

15 November 2010

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## **Response to Treasury discussion paper Implementation of a new tax system for managed investment trusts**

Dear Sir

Ernst & Young is pleased to respond to Treasury concerning the discussion paper 'Implementation of a New Tax System for Managed Investment Trusts' (the discussion paper) of 18 October 2010.

We welcome the actions of the government and Treasury to reform the taxation of collective investment vehicles (CIVs), in response to the calls from the industry and professionals and following the government acceptance of many of the recommendations of the Board of Taxation (the Board) and its report 'Review of the Tax Arrangements Applying to Managed Investment Trusts'.

The limited time allowed for responses has necessarily restricted our comments, which are based on our experiences and discussions with Ernst & Young clients in the managed funds and investment industry.

Our submission recognises the key objectives of the proposed tax reforms for MITs should result in reduced complexity and increased certainty for the taxation of CIVs and for their investors and should also minimise compliance costs to both. The reforms should be made without the introduction of complex law leading to significant costs of compliance and uncertainty, and should be available as broadly as possible to all widely held CIVs. The reforms should be available to MITs as currently defined for making the Division 275 of the Income Tax Assessment Act 1997 (ITAA 1997) capital election as well as to resident and non-resident private equity, hedge fund and venture capital funds which are also CIVs.

Unfortunately, the discussion paper does not achieve these aims. We submit that the proposals require a modified approach to remove the proposed complex tests including the clearly defined rights and entitlements test and also to broaden the application of the measures.

We submit that a 'hard' start date of 1 July 2011 is unworkable for the measures (even if they are simplified). We submit that any compulsory start date (other than for the proposed changes to Division 6B corporate unit trust and the Division 6C public trading trust definition rules) should be deferred to the commencement of MITs' 2012/13 income tax year (with the start date designed to address taxpayers with substituted accounting periods as well as taxpayers balancing on 30 June each year). At minimum, any application to the 2011/12 year should be optional for taxpayers.

These deferrals are needed to allow the law to be developed properly through the next stage of consultation on an exposure draft of the law, and then to allow funds, custodians and other service providers, and indeed the Australian Taxation Office, to implement what will be in many circumstances a major project including changes to trust deeds, offering documents, product disclosure statements, systems and procedures. We want to assist government and Treasury to have a smooth transition for this major reform, without criticisms or political or administration risks.

This law must be sufficiently clear and unambiguous to serve the needs of MITs, the thousands of Australian and foreign investors in MITs, interacting with the ATO. We emphasise that the funds management industry and advisors need to work through the proposals at exposure draft phase and to road test them where possible so that workable law is delivered before the Bill is introduced and implementation commences. You will recall that, in relation to the MIT irrevocable capital election changes passed in early 2010, the consultation process and drafting resulted in some last minute significant issues.

Taxpayers will need significant lead time to implement the rules because many changes will be needed to their internal processes and systems, to some or all constituent documents (which might require formal meetings of investors), to product disclosure statements (PDSs) and to client and marketing materials for both current and new investors. This must all be ready in advance of the start date for the changes.

The exposure draft must also address any transitional issues and the interaction issues with other parts of the law which are not developed at this stage.

The appendix sets out our key issues and responses. We highlight that:

- the proposals should apply broadly to all non-closely held CIVs and should be not be unnecessarily restricted to the current definition of MITs or some narrower group thereof;
- there should be no additional requirements for clearly defined rights/entitlements for the attribution regime and fixed trust status as MITs are widely held with constituent documents of high quality;
- the attribution method should be drafted in a flexible way to meet the needs of funds to practically deal with their income in accordance with their fund rules and in compliance with other laws;
- the punitive 46.5% tax rate for failing to attribute within time limits should not be adopted and instead a statutory period shortfall interest rate should apply in respect of any late attributions;
- the attribution method should not contain any prescriptive rules for the allocation of expenses or the offsetting of losses between classes of units but they should instead be dealt with in accordance with the fund's rules;
- we do not see any requirement for new general anti-streaming and value shifting rules;
- we call for unders and overs to be dealt with through a series of alternative rules to account for different situations of taxpayers;
- the proposed default 46.5% final tax to a trustee that does not reissue distribution statements where its under exceeds the de minimis should not proceed. Instead a tax withholding system should be implemented similar to the TFN withholding tax rules;
- reporting of cost base adjustments to fund members should not be mandated. Funds should only be required to provide the information necessary for investors to make their own calculations;
- we welcome the proposed Division 6C public trading trust definition changes however these should also apply to Government ownership and the further proposed reforms of these rules should be progressed at the earliest opportunity;
- the proposed arms-length rules for transactions between stapled group entities should be clarified. The discussion is inadequate to commence legislative development and this measure is premature given that the government has deferred consideration of Division 6C changes. If a measure is to be introduced then a simple rule is needed;
- any rules which would impact the constituent documents of funds and require changes should also include express rollover relief rules so that inappropriate taxation does not arise and the Government should seek matching stamp duty rollover relief from the states and territories;
- the rules should not require unnecessary reporting of carry forward amounts;
- interactions with withholding tax and TOFA should be addressed and other areas identified as part of further consideration in the development of the measures.

