

16 November 2010

Raphael Cicchini
General Manager
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BY POST & EMAIL: SBTR@treasury.gov.au

Dear Mr Cicchini

A New Tax System for Managed Investment Trusts

The Financial Services Council (FSC) welcomes the opportunity to comment on the Discussion Paper regarding the implementation of a new tax system for managed investment trusts (MIT) released by the Treasury on 18 October 2010.

The FSC is the peak body representing the retail and wholesale funds management, superannuation and life insurance industries. The FSC has over 135 members who are responsible for investing over \$1.4 trillion on behalf of more than ten million Australians.

We appreciate your ongoing support and commitment to developing and implementing a new tax system for MITs. We also appreciate the opportunities to participate in the appropriate consultation phases of these reforms.

A new tax system for MITs will require our members to undertake significant changes. To accommodate the time it will take to scope and develop these changes we submit that MITs be allowed to opt-in from 1 July 2011, with the new regime being compulsory from 1 July 2012. Additionally, it may be necessary for trusts to amend their trust deeds

Given the Government's short timeline for implementing these reforms and in the interest of ensuring that any legislation correctly reflects the Government's policy intent, we request the opportunity to confidentially review draft legislation before it is released for the next phase of public consultation.

We attach our comments in relation to other aspects of the discussion paper for your consideration. We would welcome the opportunity to meet with you to further discuss our submission.

If you have any questions regarding the FSC's submission, please do not hesitate to contact Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely



MARTIN CODINA
Director of Policy

1. Background and the Concept of a Managed Investment Trust

Chapter 1 of the Discussion Paper confirms that it is not proposed to revisit the meaning of a MIT. We would support that recommendation and note that the Division 275 requirements are sufficient for the purposes of this new regime.

2. MIT attribution rules

Chapter 2 of the Discussion Paper contains proposed rules relating to clearly defined rights or entitlements, the allocation of expenses against trust income within a MIT (paragraphs 44 and 45), the allocation of the MIT's taxable income between the MIT's beneficiaries and/or to the trustee of the MIT (paragraphs 48-57) and integrity rules for the attribution method.

Clearly Defined Rights or Entitlements

The Discussion Paper suggests that in order for a MIT to qualify for the elective attribution method of taxation its constituent documents must provide for clearly defined rights or entitlements to its unitholders.

We note that the examples provided to explain the test of a clearly defined right or entitlement appear to be based on an extrapolation of current fixed trust and present entitlement concepts. This is not helpful as it perpetuates the technical issues and uncertainties referred to above, albeit under a different label.

Our recommendation

In order to provide the legislative certainty which the new rules aim to achieve and which the Board of Tax has set as an objective, we submit that the trust deed of all MITs, whether registered or unregistered, should be deemed to provide unit holders with 'clearly defined rights and entitlements' such that the attribution method of taxation can be accessed.

Our submission is based on the fact that MITs are heavily regulated and have existing reporting requirements under the Corporations Act that provide comprehensive unit holder protection by, together with other requirements, requiring responsible entities to treat members equally and fairly. Such a deeming provision will be simple, would lower compliance costs and remove the uncertainty that could be associated with interpreting the meaning of 'clearly defined rights and entitlements' under different circumstances.

Such a deeming provision will also acknowledge that MITs warrant a different treatment than discretionary trusts which are more open to the possible manipulation of unit holder rights and interests because they are not regulated.

We submit that the regulatory protection surrounding unitholders and MITs in general, coupled, with the regulations and fiduciary duties associated with unit pricing ensures that there is no inappropriate manipulation of distributions of taxable income.

It is also important that the new MIT tax rules dovetail with the proposed Investment Manager Regime (IMR). It is conceivable that the proposed IMR rules may be undermined if non-residents do not have absolute certainty (in line with what the IMR aims to provide) about whether their share of a MITs income will be calculated on an attribution basis. Providing a deeming rule as set out above will align the new MIT tax rules with the objective of the proposed IMR.

Allocation of expenses

Specific v Reasonable Allocation

The trustee or Responsible Entity (RE) of a MIT must allocate expenses against income within the MIT in accordance with the rules of the MIT's constituent document or, absent such rules, in a reasonable manner so as not to unfairly benefit or prejudice the interests of one beneficiary over another. To allocate expenses unreasonably is contrary to the duty of the trustee or RE to act as a fiduciary in the best interests of beneficiaries. The experience of FSC members is that these principles are working effectively to prevent inappropriate allocation of expenses within a MIT.

Our recommendation

We are therefore in favour of keeping any MIT expense allocation rules general and expressed as a broad principle that the allocation be reasonable. We believe that adding detail to such a rule would add complexity and rigidity to the MIT calculation rules without providing further protection to MIT investors. Implementing this would be costly for both industry and ultimately Government too.

