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Secretary,
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c- The Treasury
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19 December 2008

By email

Dear Sir

**Interim Submission on Tax Arrangements Applying to Managed Investment Trusts**

Greenwoods & Freehills is Australia's largest advisory firm practising exclusively in revenue law. Its clients include many of Australia's largest managed funds.

This submission is made in response to the request for submissions by the Board of Taxation's on its paper, Review of the Tax Arrangements Applying to Managed Investment Trusts ('the Paper'). This submission supplements the firm's submission lodged with the Board earlier this month on Chapter 7 of the Paper.

We address below each of the questions posed in the Paper.

## Chapter 4: Options for determining tax liabilities

*Q 4.1. The Board seeks stakeholder comment on:*

*(a) the high level Options outlined above including comment on any issues that affect their workability as alternative models;*

*(b) the alternative that the current arrangements, which rely on Division 6 concepts such as trust income, share of trust income and present entitlement, could be modified to overcome the current issues and in that case, what modifications would be desirable; and*

*(c) any other options for change.*

*Q 4.4. The Board seeks stakeholder comment on:*

*(a) the scope to move to a receipts based approach under a model that allows trustees a deduction for their distributions;*

*(b) the feasibility of other options to simplify arrangements for beneficiaries including changing the tax year for MITs; and*

*(c) whether, under the trustee assessment and deduction model, resident individuals should be the only class of beneficiaries assessable on a receipts basis.*

The Options in the Paper are put in general terms only and the detail will need to be amplified over time, but in our view, Option 2 currently presents a more attractive method for taxing the income of MITs than Option 1 or Option 3.

Option 1 presents a number of potential difficulties. Option 1 will require cash distributions to occur to avoid tax at the MIT level and this will interfere with what should be commercial decisions about how much of an MITs cash to retain or distribute. Option 2 does not raise this difficulty.



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Second, as the examples in Appendix H show, cash distributions may need to be funded out of borrowings if the MIT has taxable income but no cash to distribute. Again, the tax system should not interfere with decisions about how much debt an MIT should carry. Funding distributions out of subscribed capital or retained earnings raises the same issue. Option 2 does not raise this difficulty.

Thirdly, because the connection between cash and taxable income is so tenuous there will need to be a new set of rules to decide what amounts to a distribution, how much it represents and so on, or new rules changing the amount of taxable income. For example, an MIT which receives $70 in cash as a franked dividend and distributes the same amount should be regarded a having made a full distribution and not being liable to tax. But is that result to be brought about by:

- a special rule on the income side which says the MIT has only $70 net income, in which case the amount of cash paid out is commensurate; or
- applying the usual income rules and treating the trust as having $100 net income, but having a special rule on the deduction / distribution side so that the amount of cash paid out is treated as amounting to $100?

Appendix H suggests it will be the latter but it does mean a new regime will need to be created to bring about this kind of adjustment.

While Option 2 might look and feel like the current Division 6, that is not necessarily a disadvantage – it has the air of familiarity. Further it is certainly possible to devise a simpler, clearer and less complex version of Division 6. That can be done for MITs because they are not like private trusts:

- investors in widely held or listed MITs will be dealing with each other at arm's length;
- interests in MITs invariably confer fixed rather than discretionary entitlements;
- interests in MITs are usually entirely fungible – they do not confer different entitlements to share in income and capital gains, or in interest income and dividend income;
- if an MIT does issue preferred interests, they will usually create a preference to an amount of income, not a class of income, so that streaming and similar practices will not occur;
- MITs are obliged by the market (if not their deeds) to pay regular distributions to investors; and
- trustees operate under strict fiduciary duties and ASX rules which eliminate the kinds of partial practices seen in private trusts.

Hence, instead of using the entitlement to share in the income of a trust, it would be possible to use other indicators as the basis for allocating the liability to pay tax on the MIT's taxable income, such as:

- the number of units or interests held by the investor; or
- the share of distributions received by each investor.

We submit that a system which used the indicators as the basis for attributing the liability to pay tax on an MIT's income would be less contentious, robust, accurate and feasible. It would also be superior to a system such as Option 1 based on distributions.

