ACN 080 744 163

22 May 2007

Mr Peter Hallahan
Committee Secretary
Senate Economics Committee
Department of the Senate
Parliament House
Canberra ACT 2600

Dear Mr Hallahan

Inquiry into the provisions of the *Tax Laws Amendment (2007 Measures No. 3) Bill 2007*

Thank you for the opportunity to provide a submission on *Tax Laws Amendment (2007 Measures No.3) Bill 2007* (TLAB No. 3). Our comments are limited to Schedule 10 of the Bill, which relates to the tax collection mechanism for the 30% withholding rate on distributions from managed funds to non resident investors.

The **Investment and Financial Services Association Limited** (IFSA), is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 140 members who are responsible for investing over $950 billion on behalf of nearly ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

1. Australian managed funds

Australian Managed Funds manage over $1 trillion in total consolidated assets. At both a retail and wholesale level, there is an extensive and growing investment by offshore portfolio investors who may include large institutional investors, pension funds, fund managers and global custodians. Alongside management expertise and innovative products, offshore investors are looking to invest in funds within a tax regime that is competitive and streamlined.

Most Australian managed funds are widely-held unit trusts that distribute their income fully, and offer portfolio investments across local and overseas assets (equities, property and bonds). They are taxed on a flow-through basis, providing the ultimate beneficiary with tax treatment comparable to direct investment, but with simpler tax reporting and compliance requirements. These features make them an attractive collective investment

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vehicle.

Managed funds typically make monthly, quarterly or half yearly distributions ("interim distributions"). However, the net income of the fund is not known at the time of the interim distributions are made as net income is only calculated on an annualised basis at the end of the year of income.

2. Current withholding tax arrangements

Income subject to withholding tax
The Pay As You Go (PAYG) withholding provisions currently require that withholding tax amounts be withheld from interest, unfranked dividends and royalty income distributed to non-resident beneficiaries. These amounts are subject to a final tax in Australia.

The remaining part of an Australian managed fund's taxable income is subject to annual taxation in the hands of the trustee under sub-sections 98(3) and (4) of the *Income Tax Assessment Act 1936* in respect of assessable Australian sourced income distributed to non-resident beneficiaries that are individuals or companies. The section 98 tax is creditable to a non-resident beneficiary against their Australian tax liability if they lodge a tax return in Australia.

Withholding tax rates
Under ss98(3) and (4), non-resident investors in Australian managed funds pay Australian tax on the trust distributions of 30 percent if the investor is a company, 47 percent if the investor is a super fund and 29 percent to 47 percent if the investor is an individual. These amounts can be reduced if the foreign investor lodges a tax return and claims offsetting deductions.

Mechanism for withholding
Managed funds typically make monthly, quarterly or half yearly distributions ("interim distributions"). However, the net income of the fund is not known at the time of the interim distributions are made as net income is only calculated on an annualised basis at the end of the year of income.

As such, the amount of withholding tax deducted from interim distributions is based on estimated taxable income components at that point in time and may not be representative of the annualised liability in respect of the actual components of taxable income which ultimately flow through to investors. This is because the managed fund's taxable income, and distribution components, as a matter of tax law will not be known until the end of the year of income. In practice, both are determined within 2-3 days of year-end.

Issues
The application of marginal tax rates to distributions to non-resident individuals is difficult where the non-resident individual derives Australian sourced income from multiple sources, primarily because the fund making the distribution will not be aware of the unitholder's other amounts of Australian sourced income.

Additionally, as withholding tax has been deducted on estimated taxable income

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components, an administrative 'wash up' process needs to occur to determine if tax has been over or under withheld. As the income flows through to the investor, and is reported in their tax return, it is near impossible to recover money from the investors if tax has been under withheld, for example. The 'wash up' is not an exact science, but based on the best information available at the time of distribution.

3. Schedule 10 of TLAB No. 3

Income subject to withholding
No variance from the current withholding tax regime

Withholding tax rate
The proposed measure in TLAB No. 3 is a flat withholding tax, at a 30% rate, and IFSA welcomes the removal of marginal tax rates for distributions to non-resident individuals from managed funds. Our concerns regarding the withholding tax rate are discussed further in the submission.

Mechanism for withholding
IFSA believes that, as the tax is not final, many of the administrative difficulties remain, such as the management of any discrepancy between the interim distribution tax components and the annualised liability. In addition, as the 30% rate only applies to distributions from managed funds, some of the integrity measures place additional compliance requirements on fund managers.

Detailed below are some of our key concerns.

Definition of a 'managed unit trust'
Unit trusts will be required to satisfy a definition of "managed unit trust" which is tested at the time each distribution is made. This definition includes a widely held test for non listed trusts which requires a review of members at the date of each distribution. While the requirements of the test are reasonable, the requirement to test members at the time of each distribution (which often occur monthly or quarterly) is onerous. A "once off" test subject to a requirement to review if the manager has notice of significant changes in membership would be a workable alternative and satisfy integrity concerns.

Definition of an intermediary
A key component of the new system is that if an intermediary receives a notice from a managed fund[1] in respect of a distribution payment, then it is required to withhold appropriately from that distribution payment if it is passing that payment on to a non resident.

In practice, it is necessary for the managed fund to be certain that the intermediary is an intermediary as defined s12-405 [2]and not just an investment company. Whilst some

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[1] s12-415
[2] s**12-405 Meaning of intermediary**
(1) An entity is an ***intermediary*** in relation to a payment it receives at a time (the ***receipt time***) if:
(a) it is *carrying on a *business at the receipt time that consists predominantly of providing a custodial or depository service (as defined by section 766E of the *Corporations Act 2001*) pursuant to an Australian financial services licence (as defined by section 761A of that Act); and
(b) it received the payment in the course of that business; and

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intermediaries are easily identifiable, such as the international custodians, many are not. As such, managed funds require a mechanism for intermediaries to identify themselves as such to managers. Fund managers are not comfortable providing s. 12- 415 notices to all investors, as it would cause confusion in the market. Further consideration of the operation of the notice requirement is necessary.

Compliance - Costs

Fund managers will incur significant costs in complying with the new withholding tax regime contained in Schedule 10. Firstly, managers will be required for the first time to have their tax accountants and/or external tax advisors review interim distribution tax components for all unit trusts. Such distribution components are currently only reviewed by tax accountants and/or external tax advisors at each tax year end. *An IFSA member who manages approximately 200 unit trusts which make quarterly distributions has advised that it will be required to review 800 quarterly tax component calculations under the new rules, instead of 200 annual tax component calculations.*

Under distributions

As mentioned previously, managed funds typically determine their annual taxable income and distribution components within 2-3 days of the fund's tax year end, and conduct a 'wash up', which will usually rectify any variances between the two.

However, it is possible that, upon finalisation of the fund's tax return in the week's following year-end, a reconciliation between the sum of taxable distributions that were made to investors will show that a shortfall exists - an 'under' distribution. Alternatively, a surplus may exist between the taxable income reported to investors and the taxable income of the managed fund as reported in its tax return – 'over' distribution.

Under and over distributions are due to a number of factors, including the growth of inter-funding in the industry (funds investing into other funds, which are often have specialised investments), which means that exact information is not always available at the time of distribution, particularly if the third party is also finalising its year-end tax distribution component information. The correct information may only arrive a few weeks after year-end.

The current industry practice is to pay under distributions to beneficiaries in the following year (except in cases where the amounts involved may be significant), which has the effect managing the potential administration costs of revised tax statements and late tax returns, and should not result in tax revenue leakage.

However, under TLAB No. 3, managed funds will have to make distributions to non-residents within 3 months after the end of the income year, or seek further time to from the Commissioner.[3]

(c) before or at the receipt time, it received a notice of the kind referred to in section 12-415 in relation to the payment; and
(d) either:
(i) subsection (2) is satisfied for the entity at the receipt time; or
(ii) the business is carried on at the receipt time through an Australian permanent establishment.

[3] S 12-400(4) and (5) of new Subdivision 12-H. In particular, s12-400(5) states:

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The 3 month timeframe is problematic where there is an under distribution of income at year end (ie the taxable income reported in the tax return is more than the taxable income reported to investors), as this income should have been distributed within 3 months rather than paid as part of the first distribution in the following year.

Given that an under or over distribution is a likelihood, each year a fund manager would need to seek approval from the Commissioner, even though it is not certain whether permission for a late distribution will be provided.

Further, in the event that the Commissioner declines to allow the additional time, the proposed Section 99H effectively results in the application of a 46.5% tax rate to the component of the distribution that is late (ie the under distribution).

This is an undesirable consequence as the current industry practice, as outlined above, is a simple and effective solution to an under distribution issue. As a result, we would suggest that the industry practice around late receipt of information should be recognised.

4. Industry's preferred withholding tax regime

IFSA submits that Australia needs a withholding tax regime, which is both competitive and removes the need for complex administration. On the basis of the costings in the Econtech Report (Attachment A),[4] IFSA advocates the introduction of a flat and final withholding tax at the rate of 12.5%.

Competition for the designation 'Asia's financial hub' is fierce.[5] *Our nearest neighbours, and competitors, have far more competitive rates of withholding: Japan has a withholding tax rate of 7% on REITs (Real Estate Investment Trusts) (and 0% for super funds), Singapore imposes 0% for individuals and 10% for other investors and Hong Kong has an effective rate of 15% on REITs, as does the US.*

The proposed 30% rate is not final and, in addition to the compliance burden for Australian fund managers, permits the investor to offset it with deductions. After these deductions, the same net Australian tax cost as a reduced flat rate could be produced.

However, many non-resident investors in Australian funds are large institutions (eg pension funds), who are only concerned with obtaining the best return for their investors. They are interested in the headline rate, as well as minimising any compliance costs. If they need to lodge an Australian tax return, and obtain a refund, when they could simply invest in a jurisdiction like Hong Kong, they will – even if the rate is ultimately the same.

The Commissioner may allow a longer period as mentioned in paragraph (4)(c) only if the Commissioner is of the opinion that the trustee was unable to make the payment during the income year, or within 3 months after the end of the income year, because of circumstances beyond the influence or control of the trustee.

[4] *Budget Costing of a Proposal to Reform Withholding tax on Property Income Distributed by Listed Property Trusts to Non-residents* by Econtech (18 April 2006).

[5] *Hong Kong as Asia's Asset Management Hub* by Secretary for Financial Services & the Treasury, Frederick Ma: http://www.news.gov.hk/en/category/ontherecord/070418/html/070418en11001.htm

Australian managed funds are concerned that, if the present system is not changed, it will be a major deterrent to offshore investment.

IFSA believes that if Australia can attract further offshore investment considerable community benefits would accrue, in terms of the increase in employment opportunities, the development of further expertise, and stemming the tide of young Australians heading overseas to work in larger fund centres.

Given the concerns we have outlined above, it is fundamental that the withholding tax regime is both flat and final. IFSA's preferred approach is that a final withholding tax be deducted from distributions to non-resident unitholders based on the actual taxable income at the time the distribution is paid. The use of the actual taxable income at the time of the distribution is an appropriate basis, as the annualised tax component information cannot be determined when interim distributions are paid. Attached is a copy of IFSA's *Managed Investment Tax Regime* (MITR) proposal (Attachment B), which covers the issue in depth.

Conclusion

IFSA has been actively involved in the confidential consultation on the proposed changes to managed fund distributions to non-residents. We would like to acknowledge Treasury's commitment to extensive consultation. We believe, however, that the particular measure does not achieve the necessary simplicity or certainty that it is intended to provide.[6] The current legislation, whilst introducing a flat rate which is welcomed by the industry, does not alleviate the compliance costs and burden of administering a non-final tax. Furthermore, IFSA is deeply concerned that the high rate of 30% will dissuade offshore investors from using Australian managed funds, and encourage them to invest elsewhere in the region.

We would welcome any opportunity in the future to further refine the legislation, and if you require further information, please do not hesitate to contact myself, or Preetha Manoharan, on (02) 9299 3022.

Yours sincerely

Richard Gilbert
Chief Executive Officer

[6] Explanatory Memoranda, *Tax Laws Amendment (2007 Measures No. 3) 2007*: p 196
"These compliance cost savings and reduced uncertainty would have the effect of increasing the efficiency of the Australian managed funds industry in providing funds management services to foreign residents. This results in a greater ability of the Australian managed funds industry to compete against foreign managed fund industries for the management of the investment of foreign residents' savings."

BUDGET COSTING OF A PROPOSAL TO REFORM WITHHOLDING TAX ON PROPERTY INCOME DISTRIBUTED BY LISTED PROPERTY TRUSTS TO NON-RESIDENTS

This report was prepared for
Speed and Stracey Lawyers
by Econtech Pty Ltd.

18 April 2006

Econtech was commissioned by Speed and Stracey Lawyers to provide a budget costing of a proposal to reform withholding tax on property income distributed by listed property trusts to non-residents. This report sets out Econtech's findings. Econtech makes no representations to, and accepts no liability for, reliance on this work by any person or organisation other than Speed and Stracey Lawyers. Any person, other than Speed and Stracey Lawyers, who uses this work does so at their own risk and agrees to indemnify Econtech for any loss or damage arising from such use.

