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Law Council
OF AUSTRALIA

Business Law Section

28 April 2015

Ms Luise McCulloch
General Manager
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: MITs@treasury.gov.au

Dear Ms McCulloch,

A New Tax System for Managed Investment Trusts – Exposure Draft

The Tax Institute and the Business Law Section of the Law Council of Australia (together **the Bodies**) welcome the opportunity to make a submission to the Treasury in relation to the *Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015 – Exposure Draft (Exposure Draft)*.

Summary

The Bodies support the objectives of a discrete tax regime for managed investment trusts.

In light of the very short two week consultation period allocated, the Bodies have had very little time to consider the proposed amendments in any amount of detail. Although extensive consultation has already taken place with respect to these new measures, the 'full drafting package' has not been made available for review and consideration as part of the public consultation process.

For these reasons, our comments are limited to some issues that are immediately apparent to us. This submission does not encompass all of the issues that more time may have allowed us to bring forward¹.

The Bodies are nevertheless of the view that the proposed changes are broadly in line with our expectations in most respects and are comprehensive in setting out a new tax regime for managed investment trusts (**MIT**).

¹For example, there are attribution MIT / MIT withholding interactions which, with more time, we could address.

Discussion

Issues

We raise the following issues for Treasury's further consideration.

1. Commencement

The Bodies applaud the efforts being made by Government to have the new regime available from 1 July 2015. For many and perhaps most MITs, the commencement of the new regime this year will be welcome.

However, we do not consider that a mandatory commencement time of 1 July 2015 is appropriate. The new provisions are necessarily complex and we consider the tax profession, Australian Taxation Office (**ATO**) and business (including systems) will require additional time to consider and implement these measures.

Furthermore, it is critically important that the regime be elective in nature rather than mandatory, particularly as it departs from the original Board of Taxation recommendation that the new regime be available on an elective rather than compulsory basis. That proposition was consistent with the regime being part of an initiative to ensure an internationally competitive funds management industry and make Australia the financial services hub of Asia.²

These objectives should not be overlooked. The legislation should not operate on a basis that potentially impedes rather than enhances industry efficiency. A mandatory regime will only result in unintended vehicles being caught by the new attribution MIT (**AMIT**) rules and these entities will be subject to greater administrative requirements and therefore compliance costs. Therefore, to ensure it does not, the new regime should only apply on an elective basis, from the year of election, rather than be allowed to penalise some funds through compulsory application.

In our submission therefore, the attribution MIT regime and, all it entails, should only apply from 1 July 2015 at the election of eligible MITs.

At the very least, given the very late release of the Exposure Draft, any compulsory application of the regime should not occur before 1 July 2017. That would at least allow some time for MITs to identify whether they might be adversely affected by it and to explore means of adapting to it.

That further consideration of commencement/application is necessary is evident in the proposal, for example, to extend the class of eligible investors with retrospective effect back to 1 July 2014. That will presumably make some funds MITs when otherwise they would not

² Board of Taxation *Review of the Tax Arrangements Applying to Managed Investment Trusts* Report to the Assistant Treasurer, August 2009.

have been, and potentially therefore give them MIT withholding obligations they otherwise would not have had. The funds industry should be given time to understand and accommodate these changes.

2. *Clearly defined rights (CDRs)*

The requirement that the interests of the members are clearly defined at all times in new draft section 276-10 of the Exposure Draft is a gateway provision. As such, it is important that there is little room for misunderstanding.

We think there are some aspects of the CDR rules that could be improved so as to make the rules less ambiguous:

