19 December, 2008

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

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Dear Ms Barron

Submission on Tax Arrangements Applying to Managed Investment Trusts

Thank you for the opportunity to provide our submission to the Board of Taxation Managed Investment Trust ("**MITs**").

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

The property industry helps underpin the retirement savings and economic prosperity of Australia with one in every two Australian's having a direct stake in commercial property through superannuation and managed funds.

The Property Council welcomes the Government's decision to implement a Board of Taxation review of the tax regime applying to managed investment trusts.

We strongly support Government's commitment to expand the managed funds sector domestically and internationally and make Australia an internationally competitive funds management hub for the Asia Pacific region. We see improved tax laws as a key factor to achieving this goal.

Implementing a simple elective tax flow-through regime will facilitate the growth of the Real Estate Investment Trust (REIT) sector and is an effective way to further Government's commitment.

Drawbacks in the current laws

The property industry firmly believes that the current law needs to change. The current laws:

- **are out of date** and they have not kept pace with developments in the property industry which unnecessarily restricts appropriate growth opportunities;

- **create significant uncertainty** and inappropriately constrain the activities of funds trying to maintain their current flow through tax status.

While we welcome the recent interim Division 6C reforms, the tax laws governing MITs still impose significant impediments on the operation of an efficient and internationally competitive REIT industry.

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Many of today's commonplace property investment opportunities simply didn't exist when the legislation was first drafted and without an overhaul of the flow-through taxation system, our REIT industry will lose investment capital to competition from global REIT markets.

The current tax flow-through rules focus heavily on activity and location based restrictions that do not make sense in a global commercial environment. The tax flow-through rules do not involve any concessional tax treatment, but impede investment decisions by restricting investments based on activities and location.

What needs to change

The property industry would welcome a simpler, elective, more widely-accessible, transparent tax regime for MITs. In particular:

- directly and indirectly widely held entities should be able to elect into the regime;
- tax should be imposed just once, at the investor-level where the appropriate amount of tax is paid;
- no additional tax cost should be imposed just because an investor uses a fund instead of direct investment; and
- the tax system should not interfere with commercial decisions such as distribution policies and location choices.

We attach our two submissions that address the issues raised in the Board of Taxation MIT discussion paper.

We would be pleased to expand on any issues we have raised in the submissions.

In the meantime, please do not hesitate to contact Andrew Mihno on 0406 45 45 49.

Yours faithfully,

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

Board of Taxation Submission:

Tax Arrangements Applying to Managed Investment Trusts

Property Council of Australia
19 December, 2008

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Preface

The Property Council welcomes the opportunity to participate in the Board of Taxation's Review of Tax Arrangements Applying to Managed Investment Trusts ("**MITs**").

The Property Council has already lodged an interim submission on the issues raised in Chapter 7 of the Board's Discussion Paper released in October 2008 ('**the Paper**'), "Capital Versus Revenue Account Treatment of Gains and Losses Made on the Disposal of Investment Assets by MITs." That submission is attached as an Appendix to this document.

This submission addresses the remainder of the issues raised in the Paper.

This submission is organised in the following steps:

Issue	**Dealt with in the Paper in chapters …**
Definition of Qualifying Entities	Chs 11, 12
Method of Relieving an MIT of Tax and the Treatment of Resident Investors	Chs 4, 6, Appendix B, Appendix H
Activities Test and Control Issues	Ch 9
Cross-border Issues	Ch 5
Definition of "Fixed Trust"	Ch 8, Appendix G
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Executive Summary

1. The Board should focus its efforts on improving the operation of a flow-through taxation system for Australian MITs and their investors. It is less important today to retain limits on access to flow-through taxation because flow-through taxation does not involve any concessional treatment being offered, nor is there likely to be a significant detriment to the government were flow-through taxation to become more widely accessible.

2. This focus on improving the operation of a flow-through taxation system for Australian MITs and their investors means removing outdated activity-based and location-based restrictions on the operations of Australian MITs. Such restrictions were based on matters that are now less significant.

3. A new dedicated regime for MITs should be enacted in Australian tax law (as an alternative to the current Division 6 which would remain as the fall back regime for trusts which do not qualify, or elect not to enter, the MIT regime).

4. Access to the flow-through MIT regime should be elective and available to any entity which is directly or indirectly widely-held. A requirement that an MIT must be widely held should be treated as satisfied if the MIT is listed.

5. The Property Council has no strong preference between Options 1 and 2 (although Option 3 is not an improvement to current law and should be discarded). This submission emphasises the outcomes which the Property Council would expect a flow-through model to achieve:

    - entity transparency;
    - amount identity;
    - character retention; and
    - source retention.

6. The Property Council recommends that the tax liability on income earned by an MIT for its investors should be allocated to investors based on the percentage of distributions in cash or property made to the investor in respect of an income year. Amounts should be taxed to the trustee only if no distribution at all are made for an income year.

    An (inferior) alternative would be to allocate the tax liability on income earned by an MIT to investors based on the percentage of units or interests held by the investor where the trust has a single class of interest (or a single class of interest and debt). Under such a system, no amounts would need to be taxed to the trustee.

7. In addition to the matters raised in the Paper, there are other issues which need to be addressed in the legislation to produce a thorough and complete MIT regime:

- statutory recognition of current practices to solve the last man standing problem for unlisted REITs;

- statutory recognition of current practices to allocate exceptional gains and losses to the beneficiaries which trigger them;

- the treatment of debt instruments issued by MITs should be regularised.

8. There is little ongoing justification for rules which restrict the type or location of the activities which an MIT may undertake. If such limits are to remain, their scope must be significantly limited. There can be no justification for rules which prevent an MIT from setting up a taxpaying subsidiary which undertakes offending activities.

9. The Board should ensure that any new MIT regime will entitle Australian MITs (rather than their investors) to enjoy treaty benefits on their inbound income.

10. A few additional modifications Not mentioned in the Paper would improve the operation of Australia's tax regime for non-resident investors.

11. Any trust which is an MIT should be deemed to be a fixed trust where that is a relevant concept in tax law.

12. Amendments to the constituent documents of a trust should not trigger consequences at the MIT level. Consequences should be triggered at the level of the investor, but only where the amendment results in value-shifting between members.

1. Focussing the Board's Review

One of the most significant issues underlying the Paper is the precise purpose of a revised MIT regime. The tenor of the Paper is that the Board is examining a specific taxation regime for managed funds that operate as MITs that are widely held vehicles undertaking primarily passive investments [para 1.5]. Underlying this statement are potentially different visions of the focus of the Board's review:

- whether the MIT regime being designed is one which is intended to preserve and perhaps re-express the border between flow-through taxation and corporate taxation;

- whether the MIT regime being designed is one which is intended to regularise and facilitate the operation of a flow-through taxation regime, with particular reference to widely-held trusts; or

- whether the MIT regime being designed is one which is intended to offer / sustain concessionary measures for some types of entity or activity.

These different visions of the purpose and desired outcome of the review bear on the answer to many questions in the Paper. While the three positions are not necessarily contradictory or mutually exclusive, they do tend to lead in different directions.

The Property Council submits that the main purpose of the review should be on regularising and facilitating the operation of a transparent taxation regime, particularly for widely-held trusts with non-discretionary and typically uniform entitlements – the main goal is to fix flow-through taxation whether that is achieved by adopting Option 1 or Option 2.

Maintaining a border between flow-through taxation and corporate taxation is less relevant today and the scope of such rules should be significantly wound back and imposed only where that border is necessary for compelling reasons. It is a principal contention of this submission that in 2008 there is little tax policy basis today for rules which impose the corporate tax regime on certain trusts:

- It is clear – and we understand accepted by Treasury – that the historical justification for these rules ceased to apply in part with the commencement of the imputation system in 1987, and passed almost entirely with the advent of refundable imputation credits in 2000.

- Furthermore, Policy Principle 1 [p. 2] notes that an MIT regime should be designed to achieve, so far as possible, the same tax outcomes that would have occurred had the investor made the investment directly – that is, without using an intermediary for pooling funds with other investors.

Hence the imposition of corporate tax should be retained only if and where it is necessary to accomplish some other goal, given that it adds to complexity, uncertainty, compliance cost, undermines Policy Principle 1 and restricts the desirable expansion and modernisation of the MIT sector.

Flow through taxation along the lines of Division 6 currently best approximates Policy Principle 1; the corporate tax paradigm is less successful. Division 6 achieves for the investor in a trust:

- the same tax rate, the same time at which tax is paid and the same PAYG instalments as direct investment (although perhaps paid less often than quarterly);
- the same source and character of income in the hands of the investor as direct investment;
- the same entitlement to enjoy some of the attributes conferred on direct owners – pre-CGT status, CGT discount, Div 43 deductions, imputation credits, foreign income tax offsets, etc – as direct investment.

Division 6 does not entitle the investor to enjoy the immediate benefit of income tax losses, the ability to make individual elections relevant to the ownership of the asset (such as valuation options or TOFA timing options), the same time of derivation of income as direct investment, nor create the existence of a single cost base – that is, a cost in the relevant portion of the assets, not a cost in the interest in the MIT. However, the corporate tax paradigm has these same features.

The corporate tax paradigm changes this position (and undermines Policy Principle 1). One would have thought, such an outcome requires justification. The Paper does not fully explain why the corporate tax paradigm is required for some trusts. Policy Principle 2 says,

> **"In recognition of the tax advantages available to trusts that are not available to companies deriving business income,** flow through taxation of income from widely held trusts, such as managed investment trusts, should be limited to trusts undertaking activity that is primarily passive investment" [p. 2]

What these tax advantages are is not elaborated. Their existence, their relevance to the topic and their policy primacy is assumed.

The syllogism which underlies this part of the Paper is not explained. In logical terms, there is no self-evident connection between the premise of the argument – trusts enjoy tax advantages compared to companies – and the conclusion which is asserted – only trusts undertaking passive investment should be able to enjoy flow-through tax treatment. The premise might or might not be true, but it is not inevitable that the conclusion which follows from that premise is that the corporate tax paradigm should be imposed on some classes of trust.

Given this emphasis on "tax advantages" as the basis for the need to attach the corporate tax model to some trusts, it is worth recalling the tax advantages enjoyed by companies:

- companies offer high marginal tax rate investors the ability to shelter current income by retaining profits; trusts cannot retain profits in this way;
- after-tax profits distributed by companies will typically be taxed at the marginal tax rate of investors who are individuals or superannuation funds because of refundable imputation credits; where profits are taxed in a trust under s. 99A ITAA 1936, they will be taxed at the highest rate of 46.5% with no refund if this rate exceeds the investor's rate;

- companies are able to determine continuity of ownership for the purpose of carrying forward income tax losses using the concessionary tracing rules in Division 166 ITAA 1997; trusts have to apply the more onerous trust loss rules;

- foreign source income earned by companies will typically be exempt from Australian tax under s. 23AJ ITAA 1936 or s. 23AH ITAA 1936; these provisions are not accessible by trusts;

- non-resident investors in Australian trusts are liable to tax on distributions at rates which will eventually decline to 7.5%; non-resident investors in Australian companies can be liable to tax on distributions at a 0-rate in certain cases; and

- for companies, distributions on shares that are debt interests reduce the company's taxable income and the remainder is subject to tax in hands of the company and its equity holders; for trusts, distributions on units that are debt interests issued by the trust do not reduce the net income of the trust and thus distort the proper allocation of tax liability between the trust's financiers and its owners.

