The Institute of Chartered Accountants in Australia

16 November 2010

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

email: SBTR@treasury.gov.au

Dear Raphael

Discussion Paper - Managed investment trusts

The Institute of Chartered Accountants in Australia (the **Institute**) welcomes the opportunity to comment on the Discussion Paper entitled "Implementation of a new tax system for managed investment trusts" (the **Discussion Paper**), which was released for consultation on 18 October 2010.

The Institute is the leading tax and accounting professional body in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing over 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

In broad terms, we support the introduction of a new tax system to provide certainty for managers of, and investors in, managed investment trusts (**MITs**) without added complexity or compliance costs. The issues raised in the attached submission, some of which are significant, are designed to ensure that this objective can be achieved by the majority of such funds which are intended to fall within the scope of the new rules.

The Institute would welcome any further consultation with Treasury on any of the issues raised in the submission prior to the release of draft legislation. Please do not hesitate to contact me on 02 9290 5623 or Susan Cantamessa on 02 9290 5625 to discuss any aspect of the submission.

Yours sincerely

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

GPO Box 9985
in your capital city

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000
Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601
Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street
Brisbane Qld 4000
Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L11, 1 King William Street
Adelaide SA 5000
Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000
Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
Ground, 28 The Esplanade
Perth WA 6000
Phone 61 8 9420 0400
Fax 61 8 9321 5141

Introduction

The Institute welcomes the Government's decision to commence consultation on the design and implementation details of the proposed new tax system for managed investment trusts.

Our comments on the questions posed in Treasury's October 2010 Discussion Paper are set about below. We have also commented on a number of other aspects of the Discussion Paper in respect of which no specific questions were posed.

1. Background and the concept of a managed investment trust

Definition of a MIT

1. Whether any or all of the rules about trusts treated as MITs for the purposes of the capital account election (Division 275) should be incorporated in the concept of a MIT that applies generally to the treatment of MITs for income tax (but not withholding tax)?

In our view the concept of a MIT to which the new tax system applies (a **regime MIT**) should be based on the concept used in Division 275 of the Income Tax Assessment Act 1997 (the **ITAA 1997**) for the purposes of the capital account election.

2. Attribution method of taxation

Clearly defined rights

2. Should the core clearly defined rights rules be supplemented by tests which would allow some types of MITs (e.g. registered MISs) to automatically satisfy the requirement in situations where rules already operate to prohibit a MIT from acting in a manner inconsistent with the core rules? If yes, in which situations should these tests apply?

3. Would it be possible for the clearly defined rights rules to accommodate trustee powers to accumulate income in the trust or issue units at a significant discount without impacting on the integrity of the rules?

4. Is it appropriate to describe 'constituent documents' by way of a general principle, similar to the approach adopted by the Board in its Report, or should specific rules which list those documents that form part of a MIT's constituent documents be adopted?

Proposed options

Recommendation 3 of the Board of Taxation (**BoT**) report into the review of the tax arrangements applying to managed investment trusts (the **Report**) provided that:

> *"The Board recommends that a trust will satisfy the "clearly defined entitlements" requirement if the beneficiaries' rights to income (including the character of income) and capital are clearly established at all times in the trust's "constituent documents". The right should only be able to be changed by a change in the trust's "constituent documents".*
>
> *The Board also recommends that provisions akin to the Corporations Act requirements in sections 601FC and 601GC which specify the circumstances under which the constitution may be amended and prescribe rules the Trustee must follow when dealing with beneficiaries should be incorporated within the taxation legislation applying Regime MITs."*

The Institute of Chartered Accountants in Australia

The Discussion Paper appears to propose two basic options for the ‘clearly defined entitlements test’ with an accompanying exclusion. The two basic options are:

- an option based on the “no material discretionary elements” approach in Subdivision 126-G of the ITAA 1997 (CGT rollover relief for the transfer of assets between fixed trusts); and

- an option that requires a trustee to confirm that at any point in time it is possible to determine the entitlements of beneficiaries to income and capital of the trust and the character of these amounts. An assessment is then required as to whether, having regard to the trust’s constituent documents, it is highly unlikely that a trustee would exercise any discretions or powers in a way that has an adverse impact on unit holders.

Significant detail is provided in relation to the first option, however little detail is provided in relation to the second option. In any event, both of these options suffer the same issues that currently affect the fixed trust test contained in the Income Tax Assessment Act 1936 (the **ITAA 1936**).

For example, in relation to the first option raised by the Discussion Paper, paragraph 33 of the Discussion Paper provides examples of powers that may, depending on their context, be capable of significantly affecting the manner and extent to which a beneficiary can benefit from a trust. Included within the examples provided, are the following:

- the power to characterise receipts or expenses as income or capital, or to accumulate trust income to capital (unless those otherwise entitled to the income have the same interests in the capital);

- the power to add new beneficiaries (other than by issuing new units or interests in a way that does not significantly affect the value of existing interests); and

- the power to issue new interests with rights attached that significantly alter the rights or the value of the rights attached to existing interests (e.g. a right to a preferential distribution of income).

