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Dear Sir

Submission on Implementation of a new tax system for managed investment trusts – Discussion Paper October 2010

We welcome the opportunity to make submissions in relation to the Discussion Paper released in October 2010 on the design and implementation details of the Government's new income tax system for managed investment trusts (**MITs**) (**Discussion Paper**).

In this letter we make certain submissions on the points covered by the Discussion Paper. We are available to discuss or meet in relation to any items contained in this letter or generally in relation to the implementation of the new income tax system for MITs.

The reforms to the tax laws applying to MITs outlined in the Discussion Paper contain a number of positive measures, including the application of the carry forward approach for correcting net 'unders' and 'overs' below a *de minimus* level, the cost base adjustment arrangements to address potential double taxation issues and the character and source retention principles. These measures represent significant progress towards the MIT reform process.

There are a number of issues that we identified in reviewing the Discussion Paper that we submit require further consideration as follows:

1. Definition of a MIT in the existing capital account election (Division 275) rules should be retained when formulating the rules for qualifying as a MIT for income tax purposes subject to certain carve outs.

2. The proposed clearly defined rights or entitlements is not sufficiently tailored to today's MITs.

3. It is inappropriate to tax the trustee of MITs at the top individual marginal rate for unattributed income.

4. Specific integrity rules for countering the streaming of tax benefits and value shifting should be drafted having in mind the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (Part IVA) and the existing value shifting regime.

5. Some form of roll-over relief or other relief is required to facilitate amendments to a MIT's trust deed that may be required to comply with

any clearly defined rights requirements in order to avoid any unintended income tax and stamp duty resettlement issues.

We will discuss each of these issues in turn in the course of this submission.

1. Definition of a MIT

In formulating the rules for qualifying as a MIT for income tax purposes, as much as possible, the existing rules for qualifying as a MIT should be retained so as to avoid unnecessary duplication. However, there are two exceptions to the existing Division 275 rules which we submit may not be relevant or appropriate when outlining the availability of the attribution system of taxation.

The first exception should be the "widely held" and "not closely held" requirements imposed on trusts seeking to qualify as MITs for capital account election purposes. As noted at paragraph 14 of the Discussion Paper, under Subdivision 12-H of Schedule 1 to the ITAA 97, a trust must satisfy certain "widely held" and "not closely held" tests depending on what type of trust it is. Division 275 of the ITAA 97 extends the concept of MITs for capital account election purposes to also encompass licensed Australian trusts where the only member of the trust is a specified "widely held" entity.[1]

We submit that there is no basis for restricting the attribution system of taxation only to these ultimately "widely held" or deemed to be "widely held" trusts. While this restriction makes sense in the context of the withholding tax and capital account election provisions, which are designed to enhance the competitiveness of the Australian managed funds industry, the attribution system of taxation is intended to remove longstanding uncertainty for investors and trustees as to the taxation of beneficiaries of MITs. This is a clarity which would equally benefit investors and trustees of closely held trusts and so there is no reason why closely held trusts should not also be to apply the attribution system. We note that any closely held trust would still need to satisfy any formulation of the "clearly defined rights" test to have the benefit of the attribution regime, and therefore discretionary closely held trusts would not qualify.

Secondly, even if the "widely held" requirements as applicable to trusts seeking MIT treatment for capital account election purposes are retained, we submit that there should be no carve-out for trusts whose sole member is "an entity that is recognised under a *foreign law as being used for collective investment by means of pooling the contributions of at least 50 members of the entity as consideration to acquire rights to benefits produced by the entity, if the members of the entity do not have day-to-day control over the operation of the entity" (**foreign MIS equivalent**), as exists in the capital account election rules.[2]

While the capital account treatment may not be relevant to such a trust (and therefore a carve-out for these trusts in the context of those provisions is appropriate), for general income tax purposes including the attribution system of taxation, a trust whose sole beneficiary is a foreign MIS equivalent may still need to determine the taxation of its income in certain circumstances.

For example, take the case where 100% of the units in a MIT are held by an entity that qualifies as a foreign MIS equivalent under subsection 12-402(3)(e). If the MIT receives $100 of rental income in an income year, but only distributes $50 as a fund payment (which is subject to MIT withholding tax), then (assuming the other requirements of attribution are satisfied) the remaining $50 should be capable of being attributed by the trustee of the MIT to the foreign MIS equivalent unitholder and be subject to MIT withholding to provide clarity and certainty for the unitholder and trustee as to the tax treatment of the retained amount. Similarly, if the MIT instead distributed none of the $100

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1 Subsection 275-15(1) of the ITAA 97.

