Australian Government

The Board of Taxation

REVIEW OF THE TAX ARRANGEMENTS APPLYING TO MANAGED INVESTMENT TRUSTS

A report to the Assistant Treasurer

the board of taxation

www.taxboard.gov.au

Board of Taxation

August 2009

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ISBN 978-0-642-74599-6

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FOREWORD

The Board of Taxation is pleased to submit to the Assistant Treasurer its Report on the Tax Arrangements Applying to Managed Investment Trusts.

The Board has made a number of recommendations that, consistent with the terms of reference, seek to improve certainty and reduce compliance costs for the managed funds industry and assist the industry's international competetiveness.

The Board established a Working Group, chaired by Mr John Emerson AM, to conduct the review. The Board held discussions with a range of stakeholders and received 40 submissions. The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance provided to the Working Group by tax practitioners as members of the Expert Panel and by officials from the Treasury and the Australian Taxation Office.

On behalf of the Board, it is with great pleasure that we submit this report to the Assistant Treasurer.

The *ex officio* members of the Board — the Secretary to the Treasury, Dr Ken Henry AC, the Commissioner of Taxation, Mr Michael D'Ascenzo, and the First Parliamentary Counsel, Mr Peter Quiggin — have reserved their final views on the recommendations in this report for advice to Government.

Richard Warburton AO
Chairman, Board of Taxation

John Emerson AM
Chairman of the Board's Working Group
Member, Board of Taxation

GLOSSARY OF TERMS

A-REIT	Australian Real Estate Investment Trust
ABS	Australian Bureau of Statistics
ACSA	Australian Custodial Services Association
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Taxation Office
CGT	capital gains tax
CIVs	collective investment vehicles
EIB	eligible investment business
TFN	Tax File Number
GIC	general interest charge
IDPS	investor directed portfolio services
IFSA	Investment and Financial Services Association
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
LICs	listed investment companies
MIT	managed investment trust
OECD	Organisation for Economic Cooperation and Development
REIT	real estate investment trust
TAA 1953	*Taxation Administration Act 1953*
WP1	OECD Working Party 1

EXECUTIVE SUMMARY

The Board of Taxation has completed its review of the tax arrangements applying to managed investment trusts (MITs).

The underlying taxation legislation that currently applies to managed investment trusts relates to trusts more generally. The key issue before the Board was whether those taxation arrangements are appropriate for an industry that as at 31 March 2009 represents $1,169 billion in funds under management and that competes in the international funds management industry.

The recommendations seek to ensure that the industry is able to continue to operate through trust structures, recognise the commercial needs of the industry, the needs of beneficiaries, and the need to ensure appropriate integrity, without imposing unnecessarily burdensome compliance costs on MITs and their beneficiaries and unnecessary administrative costs on the Australian Taxation Office (ATO).

The Board's key recommendations are:

- There should be a separate taxation regime for qualifying MITs, to be known as 'Regime MITs';
  - To be a 'Regime MIT', a trust must meet a 'widely held' requirement[1], comply with revised eligible investment business rules in Division 6C of the ITAA 1936[2] and satisfy a clearly defined rights requirement[3].
- Given the level of regulation and integrity rules governing these trusts, the Board was able to recommend that Regime MITs be able to use an attribution model to determine their tax liabilities as an alternative to Division 6 of the ITAA 1936. The attribution model will operate such that:
  - a beneficiary is assessable on the amount of taxable income of the trust that the trustee allocates to the beneficiary;
  - the trustee must allocate the taxable income of the trust between beneficiaries on a fair and reasonable basis, consistent with their rights under the trust's constituent documents and the duties of the trustee; and

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1 See Recommendation 2.
2 See Recommendation 8.
3 See Recommendation 3.

  - the trustee will be taxed on any taxable income of the trust which the trustee fails to allocate to beneficiaries within three months of the end of the financial year.

- Regime MITs will also be able to use various other measures recommended to ease compliance and increase certainty, such as a simpler method for dealing with 'unders' and 'overs', measures to address double taxation, being deemed to be fixed trusts for other purposes of the tax law and being entitled to make an election to treat the gains and losses arising on disposal of their investment assets on capital account.

  - The Board also recommends that these measures be available to other 'widely-held' MITs that meet the proposed new eligible investment business rules.

- The eligible investment business rules in Division 6C be amended to apply to both public unit trusts and other 'widely held' trusts as defined so as to provide a 'safe harbour' of 10 per cent for income from non-eligible activities, a revised control test and an arm's length dealing rule for transactions between related entities.

The Board has made these recommendations seeking to reduce the complexity, compliance and administration costs that arise from the current regime. However, the Board is concerned to ensure that industry practices do not develop that would undermine the integrity of the new MIT regime. To help address that concern, the Board is recommending that a Post-Implementation Review of the new MIT regime should be conducted after the legislation has been in operation for at least two years. The Post-Implementation Review will take account of industry behaviour and practices from the commencement of the new regime.

CHAPTER 1: INTRODUCTION

1.1 In the introduction to the Board's discussion paper 'Review of the Tax Arrangements Applying to Managed Investment Trusts' released in October 2008, the objective of this review was described as to reduce complexity, increase certainty and minimise compliance costs for managed investment trusts.

1.2 The Board has made 48 recommendations that have been framed against the Government's objective, outlined when the review was announced, to make Australia the financial services hub of Asia. The recommendations have taken into account the terms of reference for the review and the policy principles that form part of the terms of reference. As outlined in the discussion paper, in considering the issues the Board also applied a framework that weighed up the efficiency, equity and simplicity of the proposals that were considered.

1.3 In particular, the Board's recommendations required a number of key issues to be weighed against each other:

- reducing the cost of complying with the law while ensuring that the degree of compliance with the law does not compromise the integrity of the revenue base;
- simplifying taxation arrangements that apply to MITs against the background of a level of complexity resulting from using a trust structure for collective investment vehicles; and
- providing greater certainty while ensuring that MITs retain the flexibility to make capital management decisions on commercial grounds.

1.4 Through balancing these factors the Board believes its recommendations will improve the competitiveness of the Australian MIT industry and make it easier for trustees and beneficiaries to comply with taxation obligations while maintaining the key advantages of investing through a trust structure.

TERMS OF REFERENCE

1.5 On 22 February 2008 the Government asked the Board of Taxation to undertake a review of the tax arrangements applying to managed investment trusts[4] and to complete its review by the middle of 2009.

1.6 The objective of the review is to provide advice on revenue-neutral or near revenue-neutral options for introducing a specific tax regime for managed investment trusts which would reduce complexity, increase certainty and minimise compliance costs.

1.7 The review is a key part of the Government's commitment to make Australia the financial services hub of Asia. The Government wishes to implement reforms to enhance the international competitiveness of Australian managed funds to help ensure the future prosperity of the Australian economy.

1.8 The broad policy framework for the taxation of trusts is to tax the beneficiaries on their share of the net income of the trust, so that the trustee is only taxed on income that is not taxable in the hands of beneficiaries. Within this framework, the Board was asked to ideally develop options for reform with taxation outcomes that are broadly consistent with the following five key policy principles:

Policy Principle 1

1.9 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 2

1.10 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.

Policy Principle 3

1.11 Beneficiaries should be assessable on their share of the net income of a trust whether it is paid or applied for their benefit, or they have a present right to call for immediate payment.

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4 Managed investment trusts are collective investment vehicles that allow investors to pool together their capital to enable investment in larger and more diversified assets than would otherwise be the case.

Policy Principle 4

1.12 The trustee should be liable to tax on the net income of the trust that is not assessable to beneficiaries in a particular income year.

Policy Principle 5

1.13 Trust losses should generally be trapped in the trust subject to limited special rules for their utilisation.

1.14 The objective of the review is to provide advice on options for introducing a specific tax regime for MITs which would reduce complexity, increase certainty and minimise compliance costs. The Board was to have regard to the policy framework and principles outlined above, as well as the following:

- the current taxation treatment for trusts relies on the use of *present entitlement* to determine the income tax liability as between beneficiaries and trustees. The Board should explore alternatives that provide broadly similar taxation outcomes for beneficiaries, having regard to the costs and benefits of those options; and
- international developments in this area, especially those in the US, UK and Canada.

1.15 The Board was also asked to examine potential reforms to the eligible investment business rules in Division 6C of the *Income Tax Assessment Act 1936* that, while not compromising the integrity of the corporate revenue tax base, would enhance:

- the international competitiveness of Australia's real estate investment trusts (REITs) [5]; and
- the capacity of Australia's managed funds industry to attract funds under management from other countries.

1.16 The Board was also asked to examine:

- whether there is a continuing need for the tax integrity rules in Division 6B of the *Income Tax Assessment Act 1936*, in light of the operation of the capital gains tax regime, dividend imputation and Division 6C;
- the costs and benefits of establishing a separate taxing regime for REITs; and
- the desirability of extending relevant aspects of the recommended changes to the tax arrangements for other trusts.

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5 REITs are collective investment vehicles that allow investors to pool together their capital to enable investment in real estate assets. In some jurisdictions, such as the USA, they are structured as companies whereas in others, such as in Australia, they are structured as trusts.

1.17 The Board was asked to complete its review by the middle of 2009.

THE REVIEW TEAM

1.18 The Board appointed a Working Group of its members comprising John Emerson AM (Chairman), Keith James, Chris Jordan AO and Dick Warburton AO to oversee the review.

1.19 The Board received assistance from Professor Richard Vann (The University of Sydney) in the consideration of technical issues. In addition, the Board asked two members from its Advisory Panel, Teresa Dyson and Ken Schurgott, to assist as members of the Working Group. It has also benefited from comments of an Expert Panel comprising Michael Brown, David Cominos, Michael Hennessey, Alexis Kokkinos, Andrew Mills, Tony Mulveney, Karen Payne and Karen Rooke. At the request of the Working Group, Messrs Brown, Kokkinos and Mills and Ms Payne provided detailed technical advice.

REVIEW PROCESSES

1.20 The Board has consulted widely in developing the recommendations in this report. The Board's consultation processes involved:

- preliminary targeted consultation with selected stakeholders representing a diverse range of views;
- the development of a discussion paper;
- inviting written submissions to assist with the review and holding consultation meetings in Sydney and Melbourne during November 2008 to explore further the issues raised in the discussion paper; and
- further targeted consultations with selected stakeholders between December 2008 and May 2009 relating to the Board's consideration of specific issues.

Discussion paper

1.21 The views received in the targeted consultation process assisted the Board in developing a discussion paper, which was released on 29 October 2008.

1.22 The discussion paper included 18 questions that covered the different issues covered by the review. The paper included a summary of key features of international managed investment fund regimes and real estate investment trust (REIT) regimes.

Interim advice

1.23 After the review commenced, the Board was asked by the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs to provide interim advice on the appropriate treatment of gains and losses made on the disposal of MIT investment assets.

1.24 Following further targeted consultations with stakeholders between October and December 2008, the Board provided its interim advice to the Government in December 2008. The interim advice recommended that the capital gains tax (CGT) regime be the primary code for calculating the gains and losses made on the disposal of investment assets held by MITs, subject to appropriate integrity rules.

1.25 On 12 May 2009 the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that the Government would implement the Board's interim advice on taxation of managed funds to provide deemed capital account treatment for gains and losses made on disposal of investment assets by MITs, subject to appropriate integrity rules.

Submissions

1.26 The Board invited written submissions to assist with the review. In total the Board received 40 submissions from individuals and organisations. Except for those made in confidence, submissions have been published on the Board's website and a list of individuals and organisations that provided public submissions to the review is at Appendix B.

Consultation meetings

1.27 Following the release of the discussion paper, the Board held consultation meetings in Melbourne on 12 November 2008 and in Sydney on 13 November 2008 to explore issues raised in this discussion paper and any other relevant issues. These meetings were open to all stakeholders. A number of meetings were also held with specific stakeholder groups.

Board's report

1.28 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings. However, the Board's recommendations reflect its independent judgment.

CHAPTER 2: A SEPARATE TAXATION REGIME FOR MITS

2.1 As outlined in the Board's discussion paper, the current legislation for the taxation of trusts does not encode a single coherent policy for the taxation of trusts. The current trust taxation provisions in Division 6 of the ITAA 1936 date back to a time when trusts were generally closely held and often testamentary or discretionary vehicles used in a personal rather than commercial context. The provisions also predate the introduction of CGT. The introduction of CGT meant that discrepancies more commonly arose between what was trust law income and what was net income for tax purposes.

2.2 There has been little adaptation of the trust taxation legislation to align with the modern practice and modern use of trusts as commercial vehicles. This has resulted in legislation which is often uncertain in its application. In particular, uncertainties arise regarding how beneficiaries should be taxed on the income and capital of the trust and how income from different sources and of different character derived by the trust should be treated in the hands of beneficiaries.

2.3 The terms of reference asked the Board to review the current tax arrangements applying to MITs and to provide advice on options for introducing a specific tax regime for MITs that would reduce complexity, increase certainty and minimise compliance costs. The terms of reference broadly defined MITs as trusts operating as widely held collective investment vehicles undertaking primarily passive investment.

2.4 The Board was also asked to examine the potential costs and benefits of a separate REIT regime.

Views in submissions

2.5 A number of written submissions recommended that a new taxation regime, including an alternative mechanism for determining tax liabilities, should be applicable only to MITs as to be defined. For example, Infrastructure Partnerships Australia noted in its submission that:

> … the entire rationale of this MIT review by the Board is to cut through the highly complex and challenging problems that arise for MITs under the current law. Since trusts are used not only for MITs (that is collective investment vehicles) but also for the conduct of business activities by private and widely held organisations, Division 6 has many policy pressures to reconcile tax integrity and system design requirements to deal with privately held trusts of all types… IPA is more attracted to a stand-alone mechanism, applicable solely to MITs, which would operate efficiently…

2.6 Some submissions argued that given the strict fiduciary duties and requirements of the *Corporations Act 2001* which are placed on the trustees (responsible entities) of MITs, there are fewer integrity concerns in allowing a degree of flexibility to responsible entities of MITs. According to Deloitte:

> MITs or their responsible entities are generally covered by the requirements of the *Corporations Act 2001* (Cth)… These provisions impose a significantly higher level of fiduciary responsibility on the responsible entity over and above that of a trustee of a privately owned trust. For this reason alone, there is a much lower integrity concern with MITs as compared to other forms or categories of trusts.

2.7 Deloitte also emphasised that, if the model chosen applies specifically to MITs, then the Commissioner of Taxation is able to interpret the law based solely on its effects on MITs.

Board's consideration

2.8 The current taxation arrangements applying to trusts create a level of complexity and uncertainty when applied to MITs that the Board considers to be unacceptable, particularly for an industry of its significance to the economy. The Board considers that it is important that the development of the MIT industry not be constrained by taxation laws which have largely been shaped by consideration of closely held or discretionary trusts and the integrity concerns associated with those arrangements.

2.9 The Board's terms of reference asked it to consider options for reform that would apply to MITs which were defined as 'widely held' trusts 'engaged in primarily passive investments'. The Board's recommendations for defining 'widely held' and 'engaged in primarily passive investments' are discussed later in this Chapter and in Chapter 3 respectively. The terms of reference also asked the Board to recommend alternative approaches to the current taxation treatment of trusts as contained in Division 6 of the ITAA 1936, which relies on the concept of 'present entitlement'.

2.10 One of the key concerns the Board had when considering alternatives to 'present entitlement' was to ensure adequate integrity. In particular, the Board considered that the 'widely held' and 'engaged in primarily passive investments' requirements alone did not impose sufficient restrictions on the discretions and powers available to trustees to enable the preferred model for determining tax liabilities to be applied with sufficient integrity.

2.11 Accordingly, the Board recommends that a separate taxation regime be applicable to certain trusts which it will refer to as Regime MITs. Regime MITs will be able to make an irrevocable election to apply the attribution model of taxation (see Chapter 5). Regime MITs will also access other recommendations to ease compliance and increase certainty, in particular, being deemed to be 'fixed trusts' for other

purposes of the tax law[6], a simpler method for dealing with 'unders' and 'overs[7]', measures to address double taxation[8], and being entitled to make an election to treat gains and losses arising on disposal of their investment assets on capital account.[9]

Recommendation 1

The Board recommends that:

- there be a specific taxation regime for qualifying MITs to be known as Regime MITs.
- in order to be considered a Regime MIT an MIT must:
  - satisfy a 'widely held' requirement;
  - be 'engaged in primarily passive investment;' and
  - satisfy a 'clearly defined rights' requirement.

Widely held

2.12 In its discussion paper the Board noted that the taxation laws have various approaches to defining a widely held trust, although the definitions generally incorporate the common features of a trust being a unit trust which meets a stipulated regulatory or membership requirement.

Views in submissions

2.13 Many submissions supported using the definition of a managed investment trust in Subdivision 12-H of Schedule 1 to the *Tax Administration Act* 1953 (TAA)[10] as the starting point for the definition of an MIT for the purposes of a new MIT regime, noting that the Subdivision 12-H definition relies on the definition of a managed investment scheme in the *Corporations Act 2001* (Cth).

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6 Refer Chapter 11.
7 Refer Chapter 8.
8 Refer Chapter 7.
9 Refer Chapter 4.
10 The subdivision contains the withholding tax rules applying to managed investment trusts as defined in the subdivision.

2.14 The reasons given in support of this approach included:

- The test in section 12-400[11] of Subdivision 12-H of Schedule 1 to the TAA appropriately balances integrity with compliance.
- The approach would limit special treatment for MITs to trusts which are subject to the significant responsibilities imposed on managed investment schemes under the *Corporations Act 2001*. This is an additional protection to the revenue.
- The Subdivision 12-H definition already caters for start-up entities so that trusts which intend to be widely held but are not able to meet the requirement in their start-up phase will be able to meet the MIT definition.

2.15 As the submission from Deloitte notes:

> … there are a number of advantages in using the 12-400 definition as opposed to the 'widely held' definitions contained elsewhere in the Tax Act. Section 12-400 does not require specific tracing through tiers of entities and contains a deemed member rule where the interests of the MIT are held by a widely-held entity. Accordingly the definition more appropriately deals with different types of MITs including retail funds, wholesale funds, listed funds and unlisted funds.
>
> Furthermore the section 12-H definition already caters for start-up entities and exits under section 12-400(4) and (5)…

2.16 Many submissions suggested that the definition should also include wholesale[12] funds which may not meet the Subdivision 12-H definition. The reasons given for including these funds within the definition include:

- The current definition of MIT inappropriately does not recognise wholesale funds even if the investors in these funds are widely held superannuation funds.
- The definition would cause fewer administrative difficulties than the current law.
- It is important for the growth of Australian managed funds to allow wide participation in the new regime.

2.17 According to the submission from the Property Council of Australia:

> … the Corporations Act test does not easily accommodate wholesale funds. They should 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

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11 The section lists the requirements for a trust to be considered a managed investment trust for the purposes of the Subdivision.

12 Wholesale managed funds are funds which do not have interests which are offered to retail investors.

> 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… ultimate owners.

2.18 A number of submissions suggested that registration on an approved stock exchange should also allow inclusion in the new regime.

Board's consideration

2.19 The Board considers that the current definition of a managed investment trusts in Subdivision 12-H of Schedule 1 to the TAA 1953 is an appropriate starting point for determining whether a trust would be taken to be 'widely held' for the purposes of an MIT regime. This provision defines the types of trusts which are subject to the withholding tax rules for managed investment trusts. Using the Subdivision 12-H definition as the basis for defining 'widely held' would provide consistency with the withholding tax rules for managed funds and so reduce complexity and compliance costs for these MITs. Additionally, as the rule already caters for start-up and wind-down entities, it would ensure that the new rules for MITs apply appropriately in these situations.

2.20 The definition would also add a level of integrity to the MIT regime as funds which come within this definition are subject to the *Corporations Act 2001* (Cth) requirements applying to managed investment schemes.

2.21 However, the Board recognises that without extending the Subdivision 12-H definition, wholesale trusts which are owned directly or indirectly by widely held trusts, or which are ultimately widely held and subject to external regulation, may be inappropriately excluded from the MIT regime. In addition, significant complexity could arise for MITs if they were subject to taxation under the new MIT regime and held investments in subsidiary trusts that fell outside the new regime. Accordingly, the Board recommends that the definition of 'widely held' for the purposes of a new MIT regime should include:

- a wholesale trust which has 50 or more members directly (or indirectly, for example, through a trust or superannuation fund) and that wholesale trust is subject to a suitable regulatory regime, for example, it is operated or managed by the holder of an Australian Financial Services Licence (subject to regulation under the *Corporations Act 2001*); and
- a wholesale trust which is wholly-owned directly or indirectly by one or more trusts which satisfy the definition in Subdivision 12-H or by a wholesale trust, as above.