Practically, many MITs will not be capable of satisfying these requirements. The reasons for this are as follows:

- the constituent documents of many MITs contain powers that enable the responsible entity (**RE**) as trustee to issue new units of the same class as existing units at a substantial discount to the prevailing market value of those units at a particular time;

- the constituent documents of many MITs include clauses in relation to the determination of income that allow the RE/trustee to characterise receipts or expenses as income or capital or to accumulate trust income to capital in a manner so determined. Principally, these clauses are drafted in this fashion to provide the RE/trustee with an ability to distribute an amount other than the accounting profit determined under AIFRS, which typically contains many unrealised amounts which would not be practical for the RE/trustee to distribute (or in the best interests of unit holders); and

- many constituent documents of MITs will contain a power that allows the RE/trustee to determine that an amount of proceeds received by a redeeming unit holder upon redemption consists of income of the trust.

There are strong commercial reasons for the inclusion of the above powers within the constituent documents of many MITs. Inappropriate commercial outcomes would arise if the constituent documents of the MITs were amended to remove such clauses/powers simply to allow MITs to access the new MIT attribution model as contemplated.

As noted above, little detail is provided in relation to the second potential option. However, given the discretions/powers identified above it would be difficult to see how a trustee could make a positive determination unless the legislation specifically allowed the trustee to ignore the powers/discretions. Consequently, it appears that both options have practical difficulties in their application.

Alternative

As an alternative we suggest that the requirements contained within Division 275 (to the extent relevant coupled with Subdivision 12-H of Schedule 1 to the Taxation Administration Act 1953 (**TAA 1953**) be used as a basis for the MIT definition for the purposes of the new attribution model together with a requirement similar to that discussed in paragraph 29 of the Discussion Paper.

Paragraph 29 of the Discussion Paper incorporates the requirements of the *Corporations Act*, in particular those requirements contained within section 601FC and 601GC as contemplated by Recommendation 3.

In our view, the above formulation should be sufficient to provide the integrity required to support the introduction of the attribution model. Further integrity measures should be able to be introduced within the mechanics of the attribution model such that it is not possible for the RE/trustee of an MIT to allocate taxable income to unit holders that is inconsistent with the economic entitlements of unit holders to income and capital arising from the relevant trust.

Exclusions

The Institute supports the introduction of an exclusion that allows certain MITs to be treated as automatically satisfying the clearly defined entitlements requirement. Such exclusion will achieve certainty on the issue for those to which it applies and is desirable from a practical and policy perspective. Currently, registered and/or listed MITs are suggested as those types of MITs that should be excluded. Consideration should be given as to whether this exclusion could be extended to cover other MITs, in particular wholesale unregistered schemes as these comprise a significant part of the funds management industry.

Commissioner's discretion

Regardless of the model adopted, in our view it is important that the Commissioner be given a discretion to treat a fund as qualifying as a regime MIT where this might not otherwise be the case to alleviate unintended outcomes.

Attribution principles

General comments

Consistent with the BoT's Recommendation 19, the Discussion Paper proposes attribution on a principle based approach – i.e. on a fair and reasonable basis, consistent with rights under a trust's constituent documents and the duties of the trustee.

In general, we support a principle based approach to determining the tax liabilities of trustees and beneficiaries which addresses problems encountered in the past where attribution has been based on strict legal interpretations of trust law concepts contained in Division 6.

However, we are concerned that beneficiaries may be in a position to challenge the amount attributed, where they simply believe the amount attributed is not "fair and reasonable" from their own perspective. To demonstrate, consider the following simple examples:

(a) The trust retains all income for a period of five years and attributes the taxable income (net income) to the beneficiary on an annual basis. The product disclosure statements outline that this could occur. The beneficiary does not believe it is fair and reasonable to pay tax on amounts it has not received for five years.

(b) The trustee disposes of CGT assets in order to redeem the units of a member holding a significant proportion of units. The capital gain is allocated to all beneficiaries in equal proportion. The trust deed is silent on the allocation of gains on redemption. The remaining beneficiaries do not believe they should be taxed on the capital gains and accordingly do not believe that the allocation is fair and reasonable.

(c) The trustee allocates certain expenses to the cost base of CGT assets, rather than claiming them as deductions against revenue gains. The outcome is that current year capital gains are lower (with current year revenue income being higher). The beneficiary has carried forward capital losses. The beneficiary does not believe the taxable income is "fair and reasonable" having regard to the trust deed.

In our view it is critical for the "guiding principle" to be supported by supplementary principles or unfolding principles in the legislation to provide a degree of certainty for trustees and limit potential litigation issues. For example, where an MIT has one class of beneficiaries, attribution should be deemed to be fair and reasonable if attribution is based on the proportionate number of units held[1]. Furthermore, attribution should not be taken to fail the fair and reasonable principle where expenses are allocated in accordance with whichever allocation principle which is adopted (i.e. see Section 2.2 of the Discussion Paper).