- With respect to registered MITs, the Commissioner's discretion to treat a trust as having clearly defined interests in circumstances where it is 'reasonable to conclude' that the right of each member of the trust to the income and capital of the trust are clearly defined at that time is unhelpful. The level of regulation and integrity rules governing these trusts, including the various prescribed covenants that will be present in the constituent documents, will be sufficient for the purposes of determining whether or not the interests in the trust are clearly defined. We submit that the Commissioner's discretion in these circumstances only creates ambiguity and that the Commissioner should be able to exercise such a discretion only on request by the trustee of the relevant trust. At the very least, it ought to be made clear that the discretion cannot be exercised retrospectively without the consent of the trustee of the relevant trust.
- Paragraph 2.27 of the Explanatory Memorandum (**EM**) confirms that the trustee cannot have a discretion to determine an entitlement to income or capital or to determine the character of income distributed to each member. It would be useful to include a drafting note that confirms that where the trustee has a discretion to determine that an item is income or capital that this is not inconsistent with clearly defined rights, provided that the members rights to that income or capital character once determined are clearly defined. This is consistent with our construction of the provisions as proposed to be introduced, but given the gateway status of the provisions, additional clarity would be useful for the avoidance of doubt.
- Section 276-15(2) contains the new regime's CDR test. It includes an equivalent of the Division 126G rollover provision that prohibits discretionary interests. However, the proposed new test in section 276-15(2) is in one important respect deficient. It does not contain an equivalent of section 126-230(4) of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**). That provision expressly precludes rollover being denied merely because of a power that does not significantly affect the market value of a membership interest in the trust. This safeguard is not conflated into the 'materially diminished' language used in section 276-15(2)(b). What is to be read from its omission? Does it mean that even a power which does not affect the value of membership interests can prevent a trust being an attribution MIT? The contrast between the two provisions would suggest that it does mean that. Such a power might be as little as, for example, a power to determine even within constraints what

amounts to trust income. Therefore, a 'section 126-230(4) equivalent' provision should therefore be included in draft section 276-15(2).

3. *Transitional Issues*

We are concerned that a Responsible Entity and trustee that must administer the trust with a risk of transition between AMIT status and 'ordinary trust' status will be presented with an undue level of administration in managing distributions. Where the AMIT regime was elective, then this could be managed by not making the election. Alternatively and preferably, an AMIT could remain an AMIT at least for distribution purposes so that distribution policies and processes once implemented could be certain of on-going relevance. That is, the distribution policies and processes can be certain of on-going tax relevance without the need to monitor and switch processes (that is between attribution and present entitlement).

We also consider the transition periods for existing MITs for the arm's length rule and unders and overs needs to provide an appropriate time frame and opportunity for existing MITs to make the necessary implementation responses and restructures³. A period of at least 3 years from the time of enactment is considered necessary to allow for these implementation issues.

4. *Attribution MIT with multiple classes of members*

The draft provisions provide the trustee of the MIT with the choice to apply the new attribution rules to each class of members separately (refer to proposed section 276-20 of the Exposure Draft). We are supportive of this measure and note that it will provide valuable flexibility to the funds industry

Further clarity may be however be required in terms of how the rules applying to attribution MITs with separate classes interact with other parts of the tax legislation. For example, is it intended that the separation of interests can also accommodate separate currencies, to enable different classes of units being denominated in different currencies, with those classes investing in assets denominated in the same currency as the subscription price for the units? If that is the intent then consequential amendments may need to be made, for example, to the rules providing for functional currency elections.

The legislation and explanatory memorandum will need to make clear exactly what is dealt with at a class level and what is dealt with at a whole of trust level (for example, unders and overs). The current provisions also do not adequately deal with the consequences if one class is in a loss position. For example, it is not clear if losses would be available to shelter income of another class (without causing the trustee to become taxed in respect of the other class under section 276-515), or whether losses would be quarantined on a class by class basis.

³ We understand that 'unders and overs' reflects industry practice in general, but not all AMITs will necessarily have done so, and even those who have may need to make some adjustments to conform with the proposed legislative regime.

Given the additional compliance costs that will be imposed on the trustee by virtue of making this election, it is important that it remains elective as currently drafted.

5. *Changes to constituent documents to qualify as an attribution MIT*

Treasury acknowledges the concerns that have been raised that tax consequences may arise (if a resettlement of the MIT is triggered) by an exercise of the trustee's power to amend the constituent documents of the MIT to allow it to apply the new attribution MIT tax regime (see paragraphs 2.42 to 2.44 of the EM). The Bodies echo these concerns.

We note that the EM refers to *Taxation Determination TD 2012/21*⁴ to confirm that there should be no capital gains tax implications if the terms of a trust are changed pursuant to a valid exercise of a power contained in the constituent documents. We query whether TD 2012/21 is broad enough. In particular, 'resettlement' issues can affect things other than capital gains tax, such as carry forward losses.

The Bodies consider that it is not appropriate to rely on TD 2012/21 in the context of these transitional provisions, given it is fundamental to the operation of the attribution MIT provisions that eligible MIT's can avail themselves of the new regime, and be certain that there are no adverse taxation or stamp duty⁵ issues resulting.

