2 December 2008

Managed Investment Trusts Review
Board of Taxation
c/- Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir or Madam

REVIEW OF TAX ARRANGEMENTS APPLYING TO MANAGED INVESTMENT TRUSTS (MIT's)

Executive Summary

This submission to the review of tax arrangements applying to Managed Investment Trusts (MIT) provides our views on a number of current tax issues, particularly the capital versus revenue treatment of gains and losses made on the disposal of investment assets by MIT's.

We support the proposal that the Capital Gains Tax (CGT) provisions be the primary code in calculating gains and losses for specified investments by MIT's (i.e. replicating the current statutory rule for superannuation funds that deem the funds to operate on capital account[1]). This would eliminate the current uncertainty in relation to this issue, be consistent with policy principle 1 (i.e. 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), ensure the continued inflow of investment funds by superannuation funds, individuals and non-resident investors into Australian MIT's and support the Government policy objective of making Australia the financial services hub of Asia.

We also propose that any new rules introduced in relation to MIT's apply equally to listed investment companies (LIC's) to ensure parity between the two types of investment vehicles. We also recommend that the new MIT definition include all managed funds (whether wholesale or retail) that issue an Information Memorandum (IM), prospectus or similar document. Finally we recommend that MIT's are exempt from the operation of the Foreign Investment Fund (FIF) provisions unless they were established for a purpose of obtaining tax deferral.

Introduction – background to the sector and our experience

We welcome the opportunity to make a submission to the Board of Taxation review referred to above.

We recognise that there is huge diversity in the investment specialties of MIT's. These include Australian and foreign equities, property and private equity.

Moore Stephens member firms[2] provide taxation services to more than 100 managed funds, fund managers and LIC's primarily investing in Australian equities and 10 property fund managers who manage over 60 listed and unlisted Real Estate Investment Trusts (REIT's) that invest in property located in Australia and over 10 foreign countries. Moore Stephens member firms have been advising the financial services sector in relation to financial reporting, taxation, corporate governance and general advice for over 10 years. Our involvement with these entities encompasses a diverse range of investment activities and structures.

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1 Section 295-85, *Income Tax Assessment Act 1997*
2 Moore Stephens is a network of independent firms

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Reasons for our support of the proposal for the CGT provisions to be the primary code

Current industry practice is to treat most investments on capital account. In most situations it could be argued the funds are carrying on a business of investment to derive rent, interest, dividends, etc. due to the nature and scale of activities they undertake. However, there is some uncertainty that the acts of purchasing and selling assets are in the ordinary business operations, particularly where it can be seen on the facts that sales of assets normally took place only for capital preservation reasons. Some of our managed fund clients have self-assessed their MIT's as being on capital account, while others have self-assessed their MIT's on revenue account. Those that have self-assessed on capital account have a distinct advantage in attracting investment funds due to the 50% CGT discount (for resident investors) and the absence of Australian tax payable (for non-resident investors) despite funds on either side of the equation arguably sharing similar investment styles, strategies and objectives. Others have sought our advice on the current law on this issue, resulting in an increase in compliance costs. This uncertainty could be eliminated (and compliance costs reduced) by installing the CGT provisions as the primary taxation code for shares, property and units in unit trusts held by MIT's.

Adopting a similar provision to section 295-85 is consistent with policy principle 1. The revenue account classification supported by the ATO[3] differs from the capital account classification that would be available for taxpayers deriving income from the underlying investments directly and therefore encourages taxpayers, particularly large superannuation funds and high net-wealth individuals, to circumvent the MIT sector.

In respect of property transactions, there is similar uncertainty. The ATO's view of what is considered to be on revenue account is broader than what most investors would expect. This aggressive position taken by the ATO makes it very difficult for the property industry to have certainty and creates inequity between various REIT's.

The ATO position would also be contrary to the Government policy objective of making Australia the financial services hub of Asia, as non-Taxable Australian Real Property (TARP) capital gains are not subject to the Australian withholding tax payable on profits derived on investments held on revenue account (classed as 'Australian other income'). Some of our revenue account managed fund clients who have attracted international investment into their MIT's have subsequently had such funds redeemed due to the withholding tax imposed by the current Australian tax regime, despite investor satisfaction with the financial performance of their investment.

A further advantage of adopting the CGT provisions as the primary code (replicating the current superannuation fund rule) is that profits on disposals of CGT assets held for less than 12 months are not eligible for the 50% CGT discount and would be taxed the same as 'revenue account' profits in the hands of a resident investor and is a sufficient safeguard to protect the revenue.

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[3] As expressed in *Taxation Ruling TR 2005/23* Income tax: Listed investment companies, and noted by Mr. Peter O'Reilly (Assistant Commissioner of the Tax Office's Large Business & International Business Line's Financial Services Industry Group) in the minutes for a meeting of the National Tax Liaison Group (NTLG) Finance and Subcommittee held on 12 November 2007 as being "equally applicable to managed funds because they relate to the type, nature and level of activity that indicates whether gains are ordinary income"

Widely held definition

We recommend the same rules be available to all funds (whether wholesale or retail) that issue a prospectus, information memorandum (IM) or similar document. The current widely-held / closely-held dichotomy creates a barrier to entry for small wholesale funds, which provides an advantage for large established funds over new entrants, and in turn inhibits the operation of efficient capital markets. An example is a start-up managed fund client of ours who has not satisfied the widely-held definition and therefore is required to withhold tax on foreign source income to a non-resident beneficiary in country with a Double Tax Agreement (DTA) with Australia. This is because the amendments made in 2005[4] only applied to beneficiaries of widely-held trusts and the 'start-up phase' provisions in the new MIT regime only apply to the distribution of 'Australian other income' to non-residents.

Other investment structures

We recommend the same rules to apply to both MIT's and LIC's to ensure that there is a level playing field between the two sectors as the only essential difference between the two investment vehicles are their legal structures.

FIF provisions

We recommend there be an exemption from the operation of the FIF rules for both MIT's and LIC's where a significant purpose of the investment vehicle is not tax deferral.

There are a growing number of "funds of funds" MIT's established in Australia. Where the fund's mandate is international investment they invariably are subject to the FIF provisions. This adds significant additional tax compliance costs on the funds, results in arbitrary determinations of taxable income, generally before the income is realised, and often converts capital proceeds (which could be subject to the 50% CGT discount) to normal assessable income. All of these significant adverse impacts are contrary to the Government policy objective of making Australia the financial services hub of Asia.

These funds are established to provide investors with access to markets and a level of diversification that they would otherwise not be able to obtain. They are not established to defer income tax. It was acknowledged when the balanced portfolio exemption was introduced that "...portfolio diversification involve[s] minimal scope for deferral but otherwise require substantial compliance costs ..."[5]. However, the balanced portfolio exemption is only intended to apply to investors who generally invest in FIFs that are exempt, but balance out their portfolio with a relatively small parcel of otherwise non-exempt FIF's. An exemption is not available to MIT's and LIC's investing in foreign unlisted funds, despite the above acknowledgement.

Thank you for considering our submission. If you have any questions regarding the above, please do not hesitate to contact me.

Yours faithfully
MOORE STEPHENS

Allan Mortel
Chairman
National Tax Group

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4 *New International Tax Arrangements (Managed Funds and Other Measures) Act 2005*
5 Explanatory Memorandum to *Income Tax Assessment Amendment (Foreign Investment) Bill 1992*