It would also seem inappropriate for the Australian Taxation Office (**ATO**) to be the adjudicator in these cases (i.e. to determine what is fair and reasonable from both the perspective of the trust and beneficiary).

So, whilst we agree in principle that a "fair and reasonable" basis of attribution (consistent with the constituent documents of the relevant trust and the duties of the trustee) could be used as the starting point for allocating taxable income to beneficiaries, we are firmly of the view that a beneficiary should not have any objection rights to the ATO. If a beneficiary is of the view that they have not received the correct amount of income etc from a trust they can pursue other legal avenues (based on, for example, breach of trust).

Our response to the specific questions on the proposed attribution principles are as follows.

5.	Are specific rules required to ensure that amounts of tax income are appropriately attributed where a unit in a MIT is sold or redeemed during an income year? If so, what rules would be appropriate?

No specific rules are required to ensure that amounts are appropriately attributed were a unit in a MIT is sold or redeemed during an income year. However, based on above comments, we consider that Treasury should consider "supporting" or "unfolding" principles that would ensure certain methods of attribution are deemed to be "fair and reasonable" for the purpose of the MIT regime. We believe that this would be required to provide a minimum level of certainty for MITs in relation to standard practice.

6.	Would compliance issues be raised by a requirement under the attribution method that tax losses in respect of one class of unit holders cannot be used to reduce the tax income of another class of unit holders?

We believe compliance issues will arise for certain MITs if the regime did not allow losses of one class of unit holders to be offset against losses of another class of unit holders. That is, we believe that many fund managers will be comfortable with a single taxable income calculation and will not want the compliance burden of being forced to keep track of tax losses for different classes of units.

However, more sophisticated fund managers may well want to the ability to calculate taxable income according to each class of units. This approach could occur by (effectively) treating the MIT as two separate trusts for the purpose of calculating the net income to attribute to the beneficiaries.

Accordingly, it is our view that the regime should not mandate an approach, but should provide MITs with the flexibility to choose to use either approach.

[1] We note that the BoT's recommendation that the allocation of taxable income be done on a fair and reasonable basis which is consistent with a beneficiary's rights under the constituent documents appears to be used as shorthand for a requirement that the allocation follows the beneficiary's interest in the trust – refer paragraph 5.30 of its Report.

7.	Are any modifications to the proposed attribution rules needed for trustees of trusts where units may be traded on a more regular basis (compared to unlisted trusts), such as listed property trusts or exchange traded funds?

One key issue, for both listed and unlisted funds, is the determination of a "fair and reasonable" attribution basis for net income where units are sold, rather than redeemed. While this issue will occur more for traded funds, this issue is relevant for any units that are traded. For example, assume that Beneficiary A disposes of units to Beneficiary B halfway through the year, and that net income for the year is $100. The question would be whether it is fair and reasonable to attribute an amount of net income to Beneficiary A (i.e. $50).

It is noted that "attribution" for the leaving beneficiary (Beneficiary A) would simply increase the cost base of units and thus would shift a capital gain on the units to a gain derived by way of attribution (whereby its character would depend on the underlying gains made by the trust). But for special tax attributes (such as discount CGT components, franking credits etc), the effect of the cost base adjustment should be neutral to the leaving beneficiary. However, we believe that this aspect would need to be explored further by Treasury, in order to determine what would be acceptable.

If attribution is required and units are traded on a regular basis (i.e. for listed funds) practical difficulties may arise. In particular, it may require systems to be put in place to keep track of unit holders, to accurately measure the length of time that a person was a unit holder during an income year and to ensure that income is attributed between all incoming and outgoing unit holders on a fair and reasonable basis. This may give rise to systems and compliance issues over and above the current system which simply only requires distributions to be made to unit holders present at year end.

Integrity rules

8.	What would be an appropriate principle for the proposed anti-streaming provision?

Given that the Treasury has acknowledged (at paragraph 59) that the potential application of any anti-streaming rule "is likely to be narrow", we question whether a specific anti-streaming rule is required. That is, we question why the general anti-avoidance rule in Part IVA or section 177EA (with modifications for MITs) of the ITAA 1936, would not be adequate to deal with any attempt to stream (inter alia) franking credits.

9.	If certain types of MITs (e.g. registered MISs) were to be treated as automatically eligible for the attribution method, would it be necessary to consider whether the anti-streaming and/or value shifting rules might need to apply beyond changes to a MIT's constituent documents?

No, if certain MITs were to be treated as automatically eligible for the attribution method we do not consider that anti-streaming rules and/or value shifting rules need to apply beyond changes to a trust's constituent documents.

3. Unders and overs – carry forward arrangements

General comments

The BoT indicated that in assessing practical ways to address the issue of unders and overs they weighed up the desire to reduce compliance and administrative costs against the need to ensure that the right amount of tax (or close to it) is paid (paragraph 8.2 of the Report).