The point of this list is the proposition that trusts enjoy tax advantages not available to companies is true in some respects, but it is only half the story. Companies enjoy concessions as well. The two sets of rules are not congruous – advantages do not simply offset.

More importantly, it is not obvious that these advantages form a sound basis for imposing the corporate tax paradigm on public trusts. The proposition that trusts enjoy a certain set of tax outcomes might be true; that does not make it the dominant policy concern.

Submission

The Property Council submits that the main focus of the review should be on regularising and facilitating the operation of a flow-through taxation regime, particularly for widely-held trusts whether that is to be achieved by adopting Option 1 or Option 2.

Maintaining a border between flow-through taxation and corporate taxation is less relevant today. The circumstances where corporate taxation might be imposed on an MIT should be significantly wound back and retained only where doing so is necessary for compelling reasons.

2. Definition of Qualifying Entities [chs 11, 12]

2.1 Scope of the regime [question 11.1.(a)]

Chapters 11 and 12 say that the Board is examining a specific taxation regime for "managed funds that operate as MITs that are widely held vehicles undertake primarily passive investments" [para 9.31]. The questions in Chapter 11 take as given the notion that the Board's review will be subject to these kinds of limitations on the scope of the project – that the relevant questions to pose involve the definition of "widely-held," limits on class rights and so on.

It follows from what was said above, that if the main purpose of the Board's review is to "assess options for introducing a specific tax regime that would reduce complexity, increase certainty and minimise compliance costs" then this means principally regularising and facilitating the operation of the flow-through taxation regime. While a better flow-through regime might be produced just for a limited group of trusts with particular ownership structure, with membership denoted by units, and conducting particular operations, but there is no obvious reason why this should be so.

It is worth noting that we can appreciate the need for limitations and access restrictions if the purpose of the MIT regime were to deliver targeted concessionary measures to some types of taxpayer or activity, but in our view this is not the nature of the existing regime, nor do we understand it to be an intended outcome of the review.

Chapter 11 notes that MIT regimes typically have significant restrictions about the ownership structure of the entity. We note that such restrictions are usually put in place in other countries so that individuals, single corporate owners or small groups cannot avoid the classical system of corporate tax for profits made on certain activities. The benefits of flow-through taxation are only to be made available where the intermediary is a CIV – it represents collective investment for a sufficiently broad group of investors. Again, in our submission, the experience overseas is not especially useful as the basis for decisions in Australia because these restrictions are typically imposed as the means of protecting their existing classical systems of taxation.

We address here the proposition behind Chapter 11 that an MIT regime does need to be limited by a type-of-entity test. A restricted MIT regime would be constructed in at least two steps:

- the first step is the idea of a managed fund – a pooled investment with a separate manager;
- the second step is the idea of a widely-held fund.

It is important to note that, while they overlap, these ideas are not identical. Indeed, we note that the term "managed investment fund" really only imports the first – a widely-held test is not a self-evident element in the notion of a "managed investment fund."

i) Registered MIS under Corporations Act.

The definition of "managed investment scheme" in the *Corporations Act 2001* represents an appropriate place to start. The test already forms the basis of the definition of "managed investment scheme" in s. 12-400 of Schedule 1 to the *Taxation Administration Act 1953*.

The three legs to the test in the *Corporations Act* capture the elements of an MIT:

> ***managed investment scheme*** means:
>
> (a) a scheme that has the following features:
>
> (i) people contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);
>
> (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);
>
> (iii) the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions) …

The *Corporations Act* adds further elements to the system of registered MIS. Second, the notion of a registered scheme in s. 601EB of the *Corporations Act 2001* adds the element of a fund that is not tightly controlled. Section 601FA requires the responsible entity of an MIS to be a public company that holds a financial services licence.

ii) Unregistered MIS.

Because of the additional elements in the *Corporations Act*, relying simply upon registration under the MIS regime is not adequate and the definition needs to be expanded in several respects.

In particular, the *Corporations Act* test does not always capture wholesale funds. (That is understandable because the MIS regime in the Corporations Act exists largely to set up a regulatory regime for the protection of retail investors; hence non-retail situations are not covered.) Another example is managed investment schemes which are not registered under the *Corporations Act* because they are entirely held by a few wholesale clients. Again, these types of situation should be within the scope of an MIT regime. Further, there are some trusts that are not managed investment schemes under this definition as they are under the day to day control of members or the responsible entity is not a licensed entity. Again, they should be within the scope of an MIT regime.

The Property Council submits that, assuming access to the MIT regime is to be limited by a type-of-entity test, wholesale funds and other funds which are not registered as an MIS should be able to elect to be within the scope of an MIT regime where they are:

- ultimately widely held (see below); or
- directly held by other entities that are MITs.

iii) Other types of entity as a managed fund

The focus of the paper is on managed funds that are trusts. We suggest that other forms of entities, such a body corporate, should be able to elect into an MIT regime provided those entities are collective investment vehicles.

iv) Widely held.

The paper asks for submissions on the definition of a fund that is widely held.

We noted above that the *Corporations Act* test does not easily accommodate wholesale funds. They should also be within the scope of an MIT regime. One way of eliminating the difficulty that many wholesale funds will be placed in if a fund has to be "widely held," would be to allow a form of tracing to determine whether the requisite level of ownership has been met. Unlisted MITs ought to be permitted to trace through intermediate trusts, companies, superannuation funds to identify the individuals (and governments, see below) who are ultimate owners. These rules should envisage the possibility of tracing through non-resident intermediaries. Rules akin to Div 166 ITAA 1997 could be adapted to govern how far up the chain of ownership the MIT might look (and when it can can cease looking) to determine whether it is sufficiently "widely-held."

Some examples may help demonstrate a few points:

- in the simplest case, if all the units in unlisted Trust A are owned by unlisted Trust B which has 450 members, Trust A should be regarded as widely held as well. (The same outcome would apply if Trust B was instead unlisted Company B Ltd with 450 shareholders.)
- if all the units in unlisted Trust A are owned by unlisted Trust B and all the units in Trust B are owned by unlisted Trust C which has 610 members, Trust A and Trust B should be regarded as widely held as well. (The same outcome would apply for Trust A if Trust C were instead unlisted Company C Ltd with 610 shareholders.)

It may be necessary to have some provisions dealing with concentrated ownership where MITs would have 300 nominal members, but not be regarded as adequately widely held:

- if 10% of the units in Trust A are owned by Trust B which has 500 members and the other 90% by 3 other entities, Trust A should be regarded as widely held as well, unless a concentration of ownership test is failed (eg, the 3 other entities are all individuals).

v) Sovereign wealth funds.

We note in this context that sovereign wealth funds (that is, funds wholly-owned by foreign governments) are important investors in the Australian market. In the current financial crisis, they are a principal source of capital. Governments and their instrumentalities are not always well handled under current law. The Property Council submits that a government, and any sovereign wealth fund it has established, should be regarded as representing more than 300 members. In other words:

- in the simplest case, if all the units in unlisted Trust A are owned by a sovereign wealth fund, Trust A should be regarded as widely-held;

- if 10% of the units in unlisted Trust A are owned by a sovereign wealth fund and the other 90% by 3 other entities, Trust A should be regarded as widely held as well, unless a concentration of ownership test is failed (eg, the 3 other entities are all individuals).

vi) Listing.

Listing is often used as a surrogate for a widely-held test. In our submission, the fact that a trust is listed should be sufficient for it to be an MIT. The same outcome should apply if an unlisted trust is effectively owned by a trust that is listed:

- in the simplest case, if all the units in Trust A are owned by Trust B which is listed, Trust B should be regarded as widely held and Trust A should be regarded as widely held as well;

- if all units in Trust A are owned by Trust B and all the units in it are owned by Trust C which is listed, Trust A and Trust B should be regarded as widely held as well;

- if 10% of the units in Trust A are owned by Trust B which is listed and the other 90% by 3 other entities, Trust A should be regarded as widely held as well, unless a concentration of ownership test is failed (eg, the 3 other entities are all individuals).

The test should extend to listing on an approved stock exchange offshore.

However, a requirement that every trust must be listed in order to be an MIT is not necessary. In other words, listing should be sufficient but not necessary.

Question 11.1(a)
What is an appropriate approach to defining widely held for the purpose of any new MIT regime?

Response
The Property Council submits that the definition of "managed investment scheme" already used in the legislation is an appropriate place to start.

The MIT regime also needs to be available to managed investment schemes (particularly wholesale funds) which are not, and do not need to be, registered under the *Corporations Act*. Further, the MIT regime should be available to entities that are not trusts.

If a widely-held test is to be applied, then the test of 300 members used elsewhere in tax law seems appropriate, provided that there is an ability to trace through resident and non-resident intermediaries to ultimate owners. For this purpose, a sovereign wealth fund and an entity listed on an approved stock exchange should be regarded as widely held.

2.3 Ownership interests [question 11.1(b)]

The Paper asks for submissions about the appropriateness of insisting on a single class of membership interest in a MIT.

In our submission there is no need for a single class of interest rule. While the existence of different classes of membership interest may make the allocation of the tax liability on an MIT's income more difficult, the proper place to handle any resulting complexities is in the rules governing the computation and allocation of the tax liability, not in the rules which set the access conditions to the entire MIT regime. This is discussed further below.

At the very least, an MIT should be able to issue voting and non voting membership interests as well as membership interests which would qualify as debt interests under the debt-equity tests in Division 974 ITAA 1997.

Question 11.1(b)
Should rights attaching to interests in an MIT be uniform?

Response
The Property Council submits there is no need for a single-class-of-interest requirement.

If such a rule is introduced, an MIT should at the very least be able to issue voting and non voting membership interests as well as membership interests which would qualify as debt interests under the debt-equity tests without offending the rule.

2.4 Ownership of an MIT by a superannuation fund [question 9.1].

Question 9.1 is examined here because it arises from the ownership structure of an MIT.

The Paper notes that under Division 6C ITAA 1936, a trust is a public unit trust if superannuation funds hold 20% of the trust. The explanation for this rule is purely historical as the Paper notes. It serves no purpose now that Australian superannuation funds are taxpaying entities, especially when imputation credits are refundable to complying funds. Today, the rule creates compliance concerns for no apparent policy goal.

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

Response
The Property Council would welcome the repeal of this test.

2.5 Entering (and leaving) the MIT regime [question 11.1(c)]

Question 11.1(c) poses the question whether an MIT should be able to make "an irrevocable election to be governed by the new MIT regime …" As was noted above, this formulation begs the answer to a prior question about the purpose of the review – whether it is intended to examine a border between flow-through taxation and corporate tax treatment, or to regularise and facilitate the operation of a flow-through taxation regime.