2.22 As the Subdivision 12-H definition already refers to Australian trusts listed on the ASX, the Board does not believe that a separate aspect of the definition is required for trusts listed on an approved stock exchange.

Recommendation 2

The Board recommends that an MIT will be considered 'widely held' if it:

- satisfies the definition in Subdivision 12-H of Schedule 1 to the TAA;
- is a wholesale trust which has 50 or more members directly (or indirectly, for example, through a trust or superannuation fund) and that wholesale trust is subject to a suitable regulatory regime; for example, it is operated or managed by the holder of an Australian Financial Services Licence (subject to regulation under the *Corporations Act 2001*); or
- is a wholesale trust which is wholly-owned directly or indirectly by one or more trusts which satisfy the definition in Subdivision 12-H or by a wholesale trust, as above.

Clearly defined rights

2.23 Chapter 5 outlines the Board's recommended method for determining tax liabilities of beneficiaries of Regime MITs. The method relies on the trustee allocating taxable income between beneficiaries on a basis which is fair and reasonable and consistent with their rights under the trust's constituent documents.[13] This recommendation means that it is vital that there be sufficient certainty for beneficiaries about their rights. Certainty is also required to address any disagreements between the beneficiary, the trustee and the Commissioner of Taxation (Commissioner) about the attributed taxable income.

2.24 The Board was concerned that if a trustee was able to alter the rights of beneficiaries to the income and/or capital of the trust or have unrestricted discretion to determine the beneficiaries' rights to income and capital, there would be insufficient certainty for beneficiaries and the ATO. The Board was also concerned that tax integrity could be undermined if the trust was able to 'stream' certain tax benefits or 'value shift' between beneficiaries.

2.25 One way of addressing these concerns would be to introduce a 'fixed trust' type requirement that would limit the discretions of the trustee of a Regime MIT. However, the Board was also aware that trustees of commercially traded and externally regulated (e.g. by ASIC) trusts need discretions in order to act responsibly as trustee, in the best interests of the beneficiaries as a whole. They require discretion in order to determine the assets in which to invest and to be able to respond appropriately to changing economic circumstances. For example, decisions such as whether and on what basis to

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13 See Recommendation 19.

issue additional units, how to fairly allocate income to a large redeeming unit holder or decisions about freezing redemptions need to be able to reflect the commercial environment and not be limited by the taxation regime to any significant degree.

2.26 Accordingly, the Board was concerned that imposing specific restrictions on particular types of discretions or powers available to the trustee of an MIT under the constituent documents would inappropriately exclude some MITs from accessing the proposed attribution rules and other specific recommendations.

2.27 The Board was also aware that the exercise of discretions by such trustees would in many cases be governed by the *Corporations Act 2001* requirements to act equally as between beneficiaries of the one class and fairly between classes of beneficiaries.[14] The principles of the attribution method also require the trustee to act fairly and in accordance with the 'constituent documents'[15] of the trust.

2.28 Accordingly, the Board considers that the most appropriate balance between allowing access to the attribution rules and other measures and maintaining certainty and integrity is to introduce a requirement that, in order to qualify as a Regime MIT, the beneficiaries' rights to income, including the character of the income, and capital must be clearly established at all times in the trust's 'constituent documents'. The rights should only be able to be changed by a change in the trust's 'constituent documents'. This, coupled with the integrity measures referred to below, should ensure that the rights, although established in the 'constituent documents', cannot be defeated during an income year by the exercise of certain types of discretion provided to the trustee. The rule is needed in order to ensure that the Commissioner and beneficiaries will have sufficient certainty to determine whether the attribution of taxable income is fair and reasonable and consistent with the beneficiaries' rights under the trust's 'constituent documents'. The Board notes that a change to a trust's 'constituent documents' may give rise to a CGT event.

2.29 As a further integrity measure, the Board considers that all Regime MITs should under the tax legislation, be subject to provisions akin to those in the *Corporations Act 2001* which specify the circumstances under which the constitution may be amended and prescribe rules the trustee must follow when dealing with beneficiaries.

2.30 As with all qualification rules, a trust would need to continuously qualify in order to be a Regime MIT.

2.31 The Board has also proposed that a specific anti-streaming rule be introduced to address concerns it has in relation to the application of the attribution model for

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14 Section 601FC(1)(d).

15 For the purposes of the Board's recommendations, 'constituent documents' means all documents or instruments that evidence the rights of beneficiaries to income, including the character of the income, and capital. They could include the trust deed, product disclosure statements, and minutes specifying terms of issue of units.

determining tax liabilities (see recommendation 21). It considers that such a rule is more appropriate than imposing restrictions on the powers and discretions of trustees which may unfairly prohibit MITs from benefiting from the attribution rules and other recommendations, or restrict reasonable commercial decisions.

Recommendation 3

The Board recommends that a trust will satisfy the 'clearly defined entitlements' requirement if the beneficiaries' rights to income (including the character of income) and capital are clearly established at all times in the trust's 'constituent documents'. The rights should only be able to be changed by a change in the trust's 'constituent documents'.

The Board also recommends that provisions akin to the *Corporations Act* requirements in sections 601FC and 601GC which specify the circumstances under which the constitution may be amended and prescribe rules the trustee must follow when dealing with beneficiaries, should be incorporated within the taxation legislation applying to Regime MITs.

Uniformity of rights

Views in submissions

2.32 All submissions which addressed the issue of whether rights in an MIT should be uniform in order to fall within the new regime, argued against the proposition. Submissions argued that requiring uniformity of rights would create uncertainty and compliance problems as well as hindering the development of the MIT industry.

2.33 The submission from the Taxation Institute of Australia noted:

> … There are a significant variety of managed investment trusts currently on offer that provide different classes of units to meet different commercial requirements. Often, for example, differential fees between wholesale, mezzanine and retail unitholders are necessary to reflect the costs associated with those types of unitholders. This necessitates different classes of units to reflect those different fees and subsequent interests in the underlying assets that a unitholder will benefit from. Further as greater sophistication is achievable in the system design supporting MITs, it will be possible that a greater number of trusts will allow for differential asset election within a single trust. This will necessitate differential unit classes. There is no fundamental integrity issue that should necessitate uniformity of the interest in order for a trust to qualify for an MIT regime…

Board's consideration

2.34 The initial question of whether rights in an MIT should be uniform was based on the consideration that a single class of units would have allowed for the development

of a simple regime for allocating tax liabilities between beneficiaries. While this may be true, feedback from stakeholders and written submissions have confirmed to the Board that requiring a single class of units would ignore the commercial reality for many MITs where multiple classes are seen as necessary to attract investment in units.

2.35 The Board recognises that substantial compliance costs and other taxation consequences would be faced by many existing MITs if they were required to restructure to a single class of units in order to benefit from the new regime. At the same time, the Board recognises that maintaining a structure with multiple classes of unit holders does, and will continue to, impose compliance costs on MITs when making distributions. However, this reflects a decision by the MIT made against the background of the commercial operation of the industry.

2.36 The Board considers that the MIT regime should not hinder genuine commercial decisions by MITs to issue different classes of units. Accordingly, the Board recommends that the rights in an MIT should not have to be uniform in order to qualify for the MIT regime.

Recommendation 4

The Board recommends that there be no requirement that the rights in a trust be uniform in order to be a Regime MIT.

Carve-out for investor directed portfolio services and similar bare trust type arrangements

2.37 In its discussion paper, the Board requested stakeholder comment on whether it would be appropriate to carve out certain arrangements from the scope of an MIT regime, for example investor directed portfolio services (IDPS) and similar arrangements where investors have an absolute entitlement to specific assets.

Views in submissions

2.38 All submissions which addressed the issue supported a carve-out for bare trusts, IDPS and custodian arrangements, noting that these types of arrangements differ markedly from commercially managed funds.

2.39 As the submission from IFSA notes:

> 11.55 The beneficiaries of an MIT have rights in respect of the pool of assets as a whole but have very limited rights in respect of any particular asset on its own. The beneficiaries share, on a periodic basis, the net income that the assets generate. They have very limited rights in respect of any particular gross income.

> 11.56 The IDPS operator provides a service to its clients which is to acquire and hold specific investment assets that the clients have selected from a menu. These investment assets are typically units in MITs but can also be direct shares…
>
> 11.57 The service provider takes legal title to the investment assets because this allows it to perform its tasks in the most efficient way. The client maintains control of the investment assets it has chosen. They have almost unlimited rights to deal with those assets as they choose. They have almost unlimited rights to exactly the income that their chosen investment assets generate. No more and no less. Their right is to the gross income although at the same time they are committing to pay certain fees and the IDPS operator has a right to divert that income to meet these obligations.

Board's consideration

2.40 The Board considers that IDPS and similar 'bare trust' type arrangements are sufficiently different from modern managed funds that they should be subject to different taxation arrangements. Accordingly, the Board considers that IDPS and other similar 'bare trust' arrangements should specifically be excluded from the MIT regime.

Recommendation 5

The Board recommends that IDPS and similar 'bare trust' type arrangements not qualify as Regime MITs.

No separate taxation regime for REITs

Views in submissions

2.41 Most stakeholders who commented on the issue had the view that while a separate REIT regime may have some limited benefits in attracting offshore investors because the term REIT is internationally recognised, the issues affecting REITs could be addressed in a regime applying to MITs generally.

2.42 The Property Council of Australia advocated the development of an effective tax flow-through regime for MITs as a means of facilitating the growth of the REIT industry:

> We strongly support the 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 the Government's commitment.

2.43 The submission from BDO Kendalls noted the additional complexity that a separate REIT regime would create:

> Establishment of a separate REIT regime would also create an additional structure for stakeholders to grapple with, which would if anything increase complexity associated with the taxation and regulatory regime affecting CIVs…

Board's consideration

2.44 The Board considers that any property-specific issues can be addressed within the new MIT regime. A separate REIT regime would add cost, complexity and administrative difficulties that would not be outweighed by the limited potential benefits such as market recognition and property-specific tax rules of such a regime. As a result, the Board does not recommend a separate REIT regime.

Recommendation 6

The Board recommends that there should be no separate REIT regime.

CHAPTER 3: DEFINING PRIMARILY PASSIVE INVESTMENTS

3.1 The terms of reference asked the Board to review the current income tax arrangements applying to managed funds that operate as MITs, that is managed funds that are widely held collective investment vehicles undertaking *primarily passive investments* (emphasis added).

3.2 The Board was also asked to examine potential reforms to the eligible investment business (EIB) rules in Division 6C of the ITAA 1936 that, while not compromising the integrity of the corporate revenue tax base, would enhance the international competitiveness of Australia's REITs and the capacity of Australia's MITs to attract funds under management from other countries.

3.3 One of the key policy principles included in the terms of reference also stresses the passive nature of investments to be undertaken by MITs subject to flow-through taxation (as distinct from company taxation):

> 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.

3.4 A key issue for the Board therefore was to consider what investments are consistent with characterising MIT activities as 'primarily passive investment' against the competitiveness of the industry and the need to ensure integrity in the corporate tax base.

THE SUPERANNUATION FUND RULE

3.5 Division 6C currently has a look-through provision that results in certain non-widely held trusts becoming public unit trusts that must comply with the EIB rules or be taxed like companies. This occurs when one or more persons or bodies which are exempt from income tax (the definition includes complying superannuation funds) own 20 per cent or more of the beneficial interests in the trust.

3.6 As noted in the discussion paper, a particular concern at the time the rule was introduced was that superannuation funds preferred to invest through unit trusts rather than companies as they originally did not benefit from the imputation system, so

that the corporate tax system remained a classical system so far as they were concerned. However, this concern appears to have been addressed in 1988 when superannuation funds were made taxable and became able to access imputation credits. The introduction of dividend imputation that provides resident shareholders with a tax credit for company tax paid removed some, but not all, of the tax advantages arising through the use of trusts. An advantage still exists in the trust form for those tax exempt investors not able to access refunds of imputation credits.

Views in submissions

3.7 All submissions commenting on this topic supported removing superannuation funds from the application of the rule. The submissions noted that since superannuation funds became tax paying entities able to access franking credits, the application of the rule to them was unnecessary.

3.8 Submissions also noted that removing the rule would reduce compliance costs. It would avoid the need for a non-widely held unit trust to monitor its register of unit holders to determine whether entities that hold units are tax exempt entities. It would also be fairer, as other unit holders in the unit trust would not suffer the consequences of a change in taxation treatment of the income of the unit trust if, say, an unrelated complying superannuation fund subsequently acquired 20 per cent or more interest in the unit trust. As noted by BDO Kendalls:

> This rule is no longer appropriate. Its continued operation brings about unfair implications to the relevant unit trust which must monitor its register of unit holders to determine whether entities that hold units are acting for complying superannuation funds. It is also unfair for other unit holders in the unit trust who suffer the consequences of a change in taxation treatment of the income of the unit trust if complying superannuation funds subsequently acquire interests in the unit trust totalling 20 per cent or more, notwithstanding that the complying superannuation funds may be completely unrelated to the other unit holders.

Board's consideration

3.9 As superannuation funds are tax paying entities able to access refundable franking credits and many tax exempt entities are entitled to refunds of imputation credits, the policy rationale for bringing them within the rule (addressing the potential preference for trusts over companies as tax exempt entities) no longer exists.

3.10 There is still an incentive to invest through a trust over a company for the types of tax exempt entities that are not entitled to a refund of their franking credits. Accordingly, the rule should remain applicable only to these entities.

Recommendation 7

The Board recommends that complying superannuation entities and tax exempt entities which are entitled to a refund of franking credits should be excluded from the rule by which, when one or more persons or bodies exempt from income tax own 20 per cent or more of the beneficial interest in a non-widely held trust, it causes the fund to be taken as a public unit trust.

The rule should remain applicable only to tax exempt entities that are not entitled to a refund of franking credits.

PASSIVE INVESTMENT AND THE EIB RULES

3.11 Industry raised concerns with the Board that the existing EIB rules in Division 6C are overly restrictive and unduly impede commercial practice, especially in respect of REITs.

3.12 The current EIB rules define EIB to be investing in land for rent and/or investing or trading in specific financial instruments, including shares in a company and units in a unit trust. Investing or trading in financial instruments (where the instruments themselves derive passive returns such as dividends) is primarily passive investment for the purpose of the EIB rules.

3.13 Interim changes to the EIB rules were made in the *Tax Laws Amendment (2008 Measures No.5) Act 2008*. These changes involved:

- clarifying the scope and meaning of investment in land for the purpose of deriving rent;
- providing a 25 per cent safe-harbour allowance for non-rental income (excluding capital gains) from investments in land;
- expanding the range of financial instruments included in the definition of eligible investment business that a trust may invest in or trade; and
- providing a 2 per cent safe harbour allowance at the whole-of-trust level for non-EIB income.

3.14 As noted in the discussion paper, the 2008 interim changes to the EIB rules provided that non-rental income is within the scope of the 25 per cent safe harbour for property income, provided it is not income from the carrying-on of a business that is not incidental and relevant to the renting of land.

Views in submissions

3.15 Submissions expressed support for more flexible EIB rules beyond those included in the 2008 amendments. Submissions supported both an expanded definition of qualifying eligible activities and an allowance for trusts to earn a 'minor' amount of income from non-eligible trading activities on a commercial basis without losing trust taxation. It was argued that more flexible EIB rules would enhance the international competitiveness of Australia's REITs. As noted by Ernst & Young:

> The Division 6C rules are complex and their potential application is problematic. They impede Australian superannuation funds' and managed funds' participation in infrastructure investment and global investment. The rules also restrict the ability of Australian funds to attract international capital.

3.16 Some submissions suggested that the EIB rules should include all forms of returns on investments, including any income accruing to the owner of the land from managing the land to its own advantage, with the exception of trading in land and undertaking land development for resale. As noted by Greenwoods & Freehills:

> More generally, it may be preferable to frame a test for eligible investment business using the kind of approach taken in defining 'personal services income' in Division 84 ITAA 1997… An MIT would be allowed to earn any type of income or gain which it earned from owning the land. The idea would be to distinguish income it derives from owning and exploiting its land on the one hand, from income which it might derive from selling the land (ie, development) or from selling goods or services on the land.

3.17 As an alternative to an expanded list of EIB rules, some submissions have supported using a 'black list' approach of prohibited activities that are to be taken *not* to be EIB. It has been suggested by these submissions that this approach, coupled with a 'ring fencing' provision, would provide greater certainty and flexibility compared to the current test. As noted by Deloitte:

> Section 102M should be amended so that an MIT is deemed to carry on an eligible investment business, unless it carries on activities that are 'ineligible'. This, coupled with a ring fencing provision, would provide greater certainty and flexibility compared with the current test.

Board's consideration

3.18 The issue before the Board was to weigh up the requirement that the MIT regime be limited to trusts undertaking activity that is primarily passive investment, against improving the ability of Australian MITs (including REITs) to compete in the international market and the need to maintain integrity.

3.19 It is the Board's view that, from a tax integrity perspective, it is preferable to have a clearly defined description of passive investment activities, rather than attempting to compile a list of what would be considered not to be eligible activities. To do so raises

the risk of omitting other non-eligible activities, particularly as, over time, the types of activities available as investments can change and expand.

3.20 At the same time, it is the Board's view in connection with REITs that clarification should be provided on the type of active business activities that may occur on real property but would not qualify as passive investments. A more clearly defined set of rules should assist in reducing compliance costs.

3.21 The Board considers that the international competitiveness of Australia's REITs can be improved while maintaining 'passive investments', by allowing within the EIB rules the inclusion of income from licenses and other rights to use real property, and from the provision of services that are incidental to the earning of rent from investments in real property. For the same reason, it also considers it appropriate to include some scope for the trust to derive a 'minor' (10 per cent) amount of income from non-eligible activities without losing trust taxation. This set of rules would provide an enhanced flexibility compared to that provided under the 2008 interim changes to the EIB rules.

3.22 Accordingly, the Board considers that the EIB rules should be amended to permit an MIT to be subject to trust taxation if at least 90 per cent of its gross revenue is income from passive investments. The test will allow an MIT to derive up to 10 per cent of its gross revenue from non-eligible activities.

3.23 The Board considers that, for the purpose of this EIB test, passive investment means:

- investment in real property (and movable property incidental to the investment in real property) to derive rent income and/or other passive (or non-trading) income. Passive (or non-trading) income includes:
  - income from the provision of services incidental to the earning of rent from the investment in real property. For example, parking fees, utilities, common security services provided in rental properties to lessees; and
  - income from licenses and other rights to use real property (other than hotel room and similar accommodation, such as serviced apartments) that is not associated with the sale or provision of facilities, goods or services;
- investing and/or trading in:
  - financial instruments that arise under financial arrangements (but, subject to the existing carve-outs under the 2008 interim amendments to Division 6C, for example, car leases); and/or
  - shares in a company and units in a unit trust.

3.24 Examples of non-eligible activities would include:

- sales of goods or services or provision of facilities on the real property (such as childcare services or toll road fees);
- the sale or disposal of real property (or of a long-term lease of real property) that has been acquired for development, re-sale or disposal; and
- profit/turnover rents applied to associates — those designed to convert business profits into rent or other non-trading income from real property.

3.25 Given the approach of a positive list, the Board considers that modifying the current provisions of Division 6C will allow an expanded definition of 'passive' while operating within a framework that is already known to taxpayers. This definition should replace the existing EIB rules.

Recommendation 8

The Board recommends that MITs be considered to be undertaking primarily passive investment if they carry on an eligible investment business (EIB) as defined.

An MIT will be treated as carrying on an EIB if at least 90 per cent of its gross revenue is income from passive investments.

For the purpose of this EIB test, passive investment means:

- investment in real property (and movable property incidental to the investment in real property) to derive rent income and/or other passive (or non-trading) income. Passive (or non-trading) income includes:
  - income from the provision of services incidental to the earning of rent from the investment in real property. For example, parking fees, utilities, and common security services provided in rental properties to lessees; and
  - income from licenses and other rights to use real property, (other than hotel room and similar accommodation, such as serviced apartments) that is not associated with the sale or provision of facilities, goods or services;
- investing and/or trading in:
  - financial instruments that arise under financial arrangements (but, subject to the existing carve-outs as per the 2008 interim amendments to Division 6C, for example, car leases); and/or
  - shares in a company and units in a unit trust.

