Infrastructure Partnerships Australia is a national forum, comprising public & private sector CEO Members, advocating the public policy interests of Australia's infrastructure industry.

Infrastructure Partnerships Australia

Submission to the Board of Taxation on the Review of the Tax Arrangements Applying to Managed Investment Funds

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Contact

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INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

Infrastructure Partnerships Australia (IPA) is the nation's peak infrastructure body. Our mission is to advocate the best solutions to Australia's infrastructure challenges, equipping the nation with the assets and services we need to secure enduring and strong economic growth and importantly, to meet national social objectives.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how we do business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

Infrastructure Partnerships Australia seeks to ensure governments have the maximum choice of options to procure key infrastructure. We believe that the use of public or private finance should be assessed on a case-by-case basis. IPA also recognises the enhanced innovation and cost discipline that private sector project management and finance can deliver, especially with large and complex projects.

Our Membership is comprised of the most senior industry leaders across the spectrum of the infrastructure sector, including financiers, constructors, operators and advisors. Importantly, a significant portion of our Membership is comprised of government agencies.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the challenges ahead.

Ms Barron
Managed Investment Trusts Review
Board of Taxation
taxboard@treasury.gov.au

**RE: Review Of The Tax Arrangements Applying To Managed Investment Trusts
Submission By Infrastructure Partnerships Australia**

Dear Ms Barron

Infrastructure Partnerships Australia (IPA) is pleased to make this submission to the Board of Taxation's review of the Australian tax rules applying to managed investment trusts (MITs). This Submission seeks to succinctly highlight certain issues that are of relevance to the effective provision of infrastructure in Australia.

Obviously, tax rules dealing with managed funds and their flow-through treatment are of fundamental importance to the delivery of infrastructure. As recognised in the Board's discussion paper, superannuation funds represent the majority of invested funds in the managed funds industry. This long-term capital, particularly from superannuation funds, is a core element of private sector investment in infrastructure in Australia and increasingly overseas.

IPA considers that certain aspects of the current tax rules affecting MITs are sub-optimal to foster infrastructure investment and indeed, can create obstacles to efficient investment in infrastructure both in Australia and overseas.

In summary, IPA submits that from an infrastructure perspective there is a critical need for an MIT regime which affords:

(i) maximum transparency to investors of tax treatment, including for early stage losses, character retention, and extension of loss utilisation rules available to listed widely-held trusts to all MITs; and

(ii) a coherent and certain framework within which MITs can efficiently mobilise and streamline investment in infrastructure projects, in a manner which is flexible and responsive to marketplace developments and investor needs;

This necessitates, amongst other things, a rationalisation of antiquated and unnecessarily restrictive aspects of provisions such as ITAA Division 6B and Division 6C.

Overall, IPA supports the Federal Government's initiative to review and introduce legislative reforms to develop a simple, efficient, adaptable, commercial and internationally competitive managed investment tax regime.

IPA would like to be involved in further consultations and communications regarding the MIT review and proposed reform measures. We would welcome the opportunity to meet with the Board of Taxation, if required, to discuss in further detail any of the matters raised in this submission.

Should you wish to discuss any aspect of this submission, please contact either IPA's Taxation Taskforce Chairman, Mr Don Green, on (02) 8295 6104 or our National Manager, Policy Ms Julie Burke on (02) 9240 2053 anytime.

Yours sincerely,

Brendan Lyon
Executive Director | Infrastructure Partnerships Australia

Review of taxation of managed investment trusts

General comments

Infrastructure Partnerships Australia (IPA) welcomes the Board of Taxation's initial discussion paper on the review of the tax arrangements applying to managed investment trusts ("MITs").

IPA also welcomes the comprehensive stakeholder consultation and legislative review process aimed at amending the current taxation legislative framework to better align with and reflect the current tax administrative, funds management and investment practices and expectations. We endorse the Board's review objective to seek out reform options for a more workable MIT tax regime to reduce complexity, increase certainty and minimise compliance costs, to establish a "clear and efficient" tax regime for managed investment trusts and to promote Australia as an international and regional financial hub.

However, care should be taken to preserve the current status and growth of the Australian managed funds industry to reach its potential. Any reformed tax arrangements should not create "unnecessary or unintended barriers to investment in Australian managed funds". Indeed, the reform should enhance the attractiveness of investing in Australian managed funds in general; and in infrastructure assets specifically.

As our taxation law does not contain a specific comprehensive tax regime for managed investment trusts, and given that the Board's observations of the "piecemeal and often uncertain" nature of the ITAA Division 6, we believe it is both prudent and timely to systematically and conceptually review the current legislative provisions, with a view to ensuring a coherent and efficient tax regime for our current and future use of managed trusts.