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Key Findings

- Econtech was commissioned by Speed and Stracey Lawyers to estimate the cost to the Federal budget of a reform proposal to reduce to an internationally competitive rate withholding tax on property income of Listed Property Trusts (LPTs) sourced in Australia and distributed to foreign investors.
- In May 2003 the Government announced that the rate of tax imposed on LPTs in respect of those distributions would be set at the company tax rate of 30 per cent. This rate, when implemented, would be subject to reduction under any double tax treaty subsequently entered into by Australia. The reform proposed is that rather than wait the many years to renegotiate each separate double tax treaty, Australian should unilaterally reduce the rate to an internationally competitive rate.
- The equivalent withholding tax rates that apply (or will apply) on property income of Australian investors in Japan, Singapore and the United States are only 7 per cent, 10 per cent and 15 per cent respectively. Further, the Australian withholding tax rates where the non-Australian investor is resident in a country which Australia has a double tax treaty is 15 per cent for unfranked dividends and 10 per cent for interest.
- Speed and Stracey Lawyers advise that in their opinion if from 1 July 2006 the 30 per cent rate remains, gearing will be used so that interest deductions will equal at least 60 per cent of LPT distributions to non-residents. This means that while the "headline" tax rate is 30 per cent, the average effective tax rate (after interest deductions) would be only 12 per cent. As part of the reform proposal, such interest deductions would no longer be allowed, so that the average effective tax rate would match the new "headline" rate. In that context, Econtech has been commissioned to cost the reform proposal under alternative internationally competitive tax rates of 15 and 12.5 per cent.
- Speed and Stracey advise that foreign investment in Australian LPTs stands at about $11 billion. Econtech estimates that of this amount, about $6.9 billion relates to Australian property assets of unit trusts, while the remaining amount relates to foreign property assets and to shares that are "stapled" to units in property trusts. Applying the current gross yield of Australian LPTs of 6.5 per cent to this invested amount, gives an annual income stream of $450 million. Excluding about 33 per cent of this amount as "tax deferred" income, gives a final estimate for the current tax base of $301 million.
- Applying the estimated average effective tax rate of 12 per cent to this tax base gives an estimate for annual tax collections of $36 million. By comparison, introducing a new headline and effective rate of 15 per cent would raise $45 million, a gain of $9 million. Alternatively, a new rate of 12.5 per cent would raise $38 million, a gain of $2 million.
- The above results show the "direct" effects on the budget, and hence neglect any "indirect" effects arising from any behavioural responses to variations in the rate of withholding tax. In estimating indirect effects, Econtech has assumed that foreign investors in Australian LPTs would view a reform scenario with a readily available tax rate of 15 per cent, as broadly equivalent to the existing situation under which an effective rate of 12 per cent would only be achieved at the cost of arranging gearing. In that case, foreign investors might be content to maintain their current investment in LPTs of $11 billion. Under this absence of indirect effects, the estimated gain to the budget under a new rate of 15 per cent, and no gearing, is confirmed at $9 million.
- A new lower tax rate of 12.5 per cent could stimulate further foreign investment in Australian LPTs, increasing the tax base by 7.5 per cent or $23 million. Under certain portfolio adjustment assumptions, this may displace a similar amount from the tax base for dividend income paid to foreign investors, which has a higher estimated average Australian tax rate of 24 per cent. This implies an indirect net loss in revenue from portfolio substitution of $3 million. Combining this with the direct gain to the budget of $2 million under this scenario, gives an overall net loss to the budget of $1 million.

1. Introduction

Econtech was commissioned by Speed and Stracey Lawyers to estimate the cost to the Federal budget of a reform proposal to reduce to an internationally competitive rate withholding tax on property trust income of Listed Property Trusts (LPTs) sourced in Australia and distributed to foreign investors. Speed and Stracey Lawyers provided as background their report on "Australian Listed Property Trusts: Withholding Tax".

The applicable withholding tax rate is presently 30 per cent[1]. By comparison, the withholding tax rate is only 15 per cent for unfranked dividends and 10 per cent for interest, provided the foreign investor is resident in a country for which Australia has a double tax treaty. LPT distributions, unfranked dividends and interest paid to foreign investors have the common characteristic that they are free of Australian company tax, so withholding tax is applied. Overall, the current withholding tax arrangements are slanted against foreign investment in Australian LPTs compared with foreign investment in Australian companies paying unfranked dividends[2].

It is also reasonable to compare the withholding tax rates that are applied on foreign investment in Australia with the equivalent withholding tax rates that are applied on Australian investment abroad. Withholding tax rates that apply (or will apply) on property trust income of Australian investors in Japan, Singapore and the United States are only 7 per cent, 10 per cent and 15 per cent respectively[3].

When the settlement presently being finalised is announced, most foreign investors will realise that tax at 30 per cent is payable on property trust distributions from Australian LPTs. Speed and Stracey Lawyers advise that in their opinion if from 1 July 2006 the 30 per cent rate remains, gearing will be used so that interest deductions will equal at least 60 per cent of LPT distributions to non-residents. This means that while the "headline" tax rate is 30 per cent, the average effective tax rate (after interest deductions) would be only 12 per cent. As part of the reform proposal, such interest deductions would no longer be allowed, so that the average effective tax rate would match the new "headline" rate. In that context, Econtech has been commissioned to cost the reform proposal under alternative internationally competitive tax rates of 15 and 12.5 per cent.

In that context, Econtech has been commissioned to cost the reform proposal under alternative internationally competitive tax rates of 15 and 12.5 per cent. A rate of 15 per cent would match that currently applied to unfranked dividends under double tax treaties. A rate of 12.5 per cent is midway between the withholding tax rates that apply (or will apply) on property income of Australian investors in Singapore and the United States and midway between the withholding tax rates that apply in Australia on unfranked dividends and interest paid to foreign investors. Table 1.1 shows the existing and alternative scenarios that are modelled in this report.

[1] Speed and Stracey Lawyers, 2006, p. 69

[2] Franked dividends distributed to foreign investors have already been subject to Australian company tax of 30 per cent and hence are free of withholding tax.

[3] ibid. pp. 47-63

Table 1.1
Existing and Alternative Withholding Tax Scenarios

	existing	15% tax	12.5% tax
"Headline" Withholding Tax Rate	30.0%	15.0%	12.5%
Gearing - share of FIA-LPT not subject to withholding tax	60.0%	0.0%	0.0%
Average Effective Withholding Tax Rate	12.0%	15.0%	12.5%

In modelling the reform proposal, this report assumes that the same withholding tax rate is applied to all foreign investors. It therefore does not take into account the recommendations of Speed and Stracey Lawyers[4] that a higher rate of 30 per cent be applied on non-portfolio investors and a lower rate of zero be applied to tax exempt investors. This simplifying assumption reflects the limited timeframe and information for this report.

The tax base for withholding tax on property trust income of Listed Property Trusts (LPTs) sourced in Australia and distributed to foreign investors is estimated in section 2. This provides the platform for undertaking the budget costing of the reform proposal in section 3.

[4] ibid. pp. 2-3

2. The Tax Base

This section estimates the tax base for withholding tax on property trust income of Listed Property Trusts (LPTs) sourced in Australia and distributed to foreign investors. This involves identifying the appropriate asset base, estimating its income stream, and then isolating off the "tax deferred" component of that stream.

The first step in this analysis is to identify the appropriate asset base which attracts the withholding tax that was identified above. This withholding tax is applied to the non tax-deferred income from Australian property assets of unit trusts that is distributed to foreign investors. So the appropriate asset base will be the level of foreign investment in Australian property assets of unit trusts. Table 2.1 shows the steps involved in identifying this asset base.

Table 2.1
Foreign Investment in Australian Property Assets of Property Trusts

FIA: Aust. LPTs ($ million)	11,000
stapled shares proportion	9.4%
FIA: Aust. LPTs - shares ($ million)	1,030
FIA: Aust. LPTs - units ($ million)	9,970
share of Aust. LPT invested overseas ($ million)	31.1%
FIA: Aust. LPTs units invested o/s ($ million)	3,100
FIA: Aust. LPTs units invested in Aust. ($ million)	6,871

Speed and Stracey Lawyers[5] estimate that foreign investment in Australian LPTs amounts to about $11 billion, as shown in the top row of Table 1. Of this amount, about $6.9 billion (or $6,871 million as shown in the bottom row of Table 1) relates to Australian property assets of unit trusts. The remaining amount ($4,129 million) relates to foreign property assets and to shares that are "stapled" to units in property trusts. This is based on the assumptions in Table 1 that 9.4 per cent of the value of LPTs is in stapled shares, and that 31.1 per cent of LPT assets are invested overseas, and therefore are not subject to Australian withholding tax. Both of these shares are calculated in Table 2.3, which uses data on the 23 LPTs included in the ASX200.

The second step is to estimate the income stream received from this asset base. Table 2.2 shows that applying an estimated gross yield of 6.5 per cent (which is also calculated in Table 2.3) to the asset base of $6.9 billion, gives an annual income stream is $450 million.

Table 2.2
Tax base for Withholding Tax on property income of LPTs

annual yield Aust. LPTs	6.5%
annual income stream for FIA: Aust. LPTs units invested in Aust. ($ million)	450
tax-deferred share for Aust. LPTs units invested in Aust.	32.9%
current tax base ($ million)	301

The final step is to isolate off the tax-deferred component of this income. The tax-deferred share is estimated at about 33 per cent in Table A1 of the Attachment, based on data for

[5] ibid. p. 28

Australian LPTs that hold no offshore property assets. Excluding the tax-deferred component, gives a final estimate in Table 2.2 for the current tax base of $301 million.

Table 2.3
Selected Statistics on LPTs in the ASX200

ASX code	mkt cap $m	o/s assets %	gross yield %	div cents	distns cents	gross div $m	distns $m	total $m
BJT	511	100%	5.5	0.0	10.1	0	28	28
BWP	600	0%	6.2	0.0	12.4	0	37	37
CER	821	52%	7.7	0.0	12.2	0	64	64
CNP	5,459	10%	5.3	0.0	35.5	0	291	291
CPA	1,562	0%	7.0	0.0	9.6	0	109	109
DRT	4,133	19%	7.3	0.0	10.8	0	302	302
GAN	3,918	0%	5.5	0.0	10.8	0	217	217
GPT	8,531	0%	5.8	0.0	24.4	0	492	492
GSA	1,171	100%	8.0	0.0	10.1	0	94	94
IIF	1,868	7%	6.8	0.0	15.3	0	127	127
IOF	1,537	31%	7.2	0.0	10.3	0	110	110
IPG	3,402	0%	7.5	0.1	16.6	2	253	255
MCW	2,425	78%	7.6	0.0	15.1	0	184	184
MDT	1,113	100%	8.6	0.0	10.7	0	96	96
MGQ	7,743	15%	5.2	0.0	27.1	0	400	400
MGR	3,806	0%	8.6	12.7	19.1	159	167	326
MOF	2,719	45%	8.2	0.0	11.4	0	222	222
MPR	1,046	100%	9.5	0.0	11.8	0	99	99
MXG	2,529	0%	7.3	0.0	22.0	0	184	184
SGP	9,065	0%	6.4	8.6	31.5	163	417	579
TSO	677	100%	7.8	0.0	17.8	0	53	53
VPG	758	0%	7.3	0.0	10.1	0	55	55
WDC	30,463	61%	6.4	10.5	96.1	263	1,682	1,945
Total	95,857					587	5,685	6,272
Wt Average		31.1%	6.5			9.4%	91%	100%

Notes:
1. Distributions are defined to include foreign tax credits.
2. Gross dividends ('gross div') include franking credits, while dividends ('div') do not.

3. Budget Costings

As discussed in the Introduction, this report examines the cost of a reform proposal to reduce (to an internationally competitive rate) withholding tax on property income of LPTs sourced in Australia and distributed to foreign investors. The analysis examines two alternative scenarios involving internationally competitive tax rates of 15 and 12.5 per cent (as outlined in Table 1.1). This section uses the estimated tax base from Section 2 to calculate the costs of these alternative rates.