One place where these differing conceptions of the review matter is in relation to access to the regime. A regime which focussed primarily on policing the boundary of flow-through tax treatment would be defined in one manner and would be mandatory. A regime which focussed primarily on fixing flow-through tax treatment would be defined quite differently, and could be elective.

In our submission, a new MIT regime should be elective, in addition to any other access tests. Because it will likely differ substantially from the treatment for other trusts, access to a new MIT regime should be a conscious decision – the subject of a deliberate choice by the trustee.

That is not to say that entry needs to be a permanent state. As funds can change their interests and operations by evolution or acquisition, it would be preferable for the status to be revocable, subject to appropriate transitional rules being triggered. The impact of making (and revoking) the election should be prospective, taking effect from the start of an income year, rather than a day within an income year.

Question 11.1(c)
Should an MIT be able to make an irrevocable election to be governed by the new MIT regime

Response
A new MIT regime, supplementary to Division 6, should be added to the legislation. Access to the regime should be elective. The election should have indefinite effect but be revocable, with appropriate transitional safeguards.

2.6 Bare trusts, nominations, etc [question 11.2]

In our submission, it will definitely be useful for the Board to clarify that a bare trust, nomination, custodian arrangement, IDPS, resulting trust or any other similar arrangement known by whatever name, is entirely transparent for any purpose in tax law. That is, none amounts to an "entity." This would remove the need for many rules that currently exist in order to prevent the arrangement amounting to an "entity."

It would also be helpful if the legislation defined a single term preferably by reference to a series of functions and this term was then used consistently in the Act. That is, care needs to be taken to avoid the kinds of difficulties that have been created by the use of multiple terms for the same idea [eg, s 160APHH(6) ITAA 1936, s. 106-5 ITAA 1997, s. 703-45 ITAA 1997] and the use of undefined terms where the meaning has to be created by the ATO. The obvious example is the term "absolutely entitled" in s.

106-5 ITAA 1997. The difficulties with this undefined term can be seen in the failure to finalise the draft Taxation Ruling TR 2004/D25 "Meaning of the words 'absolutely entitled to a CGT asset as against the trustee of a trust' as used in Parts 3-1 and 3-3 of the Income Tax Assessment Act 1997." The difficulties have arisen because the ATO has attempted to create extremely fine distinctions between various situations which are, or ought to be, identical for tax purposes (since they all represent the same economic position).

As to the definition of the appropriate scope of arrangements which should be disregarded, the essential idea is well captured in the judgment of Gummow J in *Herdegen* (1988) 20 ATR ATR 24:

> Today the usually accepted meaning of "bare" trust is a trust under which the trustee or trustees hold property without any interest therein, other than that existing by reason of the office and the legal title as trustee, and without any duty or further duty to perform, except to convey it upon demand to the beneficiary or beneficiaries or as directed by them, for example, on sale to a third party…
>
> What is meant in these situations by saying that the trustee holds the property without any duties to perform other than that to convey the property to the beneficiary or as the beneficiary directs? The answer is supplied by Professor Waters in his work *Law of Trusts in Canada*, 2nd ed, 1984, at 27:
>
> > *It is, of course, true that so long as a trustee holds property on trust he always retains his legal duties, namely, to exercise reasonable care over the property, either by maintaining it or by investing it; he cannot divest himself of these duties. The reference, however, is to duties which the settlor has enumerated… If the trustee possesses his legal duties only for the purpose of guarding the property, prior to conveyance to the beneficiary, these duties are said to be passive.*

If an arrangement is such that a trust arises (rather than an agency or co-ownership), but the trustee has no independent powers of management, the arrangement should not amount to an entity for tax purposes. Thus, if the duties of the trustee are limited to:

- holding title to the property;
- defending that title, if necessary;
- exercising the rights of the owner (eg, voting) as directed by the owner, whether that direction is conveyed once on establishing the arrangement or periodically throughout the course of the arrangement;
- collecting (and distributing) the income which the property generates;
- delivering the property (or the proceeds of selling the property as directed) to the owner upon request; and
- record-keeping and reporting;

then tax law should disregard the existence of the arrangement, whatever label is attached to it. And for these purposes, an owner could be one person or several.

Question 11.2
[Whether] 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);
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
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.

Response
A bare trust, nomination, custodian arrangement, IDPS, resulting trust or any other similar arrangement should not amount to an "entity" for any purpose in tax law. This rule should apply if the arrangement involves no greater duties on the trustee than holding and defending title, exercising certain rights of the owner and collecting and distributing the asset and the income it generates and record keeping.

3. Method of Relieving an MIT of Tax and the Treatment of Resident Investors

[chs, 4, 6, Appendix H]

Chapters 4, 6, and Appendix H of the paper address different parts of the same issue – methods for improving the tax regime which is to apply to MITs and their resident investors. This part of the submission examines these parts of the Paper together.

Before reviewing these parts of the paper, we make two general background observations:

- any new MIT regime should be located in a discrete Division in the income tax legislation. This will aid its visibility to the international community of investors. It will also make it easier to restrict the access of other types of trust which are not intended to enjoy access to the MIT regime; and

- as was noted above, any new MIT regime should operate as an alternative to Division 6, with Division 6 retained for trusts that do not qualify for the new MIT Division or which choose not to enter it.

3.1 Alternatives to the present regime for amounts flowing through MITs [question 4.1]

i) Focussing on outcomes.

The Property Council does not have strong views about what might be termed the legislative plumbing, although Option 2 appears to us to have more appropriate features – that is, we express no decided preference about how the legislation is to be constructed so that it achieves the outcomes which the Property Council would like to see accomplished. That considered agnosticism as to the legislative mechanics is because either Option 1 or Option 2 could be made to achieve appropriate outcomes. (The Property Council does, however, take the view that Option 3 is unacceptable and should be discarded.)

Because the Options are not fully articulated, and any of the models could be made to accomplish the appropriate outcomes, the Property Council prefers instead to highlight the outcomes which a model MIT regime should achieve for investors – in this part of the submission we focus on resident investors.

The Property Council takes seriously the goal of Policy Principle 1:

> 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.

Policy Principle 1 means that an MIT regime should be as transparent a regime as can be accomplished (with the stipulated exception of the treatment of losses in accordance with Policy Principle 5). A transparent regime would ensure (regardless of the legal form of the MIT):

- entity transparency – the amounts which the MIT earns for investors are not diminished by tax or PAYG as they pass through the MIT to investors (unless they were received by the MIT already reduced by such an amount);
- amount identity – the amount of taxable income computed at the level of the MIT is the same amount that is taxed in the hands of the investor. In other words, the investor does not suffer more tax because the amount was earned by an MIT;
- character retention – income which the MIT earns for investors possesses the same character in the hands of the investor as it had in the hands of the trustee; and
- source retention – income which the MIT earns for investors possesses the same source in the hands of the investor as it had in the hands of the trustee.

These outcomes have obvious practical implications for different kinds of income and expense passing through an MIT:

- dividend income received by an MIT would be treated as dividend income in the hands of the investor and carry any franking credits attached to the dividend;
- capital gains derived by an MIT would be treated as capital gains in the hands of the investor and be entitled to CGT discount. (Our earlier submission has already proposed a statutory rule to clarify that amounts which represent gains made on the disposal of MIT assets should be regarded as having the same character and attributes in the hands of the investors); and
- foreign source income earned by an MIT would be treated as foreign source in the hands of investors; foreign taxes would be treated as paid by the investor and the investor would be entitled to a FITO for that tax.

Question 4.1(a)
The Board seeks stakeholder comment on the high level Options outlined above …

Response
The Property Council does not have a strong preference between Option 1 or Option 2 because either could be made to achieve appropriate outcomes. What matters most is that certain outcomes are achieved:

- entity transparency;
- amount identity;
- character retention; and
- source retention.

The Property Council does, however, take the view that Option 3 should not be considered further.

ii) Issues with a distribution-based regime.

While either Option 1 or 2 could be made to accomplish these outcomes, it seems to us that Option 1 has some drawbacks that may render it inferior to an improved attribution regime along the lines of Option 2.

First, a deduction-based model will create significant pressure for cash distributions to occur which will interfere with the factors that should drive decisions about retaining or distributing cash, and the level of distribution – the trust's constituent documents, appropriate capital management policies and the expectations of the market. There seems to us to be a real risk that the tax imperative will come to be the driving force dictating capital management practices. The government's concern should be that the proper amount of tax will be paid at the set time, but using a cash-based distribution system as the means of ensuring this risks bringing with it an imperative to make physical distributions. An attribution-based system does not carry this difficulty; the government's proper concerns can be met, whether or not distributions occur.

Second, it seems likely to us that Option 1 will require some robust deemings to accomplish the desired outcomes. At present, the trust model in Australia accomplishes most of these outcomes. These outcomes are not as fully achieved for investors in resident companies and Option 1 appears to import the flavour of a corporate model. Hence, another reason for our hesitation about Option 1 is the possibility that it will carry with it these implications from the corporate model:

- distributions would be viewed as dividends; and
- Option 1 would not permit income to retain its source and character.

As we noted above, these implications need not arise (or could be reversed if they did), but doing so appears to involve more, and more complex, adjustments for Option 1 than for Option 2.

A third reason for our hesitation about Option 1 is the extent of the tinkering that will have to occur to the computation of taxable income and deductible distributions in order to ensure entity transparency – that is, to prevent taxation occurring at the intermediary level. Under Option 1, the basis upon which the intermediary level tax is removed depends upon the MIT distributing in cash or property an amount equal to the taxable income earned by the MIT. However, the tax system contains many fictitious (or accelerated) inclusions in assessable income – franking credits, foreign income taxes paid, Division 16E amounts, CFC or FIF attributions for example – and other allowable deductions – deductions under the proposed 10% investment allowance, Division 40 or Division 43 for example – so that the relationship between the amount of a cash distribution and taxable income is tenuous. Whether an MIT can fully eliminate the entity level tax would thus seem to depend upon the rather fortuitous balance between its tax-generated additional deductions and its tax-generated additional income inclusions (or else its willingness to take on debt or return capital to fund adequate levels of cash distribution).

It seems to be anticipated in Appendix H that some of these fictitious inclusions will be reversed to avoid this problem in part – for example, that a cash distribution of $70 depletes the MIT's taxable income by $100. No similar example is given for foreign income taxes ($15) paid showing that a cash distribution of say, $85 depletes the MIT's taxable income by $100, although p. 123 contains a reference to "a deduction for … other tax offsets distributed to the beneficiaries."

And the discussion of the reverse situation is less fully articulated – where the trustee distributes more cash than the taxable income of the MIT because of additional tax-only deductions. There is no analysis of the possibility of surplus distributions generating a loss which is carried forward at the entity level to subsequent years – which would be the obvious implication of a distribution-based model.

Tinkering of this kind in both directions is of course possible, but on balance it seems to us to require more effort, complexity and a heightened possibility for error than does Option 2.

Question 4.1(a) [continued]
The Board seeks stakeholder comment … on any issues that affect their workability as alternative models.