While we believe that the Board's discussion paper identifies the key taxation issues affecting managed investment trusts generally, IPA would like to highlight some specific areas of concern in relation to the impacts on infrastructure investment funds and investors.

Managed investment trusts are increasingly popular in structuring infrastructure investments and projects to manage risks, as flow-through vehicles for tax purposes, and for their flexibility in the distribution of trust income and the transfer of interests. However, complex (often at times ambiguous) laws govern the use of trusts for investment purposes and the taxation treatment of gains and losses in the hands of the investor/beneficiary and at trust level.

Currently, there are no special taxation rules in Australian tax law to promote MIT investment in infrastructure. Yet, taxation impacts on infrastructure in a critically important way, because of the long-term lease or transfer and concession period arrangements involved in investing in major infrastructure projects and assets.

IPA has some concerns how the current tax arrangements for managed investment trusts (MITs) impact on attracting and maintaining domestic and offshore investment in critical infrastructure. At present, these concerns relate to accessing the early stage tax losses in infrastructure projects, the harshness of the trust loss rule and how current tax provisions pose a considerable tax disincentive for managed investment trusts to invest in infrastructure, due mainly to the inability of trusts to use the same business test (SBT) as corporate entities.

On addressing the issues set out in the Board's discussion paper, IPA would like to make some general preliminary points to the Board. From the MIT taxation point of view, although disadvantaged by ITAA Division 6B and Division 6C provisions, the infrastructure sector does not see itself as having the same problems as the wider MIT sector might have. As against various substantial submissions to the Board from the funds management industry representative bodies, professional bodies and professional advisors of which we are aware, this submission is more narrowly focused on the specific tax application to infrastructure and on certain issues which are particularly relevant to private sector investment in infrastructure in Australia.

At this stage, IPA is content to observe the MIT issues and tax treatment development options proposed by respondents to the Board's review. When the Board's proposed legislative reform thinking and material changes are more developed and evolved towards inclusion in its ultimate report to Government, IPA would be interested in being consulted by the Board on the specific implications for infrastructure assets and investment activity.

We have some concerns about the timing of the proposed reforms and of the Federal Government's urgency in trying to pursue the tax reform agenda to attract investors and promote Australia as an international financial hub; particularly given the current volatility and uncertainty in financial markets. Also, we would contend that the requirement that reform initiatives should be revenue-neutral appears to be at odds with fostering our attractiveness as a regional financial hub.

Since the Government's initial review announcement in early 2008, the investment world has significantly changed. We therefore caution the Board against making the tax policy for MITs too complex, as there is a real risk that such action could lead to Australia losing its MIT industry and competitiveness in investment and funds management altogether.

As today's investors can readily make investments in Australia or anywhere else in the world in pooled or collective investment vehicles or other direct investment types, we urge the Board to not make the MIT tax arrangements process too difficult, to not complicate the issues with too many options or with lack of clarity or direction.

At this point in time, what investors now require from their MIT investment is increased transparency on the tax costs involved so that they know what to expect from their investment in the trust assets all the way through including the costs on exit, the costs when the market is up, when the market is down and when debt financing or refinancing is involved.

Support for an improved flow-through tax mechanism for managed funds

IPA supports an improved flow-through tax code for managed funds.

Tax rules dealing with managed funds and their flow-through treatment are important to the provision of infrastructure in Australia. Superannuation funds represent the majority of invested funds in the managed funds industry, as recognised in the Board's discussion paper released in October 2008. This long-term capital, particularly from superannuation funds, is a core element in private investment in infrastructure projects in Australia and increasingly overseas. IPA considers that various aspects of the Australian rules dealing with MITs create obstacles for the structuring of infrastructure projects in Australia and investments overseas, and add significant complexity and compliance costs in relation to such projects.

IPA considers that the existing tax rules relating to MITs are not appropriate for investment by MITs in infrastructure assets. In making its recommendations to Government in relation to tax policies applying to MITs, the strategic nation-building priority of infrastructure projects needs to be considered by the Board, including the policy relating to the Division 6C trading trust rules, which are inappropriate for infrastructure investments.

Support for Policy Principle 1: Equalising tax outcomes for investors

IPA strong agrees with Policy Principle 1 that "the tax treatment for beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly".

The MIT tax rules must generate similar outcomes for superannuation funds and other major investors using MIT structures to invest in infrastructure projects, as would be the case if they invested directly. Each distortion, overlay or limitation on the tax outcomes which arise from a collective investment adds complexity, compliance costs or uncertainty in relation to the structuring of a transaction.