As well the MIT reforms will need to interact with upcoming reforms currently under consideration for the Financial Services sector such as the Investment Manager Regime (IMR) and the Discussion Paper regarding Islamic Finance.

If you would like to discuss this submission in more detail please contact in the first instance either Antoinette Elias on 02 8295 6251, Daryl Choo on 02 9248 4472, Dale Judd on 03 9655 2769 or Tony Stolarek on 03 8650 7654.

Yours sincerely



Antoinette Elias

Dale Judd

Tony Stolarek

cc. Office of the Assistant Treasurer

## Appendix

### Ernst & Young response to Treasury MIT discussion paper

#### Concept of a Managed Investment Trust – Treasury paper section 1

**Consultation Question 1**

Whether any or all of the rules about trusts treated as MITs for the purposes of the capital account election (Division 275) should be incorporated in the concept of a MIT that applies generally to the treatment of MITs for income tax (but not withholding tax)?

In our view, the proposed reforms should apply widely to include all non closely held entities operating as collective investment vehicles (CIVs). The rules governing eligibility should not be overly prescriptive other than to ensure that the regime does not apply to family and wholly private trust arrangements.

In our view, the underlying policy is that widely held MITs which have public investment and are CIVs do not exhibit the characteristics of private family trusts or private unit trusts, and therefore should not be subject to narrowly drafted restrictive and problematical rules of the type more appropriate for private family trusts or private unit trusts. The assets invested in the MIT sector are overwhelmingly from superannuation funds and individuals (or other MITs representing their interests), and are subject to numerous regulatory requirements. MITs are not designed or operated as mechanisms for the management of individual families' wealth as are family trusts. Therefore we are concerned about the overly prescriptive approach which underlies various elements in the Treasury discussion paper.

We recognise also that there is a spectrum of MITs ranging from the listed or widely held unlisted MITs which might have thousands of investors to smaller MITs which might have a small number of investors.

However we submit that the definition of the MIT for any element of the reforms should be no narrower than the application of the MIT definitions for the purpose of the Division 275 of the Income Tax Assessment Act 1997 (ITAA 1997) capital election rules, as they modify the Subdivision 12H of the Income Tax Administration Act definition.

The inclusion of any new prescriptive MIT definition for some or all of the reforms proposed in the discussion paper will create further administrative and compliance burdens and costs and may lead to significant confusion if three definitions were to interplay for the application for various MIT provisions. This would add to complexity from the concurrent application of two systems of taxation for similar taxpayers (ie the MIT rules and Division 6 of the Income Tax Assessment Act 1936 (ITAA 1936)).

We note however that there are various shortcomings in those definitional rules which should be addressed, including the complex ongoing eligibility testing required and uncertainty over particular elements of the rules.

We submit that a simple rule could allow application of the proposed measures to the full range of CIVs excluding only discretionary trusts and other privately held trusts (as well as excluding IDPSs and bare trusts (i.e. custodians) as recommended by the Board).

It is important that particular CIVs should not be left to continue to attempt to deal with the uncertainty of the Division 6 rules. Whilst we understand Division 6 will be rewritten in due course which will address some of the uncertainty in those rules, we expect that this will be a long process, we would not expect that the rules could apply from 1 July 2011 and they would also be unlikely to apply from the 2012/13 year. So CIVs should not be locked into the current problematic Division 6 rules for the short to medium term.

The MIT definition needs to ensure that such volatility of status does not arise from excessively complex rules which might result in minor unintended breaches. It will also be very problematic if funds were to fall in and out of the proposed MIT reforms and back into Division 6 rules. We emphasise in particular that complex annual eligibility testing is unworkable and should be unnecessary for these reforms.

We support the consolidation and streamlining of the current MIT definitions in one place for ease of understanding and application.

## Attribution method of taxation - Treasury paper section 2

### Clearly defined rights or entitlements

We are concerned that all CIVs would likely fail the proposed clearly defined rights or entitlements tests as the proposed tests essentially replicate the current fixed trust test problems rather than address them.

In our view the underlying policy is that widely held MITs which have public investment and are collective investment vehicles should not be subject to narrowly drafted restrictive and problematical rules of the type more appropriate for private family trusts or private unit trusts.

We submit that MITs should not fail the test due to the exercise of powers needed to operate commercially and deal with their funds and investors in accordance with their mandates and fund rules including rules to:

- accumulate income
- issue new units at a discount
- redeem units including at a discount
- amend trust deeds and other documents
- determine income/capital/cash entitlements at year end and/or at redemption

The proposed general exceptions to the clearly defined rights test would most likely to lead to uncertainty and confusion rather than be of assistance in applying the rules. We are concerned by the proposed rule to disregard certain powers if their existence does not affect market value and the variation proposed in paragraph 39 where requirements are met (including that it is highly unlikely that the trustee would exercise a power to materially affect the beneficiaries' entitlements).

We are also concerned that onerous clearly defined rights requirements will exclude certain funds including hedge and venture capital funds with fixed entitlements from access to the benefits of attribution and fixed trust treatment.

