28 November 2008

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

Dear Sir / Ms,

Interim Submission on Tax Arrangements Applying to Managed Investment Trusts

Thank you for the opportunity to provide our interim submission on the tax arrangements that should apply to managed investment trusts.

The Property Council of Australia ('**the Property Council'**) is the peak body representing the interests of owners and investors in Australia's $320 billion property investment sector.

This interim submission takes up 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."

The Property Council will lodge a complete submission on the entire Paper with the Board shortly. That submission will address the appropriate scope of an MIT regime, and in particular the need for such a regime to incorporate unlisted and wholesale funds.

1. Summary of interim submission

Disposals of assets at the trust level. There is potentially great benefit from having the capital income dichotomy addressed by a statutory rule rather than case law. The statutory rule should ideally operate at the trust level. The superannuation fund rule in s. 295-85 ITAA 1997 provides an ideal model for this purpose.

Flow-through characterisation. A corollary statutory rule should be enacted to the effect that amounts which are distributed (or attributed) to investors in MITs which represent (net) gains made on the disposal of MIT assets should be regarded as having the same character and attributes in the hands of the investors.

Transition to the new regime. The transition to a new regime should be managed by having the new rules apply to any realisation occurring after the commencement of the regime, with an option for the trustees of MITs to designate assets held at that date as being held on revenue account.

2. Preliminary comment

It is important to recognise that the capital v. income dichotomy arises at three conceptually distinct points in a tax regime for MITs and their investors. It is relevant in determining the character of:

1. gains (or losses) made by the trustee on the disposal, surrender or other realisation of trust assets;

2. distributions (or the attribution) of amounts made to unitholders that are sourced from gains arising on the realisation of trust assets; and

3. gains (or losses) made by unitholders on the disposal of their units in a MIT.

The distinction between points 1 and 2 is not carefully delineated in the Paper which is understandable given the way Australian tax law currently operates. Because trusts are not taxpayers, trustees are rarely taxed on trust income and investors are taxed on amounts they are presently entitled to (rather than what they receive), the principal tax question under current law is the nature of the amount (in the hands of the investor) that is being attributed to the investor to be assessed. The capital income dichotomy is thus operative and relevant in the hands of the investor, even though the answer to that issue is currently determined by examining the nature of the amount realised by the trustee. Nevertheless, this submission will separate character issues arising at points 1 and 2 because it will help to clarify the later analysis.

3. The Desirability of a Statutory Rule [Question 7.1(b)]

The Paper notes the amorphous nature of the common law on the capital v. income dichotomy and the important tax consequences which turn upon it, especially with respect to loss quarantining, eligibility for CGT discount and the treatment of non-residents.

The difficulty of making a decision with respect to character is rarely a significant problem for managed funds operating in the property sector because the status of their assets is usually quite clear – the majority of their funds will be invested in land rather than securities, and the underlying land and structural improvements on it will almost always be held as a capital asset. This ought to be the case even for so-called "closed-end funds" with a defined life. The same situation should apply where a property MIT holds interests in other MITs.

Nevertheless, the Property Council submits that there is potentially great benefit from having a properly drafted and clear statutory rule rather than the uncertainty of case law 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. The important qualifications to this position are the obvious ones – a statutory rule will only be an improvement to the status quo if:

- it is clear and well drafted; and

- it effectively clarifies and simplifies current law (or else is optional and so can be ignored).

The experience of the superannuation industry shows that this is possible. Having a single statutory rule – in that case, the CGT regime – as the exclusive regime for taxing gains and losses made on most fund assets has removed significant areas of uncertainty for fund managers, and eliminated the kinds of dispute with the ATO that appear now to be emerging in the managed funds industry.

4. The Appropriate Rule at the MIT level [Question 7.1(c), (d), (e)]

The next question is the design of an appropriate rule.

Capital treatment. In our submission, the rule for superannuation funds in s. 295-85 ITAA 1997 is an appropriate rule for the taxation of gains and losses made by the trustees of MITs. That is, (residual) gains and losses realised on assets should be taxed solely under the CGT rules rather than s. 6-5 or s. 15-15.

