SUBMISSION

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

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To whom it may concern

Board of Taxation Discussion Paper: Review of the Tax Arrangements Applying to Managed Investment Trusts, 29 October 2009

Introduction

This Submission is from:

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Platinum Investment Management Limited ("Platinum") is an Australian based fund manager which specialises in investing its clients' monies into global equities with a view to achieving absolute returns whilst managing downside risk.

Platinum manages a number of Australian resident unlisted unit trusts and a listed investment company (Platinum Capital Limited).

Platinum manages around A$14 billion and has many thousands of Australian and non-Australian resident investors.

We provide our comments in relation to the abovementioned Discussion paper.

Chapter 4 – Options for Determining Tax Liabilities
Chapter 6 – Trusts as a Flow-Through Vehicle

The existing principles underling the general trust provisions in Division 6 of the *Income Tax Assessment Act 1936,* ('ITAA36') such as the concept of present entitlement and the flow-through status afforded to trusts, operate suitably for Platinum's products.

However, Platinum does see the need to clarify the operation of Division 6 in a number of areas. For example, statutory amendments should make it clear that the proportionate method applies to determine the beneficiaries' share of net income of the trust. The relevant proportions should be based on entitlements to distributable income as defined in the trust deed, not on vague concepts of trust law income.

The proportionate method should apply not just in relation to section 97 of ITAA36 but in other provisions such as section 99A ITAA36. On that basis interpretations of Division 6 which are inconsistent with the obvious intention of the legislation, such as those expressed by the Commissioner of Taxation in ATO Interpretive Decision 2005/200 can be eliminated.

Chapter 7 – Capital versus Revenue Account Treatment of Gains and Losses Made on Disposal of Investment Assets by MITs

Platinum believes that the long running debate about whether managed investment trusts hold their assets on revenue or capital account is an unnecessary waste of time, effort and money. There are no statutory provisions dealing with the issue and there is a history of case law dating back more than 100 years (which precedes the introduction of the capital gains tax (CGT) regime) which is inconsistent, confusing and in many cases not relevant to modern investment practices. The issue is an unnecessary drag on fund manager resources and creates a degree of uncertainty, which is prejudicial to the efficient running of the Industry and the ability of the Industry to earn export dollars by attracting non-resident investors into Australian funds.

Platinum believes there is a clear and compelling case for the Government to legislate this point beyond doubt and provide clarity and simplicity.

Given that complying superannuation entities have a deemed CGT status, under section 295-85 of the *Income Tax Assessment Act 1997 ('ITAA97')* and that "Mum and Dad" investors traditionally hold their investments on capital account, it is imperative that managed investment trusts are afforded identical treatment. This is consistent with Policy Principle 1 of the Board of Taxation's Terms of Reference for this review, i.e. that "the tax treatment for beneficiaries who derive income from the trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly".

The need for a level playing field is obvious and if the ATO were to succeed in its efforts to force MITs to treat assets as being on revenue account, there is the potential for major structural change with investors withdrawing from managed investment trusts, and in the case of superannuation funds of significant size going to a direct mandate arrangement. In the case of individual investors the outcome is not clear but it may result in them not accessing professional advice or missing out on investment opportunities which they are incapable of accessing on their own.

Given that superannuation funds and Mum and Dad investors are the predominant investors in Australia's managed investment trusts, such a dislocation could threaten the very existence of the managed investment trust industry. From the point of view of economic efficiency there are clear benefits arising from the use of pooled vehicles based on access to professional investment skills, economies of scale, ability to access overseas markets and non-standard asset categories and a minimisation of administration and compliance costs.

Platinum believes that MIT's should have deemed CGT treatment under a statutory provision equivalent to s295-85 of ITAA97. However, for MITs which wish to adopt a short-term strategy there should be an option to make an upfront irrevocable election to have assets treated on revenue account such that losses may be offset against ordinary income in determining the MIT's net income for tax purposes.

Platinum notes that under *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* which was introduced into the House of Representatives in December 2008, there is proposed to be an option to elect for equities to be within the TOFA regime with an effective revenue account treatment. However, such an election would require the adoption of a mark to market method of determining assessable income. Whilst this may be appropriate for some investments, Platinum believes it would be highly inappropriate for equity investments particularly where retail investors are involved. Going down this path would mean that an MIT's taxable net income would be required to include unrealised gains on its equity portfolio and that such amounts would have to be distributed in cash to unitholders. The extreme volatility in equity markets in recent times has shown that unrealised gains can disappear very quickly and that it would be imprudent to treat income as having come home to an investor prior to realisation. Consequently Platinum believes that MITs which elect for revenue treatment should only ***be assessed on gains and allowed a deduction for losses on a realisation basis.***

If statutory capital or revenue account treatment were to apply to MITs, how could specific rules be structured?

