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Managed Investment Trust Review
Board of Taxation
C/- Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

Submission to Treasury
Review of the Tax Arrangements Applying to Managed Investment Trusts

Thank you for the opportunity to comment on the Review of the Tax Arrangements applying to Managed Investment Trusts (MITs).

We have set out below a discussion on each of the following issues:

1. Options for determining tax liabilities
2. International considerations
3. Trusts as flow-through vehicles
4. Implications for the definition of fixed trusts
5. Eligible investment business rules in Division 6C of the *Income Tax Assessment Act 1936*
6. Division 6B of the *Income Tax Assessment Act 1936*

We note that in providing these comments, we have sought to highlight the key issues and introduce some important considerations without providing a comprehensive analysis.

We trust the content of this submission is constructive to your purposes. We would be happy to elaborate on any aspect of this submission should you require any further explanation.

Please contact Wayne Ngo on 03 8320 2302 (wayne.ngo@bdo.com.au) if you have any queries.

Yours faithfully
BDO Kendalls (NSW-VIC) Pty Ltd

Wayne Ngo
Director

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Submissions

1. Options for determining tax liabilities

Question 4.1

We acknowledge that there are uncertainties with the current operation of Division 6 of the *Income Tax Assessment Act 1936* which relies on the use of the concept of present entitlement to determine the income tax liability between beneficiaries and trustees. However, we also note that many of these uncertainties have a greater impact on discretionary trust structures than they do MIT structures which generally operate as unit trusts.

For example, many MIT structures ordinarily do not make distinctions between income and capital beneficiaries as investors have rights to both income and capital of the trust. Furthermore, in practice, most if not all MITs rely on the proportionate approach to determine a unit holders share of trust income and on this basis, the debate between the quantum approach or the proportionate approach becomes academic in relation to MITs.

Whilst we recognise that concepts of 'trust income', 'share of trust income' and 'present entitlement' may produce difficulties in relation to certain types of trusts, we believe that most if not all MITs operate under trust deeds which often have features dealing with many of these uncertain issues raised under tax law.

Accordingly, we do not believe that any wholesale changes to the existing rules in Division 6 are warranted in relation to MITs as they would simply introduce a greater layer of uncertainty and compliance cost to an already complicated tax system.

In particular, we note that each of the 3 alternative approaches to the current system may produce some other complications of their own.

Under Option 1, where the trustee is assessable on all net income but receives a deduction for distributions made to beneficiaries, there could be a number of complications in determining which distributions would result in tax deductions and which would not. More often than not, an MIT may make distributions in excess of its net taxable income. Will the excess result in a tax loss for the trustee and if not, would this result in inequitable treatment for future beneficiaries? What if the trust is in a net loss position but makes a cash distribution to beneficiaries, will the distribution be subject to a deduction? These are some examples of the uncertainties that any new regime would have to consider. Where there are complex rules required to determine the extent or eligibility to a deduction for distributions, this is likely to produce even greater uncertainty. Furthermore, certain trusts may not have sufficient cash to enable it to make distributions which in itself could be problematic.

Under Option 2 and 3 where beneficiaries are always assessable on net income of the trust (in the case of Option 3, provided the trustee makes a minimum level of annual distribution), we note that this may cause some difficulties where beneficiaries' cash distribution from the MIT does not match their tax assessment, particularly under Option 2 where a trustee could

hold back on making distributions entirely whilst the beneficiary is fully assessable on net income of the trust.

Furthermore, under Option 2 and 3, where a beneficiary's share of taxation of a MIT's net income is not on the basis of the beneficiary's distribution (i.e. not on the basis of the beneficiary's present entitlement to the MIT's income), some other basis for allocation of the MIT's net income is required. This again is likely to be a source of complexity. For example, where a MIT has separate classes of unit holders or where preference units have been issued, Option 2 and 3 would require a mechanism in differentiating between such classes of unit holders' share of the trusts net income.

Question 4.2

For reasons above, we do not recommend Option 1. We are of the opinion that the definition of distribution on the basis of payment would be problematic.

