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19 December 2008

The board of Taxation
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Langton Crescent
Parkes ACT 2600

taxboard@treasury.gov.au

Dear Mr Warburton,

**REVIEW OF THE TAX ARRANGEMENTS APPLYING TO MANAGED INVESTMENT TRUSTS**

Attached please find a response from the Association of Superannuation Funds of Australia to the Board of Taxation's discussion paper on the tax arrangements applying to managed investment trusts (MITs).

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. Our members, which include corporate, public sector, industry and retail superannuation funds, account for more than 5.7 million member accounts and over 80% of superannuation savings.

ASFA welcomes this review and the opportunity it presents for a review of the tax arrangements applying to widely held collective investment vehicles undertaking primarily passive investments.

For several years ASFA has been raising with government concerns with the current laws.

On the following pages we have addressed the specific issues that are of concern to superannuation funds as significant investors in MITs.

Pauline Vamos

Chief Executive Officer

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## REVIEW OF THE TAX ARRANGEMENTS APPLYING TO MANAGED INVESTMENT TRUSTS

The Association of Superannuation Funds of Australia's (ASFA) comments on the discussion paper are restricted to those raised questions that have direct impact on the manner in which superannuation funds undertake investments.

### TRUSTS AS FLOW THROUGH VEHICLES

We note that the Board of Taxation has proposed a number of methods regarding the above. There are a number of issues to be considered including:

a. Determination of income and expenses

b. Allocation of deductions to income classes

c. Attribution of character of income

d. Non-taxable distributions

e. Systems changes and administration

ASFA recommends appropriate comprehensive road testing of examples before any changes are settled on by the Board to ensure that the five principles/objectives are satisfied. If there are any significant departures from these principles, these changes are likely to be detrimental to superannuation funds and their members as a result of the reduction in after-tax returns on the super funds MIT investment. Subject to the proposed methodology, this could be a permanent detriment to the funds/members and not just a timing difference.

### Character retention and flow through

The Board sought comment (Q 6.2(d)) on whether flow through of character needs to be maintained in general or alternatively, needs only to be maintained in specific circumstances?

ASFA is concerned to ensure that, whichever option is adopted, flow through of character is maintained for superannuation fund investors in managed investment trusts (MITs). Any change to the nature of the income received by superannuation funds via MITs such as the re-characterisation of net capital gains to revenue gains could substantially increase the income tax applying to that income which would then result in a substantial decrease in the after-tax investment income allocated to member accounts.

If it became apparent that a significant increase in tax payable was the outcome of a proposed change in the taxation of the income of MITs, large superannuation funds would immediately begin to extricate themselves from their MIT investments. These funds would, instead of investing in an MIT, directly invest so as to regain/retain a more appropriate tax treatment. Such action would be driven by. And be consistent with, the trustee obligation to act in the best interests of the members

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of the superannuation fund. Such action would have a considerable impact on Australia's MIT sector.

That is, if flow through of character was not maintained superannuation fund trustees would need to review their current arrangements in relation to fund managers so as to ensure they were managing the impact on their portfolios. Though this may be inefficient and costly, the after tax income gains would justify the action.

The change in the tax treatment would also create an uneven playing field between larger and smaller superannuation funds. Large funds would have a greater capability to invest directly in underlying assets placing smaller funds and their members at a commercial and competitive disadvantage.

The increased complexity of the investment decision-making process would add considerable costs to many funds, both in terms of seeking and implementing advice. Discontinuing arrangements with fund managers would mean that funds would need to develop their own internal capacity in relation to investments. This is not an available option for many and would create inefficiencies and cost.

Should the removal of flow through treatment lead to an initial re-configuration of investments by funds there would be capital gain and loss crystallisation issues which would be to the detriment of fund members' retirement benefits.

Overall, the cost of the increased complexity of the investment process would be borne by fund members.

In summary, ASFA considers that flow through of character should be maintained, and if not universally, then specifically for superannuation fund investors.

## CAPITAL VERSUS REVENUE ACCOUNT TREATMENT OF GAINS AND LOSSES MADE ON DISPOSAL OF INVESTMENT ASSETS BY MITS

### Capital account versus Revenue Account

Superannuation funds are major investors in MITs. ASFA has great concerns over any proposal to treat all gains by an MIT as being on revenue account.

We note that under current legislation, MITs are required to determine whether their gains or losses are on revenue or capital account. It is a question of fact as to which method is most appropriate based on investment strategy and trading activities of the MIT.