Application of s51AAA of the Income Tax Assessment Act 1936

The Discussion Paper (paragraph 45) raises the possible application of section 51AAA of the *Income Tax Assessment Act 1936* where at least some of the MIT's assessable income consists of net capital gains. The Discussion Paper suggests that for deductions exceeding the MIT's assessable income other than net capital gains, the "standard treatment" is to carry forward the excess as a revenue loss rather than allocate it to net capital gains. This is not, in fact, FSC members' experience: which is that in virtually all cases MIT deductions reduce net capital gains as well as other income. This treatment reflects the technical position that if the net capital gain were not included in the MIT's assessable income, the deduction would still be allowable to the MIT, which means that the condition in paragraph 51AAA(1)(c) is not met. Hence the expenses remain deductible in the MIT's taxable income calculation.

Our observation

This provides a fair allocation of the expenses of the MIT, allowing the MIT investors with an economic interest in the MIT to share in the deductions. The alternative carry forward loss result is less equitable to MIT investors because of the possibility that investors in the MIT will change between the loss year and the year of recoupment. Accordingly, FSC members believe that no change to section 51AAA and no additional rule dealing with the application of section 51AAA is required.

Attribution of MIT's Taxable Income

The FSC welcomes Treasury's proposal to replace the archaic rules which currently govern the attribution of MIT income with a set of simple, principle-based rules as set out in the Discussion Paper. The proposed rules remove the current complexity associated with identifying attributable MIT investors based on the trust law concept of "present entitlement" and relating each investor's share of taxable income to their share of trust income determined using trust law, rather than tax, concepts. New principle-based rules will better suit the continual evolution of MITs as Australia's pre-eminent modern collective investment vehicle competing in a global market.

FSC members agree with the Discussion Paper's proposal to base the new attribution rules on the principle that MIT taxable income be attributed by trustees/REs:

"on a fair and reasonable basis consistent with their rights and entitlements under the trust's constituent documents and the duties of the trustee" (paragraph 49).

A MIT may choose to provide more detailed information to investors about how this “fair and reasonable” principle will be applied; for example, in its PDS. In that case, it would be helpful if the MIT were legally protected from contentions from any investor that the attribution should have been performed on a different – but also fair and reasonable – basis.

We do not believe it is necessary to list the factors trustees should consider in determining this attribution, as suggested in paragraph 53. Should Treasury insist on such a list, it would be helpful for this to be in the Explanatory Memorandum rather than the legislation, and expressed as a descriptive but not mandatory list. For example, to mandate that trustees consider “the period in which the beneficiary owned the interest in the MIT” (paragraph 53) would arguably conflict with the trustee’s obligation to consider “the entitlement of the beneficiary under the trust’s constituent documents” (also in paragraph 53) in typical unit trust situations where a unitholder on the register of the unit trust on 30 June is entitled to a proportionate share of income without the entitlement being weighted for each unitholder by the number of days invested within the distribution period – what is referred to as a “unit days” basis and not common practice.

The danger of a prescriptive list is that it will undermine the flexibility which is acknowledged in paragraphs 50 and 51 to be important in the new attribution regime; for example, to enable “last man standing”/large redeemer allocations of extraordinary capital gains and income. It is highly desirable for the new attribution rules to explicitly countenance these types of allocations to protect the interests of MIT investors. In these scenarios, the MIT attribution rules must be broad enough to allow for the fact that the MIT will typically need to wait until well after the redemption – after year end – to determine the MIT’s taxable income for the year and the amount attributable to the redeeming investor earlier in the year. For completeness, the new rules should confirm that a taxable distribution amount attributed to a redeeming investor in this scenario is not double-taxed as a capital gain (part of redemption proceeds) on redemption.

The Discussion Paper envisages that the attribution mechanism will incorporate character retention and that any residual income not attributed to MIT investors be assessed to the trustee (paragraph 49).

FSC members agree with the worked examples in paragraphs 54 (single class MITs) and 57 (multi-class MITs) as the expected and appropriate application of the “fair and reasonable” attribution principle, both as to the quantum and the character of the MIT distributions in the hands of investors. For multi-class MITs, members are not in favour of any requirement to quarantine tax losses within a particular MIT class, which in the multi-class example at paragraph 57 would result in class B unitholders receiving a \$0.45/unit taxable distribution and \$0.55/unit tax deferred distribution, and class A unitholder’s a carried forward tax loss within the MIT of \$0.20/unit, rather than the distribution outcomes set out in the example. This adds unnecessary complexity to the MIT distribution calculation and attribution. The current approach in multi-class MITs – as embodied in the worked example – in some situations can involve cross-subsidisation of tax outcomes between different unit classes. However, investors in these funds appear to be comfortable with this aspect of multi-class MITs, perhaps because at the time of investing, investors in each class are equally likely to subsidise or be subsidised, so the result is impartial and fair to all investors. There would also be systems costs associated with any move from current practices to new class-by-class attribution/quarantining rules.

