WHITEFIELD

12th December 2008

Board of Taxation
taxboard@treasury.gov.au

Re: SUBMISSION RE REVIEW OF MANAGED INVESTMENT TRUSTS

Dear Sir/Madam,

We write specifically with regard to Q7.1 Issues (Capital Gains Tax) raised in the Review of Managed Investment Trusts.

7.1 (a) Application of Case Law Principles

A. Case Law Principles are Differentially Applied Between LICs and MITs, and between differing Investment Management Strategies
The LIC asset class, many of whose members have participated in discussion or litigation with the ATO over many decades on this issue, have on the whole assessed their gains as being on capital account where the gains have been part of a very long term, low turnover, portfolio. Most LICs with higher turnover have treated gains on sale as being on revenue account.

The MIT asset class, and individual investors, have on the whole treated almost all gains on sale of assets as being on capital account, even where turnover levels are high.

The Tax Office's current interpretation of London Australia has created an artificial divide between investment management strategies, with particular investment styles and strategies considered to produce one tax outcome, and other strategies producing the opposite tax outcome. This is despite the vast majority of those strategies being mainstream, commonly accepted methods of managing an investment portfolio.

B. Why Case Law Principles are Differentially Applied
The Case Law distinction between revenue and capital has never been satisfactorily settled, nor consistent principles enunciated, resulting in legal debate and litigation for over 100 years. Further the principles which are purported to stem from London Australia are almost impossible to reconcile with contemporary strategies for long term portfolio management.

This lack of clarity primarily stems from the following:
(a) The objective of both an individual and professional investor in managing an investment portfolio is to obtain **a rate of return**. This will consist of both an income yield, plus capital appreciation.
(b) Prudent and attentive investors must consider the future rate of return they may obtain from their investments at regular points of time, and not just the return based on historic cost. This involves a consideration of whether or not investments **will provide a sufficient rate of return**, or lose capital value, relative to their current market value.
(c) For many reasons, whether risk control, unsatisfactory total return, better alternative investment opportunities, or otherwise, **investors may decide to sell an investment**.
(d) The frequency of the investment sales will in many cases merely reflect the amount of attention being given to the management of the portfolio. **An attentive investor** may be required to change their portfolio mix of holdings on a frequent basis.
(e) In these circumstances the **decision to sell in no way changes the nature of the investor's motive** – which is to maintain an investment portfolio for an extended period of time and to earn a rate of return.
(f) The actions of portfolio management shown at (a) to (e) above would logically suggest that **gains or losses on sale would fall on capital account**.
(g) Further it would appear that the **Capital Gains Tax regime** was intended in part to eliminate the copious debate over revenue and capital distinctions, and to clearly and simply bring capital gains on investment into the tax regime.
(h) Over recent years the **Aust Tax Office has attempted to re-emphasise wording from the London Australia case** suggesting that the majority of gains from current investment management practices should be treated on income account.
(i) While we acknowledge the case law commentary from London Australia, we highlight that:

Whitefield Ltd ACN 000 012 895
Level 7, 20 Hunter Street, Sydney NSW 2000
Telephone (02) 8215 7900 **Fax** (02) 8215 7901

- The revenue / capital distinction has been the **source of continual debate and uncertainty** for many decades. That is, this distinction by its nature is unclear.
- Courts during the 1970's and 1980's were **increasingly of the belief that** gains from the common practices of investment management were on capital account, and this was supported by emerging judicial comment subsequent to London Australia.
- Since the introduction of Capital Gains Tax in 1985 there has been insufficient judicial precedent to provide further clarity on the interpretation of this matter with regard to currently accepted investment practices.

7.1 (b) Costs of Distinguishing between Capital and Revenue

We see the following direct and indirect costs as major difficulties with the current regime:

(a) The lack of clarity as to how the law should be applied renders it almost impossible for individual and professional investors to know what treatment is legally correct. This in turn creates an environment where **extremely costly litigation** and debate may be required subsequent to the event.

(b) The lack of clarity as to the law is requiring most investment managers to incur **significant legal and tax advisory costs** in order to obtain a third party opinion on the uncertain state of the law.