#### **Consultation Question 2**

Should the core clearly defined rights rules be supplemented by tests which would allow some types of MITs (e.g. registered MISs) to automatically satisfy the requirement in situations where rules already operate to prohibit a MIT from acting in a manner inconsistent with the core rules? If yes, in which situations should these tests apply?

We submit that a CIV that is eligible to make the Division 275 ITAA 1996 capital election should not be subject to any clearly defined rights tests (including registered or unregistered and wholesale or non-wholesale funds).

If such a clearly defined rights test is introduced we submit that at a minimum all registered MISs should be excluded from the test. Registered MISs already have to meet regulatory rules that are aimed at preventing the abuse of investors' rights and entitlements that could lead to value shifting, including having to comply with Corporations Act rules to amend its constitution as well as being subject to the Trade Practices Act and being regulated by ASIC. All trustees' actions are further limited by their fiduciary duties to beneficiaries.

In our view it is unnecessary and inappropriate to replicate provisions of the Corporations Act in the tax law. These laws must already be complied with under the appropriate Act and such replication is unwarranted, would lead to increased compliance costs and potential uncertainty including that resulting from any inconsistent interpretation of the rules by the ATO.

If any mechanical test for clearly defined rights was to be introduced, it would require a mechanism to disregard failures arising from inadvertent arrangements or circumstances not designed for tax minimisation purposes. So a test would need not to affect MITs in their initial formative period, in their process of being wound down, MITs affected by adverse financial circumstances such as the Global financial Crisis, and other significant events. If a test was introduced, we favour the inclusion of a saving rule, perhaps requiring an ATO discretion, with a series of factors governing its exercise.

The proposed four year exclusion from the attribution method where a breach of any clearly defined rights test occurs is harsh, and should not be adopted.

It would represent poor policy, in our view, to expose funds to the risk of volatile tax classification and outcomes in any situations other than the most egregious cases, because this will greatly complicate funds' tax calculations and will have reputational impacts.

Any integrity concerns in regards to the misuse of arbitrage opportunities should be able to be dealt with under the current Part IVA general anti avoidance provisions rather than introducing such new laws which are likely to have unintended impacts.

If Treasury or the ATO consider there are integrity concerns these should be clearly articulated in the consultation process. We are prepared to sign confidentiality agreements to discuss any identified integrity concerns.

From an ongoing perspective we suggest that efficient tax administration by the ATO will identify any inappropriate behaviour, if such were to arise, to enable necessary remedial legislative action if it were ever needed.

As discussed below in Treasury paper section 6, we submit that any clearly defined rights tests should not apply for the purpose of the fixed trust treatment entitlements for MITs.

**Consultation Question 3**

Would it be possible for the clearly defined rights rules to accommodate trustee powers to accumulate income in the trust or issue units at a significant discount without impacting on the integrity of the rules?

Such a rule should be unnecessary as there should be no need for a clearly defined rights test.

#### Consultation Question 4

Is it appropriate to describe 'constituent documents' by way of a general principle, similar to the approach adopted by the Board in its Report, or should specific rules which list those documents that form part of a MIT's constituent documents be adopted?

This rule should be unnecessary as there should be no need for a clearly defined rights test. However any such rules should not list the constituent documents other than by way of example.

As discussed below in section 8, any clearly defined rights test (should they be introduced) must be introduced in conjunction with broad rollover relief rules to ensure that any changes to constituent documents cannot have any income tax impacts as the result of a resettlement of the trust, should that occur. These rules could be modelled on transitional provisions introduced following changes to the Corporations Law in 1998. The Government should actively seek a matching stamp duty relief from the states and territories in these circumstances.

### Attribution method guiding principles

#### Consultation Question 5

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

We support that the attribution method being based on guiding principles rather than prescriptive tax law.

The issues of allocation should be left to be dealt with by funds in accordance with fund rules, PDSs, other constituent documents etc. This should be able to be dealt with by the funds themselves provided that there is no additional tax law overlay creating uncertainty with MITs' approach or providing for potential disputes relating to normal fund activities. The drafting should allow for the ability to provide clarity by way of regulations where appropriate and where the need arises in the future.

The law and explanatory material should discuss however what attribution means and how it is different to present entitlement and other Division 6 concepts.

In particular the broad drafting of the rules should allow funds to deal with their 'last-man standing' issues (raised in previous submissions) part year redemptions and large redemptions and subscriptions (provided the proposed clearly defined rights rules do not operate to prevent this).

We do not favour any formal requirement to undertake attribution during an income year. The attribution process should be part of the year end distributions following preparation of the annual accounts. Any extension of this requirement would lead to significant costs of changing accounting and tax systems and distribution statements with increased ongoing administration costs, with no or little benefit to investors.

We do not believe that any specific rules in relation to redemption during an income year or other circumstances should be required as trustees and responsible entities already act in the best interests of their clients. The attribution method should reflect the allocation of the income of the trust across investors in accordance with the fund rules and trustee decisions and if necessary supported by "fair and reasonable basis" requirements.