Question 4.3

We do not believe that the current section 99A rate of tax of 46.5% is appropriate and believe this should be reduced to 30% to be in line with the corporate tax rate.

Question 4.4

As discussed above, we do not support Option 1 trustee assessment and deduction method.

Question 4.5

We support the carry forward approach to dealing with 'unders' and 'overs' which is in line with current industry practice. The credit and deduction approach is unnecessarily complex and would result in a significantly greater compliance burden to MITs.

We do not believe that a de-minimis rule should be applied but rather, in order to preserve integrity, the carry forward approach be limited to circumstances of inadvertent or unintentional mistakes.

2. International considerations

Question 5.1

a) Issues under Australian domestic law and treaties with the operation of international rules for MITs

Complexity

Currently, the rate of tax paid by a foreign investor on income derived through a MIT can take on a seemingly infinite number of permutations. The tax rate first of all depends upon

the type of income (interest, dividend, royalty, capital gains on taxable Australian property, capital gains on non-taxable Australian property, other Australian sourced, foreign sourced), as well as the investor's country of residence (refer to the relevant Tax Treaty or whether the country is a Information Exchange Country). A further permutation is added as a result of the decrease in the MIT withholding rate over the following three years from 30% to 7.5%.

These differing rates make it very hard for a foreign investor to understand what their overall tax burden will be on their MIT investment, which also acts as a disincentive to investment in Australian MITs. Furthermore, the complexity adds an additional layer of compliance burden for MITs in meeting their withholding tax requirements for foreign investors.

Inconsistency between countries

One objective of the MIT PAYG rate reduction is to stimulate investment into Australia, yet countries such as Singapore and Malaysia are excluded from accessing the reduced rate, as they are not Information Exchange Countries.

Definition of 'fund payments' under MIT regime

The formula for calculating 'fund payments' under the MIT regime is confusing, as it involves decisions as to expected income and what is reasonable, and consideration of the object of the section. This adds to the uncertainty faced by an investor and their ability to reach an informed decision about the tax on their investments.

b) Suggestions for dealing with the issues

We suggest that a simplification of the withholding rules be implemented. Foreign residents investing through MITs could be taxed as follows:

- All foreign income is free from tax.
- All Australian sourced income is taxed at a flat rate of, say, 10% or 15%.

c) Advantages in having deemed corporate flow-through CIV regime for international reasons

The advantage of a Corporate Collective Investment Vehicle (CIV) is that tax is levied at the corporate level in the first instance, simplifying the initial tax payment. However, on distribution to investors, a more complex series of withholding tax rules must be applied depending on the residency of the investor and the type of income of the CIV. Overall, the suggestion in (b) above is preferable to a CIV.

3. Trusts as flow-through vehicles

Question 6.1

We agree with the policy principle that the tax treatment for trust beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly.

We recognise that distortions and double taxation could arise as a consequence of timing differences that exist with regards to the income and expenses for tax and trust income purposes.

As discussed in the MIT Discussion Paper, this distortion could arise where unrealised gains are recognised at different times for accounting purposes and tax purposes, and where expenses are recognised at different times for accounting and tax purposes (for example non incurred accruals).

However, we do not believe that the existing law should be changed significantly. Our view is that section 104-71(1) of ITAA 1997 should be amended so that any payment referable to a timing difference should not constitute a 'non-assessable' part of the payment (i.e. the part of the payment that reduces the cost base of the units under CGT event E4). The term 'timing difference' could be drafted broadly to mean any differences that arise in the recognition of income or deductions between net income for accounting and tax law purposes.

It is our view that CGT event E4 should only apply to permanent difference between net income for accounting and tax purposes.

4. Implications for the definition of fixed trusts

The current definition of a fixed trust, which broadly requires beneficiaries to have a fixed entitlement to all income and capital of the trust, has created many problems in its application to MITs. As the requirement for a fixed interest in a trust is used to determine a number of other provisions such as losses and franking, uncertainty regarding what constitutes a fixed interest can cause significant issues for MITs.