Any aspect of the new attribution rules which results in changes to current distribution practices would need to be implemented in a realistic timeframe on a prospective basis. Larger changes such as a change in the treatment of multi-class MITs may mean that MITs will not be ready to implement the new MIT regime by the intended start date of 1 July 2011.

Paragraph 52 suggests that investors should have special objection rights. The FSC believes that this is a matter best left to the current regulator. Existing fiduciary responsibilities enshrine a “fair and reasonable” principle already.

Integrity rule for the Attribution Method - Anti-Streaming Rule

The FSC makes the following comments in relation to the anti-streaming rule proposed in the Discussion Paper.

Broadly, the FSC is supportive of a broad anti-streaming rule. The FSC does understand the rationale behind the recommendation and agrees broadly with the rationale that there should not be a broad discretion to affect rights of unitholders to stream tax benefits. This could occur, as the Discussion Paper points out, in cases where changes are made to a MIT's constituent documents that alter the clearly defined rights.

The definition of the term "clearly defined rights" and the "no material discretionary elements" within that definition are central and critical to how an anti-streaming rule is defined.

The Discussion Paper notes that a principles based approach is considered to be taken. Whether the approach taken is principles based or more prescriptive, broadly the FSC does not consider this to be a major concern. In the FSC's view, perhaps one method to ensure tax benefits are not streamed would be to introduce an integrity measure to prevent amendment to rights of the unitholder to stream tax benefits, as opposed to an integrity measure aimed at the streaming itself. This could be a broad discretion aimed at the problem itself, and could replace the broad power of the ATO as specified in paragraph 61.

Our recommendation

In applying a broad integrity measure and if a principles based approach is applied, the FSC notes that perhaps the purpose and intention of an amendment of rights should be considered. If there is a clear intention to stream tax benefits then the anti-streaming rule should be applied, however if the intention for the amendment is for other reasons (e.g. to comply with amendments made to Corporations Law or to maintain unitholders' equity) then the rule should not be applied.

Whilst the FSC believes that the value shifting principles could broadly be applied, it is noted that these principles have similar effects to anti-streaming provisions. In this respect, the FSC submits that another set of value shifting rules are not required.

Finally, it should be noted that for most retail and wholesale MITs, listed and unlisted, these entities will have defined rights as prescribed under the constituent documents. More importantly, there will be overarching fiduciary obligations which will ensure that any changes to documents will not affect rights of one set of unitholders compared to another. To that extent, it is important to acknowledge that any anti-streaming mechanism will largely not be required for MIT's that are automatically eligible for the attribution method.

Consultation Questions

Based on the above, the FSC responds to Treasury's specific consultation questions as follows:

Question 5

Are specific rules required to ensure that amounts of tax income are appropriately attributed where a unit in a MIT is sold or redeemed during an income year? If so, what rules would be appropriate?

Answer

The proposed principle-based "fair and reasonable" rule should generally be adequate. However, there should be a specific rule to avoid double-taxation of redemption proceeds. The Explanatory

Memorandum should explicitly recognise that attribution can occur in a large redemption scenario, including where the attribution is delayed until after year end when the MIT's taxable income available for attribution is known.

Question 6

Would compliance issues be raised by a requirement under the attribution method that tax losses in respect of one class of unit holders cannot be used to reduce the tax income of another class of unit holders?

Answer

Yes, this would raise compliance issues and is not favoured by FSC members.

Question 7

Are any modifications to the proposed attribution rules needed for trustees of trusts where units may be traded on a more regular basis (compared to unlisted trusts), such as listed property trusts or exchange traded funds?

Answer

No modifications for listed funds have been identified.

3. Unders and Overs

In commenting on Chapter 3 it is useful to consider that the *unders and overs* practice developed as a pragmatic way of dealing with rounding, minor errors and late information. By carrying forward the relevant amounts to the following year considerable administrative cost savings resulted for both the ATO and the trust with an insignificant impact upon tax revenue collection.

De minimis Level

It is proposed that a *de minimis* limit be established such that amounts within this limit could be carried forward to the following year. The FSC suggests that the *de minimis* amount should be the greater of:

1. A percentage of gross income. It should be noted that the UK has a 15% accumulation rule and the US a 10% accumulation rule,
2. An absolute amount, such as \$250,000,
3. An amount equal to 1.0% of gross assets as measured at year end.

By having three alternative thresholds results in flexibility which will overcome trivial outcomes. Existing practice is that the issue of revised statements is a rare event, even taking into account current Corporation Law requirements and trustee duties. Such thresholds will assist in maintaining this result.