We submit that any specific rules will be difficult to draft because they will need to allow funds to deal with special transactions including large redemptions and subscriptions. Drafting such a rule could also lead to unintended non-compliance. For example:

- large funds have large amounts of applications and redemptions on a daily basis. Requiring these funds to calculate taxable income for each of these investors would be nearly impossible to comply with

- rules requiring exit distributions may not necessarily take into account the fact that trustees and responsible entities currently undertake a special distribution with large incoming investors so as to ensure that income and credits are not inappropriately diluted in favour of the incoming investor.

Any such rules should be drafted so as to not accidentally preclude these activities or inappropriately mandate them when it is unnecessary to do so.

**Consultation Question 6**

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

We submit that there should be no rules requiring how carry forward losses should be dealt with between classes of unitholders.

Mandating such a rule would be highly problematical and would legislate against current MIT practices. Should a MIT currently choose to apply losses against an income class they should be allowed to continue to do so and funds that currently spread the loss across the income classes should also be permitted to continue to do so.

We are further concerned that any rule requiring carry forward losses to be carried forward on a unit class basis may result in trust loss testing under Schedule 2F to the ITAA 1936 that might otherwise not be required or that this testing may be compromised by such a carry forward and/or changes may be needed to those extremely complicated rules. Such a rule might also require modifications to ATO systems and reporting and introduce complex new income tax return disclosures.

We submit that any rules should not be prescribed but should be dealt with in accordance with the funds' rules. Tax rules should not interfere with the economic decisions made by trustees, responsible entities and managers to act in the best interest of the investors in how they deal with such losses.

We note this is a complex area which could easily lead to inappropriate tax outcomes.

We highlight that a trend for managed funds may be the greater use of multi-investment-class MITs, and we welcome any tax law improvements which might enable funds to offer multi-class products as contemplated. However we suggest that further consultation should be undertaken before such measures are legislated.

In addition we note that if losses could be distributed to investors this may reduce inequities that would arise from any carry forward and we would welcome such moves. Alternatively consideration of a reverse cost base adjustment in such circumstances might be warranted if considered equitable.

Mandating that losses arising in one class of units could not be offset against income and gains arising in another class will give rise to equity issues as all investors are pooled in the same investments and have their unit prices based on those investments.

***Attribution method special rules*****Consultation Question 7**

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

We submit that, as mentioned above, the allocation of taxable income to investors in accordance with the trust deed and fund rules on a fair and reasonable basis where necessary should apply to all collective investment vehicles.

Inappropriate tax outcomes may arise if there are a set of rules for one set of funds and another set for another. This could cause increases in cost of compliance for responsible entities, custodians and managers which will ultimately be borne by investors.

We are not aware of a need for any special rules for listed property trusts or exchange traded funds.

### Attribution method integrity rules

#### Consultation Question 8

What would be an appropriate principle for the proposed anti streaming provision?

We submit that there is no need for the introduction of new anti-streaming and value shifting rules in respect of the attribution method.

As discussed above MITs are already subject to significant regulation fiduciary obligations and other laws that will restrict their ability to behave in a manner contemplated in the discussion paper. It is inappropriate and an unnecessary requirement to introduce such new laws.

In particular changes to constituent documents to the detriment of a class of investors would breach other laws which govern managed investment schemes and will already subject trustees and responsible entities to legal ramifications.

Treasury's value shifting integrity concerns should be addressed by the ATO through the existing Part IVA general anti-avoidance rules.

We note that adopting the MIT definition for the Division 275 capital election rules would already provide a further level of integrity for preventing abuse of the attribution method. The Division 275 MIT definitions already have built into them many requirements to restrict taxpayers to those that would be highly unlikely to exploit the rules including because of the overlay of the Corporations Law and other laws including the Trade Practices Act. Such eligible MITs are also restricted in their actions by the reputational risks of behaving inappropriately in an open market.

#### Consultation Question 9

If certain types of MITs (e.g. registered MISs) were to be treated as automatically eligible for the attribution method, would it be necessary to consider whether the anti streaming and/or value shifting rules might need to apply beyond changes to a MIT's constituent documents?

We submit that there is no need for any specific anti-avoidance regime for these funds as they currently cannot act detrimentally to their clients.

We reiterate our concern that overly prescriptive and inflexible rules would impede the necessary flexibility for MITs to be developed which are commercially attractive, and would impede the development of multi class MITs.

## ***Other attribution method issues***

### ***Attribution method 46.5% tax impost***

We submit that the proposed punitive 46.5% tax rate to trustees for failing to attribute within a time frame is not appropriate.

The bulk of monies invested in MITs is from pension funds taxable at 0%, superannuation funds taxable at 0% or 15%, individuals taxable at varying rates from 0% through 30% to 46.5%, companies taxable at 30% or non-residents subject to withholding tax rules. It is quite inappropriate to consider imposing the top marginal tax rate in this context, and to impose it on the fund, and to deny the investor the benefit of any such payment such tax.

Concerns including with the impact on investor tax lodgement deadlines would be better dealt with through interest based penalties to the trustee, depending on the reason the attribution was not made on time.