The term 'vested and indefeasible' interest has, in practice, created situations where it is unclear whether a fixed trust has been formed. For example, the existence of certain powers within the trust deed in relation to the issue of additional units and/or beneficiary entitlements could mean that interests in income and capital become inherently defeasible, defeating the definition of a fixed trust. Whether or not a MIT is a fixed trust is of utmost importance to the taxation implications and the uncertainties within the definition of a fixed trust cause significant compliance and technical difficulties.

Question 8.1

(a) Treatment of fixed trusts

We submit that the optimal solution to this issue would be to introduce a rule whereby MITs will be deemed to be fixed trusts. We believe such a rule would mitigate any requirement to determine whether an MIT is a fixed trust. We further submit that, in practice, most if not all MITs are structured with the intent of being a fixed trust and have no intention of taxation treatment as a non-fixed trust.

5. Eligible investment business rules in Division 6C of the *Income Tax Assessment Act 1936*

A recurrent theme throughout Chapter 9 of the Discussion Paper (and as expressed in *Policy Principle 2*) is that the taxation regime should operate to effectively restrict the activities of MITs to eligible investment business (EIB) to ensure that the benefits of flow through taxation of income are only available in respect of passive income. The inference that BDO draws from these observations is that Treasury's view seems to be that there would be a potential erosion of the corporate tax base if flow through taxation were to be extended to widely held trusts that derive a material proportion of their income from trading activities. This view seems to be premised on a perception that widely held trusts would be more commonly used as a structure to conduct trading businesses if Division 6C were to be substantially relaxed. However, in our opinion, the risk to the revenue associated with widely held trusts deriving trading income have been markedly reduced now that Australian resident investors (other than companies) can access refunds for excess imputation credits. That is, the comparative taxation advantage that trust distributions enjoyed over dividends from companies in 1985 (when Division 6C was introduced) has lessened significantly.

We believe that the perceived risk of erosion of the corporate tax base associated with a relaxation of Division 6C is also misconceived. The error in the expression of *Policy Principle 2* is that while trusts may offer certain tax advantages associated with flow through taxation, these advantages are only available to the extent that the trust distributes ***all*** of its income for a given income year.

If Division 6C were to be substantially relaxed so as to permit a substantial proportion of trust income to be derived from trading activities, it is unlikely that widely held trusts would in practice be used to conduct genuine trading businesses on any meaningful scale. This is because Division 6 requires trusts to distribute ***all*** of their income for an income year in order to ensure that no part of the taxable income of the trust is assessed to the trustee at a punitive rate and for the full benefits of flow through taxation to be conferred on the beneficiaries. It is submitted that very few widely held "active" trading businesses would restructure (or be established) using a trust structure in order to access flow through taxation as very few genuine businesses could feasibly return all of their profits as cash distributions to their owners each and every income year. Trading businesses generally need to retain some of their annual earnings to meet their liabilities and ongoing working capital requirements.

Whilst it may be possible for a widely held trust to confer a present entitlement to trust income to its unit holders but retain an amount from that income for use in the ongoing business, it is highly unlikely that unit holders in a widely held trust would tolerate this situation, given that unit holders would incur a tax liability in respect of taxable income of the trust that has not been distributed to them in cash.

Although BDO does not submit that flow through taxation should be extended to widely held trusts that derive their income predominantly from trading activities, we believe that Division 6C could be materially relaxed without undue risks to the revenue. The advantages of a material relaxation of Division 6C are discussed at our response to Question 9.2(a) below.

Question 9.1

We submit that there is no longer any purpose for maintaining the rule effectively prohibiting one or more complying superannuation funds from holding 20% or more of the interests in a non-widely held unit trust without incurring the adverse consequences under Division 6C. Our view is that subsection 102P(2) is an historical relic, originating when complying superannuation funds were tax-exempt entities.