*Q 4.2. The Board seeks stakeholder comment on a definition of distribution that would provide clarity and ensure appropriate tax outcomes.*

In our opinion, adopting a regime along the lines of Option 2 should obviate the need for a definition of distribution. However, the following comments are offered if a different option is adopted.

A share of the tax liability should follow from the receipt of almost all distributions in cash or property made by the MIT. (Hopefully it would be possible to avoid tying this to distributions which represent income of the MIT. If the trust can lawfully distribute the amount under its constituent documents, that should make any need to refer to distributions of 'income' unnecessary.)

But it would be necessary to provide that payments in cash or property which represent:

- interest or interest-like amounts;

- return of invested capital;
- the splitting of an existing interest in the MIT (akin to a bonus issue which is not taxed under s. 6BA);

should not amount to a distribution.

Participating in a DRP should be regarded as involving a distribution.

> *Q 4.3 The Board seeks stakeholder comment on whether:*
>
> *(a) applying the current section 99A tax rate on the undistributed taxable income of a trust would reflect an appropriate balance between integrity and equity considerations; and*
>
> *(b) there are means, other than applying the top marginal rate, for preserving integrity.*

The economic substance, as well as the market perception, of an MIT is that it closely resembles a company and, in our submission, applying the corporate tax model to MITs is the appropriate way to deal with income which (for some reason) is not taxed on a current basis in the hands of the investors.

If the trustee of an MIT becomes liable to pay tax on some or all of the current income of an MIT (either because it cannot be allocated/distributed to investors on a current basis, or rules akin to Division 6C are triggered), then Policy Principle 4 should apply. It should work in this manner:

- the trustee would pay tax on the amount of taxable income of the MIT that is not being taxed in the hands of the investors;
- the trustee would pay tax at the corporate rate; and
- the amount of tax paid by the trustee would generate a franking credit which could pass for the benefit of the investors in the MIT.

> *Q 4.5 The Board seeks stakeholder comment on:*
>
> *(a) the desirability of adopting either a simple carry forward approach or a deduction/credit approach for correcting errors in calculating the net income of the trust. The Board also requests comments on how these approaches would interact with the Options for determining tax liabilities outlined in paragraph 4.8;*
>
> *(b) how any approach adopted could address the inequities in the allocation of tax liabilities which can arise when unit holders redeem or sell their units before errors in the calculation of the net income of the trust have been identified;*
>
> *(c) under either approach to correcting errors in the calculation of net income of the trust, whether there is a need for a* de minimis *rule of up to say 2 per cent of the net income and if yes, what should be the consequences of breaching the* de minimis *rule; and*
>
> *(d) whether the Commissioner of Taxation should have discretion to increase the* de minimis *in special circumstances, and if so, what circumstances.*

A simple statutory safe harbour regime for income omissions, deduction or tax offset over-statements that generate tax deficiencies is a welcome proposal.

In our submission, such a system should be available where:

- the omission represented a small percentage of taxable income;
- the omission was identified quickly; and
- the omission occurred despite the exercise of reasonable care.

In such a case, the omission should be rectified by adding the deficiency to the taxable income of a subsequent year, rather than by requiring amendments to the returns of investors or the imposition of tax or a compensating penalty on the trustee.

## Chapter 5: International considerations

> *Q 5.1 The Board seeks stakeholder comment on:*
>
> *(a) what issues are currently experienced under Australian domestic law and treaties with the operation of international rules for MITs;*
>
> *(b) what suggestions are there for dealing with the issues; and*
>
> *(c) would there be advantages in having a deemed corporate flow-through CIV regime for international reasons.*

With respect to the inbound income and gains of an MIT, there are issues surrounding gaining accessing to treaty benefits at the MIT level, rather than at the investor level. For this reason it may be worthwhile giving an MIT the status of an entity and a taxpayer under Australian domestic tax law albeit with a tax base that will prove to be nil or negligible in most cases (ie, only where the MIT makes no distributions or it derives tainted income). It will certainly be a great benefit to the industry if the Board can propose a flow-through taxation model for MITs which entitles MITs, rather than the investors in them, to enjoy treaty benefits on income and gains sourced in treaty countries.