MITs represent collective investment vehicles bringing together funds from various taxpayers in an efficient manner. MITs are not the only mechanism to structure collective investments, but the alternatives of joint ventures and special purpose investment vehicles are not efficient for typical superannuation fund investors – which have various prudential and governance requirements and prefer to invest through collective investment vehicles, rather than having to establish their own special purpose newly-created entities or joint ventures in relation to particular projects.

If the tax system imposes excessive complexities and compliance costs on collective investment vehicles, it will inhibit the successful development of Australia's funds and asset management industries and create additional delays and compliance costs in relation to the assembly of private sector capital for investment into infrastructure projects, and ultimately hold back the necessary development of Australia's infrastructure framework.

Questions about Policy Principle 2: Trusts and passive investment

Policy Principle 2 asserts that "in recognition of the tax advantages available to trusts that are not available to companies deriving business income, flow-through taxation of widely-held trusts … should be limited to trust undertaking activity that is primarily passive investment".

IPA notes that the reference to the tax advantages available to trusts that are not available to companies is not explained. Without a transparent explanation of this assertion, IPA is unable to express unqualified support for this policy principle. This issue is particularly important because MITs investing in infrastructure projects will have capital allowances and other legitimate deductions generated by the MIT, and from the viewpoint of neutrality and equity, it is imperative that these benefits should flow through to investors.

Policy Principle 2 talks of limiting the tax advantages available to trusts to those "undertaking activity that is primarily passive investments". In the comments below in relation to Division 6C, IPA highlights that the concept of income from "primarily passive investment" needs to be calibrated so that an investment in infrastructure projects is treated as being a primarily passive investment able to be conducted in a trust structure.

IPA recognises the actions of Assistant Treasurer and Minister for Competition and Consumer Affairs, The Hon Chris Bowen MP in initiating the interim changes to Division 6C. However, those interim changes do not address the fact that currently a MIT which invests in a passive type infrastructure project (such as a toll road generating toll revenue; or other infrastructure projects generating revenue other than simple rental revenue) will be treated as a company, and will not benefit from the flow-through tax treatment attributable to income.

IPA acknowledges that there may be a tax policy position against extending flow-through taxation to the conduct of active trading businesses such as mining projects or manufacturing in MITs. However, IPA is strongly of the view that the long-term nature of infrastructure assets and the inherently stable quality (and often, regulated nature) of cash flows from typical infrastructure assets qualifies investment in infrastructure projects for treatment similarly to other activity considered to be primarily passive investment activity.

Chapter 4: Options for determining tax liabilities
Q4.1: Alternatives to the present regime: Trustee exemption favoured

Of the three options proposed by the Board for taxation of net income of the managed investment trust, no single option satisfactorily addresses or overcomes the problems of the current model.

The key issue is around the compulsory or forced distribution requirement and also what rate to apply. Requiring an assessment net income to be paid out in cash creates a procedural compliance and process difficulty for infrastructure trusts. Conceivably, another option may be for the Board to leave the flow-through treatment provisions as is, without introducing a requirement for minimum distribution of cash (i.e. respect the trust beneficiary's present entitlement).

Looking at the options presented by the Board's paper, Option 1 (the assessment and deduction model) would require the creation of major legislative scheme to deal with the management of assessments and deductions within trusts, with a very significant re-engineering of Australia's entire MIT system and integration with the treatment of existing trusts.

Option 2 (the trustee exemption model) would mean that the beneficiary is always subject to tax, regardless of distribution. IPA prefers Option 2 which provides that for eligible MITs, the trust is not taxed and that beneficiaries are taxed instead. However, of concern, the Board's discussion paper does not contain substantive detail on how Option 2 would work in practice, and it does not describe or prescribe the mechanism to guide its application in practice.

Option 3 uses the same approach as Option 2 but with a substantial minimum distribution within a specified period. While this appears attractive, IPA notes that this Option 3 would require significant drafting of what is a distribution, and would need to deal with trusts which (in their early formative period) hold back distributions with the agreement of beneficiaries so as to strengthen the capital structure.

The fourth option presented in paragraph 4.10 of the Board's paper is that "alternatively to the above options, it may be possible to retain the basic structure of Division 6 but modify to clarify or redefine the meaning of key terms …".