This rule is no longer appropriate. Its continued operation brings about unfair implications to the relevant unit trust which must monitor its register of unit holders to determine whether entities that hold units are acting for complying superannuation funds. It is also unfair for other unit holders in the unit trust who suffer the consequences of a change in taxation treatment of the income of the unit trust if complying superannuation funds subsequently acquire interests in the unit trust totalling 20% or more, notwithstanding that the complying superannuation funds may be completely unrelated to the other unit holders.

Question 9.2

(a) Changing the eligible investment rules to reduce compliance cost

Currently MITs (and especially Real Estate Investment Trusts) incur substantial compliance costs in reviewing and structuring their activities so as to avoid the harsh outcomes associated with Division 6C. If a MIT derives any amount of income (no matter how small) from an activity that could be construed as a trading activity, all of the income of the trust will be taxed to the trustee as though the trust income were income of a company.

Because of the severe consequences of even a small breach of Division 6C, compliance with Division 6C has become a significant driver of complexity and compliance costs. It is also the case that in the absence of complex structuring, Real Estate Investment Trusts (REITs) in particular are constrained in their ability to maximise their income associated with their real estate investments, undermining the international competitiveness of the Australian REIT sector.

In response to the risks associated with a breach of Division 6C, Australian REITs in particular are forced to use complex structures such as stapling, and also to find means of structuring large investments in companies to fall just below the 50% control test. The complexity associated with such structures makes Australian REITs less readily understood as a structure, especially by foreign investors, further undermining the international competitiveness of the Australian REIT sector.

We have submitted above that the policy drivers for the harsh outcomes associated with a breach of Division 6C originated when the taxation of trust distributions had a significant comparative advantage over the taxation of company distributions, due to the classical system of taxation of dividends that existed in 1985 (when Division 6C was introduced). As this comparative advantage of trust distributions has been markedly reduced as a result of the introduction of refundable imputation credits, the strict tests and harsh operation of Division 6C is no longer appropriate.

The recent amendments to Division 6C in *Tax Laws Amendment (2008 Measures) No. 5 Act 2008*, while laudable in that they provide certain *de-minimis* thresholds for income that is not strictly speaking rental income or EIB income, do not apply to income that could be construed to be trading income. Thus, the current rules surrounding permitted activities for MITs (especially REITs) are inflexible and represent a major impediment to REITs seeking to maximise their returns from investments in real estate.

For example, the following areas provide significant doubt in terms of compliance with the definition of EIB:

- Derivation of tolling revenue or licence revenue associated with infrastructure assets.
- Income from granting advertising and/or signage rights on land owned by the REIT.
- Provision of services for a separate fee that are incidental to the ownership of real property (eg: security services etc).

However all of these items are income that is clearly incidental to the ownership of real property and, in the modern context where international competitiveness is a major policy driver, should not be precluded from being acceptable within the REIT/MIT regime. Clearly, the existing Division 6C is not sufficiently flexible in the modern environment where REITs will increasingly look to more innovative ways to maximise income from their investments in real estate.

Accordingly, it is submitted that MITs and REITs in particular should be permitted to derive up to 25% of their income from any non-EIB (including trading income) without falling foul of Division 6C. We note that the REIT regimes in both the UK and US permit REITs to derive up to 25% of their income from “ineligible” sources – accordingly such as measure would be consistent with those adopted by the US and UK. The advantages of such a relaxation of Division 6C would include:

- Greater simplicity and certainty for MITs (especially REITs) that derive income predominantly from the rental of land, but also derive other forms of non-rental

income or trading income in association with their ownership of land, buildings and fixtures to land. This would result in lower compliance costs for Australian REITs.
- Removal of taxation impediments to greater innovation for MITs and REITs to maximise income from their investments in real estate, which would enhance their potential returns to investors and hence their international competitiveness.
- The necessity for complex structures such as stapling would to some extent be redundant – allowing MITs and REITs to adopt simpler structures that are more readily understood by investors (both domestic and foreign), achieving a corresponding reduction in compliance costs.

