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19 December 2008

The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email to: taxboard@treasury.gov.au

Dear Sirs,

Review Of The Tax Arrangements Applying to Managed Investment Trusts (MITs)

We welcome this review by the Board and are pleased to make the following submission on behalf of our members.

CPA Australia represents the diverse interests of more than 122,000 finance, accounting and business advisers worldwide. We are committed to working with governments and their agencies to ensure economic and social policies foster an environment that facilitates sustainable economic growth.

In view of the limited time for providing comments on the issues raised in the Board's Discussion Paper on this topic and the fact that detailed submissions are being made by the relevant industry bodies, our comments and observations below are limited to the following specific issues raised in the paper:

- precise purpose and scope of the proposed MIT tax regime
- options for determining tax liabilities
- desirability of extending relevant aspects of the recommended changes to tax arrangements for other trusts
- capital versus revenue treatment of gains/losses on disposal of investment assets by MITs, and
- Australia as a financial services hub.

Purpose of proposed regime

It is not entirely clear as to whether the purpose of the proposed new arrangements is to preserve and perhaps re-express the border between flow-through taxation and corporate taxation or alternatively to facilitate and regularise the operation of a flow-through taxation regime, with particular reference to widely-held trusts.

In relation to the 'border' issue, we note that the Board is charged with examining whether there is a need for the tax integrity rules in Division 6B of the ITAA 1936 in light of the operation of the capital gains tax regime, dividend imputation (including availability of franking credit refunds in appropriate circumstances) and Division 6C. This seems to imply that Division 6C should be retained at least in some form notwithstanding that it remains problematic for the funds management industry even in light of the recently proposed amendments to the existing rules.

While some differences (such as preserving the character or source of income, access to foreign tax credits or the benefit of capital allowances) between the taxation of trusts and companies still remain, they would not appear to raise systemic 'integrity' issues such as those that led previous governments to introduce Divisions 6B and 6C. In the circumstances, therefore, it may now be desirable for the Board to consider whether, in fact, there remains sufficient policy support for either set of rules going forward. We note though that any conclusion on this matter may need to be qualified pending the outcome of the Henry Tax Review.

Options for determining tax liabilities

We welcome the Board's discussion of alternative models or options for determining the tax liabilities of MITs in lieu of using the current Division 6 provisions, particularly given the current problems associated with Division 6 (see also below) for MITs and other trusts. However, we are not in a position at this stage to offer a concluded view on the efficacy of these various options, particularly in respect to their application to private trusts.

Desirability of extending relevant aspects of the recommended changes for MITs to the tax arrangements for other trusts

Both the Australian Taxation Office (ATO) and the tax profession acknowledge that there are different views about the interpretation of Division 6 in respect to both MITs and other trusts. These issues are highlighted in a draft discussion paper on this topic which was recently released by the ATO to the National Tax Liaison Group (NTLG) for comment as noted in the Board's Discussion Paper.

While the ATO is keen to clarify these differing views via the judicial process and, in the meantime, provide guidance to its staff based on its current view of the law, we are concerned that the views outlined in the ATO's current draft discussion paper appear controversial as being in many instances contrary to long-standing practice in this area and that clarification through the courts, even if possible, may be a long drawn out process.

If the ATO persists with its current views on Division 6 and commences to overturn longstanding practice in this area before the judicial process is finalised, it is our strong view that there is a need for the relevant legislative provisions to be amended to provide both clarity and certainty in relation to the taxation arrangements for both MITs and other trusts, especially as the latter are widely used in the small business area..

That said, however, CPA Australia welcomes the fact that the terms of reference for the Board's current review includes the desirability of extending relevant aspects of its recommended changes to tax arrangements for MITs to other trusts and we would be pleased to participate in further consultation on this matter at an appropriate stage.

Capital v revenue treatment of MIT investment gains/losses

In our view, the main concern to be addressed in this area is the need for greater certainty as to the circumstances in which a gain made by a MIT trustee will be regarded as being on capital rather than revenue account. The attempted application of case law principles does not achieve this objective but instead raises the prospect of amended assessments for large numbers of unitholders should the ATO take a view contrary to that of the trustee.

We understand that historically MITs apply the CGT rules in calculating gains or losses in respect to the disposal of assets (other than those assets where revenue treatment is mandatory such as financial securities) unless the MIT was specifically established to hold investments on revenue account. Different considerations may apply to property trusts which will typically hold assets on capital account.

In these circumstances, significant compliance costs have probably not been incurred by MITs in distinguishing between capital and revenue treatment on disposal of specific assets in the past. However, compliance costs could increase significantly in the future in the light of the ATO's expected greater focus on issues in this area going forward.

The provision of a specific statutory rule treating gains and losses made on disposal by MITs of certain investment assets as being on capital account where they met a specific statutory holding requirement (such as the 12 month rule currently applicable to individuals and complying superannuation funds) would provide certainty and would appear to be consistent with the tax treatment for the great majority of trust beneficiaries had they made the gain themselves. The relevant assets in this context would include shares, units in unit trusts and real property.

MITs could be given an irrevocable election to have such proposed CGT treatment applied to them as from the commencement date of the new regime. It may also be desirable for such an election to be deemed to have applied in the past.

We see no merit in a statutory rule which treated gains/losses made on disposal of such assets by MITs as being on revenue account as this would seem, in our view, to be clearly inconsistent with Policy Principle 1 as stated in the Board's paper.

The statutory rule proposed above should apply to individual and complying superannuation fund unitholders and could be simply structured along the lines of the relevant provisions which currently apply to these taxpayers where they hold such investments directly rather than via an MIT.

In the interests of creating a level playing field, statutory capital account treatment should be extended to other collective investment vehicles such as listed investment companies (LICs) which would also benefit from certainty in this area.

We do not consider that different considerations should apply to private equity funds coming within the ambit of the relevant provisions of the Income Tax Assessment Act (ITAA) 1997. In this regard, we note that the CGT rules already treat the 'carried interest' of a relevant fund manager as being on capital account - refer to section 104-255 (CGT event K9) of ITAA 1997 regarding a Venture Capital Limited Partnership (VCLP) and other related entities.

In relation to the potential revenue implications of the approach proposed above of broad-based capital treatment for managed funds, we note that there would not appear to be any significant cost to the revenue on a go-forward basis given that the main investors claiming access to the CGT discount would be individuals and superannuation funds that would otherwise obtain access to the discount if they invested directly rather than via an MIT. Any concerns about existing revenue unit holders being also able to access the CGT discount by investing in managed funds could be dealt via a specific exclusion for such investors if that was considered to be appropriate.

Australia as a financial services hub

CPA Australia supports the Government's commitment to making Australia the financial services hub of Asia and notes that the current review of MIT tax arrangements is a key component of this commitment. We note in this regard that the discussion paper does not consider a number of international issues associated with MITs. For example, the five options proposed for dealing with the attribution of tax liabilities to beneficiaries (eg. TADM, TEM, MDM, etc) may have different tax consequences for non-resident investors. Consideration of the tax consequences for trustees, withholding tax provisions and the ability to claim treaty benefits at the trust or investor level are all relevant characteristics that will be considered by non-resident investment managers looking to invest in Australia or globally through Australian-resident funds.

As part of its review, the Board may wish to consider other measures that could assist the achievement of the abovementioned objective, including tax incentives for fund managers and their employees, clarifying the taxation of sovereign wealth investments, measures to facilitate the IPO of foreign countries in Australia and special economic zones for genuine international fund management activities or offshore banking (OBU) type concessions for such activities.

Please call me if you wish to discuss any aspect of the above.

Yours faithfully,

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