When determining whether a fund has an *over or under* the net position should be the determinant rather than the individual positions for the various components of a distribution. This is important because the Discussion Paper and Government have accepted "a general principle of character and source flow through." [Paragraph 106]

It is the preferred position that a trust determine an *under or over* figure for each income or gain category and carry that forward for inclusion in the following year's process. The number and type of categories will depend upon the prevailing tax laws, in particular the different types of withholding that may apply, tax offsets rules and any concessions such as the current CGT discount. *Unders and*

overs should also be permitted for tax offsets such as imputation credits and foreign tax payments provided the under or over arose as a result of rounding, late information and / or genuine error.

One difficulty with unders and overs is that occasionally a loss will arise in the particular income categories for the following year. For example

Year 20x0 / 20x1	undistributed capital gain of \$1,000
Year 20x1 / 20x2	realised capital loss of \$5,000

Ordinarily the Australian tax system does not allow the carry back of losses. For administrative ease and simplicity the FSC's preferred position is that an under would result in a reduction of the following year's loss and in the case of an over would result in an increase in the following year's loss. This would be subject to a safeguard that the unders or overs arose as a result of rounding, late information, and circumstances beyond the RE's control and / or genuine error.

Other reasons that result in Unders / Overs

Overs and unders can arise for various reasons including rounding and genuine error. However, there are two other causes that need to be explicitly dealt with.

1. Firstly, the situation where one trust is investing into a second. If that second trust discovers it has potentially made an excessive or inadequate distribution and subsequently opts to make and additional distribution or issue a correction notice then the investing trust could find itself outside the *de minimis* limits.

Example - Trust 1 invests in trust 2

Trust 2 has made an earlier distribution to its unitholders of \$1,000 but discovers an error and makes a further distribution of \$100.

Trust 1 received \$100 from trust 2 in the first instance and had other income of \$50. It has already distributed \$150 to its unitholders. Subsequently it receives a further \$10 from trust 2. 10 / 160 represent 6.25% of net income and therefore trust 1 exceeds the 5% *de minimis*, as articulated in the Discussion Paper, and potentially has a taxable under distribution.

Our recommendation

It is suggested that where one trust would exceed its *de minimis* due to the activities of another trust such a breach should be capable of being carried forward as an under or over as appropriate. Such a concession would be subject to a requirement that the RE of the investor trust did not collude with the RE of the investee trust in advance.

It should also be noted that many superannuation entities invest via unit trusts. Where there is a secondary distribution to a superannuation fund this can cause difficulties with annual statement requirements.

2. Secondly some trusts take considerably longer than others to determine their year end tax position and required distribution. Such funds include listed property trusts and infrastructure funds. If their figures are not released until, say, late August other trusts will be forced to delay their distributions. Currently such trusts overcome this delay by making estimates of the likely distribution based upon prior year figures or interim figures. Under the new regime the consequences of a significant divergence between actual and estimates are sufficiently severe as to warrant deferring making distributions until clarity is received. This would mean that the entire sector's distributions would be released later than currently is the norm. Indeed

the least efficient managers will end up setting service standards for the entire sector. It is therefore suggested that some allowance should be made for such vehicles. An appropriate mechanism would be to allow investing trusts to use estimates based upon the prior year or half year for Australian listed property funds and infrastructure funds.

Our recommendation

Any variance between these estimates and actual distributions that caused a fund to exceed its relevant *de minimis* would be permitted to be carried forward as an under or over. Such estimates could be based upon the APRA / ASIC *Guide to good practice in unit pricing*.

Under exceeds the de minimis amount

In the Discussion Paper it is suggested that under distributions should be taxed if greater than the *de minimis*. It is further suggested that the appropriate tax rate to apply to such an under distribution is the top marginal tax rate and that the after tax amounts should be treated as Non Assessable Non Exempt Income ("NANE") when eventually distributed.

Our Recommendation

The FSC submits it is inappropriate to treat the distribution of the net income as NANE. This is because 80% of monies invested through trusts are superannuation monies where the appropriate tax rate is either 15% or nil. Accordingly it is the FSC's view that a credit system should be used where a trustee is taxed, and the recipient is entitled to a credit for any tax paid by the trust, in a manner akin to that used for imputation credits. This will ensure superannuation investments are not disadvantaged by using trusts as a conduit investment vehicle.

Additionally it is suggested that a more appropriate tax rate would be the company tax rate rather than the top marginal tax rate.

Any excess tax payable as a result of an excessive under distribution would be payable at the same time as a final tax payment is required to be made for corporate taxpayers. Typically this is 1 December. Any such tax needs to be excluded from the instalment system because it is unlikely to be repeated.

Lastly, notwithstanding any unders or overs the withholding taxes deducted from distributions to non residents, be they interest, dividends or subdivision 12H should not be required to be modified. If late distributions are made withholding tax should be determined in respect of those distributions on a "stand alone basis".

Over exceeds the de minimis amount

The Discussion Paper proposes that where the trustee becomes aware that there is an over greater than the *de minimis* amount, the trustee will be required to reissue distribution statements.