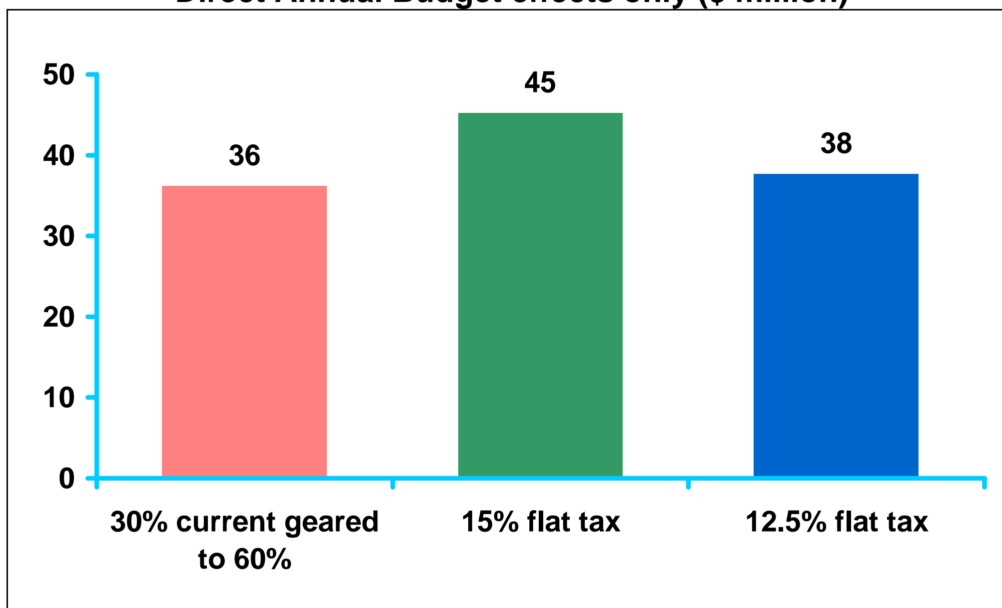
There are two parts to the budget effects of a proposal such as this. The first is the "direct" impact of changing the rate of taxation, which is calculated by simply applying alternative effective average tax rates to the current tax base. The second is the "indirect" impact, which examines the impact of any behavioural responses to variations in the rate of withholding tax. These two effects are now discussed in turn.

3.1 Direct Impact on the Budget

Chart 3.1 estimates the amount of withholding tax collected from foreign investment in Australian LPTs, under the current and two alternative tax rates.

Applying the estimated current average effective tax rate of 12 per cent to the tax base of $301 million gives an estimate for current annual tax collections of $36 million. By comparison, introducing a new headline and effective rate of 15 per cent would raise $45 million, a gain of $9 million. Alternatively, a new rate of 12.5 per cent would raise $38 million, a gain of $2 million. These results are extended in Chart A3 in the Attachment, to include estimates of the impacts under a number of additional alternative tax rates.

Chart 3.1
Tax collected under alternative LPT Withholding tax rates: Direct Annual Budget effects only ($ million)



The above results only show the direct effects on the budget, and hence neglect the indirect effects arising from any behavioural responses to variations in the rate of withholding tax.

The following section explains these behavioural responses and examines the total impact on the budget when these responses are included.

3.2 Total Impact on the Budget

In addition to the direct effects calculated above, the budget cost of the alternative tax rates will also involve indirect effects. These indirect effects are the result of the reduced withholding tax rate leading to an increase in the level of foreign investment in Australian LPTs. This section examines the total impact under the alternative rates of 15 per cent and 12.5 per cent, as discussed in the previous section.

15 per cent scenario

To estimate the indirect effects, Econtech has assumed that foreign investors in Australian LPTs would view the reform scenario with a new rate of 15 per cent, as broadly equivalent to the existing situation. As discussed in the introduction, under the existing situation, an effective rate of 12 per cent is only achieved at the cost of arranging gearing, and so might be regarded as equivalent to a readily available rate of 15 per cent in the reform scenario.

In that case, foreign investors might be content to maintain their current investment in Australian LPTs of $11 billion. Hence there is no change in the level or type of foreign investment in Australia. Thus, the total estimated gain to the budget under a new rate of 15 per cent, and no gearing, is confirmed at $9 million.

12.5 per cent scenario

In contrast, a new lower tax rate of 12.5 per cent rather than 15 per cent is likely to stimulate further foreign investment in Australian LPTs. While any estimate of the extent of this increase in foreign investment is subjective, it is unrealistic to assume that there is no increase.

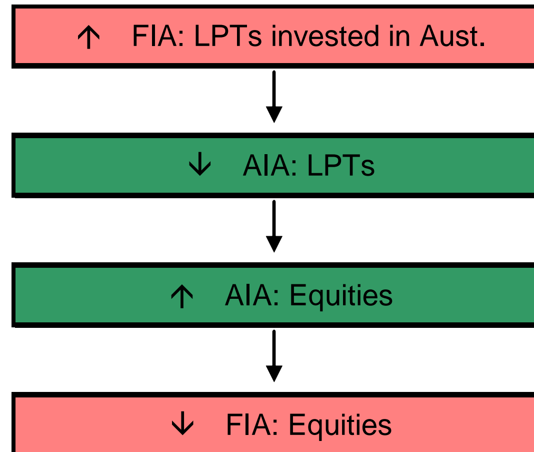
One way of developing a rule-of-thumb for the possible response in foreign investment in Australian LPTs is to consider the hypothetical case where the withholding tax were abolished instead of set to 15 per cent. It is not unreasonable to suppose that foreign investment in Australian LPTs might then increase by close to 50 per cent, because this would still leave foreign penetration of the Australian LPT market below foreign penetration of the Australian equity market.

Using this as a rule-of-thumb, a new tax rate of 12.5 per cent rather than 15 per cent might boost foreign investment in Australian LPT units invested in Australia by 7.5 per cent, which would lead to a similar increase in the tax base. Thus, the lower tax rate might increase the tax base from $301 million (as estimated in Section 2) to $324 million, an increase of 7.5 per cent or $23 million. This expansion in the tax base would boost LPT withholding tax collections under this scenario from the estimate of $38 million reported in Chart 3.1, to $41 million, a gain of $3 million.

However, this is only part of the story. The increase in foreign investment in Australian LPTs is likely to lead to portfolio reallocation effects. Figure 3.1 illustrates a plausible set of responses by foreign and domestic investors. These portfolio responses are based on the reasonable assumptions that Australian investors are the “marginal” investors in Australian

LPTs while foreign investors are the "marginal" investors in Australian equities. These assumptions and their implications in Figure 3.1 are now discussed.

Figure 3.1
Portfolio Substitution under alternative tax rates



Notes:
FIA = Foreign Investment in Australia
AIA = Australian Investment in Australia

As noted above, Australian investors are assumed to be the marginal investors in Australian LPTs, implying that the size of this asset class is determined by their investment decisions. This seems likely given that Australian investors have as much as 85 per cent ownership of Australian LPTs[6]. This reflects the fact that LPTs are to some extent a distinctive Australian investment class, with the Australian property industry far more securitised than in overseas markets. Thus, LPTs are a well developed asset class in Australia, but are only an emerging asset class internationally. As such, it is Australian investors that are likely to determine the overall level of investment in Australian LPTs.

With Australian investors determining the overall level of investment in Australian LPTs, and no change in taxation proposed for these investors, this means that the total level of investment in Australian LPTs should remain steady. Thus, the increase in foreign investment in Australian LPTs is expected to displace a similar amount of Australian investment in Australian LPTs, as shown at the top of Figure 3.1.

With no change to taxation of Australian investors, the overall level of domestic savings is unlikely to change. Thus the reduction in Australian investment in LPTs is likely to be offset by an increase in Australian investment in other asset classes, most obviously equities. Thus, the displaced Australian investment in LPTs is expected to shift to equities, as shown in the middle of Figure 3.1.

[6] Total market capitalisation of Australian LPT is about $85 billion, with foreign investors accounting for $11 billion (Speed and Stracey Lawyers, 2006, pp13 and 27). This leaves over 85 per cent in Australian investors' hands.

This portfolio switch by Australian investors will only impact significantly on the budget if rates of return or tax rates differ significantly between shares and LPTs for Australian investors. These rates of return and tax rates are now considered in turn.

The first issue is the rates of return on LPTs versus equities. Table 2.3 (in Section 2) reported a weighted average gross yield of 6.5 per cent for Australian LPTs in the ASX200. However, this return includes both a taxable and tax-deferred component. In terms of both its economic interpretation and its taxation treatment, the tax deferred component is akin to a capital gain. Thus, when comparing LPT income yields to equity income yields, it is widely accepted that only the non-tax deferred component should be included in the LPT yield. This gives an LPT income yield of 4.4 per cent, which is not dissimilar to the gross income yield from equity investments (including franking credits). Similarly, if the tax deferred component of LPT distributions is included with the normal capital gain, expected rates of capital gain from LPTs are not dissimilar to those for equities. Thus, portfolio switching by Australian residents from LPTs to equities is unlikely to significantly impact in an ongoing way on streams of income and capital gains, appropriately calculated.

The second issue is the tax treatments of LPTs versus equities. Under Australia's dividend imputation system, there is no major difference between the two forms of investment in the final tax take. While companies, unlike property trusts, are subject to company tax, this is largely refundable as a franking credit in the hands of the Australian shareholder. In broad terms, the intended end result is that the income of both companies and property trusts is taxed on an equivalent basis in the hands of the Australian owners.

Hence the rates of return (properly measured) and tax treatments are broadly comparable between property trusts and equities for Australian owners. This means that the portfolio switching by Australian investors from LPTs to equities shown in the middle of Figure 3.1 is likely to have only a minimal net indirect effect on the Federal budget.

The final issue is the likely impact of the increase in Australian holdings on equities on the Australian equity market. In contrast to Australian LPTs, foreign investors are widely considered to be the marginal investors in Australian equities. This is because equities are a mature market globally. Hence foreign investors have penetrated much further into the Australian equity market than into the Australian LPT market. With foreign investors determining the overall level of investment in Australian equities, and no change in taxation proposed for these investors, this means that the total size of the Australian equities market is unlikely to change. This implies that the increase in Australian investment in Australian equities is likely to displace a similar amount of foreign investment in Australian equities.

This is reflected in the bottom of Figure 3.1, which indicates that the expected increase in Australian ownership of equities is assumed to be offset by a reduction in foreign ownership. For foreign investors, the end result is that their increased investment in Australian LPTs is offset by reduced investment in Australian equities. This portfolio switch by foreign investors will be responsible for any significant indirect effects on the Federal Budget. This indirect budget effect will depend on any difference in the tax rates applied to the returns received by foreigners from Australian LPTs compared with Australian equities.

Under this scenario, the withholding tax rate on LPTs of 12.5 per cent is below the estimated average tax rate of 24 per cent applied to dividends paid to foreign investors[7]. Hence, while the estimated shift in foreign investors' income of $23 million from Australian equities to Australian LPTs will add an estimated $3 million to taxes collected from LPT income, this would be at the expense of a loss of $6 million in taxes collected from share income. This implies a net negative indirect effect on the budget of $3 million.

Combining this indirect loss to the budget of $3 million, with the estimated direct gain to the budget of $2 million, gives an overall net loss to the budget of $1 million. Thus, even under a new withholding tax rate of 12.5 per cent, any impact on the Federal budget is expected to be minimal. Chart 3.2 summarises the total impact on the budget under each scenario once these indirect effects from portfolio substitution are included. This can be compared with Chart 3.1, which allows for the direct effects only.

Chart 3.2
Tax collected under alternative LPT Withholding tax rates: Total Annual Budget Effects ($ million)

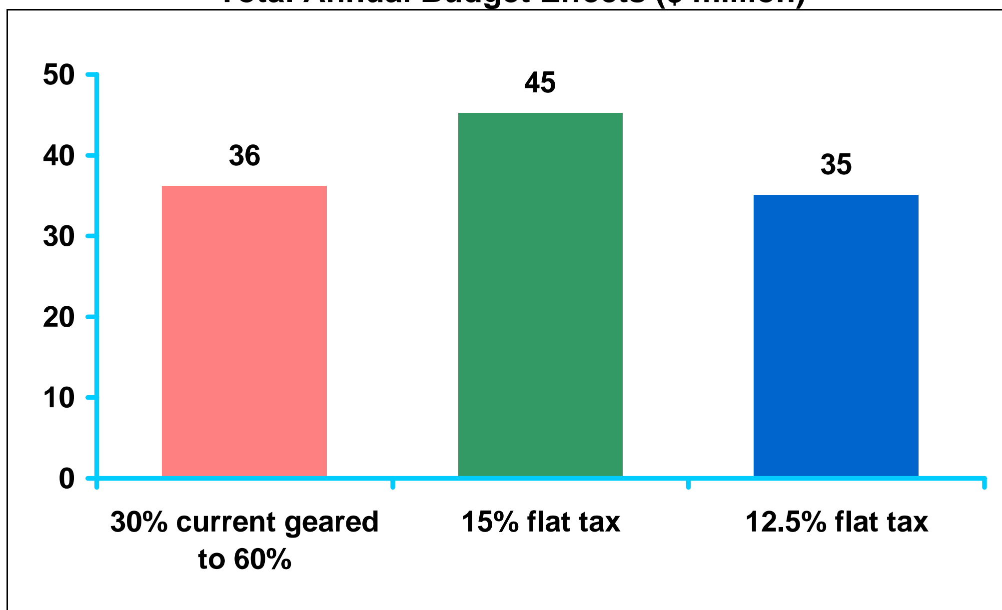


Table 3.1 shows the total impacts on Budget revenue under both the 15 per cent and 12.5 per cent withholding tax rate scenarios, compared with the present situation. The detailed calculations underlying these estimates can be found in Table A2 in the Attachment. Further, Chart A3 in the Attachment extends these results, showing the total impact on the Federal budget of a number of additional alternative tax rates.