THE CONTROL TEST

3.26 Under Division 6C, to maintain trust taxation a managed fund that is a public unit trust is not able to carry on a trading business (which is defined to mean a business that does not consist wholly of EIB activities) or control (directly or indirectly, or be able to control) another person or entity in its carrying on of a trading business. This includes owning a controlling interest in a domestic or foreign trading company. The control test was introduced to avoid the circumvention of the tax law by preventing active trading businesses operating through a controlled entity and so undermining the integrity of the corporate tax base.

Views in submissions

3.27 Most submissions supported abolishing the control test, with Deloitte requesting that the Board determine the reasons, if any, for retaining it as an integrity rule. Others note that if a control test is to remain, its meaning should be clearly defined in legislation and there should be a 'water edge' limit, that is, control of foreign entities that carry on trading activities should not cause the Australian trust to become a trading trust.

3.28 Some submissions have noted that having an arm's length test is preferable to a requirement that would limit investments in entities carrying on trading businesses to a particular percentage. As noted by Greenwoods & Freehills:

> Furthermore, we can see no justification for the continued prohibition on controlling a company which undertakes a trading business. Offering the equivalent of the US 'taxable REIT subsidiary' regime seems a most suitable method for achieving the kinds of outcomes that Division 6C is directed towards. It may be appropriate to buttress such a regime with an arm's length rule for prices of transactions occurring between the MIT and its taxable subsidiary to prevent profit shifting into the trust. We submit that an arm's length test is preferable to a requirement which limited investments in entities carrying on a trading business to a particular percentage.

Board's consideration

Stapled arrangements, top hat structures and the control test

3.29 The Board understands that the current control test was originally designed to prevent trusts from being able to control, directly or indirectly, an entity which carries on a trading business. The Board further understands that in response to these rules, industry developed stapled structures (that is, a company which carries on a trading activity that has its shares 'stapled' to units in a trust which carries on EIB, where the ownership interests are not separately tradable). Stapled structures have been operating for many years.

3.30 In 2007, Division 6C was amended to allow a stapled group of entities to restructure with an interposed head trust inserted (‘top hat’ structure), without the interposed head trust being taxed like a company merely because of its control of the active businesses of the formerly stapled entities.

3.31 The Board understands these amendments were made to enable Australian-listed property trusts to restructure into a single entity and improve their capacity to acquire property and property holding entities offshore. The Board gave lengthy consideration to the extent to which activities conducted using this structure could be considered ‘passive’. As a broad principle, the Board was concerned that if there were no limit on the size of the trading activities carried out by the company or companies within a top hat structure, when compared to the size of the overall activities of the trust, it could be difficult to characterise the activities of the trust as being ‘primarily passive’ within the scope of its terms of reference.

3.32 The Board also considered that even though the controlled entity carrying out trading activities might be subject to company taxation, there was a potential for the controlling trust to extract value from the controlled entity and distribute it to beneficiaries, including as tax deferred distributions (for example through borrowings against the increased asset value of the controlled entity) which would be a tax advantage compared to the equivalent distribution of non-franked dividends made by a holding company.

3.33 Accordingly, in reviewing the current Division 6C the Board initially considered recommending a limit on the size of the trading activities which could be carried out by the company or companies in a top hat or stapled structure, relative to the size of the activities of the MIT, in order for the trust to retain trust taxation.

3.34 However, the Board noted arguments that a significant segment of the industry would not be able to comply with a new test that limited the ratio of active trading activities conducted by a controlled entity. This may particularly be the case for some REITs and some funds that operate to provide infrastructure.

3.35 The Board also considers that investors who have invested in stapled trusts/top hat structures that currently comply with the EIB rules in Division 6C should not be penalised by a change in taxation arrangements that would subject those trusts to company-like taxation.

3.36 The Board also initially considered recommending these trusts be allowed to retain trust taxation under Division 6 rather than having them subject to company taxation, provided they met the current EIB rules in Division 6C, but preventing them from accessing the ‘new’ EIB rules. However, the Board recognised that this approach would raise some significant issues, including:

- complexity and compliance costs of having, in effect, two MIT regimes; and

- competition policy issues, with trusts in the 'old' EIB regime having a potential competitive advantage over those in the 'new' regime.

3.37 The Board's view is that given that the industry has developed stapling arrangements and now top hat structures with the current control test in place, it is appropriate not to impose a limit on the size of the trading activities carried out by a single wholly-owned taxable subsidiary of the MIT. This will provide structural neutrality between MITs which are part of a stapled arrangement or top hat structure, and those MITs which structure with a taxable subsidiary.

3.38 As noted in the Board's discussion paper, in 2007 Division 6C was amended to allow a public unit trust to acquire a controlling interest in, or control, foreign entities whose principal business consists of investing in land outside Australia for the purpose, or primarily for the purpose, of deriving rent.

3.39 The Board considers that a wholly-owned taxable subsidiary should be an additional exception to the current control test. Other than this additional exception the Board considers that the test should remain unchanged.

3.40 The Board considers that in the absence of any change to the current stapling and top hatting rules, limiting the exception to the control test to a single 100 per cent owned taxable subsidiary is a trade-off between recognising the practical effect of the top hat provisions and preventing unrestricted opportunities for corporates to restructure to take advantage of flow-through trust taxation.

3.41 However, limiting the exception to a single wholly-owned taxable subsidiary may impose unjustified restrictions on the commercial decisions of MITs. The Board recommends that this issue be considered by the recommended post-implementation review.

Arm's length dealing

3.42 In light of the flexible approach to the control test proposed by the Board, the Board considers that an integrity measure aimed at avoiding the circumvention of the EIB rules and protecting the corporate tax base is needed. The Board recommends that arm's length dealing rules should apply to transactions between common interests or related interests of an MIT, including but not limited to subsidiaries and stapled entities.

Recommendation 9

The Board supports retaining the control test in its current form with the addition of an exception for a single wholly-owned taxable subsidiary.

The Board recommends that trust taxation be retained if an MIT owns directly, or through a chain of entities, 100 per-cent of the ownership interests in a single taxable subsidiary company.

The Board recommends that consideration be given by a post-implementation review to allowing MITs to have any number of taxable wholly-owned subsidiaries engaging in active business.

Recommendation 10

The Board recommends that arm's length rules should apply to transactions between common interests or related interests of an MIT, including but not limited to subsidiaries and stapled entities.

SCOPE OF THE REVISED DIVISION 6C RULES

Board's consideration

3.43 The Board considers that the amended Division 6C rules should apply to all widely held MITs and other public unit trusts.

Recommendation 11

The Board recommends that revised Division 6C rules should apply to all widely held MITs and other public unit trusts.

Consequences of non-compliance with the revised Division 6C rules

Views in submissions

3.44 Most submissions support a minimum threshold for non-EIB activities and that only income from the non-qualifying activities of the trust (or 'tainted' income) should be subject to company-style taxation. Submissions postulate that when the threshold is exceeded, only the tainted income be taxed in a similar manner to company income. Some submissions also support franking credits being available to beneficiaries in respect of the tax paid on the 'tainted' income.

3.45 Submissions commenting on this issue recognise that dealing with the 'tainted' income would require apportionment and allocation rules for income, expenses and other attributes, implying a degree of complexity. As noted by Greenwoods & Freehills:

> We agree with the implication in the Paper that the consequence of breaching the eligible investment rules should be to impose tax on the tainted income. This will obviously require apportionment and allocation rules for income, expenses and other tax attributes, but again this complexity seems an acceptable price to pay for being able to limit the consequences of breaching the rules to just paying tax on the tainted income.

Board's consideration

3.46 While there is some argument for only subjecting the non-eligible part of the income to company taxation, the Board considers that this would create an unacceptable degree of complexity and would not act as a sufficient disincentive for widely held trusts from undertaking active business activity. Taxing non-eligible income at the corporate rate and providing franking credits for that taxed income is arguably little disincentive, as it allows the trust to maintain and pass through the tax advantages of trust taxation, such as the CGT discount and the payment of tax deferred amounts.

3.47 The Board's recommendation No 8 that will provide more flexibility around the EIB rules and provide for a 10 per cent 'safe harbour' reduces the potential for MITs to breach the EIB rules.

3.48 The Board therefore considers that if a widely held MIT or other public unit trust does not satisfy the eligible investment business test in Division 6C, then the whole of the trust income for the year should be assessable to the trustee at the corporate tax rate.

Recommendation 12

The Board recommends that if a widely held MIT or other public unit trust does not satisfy the eligible investment business test in Division 6C the whole of the trust's taxable income for the year will be assessable to the trustee at the corporate tax rate. The trust would be subject to company-like taxation and it would not qualify to have trust taxation in that year of income.

CHAPTER 4: CAPITAL VERSUS REVENUE ACCOUNT TREATMENT OF GAINS AND LOSSES MADE ON DISPOSAL OF INVESTMENT ASSETS BY MITS

4.1 On 12 May 2009 the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that the Government would implement the Board's interim advice on taxation of managed funds to provide deemed capital account treatment for gains and losses made on disposal of investment assets by MITs, subject to appropriate integrity rules.

4.2 The Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that, where an Australian MIT makes an irrevocable election to apply the capital gains tax (CGT) regime to disposals of eligible assets, resident investors will be entitled to the CGT discount on eligible taxable gains distributed by MITs, and non-resident investors will be exempt from Australian tax on distributions of gains on disposal of eligible MIT assets unless the assets are taxable Australian property.

4.3 The new rules will apply to Australian MITs and to unit trusts that are 100 per cent owned and controlled by MITs that meet the eligible investment business rules in Division 6C. It will not apply to public trading trusts or corporate unit trusts.

4.4 An integrity rule will be included in the measure. If an MIT elects into this CGT regime, the election will be irrevocable and it will also apply to all disposals of eligible investments in the first income year that commences on or after the 2008-09 income year. This will reduce the incentive for MITs to dispose of existing assets and claim deductions for losses on revenue account, before the measure is implemented or an election is made.

4.5 The Assistant Treasurer and Minister for Competition Policy and Consumer Affairs noted that there remain a number of implementation details that needed to be considered which would be canvassed in a Treasury consultation paper. This consultation paper was released by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs on 1 June 2009. As part of this release, the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs asked the Board to bring forward its final advice on the legislative design issues raised in the Treasury discussion paper.

4.6 The Board's interim advice was provided to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs in December 2008 following receipt of

interim submissions on the issue and some stakeholder consultations. A summary of the Board's interim advice and the reasons for it is set out below. The Chapter then contains the Board's final advice on some additional design features of the recommendations, including a number of issues recognised in the Treasury consultation paper of 1 June 2009.

THE BOARD OF TAXATION'S INTERIM ADVICE

4.7 The interim advice recommended that the CGT regime be the primary code (deemed capital account treatment) for gains and losses made on disposal of investment assets held by MITs, subject to appropriate integrity rules. The recommendation was made because the Board considered that the existing approach of applying case law principles in order to determine the character of gains and losses made on the disposal of investment assets by MITs created a material level of complexity and uncertainty for the funds and for certain investors, as well as administrative costs for the ATO.

4.8 One of the considerations underlying the Board's view was that investments made by complying superannuation funds in MITs should receive capital account treatment because this is the treatment complying superannuation funds would have received if they had made the investments in the assets of MITs directly. This is consistent with policy principle 1 of the terms of reference, which requires that the tax treatment for trust beneficiaries who derive income from a trust should largely replicate the tax treatment for taxpayers as if they had derived the income directly. The Board has been informed by the MIT industry that around 70 per cent of funds invested are from superannuation funds. Without capital account treatment for investments made through an MIT, superannuation funds would face an incentive to invest directly which could add to their own compliance costs.

4.9 For non-resident investors, the recommendation means that distributions of gains made on the disposal of investment assets by MITs would not be subject to tax unless the assets are taxable Australian property. This provides certainty for non-resident investors and complements the objective of the 2008 reforms introduced by the Government to the withholding tax regime. It also enhances the capacity of Australia's managed funds industry to attract funds under management from other countries, which is one of the objectives set for the review.

4.10 For non-superannuation resident investors, on capital account, the recommendation provides a tax outcome which is broadly consistent with that which would have been achieved if they had held the investments directly and sought to manage their investment risk. The recommendation acknowledges that MITs provide a means to manage and diversify the risk of individual investors in a manner which would not be possible without the pooling of resources in a professionally managed collective investment vehicle.

4.11 The Board's interim advice noted that there could be some MITs which would prefer to attract revenue treatment for their activities. Acknowledging the need to preserve a variety of fund management options available to the market, the Board recommended that funds be able to elect or opt in to the regime, but once an election is made by a fund, it should be irrevocable.

4.12 The Board noted that further discussion and consultation was required in order to finalise the design features of the recommended option and that its views on these issues would be included in its final report. The issues to be further explored included the definition of an MIT which would be eligible to make the capital account election, the type of MIT investment assets which would be covered, the type of funds or transactions which could be excluded, the type of other collective investment vehicles for which similar considerations to those outlined for MITs could apply and any associated transitional and integrity considerations. These issues are addressed in the remainder of this chapter.

Making an election

4.13 The Board notes that in instances where an MIT does not elect to apply the CGT regime to its disposals of eligible assets, issues of uncertainty could still arise on the treatment of the proceeds on disposal of these assets. The Board considers that to provide greater certainty and to reduce administrative costs, where an MIT does not elect to apply the CGT regime, the proceeds on disposal of its eligible assets will be deemed to be on revenue account.

ELIGIBLE MITS

4.14 The Board sought stakeholder comments on the design of specific statutory rules providing for capital or revenue account treatment for MITs and whether different considerations should apply for MITs that are private equity funds.

Views in submissions

4.15 Submissions commenting on this issue were supportive of a specific statutory rule providing deemed capital account treatment for all MITs, similar to the current rule for superannuation funds contained in section 295-85 of the ITAA 1997. Ernst & Young argued that the statutory rule should apply to all MIT funds, including property funds, equity funds, private equity funds, wholesale funds and other funds used to collect savings (particularly those used as collectors of superannuation funds' monies). No support was given in submissions for different considerations applying for MITs that are private equity funds. As noted in the submission by IFSA:

> We have demonstrated above the purpose behind the introduction of the CGT discount. There is nothing in that purpose that would justify excluding some MITs from the rule.

> Nor is there anything in that purpose that could be used as a logical basis for that distinction. …
>
> Division 6C or a variation thereof will exclude any fund that carries on a business from the MIT regime so all the funds in the regime will be investors of a type that were targeted by the Review of Business Taxation to benefit from the CGT discount.

The Board's consideration

4.16 For similar reasons to those outlined in Chapter 2, the Board considers that all widely held MITs as defined in Recommendation 2 that meet the proposed new eligible investment business rules should be eligible to make the capital account election.

Recommendation 13

The Board recommends that widely held MITs as defined in Recommendation 2 that meet the proposed new eligible investment business rules be eligible to make the irrevocable election to apply the CGT regime to disposals of its eligible assets. Where an MIT does not elect to apply the CGT regime, proceeds from the disposals of its eligible assets will be deemed to be on revenue account.

Type of investment assets

Views in submissions

4.17 Most submissions supported a statutory rule similar to the rule applied currently to superannuation funds (section 295-85 of the ITAA 1997, which covers certain assets held by complying superannuation fund, with a general carve-out for financial instruments such as bonds, debentures, loans and other securities). A number noted that the superannuation rule is well understood, simple and easy to apply. As noted in its interim submission:

> … 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 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.

Board's consideration

4.18 The Board considers that adopting the current provisions that apply to superannuation funds, which would include certain carve-outs, will significantly increase certainty and decrease complexity for MITs as the operation of the current provisions is widely understood and able to be applied in practice. There was some consideration by the Board about the appropriate treatment of hedges, given concern that hedges may not be given the same taxation treatment as the underlying asset under the superannuation provisions. Treasury has advised the Board that the current provisions of the tax law, in particular the amendments made by the *Tax Law Amendments (Taxation of Financial Arrangements) Act 2009*, facilitate character matching (and therefore capital account treatment for hedges of hedged items that are on capital account) where the requirements of the tax hedging rules are met. The Board considers that hedges should have the same taxation treatment as the underlying assets.

4.19 The recommended approach will also exclude certain financial instruments from the deemed capital account treatment (as is currently the position under the superannuation provisions).

4.20 The Board considered how this rule would apply to eligible MITs that may be subject to taxation under Division 230. The Board was advised by Treasury that where a fair value or financial reports election under that Division applies to an MIT, then their gains and losses are brought to account and taxed in accordance with that Division.

Recommendation 14

The Board recommends that:

- a rule in similar terms to the superannuation fund capital account rule be introduced for eligible MITs. The assets covered by the legislative rule would be similar to those covered by section 295-85 of the ITAA 1997; and
- hedges should have the same taxation treatment as the underlying assets.

Type of funds or transactions which could be excluded

Views in submission

4.21 As noted above, submissions that commented on this topic did not provide support for applying different considerations for MITs that are private equity funds. IFSA noted that the provisions that ensure MITs are not engaged in active business activities would ensure that only MITs that are not carrying on a business are entitled to apply the statutory rule.

Board's consideration

4.22 The Board considered whether certain private equity trusts that follow the 'plan add value and exit' model should be carved out. This refers to the case where a trust acquires an asset with the intention at the time of acquisition (on the part of the trustee or associate) of seeking to add value to the asset and to realise that value by sale of the asset. The Board has been informed by stakeholders that superannuation funds are a major class of investors in these type of trusts and, in view of the objective that investments made by investors, including superannuation funds, indirectly through an eligible MIT should receive the same treatment as if they had made the investments directly, the Board concluded that no carve-out should be applied for private equity trusts.

4.23 The Board also considered whether hedge funds should be carved out, noting that they are more likely to be carrying on a business of trading/dealing in equities and financial instruments and on that basis should be on revenue account. The Board concluded that in terms of legislative design, it may be very difficult to define a 'hedge fund'. An ill-defined carve-out would add complexity. Further, the Board noted that if these funds were to trade in qualifying assets on a significant scale, it would only be in limited circumstances that these assets would be held for a sufficient period (more than one year) to benefit from the CGT discount. Moreover, the Board understands that hedge funds are generally self-assessing their profits as being on revenue account, which allows them to offset losses against other income. In view of these considerations the Board concluded that no carve out was appropriate for hedge funds.

Recommendation 15

The Board recommends that no general carve-out from the application of the recommended capital treatment be applicable to private equity or hedge funds.

Carried interests

4.24 In addition to the recommendations applying to eligible MITs, the Board considers that the current treatment of 'carried interests' should be put beyond argument. The Board understands that 'carried interest' is a share of the profits of the trust, paid to employees of the manager of the trust (or their associated entities) as an incentive and reward for their services and which is paid as a distribution of capital gains on a 'special' or 'preferred' unit.

4.25 The Board's view is that a carried interest is not in substance a return on an investment. The carried interest recipient pays nothing, or only a nominal sum, for the special unit. To the extent that even a nominal sum is paid in return for the issue of the unit, payment of that sum may be postponed so long as the trust is solvent. The carried interest unit holder does not put contributed capital at risk. The term 'carried interest'

is widely understood by industry, and is capable of being statutorily defined for the purpose of this measure.

4.26 The Board considers that carried interest should be treated as ordinary income of the private equity fund manager or its associates which hold the special or preferred units which provide such a return. The Board also considers that any gains or losses made on the disposal of such special or preferred units should be treated on revenue account. This recommendation will not affect the capital gains tax outcomes at the MIT level.

Recommendation 16

The Board recommends that legislation be introduced to provide that any gains or losses made on the disposal of the units held by the manager of a private equity fund manager (or its employees or associates) entitling the holder to be paid 'carried interests' are treated on revenue account. The legislation should also provide that any distributions of 'carried interest' are to be treated as ordinary income of the unit holders.

OTHER COLLECTIVE INVESTMENT VEHICLES

Views in submissions

4.27 All submissions commenting on this issue supported extending the recommended capital account treatment for MITs to listed investment companies (LICs), in view of their similarity of collective investment function with MITs. As noted by the Institute of Chartered Accountants of Australia in its submission[16]:

> In the interest of creating a level playing field, statutory capital account treatment should be extended to other collective investment vehicles (including LICs) which would benefit from certainty in the same way as MITs.

Board's consideration

4.28 The Board noted that LICs are similar to eligible MITs, in that their collective investment activities and ability to pass on the CGT discount are also restricted under the tax law. For a company to qualify as a LIC, for the purposes of subdivision 115-D of the ITAA 1997, at least 90 per cent of the market value of its CGT assets must consist of 'permitted investments'. In addition, a LIC cannot own more than 10 per cent of another company or trust except where it is another LIC. The definition of 'permitted investments' (subsection 115-290(4)) is broadly similar to the 'eligible investments

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16 At page 6.

business' test in Division 6C of the ITAA 1936, except that trading in financial assets on revenue account is not a 'permitted investment'.