This approach would not unnecessarily penalise the funds' investors which overwhelmingly will be taxable at a significantly lower tax rate or who may not be taxable at all.

### ***Attribution basis expense allocation***

We submit that expenses should be allocated by funds on a reasonable basis and the method should not be 'locked in' to the legislation. We note that carrying forward revenue deductions rather than offsetting them against capital gains is not standard industry practice and again flexibility is needed.

We further submit that section 51AAA should not apply in respect of MITs. The potential application of this section creates unnecessary uncertainty and complexity in the law.

The view has been expressed that section 51AAA should not apply to leverage MITs in any case (as they would be entitled as deductions under the section 8-1 ITAA 1997 limb in respect of their investment income). However the matter is not free from doubt and this uncertainty should be removed. This amendment will also avoid any potential future disputes with the ATO based on arguments by them for example that the provision could apply to MITs because of the statutory capital treatment of MIT gains and losses.

### ***Attribution method - providing investors with rights of objection and review***

We do not see that any additional rights of taxpayers to object against a tax assessment in respect of a dispute over the allocation from a fund are needed. The assessment should be able to be amended by the taxpayer based on any revised attribution details.

This proposal for additional reporting would only seem to lead to additional complexity and would create opportunities for potential litigation by unitholders with funds with potential additional tax penalty tax consequences including from any new resulting under and overs. As discussed above, funds are already subject to significant levels of regulation and fiduciary obligations in respect of their investors. These laws should be sufficient to allow investors to challenge their fund allocations in accordance with the fund rules without creating complex and costly new obligations on funds.

## **Unders and Overs - Treasury paper section 3**

We suggest that it is necessary to consider the reason for these reforms and what value is generated by the proposals before considering the drafting in detail.

The purpose of this legislative reform is in our view to confirm reasonable industry practice to provide information to investors within a short period of time which does not allow for full tax computation processes to be completed. Therefore the funds and their custodians and administrators necessarily work on estimates and materiality levels. The reform proposal must be responsive to these needs and not introduce unnecessary new compliance and tax penalties other than in cases where there is an intent to gain some advantage.

For most MITs the unders/overs are unavoidable and there is no income deferral motive.

The ATO has allowed appropriate informal arrangements for funds to deal with unders and overs to date, recognising that there is no clear statutory basis for this in the current Division 6. We suggest that this has not resulted in any revenue risk to our knowledge.

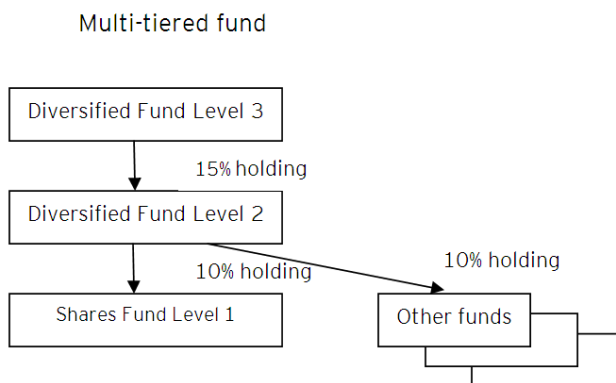
To illustrate the minimal revenue risk, consider an under distribution by a MIT of, say, \$100 per average investor in a year, and whether that under distribution is carried forward or is dealt with using supplementary advices and calculations to the investor. An under distribution of \$100 of revenue per average investor might (given the preponderance of superannuation funds and individual investors and foreign investors) mean on average an amended tax liability of less than \$15 per average investor in that year (rather than the following year) and, if the under distribution were of capital gains, an even smaller amount. The transaction costs of the communication, and the amendment of returns by the investor, and the administration costs to the ATO, and then the administration by the investor of amended returns and refunds or amounts payable would far exceed any revenue advantage to the Australian government from bringing forward the taxation, instead of allowing the under distribution to be corrected in the following year.

In such a scenario, to force a costly reporting and compliance chain of transactions would in fact impose additional compliance costs onto MITs.

Therefore, we are not attracted to a process for reporting of unders and overs except for very large amounts where such reporting might be justified. We suggest that the purpose of the unders/overs rules should be to confirm existing practice, and to operate flexibly and commercially, rather than to prescribe an overly complex and problematical new law which actually creates more issues than does the current practice.

***De minimis test should not be affected by distributions from uncontrolled MITs***

We highlight that many MITs ('investor MITs') will invest in other MITs ('investee MITs'), particularly where the investee MITs are listed or freely tradeable, and where the pricing of the investee MITs is attractive. So it would be not uncommon to have multiple tiers of MITs such as in the following example.



In these circumstances, we suggest that having any requirement for a MIT to deal with unders or overs, in circumstances where the unders and overs flow from activities of other MITs which are not controlled by the investor MIT, would be unworkable.

In the above example, unders or over distributions might arise due to the actions of Diversified Fund Level 3 or any of the other MITs which occur below. In our view, it would be unworkable and highly inefficient to institute a mechanism which might require Shares Fund Level 1 to reissue distribution statements up the chain, and requiring the Diversified Fund Level 3 to implement such distribution statements in relation to its own determination of whether it satisfies the de minimis rule.