IPA does not consider that this fourth option would be the most satisfactory solution. In IPA's view, the entire rationale of this MIT review by the Board is to cut through the hugely complex and challenging problems that arise for MITs under the current tax law. Since trusts are used not only for MITs (that is, for collective investment vehicles) but also for the conduct of business activities by private and widely-held organisations, Division 6 has many policy pressures to reconcile tax integrity and system design requirements to deal with privately held trusts of all types, as do numerous other tax rules dealing with trusts (such as those relating to capital gains tax rules and tax losses). Therefore, an approach of resolving all the tax inefficiencies relating to trusts involves more than the key terms mentioned in paragraph 4.10 of the Board's paper. It would involve a comprehensive analysis of the policy settings and 'repair' relating to:

- tax losses;
- capital gains tax treatment; and
- all issues in Division 6 as well.

IPA is more attracted to a stand-alone mechanism, applicable solely to MITs, which would operate efficiently to provide flow-through treatment, appropriately integrated into the trust loss and capital gains tax rules.

The trustee exemption model (Option 2), which sees all net income being assessable to beneficiaries irrespective of the level of actual distributions, would seem to IPA to be viable and able to be implemented with the appropriate tax system integrity in a consultative process.

Q4.5: Unders and overs

MITs associated with infrastructure projects must calculate not only their revenue, but also their capital allowances and other tax attributes and will often have final taxable incomes (calculated when the final returns are prepared) which are slightly different to the taxable incomes that are estimated for the purposes of the financial statements and distributions. Therefore, unders and overs are not uncommon in the infrastructure context.

IPA prefers a simple carry-forward approach for correcting unders and overs, where the unders and over are within a *de minimis* tolerance level. IPA notes that the *de minimis* level proposed of up to 2% of the net income appears inadequate and would prefer the tolerance level to be raised to an appropriate practical level, supplemented by a Commissioner of Taxation discretion to increase the level in special circumstances, as suggested in the Board's paper. Special circumstances might arise in particular uncertainties in relation to capital allowances due to resolution of tax issues and obtaining of information relevant to capital allowances or uncertainties regarding the tax treatment of any income or expenditure of the trust (refer below for discussion about revenue capital treatment) where these issues are reasonable in the circumstances.

Chapter 6: Trusts as flow-through vehicles
Q6.1: Tax deferred distributions

IPA wishes to emphasise that so-called tax deferred distributions are merely a recognition of Policy Principle 1. That is, so-called tax-deferred distributions merely equate to the position of the investor if the investor had been investing directly – in that situation, the taxable revenue to the investor would be shielded in part or wholly by tax deductions for capital allowances and other deductions. So, not every amount of cash distributed by a MIT to its investors is or should be taxable, in order to align the tax outcome of MIT distributions to the investor's treatment if the investor held that investment directly.

Q6.2: Character retention and flow-through

Consistent with Policy Principle 1, it is important that the involvement of a MIT representing widely-held collective investments in an infrastructure project should not result in distorted tax outcomes, as compared with those that would apply if superannuation funds or investors were to invest directly.

IPA strongly supports the continued character retention and flow- through of income, with special legislation to protect flow-through taxation on a general basis for all MITs.

IPA believes it does not make any difference in character retention whether the non-resident investor is a portfolio or non-portfolio investor.

IPA submits that there are commercial reasons why we should not change the flow-through treatment and why we should maintain the flow-through characteristics of tax-deferred income distributions.

To the extent that there is potential for double taxation, IPA is strongly of the view that an appropriate mechanism should be developed to prevent that outcome.

Chapter 7: Capital versus revenue treatment of gains and losses made on disposal of investment assets by MITs

Q7.1: Capital and revenue treatment

IPA is concerned about the current increased uncertainty and potential risk of major tax consequences for MITs and investors in relation to the capital-revenue characterisation of their investments. This uncertainty, if left unresolved, has potentially damaging implications for Australia's financial markets.

(a) Case law and current position

In IPA's view, the way forward is based around Policy Principle 1, for the capital-revenue characterisation rules for MITs to recognise that MITs are merely collective investment vehicles which bring together the savings of Australians and overseas parties, which have at least a theoretical opportunity to invest on a stand-alone basis, either directly or through joint ventures. As a result:

- If the capital-revenue issue is not resolved in a neutral manner, then the more astute investors such as larger superannuation funds and larger investors will, over time, move away from Australia's MIT sector and will tend to invest in projects through joint venture or direct investment models, in order to retain their existing tax treatment. This would be counter-productive to the world-class quality of Australia's MIT sector at this time of great financial uncertainty, and to the policy objective relating it to Australia as a regional financial hub. .
- Foreign investors, which have tax concessions of their own (such as foreign superannuation funds etc.) also might over time be less motivated to invest through Australian MITs if there are distortions in the capital-revenue characterisation of their investments. Foreign investors have flow-throughs in various areas such as venture capital and Australian capital gains tax rules, but potentially these are at risk if the capital-revenue issue cannot be resolved at the core.