Treating the gains and losses of MITs as being on capital account will have several advantages:

- The first is simply ease of compliance and administration. We noted above the experience of the superannuation industry that applying the CGT regime exclusively has removed significant areas of uncertainty and opportunities for dispute.

- Secondly, the Paper already notes [paras 7.8, 7.9] the distortionary effects that the distinction can have on the market if the capital v. income analysis varies between the trustee level and the unitholder. Two significant groups of investors in Australian retail MITs are resident superannuation funds and resident individuals. They would expect to receive capital gains treatment were they to invest in real estate directly, and so it would contradict Policy Principle 1 enunciated in the Paper to enact a statutory rule for managed funds which entrenched revenue treatment.

- Further, as managed funds in the property sector will almost always hold their assets on capital account, any change to the law to entrench capital treatment would not represent a change to the current law for them.

- For the same reason, it would not involve any danger of significant revenue leakage.

The Paper says that doubt could also be removed by treating all assets as held on revenue account [para 7.11]. While this might be true, a legislative rule which deemed all gains and losses of MITs to be on revenue account would have significant disadvantages for the managed funds industry in the property sector:

- It could reasonably be expected that such a rule would exacerbate the emerging trend for large resident superannuation funds and high net worth individuals to by-pass the managed funds industry in favour of direct investment. The tax system should not direct how investments are made – this is contrary to Policy Principle 1.

- It could also be expected that non-residents would not invest in Australian managed funds, and perhaps not invest in Australia at all. Again, the tax system should not direct how (or whether) investments are made.

- Since it does not seem to be in question that managed funds in the property sector hold most of their assets on capital account, changing the law to entrench revenue treatment would represent a significant and unwelcome development, potentially increasing the tax liability of resident investors. Such a change would be contrary to Policy Principle 1 for most resident investors.

- This change might actually accelerate the use of losses that would previously have been considered capital in nature, and this may involve both immediate danger to revenue (depending on how the transition to such a rule were handled) and danger in the longer term.

We noted above that characterisation is rarely a significant problem for managed funds operating in the property sector. It may be that the property industry is somewhat distinctive in this respect and there are other funds where this issue is more pressing (although the evidence suggests that most investors typically invest in managed funds in any sector for the long term). In these circumstances, the Property Council submits that there would still be great benefit from having a clear statutory rule which adopted CGT treatment even if the scope of the rule were limited to funds which invested predominantly in real estate assets – including interests in other entities which invested predominantly in real estate assets. This may imply that a designated REIT regime is an appropriate way to deal with the property sector.

Residual treatment. It is important to note that the CGT treatment only displaces the residual operation of s. 6-5 and s. 15-15 (and the corresponding rules where assets are realised at a loss – s. 8-1 and s. 25-40). Other statutory income rules that are triggered on the sale or other realisation of a trust asset would still operate where they were relevant. For this reason, MITs would still have to apply provisions such as the TOFA rules and the forex rules. Indeed, it would be very important to ensure that capital classification for underlying assets was supported by permitting MITs to attract capital classification for hedges, including foreign currency hedges, put in place to hedge exposures to their assets.

Optional v. mandatory. We noted above that the capital v. revenue issue may well be more significant for other industry sectors which would prefer to be able to attract (or retain) revenue treatment for their activities.

It may be that the simplest solution to this divergence from the property sector would be for any new regime to be elective – that is, qualifying MITs could choose whether to invoke the safe harbour of capital treatment for their activities. The Property Council would support an elective regime if it were considered important for other industry sectors.

Scope of application. If the regime is elective, there is a further issue whether capital treatment should be afforded on an "all-or-nothing basis" or might be invoked on an "asset-by-asset" basis or "class of asset-by-class of asset" basis.

Again, the Property Council would support a selective rather than a comprehensive regime if it were considered important for other industry sectors.