In considering the objective of reducing compliance and administrative costs and the options set out in the Discussion Paper, it is important to understand some of the practical issues faced by the funds management industry. One of these is that the trustees of MITs will generally consider the reissuing of tax statements to unit holders as a solution of last resort for a number of reasons including:

- concern as to damage to the reputation of the manager;
- administrative costs both in relation to the reissue of statements and possibly, compensation to unit holders for costs borne in amending their returns (which would often be in relation to relatively small amounts of tax);
- the extent of interfunding in the industry means that the implications of the reissue of statements will impact upon multiple layers of unit holders; and
- where a manager has funds on an Investor Directed Portfolio Service (commonly referred to as a 'wrap platform')' the operator of platform may refuse to reissue statements due to the complex administrative issues that would arise.

Therefore, it is important that where an under or over would exceed the *de minimis* amounts prescribed by the provisions, a practical alternative to the reissue of tax statements is provided.

Proposed options

In relation to an over distribution, no alternative to the reissue of tax statements is currently proposed. The alternative in the event of an under exceeding the relevant *de minimis* amounts is for the trustee to be assessed at the highest marginal rate. Where the trustee subsequently distributes an amount in relation to which it has paid tax at the top marginal rate, it is proposed that the amount be non-assessable non-exempt income of the beneficiary.

This proposal also needs further consideration before providing a practical alternative. Whilst this approach has the benefit of simplicity (see discussion at paragraph 8.19 of the Report), the proposed outcome is far from equitable for the unit holders of a trust which exercises this option, as it is likely that many unit holders would be assessed at a marginal rate much lower than the top marginal rate of tax (e.g. complying superannuation entities at a rate of 15%). It is also questionable as to whether the trustee of an MIT can be acting in the best interests of investors when considering the exercise of this option.

Alternatives

To deal with this, an alternative would be a refundable credit system in relation to amounts assessed to the trustee arising from an under exceeding the *de minimis* amount. This system would allow the trustee to pass the relevant share of the tax paid by the trustee through to the unit holder upon subsequent distribution of the after tax amount. Unit holders would gross up their taxable income for the relevant share of the tax paid by the trustee, and claim a credit against their income tax liability. Therefore, this approach has the advantage of the net amount of tax remitted being closer to the "right amount", had there been no under distribution i.e. the net tax paid will reflect the unit holder's marginal tax rate.

A further alternative where an under exceeds the *de minimis* amount which should be given consideration is for the trustee to pay an amount of interest to the ATO on a notional tax liability based upon the under assessed at the top marginal rate (or an amount based upon the average marginal tax rate of the unit holders). This payment would compensate revenue for the time value of money in relation to the income tax arising from the amount of the under being paid by unit holders 12 months later (when the under would be distributed to the unit holder).

These systems compensate the revenue but would not penalise unit holders by imposing a rate of tax in excess of their marginal rate. They would also significantly reduce the administrative burden in comparison to a requirement to reissue unit holder tax statements.

In the event that neither of these alternatives is acceptable then consideration should be given to imposing tax on under distributions at a rate lower than the top personal tax rate to ensure that trustees have a real option to being forced into the time consuming and expensive exercise of reissuing amended distribution statements. The flow on effect of reissuing distribution statements is that large numbers of beneficiaries will be required to lodge, and the ATO process, amended assessment requests.

Our responses to the specific questions in the Discussion Paper are set out below.

10.	Is it practically feasible to have an alternative test for a *de minimis* amount based on a prescribed dollar value per unit?

It is important that there is an alternative test for a *de minimis* amount based upon the value of assets held by an MIT. This test would ensure that the provisions would not apply to a trust holding assets with a significant value, but with only a small amount of net income for a particular income year (e.g. due to the utilisation of tax losses incurred in a prior year, or adverse market factors).

The Board of Taxation's recommendation was that this alternative be based upon a prescribed dollar value per unit. In paragraph 69 of the Discussion Paper it was noted by Treasury that

> *"A significant practical issue is how to set a suitable prescribed dollar value per unit. One example that illustrates some of the difficulties is that two MITs, A and B, have the same net worth but MIT A has 10 times the number of units as MIT B. As the actual net worth per unit for B is 10 times that for A, a prescribed dollar value per unit test is likely to be much more generous for A than for B. As the dollar value per unit could be readily manipulated (for example, by a unit split), an integrity rule could be needed to support the prescribed dollar value per unit."*

It is submitted that an approach that would avoid these integrity issues yet achieve the desired result would be to base the alternative *de minimis* level on a percentage of the net asset value of an MIT per its statutory accounts (either the value at the end of an income year, or the average of the opening and closing values for an income year). A discretion should be available to the Commissioner to allow a trustee to substitute the cost of assets for market value as a safeguard to ensure that this method provides a reasonable alternative in the event of significant declines in market value as a result of factors such as:

- adverse market conditions; and/or
- exchange rate fluctuations.