Response
The Property Council is concerned that a deduction-based model will create significant pressure for cash distributions to occur which will interfere with the factors that should drive decisions about retaining or distributing cash, and the level of distribution.

The Property Council notes that if Option 1 is adopted, it will need to be substantially elaborated to:

- ensure that it achieves the desired outcomes for an MIT regime set out above; and
- deal with, and prevent the unwelcome consequences, of cash distributions and taxable income being only tenuously connected.

iii) Improving an attribution-based regime.

Because of this, the Property Council can see merit in working toward an improved attribution-based, rather than distribution-based, regime – a regime similar to the kind of regime which the Paper describes in Option 2 as a trustee exemption method, currently reflected in part in Division 6 ITAA 1936.

An attribution-based regime should create less pressure for cash distributions to occur which should lead to less interference with the capital management goals of MITs. The proper amount of tax can be triggered and imposed under an attribution-based regime without the need for physical distributions.

Chapter 4 pays a great deal of attention to the difficulties with the current regime in Division 6 ITAA 1936. We agree that Division 6 has difficulties but in our submission they can be rectified for MITs with some modifications to the current law. In part, the ability to build a better attribution regime for MITs derives from a collection of circumstances that apply to MITs (and do not apply to private trusts):

- investors in MITs (even closely held MITs) are at arm's length and dealing with each other at arm's length;

- interests in MITs invariably confer rights to income and gains that are fixed rather than discretionary;

- for retail trusts especially, the fund's constituent documents will typically impose a requirement on the trustee to pay periodic income distributions to investors (although there may be a power in the trustee to retain some income) and market expectations will reinforce this position; and

- a fund's constituent documents and trust law will impose fiduciary duties on trustees that will constrain the ability of fund managers to undertake the kinds of practices apparently of concern to the ATO that are seen in private trusts.

As currently drafted, Division 6 uses the entitlement to share in the income of a trust (rather than the entitlement to a share of the corpus, voting rights, a share of any cash distribution made, etc) as the basis for allocating the liability to pay tax on the taxable income earned by the MIT for its investors. Chapter 4 notes difficulties with the meaning of trust "income," computing a share of that income and so on.

However, there are indicators other than sharing in earned "income" that are less contentious, very robust and more accurate for allocating the liability to pay tax on the taxable income earned by an MIT.

In our submission, the taxation of MITs could be greatly improved if the Board proposed a system which regularised and codified some of the current industry practices that employ shares of cash distributions as indicating entitlements to trust income.

1. Using cash (or property) distributions as the basis for attributing tax liability. MITs should have the option of adopting a system which allocates to investors the liability to pay tax on the taxable income earned by the MIT based on the proportion of cash or property received by an investor as a percentage of total distributions made in respect of an income year.

Using distributions made by the trustee as the basis for allocating the liability to pay tax on the taxable income earned by the MIT for its investors has several distinct advantages:

- it reflects current industry practice;

- it is clear, evident, verifiable and easily administerable;

- it should interfere less with an MITs capital management goals; and

- given that investors in MITs are typically at arm's length and that distribution practices are constrained by trust law and the constituent documents, it is an appropriate and robust system for MITs – the opportunities for manipulation are remote.

The regime could capture all MITs:

- the liability to pay tax on the taxable income earned by the MIT would be allocated to investors based on the amount of cash or property (other than amounts which represent interest or the return of invested capital) received by an investor (including cash reinvested in a DRIP) as a percentage of total cash distributed in respect a year; and

- provided some amount (even $0.01 per unit) of cash was distributed, this regime would have the effect of allocating the liability to pay tax on all income and gains derived by the trustee of the MIT – Policy Principle 4 would not need to be invoked.

If the trustee makes no distribution in cash or property at all in respect of an income year (a most unlikely scenario given market expectations and the terms of most trust deeds) then Policy Principle 4 would need to be invoked:

- the trustee would pay tax on the entire taxable income of the MIT in respect of that year;

- the trustee should pay tax on this amount at the then current corporate tax rate;

- the amount of tax paid by the trustee gives rise to a franking credit in hands of the investors; and

- the credit can be attached to the next distribution paid by the trustee after the tax has been paid.

Such a system also has the distinct advantage that it helps to smooth some of the difficulties that currently arise for investors from the fact that all trust income is derived at a single point in time – the date that accounts of the trust are (or should be) taken. Under current law, the effect of this rule is that all of the trust's income is notionally taxable to the persons who are the investors on that day – typically, the last day of the income year. Trust deeds go to some length to try to make investors presently entitled to amounts distributed to them so as to attach tax liabilities to them, but industry practice is not universal or consistent. Regularising a cash-based system for allocating the tax liability among investors allows a more appropriate amount of tax to be the responsibility of investors who enter and leave the fund during the course of a year. For MITs that distribute quarterly, notionally allocating the tax liability at four points during a year represents a significant improvement to current law.

Such a system also has the distinct advantage that it can accommodate trusts with multiple classes of units on issue. If the trust has preferred (but still equity) and ordinary interests on issue, following the cash flows will match the differing entitlements of the two groups of members.

While such a regime could lead to solvency issues for some investors – investors might receive insufficient cash to meet their tax liability – this issue is a commercial one and best resolved by allowing the interplay of the wishes of investors, the expectations of market and the capital management imperatives of the MIT to be worked out. Many types of investors will happily fund the tax liability from other sources – the popularity of dividend reinvestment plans already shows this.

2. Using ownership of units or interests as the basis for attributing tax liability. Another, though less attractive option, than using cash flows as the basis for allocating the tax liability on taxable income earned via an MIT would be to rely on unit holdings or interests held where the trust has a single class of unit (ie, the entitlements of all investors are identical). This too would capture most listed retail and most wholesale MITs. It would also capture many special purpose investment trusts where interests are not denominated in units:

- the liability to pay tax on the taxable income earned by the MIT would be allocated to investors based on the number of units (or interests) held by each investor as a percentage of total units on issue;

- this regime would have the effect of allocating the liability to pay tax on all income and gains regardless of the amount distributed by the trustee of the MIT – Policy Principle 4 would never need to be invoked;

- there would be no need for a mandatory distribution rule (akin to Option 3) because tax would be imposed on all of the taxable income regardless of distribution;

- this eliminates any need to impose tax on the trustee (and so s. 99A ITAA 1936 could be removed for them).

At first glance, using the ownership of a unit or interest may seem to possess more integrity than following cash flows, but that impression is incomplete – cash is only one stage removed from unit holdings and there is an inexorable connection between the two.

A more important observation is that using unit or interest holdings does not help solve the problem of "lumpiness" – ownership will typically have to be determined on a single day, typically the last day of the income year. All of the income could potentially end up being allocated to the owner of the units on that day. While it might be possible to pro-rate days of unit ownership, this would become technically very demanding for listed trusts where significant volumes of interests are traded daily.

Further, using the percentage of units or interests owned could only work appropriately if there were a single class of units on issue. If an MIT has both preferred and ordinary units on issue, the percentage of units held will not be an appropriate basis for allocating the tax liability.

3. Non-resident investors. We should note that a more thorough attribution-based regime may have implications for non-residents who are currently taxed under Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953*. Some modification to current law would be necessary. Under current law, non-residents are taxed on the basis of distributions made to them – that is, tax must be remitted where a fund payment is "made" by the trustee. It is, of course, possible to use the kind of regime embodied in s. 98 and s. 98A ITAA 1936 for non-residents, attributing to them a share of the tax liability on the trust's taxable income with the trustee liable to collect and remit the applicable tax to the ATO. The regime could be implemented in this way:

- where a share of the tax payable on the taxable income of the MIT is attributed to a non-resident, the trustee would be obliged to pay an amount equal to that tax to the ATO within a defined period; the trustee would presumably withhold or recoup that amount from the next distribution to be made to the non-resident; the payment by the trustee would extinguish the non-resident's liability to pay the tax;

- where the cash distribution is sufficient to pay the tax liability and occurs at about the time that the trustee must pay the ATO, the system will work simply just as if the system were based on taxing distributions;

- if no distribution at all is made to a non-resident, it is almost certainly because no distribution will have been made to any investors, and the default position where no distributions have been made would then come into play: tax would be paid by the trustee;

- if the amount of a cash distribution made to the non-resident is less than the share of tax attributed to the non-resident, or the distribution will not occur in a timely manner, the trustee would need to find sufficient funds to pay the tax and recoup the tax payable from the next occurring distribution. The Property Council does not consider this situation to be a real likelihood or one that could not be managed by MIT managers.

Question 4.1(b)
The Board seeks stakeholder comment on 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

Response
The Property Council submits that the allocation of the obligation to pay tax could be made clearer if it were based on the distributions of cash or property (other than interest and returns of capital) made by the trustee as the basis for allocating the liability to pay tax on all the taxable income earned by the MIT.

A second option would be to allocate the obligation to pay tax based on the ownership of units or fixed interests in the trust, where it has a single class of units (ignoring interest that represent debt).

Only where the trustee makes no distribution would the trustee be liable to pay tax. Any tax paid by the trustee would generate franking credits in the hands of investors.

3.2 Distributions (in cash or property) under an attribution-based regime

One important implication of an attribution-based regime such as Option 2 – and one that current law does not appreciate – is that the occurrence of a distribution (whether in cash or property) should not have significance in the tax system for MITs and their investors. There are two aspects to this observation: time and amount.

First, since investors ought to be taxed on their interest in what the MIT earns on their behalf, rather than on the amount that the MIT chooses to distribute to them, they cannot defer tax until the time of any distribution to them. Having said that, it makes sense to treat the occasion of a report (typically, though not axiomatically prepared at the time of a distribution) as the time at which the investor reports and pays PAYG instalments on the amounts the MIT has earned. Requiring the investor to do so prior to the computation of those amounts by the MIT is obviously impractical. How often MITs report to their investors is currently a matter of individual practice, but could be mandated to occur regularly and more frequently.

The second implication is the more important. Since under Policy Principle 1 investors ought to be taxed 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 amount of any distribution is not relevant to the computation of the taxable income of the investor. At present, discrepancies between the amounts attributed to the investor and distributed require adjustments because distribution is seen as another taxing point or adjustment point. Not only are these adjustments unnecessary, they are unnecessarily complex – that is, they are complex without a policy rationale which justifies the complexity.

For the property industry, the two most significant instances where the cash distribution is greater than the amount computed at the trust level arise from CGT discount, divergences between financial depreciation and Division 40 and deductions under Division 43 ITAA 1997. The proposed investment allowance will be another example. It is inconsistent with Policy Principle 1 to tax investors on the amount of the distribution when it happens to be larger than their interest in what the MIT earns on their behalf. This is true whether the additional tax is imposed immediately on the cash, or by subsequently by reducing the investor's cost in its interest.

Take for example the treatment of CGT discount. Assume an MIT invests $100 in an asset, which it sells three years later for $120. The fund can distribute $20 in cash representing the profit made by the MIT. But the amount of tax payable should not be affected by the amount of cash distributed – to do so offends Policy Principle 1. The proper amount of tax should be $4.65 if the investor is an individual [ie, $20 gross capital gain reduced by 50% x personal rate of 46.5%] or $2 if the investor is a complying superannuation fund [ie, $20 gross capital gain reduced by 33% x fund rate of 15%]. And further, the cost base of the investors in their interests should be unaffected – they have not recovered their investment; the entire amount of originally subscribed capital remains intact. Current law achieves that outcome.