From the perspective of a superannuation fund, the arguments for permitting an MIT to treat gains and losses made on disposal of investment assets as being on capital account are the same as those expressed above for retaining flow through of character. To not do so would trigger a wholesale withdrawal of superannuation funds investments from MITs in favour of direct

investments or investments through pooled superannuation trusts. From a superannuation industry perspective, fund members would be justifiably concerned that their account balances were being reduced by the impact of extra taxation imposed on technical rather than any public policy/factual grounds. The change would produce long term impacts on superannuation fund members' retirement incomes and unequal treatment of superannuation fund investments driven principally by the size of the fund the member is in and its capacity to undertake direct investment.

ASFA has had the opportunity to consider the position put forward by the Investment & Financial Services Association Ltd (IFSA) in its submission to the Board on this issue and notes that the IFSA submission also makes a distinction between 'asset profits' and 'asset gains'.

ASFA supports the IFSA proposal for a statutory rule to provide certainty for both MIT trustees and investors in MITs.

### Distribution of MIT Gains Being on Capital Account

The Board sought specific comment (Q 7.1(g)) on the desirability of a statutory rule treating MIT gains distributed to particular kinds of investors (for example, complying superannuation funds) as being on capital account.

In the context of retention of character, ASFA would be supportive of a statutory rule.

## ELIGIBLE INVESTMENT BUSINESS RULES IN DIVISION 6C OF THE *INCOME TAX ASSESSMENT ACT 1936*

### The 20% Rule

The Board sought specific comment (Q 9.1) on whether it is still appropriate to have the 20 per cent rule for complying superannuation funds.

ASFA considers the 20% rule to be antiquated and not reflective of current realities and that superannuation funds should not be treated as exempt investors.

Division 6C applies where one or more persons or bodies exempt from income tax (including governments and complying superannuation entities) holds units in a trust carrying entitlement to 20 per cent or more of the beneficial interest in the income or property of the trust.

The Government inserted Division 6C into ITAA36 by passage of Act No 173 of 1985. At this time, complying superannuation entities were exempt from income tax, pursuant to then section 23F of ITAA36.

Complying superannuation entities commenced to be taxpayers on 1 July 1988 and therefore ceased to be tax exempt entities from that point. It should be noted that assets held by complying superannuation entities are subject to CGT as the modified CGT rules deem all CGT assets of superannuation funds to be acquired on 1 July 1988. As such they are subject to CGT.

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In the present Division 6C, complying superannuation entities are the only taxpaying entities listed in the definition of "exempt entity" in section 102M of ITAA36 (and thereby subject to the "20% rule" in section 102P).

In part at least, this would appear to be an accident of history. An ASFA concern is that the Government has not formally enunciated the policy reasons for the continued inclusion post 1 July 1988 of complying superannuation entities as an "exempt entity".

The broad policy basis for Division 6C is that managed funds should not be actively involved in trading businesses because of competitive neutrality.

There would appear to be no clear basis for the extension of the competitive neutrality argument to trusts owned wholly by one superannuation entity, or by a small pool of superannuation entities. The provisions of the Superannuation Industry (Supervision) Act 1993, as amended (SIS), and in particular, section 62 of SIS (the "sole purpose test"), would appear to address all relevant issues in respect of the direct conduct of trading businesses by superannuation funds.

If policy makers have concerns with activities by superannuation funds in this regard, it is ASFA's view that such issues are best addressed as prudential matters within SIS, rather than within income tax legislation.

Further, since complying superannuation entities became taxable, the operation of Division 6C does not deliver the desired competitive neutrality position. This is because the effective tax rate on the Division 6C trust owned by a superannuation fund or funds remains at 15%, after the trust makes (assuming fully franked) distributions of its after-tax income to the unit holders. The only additional tax imposts are typically the loss of the one-third discount on capital gains, and loss of access to the benefits from certain tax deferred amounts and foreign tax credits.

Indeed, the key present impact of Division 6C to complying superannuation entities in respect of closely held unit trusts is the additional administration issues associated with:

- Annual determination as to whether the trust is subject to Division 6C or not;
- Potential confusion within the Australian Taxation Office when the trust files returns in some years as a trust and in other years as a company (following this determination);
- Maintenance of a franking account for the trust; and
- Preparation of advice to unit holder(s) in respect of the deemed "dividend" that would otherwise be a distribution, and of any attached franking credits.