With respect to outbound income:

- it should be possible to rationalise the number of classes into which distributions made to non-residents need to be dissected; and
- the current law with respect to gains and losses made by non-resident investors on sales of their interests in Australian MITs seems appropriate and does not need change.

## Chapter 6: Trusts as flow-through vehicles

> *Q 6.1 The Board seeks stakeholder comment on any options for addressing the uncertainties and potential distortions, including double taxation, which can result where there are differences between the net income of the MIT and the actual distributions made to beneficiaries.*
>
> *The Board requests that stakeholders consider their comments in the context of both listed and unlisted MITs and in the context of the alternative approaches for determining tax liabilities discussed in Chapter 4.*

Our earlier answers suggested that an attribution-based regime such as Option 2 may be a preferable system to employ for taxing income earned via an MIT. Investors should be taxed on a current basis on their interest in what the MIT earns on their behalf rather than on the amount that the MIT chooses to distribute to them.

The Paper correctly notes that our current system treats the earning of trust income and the subsequent distribution of that income as two separate taxing points (albeit with adjustments between the two points). Such a system is inconsistent with Policy Principle 1 and unnecessary if the appropriate amount of tax was collected on a timely basis when the income was earned.

Moreover, the second taxing point – the time of distribution – is not consistently analysed and treated:

- The Paper notes the Commissioner's view that sometimes distributions (but only the portion of the distribution exceeding the share of net income) are assessed immediately on receipt as income. Sometimes CGT event E4 assesses an amount on a deferred basis (by depleting cost) and as a capital gain.
- CGT Event E4 happens for distributions that represent income sheltered by deductions under Division 43; E4 events do not happen for distributions that represent income sheltered by CGT discount. We have no idea at present how income sheltered by deductions under the recently announced 10% investment allowance will be treated.
- CGT Event E4 event happens for distributions from MITs; E4 events do not happen for distributions from discretionary trusts.

- On the other side of the equation there is no "reverse E4" adjustment where retained taxed income is taxed twice because an investor sells its interest in an MIT with undistributed income.

The simplest solution, and one which is probably no less accurate a reflection of economic income and gain at the investor level than what is meant to occur now, would be to provide that distributions by MITs are simply not assessable. Eliminating any tax on distributions would certainly be more consistent with Policy Principle 1. What *is* assessable is the amount *attributed* to the investor under the rules described above.

The only exceptions to this would be distributions which represented amounts which represented the return of subscribed capital (in which case the investor's cost in the unit should be depleted.)

Discrepancies between the amounts attributed to the investor and amounts distributed to the investor which represent exempt income, or additional deductions, timing differences or other notional adjustments should be ignored in other cases.

> *Q 6.2 The Board seeks stakeholder comment on:*
>
> *(a) how current uncertainty as to the applicability of a general law principle of flow-through of character should be addressed;*
>
> *(b) whether the existing statutory flow-through mechanisms (for example, CGT, franking credits and foreign tax credits) work satisfactorily and, if not, why not;*
>
> *(c) whether flow-through of character can be maintained while reducing compliance costs and complexity and if so, by which means;*
>
> *(d) whether flow-through of character needs to be maintained in general or alternatively, needs only to be maintained in specific circumstances;*
>
> *(e) how flow-through of character might work under any options considered for changing the way tax liability should be determined (as discussed in Chapter 4);*
>
> *(f) whether non-residents can be treated differently in order to reduce complexity (for example, possible consolidation of the base from which amounts are to be withheld; and*
>
> *(g) whether character retention should be concerned with whether investors are portfolio or non-portfolio investors.*

Policy Principle 1 aims for a system under which the tax treatment of investors who derive income using an MIT replicates the tax treatment the investors would have received had they derived the income directly. This implies transparency with respect to character and source and we submit that it is worth attempting to retain this feature in any revised MIT system.

This is especially important for dividend income, capital gains derived by an MIT and foreign source income earned by an MIT.

On the other hand, we have no doubt that it may possible to rationalise some of the income classes that the law currently creates.

## Chapter 7: Capital versus revenue account treatment of gains and losses made on disposal of investment assets by MITs

These issues were dealt with in our earlier submission (copy attached).