The Bodies consider that a specific rollover provision should be inserted into the Exposure Draft to provide that no discontinuity in the trust for tax purposes will occur where a trustee exercises a power to amend the trust deed for the purpose of ensuring the MIT can apply the new attribution MIT rules. Nor should there be an assumption that in all cases the fund's trustee alone will make the necessary amendment(s). That may not be appropriate or possible in many cases. Investor vote or even a scheme of arrangement may be appropriate or necessary in some cases. The rollover should accommodate whatever is necessary to make provision for the new regime. This provision should also enable a transitional period for amendments to be made to constituent documents, for example until 1 July 2017, for the sole purpose of enabling the MIT to fall within the new regime.

If legislative change is not possible, then TD 2012/21 may benefit from an amendment to contemplate the circumstances where a trustee exercises a power to amend the trust deed for the purpose of ensuring the MIT can apply the new attribution MIT rules. Correspondingly, similar guidance ought to be given in relation to other ramifications of resettlement such as carry forward of losses.

⁴ TD 2012/21 Income tax: does CGT event E1 or E2 in sections 104-55 or 104-60 of the Income Tax Assessment Act 1997 happen if the terms of a trust are changed pursuant to a valid exercise of a power contained within the trust's constituent document, or varied with the approval of a relevant court?

⁵ Which will require the involvement of the States and Territories.

6. *Clarification of how the arm's length amount is to be determined for the purposes of the non-arm's length income rule*

The non-arm's length income rule set out in the proposed section 276-670(5) in Schedule 2 of the Exposure Draft defines 'non-arm's length income' as ordinary income or statutory income derived from a scheme the parties to which 'were not dealing with each other at arm's length in relation to the scheme' and that amount exceeds the amount expected to be derived if those parties had been dealing with each other at 'arm's length in relation to the scheme' (ie the arm's length amount).

Neither the Exposure Draft nor the EM sets out sufficiently the relevant criteria that should be considered in determining the arm's length amount. Where a dealing between the trustee of the AMIT and another party satisfies the cross-border test in subsection 815-120(3), Subdivision 815-B of the 1997 Act would apply to the dealing irrespective of paragraph 276-670(5)(b) (section 815-305). Where the trustee is able to show that a transfer pricing benefit does not arise for it under section 815-120 in relation to the dealing, then presumably the trustee would also have done more than enough to demonstrate that there was no excess amount for purposes of paragraph 276-670(5)(b). However, neither the Exposure Draft nor the EM indicate that this would be the case.

However, the transfer pricing rules in Subdivision 815 do not apply to wholly domestic arrangements and the Exposure Draft is silent with respect to the relevant criteria that should be considered in determining the arm's length amount in such cases.

The legislation should set out non-exhaustive factors that one needs to 'have regard to' in determining the amount an AMIT might reasonably expect to derive if the parties dealt at arm's length in relation to the scheme. The Bodies are of the view that the cross-border transfer pricing rules in Subdivision 815 should not be used for this purpose given the very significant compliance costs that would ensue and the different purpose for which those rules were introduced. Further, the reconstruction provisions in section 815-130 have created a great deal of uncertainty in relation to how the ATO intends to apply them (see TR 2014/6).

The listing of relevant factors would enhance clarity and certainty of the non-arm's length income rule and assist attribution MITs to better determine the arm's length nature of their income.

Two other aspects of the arm's length rule also require further consideration and amendment. Both concern the rule potentially over-reaching its intended effect.

First, the rule is intended only to cap income at the arm's length amount. It is not intended to require arm's length expenditure by an attribution MIT or its subsidiary entities. However, if a subsidiary entity 'under spends', for example because it is a property holding trust and does not pay a fully arm's length property management fee (eg to a property management company that is stapled to its parent trust), the net income of the trust will be to that extent 'inflated'. When that net income is distributed to the parent trust, arguably it will constitute non-arm's length income of the parent trust. This would seem to over-reach the intent of the rule and it should therefore be corrected.

Second, the safe harbour provided for debt interests held by attribution MITs in cases where interest on the debt is limited to the benchmark rate of return may prove to be illusory. The interplay between the thin capitalisation and transfer pricing rulings debated by various industry sectors with the ATO prior to the introduction of Subdivisions 815-A and 815-B illustrates that many would argue that a cap on an interest rate applicable to a debt interest is also a cap on the level of the debt. Once again, this would seem to over-reach the intent of the rule and it should therefore be clarified

In the absence of any legislative change, the Bodies would welcome confirmation of how the ATO will apply the non-arm's length tests in a manner consistent with the accompanying limited guidance found in paragraphs 5.52 to 5.56 of the draft EM.

