the government to introduce Divisions 6B and 6C. We therefore submit that the Board could usefully consider whether, in fact, there remains sufficient policy support for either set of rules.

However, being mindful of the aspirational goal in the *Terms of Reference* (ie. consistency with the Policy Principles, and in particular the second of these Principles, we turn now to consider some of the specific questions that the Board asked in its Discussion Paper.

Desirability of extending relevant aspects of the recommended changes to tax arrangements for other trusts

Both the Tax Office and the tax profession acknowledge that there are different views about the interpretation of Division 6 not only for MITs which are the primary focus of the Board's review but also for other trusts. Those issues are highlighted in the Draft Discussion Paper released by the Tax Office to the National Tax Liaison Group for comment and acknowledged in the Board's Discussion Paper.

Whilst the Tax Office is keen to clarify these differing views in the courts and, in the meantime, provide guidance to its staff based on its current view of the law, the Institute is concerned that the views in the Tax Office's Draft Discussion Paper are controversial, in many instances contrary to long standing practice and that clarification through the judicial process may be a long drawn out process.

If the Tax Office persists in its views and starts to overturn long standing practice before the judicial process is concluded, it is our strong view that there is a need for the legislation to be amended to provide certainty in relation to the taxation of both MITs and non-MITs – especially as the latter are widely used in the small business arena.

The Institute therefore welcomes the fact that the terms of reference for the Board's review includes the desirability of extending relevant aspects of its recommended changes to tax arrangements for MITs to other trusts and would be pleased to participate in further consultation in this area.

Potential reforms to the EIB rules in Division 6C of the ITAA 1936

In the first section of this submission we queried whether there remains sufficient policy support to justify retention of Division 6C. Having regard to this question, it would be premature to comment in detail on the Public Trading Trust rules. We nonetheless make the following general points.

The Institute first engaged the Treasury regarding the need to reform Divisions 6B and 6C in the latter half of 2006.

In a submission dated 21 December 2006 (attached as Appendix A), we acknowledged that the long term international competitiveness of the Australian industry might require a restructure of our funds management tax laws or a move towards a regime more in line with the various real estate investment trust (REIT) regimes adopted by a number of our overseas competitors. However, as an interim measure, we championed the need for Divisions 6B and 6C to be amended to overcome some of the existing issues and so simplify matters for industry in a short time frame.

In these circumstances we welcomed the Government's pre-election commitment to ask the Board of Taxation to examine options for the introduction of a specific tax regime for managed funds, including an examination of Division 6C. We also welcomed the announcement that, pending the outcome of that review, certain changes would be made to Division 6C to streamline and clarify the application of the EIB rules in the interim. Legislation to give effect to those interim changes is contained in *Tax Laws Amendment (2008 Measures No 5) Act 2008*.

The Institute took the opportunity to comment on both:

- Treasury's industry consultation paper on interim changes to the trading trust rules which apply to real estate investment trusts which was released in February 2008 and
- the draft legislation released for public consultation in July 2008. Some, but not all, of our recommendations were reflected in the Bill.

Copies of the Institute's submissions are attached as Appendix B and Appendix C respectively and contain commentary relevant to the specific issues/questions posed in the Board's Discussion Paper.

The Institute also had the opportunity to comment on a confidential draft of the legislation to allow a stapled group of entities to restructure with an interposed head trust inserted without triggering certain tax consequences. A copy of our submission dated 12 July 2007 is with the Treasury.

The need for the tax integrity rules in Division 6B of the ITAA 1936

The Board seeks stakeholder comment on:

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

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

In the first section of this submission we queried whether there remains sufficient policy support to justify retention of Division 6B. Having regard to this question, it would be premature to comment in detail on the Corporate Unit Trust rules.

Capital versus revenue account treatment of gains and losses on disposal of investment assets by MITs

In response to the specific issues/questions posed in the Discussion Paper we make the following brief comments:

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

In our view the main concern to be addressed in relation to the capital versus revenue distinction in the MIT arena is to provide certainty as to the circumstances in which a gain made by the trustee of a MIT will be regarded as being on capital as opposed to revenue account. Applying case law principles does not achieve this objective and raises the prospect of amended assessments for a large number of unitholders should the Tax Office take a view contrary to that of the trustee.

(b) *is the current requirement to distinguish between capital and revenue treatment on disposal of certain assets one that causes significant compliance costs to MITs and, if so, how;*

Anecdotal evidence suggests that historically MITs apply the CGT rules in calculating gains or losses in respect of the disposal of assets (other than those assets where revenue treatment is mandatory) unless the MIT was specifically established to hold investments on revenue account. Different considerations may apply to property trusts which will typically hold assets on capital account.

In these circumstances, significant compliance costs have probably not been incurred by MITs in distinguishing between capital and revenue treatment on disposal of specific assets in the past. However, we would expect compliance costs to increase in the future given the Tax Office's attention to this issue in recent years. In particular, we believe there is a real risk that the Tax Office's approach to the revenue/capital distinction will render the LIC concessions largely otiose, and subject "capital account" investors to "revenue account" taxation merely because they choose to pool their investments through an LIC or MIT. This would be inconsistent with the first Policy Principle.

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

The provision of a statutory rule treating gains and losses made on disposal by MITs of certain investment assets as being on capital account would provide certainty and would be consistent with the tax treatment for the majority of trust beneficiaries, had they made the gain themselves.

We see no merit in a statutory rule which treated gains and losses made on disposal of certain assets by MITs as being on revenue account. It would be in our view inconsistent with Policy Principle 1.

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

Yes.

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

Specific rules could be structured along the lines of those which apply to complying superannuation funds[1]. Similarly to the case with such funds we do not believe that an integrity rule is needed if equivalent rules are introduced for MITs – it would be sufficient to enable an MIT to elect for statutory capital treatment in respect of all its assets (except those already carved out of the equivalent "complying superannuation fund" rules.

[1] Refer to s295-85 of the ITAA 1997. Note that ss295-85(3) and (4) specify the gains and assets to which the statutory capital account rule does not apply.

To the extent that the Board (contrary to our view above) believes that an integrity rule is required, we suggest that one potential "integrity" rule might involve broadening the distinction between assets that a taxpayer holds for less than 12 months, rather than for 12 months or more. Before our comprehensive Capital Gains Tax was introduced, assets that a taxpayer held for less than 12 months were assimilated to ordinary income.[2] Under the CGT rules, initially the cost base of such assets could not be indexed for inflation (ie. as in the case of ordinary income, the nominal gain was taxed). Now, gains in respect of such assets are not eligible for the CGT discount (ie. as in the case of ordinary income, the nominal gain is taxed). One might therefore define a "bright line" rule that assets held for less than 12 months fall on revenue account, whereas assets held for 12 months or more fall on capital account.

However, in our view such an integrity rule is not required. It would be sufficient to enable an MIT to elect for statutory capital treatment in respect of all its assets (except those already carved out of the equivalent "complying superannuation funds" rule).

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

In the interests of creating a level playing field, statutory capital account treatment should be extended to other collective investment vehicles (including LICs) which would benefit from certainty in the same way as MITs.

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

The CGT and ordinary income rules still do not fit well together and, in particular, statutory CGT treatment for MIT gains may still be undone if an investor is on revenue account. We therefore consider that there may be grounds for continuing the statutory CGT treatment through into the hands of the investor.

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

We do not consider that different considerations should apply to Private Equity funds. In particular, we note that the CGT rules already treat the "carried interest" of a fund's manager, as being on capital account.[3] An investor in a fund would be astonished to find that its own investment fell on revenue account.

Although we have limited our comments to certain specific aspects of the Board's Discussion Paper, we welcome the fact that the Board will be reviewing the current concept of a MIT, which inappropriately does not recognise wholesale funds, as well as concepts of fixed trusts and fixed entitlement which also inappropriately affect legitimate MITs.

If you wish to discuss any aspect of our submission please call Susan Cantamessa on 02 9290 5625.

Yours faithfully

Susan Cantamessa
Tax Consultant

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2 Refer to (repealed) s.26AAA of the ITAA 1936.

3 Refer to s.104-255 (CGT event K9) which applies to the carried interest of:

- A general partner in a Venture Capital Limited Partnership (VCLP);
- A general partner in an Early Stage Venture Capital Limited Partnership (ESVCLP);
- A general partner in an Australian Fund of Funds (AFOF);
- A limited partner in a Venture Capital Management Partnership (VCMP).

The Institute of Chartered Accountants in Australia

21 December 2006

Mr Matthew Flavel
Principal Adviser
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Dear Sir,

Divisions 6B and 6C – modifications to improve their efficiency and competitiveness for Australia's property funds management industry

We refer to the meeting held on 18 October 2006 between yourself and a number of representatives of the Institute of Chartered Accountants in Australia (the Institute) to discuss potential reforms to Divisions 6B and 6C of the *Income Tax Assessment Act 1936* (the 1936 Act) dealing with issues associated with those Divisions in the property funds management industry.

In essence, Divisions 6B (public unit trusts) and 6C (public trading trusts) were introduced into the 1936 Act at a time when the use of property funds as collective investment vehicles was in its infancy. The law has changed since then with the result that some of the policy drivers underpinning those divisions are no longer appropriate. Existing issues with those divisions have been exacerbated by the growth in such funds both domestically and internationally.