5. The Appropriate Rule at the Investor Level [Question 7.1(g)]

We noted in the Preamble that the capital v. income distinction is relevant at three distinct points in the tax regime:

1. gains (or losses) made by the trustee on the disposal, surrender or other realisation of trust assets;

2. the attribution of amounts to unitholders that are sourced from gains arising on the realisation of trust assets; and

3. gains (or losses) made by unitholders on the disposal of their units in a MIT.

and that the distinction between points 1 and 2 is not carefully delineated in the Paper. As to point 3, this submission is not proposing any change. The current law appears to work appropriately and, while most tax rules can be made simpler, this is not an area that requires immediate attention. We turn instead to the capital income distinction at point 2.

The title of Chapter 7 suggests that it is examining only point 1, although large parts of the text and the accompanying questions are actually directed at point 2. (For example, paragraph 7.3 comments on the absence of "statutory rules for determining whether gains and losses on the disposal by MITs of [trust assets] should be on capital or revenue account" which is point 1. Paragraph 7.4 then immediately proceeds to note the "special treatment for … individuals, trusts and superannuation funds [and] for non-resident investors" which is point 2. This same blending of point 1 and point 2 occurs elsewhere in the Chapter.)

The text of Chapter 7, as it is currently drafted, appears simply to assume that the character of attributed (and perhaps distributed) amounts sourced from gains made on the realisation of trust assets will have the same character in the hands of the investors. While this assumption is understandable, it sits rather oddly with other parts of the Paper – question 7.1(g), Chapter 6 and Appendix C – which question whether trust distributions can or should have a different character to the source from which they are funded.

Flow-through characterisation. In our submission, it is desirable to make that assumption explicit in the tax legislation. That is, amounts which are attributed to investors in MITs which represent (net) gains made on the disposal of MIT assets should be regarded as having the same character and attributes in the hands of the investors. This rule would have broader implications than simply the retention of capital character; it would also operate to retain character as interest, dividend, foreign source and so on.

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 paras. 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.

One reason for doing so is already explained in the Paper. It notes the important distortionary effects that can happen in the market if the capital v. income analysis varies between the trustee level and the investor:

- The Paper notes [paras 7.8 and 7.9] the problem that arises if the trustee is treated as holding a trust asset on revenue account, when the investor would expect to receive capital gain treatment.

- The Paper does not note at this point [although it does in Appendix C] another manifestation of the same problem – if the trustee is treated as holding a trust asset on capital account, but the distribution is treated as giving rise to an additional and revenue amount in the hands of the beneficiary.

In the property sector, it is this disjunction between the character at various points which is the source of difficulty. The possibility of this disjunction should be removed.

Independent characterisation at the investor level. Question 7.1(g) in the Paper implies that a different model might be under consideration by the Board – that regardless of the character of assets in the hands of the trustee, amounts which are attributed to particular kinds of investors in MITs should be regarded as having a capital character in their hands. This method would make the relevant characterisation occur at the investor level and be independent of the treatment at the trustee level – that is, the character at point 2 would not follow from the character at point 1.

We consider this an inferior approach to determining the character at the trustee level – at point 1 – and to do so by applying the superannuation fund rule. It would require significant tracing compliance where amounts might flow to one of the chosen entities but through an intermediary which did not qualify for capital treatment. This problem of "character switching" at various points does not arise if character is attached once and attached at the originating trust level.

6. Revenue implications

It is worth repeating our view that it is highly unlikely for such a change to involve cost to the revenue so far as the property industry is concerned.

Changed character at point 1. At first glance, one situation where it might appear that there would be a potential loss of revenue would arise if fund assets were currently held on revenue account and this was changed by statute to capital treatment.

In our view this is very unlikely to arise in practice. As we noted above, managed funds in the property sector will almost always hold their assets on capital account already – capital treatment invariably applies at point 1.

