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Mr Dick Warburton
Chairman
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Mr Warburton,

Managed Investment Trusts Review on Capital/Income Distinction – Managed Funds

Thank you for the opportunity to comment on the Discussion paper on the Board's review of the tax arrangements applying to managed investment trusts.

The Business Law Committee (the Committee) of the Law Society of NSW considered the Discussion Paper and makes the following remarks. The views expressed are those of the Committee alone.

Law Society Key Recommendation

The Law Society believes that the change in approach to the treatment of assets held by managed investment funds should be that the assets should generally be treated as being held on capital account.

1. Capital or Revenue Treatment

- *The persons affected*

The revenue / capital distinction is relevant broadly in two contexts:

- Australian investors in trusts can effectively obtain the benefit of the capital gains tax (CGT) discount (of 50% for individuals and trustees and 33 1/3 % for superannuation funds) where they derive their gains via a managed investment trust which itself holds assets on capital account.
- Foreign investors who make capital gains via a managed investment trust are exempt from Australian tax - whereas income received on revenue account which is Australian sourced (and not treaty protected) may be subject to 30% or higher rates of tax.



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Whether gains or losses on the disposal of investments are on capital account or revenue account is a factual matter. As a general rule where the disposal of assets takes place as part of a business operation, carried out in the course of the business of profit making, the profit arising on the sale will be income according to ordinary concepts: *California Copper Syndicate v. Harris* (1904) 5 TC 159. Such a position can however be proved otherwise where the facts support the argument that the disposal was not such an incident of the business carried on.

In this regard, an investment by a managed investment trust is different to the banking and insurance cases where disposals are an inherent part of the business as circulating capital (*National Bank of Australasia Ltd. v. FC of T* 69 ATC 4042). This is because managed investment trusts are meant as pooled investment vehicles allowing underlying investors to make investments usually of a passive nature (as otherwise they would be taxed as trading trusts - i.e. as companies) and so the trustee is acting for the benefit of unit holders in making passive investments which are not themselves working capital assets.

- *The difference between capital and revenue*

An often cited case in terms of the difference between capital and revenue is *London Australia Investment Co. Ltd v. F.C.of T* 77 ATC 4398. There the majority of the High Court (per Gibbs) stated:

However it is in my opinion established by this and the many other cases in which Californian Copper Syndicate v. Harris has been applied that if the sale in question is a business operation, carried out in the course of the business of profit-making, the profit arising on the sale will be of an income character. To apply this criterion it is necessary "to make both a wide survey and an exact scrutiny of the taxpayer's activities": Western Gold Mines N.L. v. C. of T. (W.A.) (1938) 59 C.L.R. 729, at p. 740. Different considerations may apply depending on whether the taxpayer is an individual or a company. In the latter case it is necessary to have regard to the nature of the company, the character of the assets realized, the nature of the business carried on by the company and the particular realization which produced the profit: Hobart Bridge Co. Ltd. v. F.C. of T. (1951) 82 C.L.R. 372, at p. 383, citing Ruhamah Property Co. Ltd. v. F.C. of T., at p. 154.

The Commissioner of Taxation in Taxation Ruling TR 2005/23 notes the distinction between capital and revenue transactions in the following terms:

77. Similar reasoning would apply to any investment process which implicitly or explicitly envisages an exit point. For example, portfolios managed according to a 'value style' normally envisage the purchase of undervalued stocks and subsequent sale of the stocks once they become 'fully valued' by the market. It would normally follow that such portfolios would be held on revenue account. Similar conclusions may be reached about other investment styles.

78. On the other hand, where the sale of stocks is no more than a mere realisation or change of investment, the proceeds are not recognised as income according to ordinary concepts but as capital gains or losses. The Full High Court set out this principle in FC of T v. Myer Emporium Ltd (1986-1987) 163 CLR 199 at 213 as follows:

...over the years this Court, as well as the Privy Council, has accepted that profits derived in a business operation or commercial transaction carrying out any profit-

making scheme are income, whereas the proceeds of a mere realisation or change of investment or from an enhancement of capital are not income

The proposition that a mere realization or change of investment is not income requires some elaboration. First, the emphasis is on the adjective 'mere': Whitfords Beach ((1982) 150 CLR at p 383). Secondly, profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the profit arising from their expected increase in value: see the discussion by Gibbs J in London Australia ((1977) 138 CLR, at pp 116-118). It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realization. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.....