During the meeting it was recognised that in the long term, international competitiveness may mean that Australia might restructure its funds management tax laws or move towards a regime more in line with the various real estate investment trust (REIT) regimes adopted by a number of our overseas competitors.

However, at that meeting and later in our pre-budget submission, we undertook to make a submission to Treasury, on a no prejudice basis, outlining possible ways in which the existing provisions may be amended, relatively simply, to overcome some of the existing issues with these divisions, and so simplify matters for the industry in a short time frame.

We acknowledge that issues arise in relation to the application of Division 6C, in particular, to managed funds other than property funds. We have not sought to specifically address those issues in this submission.

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Background

In broad terms, where a unit trust is a public trading trust in respect of an income year, Division 6C operates to tax the trustee as if the trust were a company. A unit trust is a public trading trust in respect of an income year if, at any time during that year, it is:

- A public unit trust
- A trading trust and
- A resident unit trust.

The main issue for property funds, whose attractiveness and international competitiveness depend upon being treated as "look through" entities, is the definition of a "trading trust". Under section 102N, "a unit trust is a trading trust in relation to a year of income year if, *at any time during the year of income*, the trustee:

(a) carried on a trading business; or
(b) controlled, or was able to control, directly or indirectly, the affairs or operations of another person in respect of the carrying on by that other person of a trading business." *(our emphasis)*

Our recommendations for an interim solution to the current issues in relation to Division 6C are set out below under the following headings:

- Trading business and the definition of "eligible investment business"
- The control test
- Technical anomalies with the interaction of Division 6C with other provisions.

The need for Division 6B to continue to exist will be largely impacted by the acceptance or otherwise of certain of our recommendations in relation to Division 6C from a policy perspective.

Trading business and the definition of "eligible investment business"

As indicated above, section 102N provides that a unit trust is a trading trust if, at any time during the year, the trustee carried on a "trading business" or controlled another person that carried on a trading business. A "trading business" is defined in section 102M as *"a business that does not consist wholly of eligible investment business."*

The section 102M definition of "eligible investment business" (EIB) is, therefore, central to determining whether a public unit trust is a public trading trust. An EIB is defined as meaning either or both of:

> "(a) investing in land for the purpose, or primarily for the purpose, of deriving rent; or
>
> (b) investing or trading in any or all of the following:
> (i) secured or unsecured loans (including deposits with a bank or other financial institution);
> (ii) bonds, debentures, stock or other securities;
> (iii) shares in a company;
> (iv) units in a unit trust;
> (v) futures contracts;
> (vi) forward contracts;
> (vii) interest rate swap contracts;
> (viii) currency swap contracts;
> (ix) forward exchange rate contracts;
> (x) forward interest rate contracts;
> (xi) life assurance policies;
> (xii) a right or option in respect of such a loan, security, share, unit, contract or policy;
> (xiii) any similar financial instruments."

In its current form, in determining whether there is a trading business, there is therefore:

- a focus on the potential breach arising from individual activities, regardless of size, rather than by an examination of the entire trust;
- no de minimus rule;
- no requirement for materiality;
- no process for rectification; and
- no opportunity for judgement by the Commissioner of Taxation as the relevant regulator, on the face of the legislation.

In our view, the EIB definition is no longer an appropriate test for determining whether a unit trust is conducting a business other than one of investment, in today's investment environment. A number of examples of EIB definitional problems are set out in the Appendix.

The current policy setting seems harsh and inappropriate in today's sophisticated financial markets and with the larger array of investment choices and options available globally.

Set out below are our recommendations to address the problems associated with the definition of EIB.

Recommendation 1: Modernise the 'sudden death' approach to the trading trust and trading business definitions, to align these with international practice

Public unit trusts are exposed to the operation of Division 6C by virtue of immaterial activities not being EIB activity.

The Division needs to allow for an amount of trust income to be earned that is not EIB income before the trust is taxed as a company under the Division.

We submit that the most appropriate strategy is to harmonise the definition of a trading trust with international practice. In the US and UK, a REIT is allowed to receive up to 25% of its income from non-eligible sources without losing its REIT status. So the cut-off for eligibility of a particular managed fund is whether at least 75% of its income is from the relevant sources – a 75% test. A similar 75% test may be introduced for Division 6C purposes by reference to the entire income of the relevant trust.

This could be done in one of several ways:

(a) Amending the section 102N definition of a trading trust

Section 102N could be subject to a requirement that the relevant trading business of either:

- the trust itself; or
- the controlled person

must constitute more than 25% of the net income of the trust or the controlled person, as the case may be, in order for section 102N to apply.

The drafting of such a 75% test could be achieved quite simply. For example, the UK achieved this by providing that, in the accounting period, the income accruing from tax-exempt investment business must be at least 75% of the total income, with total income and income from tax-exempt business defined to satisfy its REIT rules.

An example in the *Income Tax Assessment Act 1997* (the 1997 ACT) of the simple drafting of such a rule is in subsection 118-425(3) concerning the venture capital exemption rules.

(b) Replace, in the definition of trading business, the word "wholly' by a specific threshold of eligible investment business, say 75%

The definition of a trading business should also contain a 75% test along similar lines. This could be achieved if a trading business was defined to mean "a business the income of which is not at least 75% attributable to eligible investment business."

(c) A de minimus rule

Introducing a de minimus rule was discussed at the meeting. However, in our view a bright line 75% test as noted above, consistent with international practice, would make an additional de minimus rule unnecessary.

Recommendation 2: Modifications to the definition of Eligible Investment Business

(a) Land and rent

Paragraph (a) of the EIB definition concerning investing in land needs to be amended to replace the words *"for the purpose, or primarily for the purpose, of deriving rent"* with a reference to deriving income on a long-term basis from the land. This approach will enable the unduly prescriptive focus on derivation of rental income to be removed, and will more appropriately allow trusts to generate income, such as licence fees, without a highly technical analysis of whether such other forms of income constitute rent for this purpose.

We recommend that the reference in paragraph (a) to *"deriving rent"* instead be to "…deriving income from the holding of the land" or a similar broad reference.

(b) Redevelopment of land

Paragraph (a) of the EIB definition concerning investing in land also needs to clarify that a trust undertaking the development of its own long term property, principally for the purpose of retention of a majority of the development, will comply with the EIB rules. That is, if a trust engages in the development of an asset primarily for the purpose of deriving a long term income flow, principally from rent, and the initial construction activity involves some peripheral sale of elements of the property, but not in a way as to characterise the trust as primarily a property development entity, the trust should not be prohibited from flow through trust taxation for this purpose.

Such clarification could be achieved by amending the definition or by way of a note.

(c) Investment in securities

Paragraph (b) of the definition of EIB, which lists a number of categories of investments, has some notable omissions that need adjustment in today's environment.

The only references to investments in managed funds are those which might be read into the phrase "units in a unit trust" or "shares in a company". However, these references do not adequately deal with the investment structures which are available for trusts which might invest in long term assets such as property, in Australia and overseas, using mechanisms such as Partnerships (including foreign partnerships), foreign companies or partnerships which are treated as partnerships for Australian purposes under the foreign hybrid rules in Division 830 of the 1997 Act (presuming these rules change the nature of the interest for all Australian tax purposes) and fixed trusts and similar interests.

As a result, we submit that there needs to be an express inclusion of investments in other taxpayers, entities or managed funds including:

- Partnerships in Australia or overseas;
- Fixed trusts in Australia or overseas;
- Foreign hybrids covered by Division 830; and
- Investments and contractual arrangements with similar commercial effects.

(d) Expansion of financial instruments

A new paragraph (c) to the EIB definition is required to introduce a list of further eligible activities that are similar to those listed in paragraph (b). This should allow additional activities to be eligible that might not be investment or trading activities as such, including the entering into hedging and guarantee arrangements.

(e) Foreign investments

This policy adjustment, which we believe will not adversely affect the Australian revenue, has now become highly significant given the maturity and development of Australia's managed funds industry.

As Australia's managed funds have developed, they increasingly look overseas for investment opportunities in order to achieve the necessary diversification of portfolios and to maximise the opportunities for Australian investors, including Australian superannuation funds, to mobilise their savings.

Given the broad spectrum of investment activities now available, we submit that it is inappropriate for Australian investor trusts to run the risk of their investments in foreign entities to cause them to be taxed as companies under Division 6C.

We recommend that an amendment be introduced by inserting the words "in Australia" into the trading trust definition in section 102N, at paragraphs (a) and (b) so that they might read:

> "…a unit trust is a trading trust in relation to a year of income if … the trustee:
>
> (a) carried on a trading business *in Australia*; or
> (b) controlled, or was able to control, directly or indirectly, the affairs or operations of another person in respect of the carrying on by that other person of a trading business *in Australia*." (*our emphasis*)

Issues which arise where a public unit trust controls foreign entities are discussed further below.

(f) Regulations to modify EIB definitions

A mechanism should be introduced to allow further eligible investing or trading instruments or other activities to be included by regulation.