The same outcome should apply where the MIT is entitled to a deduction under Division 40 or Division 43. Assume an MIT earns $20 in rent and is entitled to a deduction for tax purposes of $20 under Division 43. The fund has no net profit yet it can distribute $20 in cash representing the gross rent earned by the MIT. Again, the amount of tax payable should not be affected by the amount of cash distributed – to do so offends Policy Principle 1. The proper amount of tax should be $0. Further, the cost base of the investor in its interest should be unaffected – it has not recovered its investment; the subscribed capital remains intact. The impact of the deduction under Division 43 should be properly reflected at the time that the MIT sells the asset, generating a larger capital gain for the investor because the cost of the asset has been reduced by the deduction under Division 43. This accords with Policy Principle 1. (The cost base analysis may have been different when deductions under Division 43 did not reduce the cost base of the improvement. That has not been the law since 1997.)

The same should hold true where the cash distribution is less than the amount of taxable income computed at the trust level – for example, where the CFC regime, FIF regime, Div 16E or the proposed TOFA regime includes non-cash amounts in assessable income, or where a gross-up is required for the effect of a franking credit or the payment of foreign income tax.

Question 4.1(c)
The Board seeks stakeholder comment on any other options for change.

Response
The Property Council submits that, once the appropriate amount of tax has been imposed at the time that income is earned, the distribution of earned income should not represent another taxing point, whether by the direct imposition of tax on cash distributions or by the depletion of cost base.

3.3 Adjusting for retentions

One difficulty with the current law is the need for some adjustment to deal with retained income present in the MIT (in the form of assets or reduced liabilities) at the time that an investor sells its interest. The Paper [para 6.18] recognises this issue although does not dwell on it. Given that all the income of an MIT will have been taxed, either to the investors or the trustee, it is appropriate to provide some mechanism to prevent that amount being taxed again when an investor sells its interest and the income not been distributed.

This issue is uncontroversial in the context of Australia's other income attribution regimes – the CFC and FIF rules.

The Property Council submits that some mechanism – either a cost base step-up or a sale proceeds reduction akin to s. 461 or s. 613 ITAA 1936 – should be introduced to adjust the gain or loss made on selling interests in MITs to the extent of the taxed income attributed, but not distributed, to investors.

Such a rule would be needed under either Option 1 or Option 2 as both Options present this problem (as does the current law) – under either regime it is possible for income to be taxed (either to the trustee or investor) as it is earned, to be retained by the trustee and then to be reflected in the (higher) sale price received by a selling investor.

Response
The Property Council submits that either a cost base step-up or a reduction of sale proceeds should be introduced to adjust the gain or loss made on selling interests in MITs to the extent of the retained taxed income that has not been distributed to investors.

3.4 Unders and overs [question 4.5]

Chapter 4 also examines whether some systematic solution could be achieved for the problem of "unders and overs." This is a welcome suggestion. There is a real issue for MITs that have interests in other MITs that they do not control or which have foreign source income. MITs that do not have any major divestments or acquisitions in the last 3 months of a year and invest only in Australian property probably do not have a difficulty, but this is not the norm.
The Property Council endorses the idea of a simple statutory safe harbour regime for errors or omissions representing deficiencies, preferably set at 5% of taxable income:

- Where the errors are 5% of taxable income or less, the errors may 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 on the trustee.

- Where the errors exceed 5% of taxable income, again any omissions or errors should be rectified by adding the deficiency to the calculation of the taxable income of a subsequent year, rather than by requiring amendments to the returns of investors or the imposition of tax on the trustee. In such a case, however, it is appropriate to require an interest uplift on the deficiency to be added into the taxable income of the MIT as it is more than *de minimis.* The interest rate should be set at the shortfall interest charge ('**SIC**') rate.

The Property Council accepts that a safe harbour could and should only be available for "innocent" errors. For these purposes, it would be possible to rely on existing tests such as taking reasonable care.

The Property Council also accepts that a safe harbour without interest should only be available for errors that are quickly discovered – say, during the next tax year.

Question 4.5

The Board seeks stakeholder comment on:

- 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;
- 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;
- 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
- whether the Commissioner of Taxation should have discretion to increase the de minimis in special circumstances, and if so, what circumstances.

Response

The Property Council supports the idea of a simple statutory safe harbour regime for minor deficiencies that occur despite taking reasonable care.

The safe harbour amount should be 5% of taxable income of the year.

Where errors are 5% of taxable income or less, and are rectified during the next tax year, the errors should be rectified by adding the deficiency to the taxable income of that year.

Where errors exceeds 5% of taxable income, or are discovered after the next income year, the errors should be rectified by adding the deficiency to the taxable income of the subsequent year and adding an additional uplift for interest charged at the SIC rate.

3.5 Fixing the other parts of an MIT system – entry and exit, and other problems

While the Paper examines several important problems with the current (or possible future) tax system for dealing with MITs, it does not capture some of the most intractable practical issues.

The Property Council submits that the Board also needs to add to its agenda a number of other significant practical issues that deserve to be examined. It is worth noting that the issues listed below would arise under either Option 1 or Option 2. (Note that neither problem is the same as the issue discussed at paras 4.25 ff of the Paper.)

i) "Last man standing."

This issue arises for unlisted trusts. It occurs when beneficiaries subscribe for interests during an income year or leave an MIT during an income year because of a redemption. This issue arises from the fact that current tax law treats all of the income of a trust as derived on a single date – the date that accounts of the trust are (or should be) taken. The operation of this rule can be seen for example in the *Peterson's case* (1960) 106 CLR 395 or *Galland's case* (1986) 162 CLR 408. Under current law, the effect of this rule is that all of the trust's income is notionally taxable to the persons who are the beneficiaries on that day – typically, the last day of the income year. Under either Option in the Paper this issue would remain – for example, an entire year's income could be allocated to the person who remained (or became) a member at the time of distribution (Option 1), an entire year's income is notionally taxable to the persons who are the remaining (or arriving) beneficiaries on the day that accounts are taken (Option 2).

Trust deeds will often attempt to adjust the year's income between a departing and a joining investor. Tax law does not, although current administrative practice appears content with some form of compromise – an outcome where all of the net income of a trust is allocated to somebody.

This issue deserves attention and a statutory clarification to regularise current trust practice.

ii) Allocating exceptional gains.

The second problem also occurs in unlisted trusts when beneficiaries leave an MIT during an income year because of a redemption and the trustee has to realise trust assets in order to fund the redemption of units. This will often trigger a gain or loss that would not otherwise be realised.

Current practice will often allocate this gain (and the tax liability on it) to the departing investor who caused it and received the funds generated by the realisation. Tax law does not appear to allow this practice, although again, current administrative practice – and perhaps a generous interpretation of PSLA 2005/1 – appears content with the outcome that all of the net income of a trust is allocated to somebody, even if the capital gain is allocated rather specifically.

Again, this issue deserves attention and a statutory clarification to regularise current trust practice.

iii) Properly recognising debt interests in MITs.

Under current law, MITs can issue membership interests (redeemable preference units, for example) that would be debt interests as defined under Division 974 ITAA 1997. Nevertheless, in strict terms they remain equity for many purposes in tax law with consequential distortion to the proper taxation of the taxable income earned by the MIT for its owners:

- distributions on these units do not reduce the net income of the MIT; and
- holders of these units are required to pay tax on a fraction of the net income of the MIT, rather than the precise amount paid or accruing to them.

Current practice will often attempt to ameliorate these consequences, but this issue deserves attention and statutory clarification to regularise appropriate treatment. That is, where an MIT has issued membership interests that are debt interests as defined under Division 974:

- the entitlements of the holders of membership interests that are treated as debt under the debt-equity tests in Division 974 ITAA 1997 should be treated as a reduction of the taxable income of the MIT;
- the amount (and only the amount) accruing to the holders of debt interests would be taxed in their hands as if interest; and
- the liability to pay tax on the remaining amount should be allocated to the investors with equity interests (and not those with debt interests) as described above.

Submission

The Property Council submits that Board should expand its focus in conducting the review to include other issues not currently addressed in the Paper:

- last-man standing problems;
- the allocation of exceptional gains to particular investors; and
- the proper treatment of debt interests issued by MITs.

4. Activities Test and Control Issues [ch 9]

Clearly, the main issue of concern to MITs in the property sector in Australia has been the restrictions placed on their activities by Division 6C ITAA 1936. These concerns remain despite the amendments to Division 6C made in 2007 and those contained in *Tax Laws Amendment Act (No 5) 2008* which, while welcome, go only part of the way to solving this difficulty.

4.1 A first best solution [question 9.2]

We noted at the outset of this submission that the argument for activity limitations is unconvincing in 2008. There are many reasons supporting the PCA's view that both Division 6B and 6C ITAA 1936 should simply be repealed:

- The argument that imposing corporate tax is intended to counter tax advantages available to trusts is incomplete – companies enjoy tax advantages that are not available to trusts – and the argument is unconvincing – the imposition of the corporate tax paradigm on trusts is not a sensible way to address the implications of discrepancies that do not share a single underlying driver.

- While activity restrictions may be common in the REIT and CIV regimes of other countries, the restrictions are usually the price to be paid for enjoying a concession – being taken outside the classical system of corporate tax that would otherwise operate. That is not the case in Australia where the trust regime – and even the corporate tax regime – aspire to transparency. The international experience is thus inapt as a lesson for Australia.

- The historical justification for activity restrictions – the need to protect the corporate tax base – has long since ceased to be relevant with the enactment of the imputation system (1987) and refundable imputation credits (2000). For resident investors, these measures make the corporate tax principally a withholding tax regime against an ultimate tax liability imposed and computed at the investor level.

- So far as resident investors are concerned, the introduction of the PAYG regime means there is little practical difference for the government between applying the current trust regime and the corporate regime, and the differences that do exist could be removed if MITs made (or simply reported) more frequent distributions to investors and few of them paid an annual PAYG instalment.

Thus the Property Council submits the optimal position is that there should be no limit on the range of activities that an MIT is permitted to undertake.

4.2 A second-best solution [question 9.2]

The history of the negotiations surrounding the amendments made by *Tax Laws Amendment Act (No 5) 2008* suggest that Treasury's current thinking still seems to be that it is necessary to insist upon some notion of "investment" remaining in the legislation to create and enforce the corporate tax paradigm for public trusts (though not for private trusts). Hence, we consider next a second-best solution: what changes would need to be made to Division 6C ITAA 1936 so that it can be made less burdensome in practice for MITs.

We set out below a series of seriatim observations about how some of the difficulties presented by Divisions 6B and 6C might be ameliorated so that any ongoing restrictions do not defeat industry's desire and the Government's goal "to make Australia the financial services hub of Asia … [and] enhance the international competitiveness of Australian managed funds" [para 1.4].

i) Creating a more workable test.