In the absence of an enunciation by Government of clear policy reasons for the ongoing inclusion of complying superannuation entities in the definition of "exempt entity" in section 102P of ITAA36, ASFA considers that the application of Division 6C to complying superannuation entities should be

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on the same basis as that for other taxpayers, that is, where the normal "widely held" tests in that section are satisfied.

If this were done, the only time Division 6C would affect complying superannuation entities would be in respect of managed funds where the units were held by 50 or more persons (with any particular superannuation fund counting as one person).

On this basis, the Division 6C rules would not apply to trusts wholly owned by a single complying superannuation entity, or by a small group of complying superannuation entities. The SIS legislation would continue to provide the basis to address any issues in respect to the conduct of trading businesses (for example, the extent of Board and management time within the complying superannuation entity occupied by management issues associated with the trust and its business).

ASFA submits that the application of Division 6C to complying superannuation entities should be on the same basis as that for other taxpayers, that is, where the normal "widely held" tests in that section are satisfied.

**Eligible investment business**

The Board sought comments on (Q 9.2(a)) what approaches can be taken to changing the eligible investment rules that would reduce compliance and enhance their international competitiveness.

ASFA considers that significant changes are needed to reduce compliance costs and to permit a broader range of investments so as to enhance the international competitiveness of MITs.

*Nature of present investments undertaken by the superannuation industry*

As noted above, the Government inserted Division 6C into ITAA36 in 1985, some 23 years ago.

During this period the size and nature of Australia's superannuation industry has changed virtually beyond recognition. For example, the entire industry fund sector did not exist in 1985, and the combined assets of complying superannuation entities in Australia are now more than $1 trillion.

As the large funds have grown, the nature of investments undertaken has also changed. ASFA considers that this trend is likely to continue into the future, as the assets under management by funds continue to increase, and as the global marketplace introduces new types of investments in response to market demands.

Due to the prudential requirements within the *Superannuation Industry (Supervision) Act* (SIS), many of the newer types of investments cannot be directly held by a complying superannuation entity. Therefore, it has become common for these entities to establish wholly owned or closely held unit trusts in which to undertake the investment.

Examples of present investments held by complying superannuation entities through unit trust vehicles include:

1 Agricultural land, where relevant State Government legislation now separates a variety of "water rights" associated with the land as a separate legal asset from the land;

2 Water rights acquired without acquiring any associated land, where those water rights are then leased to other entities for moneys economically equivalent to "rent";

3 The holding of "carbon rights" or "carbon credits" as part of the broader holding of certain land (for example, forestry land). Depending on the design of any Commonwealth and/or international systems for carbon trading, instances may arise in future of other carbon-related assets that funds may be able to purchase for which passive income may be obtained;

4 Development of land, including road works and other facilities, and construction of housing stock or other buildings, for the long term ownership and rental by the unit trust of the resultant housing or other buildings (this may become more and more relevant in respect to the industry's response to the Government's measures to encourage building and investment in affordable rental accommodation);

5 Investments in foreign or domestic limited partnerships and limited overseas companies that, whilst treated as "deemed" investment in companies, may not strictly satisfy the definition of "shares in a company" in paragraph (b)(iii) of the definition of "eligible investment business" in section 102M of ITAA36;

6 Investments in fixed trusts in Australia or overseas, that may not strictly satisfy the definition of "units in a unit trust" in paragraph (b)(iv) of the definition of "eligible investment business" in section 102M of ITAA36;

7 Infrastructure assets, still involving the long-term passive ownership of land, or fixtures on land, where the revenue generated is from tolls or licences rather than rent per se;

8 Investment in certain property assets, for example, car parks, where the nature of the revenue stream is not rent but licence fees or similar;

9 Investment in intellectual property, where the rights to use that property are then provided to other entities for royalties or similar passive income streams;

10 Investments with similar commercial effect to any of these, where the investor remains broadly in a passive capacity in respect of the investment and has no influence in the day-to-day decision making pertaining to any business activities that may attach. For example, the difference between the landlord of a building charging a licence fee to the car park operator (wholly passive) versus the car park operator itself (potentially active).

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In all such cases, the present definition of "eligible investment business" in section 102M may prohibit unit trusts from undertaking part or all of these investments without Division 6C applying to the trusts.

This is so, notwithstanding that the nature of the assets actually owned by the relevant unit trust are fundamentally passive in the same manner as the existing items in that definition.

ASFA recommends that the definition of "eligible investment business" be updated to reflect the types of passive investments presently undertaken by trusts used within the superannuation industry, and that the scope of the new definition either:

- Be framed broadly so as to contemplate likely future investments by the industry (such as "carbon rights"); or
- Be monitored annually, and modified following industry submissions that demonstrate the relevance of new passive investment types.