2 Subsection 275-15(1)(b)(i) of the ITAA 97 carves out such trusts from the extended definition of a MIT for capital account election purposes.

income as it wanted to reinvest the funds in other properties, that income should be able to be attributed to the foreign MIS equivalent unitholder.

2. Clearly defined rights or entitlements

We submit that the proposed "clearly defined rights/entitlements" requirement is not workable in practice. Most existing trusts will have the discretions described in the Discussion Paper and will not strictly be "fixed" in the sense described in paragraph 33 of the Discussion Paper. The exceptions to the general clearly defined rights requirement are also uncertain. For example, it is proposed that certain trustee powers can be disregarded if it does not significantly affect the market value of any of the unitholders' interests. Tests which use benchmarks such as "significantly" or "little or no likelihood" causes uncertainty and whether something will "significantly" affect the market value of unitholders's interests is subject to change.

The aim of the reforms to the taxation of MITs is to tailor the law to today's concept of a MIT. It has also been recognised that most MITs do not qualify as fixed trusts under its current definition in the tax law. However, under the proposed requirement, most existing trust deeds for trusts in the managed funds industry will have to be changed in order to, on its face, satisfy the clearly defined rights requirement and fall under the attribution method of taxation. This effectively replicates the same problem that arises with the current fixed trust definition. Accordingly, we recommend that the Treasury consider less onerous requirements in relation to when a MIT can apply the attribution method of taxation in order to benefit bona fide managed funds. In particular, we recommend the Treasury consider in detail the clauses in the trust deeds of bona fide trusts in the managed funds industry when developing the requirements. For example, most trusts in the managed funds industry will have a clause which enables new units to be issued at market discounts (eg. 15%). This clause is well accepted in the market and should not cause non-compliance with the requirement to use the attribution method of taxation.

Paragraph 40 of the Discussion Paper suggests that it could be appropriate for some types of MITs to be treated as automatically satisfying the clearly defined rights requirement. We submit that MITs that operate under the existing regulatory regimes, in particular, MITs that are registered MISs for the purposes of the *Corporations Act 2001* should be allowed to automatically apply the attribution method. As set out in paragraph 41 of the Discussion Paper, the *Corporations Act 2001* prescribes rules which sufficiently regulate Australian managed investment schemes and so there is already assurance that the integrity of the tax system is not undermined.

With regards to "constituent documents", we submit that it should be described by a general reference rather than a listing approach. There should be some flexibility in what constitutes constituent documents in order to accommodate the constant change in the industry and regulatory standards which will no doubt affect the documentation arrangements for MITs.

3. Unattributed income

We note that at paragraph 49 of the Discussion Paper, it is proposed that one of the guiding principles of the attribution method will be that the part of the tax income of the trust that is not attributed to the unit holders within three months of the end of the income year will be assessed to the trustee at the top individual marginal rate (currently 46.5% including Medicare levy), unless the income is subject to the "unders" and "overs" rules.

We submit that it is not appropriate in principle to adopt the maximum individual marginal rate (as it stands from time to time) as the rate of assessment for all tax income not attributed within the relevant timeframe. While we acknowledge that the adoption of the maximum rate would prevent the deferral of tax by any underlying beneficiary, we submit that the imposition of the maximum rate in all cases would, in fact, inevitably penalise most taxpayers. We refer to table 2.14 of the *Taxation Statistics 2007-08*, published by the ATO, which indicates that in the 2007-08 income year only 2.7% of all taxpayers had taxable income subject to the maximum rate. We also note that in the Australian managed funds market, investors are predominantly superannuation fund investors who are taxed at a rate of 15% and non-resident investors who are subject to a tax rate of 7.5%.

Instead, we propose that a rate should be chosen which more accurately captures the expected value of the tax which would be payable on the tax income of the trust if it were attributed to unit holders generally. In setting this rate, we note that a key constraint on the rate is the objective of maintaining neutrality from an investor's perspective between the MIT investment structure and a corporate investment structure. Given that the ultimate beneficiaries of MITs could also invest through a corporate structure, where retained earnings would be taxed at the 30% corporate rate, any rate higher than 30% will act as a disincentive to adopt the MIT structure.