We examine how such a distinction might be drawn so that it caused the least possible detriment. There are many elements to this process:

- deciding whether to set a hard number or an order of magnitude – ie, how to describe the bar;
- setting the level – ie, deciding where to set the bar; and
- deciding what is measured – ie, deciding what the bar looks like.

ii) A hard number v. a fuzzy line.

The Property Council submits that any activities test to be enacted should be drafted as a test that is a combination of a bright-line numerical test (as a safe harbour) and a qualitative test. An example of such a formulation would be:

- 1. An MIT must derive 'the preponderance of its income ...' / 'hold the majority of its assets ...'
- 2. An MIT will satisfy test 1. if X% of its income / assets are ...

A test which is a combination of a "fuzzy" test and a "hard" safe harbour allows MITs an appropriate but not excessive degree of flexibility. For example:

- An MIT which derives say 82% of its income as rent would satisfy the safe harbour test and need to inquire no further.
- An MIT which derives say 72% of its income as rent might not satisfy the safe harbour test, but the MIT would be permitted to avoid the consequences of triggering the corporate tax paradigm if the offending 28% was represented by, say, 7 amounts each of which represented 4% of the gross income. The rental income is clearly dominant and the MIT should be allowed to retain its MIT status despite the incidental classes of non-rental income.

iii) Income or assets test.

That number or measure must then be applied to something. Many countries employ both an income and an assets test in the design of their REIT regime – that is, they apply numeric tests to both the amount and type of the REIT's income and its assets. In our view, an active v. passive distinction would be less onerous if the test were based on amounts of gross assessable income rather than the use or application of assets. For example, the formulation:

- An MIT must derive at least X% of its income in the form of rent, other amounts of income commonly generated from providing the use of land and other types of passive income

is a more workable test than an assets-based test:

- At least X% of the assets of the MIT (by cost or value) must be used for the purpose of generating rent, interest, dividends, etc.

iv) Setting an appropriate level.

The next issue is the appropriate level at which this test should be set. 75% of gross income is common as an income test and this would seem to be an appropriate level to alleviate much of the pressure that currently surrounds the test in Division 6C ITAA 1936.

Whatever level is chosen, there is a separate issues about the strictness involved in counting to that number. For example,

- there would still be a need for a *de minimis* test – ie, in counting up to 75%, ignore any amounts of (forbidden) assessable income that are insignificant (say, up to 2% of gross income);

- there would still be a need to remove lumpy transactions from the calculation because they are unrepresentative of passive investment – ie, in counting up to 75%, ignore the proceeds of sales of capital assets (if a capital v. revenue dichotomy survives), insurance recoveries, sales of subsidiaries etc; and

- if the test were based on income rather than assessable income, there would be a need to remove the effect of accounting income or ordinary income that will not be taxable – ie, in counting up to 75%, remove the effect of asset revaluations and the derivation of exempt or NANE income.

v) Frequency.

The next issue is how often the test is to be applied – that is, is it an annual snapshot, a quarterly test or a test applied any point in time? Further, if the test is failed, does that failure trigger the prescribed consequences for that single year or for all succeeding income years?

The Property Council submits that the test should be an annual snapshot, rather than a point in time test. That snapshot would be taken at the end of the income year when the MIT is in a position to determine its final income position. The test would be determined annually and the consequences of failing the test imposed year-by-year.

4.3 Defining investment; passive operations

Apart from setting the number that is to be used, there is then the much more complex question of classifying various kinds of activities as acceptable or forbidden.

i) Black list.

At the moment, Division 6C ITAA 1936 defines passive income and assumes everything else is active. This system has proved cumbersome, restricting the expansion and modernisation of MITs.

Assuming that some form of activity limitation test is to remain, the Property Council has a strong preference that rather than attempting to define passive operations, a "black list" approach be used instead, and that black list should identify forbidden activities – ie, an MIT can do anything as long as it is not on a precise and clearly drafted black list. For example, is an MIT prohibited from operating a farm, coal mine or oil field. An MIT would be permitted to own the farm, but not operate it.

ii) A third-best option – defining active and passive.

If an activity-based restriction remains, and the black list option is not taken, then at the very least there needs to be serious revision in classifying various kinds of income or assets as either active or passive income in the hands of an MIT. The categories of "active" and "passive" are not self-defining; they have to be populated with meaningful content. This could be done by defining active or passive or both.

In our submission, the problem of the active v. passive distinction could be reduced somewhat if the test were reversed – defining active, and treating everything else as passive.

If that approach is taken, then the Board should insist that the law clarify several matters. The paradigm type of passive income is obviously rent, but this should extend beyond "rent" in strict sense. An MIT should be permitted to earn without restriction (ie, these kinds of assessable income fall within the 75% permitted income, not the 25% margin of error or the *de minimis* safe harbour):

- premiums and licence fees received for the non-exclusive use of land – eg, car parks;
- income ancillary to supplying the use of land – eg, income derived from providing the use of fixtures or movable chattels and equipment used in conjunction with the land;
- amounts which are customary in the industry – eg, income collected as a contribution to operating expenses.

We note that the recent amendments in *Tax Laws Amendment Act (No 5) 2008* address some of these issues.

But more generally, if an active v. passive distinction is to be maintained, the Property Council would prefer a more open-textured test which permitted an MIT to earn income accruing to the owner of land from managing the land to best advantage. It is intended to be a broad test that would allow an owner to exploit its land in whatever means seem best to it. The formula is trying to capture and express an intended distinction between an owner who derives income (in any form) from owning and exploiting the land, on the one hand, from say,

- an owner who derives income from acquiring land for the purpose of development and sale as trading stock; or

- an owner who derives income from conducting activities that happen to occur on the land – that is, operating a shoe shop is not exploiting the land although the activity occurs on land. The profit is made from selling the shoes.

Such a formulation would permit an MIT to earn income from leasing advertising signage space, charges to fund-raisers for granting access to the land, sales of surplus electricity from solar power collectors, car parks, and so on. These all accrue to the owner of land as the owner of the land, not as a seller of goods or services which could be provided from any location. It is a more suitable notion than attempting to describe active and passive.

There is also a need to clarify the acceptability of profit-based rents or turnover-based rents. There appears to be a concern that profit-based rents necessarily involve unacceptable forms of profit shifting. The same concern seems also to apply to turnover-based rents, though with less justification. In either case, that view could only be valid if the lease were between associates. There is no profit shifting if an MIT owns a hotel which it leases to a hotel operating company, unless they are associated. If they are not associated, the arrangement is simply one which computes the rent in a particular way. To say that the MIT 'shares the risks and rewards of operating the hotel' under such a lease adds nothing to the analysis; it is akin to saying that a depositor is operating a banking business because it lends at a floating rate.

Hence profit-based rents should be permitted without restriction:

- unless paid by an associate of the MIT (in which case the rent should be recognised at its arm's length amount); and

- even if paid between associates, if the recipient is an entity that is taxed as a company.

Question 9.2
The Board seeks stakeholder comment on the … approaches can be taken to changing the eligible investment rules that would reduce compliance costs for managed funds and enhance their international competitiveness

Response
The Property Council would prefer that all activity and location restrictions be removed.

If such restrictions are to remain then changes are needed to current law to vary and improve what is measured (income), how it is measured (gross income ignoring *de minimis* amounts), and how much extraneous activity is permitted (up to 25% ignoring lumpy, non-assessable and *de minimis* amounts).

If an active v. passive distinction is to remain then:

a black list which identifies prohibited activities is preferred
- failing that, an MIT should be permitted to earn any income accruing to the owner of land from managing the land to its best advantage.

The treatment of profit-based and turn-over-based rents should also be regularised.

4.4 Control issues [question 9.2]

One of the most annoying issues for MITs is the inability to isolate offending actions by putting them into a tax-paying vehicle. The control test in s. 102N(1)(b) ITAA 1936 makes the control of an entity undertaking offending activities just as toxic to the MIT as conducting the activities itself. This means that the MIT is effectively prevented from undertaking the activity altogether or else putting in place expensive and inefficient stapling structures. If it does not abandon the field to others or engage in efficient structruing, it risks putting its entire income stream in jeopardy.

This is especially odd as the impact of Division 6C ITAA 1936 is to treat certain MITs as companies. Yet, were an MIT to establish a company and deliberately attract corporate tax treatment, it gains no comfort from doing so.

In our submission, this rule is nonsensical. Paragraph 9.24 of the Paper seems to imply that MITs should not be able to own or control companies which undertake prohibited activities:

> If the control test were to be abolished, then an MIT could become a holding entity owning subsidiary trading businesses.

But it is hard to see why there is anything untoward in an MIT doing just this. If an MIT is to be prohibited from undertaking certain activities upon pain of triggering corporate tax treatment, then the Government should have no qualms if an MIT voluntarily submits itself to that very treatment, even in part. One could go further and say that an MIT should be encouraged to set up structures that attract corporate tax treatment for the activities that are to be subject to corporate tax treatment.

Indeed, the "top-hatting" amendments in s. 102NA ITAA 1936 enacted in 2007 go most of the way to conceding this issue – they allow a group of stapled entities to re-structure by inserting a head trust without triggering CGT at the time of the re-structure or invoking Division 6C ITAA 1936 for the head trust thereafter. The logic of these amendments is that a structure in which a trust owns or controls a taxpaying company does not offend sound tax policy. But these measures are unnecessarily constrained – they only apply where the trust is placed on top of an existing stapled structure; they only apply where the rollover under Division 124-Q ITAA 1997 was activated; and so on.

The legislation needs to take the next step – to permit an MIT to own all the shares in a taxable entity which conducts prohibited activities (assuming that activity prohibitions are to remain), regardless of the starting point of the structure.

The next issue is the treatment of the franked dividends in the hands of the MIT. These dividends should be treated in the same way as other dividends – the MIT should pass the franking credits through to its investors in the same way as franking credits on dividends from unrelated companies.

Question 9.2(b)
The Board seeks stakeholder comment on [whether] the control test [should] 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.

Response

Assuming activity restrictions are to remain, an MIT should be permitted to isolate offending actions by putting them into a tax-paying vehicle.

There should be no limit on the amount of the tax-paying vehicle that the MIT owns – an MIT should be permitted to be the holding entity for companies carrying on trading businesses.

The imputation system should operate for dividends flowing from the wholly-owned trading subsidiaries of an MIT in the same way as for other dividends from investments in unrelated companies.

i) Location restrictions.

Section 102N(2) ITAA 1936 is also an inefficient restriction on the operations of Australian MITs.

It permits an Australian fund to control a foreign entity provided its principal business consists of investing in land for the purpose of deriving rent. The Paper seems to view this provision as an exception or expansion to the ordinary control rule (probably because of the possibility of aggregating the activities of related controlled foreign entities) and says of this rule:

> there is considered to be minimal risk to the Australian taxation revenue if the foreign REIT owns or controls trading business in the course of its principal business [para 9.13]

If the purpose of the control rule were to protect the Australian revenue then it would seem that there is no risk to the Australian revenue even if the foreign entity were conducting only trading activities. If the test were, does this structure jeopardise any Australian tax, then on that test an Australian MIT should be permitted to acquire and control any offshore entity, trading or not (so long as its operations are conducted exclusively offshore).

