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Major Tax changes for Managed Investments

The Government has announced major tax reforms for managed investments, including allowing Australian domiciled funds with investments in offshore assets to have those assets managed off shore and still be treated as a MIT.

As part of its commitment to improving the tax regime for MITs, increasing tax certainty and attracting foreign funds, the Government has introduced three separate changes. The most significant change being the introduction of a completely new tax system for MITs. In addition to this, the Government has introduced new legislation allowing MITs to treat gains and losses on the sale of certain investment assets to be assessed under the capital gains tax (CGT) provisions instead of on revenue account. The Government is also considering recommendations for the introduction of an Investment Manager Regime to promote Australia as a financial services centre. The three changes are explained below.

New Tax System for Managed Investment Trusts

In May 2010 the Government announced it will introduce a new taxation regime for Australian qualifying MITs effective from 1 July 2011. The measures announced are in response to the Board of Taxation's Report into the tax arrangements applying to MITs.

Broadly, a qualifying MIT is a public unit trust that is listed, widely held or a publicly offered managed investment scheme that only invests in eligible investment businesses such as investing in land for the purpose of deriving rent, or investing or trading in shares in a company or units in a unit trust.

The key features of the new MIT tax system are outlined below.

Elective attribution method

The new regime will provide an elective "attribution" system of taxation for qualifying MITs (those with clearly defined rights) to replace the "present entitlement to income" system.

Under the new attribution system, investors in MITs will only be taxed on the taxable income the trustee allocates to them on a fair and reasonable basis, consistent with the investor's entitlements and rights under the trust's constituent documents (i.e. trust deed). It is also proposed that qualifying MITs will be deemed to be fixed trusts for various other tax law purposes.

Under the current system, problematic tax outcomes can occur when trust beneficiaries may be taxable on amounts they are not entitled to receive, and trustees may be taxed on capital gains they have already distributed to investors. This is still the case despite the recent High Court decision handed down in Bamford's case, which failed to provide judicial clarity for many trusts.

The attribution model will remove the inconsistent interaction between Australia's tax law and trust law, providing absolute certainty on the tax that will be imposed on investors in MITs.

Five per cent de minimis rule

The new regime will establish a carry-over facility to allow MITs to deal with "over or under" distributions within a five per cent cap.

This means where tax adjustments fall within the five per cent range, i.e. they amount to no more than five per cent less or more than the amount outlined in the issued statement, taxpayers who receive trust income will **not** have to amend their returns to reflect their revised distribution from the trust. These de minimis amounts will be carried forward and accounted for in the trust's next year tax return.

Where the adjustments are within the five per cent de minimis threshold, the trustee will not be required to re-issue their investor statements to the investors.

Removal of double taxation

The new rules will allow unit holders to make upward cost base adjustments to the CGT cost base of their unit holdings in certain circumstances. This is to eliminate double taxation that may otherwise arise.

Double taxation can arise where the beneficiary sells the units before receiving the distribution, so they are taxable on the attributed taxable income and also taxable on a gain on the sale of the units which would reflect the value of the undistributed amount. Currently there is only a mechanism to reduce the cost base of the unit holdings. The details of when these cost base increases will be allowed are yet to be developed.

Corporate unit trust rules to be abolished

The corporate unit trust rules will be repealed. These rules, which aim to discourage the reorganisation of companies involving the transfer of assets into a public unit trust, will be replaced with an arm's length rule to be included in the public trading trust provisions.

This measure will also amend the 20 per cent tracing rule for public unit trusts so that it does not apply to superannuation funds and exempt entities that are entitled to a refund of excess imputation credits.

A new definition of MITs

On 26 May 2010 the Government introduced new legislation expanding the definition of MITs to include both wholesale managed investment schemes and Government owned and managed investment schemes subject to appropriate integrity rules. The new definition of MITs is for all purposes of the Tax Act and is contained in Tax Laws Amendment (2010 Measures No.3) Bill 2010.

For a trust to qualify as a MIT under the new rules, the following general conditions must be satisfied whether the managed investment scheme (MIS) is registered under the Corporations Act or not:

- ▶ the trustee must be an Australian resident or central management and control of the trust must be in Australia;
- ▶ the trust must qualify as a MIS under section 9 of the Corporations Act 2001 (this is the same condition as currently applies);
- ▶ in the case of a unit trust, the trust must not be a trading trust. For any other trust, the trust must not carry on a trading business or be able to control such a business; and
- ▶ the trust's investment management activities must be carried out in Australia (however, this rule has subsequently been relaxed so that it only applies to assets situated in Australia. See below).

Additional conditions for registered MITs

Further to the above general requirements, the following are specific requirements for MITs that are registered as a MIS under the Corporations Act 2001:

- ▶ the trust satisfies certain widely-held requirements if it is listed on an approved stock exchange in Australia or has at least 50 members and is not closely held by 20 or fewer persons or by one foreign resident individual; and
- ▶ is operated by an appropriately qualified financial services licensee.

Additional conditions for unregistered MITs

In addition to satisfying the general rules, a trust that is not registered must also satisfy the following specific conditions. The trust must be:

- ▶ a genuine wholesale fund;
- ▶ appropriately regulated; and
- ▶ widely held.

The above amendments will apply to the first income year starting from 1 July after the legislation receives Royal Assent. This is unlikely to occur until 1 July 2011. Transitional rules have also been introduced to provide time for investors and managed funds to restructure their arrangements to comply with the new definition of MITs.