We submit that having regard to the above factors, 30% would be the most appropriate rate at which to assess unattributed tax income of a MIT.

4. Integrity rules for the attribution method

We note that specific integrity rules are proposed to counter the streaming of tax benefits and value shifting. We submit that in drafting these rules, regard should be had to the interaction of any specific rules which are introduced in the context of MITs with the general anti-avoidance rules contained in Part IVA and the existing value shifting regime. The introduction of new rules should be limited to the extent that it is uncertain whether existing rules would suffice to ensure the integrity of the attribution method.

Part IVA gives the Commissioner of Taxation the discretion to cancel a tax benefit obtained by a taxpayer where the taxpayer is found to have entered into a scheme for the sole or dominant purpose of obtaining that tax benefit. On its face, it appears that Part IVA might well apply in the context of the proposed integrity rules, as they are only intended to apply where streaming and/or value shifting results from a change in a MIT's constituent documents. It appears that such an arrangement would be likely to constitute a scheme and result in a tax benefit for one or more unit holders. However, it is conceivable that such a change might not be found to have been procured for the sole or dominant purpose of obtaining any resulting tax benefits, where for instance that purpose is ancillary to a broader purpose of effecting governance changes in the trust. In this context, there may be a "gap" in the operation of Part IVA which an anti-streaming rule and a value shifting rule could address.

5. Resettlements

If the clearly defined rights requirements are introduced as currently proposed, it is very likely that amendments will need to be made to a MIT's trust deed to ensure it complies with the new requirements. In some cases these amendments could be substantial. Whenever there is a change of a trust deed affecting the rights of unitholders', consideration will need to be given as to whether the amendments affect a resettlement at law. This could result in uncertainty and increase compliance costs and may present a barrier for some MITs to take advantage of the reforms.

It is submitted that although the ATO has released a Statement of Principles on when changes to a trust result in the creation of a new trust/resettlement (refer http://www.ato.gov.au/print.asp?doc=/content/14283.htm), it will be difficult to predict for any particular MIT whether changes made to give effect to new clearly defined rights requirements will cause a resettlement. This is because whether an amendment or replacement of a trust deed causes a resettlement needs to be considered on a case-by-case basis. We also note that the types of amendments required are likely to affect the relationship between the trustee and beneficiaries in respect of the trust property rather than procedural matters. This is one factor which the ATO has indicated in their Statement of Principles which may cause a new trust to be created.

Accordingly, we submit that some form of roll-over relief or other relief is required to facilitate amendments to a MIT's trust deed that may be required to comply with any clearly defined rights requirements.

There is some precedent for roll-over relief in this context in Subdivision 126-C of the *Income Tax Assessment Act 1997*. That Subdivision provides roll-over relief where CGT event E1 or E2

happens in relation to a CGT asset of a trust because the trust deed of a complying superannuation fund is amended or replaced for the purpose of, among other things, complying with the *Superannuation Industry (Supervision) Act 1993*. The roll-over relief would also need to cover CGT events that could happen to members of the MIT (eg CGT event C2). Accordingly, in our submission, it would be preferable for the roll-over relief to apply to all CGT events that may happen to the trustee of the MIT or the members of the MIT as a result of a resettlement.

An alternative approach would be to introduce a deeming rule in the tax legislation which provides that for the purposes of the relevant tax legislation any new trust created because the trust deed of a MIT is amended or replaced for the purpose of complying with a clearly defined rights requirement is taken for all purposes of the tax legislation to be a continuation of the original MIT. This deeming should ideally extend to other tax legislation such as the *A New Tax System (Goods and Services Tax) Act 1999* and the *A New Tax System (Australian Business Number) Act 1999* so that there is minimal disruption to a MIT's tax compliance systems.

Resettlements also give rise to stamp duty issues and stamp duty costs. For many funds such as those investing in property, stamp duty costs would be prohibitive if the changes cause a resettlement of the trust. Accordingly, as indicated above, the clearly defined rights requirement should be drafted to allow minimal or no changes to be made to trust deeds of bona fide property funds. Alternatively, we submit that the Treasury should work with the State governments to ensure that similar stamp duty relief is provided.

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Please call Vivian Chang on (02) 9258 5732 if you have any questions in relation to this submission.

Yours faithfully

Blake Dawson

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