Ernst & Young

Ernst & Young Building
8 Exhibition Street
Melbourne VIC 3000 Australia
GPO Box 67 Melbourne VIC 3001

Tel: +61 3 9288 8000
Fax: +61 3 8650 7777
www.ey.com/au

9 December 2008

Managed Investment Trusts Review
The Board of Taxation
C/- The Treasury
Langton Crescent
CANBERRA ACT 2600

To the Board

Review of the Tax Arrangements Applying to Managed Investment Trusts
Interim submission: Treatment of gains and losses on disposal of assets

Ernst & Young is pleased to make this interim submission in response to the questions and discussions in the Board of Taxation's discussion paper "Review of the Tax Arrangements Applying to Managed Investment Trusts" (the discussion paper) concerning the treatment of gains and losses made on the disposal of assets by managed investment trusts (MITs).

We will lodge a further submission on the balance of the discussion paper by the 19 December due date.

Our submission has been informed by input received from Ernst & Young clients in the managed funds and investment industry.

We submit:

- The characterisation of gains and losses on the disposal of CGT assets of a MIT should be addressed by a statutory rule at the fund level, for all managed funds
- The statutory rule should provide that the capital gains tax (CGT) provisions are the primary code for calculating the gains and losses of a fund broadly in the same way the rule in Section 295-85 of the *Income Tax Assessment Act 1997* (ITAA 1997) applies to a superannuation fund, which includes designated exceptions to the capital treatment
- The characterisation of the gains of the MIT as capital gains should 'flow through' to all investors in the managed fund so that the distribution of these gains are also treated as capital gains to the investor
- Funds should be allowed an optional election not to apply the statutory rule to their assets
- The CGT discount requirements including the 12 month holding rule should remain, subject to amendment to address certain technical issues. The taxation treatment on the disposal of units in funds should also remain unchanged
- These rules should be applicable not only to MITs as currently defined but should apply to wholesale funds, private equity funds and other funds used to collect savings (particularly those used as collectors of superannuation funds' monies). Otherwise the resulting horizontal inequity will have severe consequences for the managed funds sector.

We submit that a single statutory capital rule, with flow through to investors, will deliver significant benefits to the managed funds industry:

- It will provide certainty to the taxation of MITs
- It will provide certainty to the taxation of investors in MITs

- It will avoid significant complexity and costs of compliance compared to MITs having to undertake a detailed analysis of individual assets to determine their capital or revenue characterisation.

Such reforms must be implemented soon, either in a permanent form or in an interim manner pending the completion of the review of MITs by the Board. Otherwise:

- MITs may instead continue to face significant uncertainty, being required to self assess their transactions and asset disposals as giving rise to either revenue or capital gains in an uncertain environment, perhaps using a detailed analysis of individual assets or classes of assets, perhaps along the lines of the ATO approach in taxation ruling TR 2005/23 for Listed Investment Companies (LICs). In any event the discussion in TR 2005/23 is not appropriate for unlisted funds which must dispose of assets to provide liquidity for redemptions of investments; the application of that ruling would have the potential to adversely affect the managed funds industry in respect of both domestic and non-resident investment.
- Australian investors will face uncertainty concerning the potential characterisation of any gains they receive from the MIT.

  The expected responses of superannuation funds and wealthy and well-advised investors would be to move to direct investment models, including through partnerships and joint ventures and wrap accounts and similar techniques. Given that the majority of funds held in managed funds represent the investments of superannuation funds this likely action of investors has the potential to at least significantly curtail the growth of the industry and, at worst, would result in a significant contraction in or disturbance to the funds management industry.
- Non-residents are also concerned that the treatment of their income from Australian investments is certain and that they can access the concessional tax treatments introduced to encourage investment in Australian funds. These expectations are supported by the Government's 'Australia as a regional financial hub' policy. A vital element for non-resident investors is the CGT exemptions in Division 855 including for distributions of gains by funds.

  Expected responses by non-resident investors to the uncertain but potential treatment of MIT gains on revenue account would be to withdraw current funds from Australian managed funds and to invest those funds directly or through new funds in a more favourable and/or certain tax jurisdiction.

We set out our reasoning further in the attached Appendix.