Example

A distribution statement is sent to a unitholder advising them to include \$100 in their assessable income as the amount attributed to them. The trustee pays a \$100 cash distribution to them in order that the unitholder not be required to make any cost base adjustments.

The trustee later discovers that they significantly overestimated certain items and that the correct amount for the unitholder to include in assessable income would have been \$90.

The trustee sends an amended distribution statement to the unitholder advising them to seek an amended assessment to reduce their taxable income by \$10. Further, as the cash distribution now exceeds the amount of assessable income by \$10, the unitholder will be required to reduce the cost base of their units by \$10. The excess \$10 paid turns into an unintended return of capital.

We are concerned that reissuing distribution statements is inconvenient and costly for the clients, the Tax Office and the trustee of the managed fund. We are concerned that this is not justified by the benefit to the client.

Our Recommendation

We recommend that the law require the trustee to carry the over forward regardless of its size.

This approach would have integrity because an over only arises through error or the use of estimates. Intentionally using inaccurate numbers would not be allowed. It could be made an offence similar to that of making false or misleading statements to the Commissioner of Taxation.

The system then becomes one of taxing unitholders on a basis of honest estimates, with payments for excessive unders so that the revenue is protected.

There is nothing improper in basing a system on estimates. Sub-division 12-H of the Taxation Administration Act already does this. Accounting standards recognise that estimation is necessary so company dividends are often based on estimates.

It will be rare that a managed fund will pay cash less than the attributable amount. It is a long-standing practice to pay cash that matches or exceeds the taxable amount. The system could be justified on the basis that it is analogous to the taxation of dividends where the unitholder is taxed on the amounts they receive which are based on estimates.

The law would be expressed in the following terms: *The trustee shall attribute an estimate of ...*

The managed funds product disclosure statements, addressed to potential unitholders, would carry an explanation something like the text below. It is assumed in this example that the trustee pays cash equal to or greater than their estimate of the notional taxable income of the fund. It will be clear from this explanation that there is a risk that the trustee will overestimate the taxable amount and that the unitholder will still be required to pay tax.

Soon after the end of each quarter you will be paid your share of the distributable income of the fund for that quarter. You will be required to include in your tax return for the year, an amount that may differ from the sum of these payments.

You will be sent a tax statement soon after the end of the year that will show you what amount to include in your tax return and the different components of income that make up this amount. Different components can be taxed differently and will be required to be disclosed separately in your tax return. The tax statement will also show franking credits and other amounts that can be used to reduce the amount of tax you pay. Along with the tax statement will be a guide that shows you how to put these amounts in your tax return.

The distributable income for a quarter will be the trustee's estimate of the net income of the fund up to the end of the quarter calculated in accordance with income tax law, less amounts already paid in respect of earlier quarters. The trustee may increase the

distributable income above this estimated amount by including additional amounts of income that are not subject to tax.

The Fund itself will not pay income tax unless the trustee's estimate of the net income of the fund is more than the de minimis amount set out in the legislation. If this happens the Fund will pay 30% tax. This tax will be available as a credit in a future year.

It is assumed in this example that our recommendation in respect of unders and overs greater than the de minimis is adopted.

The primary reason for our recommendation is the compliance costs. The amendments will almost always be for relatively small amounts. The cost to the ATO of processing these amendments will be high relative to the benefit being obtained.

Most investors will not understand what it means to amend an assessment. Many are financially unsophisticated and will find the process annoying and stressful. There will be a high level of non-compliance.

It will also increase the cost of administering the managed fund, which may be passed on to the investor.

Investors will use this system as evidence that the tax system is too complicated. We are also concerned that they will use it as evidence that managed funds are too complicated.

One factor that needs to be taken into account is that it is very common for managed funds to invest in other managed funds. The cheapest way to construct a portfolio for a managed fund with the right asset allocation and the right fee level is often to invest in a number of other funds created by the same product provider. This can create a chain of trusts up to eight deep. Any solution needs to be tested against the risk that there is a cascading of administrative requirements. We are concerned that reissuing statements will have this problem.

4. Cost Base Adjustments

The FSC supports the policy intent behind the new cost base adjustment rules, contained in Chapter 4 of the Discussion Paper, which is to avoid double taxation of unitholders. However, we have provided suggested amendments to ensure that the new rules achieve this aim.

Our comments can be summarised as:

1. The proposed cost base adjustment rules and examples in the Discussion Paper ignore the impact of expense allocation against assessable MIT income resulting in double taxation.
2. A number of other amendments that are required to ensure that the proposed system does not produce unintended consequences.

If the Government does not agree to the amendments we have proposed in sections 1 and 2 below we would prefer the cost base adjustment rules not be changed. This is because of the double taxation inherent in the rules as currently proposed which would represent a step backwards in the tax treatment of investors in MITs.