In relation to the interrelationship of the *de minimis* rules, we agree with the approach set out in paragraph 70 of the Discussion Paper that the relevant measure should be the greater of the two alternatives.

We also submit that in relation to the *de minimis* thresholds, consideration be given to:

(i) a "safe harbour" from unders and overs taken into account for the purposes of the *de minimis* rule in relation to unders and overs to the extent that variations arise from an estimate of a distribution component provided by another trust in which an MIT has invested, or where no estimate of component information was provided by that other trust , and the MIT uses (for example) the prior year actual component information as an estimate ; and/or

(ii) a discretion afforded to the Commissioner not to apply the rules where an under or over results from other factors beyond the control of the trustee.

(iii) as there should be no mischief to the revenue arising from significant over distributions, higher *de minimis* threshold amounts should be applicable (than to unders). The early payment of tax by investors would probably be their preferred outcome, in comparison to amending their income tax return as a result of an amended tax statement.

11.	If so, what would be an appropriate way for the Government to determine a prescribed dollar value per unit?

The most appropriate way to determine an appropriate level for the alternative *de minimis* threshold is through consultation with industry participants. It is important that the appropriate level for the alternative is carefully modelled so that it is significant enough that the operation of the measures would apply only to unders and overs which are significant relative to the value of the fund.

12.	In addition to the proposed rules for overs and unders in relation to the tax income of a trust, should there also be statutory rules for overs and unders relating to tax offsets? If so, what would be an appropriate *de minimis* threshold?

The amount of tax offsets derived by a trust would generally be reflected in net income through a gross up, and would therefore constitute part of the under/over calculation. It is considered that to require separate calculations in relation to tax offsets would result in unnecessary complication.

However, should a trustee elect to be assessed in relation to an under in excess of the *de minimis* thresholds where an under of tax offsets arises, the trustee should be entitled to claim a credit for that under against the tax liability (whilst an over of tax offsets would presumably be added to the amount of the assessment).

13.	For the income year in which an under or over arises that is less than the *de minimis* threshold, what would be a suitable operative mechanism to ensure that the trustee does not need to issue revised distribution statements and that assessments made in accordance with distribution statements do not need to be amended?

We have not considered in detail the alternative operative mechanisms described in paragraphs 73, 74 and 75 for achieving the desired outcomes in respect of an under or over that is less than the *de minimis* threshold. However, we agree that those outcomes should be that:

- unders or overs do not affect the amount assessable to unit holders in the year the under or over arises;
- Any under is not assessed to the trustee; and
- Unders and overs are carried forward into the MIT's tax income calculation for the next income year following identification of the error and affects amounts assessable to unit holders in that year.

14.	In applying the carry forward of an under or over not exceeding the *de minimis* amount in a later income year: (a) should constituent amounts (e.g. capital gains; franking credits) be applied specifically against an amount of the same type?

The current industry practice would generally be to calculate and carry forward under and over amounts in respect of individual tax component categories. It is considered that this approach increases the integrity of the process (given the different tax outcomes that may arise in respect of individual components).

In paragraph 82 of the Discussion Paper, a concern is raised that this approach may cause unfavourable outcomes for the trust e.g. where for an over brought forward for a particular component, there may not be a sufficient amount to absorb it. Such situations may be avoided if for example

(i) in determining whether the *de minimis* thresholds are exceeded in the later year, only "current year" under or overs are taken into account (so that a brought forward and unabsorbed over could not contribute to a trustee having to reissue statements; and/or

(ii) granting trustees some flexibility in dealing with such situations e.g. in this case, through the pro rating of the unabsorbed over across other components determined in respect of the income year.

Whilst this is considered the appropriate treatment in respect of carried forward under and overs, it is agreed that it is the netted off amount of all components which should be utilised to determine if the *de minimis* thresholds for the under/over rules are exceeded by a trust (to the extent that it would not prejudice beneficiaries of a particular class of units).

(b)	if so, for what categories of amount should a separate under or over figure be calculated; and

The categories listed at paragraph 80 of the Discussion paper would be the appropriate categories for a separate under or over figure to be calculated (except that the "Australian source income" category would generally be referred to as "Australian other income"). Further categories may be required over time as a result of changes in the tax law.

(c)	if not, what would be a suitable rule in applying the amount carried forward?

Not applicable.

15.	What should be the specified period allowed for the trustee to reissue distribution statements to beneficiaries after becoming aware that there is an under exceeding the *de minimis* amount?

A period of three months after becoming aware of the under would be considered appropriate. This would provide consistency with the time period allowed in respect of the operation of the attribution system (in relation to the determination and allocation of net income by the trustee) and should allow the trustee sufficient time to complete the necessary calculations and send out the revised distribution statements if this is considered the appropriate course of action. A discretion should be available to the Commissioner to extend this period in special cases such as where an under or over is the result of third party error, and the process involves litigation and/or protracted negotiation and settlement.

It is noted that the trustee for many MITs would not identify an under in excess of the relevant *de minimis* threshold until the tax return in respect of the relevant income year is prepared, which may be some months after the end of the income year.