**Non-compliance with the eligible Investment Rules**

The Board sought comment (Q9.2(c) on whether non-compliance with the eligible investment rules should result in taxation only on the 'tainted' income and how this could be achieved.

ASFA has long been concerned with the "All or nothing" aspects of Division 6C.

In order for Division 6C to not apply, it is required that the business undertaken by the particular trust consists wholly of eligible investment business. This conclusion results from the definition of "trading business" within section 102M of ITAA36.

This leads to an "all or nothing" aspect to the present rules that may be inappropriate in the context of investments presently undertaken or contemplated by the superannuation industry

For example, if a trust undertakes some re-development of a building that it nonetheless intends to hold into the longer term, there is the risk that this activity may not satisfy paragraph (a) of the definition of "eligible investment business".

Similarly, it a trust were to undertake a broad acres development, and sell a small portion of the resultant buildings (for example, affordable housing stock), whilst nonetheless retaining the bulk of the development for long-term rental, it is unlikely that this combination of activities would satisfy the definition.

In this context, some modification of the present definition of "trading business" would appear appropriate, so as to allow some degree of non-eligible activities to be undertaken within a primarily passive investment framework.

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As a first step, ASFA considers that the range of eligible investment activities needs to be broadened in line with the recommendations above. Additionally, ASFA considers that some flexibility should be built into the rules that would permit a degree of 'tainted' income to be earned.

ASFA notes that some flexibility has been recently built into the rules to permit a degree of non-rental, non trading income from investments in land to be earned from *investing in land.*

Relief is now available in the form of a 25% safe harbour percentage for non-rental, non-trading income from investments in land for rent, together. There is also relief in the form of a general 2% safe harbour allowance at the whole of trust level for non-trading income. These changes, which have been introduced following industry representations, are welcomed and will result in a significant reduction in complexity.

For activities other than investments in land for rent, ASFA does not have a view on the specific percentage that should apply, but considers that any test needs to be simple to apply and not result in significant compliance costs.

ASFA is aware that similar tests in the United States REIT regime incur significant compliance costs, and is a key factor why many investment opportunities in real estate in the United States offered to Australian superannuation funds are through limited partnerships. This is the case even though the REIT regime may produce a simpler taxation outcome for Australian investors, including greater certainty in respect to foreign tax credits for related US taxes.

ASFA considers that it would not be appropriate, and indeed would be counter-productive, to establish rules where the compliance costs become a significant factor in the decision by relevant Australian trusts to undertake particular activities within trusts. This would occur should the requirement be to separately account for any 'tainted' income, rather than to exclude the investment from the Division 6C regime.

ASFA recommends that some modification of the present definition of "trading business" be made, so as to allow some degree of non-eligible activities to be undertaken within a primarily passive investment framework.

Additionally, ASFA requests that any such modification be designed so as to avoid compliance costs that would be an impediment to actual usage.

**DEFINING THE SCOPE OF A MANAGED INVESTMENT TRUST**

The Board sought comment (Q 11.1(a)) on an appropriate approach to defining widely held for the purpose of any new MIT regime.

There are a number of different definitions within the tax legislation in relation to trusts being 'widely held'. For example, there are instances where 'widely held' is defined with reference to 300

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unit holders. This causes various anomalies when certain investors in MITs are treated as one investor rather than as multiple investors.

For example, section 115-45 is an anti-avoidance provision that applies to prevent a unit holder from obtaining a discount gain on their units where more than 50 percent of the assets of the trust are 'under 12 month' assets. This provision does not apply to trusts where there are at least 300 beneficiaries. However, a MIT may be owned substantially a small number of superannuation funds that have (between them) more than 300 members. Effectively the MIT is owned by the beneficiaries of those superannuation funds. As the provision does not allow for a 'trace through' for superannuation funds, and other wholesale or retail MITs, this can result in an inappropriate application of the provision in such circumstances.

ASFA's considers that the definition of 'widely held' should be consistent throughout the tax legislation and particularly as it applies to where a superannuation fund is an investor in an MIT. We recommend the Board consider references to 'widely held' throughout the tax legislation and consider whether (in a similar fashion to Subdivision 12-H) such provisions should see certain members (such as superannuation funds) as constituting more than one member. However, as stated at the beginning of this submission, before such a change was made it may be necessary to road test a range of scenarios to determine whether there are unforseen consequences that should be addressed at the same time.