The ultimate effect of s. 102N(2) ITAA 1936 is to discourage offshore expansion. The provision should be broadened to allow an Australian MIT to control any offshore subsidiary that operates offshore.

Question 9.2(b) (continued)
The Board seeks stakeholder comment on [whether] the control test [should] 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.

Response
Assuming activity restrictions are to remain, s. 102N(2) ITAA 1936 should be broadened to allow an Australian MIT to wholly-own or control any offshore entity that operates offshore.

4.5 *Consequences [question 9.2]*

Question 9.2(c) asks (assuming that activity and location limitations survive), what consequences should follow from undertaking offending activities?

At present the effect of breaching Division 6C is that a trust's entire taxable income is taxed in the hands of the trustee – s. 102S ITAA 1936. If some such outcome is to be imposed, then the Property Council submits that the consequence should be changed so that only the net income generated from the offending activities is subject to corporate taxation in the hands of the trustee. This would obviously require several corollary rules and procedures such as:

- the allocation of expenses between permitted and prohibited activities;
- the ability for the MIT to use franking credits attached to dividends arising from prohibited activities on its own behalf; and
- the ability for the MIT to use foreign income tax offsets arising from prohibited activities on its own behalf;

etc., but there is nothing exceptional involved in making such allocations that requires any special treatment of this situation.

The second question is the franking consequence of the MIT having paid tax as if a company. Again, this should be handled by the usual rules that currently apply where Division 6C ITAA 1936 has been triggered:

- the trustee determines the amount of its offending taxable income for a year of income;
- it files a return for that year of income, pays the appropriate tax and records the tax payment in a specially-created franking account;
- a franking credit can be attached by the trustee to its next income allocation (or distribution) to investors.

Question 9.2(c)
The Board seeks stakeholder comment on [whether] non-compliance with the eligible investment rules result in taxation only on the 'tainted' income and how could this be achieved.

Response
The Property Council submits that the consequence of breaching activity or location limits should be changed so that only the net income generated from the offending activities is subject to corporate taxation in the hands of the trustee.

The usual franking consequence should follow for investors where the trustee of the MIT has paid tax as if a company.

4.6 Division 6B [question 10.1]

Question 10.1
The Board seeks stakeholder comment on whether Division 6B should be retained; and 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.

Response
The Property Council would welcome the repeal of Division 6B. It serves no purpose in tax law in 2008.

5. Cross-border Issues [ch 5]

Chapter 5 examines inbound issues – principally, the ability of MITs to enjoy treaty benefits for their foreign source income – and outbound issues – principally, the Australian tax treatment of non-resident investors in MITs. We note later some other international issues not raised in the Paper which the Board should also consider as part of its review.

5.1 Inbound issues [question 5.1]

i) Access to treaty benefits.

MIT regimes are designed to ensure that there is no taxation at the level of the MIT, but as outlined in the Paper, this can be made to come about in various ways:

- the MIT is fiscally transparent – that is, it is not a taxpayer where it qualifies for the regime;
- the MIT is taxable, but its qualifying income is exempt or subject to tax at a 0 rate in its hands, and only the remaining income is taxed at the appropriate rate;
- the MIT is taxable at the ordinary rate, but distributions made by it are deductible.

Under current treaty interpretation there are difficulties where an MIT is fiscally transparent (eg, a Division 5 partnership or a Division 6 trust) – it may not be entitled to enjoy treaty benefits such as the benefit of an exemption from source country tax because of the lack of permanent establishment, or a lower rate of withholding tax on distributions to it coming from an entity in the source country.

The issue arises because under the OECD Model, a person is entitled to treaty benefits only if it is a "resident" of either treaty country, and a resident is defined to mean a person that is subject to tax on its worldwide income in one of the contracting States. Australian treaty practice differs, but the question whether a trust or partnership or any other fiscally transparent entity can claim treaty benefits is very significant and still unsettled.

A second concern is whether it is the MIT or the investors in the MIT who are the "beneficial owners" of any dividend, interest or royalty income flowing to the MIT from an entity located in a treaty country. The entitlement to lower treaty rates on dividend, interest and royalty income is restricted to the beneficial owner of the income.

This problem is the subject of the OECD report on partnerships: OECD, *The Application of the OECD Model Tax Convention to Partnerships*. That report led to conclusions now incorporated in the Commentary to article 1:

> 5. ... Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of

> the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, *the partners should be entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions* entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence [emphasis added].

There are clearly practical difficulties with investors claiming treaty benefits for foreign income derived by MITs on their behalf.

These difficulties were re-stated in a REIT context in the 2007 REIT report – OECD, *Tax Treaty Issues Related to REITs* (October 2007). The report noted that differences in the ability to access treaties were to be expected because of the different ways that REITs were structured in various countries. While acknowledging these difficulties the Report has as yet has no solution other than suggesting that countries negotiate their treaties with REITs in mind:

> 9. Since the income of a REIT is typically distributed, the REIT is not, in a purely domestic context, taxed on that distributed income. As already mentioned, the tax mechanisms that ensure that result vary from country to country and can include, for example, rules that allow the deduction of REIT dividends or distributions, the tax exemption of a REIT that meets certain conditions, the tax exemption of the income of a REIT that meets certain conditions, the tax exemption of all the REIT's income, the tax exemption of only the part of the REIT's income that is distributed within a specified period of time or rules that allocate the income to the investors rather than to the REIT itself. It seems, however, that in most cases, the REIT would meet the condition of being liable to tax for purposes of the treaty definition of "resident of a Contracting State", subject to the particular problems arising from the application of tax treaties to trusts. There are a few countries, however, where this may not be the case and this is a question that would need to be clarified on a country by-country basis during treaty negotiations.

The Australia-US treaty contains specific provisions dealing with listed property trusts but their very existence suggests that Australia and at least one of our treaty partners regards property trusts as requiring special treatment.

Indeed, these circumstances are probably the best argument for Option 1 along with a paradigm which equates the MIT to a company – they would better attract treaty entitlements at the MIT level, albeit with other complications that would have to be reversed. However, the second method of achieving the non-taxation of the MIT listed above may also be compatible with Option 2 from the Paper and attract treaty benefits at the MIT level. That is, it might be possible to create, and the Board should explore, a regime under which:

- an MIT is conferred with the status of an entity and a taxpayer under Australian domestic tax law, making the MIT both taxable and a taxpayer for domestic and treaty purposes; and

- the tax base for an MIT is computed in a particular way so that it consists of just the tainted income that is to be taxed at the corporate rate.

Hence, the Property Council submits:

- the Board should work toward a type of flow-through taxation model for MITs which nevertheless entitles Australian MITs, rather than the investors in them, to enjoy treaty benefits on income and gains sourced in treaty countries;

- the Board should ask the Government to ensure the agreement of Australia's significant treaty partners that the flow-through taxation model being proposed for MITs will entitle Australian MITs to enjoy treaty benefits on income and gains sourced in the countries;

- in the meantime, the Board should recommend changes to Australian treaty practice for future treaties to ensure that MITs are entitled to treaty benefits; and

- further, Australian treaty negotiators should seek to confirm with treaty partners whether current treaty terminology used in existing treaties will (or will not) be viewed as extending to Australian MITs.

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

Response
The Property Council encourages the Board to consider all MIT design options that would attract treaty benefits at the level of the MIT, rather than its investors. In particular, the Board should consider whether a regime under which the MIT is made a taxpayer, but with a narrow tax base would suffice.

The Board should also ask the Government to canvass the opinions of significant treaty partners about:

- the effectiveness of the final MIT model; and

- whether current treaties will (or will not) be viewed as extending to Australian MITs.

Pending the commencement of a new MIT regime, the Property Council encourages the Board to recommend changes to Australian treaty practice for future treaties to ensure that MITs are entitled to treaty benefits.

5.2 Outbound issues

One of the most striking figures in the economic summary in Chapter 2 of the Paper is in para 2.4: "of the total assets placed with investment managers in Australia, only 4 per cent (A$48 billion) were sourced from overseas." Clearly offshore investors do not currently find Australian MITs an attractive place to invest.

i) Distributions to non-residents.

Under current domestic law amounts distributed to non-resident unitholders are taxed by final collection from the trustee at the rate of:

- 22.5% for real estate income (eventually reducing to 7.5%);
- other rates for interest, unfranked dividend and royalty income.

Other rules can apply for amounts such as capital gains realised by the MIT which flow-through to non-resident investors and business profits.

The Property Council sees no immediate reason to change this system and submits that:

- non-resident unitholders should taxed by final collection from the MIT;
- the amount of tax should be calculated on a gross basis – that is, without the need or opportunity for non-residents to lodge a return and pay tax on a figure reduced by deductions; and
- distributions to non-residents should remain dissected into the various components by reference to the type and source of the underlying income.

(This observation should be understood in light of the discussion at 3.1 above about collecting tax from amounts attributed to non-residents. If a more thorough attribution regime were to be enacted, some modifications to the way that the tax on attributed amounts was collected might be needed, where the size or timing of cash flows passing to non-residents proved inadequate.)

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

Response
The Property Council sees no compelling reasons to change the current system for taxing distributions to non-resident investors.

ii) Impact of DTAs.

The domestic tax regime is subject to the effect of Australia's tax treaties where the non-resident investor is a resident of a treaty country.

The Australia-US treaty and the Australia-Japan treaty have special provisions for distributions involving listed property trusts. For other countries, current treaty practice is in a state of flux. It seems to be current practice in the industry to treat distributions made by companies as subject to the dividend article of the relevant treaty but investors in trusts are treated as subject to no such regime on the basis that there is no relevant article which would limit the source country's right to tax.

In the 2007 REIT report, the OECD expressed the tentative view that REIT distributions should, for the purposes of the treaty, be viewed as:

- dividends, if the investor has <10% of the REIT (thus invoking a rate limit for the source country); and

- income from real estate if the investor has 10% and above of the REIT (thus allowing the source country to tax without limit).

Changes were made to the text of the Commentary to the OECD Model in July 2008 to reflect these views. However, it seems that the new Commentary is not to be understood as explaining what the Model currently provides, but rather what countries should agree to when next (re)negotiating their treaty. It seems the text of the Commentary is being changed to set out the future practice with regard to bringing REITs more clearly within the Model and to set out the OECD's position on how new provisions should be drafted.