## Chapter 8: Implications for the definition of fixed trust

> *Q 8.1 The Board seeks stakeholder comments on:*
>
> *(a) the advantages and disadvantages of the potential options for clarifying the treatment of fixed trusts outlined above; and*
>
> *(b) any other options for clarifying the treatment of fixed trusts.*

The definition of "fixed trust" used in the legislation is generally viewed by the profession as unduly restrictive. The test sets too high a standard to be met before a trust is viewed as appropriately "fixed." The suggestion that a retail listed MIT might not be sufficiently "fixed" is evidence that something is wrong with the test.

We noted above that an MIT will typically have a single class of units with non-discretionary and uniform entitlements. In our submission, a trust with these attributes should be regarded as possessing the attributes needed to satisfy a test which governs access to tax attributes such as the ability to claim losses, pass on franking credits or qualify for scrip-for-scrip measures. Whether or not a trust with these attributes is "fixed" or not is not really the point. Rather the point is that a trust, the interests in which have those attributes, possesses sufficient integrity for the tax system not to restrict access to any tax attributes.

Perhaps a different question to ask is whether the reasons for use of a definition of fixed trust could not be dealt with in better ways? Currently, the definition is used to address integrity issues (loss trafficking and franking credit trading). We observe that abuses have been successfully prosecuted by the Commissioner by using other rules within the tax laws and not relying on fixed trust concepts. Those cases support the effectiveness of, for example, Part IVA and calls into question the need for this specific integrity rule which simply adds to complexity and compliance costs for many trusts where there are no integrity issues.

### Chapter 9: Eligible investment business rules in Division 6C of the Income Tax Assessment Act 1936

*Q 9.1 The Board seeks comment on whether it is still appropriate to have the 20 per cent rule for complying superannuation funds.*

We agree with the implication in the Paper that this rule outlived its original purpose once superannuation funds became taxpaying entities, and should now be removed from the legislation.

*Q 9.2 The Board seeks stakeholder comment on the following:*

*(a) what approaches can be taken to changing the eligible investment rules that would reduce compliance costs for managed funds and enhance their international competitiveness;*

*(b) should the control test be abolished or replaced with a requirement that investments in companies or other entities carrying on trading businesses be limited to a particular percentage or with an arm's length terms requirement; and*

*(c) should non-compliance with the eligible investment rules result in taxation only on the 'tainted' income and how could this be achieved.*

There is clearly scope for reducing some of the uncertainty that still surrounds the operation of Division 6C by describing more clearly in the legislation the circumstances that are to be prohibited. This might be done in a number of ways:

- the 75% safe harbour figure in s. 102MB could be expanded by relaxing some of the restrictions attached to it and the 2% *de minimis* rule in s. 102MC;
- the initial test in s. 102M, definition of "eligible investment business," of "investing in land ..." could be re-phrased as a test based on the earning of excessive amounts and prohibited types of income, rather than a test based on the acquisition and application of assets;
- the definition of "eligible investment business" could be reversed, and the focus placed just on certain kinds of delineated activities – a black list approach of prohibited activities that are to be taken *not* to be "eligible investment business."

More generally, it may be preferable to frame a test for eligible investment business using the kind of approach taken in defining "personal services income" in Division 84 ITAA 1997. These rules try to differentiate income from performing services, on the one hand, from income from selling goods or real estate or from investments on the other. Such an approach could be adopted here. An MIT would be allowed to earn any type of income or gain which it earned from owning the land. The idea would be to distinguish income it derives from owning and exploiting its land on the one hand, from income which it might derive from selling the land (ie, development) or from selling goods or services on the land.

Furthermore, we can see no justification for the continued prohibition on controlling a company which undertakes a trading business. Offering the equivalent of the US "taxable REIT subsidiary" regime seems a most suitable method for achieving the kinds of outcomes that Division 6C is

directed toward. It may be appropriate to buttress such a regime with an arm's length rule for prices of transactions occurring between the MIT and its taxable subsidiary to prevent profit shifting into the trust, but this seems a necessary and appropriate price to pay for being able to quarantine offending activities and remove the MIT from danger. We submit that an arm's length test is preferable to a requirement which limited investments in entities carrying on a trading businesses to a particular percentage.