Looking at the principles and the case law discussed at paragraphs 7.6 and 7.7 of the Board's discussion paper, IPA observes that these comments are somewhat incomplete. They do not recognise that an unlisted MIT which has redemption or repurchase obligations will often need to provide liquidity, and conversely fresh equity will also be contributed, which will mean that the MIT will be selling and buying assets. Unlike a trustee of a deceased estate where there will be an initial fund of assets available for investment, a MIT (particularly an unlisted trust or a wholesale trust) will have transactions arising from the simple entry or exit of investors, which need to be factored into the analysis.

In some specific cases, MIT activities should be treated as being on revenue account (for example, if the MIT is dealing in financial instruments or if cash management trusts are generating income). However, having very fact-specific rules and being governed by case authority which is inappropriate or not fully aligned to the requirements for MITs, is uncertain and inadequate.

The issue of capital-revenue treatment also seems to not properly consider the implications of the CGT discount rules. IPA notes that CGT rules provide a CGT discount in relation to assets held for more than 12 months, and this CGT discount can effectively be flowed through to distributions to investors. Therefore, there is already a concession available for longer-term holdings (of more than 12 months) that is not available to shorter-term holdings. IPA notes that the complex analysis by the ATO touched on in the Board's paper, along with the high level of uncertainty in the market, does not pay due regard to the 12 month rule in place for CGT purposes. That is:

- If MIT gains (other than certain exceptions) are characterised as capital, this does not mean that Australian resident beneficiaries will generate some permanent tax advantage. Australian resident investors will be taxable in line with their normal tax position in relation to distributed capital gains.

- The CGT discount 12 month rule will mean that the discount will continue to be available only where CGT assets have been held for more than 12 months.

(b) Impact on compliance costs

In IPA's view, the inherently uncertain and changeable nature of case law authority, particularly when considered in the context of evolving infrastructure project delivery models, unquestionably increases compliance costs on an ongoing basis.

(c) Legislative reform needed

IPA submits therefore that the MIT rules for capital-revenue characterisation should align to those that apply to superannuation funds in Australia under ITAA section 295-85.

The assets of an MIT should be treated as being on capital account and not revenue account, as default position for all assets other than a specified range of exceptions. The exceptions could be modelled to those applicable to superannuation funds

That characterisation should flow through into distributions by the MIT to its investors.

(d) Trusts must have the ability to select revenue treatment and an election is an appropriate mechanism

IPA agrees that certain MITs should have a revenue, rather than capital, characterisation and should be permitted to retain or have revenue treatment. This is particularly important, for example, in situations where losses might have arisen or might arise or where the possibility of some losses being classified as capital might be inappropriate, having regard to the design of a MIT and its stock of existing assets, and also where a treaty exemption is available for revenue, but not for capital gains.

As a result, IPA submits that a MIT should be given an election to opt out of capital characterisation, so as to enable those MITs which are conducting revenue activities to continue to do so. IPA recognises that this election need not be revisited and that an irrevocable election might be appropriate, provided that there is a flexibility provision for the Commissioner of the ATO to agree to a change in a MIT's elective treatment in the event of special circumstances (such as a fundamental change in operations of a particular MIT).

(e) Flow-through

There should be a clear statutory rule that the characterisation of gains in the MIT should flow through to investors. This characterisation should apply to all investors. If the ATO or Treasury believe that there are some integrity reasons which would limit the characterisation flow-through, IPA would like to see the analysis of those integrity concerns and would wish to participate in the consultation to develop any such listing. In the absence of substantial integrity concerns, the characterisation should apply to all investors.

(f) Other collective investment vehicles?

The Board asks for comments on whether the statutory capital-revenue rules should apply to other collective investment vehicles including LICs. IPA believes that this should be the case, in order to have a level playing field for collective investment vehicles in Australia. To maintain an efficient capital market that enables Australian and international capital to be brought together for the benefit of investment including socially desirable infrastructure investment, IPA suggests that it is inappropriate to have a hugely complex array of differential tax rules. Therefore, IPA submits that the capital-revenue statutory rule should be applicable to all collective investment vehicles on an elective basis.

(g) Statutory rule treating MIT gains distributed to particular kinds of investors as being on capital account

Refer to (e) above.

(h) Private equity and other medium-term investors

As private equity funds are not typically within IPA's primary focus, IPA declines to comment on this question.