Recommendation 3: Consequences of breach, especially inadvertent breach

We submit that having major consequences for potential inadvertent breaches by public trusts represents an unacceptable policy setting for Australia. It is inequitable and inefficient, particularly if the breaches might occur for a short time and might be rectified.

This could be remedied in various ways including by way of the three methods discussed below.

(a) Rectification of inadvertent breach

In our view, at a minimum, Division 6C should provide a process whereby, if a breach of a unit trust's permissible range of investment activities is identified by the trust or the Commissioner, the trust should not be treated as a trading trust provided that:

- the breach is due to inadvertence rather than deliberate or reckless disregard of the requirements of Division 6C; and
- the relevant trust takes steps to rectify the breach as soon as the breach is identified.

Such a reporting and rectification regime operates for the purpose of the superannuation regulatory regime.

This change could be implemented by modifying section 102N to provide that, if action to rectify an inadvertent breach commences within a short time of the notification of the breach (say, 90 days from the notification of the breach), the trust will not be treated as a trading trust.

(b) Ring-fencing modifications

A ring-fencing rule could be introduced to apply the consequences of the Division 6C (see section 102S and the modifications in section 102T) only in relation to the non-EIB income of the trust.
This issue is very important if a trust can become a trading trust inadvertently. It is less significant if the trading trust definition is adjusted by the introduction of a 75% rule and the other recommendations set out above.

Under this proposal (assuming the 75% test discussed above is introduced), Division 6C would not apply to any income of the trust if the non- EIB income is less than 25% of total income. If the non- EIB income is 25% or more of the income of the trust then sections 102 S and 102T will apply in respect of the non- EIB trust income only. The trustee would then be required to perform calculations to determine the EIB and non- EIB income of the trust.

We recognise that this ring-fencing concept might involve substantial drafting and systems issues for the Australian Taxation Office.

(c) Commissioner's discretion

Flexibility could be introduced by way of a Commissioner's discretion to not apply Division 6C to a trading trust in respect of a year, having regard to a series of specifically stated factors including:

- Whether the breach was inadvertent;
- Whether the breach was reckless;
- Whether the fund commenced action, as soon as practicable after the breach was identified, to rectify it by either selling or restructuring the activity that caused the beach, mindful of the potential need in some cases for approvals by third party trustees, investors and representatives of investors; and
- The significance of the breach in relation to the level of income generated by the relevant trust.

A discretion of this type becomes very significant if the EIB and trading trust changes recommended above are not introduced, and there are no rectification or ring-fencing measures introduced to reduce the adverse impact of a breach of the rules.

If the proposed policy adjustments are adopted however, we recognise that the discretion would only need to be considered by the Commissioner in very few cases that could demonstrate some extraordinary circumstance. .

The control test

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.

The Explanatory Memorandum (EM) to the Bill which introduced Division 6C states that section 102N is a safe guarding 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 for a trading business and so avoid the operational of Division 6C.

Recommendation 1: abolish or limit the control test

We see no policy or practical reason to retain the control test currently in Section 102N as it applies to subsidiary or controlled companies in Australia. Given these are taxed in their own right, any trading income will automatically be subject to Australian income tax. Part of the reason for this policy no longer being needed is the significant change to the Australian income tax system since Division 6C was introduced, and in particular the introduction of dividend imputation and refundability of franking credits.

There is further support to have any type of control test that is required (for example, it may be required to retain a control test in respect of trusts) as having 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.

As Australian property trusts have expanded offshore, the current restrictions have caused significant concern and compliance costs. Generally, there seems no Australia 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 monitor whether an underlying entity owning rental property in distant lands is carrying on any isolated activities which could constitute trading is unrealistic.

Recommendation 2: if the control test remains in whole or part, its operation should be clarified

If it remains appropriate to have a provision relating to control of a trading entity in the new Division 6C then the following matters should be addressed:

(a) Making the legislation consistent with the policy intent of the control test. By reference to the original EM, if the intention is to prevent taking income in the form of investment income from a controlled entity, then the control test should perhaps be defined in terms of entitlements to income.

(b) Ordinary meaning of control. The Macquarie dictionary definition of control refers to the exercising of restraint or direction over another, to dominate or command another, to hold in check or curb another. This definition implies the ability to prevent someone from doing something may constitute control. In this context, the ability of a minority shareholder (for example holding 26% of shares) to prevent the passing of a special resolution by a company could constitute a form of control.

(c) In Interpretative Decision ID 2003/162 the Commissioner of Taxation has referred to this definition of control indicating this is the ATO view. However, in a typical business sense, control would refer to controlling in excess of 50% of votes etc.

(d) Certain case law on the definition of control has referred favourably to, for example, control of a company meaning control of votes at a general meeting. However, other cases for example NewsCorp Limited (1997) 15FCR 227, have indicated that in the context of the Broadcasting Act because of different wording, a wider concept of control must apply. Clarity should be provided on the exact words denoting control to be used in Division 6C.

(e) If a controlled entity is trading, only income of the unit trust from that controlled entity, should be subject to company like taxation. Other passive income (suitably defined) should not be so subject.

Technical anomalies with the interaction of Division 6C with other provisions

The “modern” treatment of Division 6C trusts for consolidation purposes under sections 713-130 to 713-140 of the 1997 Act seems to completely assimilate Division 6C trusts with companies if they have made a consolidation election. In contrast, section102T does not require Division 6C trusts to be treated as companies for all purposes.

This incomplete section102T deeming leads to Division 6C trusts being “schizophrenic” in that:

(a) “Company” tax characterisation/treatment clearly applies for the purposes specified in section 102T.

(b) “Trust” tax characterisation/treatment still applies to a Division 6C trust for certain purposes, including the following:

- Broadly, under section 23AH, foreign branch income and capital gains of resident companies are non-assessable non-exempt income in the hands of the relevant company. However, s.23AH does not apply to income and capital gains of Division 6C trusts.

- Under section 23AJ, non-portfolio dividends paid to resident companies are non-assessable non-exempt income in the hands of the recipient company. However, section 23AJ does not apply to dividends paid to Division 6C trusts.

- Broadly, “scrip for scrip” rollover relief is available under Subdivision 124-M in certain circumstances if shares in one company are exchanged for shares in another company, or trust interests in one trust are exchanged for trust interests in another trust. However, roll-over relief is not available if units in a Division 6C trust are exchanged for shares in a company (or vice versa).

- The trust loss provisions in Schedule 2F apply to Division 6C trusts, rather than the company loss provisions in Divisions 165 and 166.

- Some attempts have been made to apply the debt/equity rules to interests issued by Division 6C trusts (e.g. “non-unit equity interest” in section 102T(24)) but the interaction is incomplete (eg, there is no corresponding concept of a non-equity unit).

(c) The precise tax characterisation/treatment of Division 6C trusts is not clear in certain circumstances - for example:

- It is not entirely clear how the 45 day rule applies to units in a Division 6C trust (e.g. whether they should properly be regarded as “ordinary shares” or as “preference shares”).

- The precise treatment of Division 6C trusts, and distributions made by them, under double tax agreements is unclear.

Recommendation: as part of any review of Division 6C, the anomalies which arise when it applies should be rectified

To the extent that an interim solution to the issues posed by Division 6C is implemented then in our view the opportunity should be taken to fix the technical anomalies which arise as a result of the interaction between Division 6 and other provisions of the tax legislation. The more significant of those issues are listed above.

We look forward to discussing with you further a proposed way forward in relation to this important subject. In the meantime, any questions should be directed at first instance to myself on 02 9290 5623 or Susan Cantamessa on 02 9290 5625.

Yours faithfully

Ali Noroozi
Tax Counsel

Cc:	Mr Phil Lindsay	Senior Tax Adviser Office of Minister for Revenue and Assistant Treasurer
	Mr Mike Callaghan	Executive Director - Revenue Group Department of Treasury

Appendix

Examples of EIB definitional problems

Infrastructure assets generating toll and licence revenue

Investment in infrastructure assets has developed in response to the willingness of managed funds in Australia and internationally to invest in a diversified range of assets for Australian investors and superannuation funds. Such assets range from largely passive assets, such as toll roads, housing and school and hospital buildings to more active business activities such as power generation and water treatment plants.

The nature of these arrangements remains passive in nature, as compared with, for example, the operation of a coalmine. However these new investment forms do not fit neatly into the EIB definition of 1985 and we submit that the policy for these measures is no longer appropriate.

In particular, where investments give rise to property related income that is not rent, they are not clearly included within the EIB definition.

An example of a current investment activity in the nature of the business of investment is the hotel industry where the hotel operating company rental may cover the real property as well as fittings and fixtures.

The typical user of the property will be a hotel operating company, and the hotel operating model has developed internationally along the lines that hotel operators receive a fee and a share of the profits rather than having a conventional tenancy arrangement with a fixed rental structure paid to a landowner. In such a situation, it is challenging to align the interests of the core operator of a property with the rules of Division 6C. Mechanisms have been developed, involving companies that pay rental to a trust, but these mechanisms can cause challenges in relation to Division 6C.

Development of buildings

EIB includes investing in land for the purpose or primarily for the purpose of deriving rent. Problems arise if the investment has a dual purpose of development of the property and rental or if the intention of the fund subsequently changes from that of rental to one of development and sale.