If you would like to discuss this submission in more detail please contact in the first instance Dale Judd on (03) 9655 2769, Daryl Choo on (02) 9248 4472, Paula Houvardas on (02) 9248 4726, or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Dale Judd
Partner

Appendix

Capital 'bright-line' rule should be similar to the superannuation fund rule

The characterisation of gains and losses on the disposal of CGT assets of a MIT should be addressed by a statutory rule.

A statutory rule will have significant benefits for the managed funds industry resulting from the certainty that such a rule would provide and from the avoidance of significant complexity and costs of compliance.

Without a clear rule, continued uncertainty, complexity and compliance costs will arise should a case law based analysis be required to be undertaken on an asset by asset or a class of asset basis to characterise gains and losses. These issues would arise in particular for equity funds if the ATO's approach in TR 2005/23 for characterizing gains and losses of LICs is adopted for these MITs.

A statutory rule will also avoid potential disputes with the ATO and the administrative difficulties for the ATO associated with the seeking to amend investor taxpayers' relevant assessments.

The statutory rule should provide that the CGT provisions are the primary code for calculating the gains and losses of a MIT broadly in the same way the rule in Section 295-85 of the ITAA 1997 applies to complying superannuation entities.

Limited exceptions could apply to the rule similar to those in the exceptions to the superannuation rule (sub-sections 295-85(3) and (4)) including for example

- dealing securities; and
- that part of a gain or loss which is attributable to foreign exchange rate fluctuations.

We note that proposed TOFA legislation preserves the CGT rule for superannuation entities (see proposed amendments in Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 at item 80, discussed in the Explanatory Memorandum at paragraph 11.26). Therefore a similar rule can easily be extended to MITs.

So the revenue-capital treatment will require similar rules in relation to MITs.

This capital characterisation should apply to relevant assets without any further requirement for an asset holding period of 12 months or more, because:

- a holding period requirement would introduce a level of complexity and uncertainty, both for the MIT and investors, as it would require analysing the characterisation of gains and losses on an asset by asset basis, which would be unworkable
- any such constraint, which would be more severe than applies for superannuation funds which are the major investors in managed funds, would perpetuate the distortion in funds' tax treatment and would run counter to the intent to equalize the treatment of collective investment vehicles and their investors
- such an approach would increase compliance costs because funds would have to identify, track and report on another income category, i.e. revenue gains and existing CGT systems would need to be changed to extract the short gains and not treat them as capital gains. Further short-term losses would need to be treated as revenue deductions.

The statutory rule should apply for:

- all MIT funds (as defined, to be discussed in our further submission) including property funds, equity funds, private equity funds, wholesale funds and other funds used to collect savings (particularly those used as collectors of superannuation funds' monies)
- funds that are taxed in accordance with Division 6B (corporate unit trusts) or Division 6C (public trading trusts), which should also be included at least for simplicity and recognizing that such funds can move in and out of those provisions on a yearly basis

Private equity funds should not be precluded from this capital treatment. In our view private equity funds, while they may have a finite life, accumulate the savings of superannuation funds and other investors and invest for a medium term. In fact commentators have noted that private equity funds have a longer and more stable investment profile than do many traditional managed funds[1].

The statutory capital rule should be relatively simple to implement for most funds on our understanding that generally property funds and most equity funds currently treat their gains and losses as being on capital account.

Optional election not to apply the statutory capital rule

We note that capital treatment may have adverse implications for some funds and their investors, especially in the current global financial crisis, as losses on CGT assets will be quarantined for off-set only against current year capital gains or for deduction from future year capital gains.

Some managed funds may currently return gains and losses on some of their investment assets on revenue account and that they may want to retain such treatment. We also understand that some investors would have invested in such funds on the understanding that returns would be of a revenue nature and they would therefore likely expect their distributions of fund income to remain on revenue account.

Funds should therefore be allowed an optional election not to apply the statutory capital rule to some or all of its assets but to instead treat all gains and losses on such assets on revenue account.

This election could be irrevocable which would avoid complexity in moving from capital to revenue treatment and vice-versa and would add integrity to the process.