Any rules that penalised MITs for breaching the de minimis in circumstances where the relevant income was not within their control may also potentially result in unwanted behaviours by funds to delay their attribution and distribution statements until they have information from their lower tier investee MITs (i.e. the Level 2 fund delays its procedures until information is received from the Level 1 fund). Such behaviours, if signalled in this MIT reform process, would lead to problems for the their investor MITs in complying with the rules (i.e. the Diversified Fund Level 3 then delay's its attribution procedures until the delayed Level 2 fund distribution statement is received). This would have a flow on effect for the administration of the tax system as ultimate investors delay the completion of their income tax returns in anticipation of receiving the ultimately delayed statements.

We submit therefore that the calculation of the de minimis rule should be restricted to direct investments of a MIT, and to under or over distributions of other MITs which are wholly-owned by the relevant MIT, or which are controlled by the relevant MIT. The rules should expressly not include distributions from uncontrolled MITs for purposes of calculating the de minimis threshold. As well, as discussed below, the de minimis threshold should be set at a relatively high level.

#### **Consultation Question 10**

Is it practically feasible to have an alternative test for a *de minimis* amount based on a prescribed dollar value per unit?

#### **Consultation Question 11**

If so, what would be an appropriate way for the Government to determine a prescribed dollar value per unit?

We submit that a number of alternative tests are required to define the acceptable level of under/over distribution treatment before any adverse tax consequences arise. The de minimis threshold should be the greatest of the following four factors:

- A. A percentage of the fund's book income (not taxable income). This could be 5% of net income (as suggested) but we note that a higher threshold might be desirable for some MITs holding 'hard assets' such as real estate or infrastructure. We note that US and UK Real Estate Investment Trusts (REITs) have a distribution requirement of 90% of their income of a year
- B. a percentage of the funds' gross or net asset value (to be determined in consultation but at least 0.5% of gross assets per annum
- C. a de minimis amount per investor, determined based on the amount attributable to the distribution made to the average investor in the MIT
- D. a Commissioner's discretion to allow for another amount

The alternative 'dollar amount per unit' proposal does not seem workable, based on feedback from clients and the funds industry, given that units in each trust are likely to be trading at significantly different prices at any one time which will then move over time. A de minimis measure based on units therefore is our least favoured option.

The 5% of net taxable income proposal may help many funds, as indeed we suggested to the Board of Taxation, but it will not help many other funds; so it must be supplemented by other tests.

We note REIT regimes in foreign jurisdictions include a lower minimum annual distribution requirement, for example 90% of annual income in the United Kingdom and United States, which essentially implies an under/over de minimis test of 10% of income.

We highlight that a margin based on net income or net taxable income will not assist in any year where there is a nil or minimal or negative income; for example if foreign exchange losses which reduce the net taxable income to nil or close to nil, or a disruption in the markets causes a large write-down. A de minimis rule working off taxable income will not be appropriate in such a circumstance.

A de minimis threshold being a percentage of gross or net fund assets will address the above concern and would be easy to measure, however consultation is required to establish the appropriate level. To illustrate the rationale and potential level of this threshold, assume that the average yield on MITs was 6% of gross assets. If a 5% de minimis threshold were applied to a 6% yield this would equate to 0.3% of net assets. This suggests that an amount in the range of 0.3%-0.5% of net assets at year end might appropriately apply to those MITs which had negligible income for that year.

We also propose a further de minimis rule based on a de minimis amount per investor (on some average basis) to eliminate the need to reissue a significant number of distribution statements for only minor changes in amounts of income. We suggest that say \$500 of under distribution per average investor could be an appropriate start for consultation with industry. As illustrated earlier, we suggest that the transaction costs of:

- investor communications,
- amendment of returns by the investor
- administration costs to the Australian Taxation Office of amending assessments and issuing refunds or further amounts payable and
- administration costs for investors of dealing with amended refunds or amounts payable

for a \$500 average under-distribution would far exceed any revenue advantage to the Australian government.

These mechanical tests should be supplemented by a backup rule to facilitate reasonable commercial arrangements that do not result in large losses to the revenue.

We also submit that a discretion should be provided for the Commissioner to allow an under/over to be carried forward calculated under another method in certain circumstances. This should also be the subject of further consultation.

#### **Consultation Question 12**

In addition to the proposed rules for overs and unders in relation to the tax income of a trust, should there also be statutory rules for overs and unders relating to tax offsets? If so, what would be an appropriate de minimis threshold?

We submit that there should not be statutory rules for dealing with particular categories of unders and overs. However the rules should clarify how the distribution of franking credits and other offsets are dealt with where there is no other income of the fund.

**Consultation Question 13**

For the income year in which an under or over arises that is less than the de minimis threshold, what would be a suitable operative mechanism to ensure that the trustee does not need to issue revised distribution statements and that assessments made in accordance with distribution statements do not need to be amended?

We do not consider it necessary for the legislation to prescribe any mechanism to deal with such unders (or overs). The Explanatory Memorandum could state an expectation that the under/over distribution would be corrected in the following period.