A fund might consider a transfer of such property from or to a separate entity (not controlled by the original fund) to ensure that the Division 6C permissible range of investments would not be breached in the period that the rental may not be the primary activity. However this is a very inefficient solution and results in stamp duty and other costs.

This problem could be readily resolved by broadening the section 102M definition or by ‘ring fencing’ such ineligible activities for tax purposes without causing the whole of the trust to breach the permissible range of investment requirements for the purposes of Division 6C.

Licence fees rather than rent

Investment in property gives rise to income flows that do not constitute rent. For example, licence fee revenue such as fees from provision of parking does not come within the concept of rent for purposes of sub-section (a) of the EIB definition.

Funds investing in foreign REITs

The rules are, due to their restrictive nature, incompatible with foreign managed fund rules including, for example, the US federal tax rules for REITs, causing an Australian trust to fall within the scope Division 6C.

The US REIT regime broadly allows eligible entities to qualify for that regime by quarantining certain “non allowable” assets and income in a separate special purpose vehicle and taxing the income of that entity at a statutory rate. The REIT rules also contain a number of de minimus rules allowing broadly up to 25% of assets of the entity and up to 25% of income to be “non allowable” before such quarantining is necessary.

Australian entities that qualify for the REIT regime may still breach Division 6C, however, if a special purpose vehicle is used due to the controller provisions in paragraph (b) of section 102N. There is also no corresponding de minimus rule in Division 6C.

This warrants several changes to Division 6C, including the exclusion of foreign investee entities from the rules, and potentially ring-fencing activities which fall outside the range of allowed activities for Division 6C purposes.

APPENDIX B

The Institute of Chartered Accountants in Australia

19 March 2008

Mr Raphael Cicchini
Manager Trusts, Business Tax Division
The Treasury
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Parkes ACT 2600

Email: Raphael.cicchini@treasury.gov.au

Dear Sir

Industry Consultation Paper – Potential Changes to the Eligible Investment Rules for Managed Funds, including Property Trusts

The Institute has consulted with members who extensively practise in the area of managed funds, including property trusts, and is pleased to be able to respond to the abovementioned Industry Consultation Paper (the Consultation Paper).

We set out below brief introductory comments on the basis upon which we make our submission (Section 1) as well as our detailed comments and recommendations on the following areas:

- Section 2 - Investment in land, rent and safe harbour issues
- Section 3 - Control test
- Section 4 - Financial arrangements
- Section 5 – Division 6B

1.0 Comments regarding the basis on which we make this submission

We note the policy basis for the eligible investment rules as described in the Consultation Paper. We believe this is the first time that the current policy basis for retaining Division 6C has been set out, and we welcome that.

The policy justification put forward in the Consultation Paper is competitive neutrality. We accept for purposes of this submission that managed funds are to be limited to activities of a broadly passive nature, and that they should not be actively involved in trading businesses (on a tax transparent basis).

In particular, we accept for present purposes that at a policy level a tax transparent treatment is not to be allowed to public managed funds in relation to:

- property development for resale;
- any other discrete active business activity; and
- any other active business which is not related to or connected with a passive investment activity.

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The difficulties lie in how one gives effect to these policy approaches. It will be seen for reasons set out below that we consider that the Consultation Paper proposals are not an appropriate approach, and we suggest alternative approaches. However, we think it is important to stress at this stage that our difficulties with the Consultation Paper approach do not lie on the policy front, but rather on its practical implementation.

As a further introductory point, we note the Minister's intention that any changes be revenue neutral or close to it. We believe our suggestions would achieve this.

2.0 Investment in land, rent and safe harbour issues

2.1 Consultation Paper package

The Consultation Paper essentially raises for consideration a package comprising the following:

In relation to the "investment in land" test:

- the removal of "primarily" from the requirement that investment in land be "for the purpose, or primarily for the purpose, of deriving rent";
- the redefinition of "investment in land" to include investments which, while not themselves investments in land, are closely associated with investments in land, using a test such as "directly related to" the investment in land. (This would be intended to cover, for example, the acquisition of furniture, and consumables such as cleaning supplies, as part of an office building).

In relation to the purpose of deriving rent:

- the redefinition of rent to "clarify" it. The proposed revision would not enlarge the meaning of "rent", but rather would exclude from its meaning some profit-based (and perhaps other) rental arrangements which the Consultation Paper asserts are not rent anyway. Thus the redefinition would either leave the scope of "rent" in Division 6C unchanged or would narrow it.

In relation to safe harbour issues:

- the introduction of a form of safe harbour test. If gross income of a trust in a year of income from investments directly related to a particular investment in land did not exceed 25% of the gross income (excluding capital gains) of the trust in that year from that particular investment[1], the trust would not be a trading trust for that year by reason of holding the "directly related" investments or deriving the non-rental income therefrom. However, if the 25% threshold were exceeded, the trust would be carrying on a trading business in that year. The Consultation Paper favours the application of the 25% test (i) separately to each investment in land and investments "directly related" to it; (ii) by reference to gross income, and (iii) on a year-by-year basis. It rejects application on a "whole of trust" basis, or on a net income basis.

2.2 Our response to the Consultation Paper package

The Consultation Paper package is not considered an appropriate response to industry concerns about Division 6C. This is because the package:

- would widen the scope of "trading trust", by causing some trusts to be treated as trading trusts which would not be treated as such under Division 6C as it stands; and
- would not capture the full potential for modifying Division 6C in a way which would address the legitimate concerns of relevant stakeholders.

[1] Presumably this would be both the gross rental income from the particular investment in land and the gross non-rental income from the "directly related" investments.

In this submission we address the reasons why we think the Consultation Paper package is not appropriate. We then outline two alternative approaches which we believe would be appropriate.

2.2.1 Inappropriate broadening of scope of trading trust

The *first reason* that the Consultation Paper package is not appropriate is that it would broaden the scope of "trading trust" in two ways:

- The current "primary" purpose of deriving rent test is considered to be properly applied by reference to the total intended period of an investment in land. The replacement of this test with a per annum test would change the nature of the test in a way which could cause a trust to be a trading trust.

  For example, a trustee may invest in land and erect a shopping centre on it with the intention that it will also:

  (a) itself operate a car park, intended to maximise use of the shopping centre and thereby maximise its turnover-based rents from all tenants; and

  (b) derive additional income where possible from licence fees for billboard or other signage rights, or perhaps from licences to place telecommunications equipment on roofs etc (fixtures), granted to persons other than tenants.

  None of the car parking, signage or fixture licence fees would be rent under either the current definition or the proposed (possibly narrower) definition.

  In a circumstance where the tenancies were being ramped up over a start-up period, it could very well be the case that the total licence fees could exceed 25% of the sum of the gross rental and licence fee income of the trust from the property in one or more of the earlier years.

  Such a circumstance would not cause the trust to be a trading trust under the current Division 6C. This is because the primary purpose test is not considered to be a test applied by reference only to income in a particular year. Rather, it is clear that at all times the primary purpose of the investment in land is to derive rental income over an indefinite holding period.

- The "clarification" of the meaning of rent would at best leave its meaning unchanged and at worst narrow it. To the extent that a new definition narrowed the meaning, trusts would become trading trusts where they have current arrangements which are rent within the broader meaning but which would not be rent within the narrower definition. This would be inappropriate, particularly since there is no basis in the Explanatory Memorandum for Division 6C to support the assertions made in the Consultation Paper that "rent" in Division 6C was intended to have, or has, the narrower meaning now contended for.

  If the word "rent" does in fact have the narrower meaning contended for, as a matter of law, then no revision to Division 6C is required. If it does not, then any revision would be an expansion of the scope of trading trust and would be unwarranted.

2.2.2 Safe harbour too narrow, and related Eligible Investment Business ("EIB") issues

The *second reason* why the Consultation Paper package would be inappropriate is that it would fail to capture the opportunity to really address the problems with the current trading trust tests in a practical and effective way.

The primary reason why the Consultation Paper package would fall short of what is needed is that the 25% safe harbour test would be too narrowly drawn. It would apply only to cover investments that were "directly related" to investments in land, and to income therefrom. However, a trust could fall outside the current definition of EIB for a variety of reasons which would not be assisted by such a test, such as:

- activities which were incidental to investment in land, but which did not themselves amount to "investment" in anything. For example, for reasons of efficiency, tenant expectations or regulation, a trustee might procure utilities or services as principal, and provide them (as an ancillary activity to its leasing of the property) to tenants on a cost recovery or perhaps modest mark-up basis. Such utilities or services could include cleaning services, security services or perhaps the acquisition and reselling of water or other utilities. The Consultation Paper package would not assist in this case;

- there may also be circumstances where it may not be totally clear that an activity is related to one of the "investing or trading" activities permitted by paragraph (b) of the EIB definition, as opposed to being a separate activity. An example might be a situation where a trustee is a significant minority holder of shares in an investee company and, to protect its investment, procures its representative to be a director of that company. The company may pay directors' fees to all its directors, and the trustee's fiduciary duty would normally require that it accept the fees referable to its representative (and procure that its representative account to it for the fees). It is considered that such fees would relate to the activity of investing in shares, rather than to any separate activity of providing services for remuneration. However, it would assist to put this beyond any practical doubt if a safe harbour rule were applied by reference to the totality of the trust's activities and income (rather than just to its investment in land and in matters directly related to investments in land).