An MIT should have deemed capital treatment for all of its investments, e.g. long and short equities, equity indices, synthetic equities, commodities, derivatives on equities, derivatives on commodities, and other derivatives.

Matching of gains and losses within the trust is a strong driver for this proposition, e.g. where a long equity position is hedged by a derivative, matching the treatment of both of these assets as being on capital account is essential to achieve a tax outcome that mirrors the economic reality.

We note that derivatives are, in the vast majority of cases, short dated instruments and would not be held for the requisite 12 months in order to qualify for the CGT discount in the event that they realised a gain. In the event that the definition of eligible investment business in Division 6C of the ITAA36 is expanded to include commodities (refer comments below re Chapter 9) then we appreciate that questions may be raised as to whether a gain arising from an investment in commodities should be eligible for a CGT discount. Platinum believes it important that the deemed CGT treatment apply to commodities in order that gains and losses are in the same calculation as those arising on equities rather than so that the CGT discount might be accessed. Consequently, Platinum would not object if gains on commodities were excluded from the definition of discount capital gain pursuant to an amendment to section 115-25(3) of ITAA97.

This would preserve the equality between corporate investors and trust investors who hold such instruments as neither would have access to the CGT discount. This is in accordance with Policy Principle 2 referred to in the Discussion Paper.

Should statutory capital or revenue account treatment be extended to other collective investment vehicles (including LICs)?

Platinum believes that as far as possible, there should be equivalent tax outcomes for investors choosing to invest through Listed Investment Companies (LICs), rather than listed or unlisted MITs. Therefore the statutory CGT treatment should apply to LICs with a similar option to elect revenue account treatment on a realisation basis.

The Board seeks comment on the desirability of a statutory rule treating MIT gains distributed to particular kinds of investors (for example, complying superannuation funds) as being on capital account;

Platinum believes that it would be highly impracticable to have a statutory rule deeming a particular type of investor's share of gains realised by the MIT to be on capital account. The status of gains and losses realised by a MIT needs to be determined with certainty at the MIT level, not at the investor level. Again, we stress the importance of maintaining a level playing field for all investors.

<u>Chapter 9 – Eligible Investment Business Rules in Division 6C of the Income Tax Assessment Act 1936</u>

Question 9.1 - The Board seeks comment on whether it is still appropriate to have the 20 per cent rule for complying superannuation funds;

Given that superannuation funds are now taxed and franking credits are refundable to them, this rule is no longer appropriate.

Question 9.2 - The Board seeks stakeholder comment on the following:

What approaches can be taken to change the eligible investment rules that would reduce compliance costs for managed funds and enhance their international competiveness?

The definition of *eligible investment business* contained in section 102M of ITAA36 currently includes investing in land primarily for the purpose of deriving rent and trading in such instruments as bonds, debentures, shares, units, futures and forward contracts and similar financial instruments.

Amendments contained in *Tax Laws Amendment (2008 Measures No 5) Bill 2008* have expanded the definition of eligible investment business by adding the following subsection:

> *(c) investing in financial instruments (not covered by paragraph (b)) that arise under financial arrangements, other than arrangements excepted by section 102MA*

where *financial arrangements* are as defined in ITAA97 (currently found in sections 250-165 to 250-275, but will be in accordance with the definition contained in proposed sections 230-45 and 230-50 of *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008* ("the TOFA Bill") when passed).

Section 230-45(1) of the TOFA Bill defines a *financial arrangement* as an arrangement under which there is:

> *(a) a cash settlable legal or equitable right to receive a financial benefit; or*
> *(b) a cash settlable legal or equitable obligation to provide a financial benefit; or*
> *(c) a combination of one or more of such rights and/or one or more such obligations;*

where the cash settlable rights and/or obligations comprising the *financial arrangement* are the only significant rights and/or obligations subsisting under the *financial arrangement*.

A *financial benefit* is defined in section 974-160 of ITAA97 to include anything of economic value including property and services. To be *cash settlable,* a financial benefit is required to be money or money equivalent, i.e. has a degree of proximity to cash. In accordance with the Explanatory Memorandum to the TOFA Bill (at paragraph 2.72), bonds, loans and other forms of financial accommodation are examples of money equivalents.