We agree with the implication in the Paper that the consequence of breaching the eligible investment rules should be to impose tax on the tainted income. This will obviously require apportionment and allocation rules for income, expenses and other tax attributes, but again this complexity seems an acceptable price to pay for being able to limit the consequences of breaching the rules to just paying tax on the tainted income.

Where a trustee has triggered corporate tax, the usual consequences should follow for unitholders – a franking credit should be available to investors for the tax.

*Q 9.3 The Board seeks stakeholder comment on the costs and benefits of establishing a separate REIT regime.*

There may be some market recognition attached by international investors to the name "REIT" but having a dedicated REIT regime is not a high priority, especially if it means that there will need to be a separate regime for MITs operating in other sectors of the economy. Furthermore, market recognition may be just as easily accomplished by the ASX's practice of designating some funds as "A-REITs."

In our submission, it may be simpler to enact a single dedicated regime in the tax legislation that covers trusts in the real estate, equities and cash sectors and refers to "Managed Funds."

## Chapter 10: Division 6B of the Income Tax Assessment Act 1936

*Q 10.1 The Board seeks stakeholder comment on:*

*(a) whether Division 6B should be retained; and*

*(b) if Division 6B rules were retained in some form, what changes should be made to them and should they be integrated within any specific tax regime for MITs.*

The Paper seems to assume that Division 6B has outlived its original purpose. We agree and submit that Division 6B should simply be removed from the legislation.

## Chapter 11: Defining the scope of a managed investment trust

*Q 11.1 The Board seeks stakeholder comment on the following questions:*

*(a) what is an appropriate approach to defining widely held for the purpose of any new MIT regime;*

*(b) should rights attaching to interests in an MIT be uniform;*

*(c) should an MIT be able to make an irrevocable election to be governed by the new MIT regime; and*

*(d) what compliance burden might arise if some trusts are within the new MIT regime and others are outside and there are cross holding in funds.*

Section 12-400 of Schedule 1 to the *Taxation Administration Act 1953* represents a suitable first test for identifying the nature and type of trust that should qualify as an MIT.

Any trust which is listed on an approved stock exchange in Australia or abroad should also satisfy the dispersion of ownership test for MITs.

That test should be clarified to ensure that wholesale funds are not eliminated where they are ultimately widely held. The traditional way this has been done is by allowing funds to trace to their ultimate owners. However, we note that such tracing creates compliance burdens on responsible entities. Another way of achieving a substantially similar outcome might to treat all trusts managed by an AFSL holder as satisfying the definition of MIT.

A requirement that MITs have a single class of interest is not necessary. There is a danger that such a rule might, for example, preclude an MIT issuing interests that would be debt. There is no reason to prevent this from occurring. Similarly, there are already many trusts that have multiple classes of unitholders simply to deal with differences in fees (for example, wholesale versus retail). To treat such a trust as failing the MIT definition would cause dislocation in the industry where this is common and gives rise to no integrity concerns. The dislocation would result in additional trusts having to be created with all the attendant compliance (both tax and regulatory) and reduce efficiency within the market. Further it would hamper the ability to adjust to new technologies that may allow greater choice of investment to members within the one fund.

> *Q 11.2 The Board seeks stakeholder comment on whether:*
>
> *(a) in designing a new taxation regime for MITs, it would be appropriate to carve-out certain classes of arrangement and, if so, what classes of arrangement would it be desirable to carve out (for example, IDPSs, and arrangements where the investors have an absolute entitlement to specific assets and, accordingly, an entitlement to the income or gain from those assets);*
>
> *(b) if IDPS arrangement were to fall within an MIT regime and in substance comprise many single transparent trusts, whether it would be appropriate to provide special rules for them and, if so, what should they be; and*
>
> *(c) there should be a provision for revenue assets which is equivalent to the CGT provision that applies to treat a beneficiary as the relevant taxpayer for CGT purpose where the beneficiary is absolutely entitled to the asset as against the trustee.*

Unfortunately, at present, bare trusts and economically similar arrangements present a confusing situation. Different terms are used in the legislation for identical arrangements and discrete carve-outs are employed, each using slightly different terms.