[7] The 24 per cent dividend tax rate is a weighted average of the 30 per cent company tax on grossed-up franked dividends and the 15 per cent withholding tax on unfranked dividends, based on a split of 60:40 between (grossed-up) franked and unfranked dividends.

Table 3.1
Budget Revenue Impacts

	15% flat tax	12.5% flat tax
Direct (without portfolio effects)		
W/holding Tax on LPTs (change, $m)	9.0	1.5
Indirect (with portfolio effects)		
W/holding Tax on LPTs (change, $m)	0.0	2.8
Tax on shares (change, $m)	0.0	-5.4
Total Tax Impact (change, $m)	9.0	-1.1

References

Speed and Stracey Lawyers (2006), "Australian Listed Property Trusts: Withholding Tax", February.

Web-sites

www.asx.com.au

www.etrade.com.au

web-sites of ASX200 listed property trusts

Attachment

Table A1
Tax Deferred Distributions of Locally-Oriented, ASX200 LPTs

	mkt cap	distns	distns	distns	distns	distns	distns	distns
		tax def	other	total	tax def	other	total	tax def
	$m	cents	cents	cents	$m	$m	$m	%
BWP	600	3.1	9.3	12.4	9.3	28	37	25%
CPA	1,562	4.5	5.1	9.6	50.9	58	109	47%
GAN	3,918	4.6	6.2	10.8	92.3	125	217	43%
GPT	8,531	11.0	13.4	24.4	221.0	271	492	45%
IPG	3,402	0.7	15.9	16.6	10.8	242	253	4%
MGR	3,806	7.7	11.4	19.1	67.3	100	167	40%
MXG	2,529	5.5	16.5	22.0	45.8	138	184	25%
SGP	9,065	7.2	24.3	31.5	95.7	321	417	23%
VPG	758	0.0	10.1	10.1	0.0	55	55	0%
Total/Aver	34,171				1873.1	3,812	5,685	33%

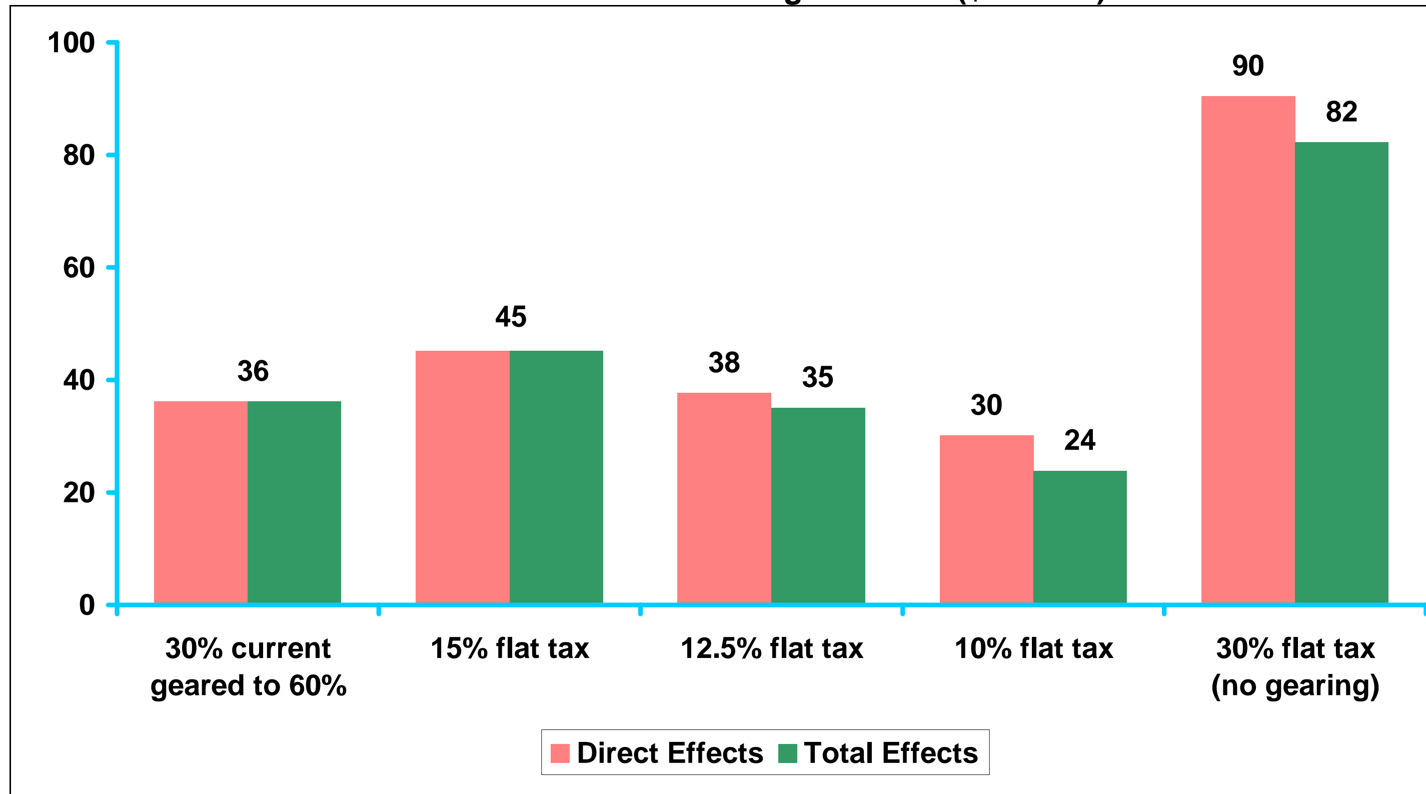
Notes:

1. Distributions are defined to include foreign tax credits.

Table A2
Revenue Modelling

	existing	12.5% tax direct effects	15% tax direct effects	12.5% tax total effects	15% tax total effects
withholding tax on LPTs					
FIA: Aust. LPTs - units ($ million)	9,970	9,970	9,970	10,486	9,970
of which:					
invested o/s ($ million)	3,100	3,100	3,100	3,100	3,100
invested in Aust. ($ million)	6,871	6,871	6,871	7,386	6,871
annual yield Aust. LPTs	6.5%	6.5%	6.5%	6.5%	6.5%
FIA: income for Aust. LPTs units investments in Aust. ($ million)	450	450	450	483	450
tax-deferred share for Aust. LPTs units invested in Aust.	32.9%	32.9%	32.9%	32.9%	32.9%
FIA: non-def income for Aust. LPTs units investments in Aust. ($ million)	301	301	301	324	301
reduction through gearing	60%	0%	0%	0%	0%
FIA: taxable income for Aust. LPTs units investments in Aust. ($ million)	121	301	301	324	301
FIA: Withholding Tax on LPTs (rate)	30.0%	12.5%	15.0%	12.5%	15.0%
FIA: Annual Withholding Tax on LPTs ($ million)	*36*	*38*	*45*	*41*	*45*
				4.3	
portfolio substitution					
FIA: Aust. LPTs - units invested in Aust. ($ million)	6,871	6,871	6,871	7,386	6,871
FIA: Change in Aust'n shareholdings ($ million)	0	0	0	-515	0
annual gross yield Aust'n shareholdings	4.4%	4.4%	4.4%	4.4%	4.4%
FIA: change in income on Aust'n shareholdings ($ million)	0	0	0	-23	0
of which:					
franked ($ million)	0	0	0	-14	0
unfranked ($ million)	0	0	0	-9	0
FIA: change in company tax on franked dividend ($ million)	0	0	0	-4	0
FIA: change in witholding tax on unfranked dividend ($ million)	0	0	0	-1	0
FIA: total change in tax on income of Aust'n shareholdings ($ million)	*0*	*0*	*0*	*-5*	*0*
Total Tax Impact ($ million)	**36**	**38**	**45**	**35**	**45**

Chart A3
Tax collected under alternative LPT Withholding tax rates: Direct and Total Annual Budget Effects ($ million)



Notes:

1. The Total Budget Effects are based on a simple 1:3 rule-of-thumb behavioural elasticity. That is, it is assumed that a 1 percentage point reduction (increase) in the tax rate leads to a 3 percent increase (reduction) in FIA[8] LPT's invested in Australia, relative to the level under a 15 per cent flat tax. For example, moving from 15% flat tax to 10% flat tax, increases FIA LPT's invested in Australia by 15%; or moving from 15% flat tax to 30% flat tax, decreases FIA LPT's invested in Australia by 45%.

[8] FIA = Foreign Investment in Australia

Attachment B

IFSA Submission

March 2006

MANAGED INVESTMENTS TAX REGIME

(MITR)

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1 Introduction

1.1 Purpose

The purpose of this submission is to propose a framework for legislative reform with respect to the taxation treatment of managed investments that are offered to investors by way of unit trust (hereafter referred to as “managed investment trust” or “MIT”).

The industry has undergone substantial change over time, especially recently, and we believe that a specific taxation regime (hereafter referred to as “managed investment tax regime” or “MITR”) is required to provide certainty to investors (retail and wholesale, resident and non-resident), financial service providers and the Australian Taxation Office (“ATO”).

It is considered that the financial services industry is in desperate need of specific rules that govern the taxation treatment of MITs in order to avoid market disruption and ensure a level playing field for all those operating in the industry, including investing consumers and the ATO.

This paper will:

1. provide background and details regarding the current state of play in the industry and make a case for reform;

2. describe the complexity and uncertainty that arises from application of the current income tax laws to MITs;

3. propose, in principle, a taxation regime that should be implemented by the Government that is:

   a. simple;
   b. efficient;
   c. certain; and
   d. largely revenue neutral to both Government and taxpayers by delivering lower taxation compliance and administration costs.

1.2 Current State of Play

The Australian financial services industry has successfully developed into one of the world’s leading providers of investment solutions and products to nearly all Australians as well as to business and government. This is evidenced by Australia having one of the highest proportions of share ownership in the world on a per capita basis, with 55% of the Australian population owning shares either directly or indirectly (through managed funds or self-managed superannuation funds), compared with 51% in 2003 and 50% in 2002.[1]

[1] *Source: Australian Stock Exchange, November 2004.*

Currently, the industry is responsible for investing over $920 billion on behalf of more than 9 million investors. The strong growth of the industry is expected to continue, with funds under management reaching $2.3 trillion by 2015.[2]

Notwithstanding this success, a robust legislative infrastructure is lacking from a taxation perspective that is capable of providing certainty to all market participants including investors both resident and non-resident. This is unfortunate, but not surprising, given that consumer and wholesale investment products have rapidly evolved to satisfy market demand without the taxation regime applicable to those products also evolving properly to ensure that taxation outcomes are appropriate and do not give rise to unintended consequences.

The financial services industry has undergone, and will continue to undergo, consolidation and rationalisation and this in itself will challenge market participants as they strive to remain relevant to investors in an already crowded and globalised market place.

A shift in consumer preferences away from traditional bank guaranteed products toward products providing exposure to global investment markets such as unitised investment products (i.e. MITs) has occurred over recent years and is expected to increase unabated as the wealth effect continues to increase and consumers increase their savings either directly or via the superannuation savings system. The choice of superannuation fund regime, superannuation co-contributions concessions, abolition of the superannuation surcharge, superannuation contributions splitting and other Government initiatives designed to ensure that consumers save for their retirement are expected to generate significant savings momentum involving MITs, either directly or indirectly.

A consumer "mass" market has emerged that demands a wide variety of investment choice and this has resulted in the development of master trusts/IDPS/WRAPs (hereafter referred to as "WRAPs") that offer a single bundled product platform that is designed to provide investors with a large and diverse investment choice with respect to different asset classes using not only the product providers' own MITs but those offered by other competitors. This can be seen in the diagram set out in Appendix A.

Investors are now able to access shares and other growth type assets directly using electronic trading facilities offered both domestically and internationally. Suffice it to say that there has never been more choice and diversity available to consumers.

Financial service providers will "pool" or "aggregate" investment capital that they have been entrusted to manage into "like" or "common" asset pools/classes using MITs in order to achieve economies of scale and to avoid duplication of investment decisions, transactions and processes.

The aggregation of investment capital into asset pools will usually take place irrespective of whether the source of the investment capital is individual private money (non-superannuation source), superannuation money (including life insurance company VPST and SEA funds as well as direct superannuation funds and PST) or WRAP money. This is a very important factor relevant to this submission because ultimately, the economic owners who benefit from the returns generated from the investment capital deployed differ in their taxation profile and are entitled to the benefit of tax concessions.

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[2] *Source: AXISS Australia, July 2004*

In this regard, a fundamental requirement demanded by investors of the current MIT taxation regime is that it does not impede the pooling of investment capital to attain investment outcomes and cost synergies for the benefit of investors. In other words, the tax rules applicable to MITs should not produce adverse taxation outcomes for investors compared to those taxation outcomes that would have occurred had the investors held assets directly themselves.