Expense Allocation

The Discussion Paper and its examples do not recognize the important fact that MITs must allocate expenses and losses against assessable income in determining MIT taxable income to be attributed

to unit holders. Without amending the proposed rules, this will lead to double taxation for most investors in MITs. This is in contrast to the stated policy intent of relieving double taxation currently faced by MIT investors.

In summary, the cost base adjustment proposals provide for a cost base increase where taxable income is attributed to a unitholder and a cost base decrease where cash or reinvested units are distributed to an investor. We agree that this methodology is an appropriate response to double taxation that may otherwise arise under the attribution system under which investors can be taxable on attributed tax amounts which may not be associated with cash distributions.

However, the proposed rules as shown in the examples make assumptions which do not reflect the current tax law and taxpayer practice in relation to expense allocation.

The proposed rules provide for a cost base decrease where "certain tax offsets" are attributed to investors. We presume that these "certain tax offsets" relate to franking credits under Division 207 and foreign income tax offsets (FITO) under Division 770. We seek your confirmation of the nature of these tax offsets.

We understand the reasoning behind this cost base decrease is to recognize the fact that the gross up of taxable income attributed that is referable to tax offsets is not received in cash by unit holders (that is it is a notional amount). Therefore increasing cost base by the amount of the gross up included in assessable income would give rise to a step up in cost base not required to achieve the policy objective of reducing double taxation.

We accept the need for this cost base adjustment, however, the appropriate amount of the cost base adjustment required is not as shown in examples 6 and 7 the amount of the tax offset or credit distributed to unitholders, rather it should be the amount of the assessable gross up relating to the tax offset after the allocation of expenses at the MIT level against the gross up amount. The rules as proposed will result in double taxation as it is only the amount of the net gross up after expense allocation which is distributed as taxable income increasing cost base. Reducing the cost base by the larger amount of tax offset distributed double taxes unitholders to the extent of the expenses allocated against the gross up amount.

Using the numbers in Example 6 contained in Chapter 4 of the Discussion Paper, we can illustrate the appropriate decrease in cost base referable to the franking credits. Assume that the deductible expenses in Example 6 of \$200,000 are of a general nature. They can therefore be allocated proportionately against all items of assessable income including capital gains and the grossed up for franked dividends in determining taxable income to be attributed to unitholders. Note that this is in line with current tax law and overwhelming industry practice.

Offsetting the expenses of \$200,000 against the \$445,000 of assessable income leaves a taxable income of \$245,000. Taxable income represents approximately 55% of the gross assessable income. Allocating these expenses proportionately to the assessable franked dividend of \$70,000 cash and \$30,000 gross up would result in a net distribution referable to franked dividends of approximately \$55,000 comprising \$38,500 cash franked dividend and \$16,500 franking credit gross up. The appropriate cost base decrease referable to franked dividends in this example is equal to the net franking credit of \$16,500 not the \$30,000 as shown in Example 6.

MIT unitholders under the proposed cost base rules are also worse off compared to their current tax position due to the partial claw back of FITOs which will arise from the reduction in cost base proposed in Chapter 4. It is strongly recommended that the cost base reduction be limited to the amount as the amount of the gross up referable to FITOs less expenses allocated.

Further, the tax law allows and overwhelming industry practice is to allocate expenses to the taxable discount component of capital gains and not to allocate expenses to the associated CGT concession

amount. Therefore it is very common for the CGT concession amount distributed to investors to exceed the taxable CGT discounted gain. The cost base adjustment rules must reflect this law and practice and not assume these two amounts will be the same.

Indeed, the reduction of cost base for the entire FITO distributed to investors as contemplated in Chapter 4 rather than reducing cost base for the gross up net of expenses allocated to the FITO gross up is arguably inconsistent with Australia's obligations under its Double Tax Agreements

Other Comments

We expect that the existing relief from CGT event E4 cost base adjustments contained in subsections 104-71 (1)-(4) of the ITAA 1997 will be continued under the new cost base adjustment rules.

Furthermore as a result of the new under and over distribution rules, provision must be expressly made to allow the non assessable non exempt income arising from the subsequent distribution of cash referable to the prior year under distribution of greater than the de minimis to occur without a cost base reduction. To not allow this would introduce a further penalty on such under distributions which is a double penalty which is not our understanding of the Government's policy intent.

Amounts withheld under the TFN withholding regime should not result in cost base adjustments.

Examples 6 and 7 in Chapter 4 of the Discussion Paper are also unclear in relation to the impact of distribution discounted capital gains and associated CGT concession amounts on cost base.

Firstly, the examples appear to contemplate a discounted capital gain of \$50,000 being realised on disposal of land which is not distributed in cash to unitholders in the current year but which is retained for distribution to investors in cash in later years. Therefore we understand that no increase of cost base for the CGT concession amount applies for the current year but would apply in a later year in which the CGT concession amount is distributed in cash.