Chapter 8: Implications for the definition of fixed trust

Q8.1(a): Application of the fixed trust characterisation to MITs

IPA submits that the entire issue of fixed trust characterisation should not apply to MITs. IPA perceives that the entire superstructure of fixed trust rules was developed to deal with privately-held trusts having substantial and dominant discretionary elements. As a result, trust taxation rules, even those including scrip takeovers by trusts and capital restructures by MITs, must navigate through fixed trust issues, which are statutorily unresolved.

IPA submits therefore that where an entity will be classified as an MIT for purposes of the tax rules, it should be statutorily treated as a fixed trust for all purposes of the tax law. Otherwise, Australia will see continued uncertainty around MITs in relation to many tax issues which are subject to the fixed trust rules, including the treatment of income, deductions, losses, takeovers and CGT rollovers including scrip takeovers etc.

Q8.1 (b): Trust losses

Trust losses represent a significant issue for infrastructure, rather than for other property or investment fund types. The need to address trust loss issues in MITs is a major practical concern for infrastructure funds – arguably for more than an y other sector. IPA believes that restrictions imposed on the ability of taxpayers to use carried forward losses presents a major disincentive to private investment in large-scale, capital-intensive 'consortia' projects where there are private sector capacity constraints, namely infrastructure assets. (See IPA's submission to the Henry Review in Appendix 1.)

In IPA's submission, it is critical for the utilisation of private sector investment in infrastructure for investors to be able to access early stage losses in infrastructure projects through MITs.

It is also critical that investors be afforded certainty with respect to utilisation of tax losses, generally, in MITs.

The current regime, in distinguishing between listed widely-held trusts (able to access the same business test) and unlisted widely-held trusts (not able to access the same business text), creates pressure to list in an environment where that may not be the most efficient option in the current market turmoil. Moreover, maintaining the distortion between listed MITs and unlisted but widely-held MITs in relation to access to trust losses can lead to structural inefficiencies.

Chapter 9: Eligible investment business rules in Division 6C (trading trusts) of the *ITAA 1936*

IPA is strongly of the view that Division 6C has a negative influence on investment by MITs in infrastructure projects, and represents a deadweight on private sector involvement in infrastructure projects.

Q9.1: The 20 per cent rule for complying superannuation funds?

IPA is strongly of the view that an investment of more than 20% by complying superannuation funds should not create a tax disadvantage for a MIT. Put simply, Division 6C has been rendered obsolete by:

(i) superannuation funds being largely taxable, where once they were exempt; and

(ii) superannuation funds and exempt entities and other Australian taxpayers being provided with refundable franking credits, where at one time they had no entitlement to refundable franking credits.

Even more importantly, it creates impediments to efficient infrastructure and related investment in Australia.

Q 9.2: Dealing with the income of MITs

IPA has a strong interest in ensuring that the rules around acceptable investments by MITs do not continue to distort and hinder investment into Australian infrastructure projects by widely-held investment vehicles.

IPA questions whether Division 6C needs to be retained at all, and observes that the Board's discussion paper does not provide the full detail necessary to resolve this policy issue – in particular, an assessment of whether trusts or companies are advantaged from a tax perspective.

(a) Approaches to eligible investment rules

It is imperative that the eligible investment activities of Australian MITs must allow for investment without tax distortions in respect of infrastructure projects, and in particular for investment in:

- toll roads producing tolls;
- ports producing income not being rental income simpliciter;
- social infrastructure projects (such as schools, hospitals and prisons) in return for a payment stream, whether producing rental income or not; and
- overseas infrastructure projects. IPA cannot see any justification for taxing MIT investments in foreign infrastructure projects, which cannot possibly involve any underlying Australian company tax, as company income.

"Investment in land": The definition around infrastructure in the context of an "investment in land" in Division 6C needs clarification. Ideally, IPA members would like to see infrastructure treated as real

property and brought into the broad property exclusions, with a specific Division 6C carve-out for infrastructure project investments.

We propose that all infrastructure activity should have its own paragraph in relation to being an eligible investment business (EIB) activity for tax purposes, such as an eligible investment business (EIB) activity includes an investment in infrastructure facilities. For example, this could be done by adding to the definition of 'investment in land' as "including infrastructure facilities" and then listing out such infrastructure. As a starting point, infrastructure facilities should be defined to include, but not be limited to, those facilities covered by the definition of infrastructure facilities in section 93L of the *Development Allowance Authority Act 1992.* IPA would wish to be consulted in relation to further inclusions to ensure the definition is adequate.