Based on this definition, it is likely that cash settlable derivatives over hard and soft commodities will be included in the Division 230 definition of *financial arrangements.* However a physical holding in hard or soft commodities is unlikely to be a *financial arrangement.*

A direct physical holding in hard or soft commodities may be more commercially beneficial to investors than investing through a derivative. Holding a direct interest in hard or soft commodities would be less costly to the investor as there would be no fees or premiums payable, as are generally associated with derivatives. In addition the risk of such an investment would be substantially reduced without the involvement of a third party, i.e. counter-party risk would be eliminated.

For completeness, we also note that a derivative that is settlable by receipt of a benefit that is something other than money or money equivalent is unlikely to meet the definition of a *financial arrangement*. Therefore, where there is physical delivery of hard or soft commodities at the end of the term of the derivative, such an arrangement would not meet the definition of a *financial arrangement* and would not be included in the definition of *eligible investment business.* It is unclear as to whether this is the intention of the legislation.

We understand from the Division 6C Consultation Paper issued prior to the introduction of the recent amendments mentioned above, that the policy basis for restricting the investments available to a Division 6 trust is to ensure that:

- the corporate tax base and the competitiveness of companies with respect to pricing and capital raisings is not restricted (given the tax benefits available to Division 6 trusts); and
- the tax outcome achieved by investors pooling their funds is similar, if not the same, as the outcome that would have been achieved had the investment been made directly.

Expanding the definition of *eligible investment business* to include direct investment into hard and soft commodities should not interfere with the competitiveness of companies. As investors in companies are now able to obtain a refund with respect to unused franking credits and the company itself can convert credits to tax losses, the tax benefits available to trusts in comparison are diminished.

In addition, gains realised by a trust from investing or trading in physical hard and soft commodities would (under the current rules) be ordinary income rather than a capital gain and no CGT discount benefit would be obtained. Consequently a trust would not be at a competitive advantage to a company which is not entitled to the CGT discount. As referred to above, if deemed capital treatment was afforded to MITs, the equality between corporate and trust investors could still be maintained by restricting the availability of the CGT discount to certain types of assets (i.e. to exclude commodities).

This is in accordance with Policy Principle 2 referred to in the Discussion Paper.

With respect to the pooling of funds, the tax outcome obtained by the collective investment into physical hard and soft commodities should not differ to that which would have been achieved had the investment been made directly by the individual investors. As a trust is effectively required to distribute all of its tax income each year there is no opportunity for a deferral in the recognition of income. In fact the taxing point for individual unitholders on such income may be at an earlier time than would be the case had the investment been made through a company (as a company only distributes its income as and when dividends are declared).

A further consideration in support of the expansion of the definition of *eligible investment business* is the Treasury's wider initiatives to promote Australia as a global financial services centre and to attract international business to Australia. Widening the scope of the investments able to be held by a Division 6 trust is likely to allow fund managers to develop new products and to enhance the attractiveness of their existing trusts, thereby contributing to these broader objectives.

Should non-compliance with the eligible investment rules result in taxation only on the 'tainted' income and how could this be achieved?

A trust should only be subject to tax on the portion of income that is deemed to be 'tainted'. A trust should then be able to distribute the after tax amount of this 'tainted' income as a franked dividend and to pass on the franking credit to its beneficiaries in respect of the tax paid.

This would maintain the competitiveness of companies (in accordance with Policy Principle 2 referred to in the Discussion Paper) by ensuring that a trust is subject to the same treatment as a company in respect of those activities that are not considered to be eligible investment activities.

<u>Chapter 11 – Defining the Scope of a Managed Investment Trust</u>

Question 11.1 – The Board seeks stakeholder comment on the following questions:

What is an appropriate approach to defining widely held for the purpose of any new MIT regime?

For the purpose of a new MIT regime, a widely held trust should be defined as a unit trust that is run by a fund manager with an Australian Financial Services License (AFSL).

Should rights attaching to interests in an MIT be uniform?

It is highly common in the Industry for a unit trust to have different classes of units reflecting different management fee arrangements. Such arrangements are broadly accepted by the Australian Securities and Investment Commission (ASIC) and are regulated in this respect. Therefore, MIT status should not be denied to a trust where the variance in a right attaching to a beneficiary's interest relates simply to a different fee arrangement.

Should an MIT be able to make an irrevocable election to be governed by the new MIT regime?

Platinum agrees that an election to be governed by the MIT regime should be irrevocable. However the trust should be able to opt out of the regime where there are changes in tax law that are disadvantageous to the MIT.

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Questions 11.3 – The Board seeks stakeholder comment on creating a new trust by amending the terms of a deed;

A change in Trustee or amendments to the terms of a trust deed should not result in the resettlement of the trust.

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Should you wish to discuss any aspect of this Submission please do not hesitate to contact me on (02) 9255 7500.

Yours sincerely,

M Halstead