4.29 The Board considered that given the similarity in investment restrictions between LICs and eligible MITs and that arguably they compete for the same investor dollar, particularly from individuals, it would be reasonable for their tax treatment to be the same.

Recommendation 17

The Board recommends that consideration be given to extending any capital account treatment provided to eligible MITs to LICs.

TRANSITIONAL AND INTEGRITY CONSIDERATIONS

Views in submissions

4.30 Some submissions contained suggestions on associated transitional and integrity considerations. The Property Council of Australia and Greenwoods & Freehills proposed that the new regime should apply to all CGT events occurring after commencement date, but with the option for the trustee to make an irrevocable election as to which assets (or classes of assets) held at that date are to be treated as being held on revenue account. Ernst & Young proposed that the new rules should apply optionally from the 2008-09 income year and earlier and mandatorily from the 2009-10 year in the absence of an op-out election to be treated on revenue account. Deloitte supports an irrevocable election, made by a certain date and subject to the MIT having consistently treated its gains in the same manner as losses of the same class over the last four years. The Corporate Tax Association supports ruling out prior year amendments. As noted by Corporate Tax Association:

> In the CTA's submission re-opening prior years would be neither practical nor fair, given that (in our view) it is more appropriate to look at the investment from the perspective of the individual or fund making the investment in the MIT. That is the only way in which the overriding efficiency objective of policy principle 1 can be achieved. For all these reasons, the government should provide certainty for both the taxpayers and the ATO by ruling out prior year amendments.

Board's consideration

4.31 As noted in the interim advice, the Board considers that as part of the design of a legislative solution, consideration should be given to a legislative prohibition on amending previous years' assessments which relate to the characterisation of gains and losses made on disposal of the specified investment assets that will be covered under any new legislation. Without such a provision, the ATO would be required to make

amendments to previous assessments based on its view of the law at the relevant time. Given the flow-through nature of trusts, this would in turn require amendment of assessments of many investors.

4.32 The Board considers that such a rule is needed to reduce complexity and assist in achieving consistent treatment of taxpayers. If legislative changes operate purely prospectively, it is likely that some taxpayers will have adjustments made by the ATO to their assessments for prior years while others will not. This will result in differing treatment of taxpayers in similar situations. It would also mean that some taxpayers may seek to amend prior year's tax returns in order to re-characterise gains and losses as being on revenue or capital account.

4.33 For integrity reasons, the Board does not recommend that eligible MITs be able to elect that certain asset classes be treated on revenue account.

Recommendation 18

The Board recommends that:

- A legislative prohibition on amending previous years' assessments which relate to the characterisation of gains and losses made on the disposal of eligible MIT assets should be introduced as part of the new legislative rule.
  - The prohibition will apply to amendments by either the eligible MITs that elect capital treatment or by the Commissioner of Taxation.
- Eligible MITs should not be able to elect that certain asset classes be treated on revenue account.

CHAPTER 5: DETERMINING TAX LIABILITIES

5.1 The Board's discussion paper outlined some of the numerous uncertainties and problems which trusts may face in attempting to apply the current trust taxation rules in Division 6 to determine the taxation liabilities of beneficiaries and trustees. Uncertainty as to the meaning of key terms in the legislation such as 'income of the trust', 'share of the income of the trust' and 'present entitlement' were highlighted as major areas of concern.

5.2 In providing advice on options for introducing a specific taxation regime for MITs, the terms of reference asked the Board to explore, among other things, alternatives to the current taxation treatments for trusts which provide broadly similar taxation outcomes, having regard to the costs and benefits of those options.

5.3 In the discussion paper, the Board requested stakeholder comment on three high-level Options for determining tax liabilities. All models focused on providing greater certainty around taxation liabilities to trustees, beneficiaries and the ATO. Submissions were sought on whether the models would improve certainty and whether the alternative models were workable given common practices in the industry.

5.4 A level of uncertainty and complexity for trustees and beneficiaries results from the complexity of some of the trust structures which MITs choose to adopt. There is, therefore, a trade-off between adopting a particular structure which meets a range of commercial objectives and achieving a less complex and more certain regime. The Board's approach has been to seek to minimise any added complexity and uncertainty imposed by the taxation system.

5.5 The three Options discussed were:

Option 1 the trustee assessment and deduction model. The trustee could be assessed on the net income after allowing a deduction for certain distributions made to beneficiaries;

Option 2 the trustee exemption model. The trustee is exempt from taxation and instead tax on the net income of the trust is always assessable to the beneficiaries, irrespective of the level of actual distributions made to them; and

Option 3 exemption provided that a minimal level of distribution is made each year. The trustee is exempt from taxation and instead tax on the net income of

the trust is always assessable to beneficiaries provided a substantial minimal level of annual distributions is made within a specified period.

5.6 Stakeholders were also asked to comment on an alternative proposal that the current Division 6 be retained with modification to overcome the current issues with its operation (referred to as the 'patch model').

OPTIONS FOR DETERMINING TAX LIABILITIES

Views in submissions

5.7 Some submissions considered that all the options were potentially workable. The Property Council, for example, argued that 'because the Options are not fully articulated, any of the models could be made to accomplish the appropriate outcomes'.

Option 1

5.8 Other submissions identified particular issues with Option 1 which reduced its attractiveness as a preferred model including:

- a deduction-based model would create significant pressure for cash distributions to occur which would interfere with the factors that should drive decisions about retaining or distributing cash and the level of distribution;
- the need for it to be substantially elaborated to ensure that it achieves the desired outcomes for an MIT regime, and deals with and prevents the unwelcome consequences of cash distributions and taxable income being only tenuously connected;
- resolving the tension between tax equivalence[17] and minimising the different types of distribution to be identified; and
- a potential increase in tax paid by non-residents (compared to the current withholding tax regime).

5.9 For example, BDO Kendalls argues:

> Under Option 1, where the trustee is assessable on all net income but receives a deduction for distributions made to beneficiaries, there could be a number of complications in determining which distributions would result in tax deductions and which would not. More often than not an MIT may make distributions in excess of its net taxable income. Will the excess result in a tax loss for the trustee and if not, would this

17 Meaning the tax position that the beneficiary would have been in if they had derived the income directly.

> result in inequitable treatment for future beneficiaries? What if the trust is in a net loss position but makes distributions to the beneficiaries, will the distribution be subject to a deduction? These are some examples of the uncertainties that any new regime would have to consider. Where there are complex rules required to determine the extent or eligibility to a deduction for distributions this is likely to produce even greater uncertainty…

Option 2

5.10 The majority of submissions were in favour of Option 2, referred to in the discussion paper as the trustee exemption model. Reasons provided in support of Option 2 included that:

- it does not interfere with commercial decisions about retention or distribution of income;
- it is similar to the existing Division 6 so it is familiar;
- it is in line with the philosophy that the MIT is a conduit investment vehicle for the investor and the investor should bear the tax on the income derived by the trust; and
- a cash distribution requirement would raise funding issues for some funds, particularly where assets are illiquid.

5.11 For example, the submission from Greenwoods & Freehills argued:

> … Option 2 currently presents a more attractive method of taxing the income of the MITs than Option 1 or Option 3.
>
> Option 1 presents a number of potential difficulties. Option 1 will require cash distributions to occur to avoid tax at the MIT level and this will interfere with what should be commercial decisions about how much of an MIT’s cash to retain or distribute. Option 2 does not raise this difficulty.
>
> Second as the examples in Appendix H show, cash distributions may need to be funded out of borrowings if the MIT has taxable income but no cash to distribute. Again the tax system should not interfere with decisions about how much debt an MIT should carry. Funding distributions out of subscribed capital or retained earnings raises the same issue. Option 2 does not raise this difficulty.
>
> Thirdly, because the connection between cash and taxable income is so tenuous there will need to be a new set of rules to decide what amounts to a distribution, how much it represents and so on, or new rules changing the amount of taxable income.

5.12 Other submissions which showed support for the Division 6 patch model approach, also suggested that Option 2 was a viable alternative model. For example, the submission from Deloitte notes:

> We highlight the administrative advantages with proceeding with a patch approach to Division 6. We highlight that the TEM approach is sufficiently similar to the current approach in Division 6 and may also be one of the easier models to implement…

Option 3

5.13 Only the submission from Taxpayers Australia Inc recommended Option 3 as a preferred model for determining the tax liabilities for MITs and investors, on the basis that:

> … this option aligns the tax consequences of the trust income closer to the trust law outcomes. Furthermore, we support the requirement that distributions be made within a specified period.

5.14 Other submissions dismissed Option 3 outright. For example, the Property Council of Australia argued that 'Option 3 is not an improvement on the current law and should be discarded.'

Patch Model

5.15 A small number of submissions favoured retaining a modified Division 6 on the basis that the issues with Division 6 were known and could be addressed for MITs. For example, BDO Kendalls argued:

> Whilst we recognise that concepts of 'trust income', 'share of trust income' and 'present entitlement' may produce difficulties in relation to certain types of trusts, we believe that most if not all MITs operate under trust deeds which often have features dealing with many of these uncertain issues raised under tax law.
>
> Accordingly we do not believe that any wholesale changes to existing rules in Division 6 are warranted in relation to MITs as they would simply introduce a greater layer of uncertainty and compliance costs to an already complicated system.

Board's consideration

5.16 The Board's assessment of each of the Options is summarised below.

Option 1

5.17 The Board considered that, although a distribution model may have the advantage of apparent equity and simplicity for beneficiaries, as beneficiaries would only be taxable in respect of amounts which have been distributed to them, the problems with the model for MITs outweighed these potential benefits.

5.18 In particular, the Board considered that a distribution model would involve substantial departure from the policy principles for the review, particularly policy principle 1 which requires that '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'. A distribution model would, without substantial modification, require that beneficiaries be assessed on a receipts basis for distributions received. This would be significantly different to the taxation treatment that would apply to beneficiaries if they had derived the income directly.

5.19 Additionally, in order for a distribution model to provide for character flow-through appropriately, it would need to incorporate complex rules to allow MITs to trace the source and character of distributions. It would also require a detailed description of what would constitute a deductible distribution to the trustee.

5.20 Finally, a distribution model would place pressure on the trustee to ensure that cash distributions were made. The Board considers that the taxation model chosen should interfere as little as possible with MITs' commercial decisions (including how much cash it is required to retain or distribute for capital management purposes).

Option 2

5.21 The Board considered that Option 2 has the most advantages of any of the Options canvassed in the discussion paper as it potentially allowed a greater degree of flexibility to MIT trustees and was less complex than some other Options. However, the Board ultimately favoured an attribution model of taxation which encompassed some of the features of Option 2 plus additional elements that the Board considered necessary to achieve the objectives of the review.

Option 3

5.22 Option 3 is similar to Option 2 except that in order for the trustee to be exempt from taxation, a substantial minimum level of distribution would be required. The Board considered that the substantial minimal distribution requirement made Option 3 inferior to Option 2. Although the distribution requirement would potentially assist beneficiaries by providing them with sufficient income to meet any tax liability, the Board was again concerned that this requirement would interfere with the commercial decisions of MITs as to whether or not to make distributions. The Board's preferred position is that market and commercial considerations, rather than the taxation law, should influence the distribution policies of MITs.

Patch Model

5.23 The Board considered there were some advantages to having an amended Division 6 model, such as being able to increase certainty for MITs and investors by addressing known specific issues as well as minimising potential unintended consequences which may arise under a totally new model. A patch model would also

ensure that the taxation outcomes for MITs produced broadly similar outcomes for beneficiaries to the existing Division 6.

5.24 However, the Board considered that developing a Division 6 patch model would not meet the requirements of the terms of reference for reduced complexity, increased certainty and reduced compliance costs to the same extent as the preferred model.

5.25 Accordingly the Board considers that a patch model would not be the best model to promote the development of the MIT industry in Australia.

AN ATTRIBUTION MODEL

5.26 The Board favours an 'attribution model' for determining the tax liabilities in respect of Regime MIT, which incorporates some of the features of Option 2 as described in the Board's discussion paper. The proposed model would produce taxation outcomes for beneficiaries that are broadly consistent with the policy principles outlined in the terms of reference, in particular policy principle 1, while reducing complexity and compliance costs and creating certainty for Regime MITs and their beneficiaries.

5.27 The Board considers that the guiding principles of the model should be:

(a) a beneficiary is assessable on the amount of taxable income of the trust that the trustee allocates to the beneficiary;

(b) the trustee must allocate the taxable income of the trust between beneficiaries on a fair and reasonable basis consistent with their rights under the constituent documents and the duties of the trustee; and

(c) the trustee will be taxed at the highest marginal tax rate on any taxable income which the trustee fails to allocate to beneficiaries within three months of the end of the financial year.[18]

5.28 The trustee will be taxable on taxable income of the Regime MIT in circumstances where:

- the trustee fails to allocate the taxable income within the three months from the end of the financial year;
- there is a net 'under' in excess of the de minimis for an income year and the trustee chooses not to reissue distribution statements to beneficiaries (see recommendation 32); or

18 There should be an exception to this rule for 'unders' and 'overs.'

- amounts are attributed to non-residents where the withholding rules do not operate effectively (see Chapter 9).

5.29 The Board considers that applying the attribution model will reduce or eliminate the current distortions that arise due to the net income of the MIT being taxable to beneficiaries based on their present entitlement to the trust income. Instead, paragraph (a) of the guiding principles seeks to provide certainty to beneficiaries as to their taxation liabilities.

5.30 The requirement in paragraph (b) of the guiding principles that the trustee must allocate the taxable income of the trust for a financial year between beneficiaries on a fair and reasonable basis, consistent with their rights under the constituent documents and the duties of the trustee, is intended to ensure that the allocation of taxable income follows the beneficiary's interest in the trust. As the beneficiary will use the taxable income allocation in their tax returns it should be open for the beneficiary to dispute a tax assessment based on the allocation if the beneficiary considers that the assessment is not fair and reasonable, having regards to their rights under the constituent documents and duties of the trustee.

5.31 The beneficiary will normally be able to take legal action personally against the trustee for breach of duty, should the trustee fail to actually distribute trust income to the beneficiary as required by the trust constituent documents. As a result of personal action against the trustee, the allocation of taxable income to the beneficiary may be revised.

5.32 The revised allocation will then be used by the beneficiary to complete their tax return. The Board recognises that a revised allocation has the potential to result in the trustee being required to revise the allocation to other beneficiaries, which could in turn result in these beneficiaries seeking to amend tax returns if they had lodged their returns prior to being notified of the reallocation.

5.33 The Commissioner will also be able to issue or amend assessments if the Commissioner considers the allocation of taxable income is not in accordance with the guiding principles.

5.34 The three-month period in paragraph 5.27(c) is linked to the time by which a Regime MIT trustee would typically have provided beneficiaries with a distribution statement.

5.35 If an amendment to the calculation and attribution of taxable income for an income year is made, the trustee will not automatically be subject to taxation. The rules for dealing with 'unders' and 'overs' as outlined in Chapter 8 may apply.

5.36 Subjecting the trustee to tax at the highest marginal tax rate on the unattributed taxable income would typically provide an incentive for the trustee to allocate within the timeframe. The Board considered the option of then providing a credit to the

beneficiaries for the tax paid by the trustee. However, this would increase complexity. Instead the Board recommends that when the trustee later distributes an amount of income upon which tax has been paid at the highest marginal rate, this amount distributed should be non-assessable non-exempt income of the beneficiary. This will ensure that there is no additional tax liability faced by the beneficiaries and is consistent with the current treatment of accumulated income taxed under section 99A of the ITAA 36. The Board considers that overall, this approach provides the most appropriate trade-off between integrity and simplicity.

5.37 Attribution provides Regime MITs with more commercial flexibility than is available under the current law in determining whether or not to make cash distributions to beneficiaries during an income year. Under attribution, the taxable income of the trust for an income year must be allocated to beneficiaries whether the trustee makes cash distributions to the beneficiaries or chooses to retain the trust income.

5.38 The model is flexible enough to enable the trustee to allocate the taxable income appropriately in the case of beneficiaries who join or exit the Regime MIT during an income year.

5.39 The greater certainty and less complexity offered by attribution may be reduced for Regime MIT structures which involve multiple classes of beneficiaries. However, the guiding principle of making the allocation on a fair and reasonable basis, consistent with the beneficiaries' rights under the constituent documents and the duties of the trustee, is equally applicable. An example of attribution is outlined below.

Example

The Skyscraper Commercial Property Trust has one class of units. The trust deed provides that the unitholders share the income for a quarter-year in proportion to the number of units they hold at the end of each quarter. There were 10 million units on issue until 1 April 201X when a placement increased this to 12 million.

For the year ended 30 June 201X, soon after the end of each quarter the trust paid unitholders 2 cents per unit. The payment was largely generated by rental income during the quarter after paying operating expenses and reserving some money for future capital works. The total paid to unit holders for the year was $840,000.

The taxable income of the trust for the year was $718,000. There were a number of reasons why the taxable income was less than the amount paid out in cash, including capital allowance deductions. There were also timing differences in revenue recognition.

The trust is listed on a stock exchange and there is a reasonable level of trading. The unitholders are therefore not the same from one quarter to the next. After considering the way the calculation of taxable income related to the events of the year and the terms of the trust deed, the trustee determined that the equitable allocation of taxable income was as follows: 1.7 cents per unit to those on the register at the end of the first quarter, 2 cents for the second quarter, 1.8 cents for the third quarter and 1.4 cents for the fourth quarter. This totalled $718,000 which was the taxable income.

The trustee used this formula to send each unitholder a statement soon after 30 June advising them of the amount they needed to include in their tax return. The total of the amounts unitholders were advised to include in their tax returns was the trust's taxable income of $718,000. The statements also advised each unitholder of the amount that they were paid in excess of the amount they were to include in their tax return. The unitholders were advised that this amount would be an adjustment to the cost base in their units when a CGT event happens in respect of those units.[19]

The trustee has allocated the trust's taxable income between the unitholders. The allocation is fair and reasonable and is consistent with the unitholders' rights under the deed. Therefore the unitholders are assessable on the amounts shown on the statements and there is no amount on which the trustee will be taxed.

5.40 The Board acknowledges that certain modifications to the current withholding tax provisions will be needed to ensure that attribution interacts appropriately with the withholding rules for non-resident beneficiaries in Regime MITs. This is discussed further in Chapter 9.

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19 See also recommendation 28 on cost base adjustments.

5.41 The Board considers that, overall, the approach recommended is superior to the current approach and to the other alternatives canvassed and has the potential to significantly increase the international competitiveness of Australian Regime MITs.

Recommendation 19

The Board recommends an attribution model for determining the tax liabilities for Regime MITs and their beneficiaries.

The guiding principles of the model are:

(a) a beneficiary is assessable on the amount of taxable income of the trust that the trustee allocates to the beneficiary;

(b) the trustee must allocate the taxable income of the trust between beneficiaries on a fair and reasonable basis consistent with their rights under the trust's constituent documents and the duties of the trustee; and

(c) the trustee will be taxed on any taxable income of the trust which the trustee fails to allocate to beneficiaries within three months of the end of the financial year.[20]

5.42 A summary structure of attribution is outlined in Table 1 (Appendix A).

Impact on beneficiaries and reporting requirements of Regime MITs

5.43 The Board recognises that under attribution, there is opportunity for the taxable income attributed to beneficiaries to exceed income distributed to the beneficiaries. This may particularly impact upon retail investors' decisions as to whether to invest in the Regime MIT.

5.44 The Board considers that greater disclosure of the possibility for the taxable income attributed to beneficiaries to exceed distributions will reduce the risk that retail beneficiaries will be unfairly affected by this approach. Accordingly, the Board recommends that the MIT Product Disclosure Statement or other disclosure documents be required to identify the possibility for the taxable income attributed to beneficiaries to exceed the cash distributed.

20 Subject to the treatment of 'unders' outlined in Chapter 8.

Recommendation 20

The Board recommends that the Regime MIT Product Disclosure Statement or other disclosure documents be required to identify the possibility for the taxable income attributed to beneficiaries to exceed the cash distributed.

Integrity concerns

5.45 The Board was mindful of concerns that the proposed method of determining tax liabilities may give rise to tax driven streaming of tax preferences or character. The issue before the Board was whether the existing anti-avoidance rules would be sufficient to prevent this type of behaviour or whether there was a need for a general rule to prevent tax driven streaming of character and tax preferences.

5.46 The Board considered that for commercially run Regime MITs where beneficiaries are acting at arm's length, the situations that would give rise to streaming issues would be limited. It was, therefore, concerned to ensure that any integrity rules were targeted to specific types of behaviour rather than proposing a general rule which might have uncertain application or unintended consequences.