Financial instruments: Despite recent amendments, the current list of financial instruments that a unit trust may invest in without triggering the Division 6C public trust trading rules is still limited, and does not encompass some of the more complex financial instruments that being developed for property and infrastructure investments. Further amendments should be made to incorporate the broader collection of such structures available and in use.

(b) Control of companies

If an infrastructure project might involve some activity which is clearly of a trading nature, as distinct from the pure infrastructure revenues outlined above, the Australian tax laws should enable this income to be earned in a company, which pays company tax and which can be controlled by the relevant MIT. In other words, the IPA supports the abolition of the control test.

From a high level policy perspective, IPA submits that if trading income is clearly subjected to the company tax system and company tax is paid, then there should be no requirement for the investment fund which happens to control such a company to be disentitled from the ability to flow-through dividend income and to conduct its own eligible activities.

(c) Consequences of breaching eligible investment rules if retained

If a fund breaches the eligible investment rule, the current policy of Division 6C sees the entire fund's income being subject to income tax. IPA submits that this is a fundamentally flawed policy setting. This "all-or-nothing" effect is not neutral or equitable.

IPA submits that if eligible investment rules were ultimately required to be retained (and for the record, IPA would not support such a proposition), then:

- any tax disadvantage should be imposed only on the "tainted" income; and
- the tax disadvantage would be the imposition of income tax at company income tax rates (as currently occurs), but only on that tainted income.

IPA recognises that tax system integrity might require that such a control test should carry with it an arms length requirement, in order to prevent uncommercial transactions between the fund and its controlled subsidiary.

Q9.3: Real estate investment trusts

IPA observes that creating a new REIT regime would appear to be a complex undertaking. IPA believes that establishment of a clear MIT flow-through regime might obviate the need for a REIT regime.

IPA has not yet fully considered the costs and benefits, pros and cons of a separate REIT regime at this point in time. However, IPA would like to engage further, as the Board's stakeholder consultation advances.

While a MIT-specific taxation regime along the lines proposed in the Property Council's submission to the Board might be an ideal solution, IPA would have concerns that the regulators might design and implement a separate MIT regime differently than suggested (for example, along entity taxation lines with a 'profits-first' rule). Accordingly, IPA would only support a codification that is "intended to regularise and facilitate the operation of a flow-through taxation regime" for MITs.

Chapter 10: Division 6B of the *ITAA 1936*

Q10.1: Division 6B and reorganisation of companies

The removal of Division 6B has been anticipated, and there was no argument in the Board's discussion paper for its retention. IPA contends that Division 6B has become obsolete in the current

framework and it is no longer needed. We support the proposal that Division 6B not be retained in the revised legislation.

Chapter 11: Defining the scope of a managed investment trust
Q11.1: Defining a MIT

IPA submits that the MIT definition should be broader than the definition which currently applies. In particular, the MIT definition should:

(i) accommodate unlisted “wholesale” trusts which bring together collective investments of superannuation funds (Australian and international) and other widely-held entities; and

(ii) recognise and accept differential rights of investors in the MIT. IPA submits that there is no compelling reason to have a requirement for a single uniform class of investment by every unit holder. If there are integrity concerns which can be identified, then these can be accommodated in some special purpose integrity rules, rather than restricting the flexibility of a MIT. In particular, we note that there might be different classes of investors with different risk tolerances, and therefore the MIT should be permitted to have investors with a mix of preferred or deferred income capital or voting entitlements.

APPENDIX 1:

Extract from Infrastructure Partnerships Australia's submission to Australia's Future Tax System Review Panel, October 2008

Restrictions on the use of tax losses in the infrastructure context:
The long life of infrastructure imposes considerable risk on the likely returns for new investment. The extent to which Australia's tax system restricts access to early stage tax losses in infrastructure projects is a major problem or inefficiency in the tax treatment of major public infrastructure projects.

Early stage tax losses in infrastructure projects are generated from the typically large capital allowance and interest expenses deductions involved in major infrastructure development and, also, the delay involved in these projects commencing to produce income.

In some cases, investors may wait until an infrastructure project commences to produce income in order to utilise those tax losses, but in most cases, it is more efficient to use them as soon as possible, maximising their value. For instance, interest costs incurred during the construction period are usually deductible during that period even though the project in question may have no revenue (i.e. the interest costs are treated as a loss). Such a loss can normally be carried forward and progressively offset against profits during the operational phase of a project.