**Consultation Question 14**

In applying the carry forward of an under or over not exceeding the de minimis amount in a later income year:

- (a) should constituent amounts (e.g. capital gains; franking credits) be applied specifically against an amount of the same type?
- (b) if so, for what categories of amount should a separate under or over figure be calculated; and
- (c) if not, what would be a suitable rule in applying the amount carried forward?

We submit that there should be no prescriptive rules in relation to how the carry forward of an under and over not exceeding the de minimis amount should be dealt with in a later income year. It is important that the rules are flexible to accommodate the fund's rules and their commercial dealings with investors.

Carry forward in income classes may be complex. Numerous MITs already carry forward unders and overs against income classes and may want to continue to do this. However by necessity they may have to adjust such amounts. For example, where a fund has a large over distribution for 'foreign other' because they over distributed a gain arising mid-year on FX hedge, instances can arise where the over may be trapped because in future years the FX gains are not as large or there is no longer a need or ability to have any FX hedges. The same or similar issues can occur where assets are moved onshore or offshore. Such problems where there is not sufficient income of a class in the next year to offset an over distribution against should be considered further in consultation.

In particular the rules need to be flexible to accommodate funds that use a class of unitholder or sub-trust structure where exact matching might be necessary and others that do not match or have a single class of unitholders.

**Consultation Question 15**

What should be the specified period allowed for the trustee to reissue distribution statements to beneficiaries after becoming aware that there is an under exceeding the de minimis amount?

As mentioned above, we submit that there should be no requirement to reissue distribution statements as contemplated in the discussion paper. That reissue should be at the option of the responsible entity of the MIT.

We submit that there should be no sanction for over distributions in a year.

If a MIT has an under distribution, we further submit that the proposed 46.5% final tax to the trustee should not proceed and should be replaced with a withholding tax mechanism.

A 46.5% final tax would be to the detriment of the overwhelming numbers of direct or indirect investors in funds as these investors are primarily superannuation funds taxed at 15% or 0%, non residents taxed at either 0%, 7.5%, 10% or 15% and resident individuals the majority of which will have a marginal tax rate of no more than 30%.

We submit that a refundable withholding tax mechanism should be introduced instead based for example on the current tax file number withholding tax rules. Funds will already be familiar with dealing with such tax credit rules and may be able to more easily modify their systems if such known law is used as a model.

If reissue of distribution statements was ultimately required, or was chosen by the responsible entity of the MIT, then any law should allow a reasonable period to reissue the statements rather than any prescriptive rules because unders and overs can arise in a large number of different circumstances.

For example it may take a long time to identify all discrepancies in particular from adjustments resulting out of ATO disputes and for discrepancies notified in respect of investments in other funds.

The reasonable period for reissue might be linked to the period for lodgement of the funds' income tax return for the year or to a period following the amendment of a year's assessment.

The reasonable period for reissuing statements might also be depend on what particular circumstances caused the error and when they were identified including for example whether the difference was due to an error or arose from amendments made by the ATO upon review or from amendments because of changes in tax law interpretation such as judicial decisions.

**Consultation Question 16**

What would be appropriate sanctions for a trustee intentionally (or recklessly) misstating the tax income of the trust?

We agree that an administrative penalty for providing false and misleading statements would appear to be the appropriate sanction for those involved in recklessly or intentionally misstating the tax income of the trust to take advantage of the de minimis rule.

We submit however that a trustee would be unlikely to try and manipulate the tax outcomes in the way suggested as this would breach various other laws including the Corporations Law, The Trade Practices Act (false and misleading deceptive trade practices) and their fiduciary duties.

## Cost base adjustments - Treasury paper section 4

### Consultation Question 17

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

We welcome the proposed amendments to permit upward cost base adjustments to eliminate double taxation for investors in MITs.

However, there should not be a requirement for funds to track and report adjusted cost bases for investors. While many MITs may elect to offer this service to investors, we consider that the law should only require that the information necessary for unit holders to track and calculate their own cost base be provided. This information could be provided annually in time for investors to complete their income tax return.

We consider that any requirement for cost base adjustments to be tracked and reported by funds would be time consuming and may require increases to the current management fees payable by unit holders which would reduce the attractiveness of investing in funds for investors.

We are also concerned that a requirement for funds to track cost base movements for investors would require substantial systems changes. Such changes would also impact the format and cost of distribution statements and other reports. The additional cost and time needed to implement these changes raise concerns that make a proposed 1 July 2011 commencement unrealistic.

We submit that any amendments to provide for upward cost base adjustments where income is retained in a trust (where further units are not issued in lieu of such retention) should give rise to upward E4 cost base adjustments.

We strongly disagree with the comment in paragraph E4 of the discussion paper that distributions of tax preferred amounts to revenue account unit holders will be assessable as ordinary income. We consider that this is inconsistent with the Board of Tax recommendations and submit that reverse E4 equivalent adjustments should be available for holders on revenue account. Please refer to our more detailed discussion below at question 20 regarding the treatment of revenue account unitholders.