5.47 The Board also considered that certain existing and proposed rules for Regime MITs would address many of the concerns. In particular, the Board noted that there were existing dividend and capital streaming rules and the current value shifting rules[21] would apply to wholesale trusts where the trustee could reasonably be expected to act in accordance with the wishes of the unit holders.

5.48 However, the Board considers that an integrity provision is required to address instances of streaming of tax benefits or value shifting that could arise as a result of changes to an MIT's constituent documents during the year.

5.49 The Board was made aware of one specific integrity concern involving tax exempt unit holders. It would be possible under attribution to set up an MIT consistent with tax law where the taxable income of the trust would only ever be received by tax exempt beneficiaries, while other beneficiaries would benefit from tax deferred distributions. The Board recognises the threat to the revenue posed by such arrangements and recommends that a specific integrity rule be designed to address this.

5.50 The Board recognises that other integrity concerns may arise as a result of behavioural changes in response to the new rules. However, it has not been possible for the Board to anticipate the types of specific integrity issues that could arise. It therefore has not been possible for the Board to consider specific integrity rules in the

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21 See paragraph 727-360(2)(b) of the ITAA 1997.

absence of a clearer understanding of non-compliant behaviour. The Board anticipates that the Government will address any integrity issues as they are identified.

5.51 In line with the recommendations of the Tax Design Review Panel, the Board recommends that a Post-implementation Review of the new MIT regime be conducted after the legislation has been in operation for at least two years. The review should include, in particular, the attribution method of taxation. If specific concerns are identified at this time, then it may be appropriate to introduce further specific integrity rules.

Recommendation 21

The Board recommends that:

- a specific integrity rule be designed to address the situation where streaming of tax benefits or value shifting arises from changes to an MIT's constituent documents during the year;
- a specific integrity rule be designed to address the situation where the rights attaching to units in a Regime MIT are structured such that the taxable income of the trust is attributed to a tax exempt entity while other unit holders receive tax deferred or tax exempt distributions; and
- a Post-implementation Review of the new MIT regime be conducted after the legislation has been in operation for at least two years. The review should include, in particular, the attribution method of taxation. If specific integrity concerns are identified at this time, then it may be appropriate to introduce further targeted integrity rules.

Carve out for 'debt like' units

Views in submissions

5.52 A number of submissions commented that an attribution regime would be improved if different rules applied to units which were essentially debt or financing units. The Property Council of Australia[22], for example, expressed that:

> 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:

22 At page 31.

- 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.

Board's consideration

5.53 The Board acknowledges that the current application of Division 6 to 'debt units' issued by MITs may produce inappropriate taxation outcomes. The Board's proposed attribution method for determining tax liabilities for Regime MITs will address some of these concerns as the attribution of taxable income will be consistent with the rights of beneficiaries. However, in order to provide certainty for Regime MITs, the Board recommends that legislative rules be introduced to provide that where units issued by a Regime MIT meet the 'substantially equivalent to a loan' test in Division 207 of the ITAA 1997, they will not be subject to the general method for allocating the taxable income for MITs. Instead, the amount accruing to these unit holders should be taxable to them as interest and these amounts should reduce the taxable income of the Regime MIT.

Recommendation 22

The Board recommends that legislative rules be introduced which provide that where units issued by a Regime MIT meet the 'substantially equivalent to a loan' test in Division 207 of the ITAA 1997, they will not be subject to the general method for allocating the taxable income for Regime MITs. Instead, the amount accruing to these unit holders should be taxable to them as interest and these amounts should reduce the taxable income of the Regime MIT.

Election to apply attribution taxation

5.54 The Board sought stakeholder comments on whether an MIT should be able to make an irrevocable election to be governed by a new MIT regime.

Views in submissions

5.55 Submissions commenting on this issue were supportive of allowing qualifying MITs to elect to be governed by a new MIT regime. The Taxation Institute of Australia argued that an 'irrevocable election' would provide a certain degree of flexibility for an MIT to 'opt in' to the MIT regime and accepted that, for integrity reasons, such election should be irrevocable. Stakeholders supported leaving Division 6 as a fall back regime for trusts which do not qualify or elect to be in a new MIT regime. As noted by the Property Council of Australia:

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).

Board consideration

5.56 For reasons of equity and integrity, the Board recommends that Regime MITs be able to make an irrevocable election to be governed by the attribution method for determining tax liabilities. Without such an irrevocable election, the Board was concerned that integrity would be compromised by Regime MITs being able to switch between Division 6 taxation and attribution taxation on a year-by-year basis.

5.57 The Board considers that Regime MITs should be required to satisfy the qualifying criteria at all times during an income year in order to benefit from the attribution method of determining tax liabilities. Trusts which do not satisfy the criteria at all times will not be considered Regime MITs.

5.58 The Board recognises that this approach may unfairly disadvantage MITs that are unable to satisfy the qualifying criteria due to inadvertent or minor circumstances. For example, there may be changes in the ultimate ownership of the trust which mean that it is temporarily not widely held, or other restructuring undertaken for commercial reasons that may mean that the trust is temporarily unable to meet certain requirements. The Board recommends that where an MIT fails to satisfy the qualifying criteria it should be able to maintain taxation treatment as a Regime MIT provided the failure was the result of inadvertent or minor circumstances and reasonable steps are being taken to rectify the failure within a reasonable time-frame.

Recommendation 23

Subject to recommendation 4, the Board recommends that:

- Regime MITs be able to make an irrevocable election to be subject to the proposed attribution method of taxation;
- a Regime MIT must satisfy the qualifying criteria at all times; and
- if an MIT fails to satisfy the qualifying criteria it should be able to maintain taxation treatment as a Regime MIT provided the failure was the result of inadvertent or minor circumstances and reasonable steps are being taken to rectify the failure in a reasonable time.

CHAPTER 6: CHARACTER RETENTION AND FLOW-THROUGH

6.1 The Board's discussion paper outlined how recent case law and doubt as to the operation of statutory provisions had resulted in uncertainty as to whether the generally accepted flow-through nature of trusts was capable of applying to MITs. The discussion paper also raised the issue of complexity and compliance costs for MITs, beneficiaries and the ATO with regard to record keeping and reporting requirements related to character retention and flow-through.

6.2 The Board requested stakeholder comment on potential options for addressing character flow-through under a new MIT regime, and in particular, how character flow-through may operate under any model for determining tax liability. Comments were sought on ways to address the current uncertainty about the general law principles of character flow though. Stakeholders were also asked to comment on whether character flow-through can be maintained while reducing compliance costs and complexity and whether character flow-through should operate differently depending on whether the beneficiary is a resident, or non-resident or a non-resident portfolio or non-portfolio investor.

Views in submissions

6.3 A number of submissions which addressed this topic recommended that legislative support be provided for the general principle of character flow-through, including source flow-through, for reasons including that:

- it is consistent with policy principle 1;
- flow-through is necessary for the success of a MIT regime;
- it impacts on the withholding tax non-residents pay; and
- there are commercial reasons as to why it should not be changed.

For example, the Submission from Greenwoods & Freehills argues:

> Policy Principle 1 aims for a system under which the tax treatment of investors who derive income using an MIT replicates the tax treatment the investors would have received had they derived the income directly. This implies transparency with respect to character and source and we submit that it is worth attempting to retain this feature in any revised MIT system.

> This is especially important for dividend income, capital gains derived by an MIT and foreign source income earned by an MIT.

6.4 Other submissions believed that the current rules operated appropriately with regards to flow-though. Platinum Investment Management, for example, believed that 'the concept of present entitlement and the flow-through status afforded to trusts, operate suitably.'

6.5 Only the submission from the Taxation Institute of Australia (TIA) made suggestions as to how the character of income could be rationalised to reduce complexity. The TIA suggested that there are certain significant characteristics which will need to be preserved for flow-through to resident and non resident beneficiaries, while others need not be preserved. Its submission outlines that:

> The relevant characteristics for the resident investor … are:
>
> - capital gain that has been reduced by the discount;
> - capital gain that has not been reduced by the discount;
> - foreign income;
> - infrastructure income subject to rebate;
> - other assessable amounts;
> - non-assessable amounts that give rise to a cost base adjustment;
> - non-assessable amounts that do not give rise to a cost base adjustment;
> - franking credits; and
> - foreign tax paid.
>
> The relevant characteristics for the non-resident investor are:
>
> - amount subject to the Division 12-H withholding rates;
> - amounts subject to the interest withholding rate;
> - amounts subject to the dividend withholding rates;
> - amounts subject to the royalty withholding rates; and
> - amounts not subject to withholding.

6.6 The IFSA submission made specific reference to how character flow-through might work under its preferred option (Option 2) for determining tax liabilities, in particular how it might work where there were multiple classes of beneficiaries. It suggests applying the current industry principles:

> The industry's method applies two principles. The first principle is subject to the second principle.

> The first principle is that the characteristics are allocated between the investors in proportion to their share of the VTI. For example, if a discounted capital gain makes up 10 per cent of the VTI, then 10 per cent of the assessable amount of each unitholder is treated as being a discounted capital gain.
>
> …
>
> The second principle is that if an MIT has more than one pool of assets then the investor only gets the characteristics that arise from the pools that they participate in. If the investors' interests in the MIT are all uniform then the second principle has no effect.

6.7 Deloitte suggested that 'Once a responsible entity determines a net amount of a certain class of taxable income be attributed to a beneficiary, we believe that a statutory rule similar to section 6B of the ITAA 1936 should be provided to MITs to allow a reasonable allocation of the amount… '

6.8 Only the IFSA submissions suggested that character flow-through could operate differently for non-residents, however, its view was that character rationalisation would not be possible without a general reduction in the rates of withholding tax. It suggests:

> 6.58 For non-residents the system of imposing withholding tax on only part of the MIT income and at different rates for different parts of the income requires a certain amount of character retention.
>
> 6.59 Non-resident investors are sensitive to the rates of withholding tax. This is why Australia recently moved to progressively reduce one of the rates to 7.5 per cent. Reducing the amount of character retention by increasing withholding tax rates would be contrary to the Board's objective of enhancing the international competitiveness of Australian MITs
>
> 6.60 IFSA would support a reduction in character retention through reducing withholding tax rates. The question would be whether this can be done in a 'near revenue neutral' way...

6.9 There was no support for treating portfolio and non-portfolio investors differently.

Board's consideration

6.10 The policy principle and terms of reference for this review argue for flow-through trust taxation of income to be retained for MITs. Policy principle 1, in particular, requires that in considering options for reform, 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.

6.11 The Board also considers that the generally accepted trust features of character and source flow-through provide Australian MITs with a commercial advantage over other collective investment vehicles and are one of main reasons why the Australian MIT industry has been successful. Industry stakeholders have particularly emphasised to the Board that the continuing success of the MIT industry in Australia relies on the preservation of flow-through taxation.

6.12 Given the terms of reference and the well-established nature of flow-through vehicles in the Australian managed funds industry, the focus of the Board was how best to give effect to the principle of flow-through. In order to provide certainty and to enhance the international competitiveness of Australian managed funds, the Board considers that the general principle of character and source flow-through should be legislated.

6.13 The Board's view is that the attribution model for determining tax liabilities for MITs (as discussed in Chapter 5) is complementary to this principle. As trustees will be required to allocate tax liabilities to beneficiaries on a fair and reasonable basis consistent with their rights under the constituent documents and the duties of the trustee, the taxation treatment of beneficiaries should be consistent with the character and amounts to which they are entitled under the trust constituent documents.

6.14 The Board recognises the issues that character and source retention can cause in relation to complexity, particularly for non-resident investors and the different withholding tax regimes. The Board considered a proposition that this review provided an opportunity to simplify the non-resident withholding regime, for example, through imposing a single, lower rate, accompanied by a broader taxation base. However, the Board was mindful that the Government has only recently introduced changes to the withholding tax provisions for MITs which were designed to further enhance the international competitiveness of Australian MITs, and considered that any further changes in connection with rate levels were outside the scope of this review.

6.15 As the Board has previously noted, some of the complexity associated with MITs taxation, particularly in relation to character and source flow-through, is the trade-off that MITs and investors accept in exchange for the commercial advantages those features provide.

6.16 Accordingly, the Board considers that character and source flow-through should be maintained for Regime MITs and distributions to non-residents should not attract different character retention arrangements. The Board also acknowledges that Australia's bilateral tax treaties impose some constraints.

Recommendation 24

The Board recommends that in order to provide clarity and certainty for Regime MITs, the principle of character and source flow-through be legislated.

Chapter 7: Addressing double taxation

7.1 In its discussion paper the Board outlined the taxation issues, including double taxation, which can arise where the taxable income of an MIT differs from the amount distributed to beneficiaries. In particular it highlighted some of the current issues with the taxation treatment of 'tax deferred distributions'. It noted that trust distributions can exceed the net income of the trust for a number of reasons, either of a timing or permanent nature. For example, a timing difference arises where amounts may be recognised in an earlier income period for distribution purposes than is recognised for tax purposes. An example of a permanent difference is where a deduction is statutorily provided for tax purposes but the outgoing or deduction is not recognised as an expense in the accounts of the trust.

7.2 The Board discussed that where distributions from a trust exceeded the taxable income of the trust, the current provisions of Division 6 are generally not interpreted as, of themselves, operating to include any of the distributed excess in the assessable income of the beneficiary. However, in the case of MITs, such amounts will generally result in an adjustment to the CGT cost base of the beneficiary's units.

7.3 The Board highlighted that some of the issues with tax deferred distributions include, on one view, the potential for such distributions to be treated as ordinary income in the hands of a beneficiary under section 6-5 of the ITAA 1997 and the complexity associated with beneficiaries having to maintain cost base adjustment records.

7.4 The Board requested stakeholder comment on options for addressing these issues. Stakeholders were asked to consider their comments in the context of listed and unlisted MITs and in the context of the alternative approaches for determining tax liabilities.

Views in submissions

7.5 The majority of submissions which addressed this issue recommended that tax deferred distributions should not be taxable as ordinary income in the hands of a beneficiary, particularly on the basis that to do so would be contrary to policy principle 1. Infrastructure Partnerships Australia, for example, stated that:

> IPA wishes to emphasise that so-called tax deferred distributions are merely a recognition of policy principle 1. That is so called tax-deferred distributions merely equate to the position of the investor if the investor had been investing directly–in that situation, the taxable revenue to the investor would be shielded in part or wholly by tax

deductions for capital allowances and other deductions so not every amount of cash distributed by a MIT to its investors is or should be taxable, in order to align the tax outcome of MIT distributions to the investor's treatment if the investor held the investment directly.

7.6 Many submissions also suggested that under a Trustee Exemption Model (Option 2 in the Discussion paper), the receipt of a tax deferred distribution should not result in any cost base adjustments to the beneficiaries' units. The Property Council of Australia emphasised in its submission that:

> 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 amounts attributed to the investor and distributed require adjustment because distribution is seen as another taxing point or adjustment point.

7.7 Greenwoods & Freehills similarly argued:

> … our current system treats the earning of the trust income and the subsequent distribution as two separate taxing points (albeit with adjustments between the two points). Such a system is inconsistent with policy principle 1 and unnecessary if the appropriate amount of tax was collected on a timely basis when the income was earned…
>
> The simplest solution, and one which is probably no less accurate a reflection of economic interest and gain at the investor level than what is meant to occur now, would be to provide that distributions by MITs are simply not assessable. Eliminating any tax on distributions would certainly be more consistent with policy principle 1…

7.8 Others submissions recommended retaining cost base adjustments subject to certain amendments. Deloitte, for example, suggested:

> … we believe that there should at least be a 'reverse CGT event E4' that results in an increase in the cost base of shares in cases where taxable income attributed to a beneficiary exceeds the payment received. A mechanism to allow for appropriate adjustments under CGT event E4 would be to reduce the cost base of units for payments made, and to increase the cost for base for taxable income attributed to the beneficiary. Furthermore, we recommend an adjustment to CGT event E4 to re-insert Division 43 deductions as tax exempt distributions.
>
> We believe that these amendments would help to correct the majority of double taxation issues identified by the Board in relation to CGT event E4.

7.9 IFSA recommended that no change be made to the current arrangements where there are differences between the net income and distributions made to beneficiaries, arguing that:

> This approach is not perfectly equitable but investors accept that. The nature of MITs is that investors get significant benefits from pooling their capital with other investors and in return accept that the tax outcomes in the short term can be slightly inequitable. These short term effects balance out over time.

Board's consideration

Beneficiary-level adjustments

7.10 In developing options for reform, a major question for the Board was how to best give effect to the terms of reference policy principles, in particular policy principle 1 that the taxation treatment of a beneficiary should largely replicate the taxation treatment of the beneficiary had they invested directly, while recognising that an investment in an MIT involves dual layers of investments. That is, the 'unit' held in the trust by the beneficiary is a separate asset from the assets held by the trust.

7.11 One approach to address these issues would be to tax Regime MITs on distributions rather than attribution. This would potentially resolve some of the distortions that occur where there are differences between taxable income and distributed income, although issues would continue as certain distributed amounts (for example capital) would be need to be excluded from being a taxable distribution. As discussed in Chapter 5, the Board was not in favour of this option on the basis that it would produce taxation outcomes that were inconsistent with the terms of reference.

7.12 Another approach would be to eliminate adjustments at the point of distribution. The Board was of the view that, in a perfectly informed market, such adjustments would not be required as future tax liabilities and other tax attributes would be factored into the price that a beneficiary would pay for acquiring a unit in the MIT. However, the Board recognises that market information is not and cannot be sufficient to allow for completely accurate unit pricing. As such, the Board considered that eliminating adjustments at the point of distribution outright would result in greater taxation distortions due to the dual layers of investment in MITs. For example, it could lead to greater incidence of double taxation and allow for artificial loss creation. The Board also considered that not requiring a beneficiary-level cost base adjustment, in some cases, would be contrary to policy principle 1, particularly if the investor would have been required to make an adjustment if they held the asset directly.

7.13 Accordingly, for reasons of equity and integrity, the Board considers that beneficiary-level cost base adjustments should continue for Regime MITs but with modification. In accordance with policy principle 1, the Board considers that beneficiary-level cost base adjustments should generally operate for Regime MITs such that:

- the non-assessable part of a Regime MIT distribution which is attributable to a permanent tax difference should not be 'clawed back' on the sale of a

beneficiary's units, except to the extent that the value of the permanent difference was already reflected in the cost base of the units; and

- except for returns on 'debt like' units[23], tax deferred distributions attributable to temporary tax differences, such as unrealised capital gains, should not be taxable to a beneficiary as ordinary income under section 6-5 of the ITAA 1997, but may result in an adjustment to the cost base of the beneficiary's units and hence be 'clawed back' upon the disposal of the units or when a distribution results in the cost base being reduced below zero.

7.14 The Board considers that this is a general principle for beneficiary-level cost base adjustments. The Board recognises that there may be certain specific tax concessions at the trust level where for policy reasons, the general principle should not apply.

7.15 While the Board considers that tax deferred distributions attributable to temporary tax differences received by a Regime MIT beneficiaries should not generally be taxable as ordinary income under section 6-5 of the ITAA 1997, it considers that an exception to this rule is required to the extent that returns on 'debt like' units are purported to be sourced from tax deferred distributions.

7.16 Among the Board's recommendations as to the design of the attribution model of taxation for Regime MITs is that 'debt like' or 'finance units' be excluded from the general attribution and that distributions on those units be treated as an amount in the nature of interest to beneficiaries. In these cases, the receipt of an interest-like distribution by beneficiaries should not result in a cost base adjustment to the beneficiaries' units.

7.17 Similarly, the Board considers that tax deferred distributions to non-residents, other than to the extent they represent returns on 'debt like' units, should not be considered ordinary income in the hands on non-residents. To avoid any doubt that may currently exist, this would mean that such distributions would not be subject to 'no Tax File Number' withholding tax.

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23 As discussed in Chapter 5.

Recommendation 25

The Board recommends that:

- beneficiary-level cost base adjustments—remain with modification for Regime MITs; and
- any legislative modification to the current approach to beneficiary-level cost base adjustments generally ensures that:
  - the non-assessable part of a Regime MIT distribution which is attributable to a permanent tax difference is not be 'clawed back' on the sale of a beneficiary's units except to the extent that the value of the permanent difference was already reflected in the calculation of the cost base of the units;
  - tax deferred distributions attributable to temporary tax differences, such as unrealised capital gains, are not, other than to the extent they represent returns on 'debt like' units, taxable to a resident or non-resident beneficiary as ordinary income under section 6-5 of the ITAA 1997 but may be subject to an adjustment to the cost base of the beneficiary's units; and
  - tax deferred distributions attributable to temporary tax differences that represent a return on a 'debt-like' unit are taxable to the beneficiary as interest and do not result in a cost base adjustment to the debt-like unit.