2.3 Our views on an appropriate safe harbour, EIB and sanction for breach

We note the suggestion in the Consultation Paper that allowing a 25% safe harbour test to apply at a whole of trust level would give an allowance of up to 25% for non-rental income across all land investments, with no particular restrictions on the proportion of non-rental income for any particular investment. The Paper expresses concern that this would effectively permit unrelated active business income to be sheltered by rental investment income, contrary to the policy intention.

We believe this concern is exacerbated by the proposed 25% safe harbour. We submit that a more appropriate safer harbour mechanism could be achieved by:

- expanding the definition of EIB; and

- allowing a more modest safe harbour of, at a minimum, 5% for non-EIB activities.

2.3.1 Expanding the definition of EIB

We consider that income from investments which, while not strictly in land, are directly related to investments in land, should be treated in effect as rent from permitted investments. As noted in Section 2.2.2 above, various forms of income might be derived by a trust which might be included in an expanded EIB encompassing "income from eligible or permitted investments". We submit that EIB should be expanded to make it clear that it is intended to cover this income.

2.3.2 Safe harbours and sanctions for breach

One of the fundamental difficulties with the current trading trust provisions is their "all or nothing" nature. Even if the scope of "investment in land" and "rent" were expanded as described above, it would remain the case that any minor or inadvertent breach of the EIB restriction would attract company-style taxation to the entire income of the trust for that year. We believe this is wholly disproportionate result (and is a fundamental concern with the present Division 6C).

We recognise a need to balance the achievement of the policy objective (ensuring on competitive neutrality grounds that managed funds do not have tax transparent treatment for active business activity) with appropriate, but not excessive, enforcement and sanctions. We believe this balance would be achieved by:

(a) allowing a modest (minimum 5%) safe harbour threshold for non-EIB activities; and

(b) if that threshold were breached, subjecting only the income from the non-EIB activities to company-style taxation (rather than subjecting the whole income of the trust for the year to such taxation).

Consistently with this approach and with our comments in Section 3 of this submission regarding the control test, we recommend that any income of a relevant trust in a year from a controlled entity or business, where the relevant activities are not wholly limited to EIB, should be treated as non-EIB income in the trust. In our opinion this would achieve the policy objective of preventing the trust obtaining tax transparent treatment on income from any active business controlled by it through an interposed entity, while limiting the sanction to an appropriate one. That sanction would be the taxing of only the offending income, rather than of all income of the trust of the relevant year, in a manner similar to company income.

We suggest that setting a non-EIB safe harbour buffer at 5% (or an appropriately higher percentage) of gross income of the relevant trust for the relevant year should not be regarded as giving rise in practice to any unacceptable potential for abuse. This threshold would be so low that, in practical terms, it would hardly be worth anybody's trouble to try to take advantage of it, even if they were minded to do so.

Thus we propose that, if the income from non-EIB activities did not exceed 5% (or an appropriately higher percentage) of relevant gross income of the trust in a year, the non-EIB income may safely be ignored as de minimus.

However, if the 5% (or higher percentage) buffer for non-EIB income were exceeded by a trust in a year, then we consider that the non-EIB income (net of appropriate deductions) should be taxed in similar manner to a company income.

Measures of this kind would:

- address any reasonable concern that unrelated active business income could be structured to a material extent in a trust; while

- ensure that minor or inadvertent breaches which caused the 5% (or higher percentage) buffer to be exceeded did not bring adverse consequences (taxation of the whole income of the trust for the whole year at the company rate) totally disproportionate to the perceived "offence".

It seems to us that Division 6C when introduced was intended to have some kind of de minimus relief for a situation where a trust was predominantly carrying on EIB (and therefore, by implication, not carrying on wholly EIB). Such an intention was not reflected in the terms of Division 6C itself, but seems to have been envisaged by the explanatory memorandum which stated (at page 81):

> *"A unit trust that generally satisfies the tests to be treated other than as a trading trust, because it is predominantly carrying on an eligible investment business, will not be taken to be a trading trust merely because it receives income from activities incidental to its main purpose that do not constitute the carrying on of a business."*

2.3.3 Imputation system where safe harbour is breached

We recognise that any proposal which envisages part, but not all, of the income of a trust being taxed in a similar manner to a company raises issues to do with:

- the imputation system and the management of franking accounts; and

- the appropriate income tax treatment of distributions out of the after-tax part of the income which has been subject to taxation in similar manner to company income, and of taxation of the other, untaxed income.

We also recognise that developing a full model to deal appropriately and equitably with all of these issues could require some relatively significant efforts. In the circumstance that all that is contemplated at present is a short term practical solution to some of the difficulties with Division 6C pending the full Board of Taxation review of the treatment of managed entities, it may be that significant effort is not warranted at this stage. Accordingly, we would advocate a model for this short term solution which achieves the benefit of simplicity but at the cost – to the trustees and their investors – of foregoing franking credits for any relevant tax paid. This model would:

- provide that no franking credit is to arise in relation to tax paid on income of a trust where part, but not all, of the income of the trust is subject to tax under Division 6C; and
- require the trustee to identify (by notice to investors) any subsequent distribution it might make to the extent that that distribution would be out of the after-tax income that had been so taxed, and require the recipients of that distribution to treat it as assessable in similar manner to an unfranked dividend; and
- exclude the relevant "taxed" income from the section 95 net income (which would continue to be dealt with under Division 6); and
- allow the trustee to have access to the above "partial taxation" regime only by election. This would mean that the trustee could, if it wished, refrain from making an election, and thereby allow all of the income of the trust for the relevant year to be taxed under Division 6C and to give rise to franking credits in the usual way, with the current unit trust dividend provisions applying in the current way.

2.4 Alternative proposals

We therefore propose two alternative models for dealing with the Division 6C problems relating to rent, investing in land and related safe harbour issues. In Sections 3 and 4 of this submission we make recommendations relating to:

- Section 3: how the control test should be applied, and the consequences that should arise if a trustee controls the carrying on of a trading business or another entity in relation to the carrying on of a trading business; and
- Section 4: appropriate modifications to the list of financial instruments in paragraph (b) of the EIB definition.

The two alternative models for dealing with the rent/investment in land/safe harbour issues are additional to, or consistent with, our Section 3 recommendation so far as concerns the consequences of a trustee controlling another entity in relation to the carrying on of a trading business, or controlling a trading business carried on by another entity.

Our preference is for model 1, as being simpler and more direct. However, both models are put forward for consideration in order to assist the exploration of all suitable options.

2.4.1 Model 1

This model would modify the existing EIB test, in a relatively simple way. Assuming a modest 5% buffer, the modifications would be as follows:

(a) a concept of "qualifying activities" would be introduced to:

  - include matters currently permitted in the EIB definition, i.e. investment in land in the stated circumstance, and investing or trading in the relevant financial instruments; and
  - also include investment in things which, while not themselves land, are directly related to investments in land; and

- specifically exclude investment in equity or debt interests in a controlled trading entity (an entity which is controlled and which carries on a trading business in the relevant year) or in a controlled trading business (a trading business carried on by another entity where the affairs or operations in relation to the carrying on of the business are controlled by the trustee, regardless of whether or not the entity is controlled by the trustee, in that year); and

(b) the trust would be taken to have carried on only EIB in that year (and so would not to any extent suffer tax in a similar manner to a company) if the ordinary income[2] of the trust from qualifying activities equalled or exceeded 95% of the whole ordinary income[2] of the trust; and

(c) the whole of the net income of the trust for the year would be taxed pursuant to Division 6C and would give rise to franking credits as currently, with the unit trust dividend rules operating as currently, ***if*** ordinary income from qualifying activities were less than 95% of ordinary income of the trust for the year and ***if*** the trustee did not make an election; but

(d) if the trustee so elected, then:

(i) only the income from non-qualifying activities of the trust for the year would be taxed in a similar manner to a company (after an appropriate share of the deductions of the trust for the year); and

(ii) that income (net of those deductions) would be excluded from the definition of section 95 net income, and section 95 net income would continue to be dealt with under Division 6; and

(iii) the tax paid would not give rise to any franking credits; and

(iv) the trustee would be required to advise unitholders accordingly if at any time it effected the distribution of the amount which represented the income from non-qualifying activities (net of the tax paid or payable thereon); such a distribution would be treated as an unfrankable unit trust dividend paid out of profits.

As will be apparent, the concept here is that:

- a modest (minimum 5%) buffer would be allowed to cover any minor or inadvertent breach of the expanded scope of EIB (to be known as “qualifying activities”);
- if a breach caused the buffer to be exceeded, the trustee could allow the entire net income of the trust to be taxed and to generate franking credits, in the way in which Division 6C currently operates; but
- if the trustee so desired, and was prepared to forego franking credits for the tax payable, the trustee could elect that only the non-EIB income would be subject to taxation in a similar manner to company income.