In our view, the current taxation system applicable to MITs falls well short of this fundamental requirement because the tax legislation and related common law concepts (such as "present entitlement", "absolute entitlement", "trust law income", "common law source", "revenue account" and "capital account") are daily becoming less relevant to recognising the different economic interests that will ultimately share in the returns generated by the MIT. Because of this fundamental lack of evolution and development, both the industry and the ATO have had to "stretch" these outdated and in many cases irrelevant concepts to make the tax law work or ensure that unintended consequences do not arise.

This has led to a lack of certainty and consistency with respect to an otherwise robust and successful industry and gives rise to unnecessary tax compliance and administration cost. In some cases, innovative product proposals that have been designed to grow the Australian and international market for financial services have been abandoned because existing tax laws are not certain enough to achieve the tax outcomes that would otherwise be achieved had the investors held assets directly themselves.

Broadly speaking, the current tax regime applicable to MITs is problematic because:

1. there could well be a loss of the capital gains tax ("CGT") discount for individual and superannuation investors resulting in over taxation of capital gains by 33⅓% for superannuation funds and 50% for individuals where a MIT does not satisfy the common law test for CGT treatment (known as the "revenue account" issue). This issue is described in more detail in 3.1.

2. double taxation and other unintended consequences can occur where the legal test of "present entitlement" is not satisfied by the investors in relation to the MITs income notwithstanding that investors will economically ultimately only receive their proportion of taxable income calculated by reference to their unit holding as a proportion of all other units on issue. This issue is described in more detail in 3.2.

3. adjustments to taxable income that arise due to imperfect information may cause product providers to reissue tax statements and potentially millions of investors to refile their tax returns (known as the "unders and overs" issue). This issue is described in more detail in 3.3.

4. the non-resident withholding tax regime applicable to distributions paid to non-resident investors is too complex and can never be correct at the time of withholding because the actual components of the net income of the MIT for tax purposes is not known until the end of the tax year and will require recalculation and adjustment to achieve the technically correct position. This issue is described in more detail in 3.4; and

5 many other issues arise in relation to the tax treatment of MITs because of various deficiencies in the tax law which we can explain further if required.

1.3 The proposed MITR

In order to specifically address the abovementioned impediments and threats to the industry, the ATO and investors, we submit that a specific tax regime should be introduced into the tax law to ensure that:

1. Complete flow through of taxable income to investors in MITs that retains its character for taxation purposes;

2. CGT be the primary taxation code for shares, property and units in unit trusts held by a MIT;

3. MIT taxable income be:

   a. fully distributed by the MIT to investors each year;

   b. assessed to investors for taxation purposes by reference to their economic interest in the MIT. This should be determined by reference to each investor's unit holdings as a proportion of total units issued by the MIT so that the concept of present entitlement will no longer be relevant for tax purposes;

   c. calculated by reference to the best information available at the time of distribution; and

   d. adjusted, by way of tax deduction or inclusion of additional assessable income, for any under or over distribution in the prior year where that under / over distribution occurred as a consequence of imperfect information available at year end; and

4. Non-resident withholding tax be simplified so that it is imposed and collected by reference to the distribution components known and made at the time liability to withholding tax arises.

We set out these proposals in more detail in sections 2 and 3 of the paper.

We note for completeness that MITR is largely a statutory codification of the industry and ATO practices from a taxation perspective and we do not expect that the introduction of MITR will give rise to a revenue cost for the Government. We consider the value generated for the industry, its investors and the ATO with respect to MITR arises because a high degree of certainty will exist in relation to the tax treatment of MITs and their investors. This certainty will in turn generate compliance and administrative cost savings as well as certainty and confidence in financial markets.

We acknowledge that, pragmatically, many of the abovementioned tax outcomes are achieved under the current taxation system as it stands, although it must be recognised that a strict view

of the tax law may not give rise to the "appropriate" tax outcomes from an investor's perspective and this has been recognised by the ATO on many occasions.

The ATO is required to administer the taxation system as it applies to MITs in accordance with the law as it stands and this itself will give rise to a lack of consistency in tax treatment of identical products across the industry, especially under a self assessment regime. This is because different parties may have different views regarding application of the tax law given that not all taxpayers will seek to test the ATO view of the law or may not wish to depart from market practice in relation to a particular regard. Further, the ATO cannot review the tax affairs of each MIT on an annual basis and thereby ATO views regarding application of the tax law to a particular arrangement will not be known for sometime after the relevant product is distributed and accepted by investors.

In an environment of increased regulatory oversight and supervision both domestically (eg financial services law) and globally (Sarbanes Oxley Act) it becomes very difficult for market participants to operate within the regulatory framework where the taxation regime applying to MITs is uncertain. Indeed certainty as to some fundamentally important tax issues ultimately may not be correctly known until many years later after taxable distributions have been made to investors whose tax affairs will ordinarily have been "finalised", should the ATO dispute the tax treatment adopted by the MIT.

It is submitted that such a system of taxation is most unsatisfactory and exposes investors to unwarranted tax risks. It is in this context that the need for a new MIT tax regime is based, rather than by undertaking legislative amendments to the tax law on a piecemeal basis to address particular issues on a stand alone basis.

Further, it must also be recognised that any change in the current taxation treatment of the MIT determined either judicially or administratively by the ATO, especially with respect to the CGT treatment of assets, will give rise to a very significant market and taxpayer compliance failure for the following reasons:

1 investors will move their investments into a direct ownership structure and may not seek out specialist investment management expertise which will give rise to more volatile markets and less stable investment returns. This will ultimately diminish the level of both private and retirement savings of individuals. This is likely to result in more demand for public / government financial support to Australians, especially post retirement;

2 the investment management function of superannuation funds and other intermediaries will be internalised, thus increasing management costs for the ultimate consumer / investor and again placing more demand on public funds to support Australians post retirement; and

3 the number of end investors that hold assets directly will increase and they will not have the knowledge or sophistication to properly track, manage and report gains and income from these investments in their tax returns annually, thus increasing the likelihood of widespread non-compliance. This will ultimately result in increased compliance costs being borne by the Government (ATO) to ensure compliance with the tax law. Recent

years have seen a marked increase in the complexity of the tax affairs of investors due to investment in new unusual asset classes (eg hedge funds), widespread investment in complex assets such as stapled securities and the complexity of recent tax law relating to investments (eg the demerger rollover relief and scrip for scrip rollover relief). This can be contrasted to the current regime applicable to MITs whereby these complex tasks are performed by financial services providers who then prepare correct tax statements for investors as well as reporting the same to the ATO using existing reporting mechanisms (eg AIIR and TFN reporting).

On this basis, we consider that MITR must be viewed as a "partnership" between the Government, ATO and industry whose success is ultimately in the national interest.

1.4 Related Matters

We note for completeness our papers regarding the Asian Markets faced by Australian financial services companies and product rationalisation, and we continue to support resolution of those fiscal and regulatory issues. We have not repeated those same issues in this paper but expect that they should be implemented in a manner consistent with the proposed MIT regime.

We also note that although there are similarities between MITR and the previously proposed collective investment vehicle ("CIV") regime – for example, qualification requirements and retention of flow-through basis of taxation – the commercial and taxation drivers that underlie the CIV regime are fundamentally different to those under MITR.

The CIV regime was proposed as an exception to the entity taxation regime proposed by the Ralph Committee's Review of Business Taxation in the late 1990s, under which trusts would have been taxed like companies. As the entity taxation regime was not adopted by Government, it was considered there was no longer a need for the CIV regime and the existing taxation treatment of trusts was retained.

MITR, on the other hand, seeks to codify the application of existing tax practices that have been applied by the financial services industry, consumers and the ATO for decades. In this regard, the development of tax law as it applies to MITs has not kept pace with changes in product and consumer investment preferences.

Non Resident Withholding Tax

MITR encompasses principles adopted in current discussions relating to unit trust distributions made to non-residents, in particular, where those distributions are paid through resident and non-resident custodians. Those discussions will need to continue separately due to the urgency in resolving those matters but, ultimately, the conclusions reached will need to mesh with the broader MITR regime.

2 The proposed MITR

2.1 MITR recommendations

A summary of the proposed MIT regime immediately follows.

2.1.1 Definition of a managed investment trust

That a managed investment trust be defined as an entity that:

1. is a trust that is:

   a. An Australian resident for income tax purposes;

   b. Either:

      i. registered with Australian Securities & Investments Commission as a managed investment scheme under [Chapter 5C] of *the Corporations Act 2001*; or

      ii. operated by an entity that holds an Australian financial services licence authorising it to operate a managed investment scheme under [section 601FA] of *the Corporations Act 2001*;

2. has made an irrevocable election to apply the managed investment trust regime;

3. is a trust to which beneficiaries subscribe capital and earn a share of the income and gains in proportion to the capital they have subscribed up until the time they redeem their capital (commonly known as unit trusts);

4. does not undertake "excluded activities" such as, film schemes, agribusiness, timeshare schemes and managed strata title schemes and is not a public trading trust or corporate unit trust; and

5. satisfies a widely held test where no fewer than 20 individual taxpayers who are unrelated have more than a 75% beneficial interest, directly or indirectly, in the MIT calculated by reference to their unitholdings as a proportion of total units issued by the MIT. This test will be satisfied if a complying super fund, another MIT or life insurance company holds more than 25% of the beneficial ownership in the MIT. For this purpose, each Self Managed Superannuation Fund (as defined in s 17A of the Superannuation Industry (Supervision) Act 1993) would be treated as one individual taxpayer.

   Further, special "start-up and wind-up" rules should deem an entity to satisfy the widely held test at all times during the "start-up" and "wind-up" period if the entity:

   a. commences to satisfy the widely held requirement within 12 months (or some other period) of the time of its creation ("start-up period"); or

b. ceases to satisfy the widely held requirement during a period not exceeding 12 months (or some other period) before the redemption of the final units on issue ("wind-up period").

2.1.2 Conduit treatment of trust income retained

That the Tax Act expressly provides that each component of the MIT's income including capital gains retains its character on distribution to unit holders for tax purposes. For example, amounts representing capital gains, tax deferred income, dividends (including attached tax offsets on distributions) or interest, flow through the MIT and retain their character for tax purposes in the hands of unitholders.

The current income tax treatment of tax preferred distributions to remain unchanged such that these amounts continue to be non-assessable but subject to CGT event E4 in the *Income Tax Assessment Act 1997* ("ITAA97"). Tax preferred distributions include tax deferred income, tax free income, tax exempt income and amounts representing the CGT discount concession.

2.1.3 Full distribution requirement for MITs

That MITs be required to distribute all of their taxable income in respect of an income year to unitholders determined in accordance with paragraph 2.1.5. If the MIT does not make a cash distribution to unitholders, taxable income is taken to have been distributed to unitholders if the MIT advises its unitholders of their share of net taxable income within 90 days of the end of the financial year.

That the trustee of a MIT not be liable to income tax in its trustee capacity on any taxable income (including notional taxable income such as attributable CFC/FIF income and Division 16E accruals) of the MIT on the basis that the MIT's taxable income is distributed to investors each income year.

2.1.4 MITs unable to stream distributions

MITs be prevented from streaming capital, taxable income or any component of taxable income (including tax offsets and foreign tax credits) to unitholders other than in proportion to unitholder entitlements. This follows from the fact that a MITs trust deed must already specify how the entitlements to income and capital for each and every unit issued by the MIT must be distributed. Such entitlements cannot usually be altered at the discretion of the RE.

2.1.5 Distribution and Determination of Actual taxable income

That distribution of Actual Taxable Income ("ATI") by MITs be taken to satisfy the full distribution requirement.

Actual Taxable Income of the MIT for an income year must be calculated so that the amount of the total distribution and the amount of each distribution component *(such as, capital gains, franking credits, foreign tax credits and other tax attributes)*:

1 is determined having regard to the best information available at the time of distribution; and

2 is not deliberately overstated or deliberately understated by the RE in preparing and making its distribution for an income year.

2.1.6 Deficiency / excess of distributions

Under distribution of taxable income

That if ATI is less than a MIT's taxable income for a given income year the MIT shall include the difference between taxable income and ATI as an adjustment to a later income tax return in the income year that the difference is first known.

Over distribution of taxable income

That if ATI is more than the taxable income of the MIT for a given year:

- the excess be taxed in the hands of unit holder in the year of distribution; and
- a tax deduction be allowed to the MIT that will be available to set off against the MIT's taxable income in the year of income that the difference is first known.

2.1.7 Present Entitlement Requirement

The current requirement that unitholders must be presently entitled to the trust law income of the MIT before they can be presently entitled to their share of the MITs taxable income be removed.

That taxable income of the MIT be imputed to unitholders for tax purposes each year in proportion to their unit holdings as a proportion of total units issued by the MIT such that:

- interim MIT distributions be included as assessable income of a unit holder in the income year in which the distribution is received; but
- year end or final MIT distributions made within 90 days of the end of that year, be taken to be paid and received in the income year to which they relate.

2.1.8 Tax treatment of gains and losses on disposal of assets held by MITs

That capital gains tax be the primary code for calculating gains and losses in respect of shares, property and trust units held by MITs. However, it is envisaged that appropriate mechanisms would be put in place to address the unintended consequences arising where hedge funds or other taxpayers such as banks or general insurers seek to carry out their investment activities using the proposed MIT regime.