7.18 The Board also considers that under an attribution model for Regime MIT taxation, beneficiary-level cost base adjustments are required where the taxable income attributed to beneficiaries exceeds the amount distributed to the beneficiaries. This will address the potential for double taxation should a beneficiary sell its units prior to receiving the distribution (that is, the beneficiary would be taxable on the attributed taxable income and may also be taxable on a gain on the sale of the units which would reflect the value of the undistributed amount which has already been subject to tax).

7.19 The Board's view is that the best way to address the beneficiary-level adjustments is to implement a system of upwards and downwards cost base adjustments. In the case of a Regime MIT, the cost base/reduced cost base of a beneficiary's units would need to be adjusted in the following circumstances:

- where taxable income is attributed to a beneficiary, then the cost base of the beneficiary's units should be increased by the amount attributed (adjusted upwards for certain amounts that are otherwise disregarded for CGT event E4 such as the discounted component of a capital gain and downwards to reflect the value of certain tax offsets such as the gross up component of a franking credit); and

- the cost base will be reduced by the amount of any distributions received.

7.20 Compared to the current regime where there are only downward cost base adjustments when beneficiaries receive certain trust distributions, the Board considers that the proposed recommendations will further reduce the scope for double taxation.

7.21 The Board recognises that this system of cost base adjustments does not create a perfect 'single layer of taxation' in the MIT context and creates a degree of complexity for Regime MITs and beneficiaries. However, in the Board's view, it is the simplest method by which taxation distortions can be addressed while maintaining taxation outcomes for beneficiaries which are broadly consistent with policy principle 1. Completely eliminating the taxation distortions which may arise due to the dual layers of investment in MITs would require either the adoption of a method of taxing MITs which departs from the terms of reference and produces an unacceptable level of complexity and increased compliance costs, or the introduction of complex targeted rules to deal with specific scenarios which are expected to occur infrequently.

7.22 Apart from implementing changes necessary to give effect to the Board's recommendations, the Board considers that the CGT rules should continue to apply to Regime MITs as per the current law.

Recommendation 26

The Board recommends that the cost base/reduced cost base of a beneficiary's units in a Regime MIT be adjusted in the following circumstances:

- where taxable income is attributed to a beneficiary, then the cost base of the beneficiary's units should be increased by the amount attributed (adjusted upwards for certain CGT amounts that are currently disregarded under CGT event E4 such as the discount component of a capital gain, and downwards to reflect the value of certain tax offsets such as the gross-up component of a franking credit); and

- where distributions are received, the cost base will be reduced by the amount of the distribution.

7.23 Appendix C contains an example of how the cost base adjustments would apply to Regime MITs.

Reporting requirements

7.24 One of the main concerns with beneficiary-level adjustments is that they create complexity and compliance costs for beneficiaries who are required to maintain records of the adjustments. In recognition of this, the Board recommends that

beneficiaries continue only to be required to make such adjustments on a yearly basis. For the purpose of making the adjustments, Regime MITs should be required to supply beneficiaries with yearly statements outlining:

- the amount of taxable income attributed to beneficiaries;
- the required adjustments for certain CGT event E4 amounts/the value of certain tax offsets; and
- distributions made during the income year.

7.25 The Board has been advised by stakeholders that this would not place an undue burden on Regime MITs as they are already required to maintain such information for the purposes of preparing distribution/tax statements for beneficiaries. The Board has also been advised that Regime MITs may be able to maintain an online record of annual adjustments (expressed as indices) to each class of units to assist beneficiaries who may have difficulty locating the original statements.

7.26 For beneficiaries, this recommended approach is a simpler approach than required under the law currently. It reduces the need for beneficiaries to track the character and amount of distributions received for the purposes of applying the current CGT event E4.

Recommendation 27

The Board recommends that Regime MITs be required to supply beneficiaries with annual statements outlining:

- the amount of taxable income attributed to beneficiaries;
- the required adjustments for certain amounts currently excluded under CGT event E4 and the value of certain tax offsets; and
- distributions made during the income year;

for the purpose of the beneficiaries completing their current year income tax returns and determining the amount of their cost base adjustments on an annual basis.

7.27 The Board considers that greater disclosure of the possibility for MIT distributions to exceed the taxable income attributed to beneficiaries and vice versa, as well as increased disclosure of the obligation to make yearly cost base adjustments, will reduce the risk that retail beneficiaries will invest in Regime MITs without being aware of the tax implications. Accordingly, the Board recommends that the MIT Product Disclosure Statement or other disclosure documents:

- prominently outline the possibility for MIT distributions to be less than the taxable income attributed to beneficiaries and vice versa (Recommendation 20); and
- alert beneficiaries to the requirements to make yearly cost base adjustments and to maintain records of the adjustments.

Recommendation 28

The Board recommends that Regime MIT Product Disclosure Statements or other disclosure documents should be required to alert beneficiaries to the requirements to make yearly cost base adjustments and to maintain records of the adjustments.

Revenue account holders

7.28 As outlined previously, the Board considers that flow-through of character should be maintained for Regime MITs and that, subject to a specific exception, tax deferred distributions should not be taxable as ordinary income under section 6-5 of the ITAA 1997, or for non-residents, not to be subject to the 'no TFN' withholding tax for Regime MIT beneficiaries.

7.29 The Board recognises that in some cases, this rule would represent a departure from policy principle 1, as the character of an amount derived by the Regime MIT beneficiary who holds their units on revenue account (that is, beneficiaries who would treat any gains and losses arising on disposal of their units as ordinary income rather than capital gains) may differ from the character of the amount if they had held the asset directly, for example in the case of distributions sourced from capital gains arising on the disposal of shares held by the Regime MIT.

7.30 Given that revenue account holders may receive the benefit of character flow-through, the Board also recommends that, as a general principle, revenue account holders use the adjusted cost of the units in determining any revenue gain or loss on disposal of their units.

Recommendation 29

To the extent that their gains and losses are not brought to account under Division 230 of the ITAA 1997, the Board recommends that revenue account holders, be required, as a general principle, to use the adjusted cost of the units in determining any revenue gain or loss on disposal of their units in Regime MITs.

CHAPTER 8: OPTIONS FOR DEALING WITH UNDERS AND OVERS

8.1 The Board's discussion paper outlined current problems faced by MITs in preparing accurate end of financial year trust income and taxable income calculations within the time-frame required. The result of the current arrangements is that often the trustee will 'under' or 'over' report the correct amount of net income to beneficiaries, and revisions are made at a later date. These revisions may then require trustees to re-issue distribution statements to beneficiaries and beneficiaries to seek amendments to their tax returns, resulting in significant compliance costs for MITs and beneficiaries and administration costs for the ATO.

8.2 In assessing practical ways to address the issue of 'unders' and 'overs' the Board weighed up the desire to reduce compliance and administrative costs against the need to ensure that the right amount of tax (or close to it) is paid. Approaches the Board considered in the discussion paper included: the desirability of either a carry forward approach or a credit deduction approach; how any approach could address the issues associated with beneficiaries redeeming or selling their units before the errors have been rectified; whether there is a need for a de minimis rule, what the consequences of breaching the rule should be and whether the Commissioner of Taxation should have discretion to increase the de minimis in special circumstances and if so, which circumstances.

Views in submissions

8.3 Most submissions favoured the carry forward approach for dealing with unders and overs given the type of circumstances which may give rise to the error. IFSA argued in its submission that differences between the distributions made and tax statements issued and the trust's income tax return is:

> … simply due to the fact that the distribution is based upon the information and estimates available at the time of the distribution, rather than the more complete information which becomes available by the time of lodgement of the trust's income tax return. These differences are not the result of any deliberate action or failing by the trustee.
>
> …
>
> It is important to note that the differences that arise are both under– and over–distributions. The debate on this matter often centres upon the potential tax deferral that

> results from under-distributions, but fails to recognise the effective pre-payment of tax that arises when over-distributions are made. In our experience it is just as likely for an over–distribution to arise as and under-distribution…

8.4 The majority of submissions also favoured a de minimis or 'safe harbour' of net income which would be greater than the 2 per cent suggested in the discussion paper. Many suggested 5 per cent of net income was more appropriate, noting that 'unders' and 'overs' would regularly exceed the 2 per cent mark. Ernst & Young, for example stated that '… the de minimis level suggested is likely to be too low for many funds and a 5 per cent rate would be a more appropriate measure for what is a reasonable level of adjustment'.

8.5 A number of submissions also argued that net income alone would not be a suitable test for a safe harbour. Warakirri Asset Management Pty Ltd stated in its submission that:

> Warakirri supports the carry forward approach for dealing with 'unders' and 'overs' in correcting errors in calculating net income. However, Warakirri does not favour a de minimis rule which only relates to the net income of an MIT. In certain circumstances, the net income of an MIT with significant net assets may be low. Due to the level of assets held, an error relating to the assets held may be disproportionately large when compared to net income only. Warakirri would favour an approach which also takes the net asset value to the MIT into account in determining any de minimis rule.

8.6 Very few submissions provided suggestions as to how the issue of redemptions could be dealt with and there was little support for the Commissioner of Taxation to have discretion to extend the de minimis.

Board's consideration

'Unders' and 'overs' below a set de minimis

8.7 The Board recognises that the practical reality for MITs is that 'overs' and 'unders' occur frequently due to incorrect information, errors and incorrect estimations used at the time that distribution statements are prepared. These circumstances can be outside of the control of the trustee. The Board also acknowledges the information provided to it by industry that the occurrence of net 'overs' and 'unders' is relatively equal, meaning that the overall effect on net revenue collection may be minimal. For these reasons, requiring MITs to reissue distribution statements and beneficiaries to seek to amend tax returns for 'unders' and 'overs' which fall within the common error range for MITs would impose a compliance burden and cost on MITs and beneficiaries and an administrative cost on the ATO which are likely to outweigh any revenue that may be collected.

8.8 Accordingly, the Board considers it appropriate to set a de minimis under which a general carry forward approach to correcting 'unders' and 'overs' is followed without

attracting interest or penalty. The carry forward approach should allow for net 'unders' and 'overs' discovered in a year of income to be carried forward into the calculation of the next income year's taxable income calculation.

8.9 As per the discussion of recommendation 19, where an 'under' amount is discovered in a later year of income, such an amount should not result in the trustee being taxable on the amount at the highest marginal tax rate for failure to allocate the amount within three months of the end of the income year in which the amount was derived. Rather, if it is below the de minimis, the carry forward approach would apply.

8.10 Given the type of matters that can give rise to an 'under' or an 'over' and the different types of MITs, the Board considers that the de minimis should comprise not only a set percentage of net income for an income year but also, as an alternative, a set dollar value per unit. As the tax liability rests with the beneficiary, the extent of the potential change in the beneficiary's tax liability as a result of the under or over is an effective measure of whether the impact on the revenue is likely to be significant. This will also accommodate Regime MITs that may only have small amounts of net income in an income year but have large asset values.

8.11 The Board considers that a net income de minimis of 5 per cent is appropriate having regard to the factors mentioned above. The Board considers that determining the appropriate dollar value per unit to be used as an alternative de minimis should be the subject of further stakeholder consultation as part of any legislative implementation process. The Board recognises that a value per unit de minimis will mean that the overall sum in question will differ depending on the number of units held per beneficiary. The Board gave consideration to a value per beneficiary test, however, this would need to have regard to the particular circumstances of the beneficiary and would, therefore, be unworkable.

8.12 For reasons of equity, integrity and simplicity, the Board believes that a set de minimis should be applicable to all types of 'unders' and 'overs'. This removes the need for any determination to be made as to why an under or over below the de minimis has occurred.

Recommendation 30

The Board recommends that:

- all 'unders' and 'overs', however arising, below a de minimis level of either 5 per cent of the net income of the Regime MIT for a year or a prescribed dollar value per unit be carried forward into the next income year following identification of the under or over.
- For 'unders' and 'overs' below the de minimis no amount of interest or penalty would be payable by the trustee or the Commissioner.

8.13 The Board recognises that as there are categories of income which may not be offset against net losses from another category, the trustee may need to determine a separate under/over figure for the different categories of income in order to accurately determine the taxable income figure for the following income year. However, for simplicity, the Board considers that to the extent that it would not prejudice beneficiaries of a particular class of units, the under/overs may be netted off against each other to determine if the de minimis is satisfied.

Recommendation 31

The Board recommends that for the purposes of applying the carry forward, the trustee may need to determine a separate under/over figure for:

- discounted capital gains;
- other capital gains;
- Australian source income ;
- foreign source income;
- franking credits; and
- foreign tax offsets.

To the extent that it would not prejudice beneficiaries of a particular class of units, the under/overs may be netted off against each other to determine if the de minimis is satisfied.

'Unders' greater than the de minimis

8.14 Under-payments of tax which are greater than the de minimis have a potentially significant effect on the revenue and individual beneficiaries. The most appropriate trade-off between the integrity of the revenue base, greater certainty and less complexity will differ from case to case depending on the size of the under, the type of beneficiaries and the cost to re-issue distribution statements. The Board therefore considers that case-by-case determination is appropriate. The best way to deliver case-by-case decision making is to allow the trustee to reissue distribution statements to beneficiaries within a certain timeframe but if the trustee does not reissue within the required timeframe, the trustee will be subject to tax on the full amount of the 'under' at the highest individual marginal tax rate. This approach will allow the trustee to determine whether the size of the 'under' warrants the level of complexity involved in reissuing distribution statements and re-attributing taxable income. Imposing tax on the trustee at the highest marginal tax rate will ensure that the revenue does not bear the cost of the trustee deciding not to reissue distribution statements.

8.15 The ability of the trustee to elect to reissue distribution statements provides Regime MITs with a degree of flexibility and assists in providing equity for beneficiaries. If the trustee is aware that a significant proportion of the beneficiaries in the Regime MIT are lower rate taxpayers (e.g. superannuation funds) and is able to reissue distribution statements without incurring prohibitive expense, it would be in the beneficiaries' best interests for the trustee to make this election.

8.16 The Board acknowledges that there will be compliance costs for MITs, investors and the ATO where an 'under' is identified and the trustee elects to reissue distribution statements. However, the Board considers that it is appropriate that the choice be available to MITs.

8.17 The Board considers that the timeframe by which a trustee must reissue distribution statements to beneficiaries in order not to be subject to taxation on the 'under' should be the subject of further stakeholder consultation as part of any legislative implementation process.

8.18 Where the trustee elects not to reissue, taxation of the trustee at the highest marginal tax rate on the 'under' provides structural integrity and acts as an incentive for the trustee to attempt to get the distribution statements and calculation of taxable income correct at first instance. It also facilitates collection of the underpaid tax and allows the trustee to be the relevant taxpayer in any appeal court case or other dispute with the ATO.

8.19 In the same manner as the current section 99A, when the trustee distributes an amount of income which has been assessed to it at the top marginal rate, this amount will be non-assessable, non-exempt income of the beneficiary. This will ensure that the income is not taxed twice – once to the trustee and once to the beneficiary. This will not achieve complete equity for unit holders (i.e. unit holders on a lower tax rate will not benefit as much from the exemption). However, it provides simplicity as it does not require complicated imputation-style rules to be introduced in order to reduce the double taxation of income which would otherwise occur at the beneficiary level.

8.20 The general power of the Commissioner of Taxation to audit a taxpayer's affairs, impose penalties and impose or remit GIC will not be affected.

Recommendation 32

The Board recommends that where an 'under' exceeds the set de minimis, the trustee may reissue distribution statements to beneficiaries and undertake a revised attribution of taxable income. If the trustee does not reissue distribution statements to beneficiaries or re-attribute within a certain timeframe, then the trustee will be assessed on the amount of tax shortfall at the top marginal tax rate.

In accordance with the current section 99A, when the trustee distributes an amount of income which has been assessed to it at the top marginal rate, this amount will be non-assessable, non-exempt income of the beneficiary.

Overs greater than the de minimis

8.21 Beneficiaries of a Regime MIT may change between the income year in which an over-payment of tax has occurred and the year in which it is discovered. Over-payments of tax which are greater than the de minimis can give rise to individual beneficiaries having paid excess tax in a previous income year. These beneficiaries may be different to the beneficiaries of the Regime MITs at the time the over is discovered. The Board considers that there is no practical and fair way for these beneficiaries to receive a refund of the additional tax paid without the trustee being required to reissue them with distribution/attribution statements and the beneficiaries having to amend their taxation returns. The Commissioner of Taxation would be required to refund additional tax paid to the beneficiary who actually paid it.

8.22 Accordingly, for reasons of equity, the Board recommends that in the case of an over greater than the de minimis, the trustee be required to reissue distribution/attribution statements to beneficiaries.

Recommendation 33

It is recommended that where an 'over' exceeds the de minimis, then the Regime MIT trustee must reissue distribution and/or attribution statements to beneficiaries.

8.23 The Board acknowledges that there is a risk that beneficiaries will be unfairly affected by the recommended approach to unders and overs. This issue was raised in the discussion paper but no submissions were made about how it could be addressed. Neither has the Board devised a workable structural solution. However, the Board considers that beneficiaries and potential beneficiaries need to be aware of the consequences for them and the trustee if the trustee decides not to reissue and re-attribute in the case of unders above the de minimis. Providing beneficiaries with this information should assist in ensuring that the beneficiaries are aware of the risks.

8.24 Accordingly, the Board recommends that Product Disclosure Statements and other disclosure documents be required to indicate to beneficiaries the potential for Regime MITs to carry forward tax errors, reissue distribution statements or, in the case of 'unders' above the de minimis, be taxed at the trustee level.

Recommendation 34

The Board recommends that Product Disclosure Statements and other disclosure documents be required to indicate to beneficiaries the potential for Regime MITs to carry forward tax errors, reissue distribution statements or, in the case of 'unders' above the de minimis, be taxed at the trustee level.

8.25 This proposed approach will not affect a beneficiary's right to seek compensation from the trustee for breach of duty should the circumstances warrant.

CHAPTER 9: INTERNATIONAL CONSIDERATIONS

9.1 Amongst the background to this review is the Government's objective of making Australia the financial services hub of Asia. A component in meeting this objective is to address any taxation barriers that limit the ability of Australian MITs to attract funds from non-residents, taking into account appropriate integrity concerns.

9.2 A wide range of issues concerning the involvement of non-residents in Australian MITs were raised with the Board. The Board has focussed on a number of priority issues: (a) clarification of MITs qualifying for treaty benefits; (b) whether there is a role for a potential corporate flow-through Collective Investment Vehicle (CIV) regime; (c) the impact on the tax status of a non-resident investor using an Australian fund manager; and (d) implications of the attribution regime for non-resident withholding tax.

MITs qualifying for treaty benefits

9.3 As noted in the discussion paper, international taxation is generally based on residence and source. Resident taxpayers of a country are taxed on their worldwide income and non-residents on income sourced in that country. Bilateral tax treaty models have been developed to deal with the double taxation that may arise where a resident of one country derives income sourced in another country.

9.4 Under these treaty models the source country reduces or gives up its taxing rights over passive income and the country of residence agrees to relieve double taxation on income of its residents which is taxed at source in another country. This latter outcome is achieved by giving a tax credit for the foreign tax paid against its own tax or by exempting the foreign source income from tax.

9.5 The OECD Model Tax Convention on Income and Capital (the 'Model Convention'), upon which virtually all modern bilateral tax treaties are largely based, does not include a specific provision dealing with CIVs. In the absence of specific rules, a CIV will be entitled to treaty benefits on its own right only if it is a person that is a resident of a Contracting State. To obtain treaty withholding tax reductions, it would also have to be the beneficial owner of the relevant income. The OECD has set up an Informal Consultative Group on the taxation of CIVs to examine issues associated with the granting of treaty benefits with respect to the income of CIVs, whether structured as companies or in other forms such as trusts, and also to consider possible improvements to procedures for tax relief for cross-border investors.

Views in submissions

9.6 A number of submissions raised concerns that there is some uncertainty and compliance costs with investors claiming treaty benefits, such as reduced source taxation, for foreign income derived by MITs on their behalf.

9.7 The Australian Custodial Services Association suggested adopting a corporate flow-through CIV regime, with investors being assessed on the distributions received on a 'receipts-basis'. Deloitte proposed to define a trust as a person in the Australian domestic income tax law. Both Greenwoods & Freehills and the Property Council of Australia suggested that, to provide greater certainty around access to treaty benefits at the MIT level, an MIT should be conferred with the status of an entity and a taxpayer under Australian domestic law, with a tax base that would prove to be nil or negligible in most cases. As noted by the Property Council of Australia[24]:

> … it might be possible to create, and the Board should explore, a regime under which: (a) 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 treaty purposes; and (b) 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.