“Qualifying activities” would be defined as investing in land in the manner described in paragraph (a) of the current section 102M EIB definition, and/or investing or trading in the manner described in paragraph (b) of that definition, but on the assumption that “investing in land” included making investments that, while not themselves investments in land, were (i) closely associated with such investments and/or were directly related to such investments, and (ii) would reasonably be regarded as “minor” relative to the investment in land. For this purpose “minor” would mean that, having regard to the total expected income under ordinary concepts over the prior and expected future period of ownership by the trustee, it would reasonably be expected that the income under ordinary concepts from the closely associated or directly related investments would not exceed 25% of the sum of that income and of the income from the investment in land with which those investments were closely associated or directly related. This would mean that such closely associated and/or directly related investments could arise only where the main investment was in land for the purpose, or primarily for the purpose, of deriving rent.

[2] Bearing its statutory meaning, i.e. income under ordinary concepts.

A footnote would give examples of qualifying activities and/or income from qualifying activities, including:

- investing in furniture for bailment to a lessee in conjunction with a lease of real property to that lessee, provided (ii) above was satisfied;
- fees received for licences granted regarding signage on, or equipment affixed to, land, provided (ii) above was satisfied;
- licence fees and similar income for allowing access (whether exclusive or not) to, or over, the land, such as by way of easement, provided (ii) above was satisfied;
- premiums received for granting, or allowing the termination of, leases of land, but only if such premiums were income under ordinary concepts;
- amounts received by way of compensation for loss of, or by way of supplement to, rent, including amounts received by way of indemnity for loss of rent, amounts received as rental support, and other amounts which were intended to supplement, or take the place of, rent;
- investment in depreciating assets used to provide services to lessees, or facilitate the acquisition of services by lessees, of a kind that could appropriately be made available or facilitated by landlords, where income is received by the landlord from lessees by way of reimbursement or recompense of or for (either on an actual cost basis or on a reasonable estimate thereof) costs or outgoings incurred by the trustee in providing the services or facilitating their acquisition.

2.4.2 Model 2

This model would involve somewhat more structural change to Division 6C than would Model 1. Under this model (again assuming a 5% buffer):

(a) the relevant Division 6C provisions dealing with rent and investment in land and trading trusts would be left as they are (except for the amendments proposed in Sections 3 and 4 of this submission); and

(b) a new safe harbour section (102NB) would be inserted which would give the trustee of a trust an election to apply it in relation to the trust for a particular year of income. If the election were made,

  (i) ***if*** the ordinary income of the trust of the year passed a 95% threshold test, the trustee would be taken to have carried on only EIB in that year, regardless of whether or not the business carried on by the trustee in that year consisted wholly of EIB;

  (ii) ***if*** the ordinary income of the trust did not pass the 95% threshold test, the trustee would be subject to tax on the non-EIB income (net of appropriate deductions) in similar manner to a company;

  (iii) the test would be as per model 1 above, i.e. it would use the concept of qualifying activities as there defined, and ordinary income from qualifying activities as there defined (including treating income from debt or equity interests in a controlled trading entity or trading business as non-qualifying). The test would require the trustee to calculate the ordinary income of the trust for the year from qualifying activities as a percentage of the whole ordinary income of the trust for the year;

  (iv) if the election were made, the income to be taxed in a similar manner to company income would be excluded from the definition of section 95 net income, which would continue to be dealt with under Division 6, and the tax paid thereon would not give rise to any franking credits, and the trustee would be required to subsequently advise unitholders (in a similar manner to model 1) if the after-tax taxed income were ever distributed, at which time it would be treated as an unfrankable unit trust dividend paid out of profits;

(v) if the new election were not made, then the position would be dealt with under the relevant Division 6C provisions as they currently stand, i.e. the current EIB test would be applied and, if failed, all of the income of the trust for the year would be subject to company taxation, and the franking and unit trust dividend provisions of Division 6C as they currently stand would operate.

It is important to note that the current EIB definition would operate, without any modification in relation to "investment in land" or "rent", if the election were not made. This is intended to mean that the trustee would have the choice to (i) have its circumstances in a future year dealt with under the current law, with the sanction being taxation of the whole of the trust income in a similar manner to company income, but with franking credits being available, or to (ii) elect for the more limited taxation of the non-EIB income under the safe harbour test which would use the expanded concept of qualifying activities and where only the non-EIB income would be taxed in a similar manner to company income, at the cost of the foregoing of franking credits.

It may be noted that this model 2 would:

- ensure that a trust would not be disadvantaged compared to its position under the current Division 6C. This is because the trustee could, if it wished, allow the current EIB rules to apply as they now do, with the same consequences (in the event of failure) as would currently arise;

- give an optional alternative bright-line test which:

  - would be easy for trustees and the ATO to administer and verify;

  - would (if passed) avoid the need to consider the current EIB test;

  - would provide an appropriate modest (minimum 5%) de minimus buffer for minor or inadvertent breach of the scope of a more appropriate set of permitted activities (qualifying activities); and

  - in the event of breach of the test at a level above a de minimus level, allow the trustee to limit the sanction to company-style taxation of only the "offending" income, at the cost of a further sanction being the foregoing of franking credits.

Thus the expectation would be that most trustees would elect to use the safe harbour/ method statement approach, which would be easier for the trustees to administer and for the ATO to verify. This would largely alleviate the current difficulties with the application of the EIB tests in relation to property without enlarging the scope of trading trust.

3.0 The control test

We were surprised that an interim solution to issues concerning the section 102N control test was not included in the Consultation Paper as one of the matters to be considered by Treasury.

"Abolishing or substantially curtailing the application of the control test to public trading trusts" was specifically included in the (then shadow) Assistant Treasurer's speech to the 2007 IFSA conference as an example of one of the options that would be "seriously examined" by Treasury (at page 3).

The Assistant Treasurer recognised that the Board of Taxation's review will take an extended period of time to examine the operation of Division 6C and the broader issues of its review and that the Treasury review is an important measure to fix the more inefficient aspects of the Division in the short term while the Board's review is undertaken.

We submit that in accordance with the Government's pre-election policy, the Treasury review should be extended to consider at least an interim modification of the control test, as originally planned. In our view it is not feasible to wait for the Board to consider this significant area of concern and for action to be delayed until the second half of 2009 or later.

Uncertainty with the meaning of the term “control” should be clarified in the Treasury review. We identify three simple measures for consideration.

3.1 What is control?

Control should be specifically defined. For example control might be defined to exist where a person has either rights to exercise more than 50% of the voting interests in an entity or rights to receive more than 50% of the income of an entity or rights to receive more than 50% of distributions of capital of an entity.

3.2 Division 6C applicable only to controlled trading business component

The consequences to a unit trust from controlling an entity that carries on a trading business should also be modified.

It is not appropriate that the whole of the income of the unit trust should be subject to the Division where it is the activities of the controlled entity that have caused the trust to be a public trading trust.

Section 102T should apply only to the income of the unit trust from the controlled entity(ies) that carry(ies) on a trading business. This could be determined on an earned basis or an entitlement to income basis. The other income of the trust should be quarantined and should remain subject to the normal trust provisions, as discussed in our comments on modifications to the definition of rent and tests for EIB.

This change would make the legislation consistent with the policy intent of the control test which is to prevent unit trusts taking income in the form of EIB income from a controlled entity with a trading business.

3.3 Foreign income of a Division 6C entity needs to be adjusted

We acknowledge the recent limited amendments made to the Division concerning control of foreign entities as part of the stapled entity rollover amendments, as discussed in the Consultation Paper. However these amendments are narrowly focused and perpetuate the EIB problems of the Division (considered elsewhere in the Consultation Paper) by limiting the exception to controlled foreign entities that are primarily investing in land outside Australia for the purpose or primarily for the purpose of deriving rent.

Even if this exception can be improved by applying our recommendations in Section 2 where appropriate, compliance cost and general concerns will remain.

We recommend that the exception from the control test in subsection 102N(2) should be expanded to include all foreign entities as one of the interim solution measures.

We accept that further, more substantial, consideration of the control test can be examined by the Board in its review, including considering the complete removal of the test.

4.0 Financial arrangements

In broad terms we support the concept of including “financial arrangements” as an additional item in the list of securities in paragraph (b) of the definition of “eligible investment business” in section 102M. However:

- Given the lack of certainty as to when Division 230 will be introduced, we suggest that the definition of “financial arrangement” be based on the current subsection 995-1(1) definition where it is defined by reference to sections 250-165 to 250-175. If Division 230 is ultimately introduced as currently drafted, the definition in section 995-1 will change to reflect the concept of financial arrangements as contained in that Division (which is substantially the same as the Division 250 concept).

- Notwithstanding the proposed inclusion of financial arrangements in the list of instruments in paragraph (b) of section 102M we recommend that, for the reasons set out below, an equivalent to paragraph 102M(b)(xiii) be retained.

- To the extent that there are instruments which should be included within paragraph (b) of the EIB definition but which currently are not then we recommend that Treasury ensures that they are encompassed by the definition of financial arrangements or otherwise amends the definition to ensure their inclusion.

4.1 Timing of introduction of Division 230 and the use of Division 250 definition

In the absence of knowing when Division 230 is likely to be enacted, we recommend the use of the definition of "financial arrangement" as currently contained in subsection 995-1(1). This definition refers to a financial arrangement which has the meaning given by sections 250-165 to 250-175.