2.1.9 Distributions to non-resident unitholders

That operation of section 98 of the ITAA36 be reformed so that:

a. distributions to non-residents of other income (excluding capital gains not connected with Australia, interest, dividends and royalties) should be subject to a single tax rate of 30%;

b. it is administered under the PAYG withholding provisions;

c. the PAYG withholding to apply to all taxable components of distributions (and not just interest, dividends and royalty as is currently the case) at the following rates:

   - Australian sourced interest – 10%;
   - Unfranked dividends (treaty country) – 15%;
   - Unfranked dividends (non-treaty country) – 30%;
   - Other Australian sourced income – 30%;
   - Taxable capital gains with the necessary connection with Australia – 30%.

d. PAYG amounts withheld from distributions to non-residents be treated as a final tax.

The MIT would be excluded from tax obligations in respect of distributions of taxable income to non-resident unitholders otherwise applicable under provisions outside the MITR, such as the application of section 98(3) and (4) by assessment at the relevant tax rates for non-resident individuals and companies.

We note discussions between IFSA, Treasury and ATO regarding the tax treatment of distributions to non-residents. Should current tax rates applicable to non-resident distributions be reduced to 15% as proposed by the industry, we expect that the reduced rate of 15% would also apply to MITs that distribute to non-residents rather than the 30% proposed above.

2.1.10 Failure to satisfy MITR

Any failure by a MIT to satisfy any of the above requirements (2.1.1 to 2.1.9 inclusive) any time after making an election to be a MIT for tax purposes will result in the MIT being subject to the rules applicable to non MITR trusts under Division 6 of the ITAA36 for the whole of the income year in which the failure occurs. A MIT which fails the eligibility requirements and is subjected to the operation of Division 6 will not be prohibited from electing back into the MITR in later years where it satisfies the relevant criteria in relation to that income year.

Where a MIT elects into MITR but later becomes subject to Division 6 of the ITAA 1936 because it has failed to satisfy the eligibility requirements, appropriate legislative mechanisms will be required to ensure that withholding taxes and other remittances are properly attributed to the MIT and its investors.

3 Fundamental issues

3.1 Tax treatment of gains and losses on disposal of assets held by MITs

3.1.1 Background

Inherent uncertainty exists throughout the industry in relation to the tax treatment of gains or losses that arise from the disposal of assets held by MITs. Whilst the industry practice is principally to treat shares, units in trusts and real property as being held on capital account, there is no clear authority or guidance to endorse this treatment and provide certainty to investors.

Whether MIT assets are held on capital or revenue account is a fundamental issue due to differences in the tax treatment of capital and revenue assets. For example:

- <u>CGT discount</u>

  Net capital gains distributed by MITs retain their character and certain capital gains are eligible for the CGT discount in the hands of a unitholder, whilst a similar concession does not apply to net revenue gains distributed.

- <u>Quarantined capital losses</u>

  Capital losses realised by MITs are quarantined – these losses cannot be distributed to investors or offset against ordinary income.

- <u>Flow through of franking credits</u>

  Franking credits are included in assessable income of the MIT for income tax purposes and flow through to unitholders as a component of distribution by the MIT. Where gains and losses are treated as being on revenue account, net losses from the disposal of assets may cause the MIT to be in a net taxable loss position such that there is no taxable income available to distribute to unitholders. If this occurs, the franking credits cannot flow through to unitholders and will be lost.

  However, if gains and losses are treated as being on capital account, net losses would be quarantined such that the MIT has taxable income, including franking credits, to distribute to its unitholders.

3.1.2 Problems

Under the existing tax law, the question as to whether gains and losses are to be treated as being on capital account or revenue account is a question of fact. Various principles and indicia have been established by the courts over many years in determining whether an item of income or expense is capital or revenue in nature (e.g. *Sun Newspapers, London Australia Investment*).

These principles and indicia are based on questions of fact and degree and are often difficult to apply in practice, as evidenced by the numerous cases that have been litigated before the courts over the years. Further, these principles and indicia were established by the courts many years ago at a time when the Australian tax system and financial markets were significantly different to today, and before development of the managed investment industry.

In the managed investments industry, it is often not clear whether investment assets are held on capital or revenue account. For example, the appointment of a new and unrelated investment manager to manage the investment portfolio may result in a change in investment style that may alter the character of assets thought to apply for tax purposes. Further, the intention of the investment manager at the time of acquisition of the asset may not be properly reflected in the turnover of fund assets (for example, assets may have to be realised to fund redemptions by the MIT's unitholders rather than based on the investment manager's decision to realise profits or losses, or the MIT's portfolio needs to be rebalanced to track a particular share index).

Changes in the style of investment may lead to a need to reassess whether assets acquired are held on capital or revenue account. The exact point in time when the change occurs can be difficult to identify, and it is inefficient and costly to constantly reassess a fund's status. Even if it is possible to identify the time of change in status, there are likely to be other constraints preventing the correct position to be reflected – for example, technology constraints, volume of assets and transactions affected – and workarounds required could be costly and complex.

The inherent uncertainty as to whether gains and losses should be treated as being on capital or revenue account does adversely impact on the ultimate investors. For example, if the ATO was to take the view that gains and losses should have been on revenue account rather than capital account and issue amended assessments, it is the ultimate investors who are responsible for any change in taxable income (including the loss of CGT discount, etc) and the corresponding tax and penalty costs. This would involve amendments to a significant number of tax returns and would result in substantial costs to the investors, ATO and the industry (refer to Appendix A for an illustration of the cascading impact). It should be noted that retail MITs often have tens of thousands of unitholders who would be directly affected by such changes.

The uncertainty regarding this issue stems mainly from decisions such as *London Australia Investment Co Ltd v FC of T* 74 ATC 4213 ("London Investments"), which found that "the activities of buying and selling shares were done as part of the business" of an investment company in respect of the 1967 to 1969 years, even though it was accepted that the "shares were never bought…for the purpose of profit-making by sale…". The decision in this case should be considered in the context of the circumstances that existed at that time, including the following:

- Australia did not have a CGT regime, dividend imputation system or retirement income system (i.e. superannuation system);

- The tax rates were very high by today's standards;

- The majority of Australia's retail investment product was bundled whole of life insurance where the life company was taxed as a proxy for policyholders;

- Investors were practically inhibited from accessing domestic and global investment markets directly and were confined to accessing such markets through institutions.

Clearly, it is anomalous that uncertainty could exist regarding such an important and fundamental issue. The existence of this uncertainty may result in a lack of competitive neutrality between the various providers in the managed funds industry. For example, MITs with identical assets managed by different providers may differ in the capital/revenue characterisation of assets held. Because of this uncertainty, investors in identical assets may experience different after tax returns.

3.1.3 Analysis

It should be noted that the dichotomy between revenue and capital is almost irrelevant today, but for CGT discount and the quarantining of net capital losses.

Industry practice is to treat assets of the MIT as being held on capital account with the exception of certain specialist trusts (for example, fixed interest trusts which only hold debt and trusts where assets are predominantly held for less than 12 months, hedge funds, etc).

This treatment is consistent with the outcome that would be achieved by investors if they were to invest in the underlying assets directly rather than through a MIT. This is on the assumption that investors would hold investments on capital account. Given that a large proportion of funds invested in MITs represent retirement funds (whether through super funds, PSTs, ADFs, VPST, SEA, etc), and individual investors with smaller investment holdings, the assumption would seem to us to be largely accurate.

If the gains and losses on the disposal of assets by MITs were to be treated as being on revenue account, investors investing through MITs would not achieve the same outcome as investors investing directly (for example, they would not be entitled to the CGT discount in respect of gains distributed by the MIT). Such a disincentive would adversely impact all investors, including superannuation vehicles in which the nation's retirement savings are held, and would be contrary to the Government's policy of ensuring investors are not disadvantaged by investing in MITs (refer NITA changes in relation to the application of the capital gains tax to non-residents).

Superannuation vehicles provide the majority of funds invested in MITs and their assets are deemed to be held on capital account under income tax law (refer to Part IX of the ITAA36 and Division 320 of the ITAA97). The treatment of MIT gains and losses as being on revenue account would be significantly disadvantageous to superannuation vehicles and would be contrary to the express policy underlying the income tax law in respect of these entities.

This is because if the superannuation vehicle was to hold the underlying assets of the MIT directly, those assets are deemed to be held on capital account and the superannuation vehicle would be eligible for the CGT discount. However, if they invest in the underlying assets through a MIT and the MIT is treated as holding those assets on revenue account, gains arising from the disposal of those assets by the MIT will be distributed to the superannuation vehicle as revenue gains that are not eligible for the CGT discount.

As a result, investors (including superannuation vehicles) are likely to move away from investing in MITs and invest directly in underlying assets. This will give rise to the following unfavourable outcomes:

1 Increased investment management and compliance costs from holding direct assets would reduce investors' returns and erode retirement savings. For example:

   a. The funds management industry has sophisticated systems in place to perform what are often complex CGT calculations in respect of MIT assets. These calculations will have to be performed individually by each investor.

   b. Investors are able to take advantage of economies of scale when investing via a MIT and share the cost of investment management and administration.

2 Limited access to investment expertise and certain asset classes resulting in the decreased ability to diversify. The nature of the underlying asset makes it difficult for individual investors to obtain direct exposure to certain assets (for example, alternative assets, bonds, global property, commodities, etc). In this regard, we note that the managed investment industry has experienced an increasing demand for alternative assets as investments in traditional assets such as shares and property are reaching capacity. MITs allow the pooling of investors' funds to gain access to such investments.

3 Growth and development will be impeded where access to alternative asset classes is denied as this can lead to the misallocation of global and national savings (both personal and retirement) into traditional asset classes.

There needs to be certainty regarding the capital/revenue issue to achieve a tax neutral regime such that the managed investments industry can offer investors the most efficient and effective investment products. Such an approach would be consistent with the choice of superannuation legislation which was recently introduced and would promote the development of better superannuation products available to investors.

It is also noted for completeness that the determination of whether assets are held on capital or revenue account requires the exercise of judgement in the discharge of the managed investment operators' fiduciary duties as responsible entity, as well as other duties in the context of today's corporate governance and regulatory framework (for example, income tax law, financial services regime, managed investment regime, Sarbanes-Oxley, etc). The existence of uncertainty makes the discharge of these duties onerous and increases the operators' exposure to risk under the corporate governance and regulatory framework.

3.1.4 Reform

It is recommended that the MITR recommendation in 2.1.8 be adopted to codify the primary taxing provisions for MITs.

Our recommendation is that MITR must specify that the CGT provisions are to be the primary taxing provisions for gains and losses in respect of shares, property and units in other managed

funds (including listed property trusts). Other assets such as traditional securities and qualifying securities will continue to be subject to income tax on revenue account under the existing provisions.

In order to address integrity issues to ensure that unintended consequences do not arise, it may be necessary to introduce mechanisms to remove the benefit of CGT discount where the unitholder would not ordinarily be entitled to the benefit of CGT discount (for example: general insurance companies, banks and share traders investing in MITs that qualify for MITR treatment).

The MITR recommendation, if adopted, will:

- Provide certainty to all investors and the managed investments industry by confirming the current industry practice;
- Eliminate uncertainty regarding the capital/revenue issue, leading to a reduction in compliance costs for the ATO and the industry; and
- Better promote and protect retirement and personal savings invested via the MIT regime.

3.2 Present entitlement

3.2.1 Background

The taxation of unit trusts and unitholders is largely dealt with under Division 6 of the ITAA 1936. Under Division 6 a trustee is notionally treated as a resident taxpayer who has derived the trust income and incurred the trust expenses, solely for the purposes of calculating the taxable income of the trust (known as the "net income of the trust").

The aim of Division 6 is to assess a unitholder on a share of the taxable income of the trust (known as the "net income for tax purposes") whenever the unitholder is presently entitled to a share of the income calculated according to trust law principles.

The 1934 the Royal Commission into the Australian taxation system stated that the policy behind Division 6 and use of the present entitlement mechanism under the existing law today is to only tax the trustee when the true owners of the income cannot be determined in a reasonable manner. In other words taxation of the trustee at the top marginal rate on the net income of a trust under s99A is only appropriate when no beneficiary can be identified as being entitled to the income arising within the trust.

A unitholder must have an indefeasible, absolutely vested, beneficial interest in possession in the trust income to be presently entitled to that income. If the unitholder's interest is only contingent, the unitholder will not be presently entitled. Once present entitlement of a unitholder to a share of the trust law income is established, the unitholder is then subject to tax on the same proportionate share of the taxable income of the trust under s 97 of the ITAA 1936.

Where unitholders are not presently entitled to all or part of the net income of the trust, that residual amount is subject to tax in the hands of the trustee at the top marginal rate which is currently 47% under 99A of the ITAA 1936.

3.2.2 Problems

Present entitlement was introduced into the Australian income tax law around the time of World War I in an environment that predated the use of unit trusts by the funds management industry by 50 years. Present entitlement could not have been contemplated as applying to the 21st century global financial markets in which MITs operate.