Board's consideration

9.8 The Board concurs that there is uncertainty in claiming treaty benefits and that compliance costs for investors in MITs would be reduced by allowing MITs to claim treaty benefits at the MIT level, rather than investors having to claim them individually.

9.9 The Board considers that achieving access to treaty benefits by Australian regime MITs is facilitated by having agreement at the international level that CIVs, whether structured as companies or in other forms such as trusts, should be granted treaty benefits at the CIV level. However, achieving that outcome may take some time, as concurrence by a number of countries with different interests and regimes is required. To support that outcome, the Board has prepared a set of objectives that the Australian Government could pursue through engagement with the OECD and in Australia's treaty program. While the key objective remains obtaining treaty benefits at the MIT level, the Board considers that concurrent objectives related to facilitating access to treaty benefits for investors in MITs should also be pursued. The Board has identified a number of specific recommendations that would assist and support these key objectives. These are discussed below.

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24 At page 42.

Objective 1

MITs should obtain treaty benefits at the MIT level.

9.10 The Board considers that MITs should be able to claim treaty benefits on foreign income, at least to the extent that the MIT's beneficiaries are residents entitled to treaty rates or non-residents entitled to equivalent treaty benefits. Due to the administrative difficulties faced by MITs in obtaining sufficient information to determine the extent of beneficiaries' rights, a proxy rule is likely to be needed.

9.11 The Informal Consultative Group to the OECD in its January 2009 report on 'possible improvements to procedures for tax relief for cross-border investors' has recommended that countries develop systems for claiming treaty benefits that allow authorised intermediaries to make claims on behalf of their customers on a 'pooled' basis. The Board considers that the implementation of this recommendation should be explored further, with a view to ensuring that MITs are able to claim treaty benefits on behalf of their investors.

9.12 The Board is of the view that the status of a trust CIV (such as a MIT) as a 'person' and 'resident' for treaty purposes (and the treaty benefits to be applied to the income that flows through such entity) is best clarified through the OECD processes and, on a bilateral basis, through future treaty negotiation or, in the case of existing treaties, by mutual agreement procedures.

Recommendation 35

The Board recommends:

- active participation by Treasury, the ATO and the Australian private sector in the current work being undertaken by the OECD on the granting of treaty benefits with respect to Collective Investment Vehicles (CIVs)[25];
- development by Treasury, in consultation with the ATO and the private sector, of draft treaty provisions, broadly based on proposals emerging from the OECD CIV work, that would specifically provide for the granting of treaty benefits to MITs that meet certain criteria designed to address treaty shopping concerns; and
- with respect to existing treaties, exploring by the ATO through the mutual agreement procedure of the extent to which treaty partners may provide treaty benefits at the MIT level.

Objective 2

Ensure that investors who derive foreign income through a MIT be entitled to credits for foreign tax paid at source.

9.13 The Board understands that there is some uncertainty about whether Australian resident investors are entitled to credits for foreign tax paid at source on income derived through an Australian MIT.

9.14 The Board also understands that the extent to which the country of residence of foreign investors in a MIT may be prepared to provide tax credits in respect of source taxation on income paid to a MIT is unclear. It is against this background that the Board recommends active participation in OECD CIV work to pursue this objective.

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[25] Private sector participation may be possible on the 'procedures' work following on from the Report of the Informal Consultative Group on taxation of CIVs on possible improvements to procedures for tax relief for cross-border investors, released in January 2009. The Group's companion report on policy and interpretative issues relating to the granting of treaty benefits, on which public comments were invited by March 2009, is currently being considered by the OECD's Working Party 1 (WP1), which is only open to Government delegates. Private sector comments may however be sought on WP1's conclusions if and when a Discussion Draft is released for public comment.

Recommendation 36

The Board recommends:

- active participation by Treasury, the ATO and the Australian private sector in the OECD CIV work with a view to developing draft treaty provisions and procedures to ensure that credits for foreign tax paid at source are flowed through to investors;
- for Australian resident investors in Australian MITs that derive foreign income under an attribution model, ensure that the foreign tax paid at source on their share of that income be subject to foreign income tax offsets in the hands of such investors; and
- for Australian residents with investments in foreign CIVs, ensure that to the extent that a foreign income tax offset is available under domestic law, it is available regardless of the form of the foreign CIV (provided it is economically equivalent to a flow-through vehicle), and draft treaty provisions be developed to provide the same outcome on a symmetrical basis.

Objective 3

Ultimate investors in MITs should be able to access treaty benefits in their own right where they can access benefits under the treaty between their residence country and the country of source of the income derived through the MIT that exceed those available to the MIT under the treaty between its country of residence and the country of source.

9.15 The Board acknowledges that the entitlements of ultimate investors are difficult to prove and this objective may be difficult to negotiate with treaty partners, particularly where it involves ultimate investors who are not residents of Australia. Implementation of this policy with respect to third country investors would need to be driven by the major treaty partners. That said, the Board recommends active participation by Treasury, the ATO and the Australian private sector in the OECD CIV work with a view to determining the viability of treaty provisions to provide more favourable treaty benefits where investors would be entitled to such benefits if they had invested directly.

Recommendation 37

The Board recommends active participation by Treasury, the ATO and the Australian private sector in the OECD CIV work with a view to determining the viability of treaty provisions to provide more favourable treaty benefits where investors would be entitled to such benefits if they had invested directly.

Objective 4

Ultimate investors in MITs be able to obtain treaty benefits in their own right on disposal of interests in an MIT and with respect to distributions/attributions from an MIT.

9.16 The Board understands that recent Australian treaties do not provide certainty with respect to gains from disposal of portfolio interests in land-rich MITs, since source taxation of such gains is not precluded under the treaty, notwithstanding that these gains are not generally taxed under domestic law. Amending the Australian preferred treaty position could address this uncertainty. Moreover, where a widely held Australian MIT takes a non-portfolio investment (on behalf of the members of the MIT) in the land rich foreign CIV, effectively this is a portfolio investment by the members of the MIT in the foreign CIV and should get the same treaty treatment as if the members invested directly. Treaty benefits for investors should be provided through a single treaty provision for income distributed or attributed by the MIT to investors.

Recommendation 38

The Board recommends that:

- the Australian preferred treaty position be to exclude source taxation of gains from disposal of portfolio interests in land-rich entities in future treaties;
- the Australian preferred treaty position be that the treaty treatment of portfolio gains on disposal be applicable where a widely held Australian MIT has a non-portfolio interest in a land rich foreign CIV; and
- subject to Recommendation 37, the Australian preferred treaty position be that the investors in CIVs be able to obtain treaty benefits with respect to distributions/attributions of income from CIVs.

Objective 5

If there is one or more interposed foreign CIVs between the MIT that derives the income and the ultimate investor, there should be no further levy of tax other than at the ultimate investor level.

9.17 The Board acknowledges that the absence of a conduit foreign income in many countries is a major barrier to ensuring that further tax is not imposed by chains of interposed CIVs that lie between the ultimate investor and the investment. The Board also recognises that Australia's ability to influence the domestic law of other countries in this regard is minimal and that tax treaties typically do not limit the right of countries to impose tax on their own residents. The Board accepts that this is probably the most difficult objective to achieve, but considers it an appropriate objective for Australia to pursue through the OECD.

Recommendation 39

The Board recommends:

- active participation by Treasury, the ATO and the Australian private sector in the current work being undertaken by the OECD on the granting of treaty benefits with respect to CIVs; and
- depending on progress on international agreement on the above objective, development by Treasury, in consultation with the ATO and the private sector, of draft treaty provisions to limit the scope for foreign income tax to be imposed where there are interposed intermediaries between the ultimate investor and the investment.

A potential corporate flow-through CIV regime

9.18 The Board considered whether a corporate CIV with non-resident investors could achieve appropriate taxation outcomes when investing overseas. A corporate flow-through CIV was described by stakeholders as a corporate or company entity, regardless of how that type of entity might normally be treated for tax purposes, to which the features normally associated with MITs such as transparency, character flow-through and access to the CGT discount would apply.

Views in submissions

9.19 Stakeholders commenting on this issue noted that many foreign investors are not familiar with trusts and would prefer to invest in a corporate flow-through CIV, which would be a corporate CIV but with MIT-like taxation. To allow Australian fund managers to serve these clients, IFSA has recommended that the new provisions that

apply to MITs should not be limited to unit trusts, but instead any legal entity that meets the prescribed prerequisite conditions would be eligible to elect irrevocably into the new regime.

9.20 The Australian Custodial Services Association (ACSA) has noted that corporate CIVs would qualify for treaty benefits in their own right. Its submission stated:

> Corporate CIVs would qualify for treaty benefits in their own right. The BOT paper at paragraph 5.16 states that the OECD considers it desirable for MITs to be able to claim treaty benefits on behalf of beneficiaries, and also that income derived by corporate CIVs should be recognised as flow-through for treaty purposes.

Board's consideration

9.21 The Board acknowledges the interest expressed by stakeholders in having a corporate CIV regime which would provide the features normally associated with MITs such as transparency, character flow-through and access to the CGT discount. However, the Board notes that providing for such a vehicle may not address all of the objectives sought by industry, particularly in flowing through credits for foreign taxes paid at source to investors. The issue is that the CIV would generally not be recognised in the country of the investor as being fiscally transparent. This situation exists with corporate CIV regimes internationally. The credit for tax paid at the CIV level in the source country therefore may not be passed through to investors. The Board notes that in this respect the Australian flow-through regime offers significant benefits over the corporate CIV regimes of other countries. As one of the aims of this review is to make Australia's regime competitive internationally a corporate flow-through CIV as currently recognised internationally would not assist this aim.

9.22 However, if corporate CIV regimes become so dominant internationally that the MIT regime becomes less competitive, the Board considers that it is in Australia's best interest to have enough flexibility in its treaties to ensure that both regimes can be accommodated if introduced in Australia. Therefore, the Board recommends that Australia ensures in future treaties that treaty language is flexible enough to accommodate both a MIT regime and a potential corporate flow-through CIV regime (and so provide for platform neutrality).

Recommendation 40

The Board does not recommend a corporate flow-through CIV regime at this stage, but that Australia ensures in future treaties that treaty language is flexible enough to accommodate both an MIT regime and a potential corporate flow-through CIV regime (and so provide for platform neutrality).

Fund manager exemption

9.23 An issue raised with the Board is that there is a lack of clarity around how income flowing from a foreign country through an MIT to non-residents is treated where the management of the investments giving rise to the income is undertaken by an Australian fund manager. The 'fund manager exemption' is an attempt to clarify that such income is not subject to Australian tax.

Views in submissions

9.24 A number of submissions have recommended that a 'fund manager exemption' be introduced to ensure that non-resident investors do not create a taxable presence (i.e. do not become subject to Australian tax) merely by virtue of having appointed an Australian fund manager to manage their funds. Both Barclays and IFSA have noted that while under Australian tax law non-resident beneficiaries in an Australian trust will only be subject to tax on income and gains having a source in Australia, there is no definition or clear concept of source of income and gains in legislation. IFSA has suggested that, similar to other jurisdictions, a 'fund manager exemption' be introduced in Australia.

9.25 In their international tax submission to the Board, IFSA argues that a 'fund manager exemption' would address situations in which foreign source income flowing through to non-residents is taken to be Australian source income under Australian tax law because the management and control function is performed by an Australian fund manager. As noted by IFSA:

> Other jurisdictions have dealt with similar issues by introducing a 'fund manager exemption' to ensure that non-resident investors do not create a taxable presence in these jurisdictions merely by virtue of having appointed a local fund manager to manage their money. Such an exemption has been introduced in the UK and Hong Kong and is currently proposed in Japan.

9.26 Related to the issue of source, IFSA has also submitted to the Board that the tax law be amended so that non-resident investors in an Australian trust would not be subject to tax on hedging gains which relate to ex-Australian assets irrespective of where they are sourced. It also argues that it would make sense to exempt hedging gains relating to Australian assets which are not taxable Australian property as defined in section 855-15 of the ITAA 1997.

Board's consideration

9.27 In its 2003 report on International Taxation Arrangements, the Board recommended that the law be amended so that a non-resident investor in an Australian managed fund is not taken to be carrying on a business in Australia (recommendation 4.6 (2)). The explanatory memorandum for the *New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004* noted that Schedule 2 to the bill gives effect to this recommendation.

9.28 As noted in the explanatory memorandum, the amendments were designed to align the tax treatment of foreign residents investing through managed funds that derive some or all of their income from sources outside Australia with the tax treatment that would apply if those foreign residents made such investments directly. The explanatory memorandum noted that by removing Australian tax in these cases the amendments will improve Australia's international competitiveness in providing fund management services to foreign investors.

9.29 The Board understands that notwithstanding the abovementioned legislative changes, the lack of a clear concept of source of income and gains continues in the law. The Board considers that the determination of source should be clarified so that income flowing from a foreign country through to non-residents is not taken to be Australian source income under Australian tax law merely because the management function is performed by an Australian fund manager.

9.30 However, the Board notes that, depending upon how it is designed, the scope of a fund manager exemption could be broadened to such a degree as to give rise to unintended consequences for Australia's source taxation, and has the potential to impact on the revenue base. The Board has also been made aware that the issue is part of a larger issue being pursued through the Australian Financial Centre Forum. The Board also notes that the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs has asked Treasury to examine and provide advice on industry's proposal to introduce an investment manager exemption.

9.31 As the fund manager exemption and some broader issues are being considered through other processes, the Board has not made a specific recommendation on this issue. However, the Board strongly reiterates the recommendation it made in its report on International Taxation Arrangements. The Board also suggests that as part of the broader review of industry's proposal to introduce a fund manager exemption, consideration be given to an examination of the source rules for determining conduit taxation outcomes, ensuring that income flowing from a foreign country through to non-residents is not taken to be Australian source income merely because the management of the investments giving rise to the income is undertaken by an Australian fund manager.

Implications of an attribution regime for the withholding tax regime for MITs

9.32 Under an attribution regime for determining the tax liabilities of Regime MITs and their beneficiaries as outlined in recommendation 19, there is the potential for the Regime MIT to attribute net income to non-resident beneficiaries without making a corresponding payment or distribution of cash. As the withholding tax regime is based on payments, the potential arises for non-resident investors to benefit from the deferral of taxation liabilities where a Regime MIT accumulates rather than distributes income.

Views in submissions

9.33 Some stakeholders, such as the Property Council of Australia, have noted that under an attribution regime some modification to the withholding tax regime for MITs might be needed to deal with amounts that are not distributed to investors. In this context it has raised the possibility of attributing to non-residents a share of the tax liability on the attribution MIT's taxable income with the trustee liable to collect and remit the applicable tax to the ATO. As noted by the Property Council of Australia in its submission:

> 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.

Board's consideration

9.34 As non-resident investors would benefit from the deferral of taxation liabilities where a Regime MIT accumulates rather than distributes income, an integrity measure is needed to avoid this inappropriate outcome. This might involve an adjustment of current withholding rules, or the general trust rules, to make the withholding liability arise on attribution for MIT income in such cases. The Board acknowledges that there may be compliance and administrative issues associated with this proposed solution.

Recommendation 41

The Board recommends that an integrity provision be introduced to ensure that non-resident investors do not benefit from the deferral of taxation liabilities where a Regime MIT accumulates rather than distributes income.

CHAPTER 10: DIVISION 6B OF THE *INCOME TAX ASSESSMENT ACT 1936*

10.1 The terms of reference asked the Board to examine whether there is a continuing need for Division 6B of the Income Tax assessment Act 1936, in light of the operation of the capital gains tax regime, dividend imputation and Division 6C.

10.2 Division 6B was introduced in 1981 to discourage the reorganisation of companies involving the transfer of assets or businesses into a resident public unit trust in which the shareholders would take equity in order to avoid continued company tax and shareholder treatment and to attract trust tax treatment instead. It was introduced when the (then) classical system of taxation applied. Under the classical system of taxation investors in trusts were tax advantaged compared to companies because investors in companies were subject to tax both at the company level and then again at the shareholder level without a credit being available for the tax paid by the company. Additionally, tax deferred distributions by trusts generally had no taxation implications for beneficiaries. At the time, assets could be transferred to a trust from a company without capital gains tax consequences. Now there is imputation and CGT.

Views in submissions

10.3 All submissions commenting on this issue argued that Division 6B should be abolished as it has outlived its purpose. Submissions noted that the purpose of Division 6B was to protect the corporate tax base under the 'classical system' of taxation, under which the profits of a company were taxed twice, once in the hands of the company, and again when they were distributed to shareholders as dividends. Subsequent changes to taxation laws, such as the introduction of the capital gains tax regime, Division 6C for public trading trusts and dividend imputation, had removed the need for Division 6B as an integrity measure. As noted by BDO Kendalls:

> BDO submits that Division 6B should be repealed. Division 6B was established at a time when there was a need to prevent companies from transferring assets or businesses into a resident public unit trust in order to attract the tax advantages associated with flow through taxation. However as a result of the introduction of capital gains tax and dividend imputation, there does not seem to be any further policy grounds for the continuation of Division 6B. In addition, we submit that Division 6B also presents a major impediment to companies restructuring their property holdings. While this provision was essential during the pre-imputation classical taxation system, given the drawbacks and the subsequent changes to taxation laws, Division 6B is no longer needed.

Board's Consideration

10.4 The Board considers that Division 6B has outlived its original purpose which was to prevent the erosion of the classical system of taxation through the use of unit trusts. The Board further considers that any integrity concerns that could arise from its removal will be better addressed through the arm's length rule (see recommendation 10) than relying on Division 6B.

Recommendation 42

Division 6B should be abolished, provided an arms length rule is introduced as part of the EIB rules proposed under the new MIT regime.

CHAPTER 11: OTHER ISSUES

FIXED TRUSTS

11.1 The Board's discussion paper outlined the current problems MITs face in meeting the fixed trust eligibility requirements for a number of taxation concessions such as the trust loss rules, simplified franking credit rules and CGT scrip-for-scrip rollover relief.

11.2 The discussion paper suggested potential options for clarifying the treatment of fixed trusts including (a) introducing a rule whereby certain MITs will be deemed to be fixed trusts; or (b) altering the definition of the term 'fixed trust' to ensure that the term does not rely on the concept of 'vested and indefeasible' interest. Comments were sought on the advantages and disadvantages of these potential options or any other options that may be suggested.

Views in submissions

11.3 Most submissions support the option of a statutory rule providing that MITs be deemed to qualify as fixed trusts for the purposes of the tax law. The submission from BDO Kendalls, for example, argues:

> The term 'vested and indefeasible' interest has, in practice, created situations where it is unclear whether a fixed trust has been formed. For example, the existence of certain powers within the trust deed in relation to the issue of additional units and/or beneficiary entitlements could mean that interests in income and capital become inherently defeasible, defeating the definition of fixed trust. Whether or not a MIT is a fixed trust is of utmost importance to the taxation implications and the uncertainties within the definition of a fixed trust cause significant compliance and technical difficulties.
>
> …
>
> We submit that the optimal solution to this issue would be to introduce a rule whereby MITs will be deemed to be fixed trusts. We believe such a rule would mitigate any requirement to determine whether an MIT is a fixed trust. We further submit that, in practice, most if not all MIT's are structured with the intent of being a fixed trust and have no intention of taxation treatment as a non-fixed trust.

11.4 Other reasons given in support of the statutory rule option included

- A deeming provision would be relatively simple;
- It would remove uncertainty for MITs about this issue and reduce compliance costs; and
- It would remove MITs dependence on the exercise of the Commissioner's discretion.

11.5 The Deloitte submission also raised the possibility of altering the definition of fixed trust to remove the current uncertainty. They argued that the benefit of this option is that altering the definition of a fixed trust would result in a 'whole of trust' solution, not just a MIT solution. They note, however, that developing a new definition would require extensive consultation, is time consuming and complicated and therefore, was not their preferred solution for MITs.

Board's consideration

11.6 The present provisions which turn on the concept of a fixed trust create an unacceptable level of uncertainty and compliance costs for MITs.

11.7 The Board considers that the key principle behind the fixed trust integrity rules is that the interests in the trust should remain sufficiently stable such that the trust would not be considered 'discretionary'. The Board is of the view that 'discretionary' trusts should not fall within the proposed Regime MIT regime and should be restricted from accessing the current concessions for fixed trusts.