7. Returns on debt interests for purposes of subsection 276-670(6)

It is not obvious why the safe harbour rule in paragraph 276-670(6)(a) has been based on the benchmark rate of return in section 974-145 rather than on the benchmark rate of return plus 150 basis points as is the case for purposes of limiting deductibility under subsections 25-85(5) and 230-15(5). We would recommend a consistent approach and use of the benchmark rate of return plus 150 basis points for purposes of paragraph 276-670(6)(a).

8. Trustee taxation on non-arm's length income of AMIT – Stapled structures

Draft subparagraph 276-670(2) operates to tax non-arm's length income at the top marginal rate of 49% (i.e. 47% + 2% temporary Budget repair levy; refer to paragraph 9.5 in the EM). We understand the provision operates to claw back tax that should have been paid had the amount of income been at arm's length. This seems overly punitive in the context of a stapled structure where a rate of 30% is the rate that would apply if an arm's length transaction was undertaken between a company and a trust in a stapled structure (i.e. the operating company would be taxed at 30%) and where there are typically no comparable transactions with which to determine an arm's length rate. On this basis, the tax rate applicable should be 30%.

The 49% rate applicable non-arm's length income derived by Self-Managed Superannuation Funds (**SMSF**) is appropriate in that context given the risk to be addressed is a shift of income from individuals to the SMSF. Whereas in this case, the risk is a shift of income from a corporate taxpayer to a MIT and accordingly the 30% tax rate should apply. In the case of widely held stapled structures in particular, there is no justification for presuming that, if the company distributed the relevant income, after tax, as a franked dividend, the average rate of tax payable by the security-holders would be anywhere near as high as 49%. We note that lower rate taxpayers, such as superannuation funds, would still be disadvantaged by such a 30% rate compared with getting a fully franked dividend (with refundable franking credits) from the company.

The 30% rate would achieve the right economic result in at least some cases and would limit the compliance cost for taxpayers (i.e. the 49% rate will mean investors will spend significantly more effort and money in confirming the 'arm's length' value of the charge as well as seeking rulings from the ATO and so forth). If the 30% rate was applied, transactions would be able to proceed more quickly with less unnecessary risk and compliance costs to taxpayers.

9. Offsets

The list of offsets contained in the table in draft section 276-150(6) should be expanded to include other offsets such as National Rental Affordability Scheme (**NRAS**) offsets governed by Division 380.

For offsets (such as NRAS) which are not 'grossed up' to a pre-tax amount for assessment purposes, the offset should not be factored into the cost base adjustment in section 104-107D (i.e. such offsets should be excluded from section 104-107D(1)(b); there is no reduction to the cost base because of the offset), since such amounts will never be matched by an amount included in assessable income.

10. Wholly owned subsidiary trusts

Proposed section 275-40, together with subsection 275-5(1)(b) will ensure that a trust that is wholly and directly owned by a single MIT can itself be an MIT. Why though is the provision limited to single member subsidiary trusts? Why not extend the provision to subsidiary trusts that are wholly owned by a single MIT, regardless of the internal wholly owned group structure?

It should not make a difference that a subsidiary trust has two members because it is in part owned by another wholly owned group subsidiary trust. There can be no policy reason for the different way that the legislation would currently deal with these trusts. They may as a result of tracing still qualify as MITs, but why not through the now simple mechanism of section 275-40. Compliance costs would be best served by allowing that.

The opportunity should also be taken in the EM to confirm that the new provision can apply on a successive basis, such that if a first tier subsidiary is by cl 275-40 taken to be an MIT, a second tier subsidiary can then also taken by cl 275-40 to be an MIT i.e. assuming it satisfies the licensing requirement and so forth.

11. Consequential amendments

The Bodies believe it is necessary to give careful consideration as to what consequential amendments or changes need to be made to other related legislative provisions or administrative practice in order to facilitate the changes set out in the Exposure Draft. In particular, consequential amendments may need to be made to the relevant provisions in the *Corporations Act 2001* and further forms of ASIC relief may be required.

Additional Guidance

As issues are likely to come up with the application of the new rules, particularly in respect of the new 'attribution managed investment trust', we encourage the Australian Taxation Office (**ATO**) to proactively issue guidance as required (and for Treasury to be involved in those discussions where appropriate.) For example, please see our comments in section 2 above concerning the Commissioner's discretion in relation to CDRs.