As a result of the 2008 changes, the Commentary to Article 10 of the Model now reads,

> IV. Distributions by Real Estate Investment Trusts
>
> 67.1 In many States, a large part of portfolio investment in immovable property is done through Real Estate Investment Trusts (REITs). A REIT may be loosely described as a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed. The fact that the REIT vehicle does not pay tax on that income is the result of tax rules that provide for a single-level of taxation in the hands of the investors in the REIT...
>
> 67.3 One issue discussed in the report is the tax treaty treatment of cross-border distributions by a REIT. In the case of a small investor in a REIT, the investor has no control over the immovable property acquired by the REIT and no connection to that property. Notwithstanding the fact that the REIT itself will not pay tax on its distributed income, it may therefore be appropriate to consider that such an investor has not invested in immovable property but, rather, has simply invested in a company and should be treated as receiving a portfolio dividend. Such a treatment would also reflect the blended attributes of a REIT investment, which combines the attributes of both shares and bonds. In contrast, a larger investor in a REIT would have a more particular interest in the immovable property acquired by the REIT; for that investor, the investment in the REIT may be seen as a substitute for an investment in the underlying property of the REIT. In this situation, it would not seem appropriate to restrict the source taxation of the distribution from the REIT since the REIT itself will not pay tax on its income.

Australia is not recorded as having expressed any position or observation on the commentary. Given what was said above about the apparent intent of the new Commentary, Australia probably did not need to take a position.

The proposed practice for REIT distributions set out in the Commentary clearly does not match current Australian practice. Hence a new MIT regime will have to be designed bearing in mind a possible change to Australia's treaty practice for REIT distributions – especially, in light of the OECD's view that:

- the proper article to apply does not depend upon the form of the REIT – the same article should apply to REITs that are companies and those that are trusts; and

- that Australia has an unlimited right to tax distributions made to non-resident investors who hold significant interests in Australian REITs.

We note, however, that the domestic rate will soon be lower than the treaty rate for portfolio dividends with the consequence that the treaty rate and future OECD developments would be irrelevant in portfolio situations. This would not be the case if the domestic rate was positive (7.5%) but the relevant DTA rate would be 0 (or the DTA assigned exclusive taxing rights to the residence country).

The Property Council sees no immediate reason to change the domestic system in light of the OECD developments, and submits that the Board should recommend that the *status quo* continue:

- Australia should continue to impose tax on non-resident unitholders in an Australian MIT under the current law, at the current and proposed rates, with tax collected by final withholding from the trustee;

- Australia should not take up the opportunity to impose a higher rate of tax on distributions to non-resident unitholders with more than 10% of the interests in an Australian MIT. (We note that under s. 12-400(3) of Schedule 1 to the *Taxation Administration Act 1953* a trust in which one foreign resident individual holds more than 10% is not an MIT for the purposes of those rules. This provision should not be expanded to apply to situations where any entity holds more than 10% is not an MIT, and consideration should be given to repealing this provision.)

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

Response
The Property Council sees no compelling reasons to change the current system for taxing distributions to non-resident investors in light of work currently being undertaken at the OECD. In particular, the Property Council would not support changes to the treatment of distributions to unitholders with more than 10% of an Australian MIT.

iii) Other improvements.

However, there are other aspects of the tax collection regime for distributions to non-residents which are not mentioned in the Paper that should be examined. The regime established under Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953* may benefit from reform in several respects.

Under current law, the withholding regime under Subdivision 12-H is applied to the gross amount of the real estate component of a trust distribution – for example, to the entire amount of a capital gain, not to the discounted amount of the gain, even where the non-resident is a trust or individual. The Property Council submits that consideration should be given to whether this combination of amount and rate reflects an appropriate amount of withholding on distributions to non-residents.

Secondly, it is evident that the cognate rules for imposing and relieving withholding tax on payments that are dividends, interest and royalties (s. 128B ff ITAA 1936) are quite dissimilar to the rules Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953*. For example, s. 128B(3) relieves the non-resident from a liability to pay Australian withholding tax in many instances where the non-resident is exempt from tax in its own jurisdiction. Common examples are non-resident charities and religious organisations (s. 128B(3)(a) ITAA 1936) and non-resident superannuation funds (s. 128B(3)(jb) ITAA 1936). No similar exemptions apply to the withholding tax levied on distributions of Australian real estate income, though the justification for an exemption is equally valid.

Again, the Property Council submits that consideration should be given to aligning more closely the rules in Division 11A ITAA 1936 and Division 12 of Schedule 1 to the *Taxation Administration Act 1953* about the imposition and remission of withholding tax.

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

Response
The Board should consider:

- applying the withholding regime under Subdivision 12-H to the discounted amount of the gain where the non-resident investor is a trust, superannuation fund or individual; and

- more closely aligning the rules in Division 12 of Schedule 1 to the *Taxation Administration Act 1953* with Division 11A ITAA 1936.

iv) Sales of interests in MITs.

So far as sales of interests in MITs are concerned, Australian domestic law asserts the right to tax gains made by non-resident investors where the investment is taxable Australian real property ('TARP') – in general terms, the investor holds a non-portfolio interest in a land-rich entity. Tax is currently imposed on a net basis and collected by assessment.

Hence, non-resident investors with portfolio interests, or with significant interests in entities that are not "land rich," are not liable to pay Australian capital gains tax on transactions affecting their interest such as sales, capital returns or liquidations.

Where Australian tax is claimed, the domestic rule is subject to the effect of Australia's tax treaties where the non-resident investor is a resident of a treaty country. The relevant articles in play are the real estate article [OECD Model, art 6], business profits article [OECD Model, art 7] and the capital gains article [OECD Model, art 13]. For taxpayers who are individuals and are investing on capital account, this will usually mean that only the capital gains article will apply. This typically allows Australia to maintain its asserted jurisdiction to tax where the gain is made on the sale of shares in a company which is "land rich." Article 13(4) of the OECD Model provides:

> 4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

For sales of interests in trusts, Australia asserts the same position. This was included in a special reservation to Article 13 in the OECD Model [see former Commentary para 33].

The 2008 Update has adjusted the Commentary to Article 13 to address sales of interests in REITs. The Commentary to Article 13 now provides for Australia's view as part of the Commentary.

> 28.11 Some States [ie, Australia], however, consider that paragraph 4 was intended to apply to any gain on the alienation of shares in a company that derives its value primarily from immovable property and that there would be no reason to distinguish between a REIT and a publicly held company with respect to the application of that paragraph, especially since a REIT is not taxed on its income. These States consider that as long as there is no exception for the alienation of shares in companies quoted on a stock exchange (see paragraph 28.7 above), there should not be a special exception for interests in a REIT.

It seems that Australia's future treaty practice will be to insist on the ability to tax maintain the tax on TARP asserted under domestic law.

The Property Council sees no immediate reason to change the domestic system in light of the OECD developments.

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

Response
The Property Council sees no compelling reasons to change the current system for taxing non-resident investors on gains (and losses) made on the sale of interests in Australian MITs.

5.3 Conduit situations

Another issue that is not dealt with in the Paper concerns conduit MIT structures – that is, an Australian MIT derives income and gains from operations offshore which are distributed to foreign investors. The notion that non-residents should not be subject to Australian tax on foreign source income passing through Australia is now accepted as sound tax policy by Australian tax policy makers.

Where the Australian intermediate entity is a trust, Australian law appears to offer that "flow through" outcome – that is, non-resident unitholders are not subject to Australian tax on income derived from a foreign source, and capital gains made on the sale of foreign assets are not subject to Australian tax.

However, the ATO has taken views in ATO ID 2005/200 which confounds this policy for conduit situations. The ATO ID takes the position that amounts attributed to an Australian MIT under the FIF rules (and presumably the same logic applies for amounts attributed the CFC rules) represent income to which no beneficiary is presently entitled, thus triggering an Australian tax liability because of s. 99A(4A) ITAA 1936. Whether or not the ATO ID correctly states the law, it certainly contradicts accepted Australian tax policy.

The Property Council submits that the Board should recommend whatever legislative (or administrative) changes are needed to make the trust rules work appropriately for all conduit situations involving resident MITs.

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

Response

The Property Council submits that the Board should recommend whatever legislative (or administrative) changes are needed to make the trust rules work appropriately for all conduit situations involving resident MITs.

6. Definition of "Fixed Trust" [ch 8, Appendix G][quest'n 8.1]

Chapter 8 of the Paper raises some of the issues arising from the current legislative definition of "fixed trust." The definition has implications for the ability to use carry forward tax losses, access the scrip-for-scrip rollover under Division 124-M ITAA 1997 and pass franking credits to investors.

It is clear that the definition presents a number of difficulties due largely to the inappropriate strictness of the drafting. Indeed, the possibility that a retail listed MIT might not be a fixed trust under the current definition demonstrates that the definition is flawed. There should not be any doubt that a retail listed MIT is, and ought to be viewed as, sufficiently fixed to satisfy all tax rules which might be made to turn on such a requirement.

The Property Council submits that there is a simple solution to this problem – either:

- every trust which qualifies as an MIT should be deemed to be a fixed trust for the purposes of all such rules; or
- all such rules should be satisfied if the trust is either a fixed trust or an MIT.

Further, with respect to trust losses, current law disadvantages some trusts in their ability to use tax losses:

- only widely-held trusts are able to access the same business test as an alternative to demonstrating continuity of ownership;
- trusts must determine continuity of ownership using the trust loss rules rather than the rules in Division 166 ITAA 1997.

These kinds of disadvantages should be eliminated for MITs.

Question 8.1
The Board seeks stakeholder comments on the advantages and disadvantages of the potential options for clarifying the treatment of fixed trusts outlined above and any other options for clarifying the treatment of fixed trusts.

Response
Every trust which qualifies as an MIT should automatically satisfy all such rules.

Any trust which is an MIT should be allowed:

- to access the same business test as an alternative to demonstrating continuity of ownership when using losses; and
- to determine continuity of ownership using the rules in Division 166 ITAA 1997.

7. Resettlement Issues [para 11.22 ff] [quest'n 11.3]

Para 11.22 of the Paper raises the issue of amendments to the constituent documents of an MIT and notes that amendments may result in the creation of a new trust estate and/or the alteration of a investor's interests in the trust, either of which can generate tax consequences. The Paper also notes that the law on what amounts to a re-settlement is very difficult. There is certainly disquiet in the industry about the approach taken by the ATO in its Statement of Principles on trust resettlements.

It should be noted that most amendments to the constituent documents of MITs are relatively innocuous:

- changing voting or notification procedures;
- permitting new classes of interest to be issued;
- permitting the trustee to retain income; or
- varying the income definition used in the fund.

In an MIT context, such amendments will typically be done between parties at arm's length and have equal impacts for all investors. There is no likelihood of serious tax omissions arising from such measures. However, current law can expose the MIT to the possibility that it is regarded as having been terminated (with consequences for its own tax attributes) and expose investors to the possibility of those consequences flowing through the trust to investors, and of CGT events occurring to their investment. These consequences would not occur for a company making similar changes to its constitution.

The Property Council submits that, for MITs, these issues should be dealt with at the investor level only, and that tax consequences should be triggered only where value-shifting arises – that is, the consequences of amendments to the constituent documents of a trust should be governed by the rules in Division 725 ITAA 1997.

Question 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 a 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*.

Response
The Property Council submits that amendments to the trust deed of an MIT should not have consequences for the MIT or its tax attributes.

Amendments to the trust deed of an MIT should only trigger consequences for the investors, and only where the amendment involves value shifting between members, in which case the value shifting rules in Division 725 ITAA 1997 should be applied.

APPENDIX A:

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
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