80. The absence of an investment style which envisages an exit point is one indicator that the portfolio would be held on capital account, so that any disposals from that portfolio would be mere realisations of investments. The 'buy and hold' philosophy is an example of such a style. The relevant case law discloses other indicia which would contribute to a capital account conclusion. These may include:

- a low average annual turnover (that is, less than London Australia , where the average turnover had been in the order of 10%);*
- a lack of regularity in sale activity (AGC (Investments) Limited v. FC of T 92 ATC 4239 (AGC (Investments)); Trent Investments Pty Ltd v. FC of T 76 ATC 4105);*
- a high proportion of stocks sold have been held for a significant number of years (see AGC (Investments) - 75% of stocks sold held more than 5 years). However, if a high proportion of the remainder are turned over, this tends to the opposite conclusion;*
- a low level of sales transactions compared to the number of stocks in the portfolio (see Milton Corporation v. FCT 85 ATC 4243);*
- profits on sale normally constitute a small percentage of total income; and*
- significant percentage of 'aged' stocks remain in the portfolio (AGC (Investments) - nearly 60% of stocks held more than 10 years).*

Applying the above tests in respect of a particular managed investment trust is highly problematic as the circumstances relevant to each factor may change. For example markets may fall meaning a trust's turnover in a particular year may be greatly increased in order to lock in gains to date. The tests also ignore the nature of the entity investing - ie the special pooling character of trusts where the trustee is acting for the best interests of unit holders as opposed to acting for their own benefit.

To date the Australian Taxation Office has taken a view that generally assets held are on capital account, however it is understood this is being revisited. This has caused great uncertainty in the industry.

2. Why Managed Investment Trusts Should be Treated on Capital Account.

The fundamental position of managed investment trusts as pooling vehicles which invest in passive assets lends itself to a proposition that the assets held should be treated on capital account.

- *Division 6C*

Firstly there are separate regimes for taxing trusts which carry on an "active business" (Division 6C).

As such the assets involved are passive in nature and are not generally considered "working capital". The assets themselves are income producing and if held directly would likely be held as longer term investments. In this sense they have the characteristics of capital assets.

- *Pooling Vehicles*

Superannuation funds (and similar entities) are deemed to hold assets on capital account - no matter how much the investment might be said to be for the purpose of acquisition for gain.

Smaller funds and individuals particularly seek to invest via pooled vehicles as they do not have the expertise to invest by themselves.

Many investors would not have a purpose of making a gain by sale but instead investing longer term.

Where trustees were to be said to hold assets on revenue account then there is arguably a disconnect between the majority purpose of the underlying investors and the fund itself.

More importantly there would be a disincentive to invest via a managed investment trust as this would be a less favourable result than investing directly. This would clearly go against a long held policy of encouraging and developing the funds industry in Australia.

- *Foreigners will have a disincentive to invest in Australia*

A revenue treatment would also mean an incentive for foreign investors to invest offshore in jurisdictions which provide more favourable treatment.

For instance, the US as a general rule exempts foreigners investing in US stocks from any US tax - even if the foreigner is trading in the stocks.

Removal of the capital gains tax exemption by treating the fund as holding on revenue account would mean foreign stocks would provide a vastly better tax treatment than those in Australia.

- *Australia as a Financial Services Hub*

The Government has repeatedly noted that the funds industry is likely to be the engine room of the economy once the commodities sector falls away.

Australia also has unique funds management skills and is a leader in many products.

The treatment of managed investment trusts as holding on revenue account would be a serious disadvantage vis a vis overseas locations which would severely inhibit the development of the industry.

- *Administrative Practice*

There has arguably been for many years an administrative practice with the ATO of treating the gains as on capital account. This has been relied on by the industry and investors.

Law Society Key Recommendation

The Law Society believes that the change in approach to the treatment of assets held by managed investment funds should be that the assets should generally be treated as being held on capital account.

We trust the above assists the Board in its deliberations.

Should you have any further queries, please contact Petra Zlatevska, Acting Executive Member of the Business Law Committee on (02) 9926 0106 or by email to pzlatevska@lawsocnsw.asn.au

Yours faithfully,



Hugh Macken
President