We acknowledge that when proposed Division 230 is enacted, it will change the definition in subsection 995-1 to refer to the Division 230 concept of a financial arrangement. However, as the concepts of a financial arrangement in Division 250 and proposed Division 230 are broadly the same, we do not see any issues arising from the interim use of the Division 230 concept.

We assume that it is intended that the concept of a financial arrangement for EIB purposes will be unaffected by arrangements which, although financial arrangements as defined, are for various reason specifically excluded from the operation of Division 230 (or Division 250 if used as an interim measure).

4.2 Retention of "any similar financial instruments"

In our view, the inclusion of "financial arrangements" in the list of securities in paragraph (b) of section 102M should be in addition to, and not in substitution for, subparagraph 102M(b)(xiii).

This is because we are concerned that there may be arrangements excluded from being a financial arrangement that may otherwise be included under the current subparagraph 102M(b)(xiii).

As we would not want the introduction of the definition of financial arrangement to impact any current arrangements, we would request that Treasury consider introducing a reference to financial arrangement at subparagraph 102M(b)(xiii), and moving the test for "any other financial instrument" to subparagraph 102M(b)(xiv).

4.3 Testing the scope of the definition of financial arrangement

While we acknowledge that the definition of financial arrangement contained in Division 250 (and the proposed Division 230) is broad, there may be arrangements that do not fall within that definition which may still cause concerns. For example, physical holdings of foreign currency would appear to be excluded under the current section 102M and the proposed modification to section 102M to include financial arrangements. Additionally, a guarantee arrangement may be excluded from being a financial arrangement if it is considered to have a significant non-cash settlable financial benefit.

Accordingly, we believe it would be prudent for Treasury to ensure that those financial instruments identified in the consultation process as being excluded under the current EIB definition and, in particular, subparagraph 102M(b)(xiii)), satisfy the proposed definition of "financial arrangements". To the extent they do not, consideration should also be given to whether they should be specifically listed in paragraph (b) of the EIB definition.

5.0 Division 6B

We note that the Board of Taxation review is only to consider the appropriateness of Division 6C in its entirety, and is unlikely to consider technical issues associated with the application of Division 6B.

There are a number of minor technical issues associated with the operation of Division 6B that we believe could also be fixed in the interim period. We would request that this be added to the scope of the Treasury consultation. For example, there are some technical concerns as to whether prescribed arrangements include "indirect" ownership arrangements, and whether Division 6B could operate where property (being cash or similar securities) is transferred to a public unit trust by a company in consideration for the issue of units in the trust as part of a prescribed arrangement. We would request that Treasury consider looking at these minor technical issues in the interim period. We would be happy to assist in collating and providing a list of these issues, should Treasury agree to including this within the current review.

* * * * *

The Institute would be pleased to meet with you and your Treasury colleagues to the extent that you believe it would be helpful in your management of the consultation process to more fully understand the points which have been made above and canvass any concerns you may have. In the meantime, if you have any questions regarding our submission please call at first instance either Ali Noroozi on 02 9290 5625 or Susan Cantamessa on 9290 5625.

Yours faithfully

Ali Noroozi
Tax Counsel

APPENDIX C

The Institute of Chartered Accountants in Australia

14 August 2008

Raphael Cicchini
Manager Trusts
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: raphael.cicchini@treasury.gov.au

Dear Raphael

Public consultation - Draft legislation to reform Division 6C of the Income Tax Assessment Act 1936

The Institute of Chartered Accountants in Australia welcomes the opportunity to comment on the draft legislation to reform Division 6C of the Income Tax Assessment Act 1936 ("ITAA 1936") which was released for public comment on 23 July 2008.

The Institute is the leading professional accounting organisation in Australia, representing over 48,000 members in public practice, commerce, academia, government and the investment community. The Institute's members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia and overseas.

Based on our understanding of the policy intent from our communications with you, our detailed comments and recommendations on the draft legislation are set out in the attachment.

In summary, our view is that the proposed amendments have the capacity to be of some assistance in reducing compliance costs and easing some of the practical difficulties with the current Division 6C, provided that:

- our recommendations are taken on board; and
- in particular, clarity is provided in the legislation or Explanatory Memorandum ("EM") in relation to the scope of "the carrying on a trading activity on a commercial basis, other than a trading activity giving rise to income which is wholly or primarily from land or from the use of land", in a satisfactory way, through inclusion of a range of examples (not necessarily limited to those in the attachment) and satisfactory "answers" thereon.

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In these circumstances, we see merit in being provided the opportunity to review a further draft of the proposed legislation and a draft of the proposed EM and request that we be provided with this opportunity.

The Institute is of the view that more wide ranging reforms to Division 6C are required and anticipates that these will be considered in due course by the Board of Taxation as part of its review of taxation arrangements that apply to managed funds. Areas requiring further reform include:

- a more appropriate de minimis exemption – the proposed 2% of gross revenue, and then only where the 2% does not to any extent come from the carrying on of a trading activity on a commercial basis, falls well short of the up to 25% unqualified de minimis exemption that was contemplated by the then shadow assistant treasurer's IFSA speech on 3 August 2007;

- the consequences of Division 6C applying still seem grossly disproportionate to the "offence". A minor "transgression", too large to benefit from the somewhat miserly 2% de minimis safe harbour proposed, will continue to attract taxation of the entire net income of the trust of the relevant year in similar manner to company taxation. Our previous submissions have pointed out how inappropriate this is, and recommended approaches that would in our view be protective of the revenue while making the "penalty" less disproportionate to the "crime". We are disappointed that those recommendations have not been taken on board to date, and trust that the Board of Taxation will address them in its broader review;

- the interim proposals now being progressed do not contain any change or reform whatsoever in relation to the harsh and unreasonable "control" test. We note that the IFSA speech contemplated that these interim measures would abolish or substantially curtail the application of that test, and we hope that that task will now be taken up by the Board of Taxation.

If you wish to discuss any aspect of our submission please call me on 02 9290 5623.

Yours sincerely

Ali Noroozi
Tax Counsel

APPENDIX C

Attachment

Comments on draft legislation to reform Division 6C of the Income Tax Assessment Act 1936 (“ITAA 1936”)

Our comments on the draft legislation to reform Division 6C of the ITAA 1936 are set out below under the following headings:

(a) Recommendation regarding proposed exclusion for “the carrying on of a trading activity on a commercial basis”
(b) Proposed paragraph (c) of the definition of eligible investment business (“EIB”)
(c) Clarification that the proposed 75% safe harbour test is indeed only a safe harbour test
(d) Measurement of rent for purposes of the 75% safe harbour test
(e) Recommendation re clarifying what is intended to be covered by an investment in moveable property
(f) Recommendation regarding clarification of measurement of gross revenue for purposes of proposed section 102MC
(g) Recommendation regarding water rights and carbon trading

As indicated in the accompanying letter, the Institute requests an opportunity to review a further draft of the proposed legislation and Explanatory Memorandum.

(a) Recommendations regarding proposed exclusion for “the carrying on of a trading activity on a commercial basis”

This exclusion is in two places in the draft legislation.

Firstly, it is in proposed section102MC. That section would have the result that a trust would not be taken to be carrying on a trading business during a year by reason that part of its income was from things other than EIB if that part was no more than 2% of its gross revenue for the year. However, this relief would be excluded if any of that non-EIB income was from “the carrying on of a trading activity on a commercial basis”.

Secondly, the proposed subsection 102MB(2) 75% safe harbour would be unavailable for a year if the trust had any gross revenue in the year “from the carrying on of a trading activity on a commercial basis” on any of the land in which it had invested.

These exclusions mean that the scope of the concepts of “a trading activity” and “a commercial basis” are critical. However, neither is proposed to be defined.

While aspects of repetition, business-like approaches and profit-making are relevant to when a trade is carried on, some clear guidance (preferably in the legislation itself, or otherwise in the explanatory memorandum (“EM”)) is required to give some practical certainty as to the concept of “a trading activity”. Similarly, the question whether an activity is carried on “on a commercial basis” will not always necessarily be clear. For example, is a profit-making purpose for a stand-alone activity a prerequisite, or would a degree of sophistication and organisation in the manner in which the activity is carried out be sufficient to found the relevant commercial basis?

Alternatively, is “the carrying on of a trading activity on a commercial basis” intended to be interpreted and applied as one composite test, rather than as separate tests of trading activity and commercial basis?

As a separate matter, we consider that the scope of the proposed exclusion is too broad. We see a qualitative difference between the carrying on of a trading activity on a commercial basis where that activity is unrelated to exploiting the particular land and such an activity that relates to the derivation of income from the land or from the use of the land. For example:

- the carrying on of a business of manufacturing goods for sale to the public should, we agree, be treated as “the carrying on of a trading activity on a commercial basis” for purposes of the two places in which the exclusion appears; but

- the derivation of licence fee or other income from the use of the land, or from granting rights to use the land, should, we submit, not be taken to give rise to such a separate trading activity. Instead, it should be recognised that such exploitation is simply one way of deriving income from the land, and that income should then be counted as part of the 25% non-rent income for purposes of the safe harbour test.