11.8 However, as discussed in Chapter 2, simply imposing restrictions on any discretions or powers available to the trustee could inappropriately exclude some Regime MITs. Accordingly, the Board has made certain recommendations to ensure that these concerns are addressed in relation to Regime MITs. The Board has recommended that a specific qualifying criteria for Regime MITs be that beneficiaries' rights to income (including the character of income) and capital must be clearly established at all times in the trusts constituent documents. It has also recommended that provisions akin to the *Corporations Act* requirements, which specify the circumstances under which the constitution may be amended and prescribe rules the trustee must follow when dealing with beneficiaries, should be incorporated within the taxation laws applying to 'Regime MITs.' [26]

11.9 Unlike the current fixed trust rules, these recommendations do not turn on the concept of fixed entitlements or vested and indefeasible interests but are designed to target specific integrity concerns.

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26 See recommendation 3.

11.10 In view of the recommended integrity rules for Regime MITs, the Board considers that Regime MITs should be deemed to be fixed trusts for all other provisions of the taxation law.

Recommendation 43

The Board recommends that a trust which qualifies as a Regime MIT will be deemed to be a fixed trust for all other provisions of the taxation law.

RESETTLEMENTS

11.11 The Board's discussion paper outlined the current legal uncertainty for MITs that arises where the terms of a trust instrument are varied. In some cases, amendment of trusts constituent documents can result in the creation of a new trust and/or in an alteration to the nature of a beneficiary's interest in the trust. Either outcome can result in adverse taxation consequences to beneficiaries.

11.12 The Board asked for stakeholder comment on potential approaches for addressing these issues and whether the extent of relief that could be provided would depend on how a MIT is defined for tax purposes.

Views in submissions

11.13 The majority of submissions which addressed the issue argued that an amendment to the trust deed of an MIT should not result in a resettlement. Some particularly noted that trust deed amendments required in order to fit within the proposed regime should not result in a resettlement. Deloitte for example argued that:

> We believe that similar issues may arise if MITs are required to amend their trust deeds to fit within a proposed MIT regime. In our view, it is crucial that a legislative amendment be introduced to provide certainty that deed amendments of an MIT in certain situations, such as these are not to be considered a resettlement for the purposes of the Tax Act.

11.14 Deloitte also emphasised that an MIT governed by the *Corporations Act 2001* would only be able to amend the trust deed in limited circumstances and therefore, there are no tax integrity concerns in allowing the concession:

> Furthermore, as highlighted in section 2.1.2 of this submission, if the Board recommends that the definition of an MIT be consistent with section 12-400 of the TAA 1953, we highlight that the constitution of many trusts governed by the CA 2001 can generally only be amended in certain limited circumstances, either by way of a special resolution of the members of the scheme, or by the responsible entity if the responsible entity reasonably considers that the change will not affect member's rights. Accordingly, we do not believe

> that there are tax integrity concerns associated with deed amendments by MITs. We believe that such a change is not different to a change to a company's constitution where that company is governed by the CA 2001. We highlight that such companies have a degree of certainty that such changes will not trigger a tax liability to either the company or its members.

11.15 Others argued that the issue had been resolved to some extent by recent case law.

Board's consideration

11.16 The Board was reluctant to recommend a general rule providing that the amendment of an MIT's constituent documents would not result in a resettlement as it would have a broad application and pose a threat to the revenue.

11.17 However, the Board considered that in order to remove any potential uncertainty or unintended consequences, resulting from MITs changing their constituent documents in order to qualify as a Regime MIT, a specific roll-over provision should be introduced. The provision should provide that if the amendment of an MIT's constituent documents, in order to qualify as a Regime MIT results in a resettlement, no adverse taxation consequences will arise.

Stamp duty implications

11.18 The Board notes that the amendment of a trust's constituent documents could trigger a liability to State or Territory stamp duty if the amendment resulted in a material change to the rights of unit holders to income or capital and if dutiable property was involved. This issue may need to be addressed but is beyond the scope of the Board's review.

Recommendation 44

It is recommended that a roll-over provision be introduced which provides that if the amendment of a MIT's constituent documents, in order to qualify as a Regime MIT results in a resettlement, no adverse taxation consequences will arise.

Chapter 12: Other widely held trusts

12.1 The terms of reference asked the Board to review the current tax arrangements applying to MITs, which were defined as 'widely held' collective investment vehicles 'undertaking primarily passive investments'. The Board was asked to advise on options for introducing a specific tax regime for MITs which would reduce complexity, increase certainty and minimise compliance costs. In this report, the Board has made recommendations for a specific tax regime for trusts which it has described as Regime MITs. Regime MITs are trusts which satisfy the Board's criteria of being 'widely held', 'engaged in primarily passive investments' and satisfy a 'clearly defined rights' requirement. As discussed previously in this report, the Board considered that the 'clearly defined rights' requirement was necessary to enable the recommended attribution method for determining tax liabilities to be applied with sufficient integrity as well as to allow Regime MITs to be deemed to be fixed trusts for other purposes of the taxation laws.

12.2 However, in light of the terms of reference for the review, the Board considers that other 'widely held' MITs and public unit trusts which are 'engaged in primarily passive investments' but do not satisfy the 'clearly defined rights' requirement should not be prevented from accessing some of the measures it has recommended for Regime MITs. Allowing wider access to these measures should contribute to the objective of reducing complexity, increasing certainty and reducing compliance costs for MITs without additional integrity concerns arising.

12.3 Accordingly, the Board considers that other 'widely held' MITs[27] and public unit trusts as set out in paragraph 12.2, should have access to the following recommendations:

- the treatment of 'debt like' units (Chapter 5);
- character retention and flow-through (Chapter 6);
- addressing double taxation (Chapter 7); and
- international considerations (Chapter 9).

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27 See Recommendation 2

Recommendation 45

The Board recommends that other 'widely held' MITs and public unit trusts which are 'engaged in primarily passive investments' but do not satisfy the 'clearly defined rights' requirement should be able to benefit, as applicable, from the recommendations the Board has made on:

- the treatment of 'debt like' units (Chapter 5);
- character retention and flow-through (Chapter 6);
- addressing double taxation (Chapter 7); and
- international considerations (Chapter 9).

The treatment of gains and losses made on the disposal of investment assets by eligible MITs and options for dealing with 'unders' and 'overs'

12.4 The Board considers that the recommendations it has made with respect to the treatment of gains and losses made on the disposal of investment assets by MITs (Chapter 4) and options for dealing with 'unders' and 'overs' (Chapter 8) should be extended to other 'widely held' MITs but not to other public unit trusts that do not satisfy the 'widely held' MIT definition requiring that the MIT be subject to a suitable regulatory regime.

Recommendation 46

The Board recommends that the following recommendations should apply to other 'widely held' MITs which are 'engaged in primarily passive investments' but do not satisfy the 'clearly defined rights' requirement, namely:

- the treatment of gains and losses on disposal of investment assets by eligible MITs (Chapter 4); and
- options for dealing with 'unders' and 'overs' (Chapter 8).

Fixed Trusts

12.5 Trusts which do not qualify as Regime MITs will be subject to the existing law in relation to fixed trusts. The Board acknowledges that the application of the current fixed trust provisions to these trusts continues to cause uncertainty. Accordingly, the Board recommends that a general review of the fixed trusts rules be undertaken with the aim of increasing certainty and reducing compliance costs for other unit trusts.

Recommendation 47

The Board recommends that a general review of the fixed trust rules be undertaken with the aim of increasing certainty and reducing compliance costs for other unit trusts.

CHAPTER 13: IMPLICATIONS FOR OTHER TRUSTS

13.1 The terms of reference for the review asked the Board to examine the desirability of extending relevant aspects of the recommended changes to the tax arrangements applying to other trusts.

13.2 In its discussion paper, the Board requested stakeholder comments on whether any options for change that stakeholders had suggested for MITs should be extended to other trusts.

Views in submissions

13.3 Very limited specific comments were received on this issue.

13.4 A small number of submission argued that legislative amendment to provide clarity and certainty for all trusts in relation to the operation of Division 6 of the ITAA 1936 was needed. For example, CPA Australia argue that:

> Both the Australian Taxation Office (ATO) and the tax profession acknowledge that there are different views about the interpretation of Division 6 in respect of both MITs and other trusts. These issues are highlighted in a draft discussion paper on this topic which was recently released by the ATO to the National Tax Liaison Group (NTLG) for comment as noted in the Boards discussion paper.
>
> …
>
> If the ATO persists with its current views of Division 6 and commences to overturn longstanding practice in this area before the judicial process is finalised, it is our strong view that there is a need for the relevant legislative provisions to be amended to provide both clarity and certainty in relation to the taxation arrangements for both MITs and other trusts, especially as the later are widely used in the small business area.

13.5 Regarding specific proposals, Taxpayers Australia Inc suggested that if MITs were to be given a three month grace period after the end of the income year to make distributions and claim deductions for that year, then for consistency, other trusts should be given the same grace period.

13.6 Deloitte suggested the need for a separate review for other trusts as their policy issues are fundamentally different to those with MITs. IFSA also recommended a separate review of Division 6 for other trusts in order not to delay the operation of a new MIT regime.

Board's consideration

13.7 In light of the terms of reference for the review and the desire to create a taxation regime for MITs which would make them more internationally competitive, the Board has made a set of recommendations designed specifically for Regime MITs, and also noted what recommendations could be extended to other widely held MITs and other public unit trusts.

13.8 The Board has the view that the most of its recommendations for MITs would not be applicable, in their current form, to other forms of trusts given their closely held or discretionary nature or the lack of external regulation to which they are subject.

13.9 As outlined earlier, the Board ultimately decided to recommend that Regime MITs be able to elect to use an attribution model of taxation because it considered that this model best achieved the desired outcomes for the review, including improving international competitiveness and increasing flexibility for these MITs. In choosing this option, substantial weight was given to the commercial nature of Regime MITs, their widely held status and the level of external regulation to which they are subject.

13.10 However, the Board is of the view that some of the Options for determining tax liabilities, such as the distribution model or the patch model might usefully be the subject of a wider review for potential application to types of trusts that are not MITs. This consideration might result in an improvement to the existing Division 6 taxation rules for other types of trusts.

13.11 The Board further recommends that IDPS and similar bare trust type arrangements should be excluded from taxation under Division 6 generally.

Recommendation 48

The Board recommends that:

- the existing Division 6 rules be the subject of a wider review to consider if some of the other Options for determining tax liabilities, such as the distribution model or the patch model, might usefully be applied to types of trusts that are not MITs; and

- IDPS and similar bare trust type arrangements should be excluded from taxation under Division 6 generally.

APPENDIX A: TABLE 1 – FEATURES OF THE TAXATION REGIME FOR 'REGIME MITS'

The Attribution Model	(a) A beneficiary is assessable on the amount of taxable income of the trust that the trustee allocates to the beneficiary; (b) The trustee must allocate the taxable income of the trust between beneficiaries on a fair and reasonable basis consistent with their rights under the trust's constituent documents and the duties of the trustee; and (c) The trustee will be taxed on any taxable income of the trust which the trustee fails to allocate to beneficiaries within three months of the end of the financial year. A special rule will apply in the case of unders and overs.
Calculation of the taxable income of the trust	The taxable income of the trust will be calculated broadly in the same manner as s.95 of the ITAA 1936 Trust Income Legislative clarification will be provided as to whether capital gains are 'income' of the trust. Allocation of expenses against trust income A legislative rule should be included for allocating expenses against trust income based on the principles from the case of *Ronpibon Tin N.L. and Tongkah Compound N.L. v. Federal Commissioner of Taxation* (1949) 78 CLR 47. That is, if an expense relates directly to a particular type of trust income, then it should be allocated against that income. If an expense is general, then it should be apportioned, on a reasonable basis, against all trust income types. Legislative clarification should be given as to: (a) whether general expenses can be allocated against capital gains (if they are considered trust income) or not. If they can it should be clarified whether this is against the gross or net capital gains; (b) how net losses related to one class of income should be allocated/offset; and (c) how manager's fees should be dealt with.

<table>
<tr><td>Who is liable to be assessed on the taxable income of the trust</td><td>The trustee must allocate the taxable income of the trust between beneficiaries on a fair and reasonable basis consistent with their rights under the trust's constituent documents and the duties of the trustee.

This rule is intended to be broad enough to apply to beneficiaries who redeem/sell their units during an income year. In this case, an exiting beneficiary will be attributed with an amount of taxable income which is consistent with the period of ownership. The same principles would apply to an incoming beneficiary.

The rule is intended to enable the fair allocation of extraordinary capital gains/income to a redeeming beneficiary where the redemption triggers the sale of underlying trust assets in order to fund the redemption.

Carve out for 'debt like' interests

The Board recommends that legislative rules be introduced which provide that where units issued by an MIT meet the 'substantially equivalent to a loan' test in Division 207 of the ITAA 1997, they will not be subject to the general method for allocating the taxable income for MITs. Instead, the amount accruing to these unit holders should be taxable to them as interest and these amounts should reduce the taxable income of the MIT.</td></tr>
<tr><td>Cost base adjustments</td><td>In order to minimise potential tax distortions arising on the sale of a beneficiary's units in an MIT it is recommended that the cost base/reduced cost base of a beneficiary's units would need to be adjusted in the following circumstances:

(a) where taxable income is attributed to a beneficiary, then the cost base of the beneficiary's units should be increased by the amount attributed (adjusted upwards for certain CGT amounts that are currently disregarded under CGT event E4 and downwards to reflect the value of certain tax offsets, for example, the franking credit gross up); and

(b) where distributions are received, the cost base will be reduced by the amount of the distribution.

MITs should be required to supply beneficiaries with yearly statements outlining:

(a) the amount of tax attributed to beneficiaries;
(b) the required adjustments for certain amounts currently excluded under CGT event E4 and the value of certain tax offsets; and
(c) distributions made during the income year;

for the purpose of the beneficiary determining the amount of their cost base adjustments on a yearly basis.

Revenue account holders

A rule should be introduced to require that revenue account holders use the adjusted cost of the units.</td></tr>
</table>

Character retention and flow-through	Legislatives rules should be introduced to specifically provide for character and source retention and flow-through generally in MITs.
Correcting errors in the calculation of notional taxable income	Unders' and 'overs' below a de minimis level of either 5 per cent of the net income of the trust for a year or a prescribed dollar value per unit be carried forward into the next income year following identification of the under or over. For 'unders' and 'overs' below the de minimis no amount of interest or penalty would be payable by the trustee or the Commissioner. Where an 'under' exceeds the de minimis then the trustee may reissue distribution statements to beneficiaries and undertake a revised attribution of taxable income. If the trustee does not reissue distribution statements to beneficiaries or re attribute within a certain timeframe, then the trustee will be assessed on the amount of tax shortfall at the top marginal tax rate. In accordance with the current section 99A, when the trustee distributes an amount of income which has been assessed to it at the top marginal rate, this amount will be non-assessable, non-exempt income of the beneficiary. Where an 'over' exceeds the de minimis, then the trustee must reissue distribution statements to beneficiaries.

Appendix B: List of public submissions

Abacus Australian Mutuals
Australian Bankers Association
Australian Custodial Services Association
Australian Foundation Investment Company
Australian Listed Investment Companies Association
Australian Private Equity And Venture Capital Association Limited
Barclays Global Investors
BDO Kendalls
Blake Dawson
Corporate Tax Association of Australia
CPA - Australia
Deloitte
Ernst & Young (submission 1)
Ernst & Young (submission 2)
Greenwoods & Freehills (submission 1)
Greenwoods & Freehills (submission 2)
Infrastructure Partnerships Australia
Investment & Financial Services Association (submission 1)
Investment & Financial Services Association (submission 2)
Investment & Financial Services Association (submission 3)
Mallesons Stephen Jaques
Moore Stephens Sydney Pty Ltd
Platinum Investment Management Limited
Property Council of Australia (submission 1)
Property Council of Australia (submission 2)

QIC Limited
REST Superannuation
Taxation Institute of Australia (submission 1)
Taxation Institute of Australia (submission 2)
Taxpayers Australia Inc
The Association of Superannuation Funds of Australia Limited
The Institute of Chartered Accountants in Australia
The Law Society of New South Wales
Warakirri Asset Management Pty Ltd
Whitefield Ltd

Appendix C: Beneficiary level cost base adjustments

Introduction

Recommendation 26 sets out the proposed adjustment methodology for beneficiary cost base adjustments under the attribution model. It is proposed that the cost base or reduced cost base of a beneficiary's units in an MIT be increased, on an annual basis, by the amount of taxable income attributed to the beneficiary (with further upward adjustments for CGT event E4 amounts[28] and be reduced, on an annual basis, by downward adjustments for certain tax offsets[29]). Furthermore, the cost base or reduced cost base will be reduced by the amount of any actual payments received by the beneficiary. A capital gain is made under the proposed rules where the payment received exceeds the cost base of the units.

The following example is used to demonstrate the proposed beneficiary level cost base adjustments under an attribution model, being the replacement for CGT event E4 for beneficiaries of an MIT.

Background

The XYZ Trust is a managed investment trust (assumed for the purpose of this example to be an MIT even though reference is made to two beneficiaries). It has two beneficiaries, Beneficiary A and B, who hold 1.75 million units and 750,000 units respectively. Each beneficiary shares in distributions of income and capital of the MIT based on their respective units held at the end of the income year.

Income statement for the 2010 income year

The following table provides a statement of accounting profit and taxable income derived by the XYZ Trust for the 30 June 2010 income year. In this example, the XYZ Trust derives interest income, dividends, rental income and a capital gain from the sale of shares.

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28 For example, the discount component of a capital gain that is disregarded under section 104-70(1) or other amounts disregarded under section 104-71(3).

29 For example, the gross up component of a franking credit.

Income items	Accounting	Tax	Difference
Rent from properties	20 000	20 000	-
Investment property expenses (deductible)	(5 000)	(5 000)	-
Division 43 deduction	-	(10 000)	(10 000)
Dividend received	70 000	70 000	-
Gross-up for franking credits	-	30 000	30 000
Interest received	60 000	60 000	
Capital gain from sale of shares	200 000	200 000	
CGT discount of 50%		(100 000)	(100 000)
Total	**345 000**	**265 000**	**(80 000)**

Attribution of taxable income to the beneficiaries

Under the attribution model, the taxable income of the XYZ Trust would be attributable to Beneficiary A and B based an allocation made by the trustee. The trustee would make such an allocation on a fair and reasonable basis consistent with their rights under the constituent documents and the duties of the trustee. In this case, it would be reasonable to allocate the taxable income of the XYZ Trust to Beneficiary A and B in proportion to their units held, being 70 per cent and 30 per cent.

Cash distribution

In this example, assume that the XYZ Trust makes a cash distribution of only $200,000 on 30 June 2010 (with $140,000 being distributed to Beneficiary A and $60,000 being distributed to Beneficiary B).

Balance sheet at 30 June 2010

The following balance sheet shows the opening and closing balance of assets and equity of the MIT for the year ended 30 June 2010.

Assets	Opening	Closing
Cash at bank	1 000 000	1 245 000
Shares	850 000	750 000
Rental property	650 000	650 000
Total	**2 500 000**	**2 645 000**
Equity	**Opening**	**Closing**
Issued units	(2 500 000)	(2 500 000)
Profit / (loss)	-	(345 000)
Less cash distributions	-	200 000
Total	**2 500 000**	**2 645 000**

Adjustments to the beneficiary's cost base and reduce cost base amounts

The following table outlines the adjustments that are made under Recommendation 26 in relation to the units held by both Beneficiary A and B.

Adjustments	Total	Unit holder A	Unit holder B
Original cost base	2 500 000	1 750 000	750 000
Adjustment for taxable income amounts attributed			
Increase for taxable income attributed	265 000	185 500	79 500
Increase for discount CGT attributed	100 000	70 000	30 000
Decrease for franking credits attributed	(30 000)	(21 000)	(9 000)
Decrease for cash distribution received	(200 000)	(140 000)	(60 000)
New cost base	**2 635 000**	**1 844 500**	**790 500**

The total adjusted cost base of $2,635,000 differs from the net assets of the MIT by $10,000. This amount represents the Division 43 capital works deduction that has been claimed by the trust as a tax deduction and has been (effectively) distributed to the beneficiaries as a tax deferred amount.

Consideration of compliance issues

It is expected that trustees will disclose the net cost base adjustment required on trust distribution statements (e.g. $7,000 downward adjustment for Beneficiary A and a $3,000 downward adjustment for Beneficiary B). We believe that this amount will be readily obtainable by the trustee and would not result in additional compliance work.

Furthermore, we note that the proposed methodology does not require a tracing or tracking of payments made by the beneficiary or trustee. The automatic uplifts for the CGT discount component and the section 104-71 amounts on attribution avoids the requirement to trace subsequent payments to these amounts.