In our submission, the tax system would be improved if it were made clear that bare trusts, nominations, custodian arrangements and similar situations should not amount to an "entity" for tax law purposes. A substantive definition should be devised: if the trustee has no management functions to perform, then there is no entity. If no entity arises for tax purposes, the individual parties who make such decisions are the only entities in place, they are responsible for their own tax affairs and without the distorting effects of an intermediary entity.

> *Q 11.3 The Board seeks stakeholder comment on:*
>
> *(a) any approaches, including potential legislative amendments, for addressing these issues; and*
>
> *(b) whether the extent of the relief that could be provided would depend on how an MIT is defined for tax purposes? For example, would it depend on whether an MIT is defined to include trusts with multiple classes of beneficiaries and/or whether MITs are required to be registered as managed investment schemes for the purposes of the Corporations Act 2001.*

This question raises the issue of the consequences of amendments to the constituent documents of an MIT. Current law can expose the MIT to the possibility that it is regarded as having been wound up, exposing investors to tax consequences which flow through to them, and to CGT events occurring to their investment.

We submit that the only issues that should arise from changes to the constitution of an MIT are the ones that would arise for a company:

- has the entity in fact been dissolved – that is, its assets distributed and the trustee no longer possessing any responsibilities;
- does the amendment trigger a transaction which represents a distribution of profit or a return of capital;
- does the transaction trigger value-shifting between members?

Unless these kinds of events are triggered, amendments to the constituent documents of an MIT should not have any tax consequences either for the MIT or its investors.

## Chapter 12: Implications for other trusts

| *Q 12.1 The Board seeks comments on whether any options for change that you have commented upon for MITs should be extended to other trusts.* |
|---|

We noted above that MITs are sufficiently different from other types of trusts that the MIT measures should be confined just to trusts with certain features. However, there will be lessons from the design of a new MIT regime that may provide opportunities to replicate changes that result in reduced complexity and compliance costs for other trusts.

Yours sincerely

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5 December 2008
Matter 14085
By email

Dear Sir

**Re: Interim Submission on Tax Arrangements Applying to Managed Investment Trusts – Response to Chapter 7 of MIT review**

Greenwoods & Freehills is Australia's largest advisory firm practising exclusively in revenue law. Its clients include many of Australia's largest managed funds.

This interim submission is made in response to the request in paragraph 1.25 of the Board of Taxation's Discussion Paper ('the Paper') for early responses on the issues raised in Chapter 7, "Capital Versus Revenue Account Treatment of Gains and Losses Made on the Disposal of Investment Assets by MITs." A further submission on other aspects of the Paper will be lodged with the Board shortly.

## Executive summary

(1) In our submission, the statutory codification of the revenue v. capital distinction will represent a very significant improvement to the Australian tax system. This single change would make the tax law simpler to administer, significantly reduce compliance costs and provide greater certainty to taxpayers, all of which would enhance the competitiveness of Australia's managed funds industry.

(2) An appropriate solution to the revenue / capital distinction would be achieved by inserting a legislative provision to make the current CGT rules the primary code for all profits generated by MITs from dealings with assets. Section 295-85 ITAA 1997, which currently applies to superannuation funds, is a suitable model for such a provision.

(3) If this proposal is not acceptable, the working of the revenue / capital distinction could be greatly enhanced by inserting a legislative definition based on a holding period – that an asset is treated as capital in nature if it has been continuously held by the same person for a period of (say) 12 months.

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(4) Any new regime should apply to events occurring after the commencement date but with the option for a trustee to make an irrevocable designation with respect to assets held on that date to treat those assets as being held on revenue account.

## 1 The need for a statutory rule

Chapter 7 of the Paper Notes that, "there are no statutory rules for determining whether gains and losses on the disposal by MITs of shares, units in unit trusts and real property should be on capital or revenue account" and asks whether the law on the capital v. income dichotomy "causes significant compliance costs to MITs."

In our view, the answers to question 7.1 varies significantly, depending largely on the industry sector involved:

- for MITs in the property sector and for bond and cash funds, the revenue v. capital distinction does not represent a serious source of difficulty;
- for MITs in the equities sector, the revenue v. capital distinction can represent a serious source of difficulty, largely because of the scope for disagreements with the ATO about the meaning and application of the appropriate law.