Accordingly, ***we recommend that the proposed exclusion be reworded to refer to “the carrying on of a trading activity on a commercial basis, other than a trading activity giving rise to income which is wholly or primarily from land or from the use of land".***

Furthermore, we believe it is essential that the proposed exclusion be the subject of clarifying examples.

Accordingly***, we recommend that examples be included in the legislation or the EM to clarify matters, including, it is suggested, the following situations:***

1. a trustee of a property trust has leased 90% of a plot of land to various tenants who use it as a shopping centre, and retains ownership of, and operates, the remaining 10% as a carpark in circumstances where alternatively:

   (a) the carpark is operated on a stand-alone commercial basis by an agent of the trustee which is a professional operator, and charges to users are set at levels which would be expected if the carpark were owned and operated by a party independent of the trustee;

   (b) the carpark is operated by an agent of the trustee which is a professional operator, is not run on a stand-alone profit making basis, but rather is operated in a manner which indicates it is intended to promote patronage of the shopping centre (for example, by below-market pricing and/or free initial parking periods);

   (c) a trustee owns an office block with different floors let to different tenants, and makes carpark spaces in the basement of the office block available to lessees of the building (but to no-one else) under licences at commercial rates;

2. a trustee which owns a property under construction grants rights to one or more third parties to place advertising hoardings on the property while the building is under construction:

   (a) for monthly periods at prices set under a monthly tender that the trustee runs under which prospective advertisers submit bids, where typically there are ten or more different advertisers with hoardings on site during a month; or

   (b) for the entire period of construction to one third party at a fee set at an annual rate.

3. a trustee owns a property with a shopping plaza on the lower levels and office floors on the upper levels and has leased all of the property to third parties on commercial terms. One of the lessees operates a coffee shop which brings custom, not just to that coffee shop, but also to the shopping levels. This indirectly benefits the turnover rent which the trustee receives from the shopping centre lessees. The coffee shop lessee becomes insolvent, defaults on its rent, and ceases trading. In consequence of these matters, the trustee has the power to terminate the lease, and does so. Pending securing a replacement tenant, the trustee engages an agent to operate the coffee shop on its behalf in the same way, and at the same pricing to customers, in which it was previously operated. The trustee makes a modest profit on this operation for a short period before a replacement tenant is secured. The trustee's subjective primary purpose in operating the shop through the agent is to preserve the customer base of the shopping levels as a whole, from which it receives turnover rent.

In relation to whether the above examples give rise to "the carrying on of a trading activity on a commercial basis, other than a trading activity giving rise to income which is wholly or primarily from land or from the use of land", we suggest that the answer "no" be given for examples 1(a), 1(b), 1(c), 2(b) and 3, and that the answer "yes" be given for example 2(a).

(b) Proposed paragraph (c) of the definition of EIB

Proposed paragraph (c) is as follows:

> "investing in financial instruments (not covered by paragraph (b)) that arise under financial arrangements, other than arrangements excepted by section 102MA."

We submit that a number of improvements or clarifications are required to this paragraph.

Firstly, the word "investing" should be replaced with words which encompass all of investing, trading, issuing or otherwise dealing in the relevant items. This is because the word "investing" on its own might not be broad enough to cover a trustee of a unit trust issuing a guarantee in favour of a third party, either with or without receipt of a premium or fee for giving that guarantee. That the term "investing" is not sufficiently broad is confirmed in ATO documents, such as Private Ruling 69650. (We understand that such guarantees are intended to be covered by paragraph (c).)

Secondly, the concept of investing "in financial instruments" that "arise under financial arrangements" seems unnecessarily complex and restrictive. The term "financial instrument" is not defined. The wording would suggest the necessity not just for a "financial arrangement", but also for a "financial instrument" that arises "under" that financial arrangement. We suggest that the "financial instrument" that ought to be covered by this paragraph may well be *the same as* the "financial arrangement", rather than one *arising under* it.

It thus seems unnecessarily restrictive and complex to require that, to come within paragraph (c), there be a requirement for both of the following:

- an investment (or, as we suggest, an investing/trading/issue or other dealing) "in" a financial instrument; and
- that the financial instrument "arise under" a financial arrangement.

We suggest that the approach be simplified to simply address investing/trading/issuing/other dealings in financial arrangements.

Thirdly, there seem to be ambiguities in the drafting of proposed paragraph (c) and its interaction with proposed section 102MA. ***We thus suggest a need for clarification of the scope and interaction of these two proposed provisions.***

One ambiguity is whether the word "arrangements" where it last appears in proposed paragraph (c) is (as we assume) referring to financial arrangements (as defined) rather than to arrangements (as defined).

In addition, the words "other than arrangements excepted by section 102MA" seem to suggest that what is covered by section 102MA is financial arrangements, as otherwise the exclusion would be broader than the population from which things are being excluded. However, proposed section 102MA does not sit comfortably with the proposition that it is describing financial arrangements. For example, "a right or obligation arising under … an arrangement that … depends on the use of a specific asset … and gives a right to control the use of the asset … " would not seem itself to *be* a financial arrangement, but rather a right or obligation *arising under* such a financial arrangement.

(c) Clarification that the proposed 75% safe harbour test is indeed only a safe harbour test

While the drafting suggests that the proposed 75% test is indeed a safe harbour only, we consider that this needs to be made clearer. In addition, we think it is essential that the legislation preclude any possibility that the 75% safe harbour test could become a basis for the statutory interpretation of the current EIB test.

We recommend that the legislation make clear that the proposed subsection 102MB(2) safe harbour test is indeed only a safe harbour test, and in particular that neither the existence of that test nor the provisions governing how things are measured for purposes of application of that test is to have any significance whatsoever in the interpretation or application of paragraph (a) of the definition of EIB.

(d) Measurement of rent for purposes of the 75% safe harbour test

Property trusts frequently grant leases which involve both the receipt of a premium for the grant of the lease as well, of course, as periodic rent. Such trusts also can receive rent support (amounts in lieu of, or as supplements to, rent). The proposed legislation would not include such premiums as rent or as gross revenue, and would not include such rent support as rent, for purposes of applying the 75% safe harbour test. ***We consider such premiums and rent support should be included in rent and in gross revenue for purposes of this test, and we recommend the draft legislation be amended in this respect.***

We agree that the legislation should exclude proceeds of any CGT event A1 (proceeds of sale) from gross revenue and from rent for purposes of the safe harbour test. However, we believe the exclusion should not be limited to CGT event A1, but should cover other sales proceeds (including from a sale of a pre-CGT property and from the sale of any property that might not be on capital account). Furthermore, since disposal proceeds could relate in part to (Division 40) depreciating assets that are integral with or affixed to real property, the exclusion should also cover that situation.

Accordingly we recommend that the CGT event A1 exclusion be broadened to cover all proceeds of disposal of property, including any part of the proceeds that relates to Division 40 assets that are affixed to or integral with the property.

(e) Recommendation re clarifying what is intended to be covered by an investment in moveable property

Proposed subsection 102MB(1) would provide that certain investments in moveable property would be taken to be investments in land. This is welcome.

However, the current drafting refers to land in a generic sense, and this could give rise to a risk of an unduly restrictive interpretation of the provision.

Certain types of moveable property might customarily be supplied in connection with leases of certain types of land. For example, beds or some other furniture might customarily be supplied with the lease of a property which is used as a hotel. We understand the proposed provision would be intended to treat the trustee's investment in such furniture as an investment in land.

However, such furniture would not customarily be supplied in connection with leases of land used in other ways, such as office blocks or shopping centres.

The use of the word "land" in the proposed provision might imply a generic use, which would risk defeating the objective of the provision.

Accordingly, we recommend that the provision be amended so that:

- its paragraph (a) refers to the renting of particular land;

- its paragraph (b) refers to the renting of land of that kind or in similar circumstances to the renting of that particular land; and
- its paragraph (c) refers to the ownership and use of the particular land.

(f) Recommendation regarding clarification of measurement of gross revenue for purposes of proposed section 102MC

Proposed section 102MC would require a measure of gross revenue. ***We recommend that***, ***the provision be amended so that gross revenue includes any premium received for granting a lease of property.***

We note that gross revenue is normally an accounting concept, which would usually exclude capital receipts. It would usually be measured by reference to accounting concepts of income in accordance with accounting timing recognition rules. Some guidance (perhaps by way of notes in the legislation, or perhaps in the EM), would assist in the practical application of the concept of gross revenue in this tax context.

We recommend that the legislation or the EM include (by way of note or commentary) some guidance on the intended measurement of gross revenue, including confirming that accounting approaches are intended, that the proceeds of asset disposals are not intended to be included, and that accounting timing rules are intended to apply.

(g) Recommendation regarding water rights and carbon trading

It may be appropriate and/or unavoidable that unit trusts will soon be involved in one way or another in carbon trading/reduction and/or dealings in water rights. It is not clear to us that the amended legislation would protect a unit trust from becoming a trading trust in all relevant circumstances. It also seems to us to be preferable to amend Division 6C to address these matters when the general architecture for carbon and water schemes is further advanced, rather than to try to do so now. However, we recommend that the EM flag the necessity for such amendments.

Accordingly, we recommend that the EM foreshadow the necessity for further amendments to Division 6C to give appropriate outcomes in relation to carbon and water trading when schemes for such trading are further advanced.