Accordingly, it is not uncommon for there to be difficulties in establishing that unitholders are presently entitled to the trust law income of a MIT. This can arise due to a variety of reasons including:

- The specific wording used in the present entitlement clauses of trust deeds, which may not anticipate each and every financial and tax situation faced by a MIT;

- Changes in the accounting rules may cause unexpected changes in the calculation of trust law income to which present entitlement attaches. The adoption of International Accounting Standards is a case in point;

- Some trust deeds define trust law income to be equal to the accounting income of the trust. In a declining investment market, an MIT may recognise a net accounting loss for the year due to unrealised losses on investments exceeding investment income. In these circumstances, present entitlement cannot be established.

Where present entitlement cannot be established and the MIT derives taxable income, the taxable income is subject to tax in the hands of the RE at the penal rate of 47%. This of course has an adverse impact on unitholders, especially those subject to low marginal tax rates such as superannuation funds, pensioners and charities. This type of adverse tax outcome can only encourage investors to hold investments directly.

Despite the Government policy behind Division 6 to only tax the trustee when the true owners of the income cannot be determined in a reasonable manner, this is NOT the manner in which the Australian Taxation Office administer these provisions. The ATO has recently issued assessments to trustees of managed funds notwithstanding distribution of cash to the relevant investors. This has resulted in double taxation of managed fund income with the product operator being commercially impeded from recovering any tax from the assets of the MIT due to identical products offered in the market place being considered to be "flow through" by investors for taxation purposes. An example of this is where the ATO has sought to tax under distributions that will be corrected in later years. The tax imposed is therefore a dead cost for the product operator and gives rise to anomalous results from an investor's perspective.

3.2.3 Reform

It is proposed that the present entitlement basis of assessment of unitholders be replaced with a simpler, clearer test. The new test would simply provide that the MIT's taxable income be assessed to investors having regard to their unit holdings in proportion to total units issued by the MIT.

The test would not require regard to be had to the trust law or accounting income of the trust. The proposed test would not focus on the precise wording of the distribution or present entitlement clauses and the different words and concepts used in trust deeds to generate income and capital entitlements of unitholders.

Instead the test would be based on the fact that all units in a MIT (i) carry the same rights and obligations and (ii) carry fixed entitlements to income and capital of the MIT. Accordingly, streaming of income or gains to different unitholders is not possible. We believe that most if not all MIT deeds could satisfy this requirement without deed amendment.

The policy rationale for the removal of the present entitlement test is to remove tax technical difficulties which may otherwise prevent "flow through" or "conduit" taxation of taxable income distributed by the MIT to its unitholders. This will assist in achieving the objective of consistent treatment of MIT unitholders with those investors who choose to hold investments directly.

In relation to drafting these new provisions, we note that the definition of "fixed trust" contained in s 272-5 of the Trust Loss provisions of Sch 2F to the ITAA 1936 would not be an appropriate basis for this test. This is due to the highly restrictive nature of the "vested and indefeasible interest" requirement that a trust must satisfy to qualify as a "fixed trust" which is very difficult for any trust to satisfy in practice.

One aspect of the present entitlement rules which we believe should be retained is the condition that a MIT need not distribute any cash to unitholders to attribute the taxable income of a MIT (and therefore trigger a tax liability) to the unitholder. This is because circumstances arise in which the RE may wish to maximise retained funds in the MIT for future investment purposes and a requirement that the cash distributed match the taxable income of the MIT may unnecessarily conflict with the MITs investment strategy.

3.3 Deficiency / excess of distributions (unders/overs)

3.3.1 Background

MITs typically determine their annual taxable income and distribution components within 2-3 days of the MIT's tax year end due to the following commercial and legal requirements:

- MITs generally issue daily application and redemption unit prices for investors entering and exiting funds. MITs must determine the amount of the annual cash distribution and its associated tax components as soon as possible after year end so as to not prolong the unit pricing freeze which normally occurs for the 3-5 business days after year end.

During this time investor applications and redemptions are suspended. The amount of cash distribution will result in a decrease in the fund's cash and therefore its net asset value which is the basis upon which application and redemption prices are struck. Until the taxable income can be calculated and its component break down is established a fund cannot be properly unit priced.

- MITs are required to issue annual tax statements to unitholders within tight statutory and unitholder imposed timeframes (refer Section 3.3.2 below).

- There is a high degree of cross investment in the funds management industry that has resulted in the need for timely reporting of tax components so that other funds that cross invest across the funds management industry can determine their own taxable income and the tax components that must be reported to their own investors in a timely manner. For example, wholesale and sector funds are required to report distribution components to retail fund unitholders to enable the retail fund's investors to determine their own tax position. This process is repeated at each tier of the investment process and will ultimately be reflected in the tax returns that will be lodged by investors (individuals, superannuation entities and companies).

The calculation of taxable income for the purpose of preparing an income tax return is generally completed with the benefit of hindsight a few months after the end of the year of income. Further information becomes available and a detailed review of income and expense items can be undertaken to ascertain the appropriate tax treatment.

Upon finalisation of the MIT's tax return, a reconciliation between the sum of taxable distributions made to investors is performed, split by component of taxable income to determine whether:

- a shortfall exists between the taxable income reported to investors and the taxable income of the MIT as reported in its tax return. Hereafter referred to as an "under distribution"; or

- a surplus exists between the taxable income reported to investors and the taxable income of the MIT as reported in its tax return. Hereafter referred to as an "over distribution".

Collectively, these differences are referred to as "unders and overs" within the industry.

We acknowledge that unders and overs have been an industry issue for a number of years. However, the increasing complexity of MIT interfunding arrangements (refer Appendix 0) has exacerbated the issue. This increasing complexity is driven by improvements in investment and risk management practices such as:

- The increased specialisation of investment management expertise leading to a proliferation of MITs managed by an ever increasing number of specialist managers;

- The emergence of alternative investments as an asset class that allows diversification and reduction of investment risk over a greater range of asset classes. This is achieved by investing in a class of asset which produce investment returns which are not correlated to returns on traditional asset classes such as shares. This results in a reduction in volatility of

investment returns and a reduction in the risk of loss of capital in a market downturn. Product providers have the expertise to package alternative asset investments in MITs and offer such investments to smaller investors.

The existence of unders and overs is not contemplated in the tax legislation and has been subject to industry practice for many years. In practice the full amount of unders and overs is always adjusted by the MIT in the following year's unitholder tax statement and is therefore self correcting. The example below illustrates the self correcting nature of under and over adjustments.

<u>Example</u>

> ABC Trust advises unitholders in its annual tax statements to include $100 taxable income distribution in their tax returns for the year ended 30 June 2004. On lodgement of ABC Trust's tax return for the 2004 year it is determined that its correct taxable income is not $100 but is $110 and $110 is disclosed as the taxable income in that return.
>
> ABC Trust has a $10 under distribution referable to unitholders as its correct taxable income of $110 exceeds its taxable income advised to unitholders and included in their 2004 tax returns.
>
> In the 2005 year, ABC Trust derives taxable income of $150. ABC Trust advises unitholders that its 2005 year taxable income is $160 and the investors will include that amount in their 2005 tax returns. ABC Trust only includes the $150 taxable income in its tax return.

The effect of the 2004 year under-distribution is corrected in the following year by making an equal and opposite adjustment in the tax statements provided to unitholders in the 2005 year.

It should be noted unders and overs do not arise because of any deliberate action or failing on the part of the trustee (also known as Responsible Entity or "RE") and usually will not arise because an error has been made in the calculation of the distribution. Rather, they may arise because the precise income, expense or other amount may not be known by the RE at the time the distribution is made and the RE will therefore determine its Actual Taxable Income after having regard to:

- Prior year experience/actuals;
- Estimates released to the market by the security issuer; or
- A combination of different estimation methods.

In most cases, however, additional information that affects taxable income of the MIT emerges after the distribution is made.

The correct application of the tax law to under and over distributions is not clear. The relevant tax law was not drafted with any consideration of unit trusts acting as pooled investment vehicles. For example an over distribution may arguably be treated as:

- a non assessable distribution to a unitholder which gives rise to a reduction in the unitholders cost base in the units under CGT Event E4 (refer section 104-70 of the ITAA97); and/or

- an amount of trust income in which the unitholder has a vested and indefeasible interest but to which the unitholder is not presently entitled – which gives rise to a deemed present entitlement to the unitholder under section 95A(2) of the ITAA36; or

- trust property paid to a unitholder which is not otherwise assessable under Division 6 is taxable under section 99B of the ITAA36.

Similar difficulties arise in relation to the application of section 99A of the ITAA36 to under distributions.

3.3.2 Problems

MITs are required to issue annual tax statements to unitholders shortly after year end under the provisions of the tax law. Commercial and competitive pressures will also mean that the tax statements are issued shortly after year end. For example:

- Unit trusts are required to issue payment summaries (which take the form of annual tax statements) to certain unitholders by **14 July** after each year end. In practice, this date applies to many MITs as it is applicable to MITs who pay distributions to at least one unitholder which

  i has had tax deducted because of a failure to quote a TFN; or

  ii who is a non resident who has had withholding tax deducted from their distribution (refer section 16-155 of Schedule 1 to the *Taxation Administration Act 1953*).

- Certain unitholders in MITs require annual tax statements within 3-4 weeks of year end, as they are in a tax refund position for the year and wish to lodge their tax return and claim the refund as early as possible.

Working backward from the date tax statements are required to be issued by MITs, it can be seen that MITs are required to determine the tax components of distributions within 2-3 business days following year end in order to give sufficient time for the testing of accuracy of figures in the tax statements, and mailing them to unitholders within the above timeframes.

The calculation of taxable income in an income tax return is generally completed with the benefit of hindsight a few months after the end of the financial year. At such time further information becomes available that is not available in the 2-3 days immediately following the end of the financial year. Also, a detailed review of income and expense items can be undertaken to ascertain the appropriate tax treatment. Unfortunately such a high degree of accuracy cannot be achieved within the tight timeframe within which the distribution components are required to be determined for the issue of MIT annual tax statements.

Many millions of unitholders rely on the provision of tax statements by fund managers in order to complete their annual income tax returns. Should managers not finalise tax calculations until the taxable income of the fund can be determined with certainty would result in tax statements being issued to clients much closer to the 31 October tax return lodgment due date. This would result in a flood of millions of tax returns being lodged close to the October 31 deadline with implications for (i) accuracy of returns lodged (ii) the ATO's ability to process those tax returns and issue assessments and refunds to taxpayers in a timely manner and (iii) the likelihood of many incomplete or late tax returns being lodged.

The difficulty in achieving 100% accuracy in determining tax component information in annual tax statements issued by MITs arises because:

- It is increasingly common for many MITs to invest in complex unit trusts which are in turn invested in alternative asset classes such as infrastructure funds or hedge funds in order to obtain investment diversification. Unfortunately, as many of these funds are invested in foreign funds and assets, it is not always possible to obtain accurate tax data in respect of the underlying investments until some weeks after the end of each financial year;

- In recent years many MIT operators have established "multi-manager" funds which invest in MITs managed by other arms length investment managers (often called boutique fund managers) on whom the MIT operator is dependent for tax information. Sometimes these boutique fund managers are unable to provide timely, accurate tax distribution component information for the reasons specified above;

- Many listed property and infrastructure trusts are unable to provide final details of tax distribution components to MITs typically until late August or September after each year end; and

- Custodians who hold legal title to assets of MITs (and on whom MITs are dependent for correct transaction processing in respect of investment assets are held in foreign jurisdictions) sometimes make mistakes in processing transactions close to year end. This results in adjustments to tax details provided to MITs after MITs have finalised data used in preparing annual tax statements.

These above factors lead to (i) the use of estimated tax distribution components in preparing annual tax statements issued by MITs and (ii) errors in MIT annual tax statements.

The ATO has only informally expressed its concern regarding the industry treatment of unders and overs in letters to IFSA and in private discussions with some taxpayers and their advisors. The ATO are technically correct in their view that the industry treatment of overs and unders is a practice which is not consistent with the tax law.

However, at the same time, although the ATO has been aware that most MITs do not strictly comply with the tax law in this regard, it has never sought to systematically enforce the law for obvious and understandable reasons.

We are aware of a small number of cases of under and over distributions which have been actively reviewed by the ATO. Unfortunately, there has not been a consistent treatment of

taxpayers by the ATO in resolving the tax treatment of unders and overs. Where an under distribution has occurred and the ATO imposes tax on the RE in its capacity as trustee of the MIT, in most cases it will not be possible for the RE to collect the tax from investors in the MIT after the distribution has been made because of widespread belief that the MIT is a "flow through" vehicle.

Economically, the payment of tax by the RE in respect of an under distribution is, in substance, a financial penalty and gives rise to a lack of competitive neutrality across the industry due to the inconsistent application of the law in relation to each and every under distribution made.