It is certainly true that many funds do not regard the Commissioner's views in TR 2005/23 as an appropriate summation of the current law, especially the implications to be drawn from the decisions in *London Australia* and *Myer Emporium*. While TR 2005/23 is helpful in that it lists a number of criteria which the Commissioner regards as indicating that assets are held on capital account:

- the taxpayer's investment policy does not envisage 'an exit point';
- there is a low average annual turnover of assets;
- sales are infrequent;
- sales proceeds represent a small percentage of total income; and
- the fund has a significant percentage of 'aged' stocks;

we share the scepticism expressed in other submissions about how accurately these factors reflect current law.

However, even if TR 2005/23 were an accurate statement of current law, its terms are so nebulous that it is incapable of simple and direct application. It is in many places just as Delphic as the law which it is meant to clarify for taxpayers.

Hence, in our submission, there is potentially great benefit for funds in some industry sectors from having a clear statutory rule to determine whether gains or losses made by a trustee on the

disposal, surrender or other realisation of trust assets are on revenue or capital account. For other types of funds, while there may be rather less benefit, there should not be any significant detriment to having a codified rule. A statutory rule should:

- greatly increase certainty for taxpayers and potential for dispute with the ATO;
- significantly reduce compliance costs for funds in certain industry sectors, as well as for the ATO (as the current law is as difficult for the ATO to apply as it is for taxpayers); and
- have little or no revenue cost for funds operating in many industry sectors.

Therefore, in our submission, any statutory rule should apply to all MITs (subject to the transitional application mentioned in paragraph 4 of section 1 above).

## 2 Defining the capital v. income border

### 2.1 Option A – the superannuation regime

The experience of the superannuation industry shows that having a single statutory rule for policing the capital v. revenue boundary – in that case, the CGT regime – as the exclusive regime for taxing gains and losses made on fund assets has removed significant areas of uncertainty for fund managers, and eliminated the kinds of dispute with the ATO that exist in parts of the managed funds industry.

In our submission, that model is appropriate for MITs as well because:

- it is a well understood system and so should greatly ease compliance and administration;
- it is regarded as simple and easy to apply;
- it matches the treatment that most investors in managed funds would expect to receive had they invested directly instead;
- it would not represent a change to the current law for most managed funds;
- it would not involve any danger of significant revenue leakage;
- it is unlikely to lead to changes in the behaviour of fund managers.

It may be that this rule would represent a change for funds in some industry sectors, but if that is so, there would still be great benefit from having such a rule just for those sectors where CGT treatment is already the norm.

## 2.2 Option B – A holding period rule

We noted above the possibility of an alternative holding period rule for determining the capital v. revenue distinction. The proposal would be for the holding period rule to operate as a safe harbour:

- CGT treatment would apply to assets held by an MIT for, say, 12 months or more;
- the current law (CGT or ss. 6-5 and 8-1) would apply to assets held for less than 12 months.

This proposal has the same benefits as any statutory rule:

- a clear demarcation greatly increases certainty and reduce compliance costs;
- because use of a statutory period mirrors the CGT-discount rule approach, it is familiar and well understood;
- it also matches the treatment that most investors in managed funds would expect to receive had they invested directly instead;
- as a matter of economic policy it more accurately rewards patient capital than the general law rule, which is largely dependent on intention at the time of acquisition rather the length of holding period;
- it does not involve any danger of significant revenue leakage; and
- it is unlikely to lead to changes in the behaviour of fund managers.

However, in our view, while representing a major improvement to current law, a holding period rule is inferior to Option A (the superannuation fund-style CGT rule). Although it should be relatively simple to administer, it will raise significant consequential issues such as handling rollovers, the treatment of successor assets (where no rollover occurs), the problem of asset stuffing (akin to s. 115-45) and significant improvements to existing assets. It would also have higher compliance costs than Option A as it would still be necessary to track dates of acquisition and disposal and for system functionality to calculate different potential outcomes.

## 3 Transition

In our submission, the new regime should apply to all CGT events occurring after the commencement date but with the option for a trustee to make an irrevocable designation with respect to assets (or classes of assets) held at that date, that those assets are to be treated as being held on revenue account.

Yours sincerely

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