(c) The lack of clear tax status is impacting on the investment strategies adopted by investment managers who may find they have to **alter a prudent long term investment strategy** merely to meet the requirements of the tax law. This may result in investment loss;

(d) The lack of clear tax status provides a **significant level of uncertainty for investors** in MITs who may consider they are investing in a product offering a particular tax status only to find that due to an alternate interpretation of law, their investment becomes subject to a different tax status.

7.1 (c) Considerations Supporting a Particular Capital and Revenue Treatment

We consider the following points **support a statutory rule** treating gains and losses on shares, unit trusts and real property held by MITs and LICs on **capital account**.

(a) The current uncertainty on this issue is problematic for investors and managers, and a **statutory rule a logical solution.**

(b) At 7.1 (a) above, we have **outlined the normal practices of investment management** in the pursuit of a rate of return. These practices will involve the periodic selling of investments. Notwithstanding this, the investor's overarching objective is to hold a portfolio of investments over an extended time horizon.

(c) The Australian Government, in introducing the Capital Gains Tax regime, has mandated a **tax treatment for investments in general**. It would not appear to be the intent of the current law to have realised gains or losses generated by managed investment vehicles treated in a manner which differs from this. To do so would be to discourage the use of managed investment vehicles.

(d) We find the following judicial support for gains or losses being on capital account, where these occur as part of the management of an investment portfolio:

- Such gains or losses represent "a mere enhancement of value by realising a security" in line with the California Copper Case test.
- In Trent Investments, in 1976, delivered after the initial verdict in London Australia, Mahoney J suggested that ***prudent investors*** in the interests of husbanding their capital, would as a normal investment procedure sell shares for the purposes of capital preservation or the pursuit of an alternative better investment. He concluded that such sales, even where undertaken in a systematic and concerted way, were incidental to the business of investing for income, and were thus not income.
- In the ***<u>High Court appeal</u>*** in the London Australia Case, in 1977, ***Barwick CJ*** (dissenting) noted that "Everything received by a taxpayer who conducts a business will not necessarily be income." "Realisations could be said…to be a ***result of the nature of the business, but no part of that nature***." He concluded that the sales were not income.
- In the same case, ***Gibbs J*** acknowledged that if the "shares were acquired on the capital account of the company, for the purpose of adding to its profit-making structure, as the means of producing dividend income, rather than as part of the profit-earning activities within that structure…the fact that the shares were ***realised in a methodical and enterprising way…would not convert the proceeds of realisation into income***
- In the ***Equitable Life Case*** (1989), it was acknowledged that the investment portfolio was managed "so as to enhance its overall capital value", and that this was deemed not in itself to create a capital profit. It was noted that the enhancement of capital value was qualified

by saying that this was still in the context that the shares were dividend yielding investments held for long term investment.

- In ***Case Z3***, heard by the Administrative Appeals Tribunal (1991) it was noted that a "***mere awareness*** [of profit potential] is not enough to make the profit assessable."

7.1 (d) Irrevocable Election

We would not consider that an irrevocable election should apply.

MITs may change their investment strategy. Should a MIT change their strategy from a strategy of investment to one of trading or vice versa, they must be placed in a position to do this and be taxed accordingly.

7.1 (e) Manner of Rules being Structured

We make no comment here on the technical structuring of the law.

7.1 (f) Extension to LICs
Should any such rule be implemented this should be extended to LICs to ensure that there is a consistent taxation regime for Australian investors in direct investments and managed investment vehicles of whatever type.

7.1 (g) Statutory Rule Linked to Investor Type
We consider that a Statutory Rule linked to particular investor types would create unnecessary complications, and would also create an uneven environment for investors. Such a rule would represent an action favouring or encouraging particular investor types over others, and we do not believe this is the objective of this review.

7.1 (h) Private Equity
At a general level we are not aware of any reasons as to why Private Equity MITs should be treated differently.

Yours Faithfully,

Angus Gluskie, Chief Executive Officer
Whitefield Ltd