Even if there were some property funds with significant holdings of revenue assets, it is not obvious whether a mandatory change from revenue to capital treatment at the fund level would lead to more or less revenue. Capital treatment has both a revenue-raising effect – losses are quarantined – and a revenue-depleting effect – CGT discount becomes available. Which of these effects predominates is not axiomatic and cannot be predicted *ex ante*, although the net impact might well be revenue positive. (For example, in the current climate, treating all fund assets as on capital account probably raises revenue because it ensures that losses on asset sales made by the trustee cannot be deducted from the fund's rent and other ordinary income.)

Moreover, a change at the fund level to attach statutory capital gain treatment will not matter if capital character is reversed at the investor level – at point 2. This is currently the case for two of the three principal classes of investors:

- where the investor is a company, treating the attributed gain as capital rather than revenue has no impact because any CGT-discount is reversed in the company's hands; and

- if the investor is a non-resident, treating a gain as capital rather than revenue has no cost because any CGT discount is reversed under the rules in Division 12-H of Schedule 1 to the *Tax Administration Act* and the final tax on the investor is collected by withholding on the amount of the undiscounted gain.

In both cases, any supposed revenue-depleting effect of changing trust assets from revenue to capital (at point 1) is effectively negated at the investor level (point 2).

If the investor is a superannuation fund and the attributed gain would be revenue, there is an argument this character is overridden by the statutory rule which attaches capital treatment to fund from sales of assets, but we understand as a practical matter this approach is not taken. So, for this group, there would be a potential loss of revenue if their returns were converted to capital account, but only to the extent that the property fund's assets were not already on capital account and this is a situation we consider extremely rare.

Changed character at point 2. Another situation where, at first glance, it might appear that there would be a potential loss of revenue would arise if for some reason there were investors who currently ignored the capital component of a distribution, treated their entitlement as being of a revenue nature, and who changed their practice to treating the amount as capital because of the new regime. The implication of the discussion in Appendix C is that such a situation can occur – the special circumstances of the investor dictate that its return always has a revenue character in its hands, regardless of what occurs at the fund level. Paragraph 12.2 also insists that, while "the current taxation policy framework for trusts assumes character of income flows through to the trust beneficiaries … there may be some doubts and it can not be assumed that flow through is a universal principle that always applies to trusts."

Assuming the view in Appendix C and para 12.2 to be correct for present purposes, we consider the proposals in this submission do nothing to change this situation. A cost to revenue would only occur where investors who currently treat their earnings from managed funds as being on revenue account ceased doing so. It is certainly not axiomatic that the special circumstances which dictate that a return always has a revenue character in an investor's hands (point 2) must be overridden by changing the character in the trustee's hands (point 1). If strict character flow-on does not already occur under the current rules (even though they would seem to require it), it is not obvious that it would commence in the future. In other words, if the character at point 2 is paramount, and it is dictated because of some special circumstance that exists at point 2, changing point 1 does nothing to that situation.

7. Transition

The Paper does not address the issue of transition to a new regime. Typically, transition might be handled in one of three ways:

- the new regime would apply to all realisations occurring after the commencement date;
- the new regime would apply to gains or losses arising after a valuation date – the approach used at the commencement of the superannuation regime; or
- the new regime would apply to gains or losses arising on assets acquired after the commencement date – the approach used at the commencement of the CGT regime.

If the model proposed here is pursued and adequate warning is given, we submit that the first option is the simplest. However, we understand that some trustees particularly in other industry sectors hold a few assets that they are treating as being held on revenue account. Automatically converting them to capital account could adversely affect either the taxpayer or the ATO – it is not axiomatic which way the impact of the change would be felt – and it might also precipitate a rush to sell assets with unrealised losses prior to the commencement date, with adverse consequences for the market.

Consequently, we submit that the transition to the new regime should be handled in this manner: the new regime would 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.

We look forward to lodging our complete submission on the entire Paper shortly.

In the meantime, please contact me on 02 9033 1929 should you wish to discuss this further.

Yours faithfully,

Roberto Fitzgerald
Executive Director International and Capital Markets
Property Council of Australia