---

[1] The president of the Australian Institute of Company Directors, Mr John Story, observed that private equity was prepared to invest for a longer period than some equity investors on the stock markets:

> "They will approach an investment on the basis of a three to five year time span. That's a healthy basis. In recent years in Australia, there's been limited (ability) on the part of our markets to make that type of assessment.
>
> "They've been looking for a return in 12 months, or at the longest two years. If you can't demonstrate a return in that period, then the company is treated harshly in its share price. Private equity is gaining an advantage there because it is more realistic."

(Quoted in "Privateers thrive in over-regulation" by Rowan Callick, China correspondent, The Australian, 10 May 2007)

Short-term gains do not attract CGT discount

We note that the availability of CGT discount is already constrained. The capital gains tax laws provide that the discount capital gain treatment for individuals, superannuation funds and trusts requires a 12 month holding period by the investor (section 115-15). This provides appropriate revenue integrity in relation to short term capital gains.

Commencement date for the capital/revenue rule

The new capital rule should operate as the default position and could apply:

- optionally from the 2008/09 income year and earlier
- mandatorily from the 2009/10 year, in the absence of the making of an opt-out election to be treated on revenue account.

This will ensure funds are not disadvantaged by any new ATO published views but also to allow them sufficient time to adjust systems if necessary and to consider their position for the optional election not to apply the statutory capital rule.

Flow through characterisation for taxation of investors

The characterisation of the gains of the MIT as capital gains should 'flow through' to all investors in the MIT so that these gains are also taxed as capital gains to them.

This treatment would appear to result in all cases from the current operation of Division 115 of the ITAA 1997 and therefore these provisions should be retained. However there are some technical issues with the operation of the CGT discount rules which should be examined at the drafting stage of the above measures.

Investors in managed funds are in almost all cases either superannuation funds or individual or intermediaries for superannuation funds and individuals. Flow through capital treatment will therefore accord with Policy Principle One of the review in respect of almost all investors, that the tax treatment for beneficiaries who derive income from the trust should replicate the tax treatment they would have if they had derived the income directly.

We note that the adoption of a further general principle of flow through, as enshrined in the legislation for capital gains, would ensure that investors have certainty in respect of the taxation of distributions from their fund investments. This proposition is consistent with existing policies supporting the 'flow-through' or consistent characterisation in the hands of the trust and the investor, as mentioned in the Paper at paragraphs. 3.17-3.18, 3.21 and 6.20. However, as noted in para 6.20, those rules are somewhat uncertain and they are scattered throughout the tax law. A clear codification of the rules is therefore necessary. This is particularly important for superannuation funds and non-resident investors.

Limiting the flow through of capital gains treatment of gains made by MITs to particular kinds of investors, for example complying superannuation funds, would introduce further complexity and compliance costs. For example, differential disclosures on distribution statements would be required. Further for the purposes of TFN withholding and MIT withholding the MIT would need to ascertain the type of each investor, which can be difficult where nominees or custodians hold units on behalf of investors, in order to ascertain the correct amount of the distribution to which withholding should apply.

As noted above, Policy Principle One requires alignment of the rules for MITs with the rules for investors investing directly. Any additional rules for MITs over and above the rules applying to investors investing directly would reintroduce the very complexity, uncertainty and costs of compliance that the statutory rule for MITs is seeking to address.

We note that company investors and non-resident investors are not entitled to the CGT discount and so they will not inappropriately benefit from any change in classification from revenue to capital tax treatment in this regard.

The taxation of investors on disposal of their units or other interests in a MIT would not be changed by these new rules.

Revenue cost concerns

The terms of reference of the Board's review include that the options presented to the Government should be revenue neutral or near revenue neutral.

Although it is difficult for us to gauge the revenue impact of our submission proposals we believe that they should be largely revenue neutral on our understanding that a statutory capital rule for all CGT assets of a fund would:

- Align with the current practice of almost all managed funds, including property funds and equity funds
- Align with the current practice of almost all investors in managed funds, including in property and equity funds.

As noted above, capital treatment may have a positive impact on the revenue in respect of some funds as losses on CGT assets will be quarantined for off-set only against current year capital gains or for deduction from future year capital gains. Such revenue positive effects may offset any revenue reductions from what we believe would be the unusual case of a taxpayer changing their treatment of gains distributed by funds from revenue to capital account.