Further Changes to MIT definition

On 21 June 2010 the Assistant Treasurer announced further changes to the definition of MIT by way of Government amendments to Tax Laws Amendment (2010 Measures No.3) Bill 2010.

An important change in the amendments to the Bill is that the requirement for the investment management activities be undertaken in Australia, will only apply to the fund assets relevantly connected with Australia. This requirement will not apply to non-Australian assets. This means the vast majority of Australian domiciled funds with investments in offshore assets, which may have been excluded from the new tax system for MITs will now be eligible for this concession as well as the MIT withholding tax regime and capital account election.

Other changes to the definition of MIT include:

- ▶ extensions to the widely held rules for registered MIS
- ▶ an expansion in the list of entities considered to be widely held to include foreign government pension plans, sovereign wealth funds and certain government agencies and widely held foreign equivalents of a managed investment scheme;

- ▶ an 18-month start up period during which a trust may be treated as a MIT prior to meeting the widely held requirements; and
- ▶ an extension of the transitional rules to seven years for trusts that were MITs prior to these amendments.

Benefits of a new MIT system

The purpose of this measure is to further promote Australia as a financial services hub and ensure that Australian managed funds remain competitive in global financial markets.

This new regime is limited to managed investment trusts. Other trusts will still be subject to the current tax rules for trusts. Unfortunately, the Government has not yet announced much needed changes to the general rules for taxation of trusts.

Capital Account Treatment for Managed Investment Trusts

In addition to the above measures, the Government has now passed legislation containing the 2009-10 Budget measures to allow eligible Australian MITs to make an irrevocable election to apply the CGT regime as the primary code for taxing certain disposals of assets. These changes apply to eligible CGT events that happen on or after the start of the 2008-09 income year.

Under the previous rules, the tax treatment of gains and losses on disposal of investment assets by MITs was assessed on revenue account or capital account depending on the individual facts and circumstances.

Irrevocable election

The new measures will allow eligible MITs to make an irrevocable choice to apply the CGT provisions for assessing gains and losses on disposal of assets such as shares, units and real property, subject to integrity rules.

Furthermore, the specific asset types covered by the measure will be expanded from shares, units and certain land investments to also include investments that are broadly identical to a share (i.e. equity interests) in a company and shares in a foreign hybrid company.

Failure to make a choice

If a MIT is eligible to make a choice but has not done so, any gains or losses on the disposal of eligible assets (other than land, an interest in land, or an option or right to acquire or dispose of land) will be treated on revenue account under the new measures. Land is not subject to this deemed revenue account treatment, and whether land is treated on capital or revenue account will be

based on an application of the general principles of the tax law.

These changes were given Royal Assent on 3 June 2010.

2010/11 Budget Announcements

In the 2010/11 Federal Budget, the Government announced further refinements to these measures by:

- ▶ expanding the definition of MITs to ensure that a broader range of widely held trusts, such as state-operated trusts and certain wholesale trusts, are able to make an election, with effect from the 2008-09 income year. This change has already been introduced into Parliament as described above under "A new definition for MITs";
- ▶ expanding the scope of eligible assets, with effect from the 2008-09 income year;
- ▶ preventing the Commissioner of Taxation from amending, without the consent of the taxpayer, prior year assessments in respect of a re-characterisation of gains or losses from eligible assets from capital to revenue or vice versa. This change will have effect from the 2008-09 income year; and
- ▶ Distributions or gains on "carried interest" units in eligible MITs will also be treated on revenue account. These changes will have effect from the date of Royal Assent of the enabling legislation.

Investment Manager Regime

The Federal Government has announced it will reform and expand Australia's managed funds industry by removing impediments to international investment.

As a first step the Government will start a consultative process on the introduction of an Investment Manager Regime (IMR). This was accepted by the Government in response to the recommendations of the "Australian Financial Centre Forum report" which is also known as the "Johnson report".

The IMR is recommended to encourage a greater volume of cross-border financial transactions. It is also intended to provide greater clarity and certainty as to the tax treatment of offshore transactions undertaken through Australia.

Conduit income

A fundamental aspect of the IMR is to ensure that non-residents investing in foreign assets will not face further Australian tax on their investments when using Australian fund managers (i.e. non-residents receive conduit relief).

Source and permanent establishment thresholds

Another key issue raised by the “Johnson report” was there is a lack of certainty about the source of income and related issues of permanent establishment and the capital/revenue distinction. The IMR proposes different treatment for income from investment in Australian and offshore assets designed to improve Australia’s rules on source of income, including in relation to permanent establishments.

The recommendations of the “Johnson report” include:

- ▶ the introduction of an IMR based on the following principles:
 - the IMR would have wide application, to both retail and wholesale funds and to other areas of financial services beyond funds management, but would be confined to entities operating within the financial sector;

- non-resident investors using an independent resident investment adviser, fund manager, broker, exchange or agent would be exempt from Australian tax on investments in foreign assets. Investments in Australian assets would be treated the same as if they were made directly by the non resident investor;
- ▶ non-resident investors using a dependent intermediary acting at arm’s length would be exempt from Australian tax on investments in all foreign assets. Investments in Australian assets would be treated as they are currently, subject to an agreed de minimis exemption to cater for global investment strategies that may include a nominal portion of Australian assets; and
- ▶ the location of central management and control in Australia of entities that are part of the regime will not of itself give rise to Australian tax residency of those entities.

Should you require assistance or additional information, please contact your PKF Tax Adviser

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