Secondly, the Discussion Paper seems to confuse the CGT discount amount and the CGT concession amounts. It is the CGT concession amount which when distributed in cash should increase cost base. We understand that the cash distribution of amounts referable to the taxable CGT discount amount will be treated like any other cash distribution reducing cost base. Clarification of these two issues is sought.

Consultation Questions

Question 17

Are there any significant compliance costs associated with requiring a MIT to track cost base movements on each event?

Answer

Yes, significant compliance costs will arise. The additional compliance costs have three components:

- (i) MITs are required to track the cost base of their unitholdings in other MITs. For example many fund managers will manage chains of unit trusts which invest into each other. The funds' RE will be required to calculate each MITs capital gains and losses on disposal of unitholdings in other MITs. These calculations are performed via IT systems which will need to be reprogrammed and those changes tested before 1 July 2011 in order to comply with the new cost base adjustment law in relation to calculating capital gains.
- (ii) Many MITs, particularly those offered to retail investors provide CGT tax statements annually to those investors who redeem units from a MIT during the year. The IT systems and associated tax statement processes will require significant change.

- (iii) For the first time MITs will be required to establish accounting systems and procedures to track CGT concession amounts and Division 43 building allowance amounts that have not been distributed in the year they are realized or incurred. These amounts will be needed to be carried forward to adjust the cost base decrease that would otherwise occur when they are distributed in cash to unitholders in later years.

Given the complexity of the adjustment to cost base changes, we would expect that IT and associated testing costs would exceed \$25m across the funds and custodial industries.

Question 18

Should the requirement for MITs to notify unit holders of cost base adjustments be an annual requirement, or should MITs be required to notify unitholders more frequently?

Answer

The notification requirement should occur annually as part of the annual tax statement process. Cost base adjustments are essentially only relevant to calculating capital gains on redemptions from MITs as part of investors' annual tax return lodgments.

Any requirement to more frequently advise cost base adjustments is unnecessary and would give rise to very significant compliance costs in communicating with the hundreds of thousands of investors in MITs.

Question 19

Are any modifications to the proposals warranted for MITs that are Exchange Traded Funds?

Answer

No, there is no meaningful distinction between ETFs and other MITs in this regard. That is, both ETFs and other MITs are subject to investors entering and exiting the funds regularly during the course of the year. This is why most MITs provide daily application and redemption prices.

ETFs currently adequately deal with the E4 cost base adjustments arising under the current rules and should be similarly required to deal with the new cost base adjustment rules.

5. Character and Source Retention

The discussion paper makes three references to character retention in relation to unitholders who hold their units on revenue account:

- Paragraph 3 – implies that character retention in general will not apply to revenue taxpayers (i.e. that the components of a distribution including distributions of capital gains will not flow through to revenue taxpayers);
- Paragraph 100- indicates that “tax preferred” amounts to revenue taxpayers will be assessed as ordinary income (i.e. no character retention for “tax preferred” amounts); and
- Paragraphs 104 and 107 – indicates that “tax deferred” amounts to revenue taxpayers will be assessed as ordinary income. This is based on the assertion that this is current law.

The FSC recommends that character retention be retained for all taxpayers, including “revenue” taxpayer. We disagree with the assertion in paragraph 104 that it is current law for tax deferred

amounts to be taxed as ordinary income to revenue taxpayers. Under current law (and ATO practice) character retention applies to revenue taxpayers – specifically, tax deferred amounts are not treated as ordinary income, but rather give rise to a CGT Event E4.

This major tax policy change has not specifically been articulated by the Government previously. Rather in a press release issued by the former Assistant Treasurer on 7 May 2010 detailing the Government's response to the Board of Tax Report on the new regime for taxation of MITs, recommendation 25 contained the following comments:

“The Government has also decided to defer consideration of the treatment of tax deferred distributions - attributable to temporary tax differences (in relation to revenue account unit holders)”

The proposed removal of character retention for revenue taxpayers is concerning for the following reasons:

- It is contrary to current law;
- The policy intent of the MIT regime is to encourage investment in MITs which will not be facilitated by this proposal;
- The different treatment of revenue account and capital account unitholders offends the basic tax design principle of competitive neutrality;
- Current law and industry practice is to treat tax deferred amounts as reducing cost base in exactly the same manner as capital account holders are required to do under CGT event E4. It is therefore difficult to see the mischief being targeted.

Extension of the new system to tax preferred amounts instead of tax deferred amounts further disadvantages revenue account unit holders. This is inconsistent with the abovementioned 7 May 2010 press release.

We strongly recommend the Government reconsider this proposal and suggest that the current principles of character retention be retained.

6. Fixed Trusts

In line with our submission that all MITs, whether registered or unregistered, should be treated as having clearly defined rights and entitlements, we submit that all MITs should be treated as fixed trusts for purposes of the tax law.