(b) Control test

BDO considers that the control test is now irrelevant and should be abolished. Given that companies are taxed in their own right, trading income of the controlled company is taxed at the company rate in any event. Since the introduction of refundable imputation credits, there is no revenue at risk from structures where a widely held trust owns a controlling interest in a company.

(c) Non-compliance with the eligible investment rules

It is submitted that where there is a breach of the eligible investment rules, only the non-EIB income ('tainted' income to use the parlance of the Discussion Paper) should be subject to taxation as though the income were derived by a company. It would be antithetical to the objective of enhancing the international competitiveness of Australia's REITs if Division 6C continues to operate to deny flow through taxation in respect of ***all*** of the income of the trust when only part of the income may be non-EIB income.

Question 9.3

It is submitted that there is no meaningful benefit in establishing a separate REIT regime. Currently, Division 6 effectively compels trusts to distribute all of their income in order to achieve the full benefit of flow through taxation of income, and Division 6C already restricts the types of activities that a widely held trust can undertake. Thus the key issues required of a REIT regime already exist in the current regime. This being the case, it is difficult to see how a separate REIT regime would achieve any level of clarity that could not otherwise be achieved by amending Divisions 6 and 6C to overcome any existing shortcomings.

It is also difficult to envisage a set of rules being drafted for a separate REIT regime that would not create new issues and difficulties for investors, REIT managers and their advisers in terms of the permitted investments and distribution requirements. A new REIT regime would inevitably bring about new legislation, the interpretation of which could be subject of uncertainty and inconsistency with legislative intent. One recent example is TR 2005/23 which effectively seeks to curtail the distribution of listed investment company (LIC) capital gains to investors. In our opinion, the Ruling stands at odds with the generally accepted treatment of distributions of the same types of gains made by MITs carrying on essentially the same types of activities. This is a relevant example of the ATO issuing a ruling that effectively negated the intention of Parliament to harmonise the taxation treatment of

capital gains derived by LICs with those derived by MITs. Thus, opening an avenue for the ATO to reconsider and reinterpret principles thought to be settled in the context of the existing Division 6 by introducing a new legislative regime for REITs would in our opinion undermine the desire for certainty.

We also submit that the argument for the introduction of a separate REIT regime would result in Australian REITs being more recognised internationally is not entirely valid. The overseas REIT regimes vary markedly across countries, with the REIT rules of each jurisdiction differing in the types of entity structure required, the definition of permitted activities, specific distribution requirements and the taxation of different classes of income and gains. Arguing that a separate Australian REIT regime should be introduced on the basis that the international competitiveness of Australian REITs would be enhanced on the basis of being more comparable with foreign REIT regimes begs the question – with which foreign regimes would a new Australian REIT regime be more comparable? Arguably an Australian REIT regime would have its own unique design features in any event, which would undermine any perceived comparability advantages driving the push for a separate Australian REIT regime.

Establishment of a separate REIT regime would also create an additional structure for stakeholders to grapple with, which would if anything increase complexity associated with the taxation and regulatory regime affecting CIVs. Given that an objective of the Review is to "…reduce complexity, increase certainty and minimise compliance costs…" it is submitted that the introduction of a separate REIT regime would not advance these objectives and could, if anything, achieve the opposite. In BDO's view, the existing trust regime, with some modifications to Division 6 and 6C, would serve adequately for almost all of the functions that a REIT regime requires.

6. Division 6B of the *Income Tax Assessment Act 1936*

Question 10.1

(a) Whether Division 6B should be retained

BDO submits that Division 6B should be repealed. Division 6B was established at a time when there was a need to prevent companies from transferring assets or businesses into a resident public unit trust in order to attract the tax advantages associated with flow through taxation. However as a result of the introduction of capital gains tax and dividend imputation, there does not seem to be any further policy grounds for the continuation of Division 6B. In addition, we submit that Division 6B also presents a major impediment to companies restructuring their property holdings. While this provision was essential during the pre-imputation classical taxation system, given the drawbacks and the subsequent changes to taxation laws, Division 6B is no longer needed.