16.	What would be appropriate sanctions for a trustee intentionally (or recklessly) misstating the tax income of the trust?

It is considered that incidences of the trustee of an MIT intentionally or recklessly misstating the tax income of the trust should be rare.

To the extent that the Commissioner considered that an intentional misstatement of tax income did arise, he could seek to apply the general anti-avoidance provisions of Part IVA of ITAA 1936 to cancel the perceived tax benefit derived by unit holders. Section 284-30 of the TAA 1953 prescribes the trustee of a trust is liable to pay any penalty arising from the trust's participation in a scheme. In determining the appropriate penalty, any shortfall amount or scheme shortfall amount of a beneficiary that relates to the trust's net income or obligations is taken to be the shortfall amount of the trustee.

However, we acknowledge that recklessly misstating the net income of a trust may not attract the provisions of Part IVA. To the extent that the Treasury perceives that there is a real risk of this occurring then some sanction is appropriate.

Alternatively, given that the BoT has recommended a post-implementation review of the new MIT regime after the legislation has been in place for at least two years to take account of industry behaviour and practices, the introduction of sanctions could be deferred pending the outcome of that review.

4. Cost base adjustments

17.	Are there any significant compliance costs associated with requiring a MIT to track cost base movements on each event?
18.	Should the requirement for MITs to notify unit holders of cost base adjustments be an annual requirement, or should MITs be required to notify unit holders more frequently?

CGT event E4 generally only happens just before the end of an income year, unless units are disposed of (whereby the event happens just before the other CGT event). Accordingly, the current provisions only require MITs to provide yearly distribution statements that enable unit holders to calculate their relevant cost base and CGT event E4 amounts.

While the Treasury paper suggests that the Board recommended adjustments to be made on events occurring, we believe that this is not consistent with the Board's paper. At paragraph 7.24, the Board stated "the Board recommends that beneficiaries continue only to be required to make such adjustments on a yearly basis." Accordingly, we believe that the Board proposed that the new statements and adjustments be done on an annual basis.

Significant compliance costs would arise if a MIT is required to track cost base measurements on each CGT event. That is, it would require a trustee to provide what effectively amounts to a running balance cost base account for each beneficiary.

Furthermore, we do not see any significant benefit in being able to provide this information to beneficiaries on an event by event basis as compared to an annual basis. We highlight that if an annual statement is provided, beneficiaries will be in a position to calculate their taxable position for that year. While we acknowledge that a beneficiary disposing (or redeeming) their units would not be able to accurately calculate their cost base at the time of disposal and thus the expected tax liability on disposal (e.g. where net income is later attributed to the beneficiary), we highlight that moving to an event by event mechanism would not correct this issue. This is because the net income would still be attributed to the beneficiary at year end (and thus would be an event that occurs subsequent to disposal).

Accordingly, in our view, the MIT regime should be based on annual adjustments and annual distribution statements. As MITs already produce most of the information required on such statements, we believe that this would result in a lower level of compliance for MITs transitioning to the new system.

19.	Are any modifications to the proposals warranted for MITs that are Exchange Traded Funds?

We do not believe that any modifications to the proposals are warranted for MITs that are Exchange Traded Funds. The systems issues and compliance costs associated with tracking attribution amounts and cost base adjustments of unit holders entering and exiting an MIT in 'real-time' would be onerous (also acknowledged in paragraph 103 of the Discussion Paper). These funds should also be required to notify unit holders of cost base adjustments on an annual basis (similar to other MITs and consistent with existing practice).

5. Character and source retention

20.	Is the proposed approach workable in practice?
21.	Are there any alternative approaches that should be considered?

We support the proposed approach and consider it to be workable in practice. As noted in the earlier comments regarding the attribution of taxable income, similar "supporting" principles should be included in relation to the allocation of the various components of income on a fair and reasonable basis so that trustees of MITs have certainty. For example, an allocation of each taxable income component based on the proportionate number of units held should be deemed to be "fair and reasonable".

6. Fixed trusts

It is proposed that regime MITs be treated as meeting the fixed trust requirement for tax purposes. Although not expressly stated in paragraph 110 of the Discussion Paper, it is implicit that beneficiaries of regime MITs will also be taken to have fixed entitlements to the income and capital of such trusts. This is because the Discussion Paper lists a number of provisions which use the concept of a fixed trust or fixed entitlements to income and capital of a trust which will be impacted by the proposed new regime. Those provisions are split into those which are particularly relevant and less relevant for MITs.

It is not clear whether this list is meant to be exhaustive and at this stage we have not sought to determine whether there are other provisions which should also be listed. However, we note that the ATO has appended to a confidential discussion paper on "The concept of vested and indefeasible interests" a list of provisions which use that term[2]. As the concept of a vested and indefeasible interest in the income and capital of a trust is a requirement which must be satisfied for beneficiaries to have fixed entitlements, that list may provide Treasury with a useful cross check.