Such a rule will be simple, lower compliance costs and will be consistent with the five key policy principles in the Board of Tax Discussion Paper *Review of the Tax Arrangements Applying to Managed Investment Trusts*. It is also consistent with the Federal Government's goal of establishing Australia as a regional financial services centre for managed funds as certain CGT concessions available to non-residents depend on whether the fixed trust definition is satisfied.

Apart from treating all MITs as fixed trusts, it should be noted that there are other unit trusts which may not necessarily qualify as MITs (because of current tax technical reasons), but that operate on an arms length basis, for example IDPS platforms. These unit trusts are currently able to rely on the fixed trust provisions to access the tax concessions associated with being a fixed trust and it would in our view be unfair to remove or restrict their ability to continue to access these concessions, especially if it is considered that the fixed trust concept arose principally to distinguish between unit trusts and discretionary trusts, which trusts operating within the wealth management space are clearly not.

In light of the aforementioned, we submit that all unit trusts of which the unit holders have clearly defined rights and entitlements should likewise be treated as fixed trusts.

7. Divisions 6B and 6C

Repealing Corporate Unit Trust Rules and including an arm's length rule in the public trading trust rules.

FSC welcomes the abolition of Division 6B.

As identified in the Discussion Paper, following the repeal of Division 6B, those trusts should only be subject to corporate taxation if the Division 6C rules apply.

Public Unit Trust Definition in Division 6C

The FSC welcomes the proposal to amend the definition of 'public unit trust' in Division 6C of Part III of the ITAA 1936 to exclude trusts that are treated as a public unit trust solely because complying superannuation funds and tax exempt entities entitled to a refund of franking credits have a 20% or more membership interest in the trust.

However, the FSC also submits that the public unit trust definition should be amended to exclude all exempt entities, thereby allowing Government entities and other tax exempt entities to invest more than 20% in trusts without the need to consider the application of Division 6C.

8. Other Issues

Investor Directed Portfolio Services and the present entitlement system

Paragraph 19 of the Discussion Paper states

Investor Directed Portfolio Services and 'bare trusts' ... will generally be assessed to the investor under the present entitlement system ...

We agree that these vehicles do not need to be included in the new system but we reject the assertion that the present entitlement system in Division 6 applies.

It is clear that section 106-50 Income Tax Assessment Act 1997 takes capital gains out of Division 6 where the investor is absolutely entitled to the asset.

For amounts assessable outside of the capital gains tax rules it is not straightforward that Division 6 applies. The technical question is whether the trustee derives the income or the beneficiary does. There is case law where the legal owner of an asset has been held to have not derived the income themselves but that the beneficial owner has.

While the treatment of these vehicles is a separate matter to the treatment of managed funds, it would be opportune to clarify the treatment of these vehicles at the same time.

It would also be appropriate to fine tune the concept of 'absolute entitlement'. The ATO was unable to finalise its draft ruling on this concept. This is an unfortunate situation for the investors to be in.

The discussion paper seems to suggest that tax statements should be revised to disclose unders and overs to unitholders. We are of the view that such reporting would result in confusion, additional complexity and cost.

Opportunity to amend trust deeds

Existing deeds constituting managed funds have been drafted to fit into the current present entitlement system. The new system will give managed funds more flexibility enabling better outcomes for investors. To get the most value out of this new legislation there should be no obstacle to managed funds amending their deeds in response to this new legislation. The new system does not force them to amend deeds but grants them an opportunity to amend the deed to improve the operation of the fund.

There can be arguments that amending the core provisions of a deed can cause the existing trust to cease to exist and a new trust to come into existence. This can have tax consequences such as losing losses carried forward, losing franking credits under the 45 day rule and crystallising revenue and capital gains.

It would be appropriate to include a transitional provision allowing trusts a one-off opportunity to modernise their deeds in response to this new legislation. The amendment would not be "in order to comply with the new legislation" so they would not be the right words. The amendment would be "to take advantage of the new legislation".

This transitional rule should make it clear that the trust continues in existence. The managed fund should be entitled to improve other aspects of the deed at the same time.

Lastly it is noted that any such changes to deeds may result in a State stamp duty liability. In the past the various State Governments have been accepting of the need for a concession where a Federal initiative results in the need for trust deed amendments. It is requested that if this measure proceeds that a similar request be made to State Governments.

Reporting

The discussion paper seems to suggest that tax statements should be revised to disclose unders and overs to unitholders. We are of the view that reporting on such amount would result in additional complexity and cost that is deemed unnecessary.

Application

The discussion paper states that the rules will apply from the 2011 income year.

The FSC membership would strongly recommend that the managed investment trusts be allowed to opt-in from 1 July 2011, with the new regime applying from 1 July 2012.

This will ensure that the FSC membership will have a sufficient amount of time to make the necessary changes to our systems and processes.