Further and more general guidance in this area may also be useful. The circumstances in which the members of a trust will be regarded by the ATO as having clearly defined interests in the income and capital of the trust in particular warrants further guidance, given the prevalence of these powers. One of the main drivers behind the introduction of the 'clearly defined rights' test was to remove some of the uncertainty that currently exists around the use of the term 'fixed trust' and the application of concepts such as 'vested' and 'indefeasible' to interests arising under a unit trust deed.

The EM provides three examples of the proposed application of the 'clearly defined interests' test which are helpful but uncontroversial. The legislation however (see proposed section 276-15) incorporates several additional elements into the meaning of 'clearly defined interests' that would benefit from further guidance being issued. For example:

- Proposed subparagraph 276-15(2)(a) requires that the amount of each member component for the income year of each member of the trust can be worked out on a 'fair and reasonable basis'.
- Proposed subparagraph 276-15(2)(b) requires that the right of each member of the trust to the income and capital of the trust cannot be 'materially diminished' through the exercise of a power or right. This seems too broad, even assuming a s 126-230(4) equivalent as recommended above, in light of section 601GC of the *Corporations Act 2001* (Cth) and the decision in *Colonial First State Investments Limited v FCT* [2011] FCA 16 – what is 'material' depends very much on the eyes of the beholder.

In *Colonial First State Investments*, it was held that the interests of unitholders in the income and capital of the managed fund could be defeated by the unitholders exercising the power under section 601GC(1)(a) to pass a special resolution to modify or repeal the constitution. Therefore, the fact that section 601GC provides a mechanism to modify/repeal the constitution means that just about every registered scheme would be in danger of not satisfying section 276-15(2)(b). The test for 'clearly defined interests' should therefore provide that section 601GC is disregarded for the purposes of applying the test in proposed subparagraph 276-15(2)(b). Only actions of the trustee acting alone should be taken account of.

- Proposed subsection 276-15(4) provides the Commissioner with a discretion able to be exercised in circumstances where it is 'reasonable to conclude' that the right of each member of the trust to the income and capital of the trust are clearly defined at that time.

It may be useful for the ATO to provide guidance on what the Commissioner will consider to be a 'fair and reasonable basis', what the materiality threshold may be in terms of the powers and rights referred to in subparagraph 276-15(b), and an explanation as to what factors or circumstances the Commissioner will consider when exercising his discretion in subsection 276-15(3).

It is also important that the new tests are able to be applied by taxpayers in a practical manner to commercial arrangements, and in a way that minimises uncertainty and the cost of complying with the new provisions.

We also note that the 'clearly defined interest' test will almost certainly form part of the broader policy discussion to be had around fixed trusts more generally, and so it is important that the provisions be given the utmost chance of success.

In addition, section 276-205 is a little confusing. That is, for a member to make a 'choice' to apply section 276-205(6), the member must make a written choice covering all the things set out in section 276-205(3) and give that written choice to the Commissioner within 4 months of the end of the income year. However, section 276-205(4) says that 'the way the member's income tax return is prepared is sufficient evidence of making the choice'. That statement appears incorrect given the taxpayer has to lodge written evidence of the choice with the Commissioner. We suggest that perhaps section 276-205(4) should say that lodgement of a tax return prepared on the basis of the choice will be written notice to the Commissioner for the purposes of section 276-205.

It would be useful if Treasury could include a simple (numerical) worked example in Chapter 3 of the EM. An example showing three different types of AMIT income categories, with some expenses which related specifically as well as some expenses which had to be allocated between the different income types, would assist taxpayers to understand how the proposed calculations are intended to operate. It would also be useful if the example showed what happened when one of the categories worked out as a loss.

Other

There are many outstanding issues that relate to the taxation of trusts whose resolution was contingent on those particular issues being dealt with in the context of the taxation of MITs, such as the taxation of fixed trusts that are not MITs. We strongly encourage Treasury to forge ahead with resolving those issues now that the process to advance the MIT-related amendments is close to concluding. The Bodies would be more than happy to discuss these matters separately with Treasury.

If you would like to discuss any of the above, please contact Tax Counsel, Stephanie Caredes, on 02 8223 0059 for The Tax Institute or Adrian Varrasso on 03 8608 2483 for the Business Law Section of the Law Council of Australia.

Yours sincerely



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