The only additional comment we make at this time is that whilst the BoT has recommended and the Government has accepted that regime MITs qualify for the more flexible trust loss and debt deduction rules currently afforded to fixed trusts, those rules are themselves over prescriptive and difficult to apply in practice. In our view, testing and tracing concessions, similar to those in Division 166 of the ITAA 1997 which apply to widely held and "eligible Division 166" companies, should be introduced to assist regime MITs.

7. Repealing corporate unit trust rules and including an arm's length rule in the public trading trust rules

Implications of repealing corporate unit trust rules – transitional issues

The Government proposes repealing Division 6B (corporate unit trusts) of Part III of the ITAA 1936 (BoT Recommendation 42).

We support the repeal of Division 6B providing that transitional issues, in particular those arising in a franking and consolidation context, are appropriately addressed. Specifically we recommend that:

- the trust be capable of being treated as a corporate tax entity for franking purposes for a period of at least 12 months for purposes of paying income tax (and recognising franking credits) and making distributions capable of being franked in respect of taxable income derived in income years ending prior to the repeal of Division 6B, and
- there be targeted consultation with those existing Division 6B trusts which have chosen to form a consolidated group to assess possible transitional consolidation issues which may include the option to revoke a choice to consolidate, and reform a new lower tier consolidated group, but with suitable relief from CGT event L5 with the potential for the newly formed group to inherit tax history and tax costs.

General comments

In the interests of simplicity and equity, it would be logical to have the operation of Division 6B cease to apply to all affected trusts in existence at the commencement of the repeal, but with suitable transitional rules to cater for franking and the interaction with the consolidation regime for those trusts which would not qualify as a Division 6C trust.

Franking transitional issues will arise on the repeal of Division 6B as income tax will be payable by the trust in respect of the last income year it is treated as a corporate tax entity subject to Division 6B and distributions to unit holders in respect of that income year may be made subsequent to its repeal. No franking credit would arise for the payment of the income tax and no distributions to unit holders would be capable of being franked as the entity would not be a corporate unit trust in relation to the income year in which those times occur[3]. In the absence of transitional rules this would result in double taxation of the same income (once to the trustee and again to the unit holder on distribution).

---

[2] This paper was released to external members of the ATO's Trust Consultation Subgroup in May 2006.

[3] Section 960-115.

In a consolidation context, section 713-135 has the effect that once a Division 6B trust has chosen to form a consolidated group, there is no provision in the law which causes the group to deconsolidate even if the trust ceases to be a corporate unit trust[4]. It would seem that in the event that Division 6B is repealed, such groups could continue to operate under the consolidation regime.

While there is some merit in the law continuing to apply to such trusts on a consolidated basis, as it removes some of the transitional issues (including the franking issue as noted above), it creates an inequitable dichotomy in the law as compared to those trust groups which come into existence after the repeal of Division 6B and which could not consolidate. In addition, under current law, there is lack of flexibility in that section 713-135 applies to treat a Division 6B trust as the head company of a group even if the group subsequently ceases to have any subsidiary members.

It is acknowledged in the Treasury Discussion Paper[5], that there are few trusts actually subject to Division 6B. It is expected that not all of those would have chosen to form a consolidated group in accordance with section 713-130. Accordingly, it is our recommendation that there be targeted consultation with those existing Division 6B trusts which have chosen to form a consolidated group to assess possible transitional consolidation issues which may include:

- a choice to have the former Division 6B trust revoke its choice to consolidate (on a prospective basis only) within a specified time frame of the repeal of Division 6B
- the ability for a lower-tier subsidiary member of the existing group to form a new consolidated group provided that it meets the requirements to be the head company of a consolidated group having regard to the requirements set out in item 1 of the table in subsection 703-15(2), and
- relief from potential CGT event L5 (section 104-520) in the event of deconsolidation with the potential for the newly formed group (noted above) to inherit tax history and the tax costs on assets.

Arm's length rule in public trading trust provisions

22. Under the proposed rule about non arm's length transactions in Division 6C:
    (a) Should the market value treatment apply to transactions where a MIT does not deal at arm's length with another entity, transactions between an entity and its associates or both?
    (b) Should the market value treatment also apply to the other party to the transaction?
    (c) Are any exemptions from the rule appropriate?

Section 7.2 of the Discussion Paper discusses the proposed arm's length rule. As an initial observation, the Discussion Paper proceeds on the basis that the arm's length rule is to form part of Division 6C of the ITAA 1936. However, Recommendation 10 of the BoT Report states:

> *"The Board recommends that arm's length rules should apply to transactions between common interests or related interests of an MIT, including but not limited to subsidiaries and stapled entities."*

The BoT did not recommend that the arm's length rule form part of Division 6C and we believe that the Discussion Paper has inappropriately expressed the intent of the BoT's proposal. The arm's length rule should be a separate rule applying to MITs outside the operation of Division 6C. To incorporate the arm's length rule into Division 6C would create significant uncertainty for MITs. Depending on how any pricing adjustment is characterised, it could result in a breach of Division 6C. We do not believe this would be workable in practice.