The ability to use carried forward losses depends on continuity of ownership and the same business tests. Should a change in majority ownership in the entity occur early in the life of the project before those losses are fully offset against profits, those losses cannot be deducted by the new owner against future project profits. Instead, in these circumstances, profits from the project are arguably taxed on an illusory basis during the operational phase because the tax treatment of the project's profits fails to take into account the significant sunk costs incurred at the outset of the project (i.e. interest incurred during construction).

IPA contends these restrictions imposed on the ability of taxpayers to use carried forward losses is a disincentive to private investment in assets with a higher risk profile, such as infrastructure assets.

APPENDIX 2:

Extract from Infrastructure Partnerships Australia's submission to the Treasury, 26 March 2008: "Potential changes to the eligible investment rules for managed funds including property trusts: Industry consultation paper"

Infrastructure Partnerships Australia (IPA) is pleased to provide this submission to concerning its Industry Consultation Paper which outlines certain potential interim changes to the Division 6C of the ITAA 1936 Public Trading Trust Rules.

IPA welcomes the Government's review of Division 6C and the wider review into the taxation of managed investment trusts to be conducted by the Board of Taxation (the Board) as announced by the Assistant Treasurer on 22 February 2008.

We are concerned to ensure that the interim Division 6C changes and the further review by the Board considers the importance of an effective flow-through taxation regime for collective passive investment in infrastructure assets in formulating its responses. It is useful that the proposals address the particular problems with the taxation of trust vehicles encountered by the infrastructure sector and investors in the sector.

A major concern of IPA in respect of Division 6C is that the current formulation of the "eligible investment business" rules do not clearly account for the range of passive investments undertaken in the infrastructure sector which should be accepted as not being a "trading business". This has led to significant uncertainty surrounding the potential adverse application of the rules.

IPA welcomes Treasury's consideration of ways in which the Division 6C rules can be improved to provide greater certainty as an interim measure, pending the wider modification of the rules. We provide a number of brief recommendations below in relation to the items discussed in the consultation paper.

Investments in land and the definition of rent
IPA recommends that the current structure of Division 6C which tests the trust's activities in terms of the definition of "eligible investment business" (EIB) and assets is retained as the primary test for the Division with modifications as set out below.

IPA is concerned with the limitations inherent in the suggested replacement of the definition with a "25% non-rental gross income test" as described in the consultation paper. We support however the formulation of an additional safe harbour type test where there is a limited amount of income which does not meet the revised EIB definition, to provide greater certainty.

Investment in land modifications
It is submitted that the definition of EIB which includes investing in land for the purpose or primarily for the purpose of deriving rent should be modified in order to ensure that investments that are closely associated to land and infrastructure assets are covered by the definition. The definition should also cover investments that may not strictly be land assets. (For example, it could be chattels on leased land or deemed as chattels under specific state or federal legislation which may or may not make the items land for Section 102M).

Further, the definition of land should be clarified to ensure that interests are included that may potentially, in certain circumstances, fall outside the general concept of land (e.g. underground/underwater tunnels).

The definition of land for this purpose should include all types of infrastructure assets regardless of whether the assets constitute land or an interest in land in the strict sense, and regardless of sector. Such assets include, without limitation, infrastructure being road, rail and rail facilities, ports (including airports) and port facilities, power generation, transmission and reticulation, telecommunication towers, natural resource processing, treatment and transportation, and waste treatment and disposal infrastructure.

Rent modifications
The definition of EIB also requires a change to the term “rent” which does not appropriately encompass the types of passive investment activities which should be acceptable under the Division. The narrowness of the term also creates uncertainty and inequities. In particular, the general or common law definition/concept of 'rent' is no longer relevant to modern day infrastructure, property and related trusts as the activities of many trusts give rise to passive income that may not rightly fall within this definition/concept.

The definition should encompass all passive income, irrespective of the form of such income, derived from the granting of relevant rights in or over use of land, associated land assets and infrastructure assets, as discussed above. Such income whilst not technically rent is economically equivalent to rent and should therefore be acceptable.

Investments in financial securities
In relation to Treasury’s interim proposals for expanding the list of other financial securities which are acceptable in section 102M of Division 6C, IPA agrees with Treasury’s approach to add an additional broader definition of financial arrangements.

Treasury must confirm however that such a broader definition would resolve the uncertainty with the range of financial securities which are currently considered uncertain as to whether they fall within the current definition. This includes for example certain guarantee arrangements and financial derivatives. It may be necessary to separately list some further arrangements in the definition of EIB if any such doubt exists.

In this regard, IPA recommends that:

1) The list of financial securities in section 102M should include an item which adopts a broad definition of financial arrangement.
2) Treasury should ensure the broad definition covers all uncertain items or should include any such items where there is doubt separately on the EIB list.

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