Currently, one unpleasant alternative to the practice of making over and under distribution adjustments is to reissue tax statements to all affected unitholders in the MIT should issued tax statements prove to be incorrect. This can be a very costly and time consuming process because:

- Tax statements may need to be reissued to tens of thousands of unitholders in a retail MIT, which may result in thousands of amended assessments being issued by the ATO;
- Withholding tax calculations and payments to the ATO may need to be amended for thousands of unitholders;
- where investments are held by custodians, adjustments to records may be required at a number of different levels; and
- Adjustments to tax statements are often not discovered until lodgement of the MIT's tax return which can be up to 11 months after the end of the financial year.

These costs are further increased because of the high degree of cross investment between MITs and other pooled investment vehicles such as WRAP account providers and superannuation entities.

We recommend that an amendment be made to the tax law in order to resolve the:

- current uncertainty for unitholders arising from the adoption by MITs of an unders and overs treatment; and
- potentially high compliance costs resulting from a strict application of the current law which would require the issue of amended tax statements and preparation of amended unitholder tax returns in respect of each and every over and under distribution for each and every taxpayer that is an investor in a MIT.

3.3.3 Reform

It is proposed that MITs be allowed to determine the Actual Taxable Income ("ATI") of their funds using the best information available to them at year end (usually 30 June).

Under the proposal, the MIT is to be regarded as distributing the ATI of the MIT for an income year when the amount of the total distribution and the amount of each distribution component (such as, capital gains, section 6-5 ordinary income, franking credits and foreign tax credits):

- is determined having regard to information available at the time of determination; and
- is neither deliberately overstated nor deliberately understated to obtain a tax benefit or tax benefits.

The time of determination would be no earlier than the end of the year of income of the MIT. This would prevent any deferral of the liability to pay tax on annual taxable income to later years which may otherwise occur if the determination date was before the end of the year of income.

Distribution components would be reported to unitholders in annual tax statements on a ATI basis. Any under/over distributions to be carried forward to the MIT's taxable income calculations in the following year as income/credits of the same class (i.e. foreign v domestic, capital v revenue, classes of foreign income, cash v credits, etc).

Concerns that this regime could lead to the deferral or avoidance of tax liabilities of unitholders are unfounded due to:

- The RE s of MITs being subject to a number of strict regulatory regimes that require the RE to manage the MIT's affairs with a high degree of probity and to ensure that all decisions taken are in the best interests of all unitholders;
- The strict eligibility requirements that must be satisfied in order to become a MIT for taxation purposes; and
- The likely application of the general anti avoidance provisions of Part IVA of the ITAA36.

We are confident that this recommendation would not involve any significant cost to the revenue as it reflects current industry practice in relation to unders and overs. In our experience under/over distributions occur on a random basis leading to neither a systemic overpayment nor underpayment of tax. It is also noted that any underpayment or overpayment of tax by unitholders would be corrected in the subsequent year.

3.4 Distributions to non-resident unitholders

3.4.1 Background

As discussed above, taxable income distributed by a MIT retains its character in the hands of the unitholders due to the "flow-through" treatment of trusts adopted for tax purposes.

3.4.1.1 *Non-resident individuals and companies*

The PAYG withholding provisions currently require that withholding tax amounts be withheld from interest, unfranked dividends and royalty income distributed to non-resident beneficiaries. Amounts subject to the withholding tax regime are subject to a final tax in Australia. The remaining part of a MIT's taxable income is subject to annual taxation in the hands of the trustee under sub-sections 98(3) and (4) of the *Income Tax Assessment Act 1936* in respect of assessable Australian sourced income distributed to non-resident beneficiaries that are individuals or companies. The section 98 tax is creditable to a non-resident beneficiary against their Australian tax liability if they lodge a tax return in Australia.

The current PAYG withholding rates that apply to distributions to non-residents are broadly as follows:

- Interest – 10%;
- Unfranked dividends (treaty country) – 15%;
- Unfranked dividends (non-treaty country) – 30%; and
- Royalty – 30%.

Taxable components of distributions that are not subject to PAYG withholding (such as other Australian sourced income and capital gains with the necessary connection to Australia) are subject to tax under section 98 of the ITAA36 at the following rates:

- Distributions to non-resident individuals – marginal rates; or
- Distributions to non-resident companies – 30%.

In practice, the section 98 liability is deducted from distributions in the same way as PAYG withholding although the method of remittance to the ATO is different (PAYG withholding is remitted during the year via the Business Activity Statement ("BAS") whilst the remainder of the tax liability referable to the distribution is determined on an assessment basis under section 98 upon lodgement of the MIT's income tax return).

3.4.1.2 *Non-resident trustees*

Section 98 does not apply in respect of distributions to non-resident trustees. However, the ATO has controversially expressed its view in correspondence with IFSA that distributions paid to non-resident trustees are, at least in some cases, subject to the TFN withholding provisions at the rate of 48.5%. The method of remittance of TFN withholding to the ATO is the same as that for PAYG withholding (refer above).

It is noted that this is the subject of a separate submission to Treasury made by IFSA in relation to the obligations of custodians and a related submission by the listed property trust industry in relation to the way in which tax should be deducted on trust distributions more generally. It is

essential that these issues be resolved for the 2007 financial year. However, it remains an important issue to integrate with MITR in due course.

3.4.2 Problems

3.4.2.1 Non-resident individuals and companies

MITs typically make monthly, quarterly or half yearly distributions ("interim distributions"). However, the net income of the fund is not known at the time of the interim distributions are made as net income is only calculated on an annualised basis at the end of the year of income.

As such, the amount of withholding tax deducted from interim distributions is based on estimated taxable income components at that point in time and may not be representative of the annualised liability in respect of the actual components of taxable income which ultimately flow through to investors. This is because the MIT's taxable income as a matter of tax law will not be known until the end of the year of income.

The application of marginal tax rates to distributions to non-resident individuals is also difficult where the non-resident individual derives Australian sourced income from multiple sources, primarily because the responsible entity of the MIT making the distribution will not be aware of the unitholder's other amounts of Australian sourced income.

There is also uncertainty regarding whether tax deducted under section 98 is creditable to the non-resident unitholder in its country of residence, particularly where the non-resident does not lodge an Australian income tax return, which is often the case in practice. This is because the responsible entity's liability for section 98 amounts arises upon assessment of the MIT. Further, as is evident from the current discussions with the custodians, it has been extraordinarily difficult for the industry and the ATO to correctly administer the collection of these amounts.

3.4.2.2 Non-resident trustees

Although PAYG withholding applies to distribution of interest, unfranked dividends and royalty to non-residents, there is uncertainty as to the responsible entity's obligations in respect of the other distribution components. These other distribution components would typically include:

- Australian sourced income (other than interest, dividends and royalty);
- Foreign sourced income;
- Tax deferred/tax free/tax exempt income;
- Return of capital;
- Capital gains (both with and without connection with Australia); and
- CGT concession.

The ATO has asserted that the TFN withholding provisions should apply to these other distribution components. This is by no means clear but, even if correct, could do significant damage to offshore investment in MITs as tax would have to be withheld at the rate of 48.5% (equivalent to the highest marginal rate plus Medicare levy), on an amount in excess of the distribution that would be taxable to any non-resident. This anomalous result arises as the balance of the distribution can include certain components that would not be subject to Australian income tax in the hands of a non-resident on an assessment basis (for example, foreign income, tax free, tax deferred, return of capital, capital gains with no necessary connection with Australia and/or CGT concession). In particular, it should be noted that foreign sourced income and certain capital gains derived by non-residents are exempt from Australian income tax – see section 23(r) of the ITAA36 and section 768-605 of the ITAA97 (introduced by the *New International Tax Arrangements (Managed Funds and Other Measures) Act 2005*.

On the other hand, to the extent that TFN withholding provisions do not apply to the other distribution components, other Australian sourced income and capital gains with the necessary connection with Australia distributed to non-resident trustees would only be subject to Australian income tax through assessments levied on the ultimate non-resident beneficiaries, with recourse to section 255 notices and similar mechanisms to collect that tax.

3.4.3 Analysis

3.4.3.1 Non-resident individuals and companies

PAYG withholding and section 98 tax are imposed on distributions to non-residents to ensure that tax on Australian sourced income derived by non-residents is collected in a timely and efficient manner. This recognises implicitly that non-residents are unlikely to lodge Australian income tax returns and be subject to taxation by way of assessment in Australia.

The financial services industry recognises the need to maintain a withholding regime in relation to distributions to non-residents in order to protect the Australian revenue. However, application of the existing withholding rules to MITs is problematic in respect of interim distributions (because tax components of interim distributions are often different from tax components on an annualised basis) and administratively inefficient (PAYG withholding reported and remitted on BAS whilst section 98 tax reported and assessed on income tax return).

Ideally, the tax withheld from distributions for the year should be based on the full year component of distributions calculated in accordance with the taxable income in the tax return. However, in practice, this is not possible because the taxable income in the tax return is not known at the time the interim distributions are paid.

A partial solution that may be adopted is to adjust the amount deducted from the final distribution having regard to the actual distribution components for the year and amounts previously deducted from interim distributions (i.e. a balancing adjustment is made to the final distribution). However, this approach would only work in limited circumstances. For example, it would not work where the unitholder has fully redeemed from the MIT prior to the end of the financial year. Further, such an approach will be costly to develop and implement for both MITs and custodians and cannot be justified if it only provides a partial solution.

The problems arising from the inherent differences between interim distribution components and annualised tax components for tax return purposes can be avoided by clarifying the basis upon which tax is to be deducted from distributions to non-residents. It is submitted that the use of interim distribution components on a ATI basis would be appropriate, on the basis that annualised tax components cannot be determined at the time of payment of interim distributions.

In addition, the application of non-resident individual marginal rates is also problematic because:

- The distribution from a MIT may only be one of multiple sources of Australian income for a particular non-resident individual.
- The responsible entity of the MIT will often not know the extent of a non-resident unitholder's total Australian sourced income.
- It is difficult and impractical for a responsible entity to collect and incorporate information in respect of a non-resident unitholder's other Australian sourced income for the purposes of determining the appropriate marginal rate to apply.

As a result of the above, the section 98 liability on most distributions to non-resident individual unitholders is calculated based on the rate of 29%.

3.4.3.2 Non-resident trustees

In relation to distributions to non-resident trustees, the imposition of TFN withholding tax on distributions at the punitive rate of 48.5% provides a disincentive to non-resident trusts investing in Australia. Unlike distributions to non-resident individuals and companies, the amount of tax deducted from distributions to non-resident trustees is not representative of the Australian income tax that would apply on assessment.

Although the additional amounts deducted under the TFN withholding rules can be recovered by non-resident trustees by lodging an Australian income tax return, in practice, non-residents acting in the capacity of trustee will rarely obtain a TFN let alone seek to lodge Australian tax returns. With tiers of holdings between the MIT and the ultimate non-resident taxpayer in many cases, tax returns tracing through in accordance with section 98 are simply not feasible.

As such, the practice of applying the TFN withholding rules to non-resident trustees (even if correct technically) is contrary to the Government's policy of attracting offshore investors, as it will discourage foreign funds operated through a trust structure from investing in MITs.

Further, it is often difficult to determine whether units are held by non-residents in the capacity as trustee, particularly where the trustee is a corporate trustee. As such, it would be administratively simpler to apply a single tax rate for the purposes of section 98 liability.

3.4.4 Reform

It is recommended that the MITR recommendation 2.1.9 be adopted in relation to the responsible entity's obligations in respect of distributions to non-resident unitholders.

The MITR recommendation is to:

- Treat all non-resident unitholders (individuals, companies and trustees) equally and apply a single rate of tax of 30% under the PAYG withholding rules (instead of 29% for individuals) for the purposes of section 98 of the ITAA36 in respect of Australian sourced income (other than interest and dividends), and taxable capital gains with the necessary connection with Australia. This will:
  - Provide certainty and clarity in respect of the responsible entity's obligation in respect of non-interest, dividend and royalty components of distributions to non-resident trustees;
  - Eliminate the requirement to determine the non-resident unitholder entity types; and
  - Ensure that a reasonable amount of tax is collected in respect of distribution of Australian sourced income to non-resident unitholders.
- Administer the section 98 liability under the PAYG withholding regime, such that tax deducted from distributions is generally treated as a final tax. This will:
  - Streamline the methods of remittance of tax deducted from distributions;
  - Endorse current practices by eliminating the formal requirement for non-resident unitholders to lodge Australian income tax returns; and
  - Provide greater certainty and clarity to non-resident unitholders in determining whether the tax withheld is creditable in their country of residence (although this will ultimately depend on domestic tax laws in the relevant jurisdiction).
- Determine the amount of tax withheld to be deducted from distributions to non-resident unitholders based on the ATI at the time the distribution is paid. This will:
  - Eliminate the difficulties that currently exist because of inherent differences between interim distribution tax components and annualised tax components for tax return purposes;
  - Provide greater certainty to investors, the ATO and the responsible entity of the MIT in respect of the amount deducted and remitted.

As the MITR recommendations reflect current practices, the adoption of these recommendations should not result in any additional costs to the revenue.

Appendix A: Typical product investment structures used in the managed investment industry