The arm's length rule should apply to transactions between an MIT and its associates as this is in accordance with the BoT's Recommendation 10. To extend the arm's length rule's ambit to include transactions not at arm's length, which can occur between non-associates, would be to widen the rule beyond its intended scope.

[4] Unless it breaches one of the requirements in item 1 of the table in s703-15(2) such as becoming wholly-owned by a resident Australian company

[5] Paragraph 115

Where pricing adjustments arise under the arm's length rule, such adjustments should be made to both parties to the transaction to ensure equity in its operation.

Consideration should be given to excluding transactions between a MIT and another entity that is also treated as an MIT or subject to Division 6. In other words, the arm's length rule should only apply where a corporate entity (including a Division 6C trust) is involved in the transaction. The reason for this is that paragraph 3.42 of the Report notes that the arm's length rule is intended to protect the corporate tax base. If both entities involved are taxed on a 'flow through' basis, such that the taxable income of the entities is ultimately taxed in the hands of their unit holders/beneficiaries the arm's length rule would serve little purpose in this circumstance.

8. Other issues

Resettlements

23. What are the possible types of amendments to deeds that may be required to be made (in particular, to satisfy the clearly defined rights requirement) and would they likely result in a resettlement?

24. Are many MITs likely to wish to amend trust deeds?

25. What would be appropriate roll-over relief where a resettlement of a trust occurs as a result of a MIT amending its constituent documents so as to be eligible for the attribution method of taxation?

Specific MITs or their industry body are probably better placed to comment on the possible types of amendments to deeds that may be required to be made in order to qualify as a regime MIT.

In our view, consistent with Recommendation 44 of the Report, a roll-over provision should be introduced which provides that if the amendment of a MIT's constituent documents in order to qualify as a regime MIT, results in a resettlement no adverse taxation consequences will arise.

We also note that amendments to deeds may result in a resettlement for stamp duty purposes. Accordingly, we would urge the Government to canvass with the state governments the benefits of providing a stamp duty exemption to allow as many MITs as possible to take advantage of the new regime.

Reporting

26. Should the trustees of MITs be required to notify unit holders of the amount of unders and overs identified and to be carried forward? If so, what would be the best way for the notification to occur?

The ability to carry forward over or under distributions is contingent on the amount of the over or under being *de minimis*. In these circumstances, we do not see any merit in the trustees of MITs being required to notify unit holders of those amounts.

Application

27. Do some MITs need time before the commencement of the new attribution rules to amend trust deeds and, if so, what would be a reasonable amount of time to allow?

28. By what date would industry need to implement changes to its systems and how much time would it be likely to take industry to make those changes?

As we understand it, all MITs, adoption of the attribution basis of tax to work out liabilities in relation to the tax income of a MIT is elective, i.e. an MIT may choose if and when the new attribution regime applies to it. However, it is currently proposed that other aspects of the proposed changes apply from 1 July 2011.

It is recommended that taxpayers be provided with an elective start date of 1 July 2011 with a 'hard' start date of 1 July 2012. This is consistent with the approach taken by the Government in relation to other new tax 'regimes', for example the Taxation of Financial Arrangements rules, the tax consolidation regime and the introduction of the current thin capitalisation provisions.

As with any significant new legislation there will undoubtedly be a number of areas which will require clarification during the course of the first year of operation of the regime, and taxpayers should be permitted to delay application of the rules pending clarification of such issues, rather than suffer the risk of forming independent interpretations of the provisions or seeking ATO rulings. In cases where amending legislation is required to alleviate unintended outcomes, taxpayers may be required to adopt inequitable tax positions or risk the application of penalties.

As outlined in the Discussion Paper, there are a number of key design features of the MIT regime which are still being formulated. This currently makes it difficult for taxpayers to make appropriate decisions regarding investing in new systems or implementing new processes within the business to deal with the changes. The impact on trust groups and investors is expected to be significant, with a large number of stakeholders outside the tax function including the board of directors, the finance and treasury functions, investor communications, in-house legal, human resources, trustees and custodians, external lenders, internal audit and external audit providers. The education of stakeholders and implementation of systems in a large organisation with international operations and non-Australian investors will require significant resources. An elective start date will allow taxpayers to implement an efficient 'roll-out' of the changes with improved certainty as to the outcomes for stakeholders.

Providing an elective 1 July 2010 start date will allow a large number of smaller or less complex MITs to adopt the regime earlier, and thereby alleviate longstanding investor uncertainty, in line with the Government's stated objectives.

Interactions

29. What specific interaction issues should be addressed in the legislation and what are possible solutions to those issues?

30. What amendments should be made to the withholding tax (and associated PAYG withholding) provisions to ensure that they mesh appropriately?

We have not considered in detail the interaction issues which will result from the proposed legislation and how those issues might best be addressed.