We recommend that any exposure draft law to insert this measure should be accompanied by a draft explanatory memorandum containing several simple examples to demonstrate the way that the new cost base adjustments will work. The additional examples should include all distribution components that may have an upward or downward impact on cost base. To remove any doubt about their impact to the cost base, additional items that should be included in the examples are foreign income tax offsets (FITOs), CGT concession amounts, building allowances and any other expense allocation items.

### Consultation Question 18

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

We submit that any cost base adjustment reporting should be an annual requirement.

It would be excessive and unnecessary for cost base adjustment notifications to be completed each time a distribution is made or on a quarterly or six monthly basis. It would be more appropriate to modify current yearly reports to include any new cost base adjustment information that is to be required under the new rules.

We consider that an annual statement would be most appropriate from the perspective of investors to facilitate simple preparation of their income tax returns. An annual statement shortly after 30 June each year would be ideal and consistent with the receipt of other information needed to prepare income tax returns including their PAYG payment summaries from employers. Mandating cost base adjustment details to be provided more regularly than on an annual basis would provide little benefit to investors.

**Consultation Question 19**

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

Ernst & Young does not consider that there should be any modifications to the new tax system for MITs that are Exchange Traded Funds. We submit that all collective investment vehicles should have the same taxation treatment, and that treatment should result in fairness without increasing compliance costs.

## Character and source retention - Treasury paper section 5

**Consultation Question 20**

Is the proposed approach workable in practice?

We support, in principle, the proposal for legislating character and source flow-through to investors in MITs. We agree that character and source retention will address long standing uncertainty and consider that it is both appropriate and workable for a rule to be inserted to ensure that investors receive the distributions from their investments in the same form as if they had held the investments directly.

In order to ensure that the operation of the character and source flow through rule is clear, we recommend that a series of examples should be provided in an exposure draft explanatory memorandum.

Ernst & Young agrees with the broad proposal on the part of the government to (para 106) "introduce into the law a rule which provides for a general principle of character and source flow-through", in line with the recommendations of the Board of Taxation.

This is highly desirable in order to enhance Australia's funds management sector, to remove the risk that the involvement of MITs, collective investment vehicles representing investors being superannuation funds and individuals, in Australia and overseas might in some way taint or alter the character of the investments as compared with the position if the investors held the investments directly.

Treasury should ensure that the character retention measure recognises the existence of multiple tiers of trusts in MIT structures. This should accommodate circumstances for example where a master trust or holding trust might hold minority or majority interests in lower level trusts, which might hold interests in other trusts making particular investments in particular sectors. The legislation should allow for and require a MIT to clearly identify the capital-character and other characteristics of distributions, in order to avoid confusion.

## Character retention where investors are investing on revenue account

However Ernst & Young has significant concerns about:

- a) the comment in para. 100, relating to cost base adjustments in relation to tax deferred distributions, that “Distributions of tax preferred amounts **to revenue account unit holders (for example banks and insurance companies)** will be assessable as ordinary income to these unit holders” (emphasis added) and
- b) the comment in para 104 of the Treasury discussion paper that ‘the government did not agree (recommendation 25) to change the tax treatment of tax deferred distributions to revenue account unit holders (**i.e. they remain on revenue account**)’ (emphasis added)

We refer to both emphasised phrases as ‘the revenue account comments’.

We submit that the revenue account comments misinterpret the Board of Taxation report and represent inappropriate policy.

The Board of Taxation recommendation 24 stated

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

and Recommendation 25 stated (relevantly):

1. “any legislative modification to the current approach to beneficiary-level cost base adjustments generally ensures that: ...
  - tax deferred distributions attributable to temporary tax differences, such as unrealised capital gains, are not, **other than to the extent they represent returns on ‘debt like’ units**, taxable to a resident or non-resident beneficiary as ordinary income under section 6-5 of the ITAA 1997 but may be subject to an adjustment to the cost base of the beneficiary’s units ...” (emphasis added)

The intention of the Board was, in our view, to confirm the current position, which is that the underlying character of trust gains is retained. The exception, for debt-like trust interests, flows from the 1998 case of *Commissioner of Taxation v ANZ Savings Bank* (1998) 194 CLR 328, in which the High Court held that a trust deed could not alter the ‘character of the moneys in the hands of the trustees’.

The Board recommendation and comments relate only to debt-like interests.

We recognise that CGT treatment is not available for taxpayers whose gain is taxable as ordinary income. However there is no basis for suggesting or prescribing that all banks and all insurance companies will be holders on revenue account in respect of all their assets.

In our view, the revenue account comments significantly broaden the proposal beyond the Board’s recommendation, and is inconsistent with the present tax law and how the ATO and the industry have interpreted/applied the law for many years. The Board’s report in fact notes the “well established nature of flow-through vehicles” at paragraph 6.12 and recommends legislation of the principle.

We also note that the Government stated in the former Assistant Treasurer Nick Sherry’s 7 May 2010 press release in response to the Board’s report that consideration of these matters were to be deferred. On this basis, we consider that there has been no earlier Government announcement to alert the industry regarding the revenue account comments now proposed in the discussion paper.

We do not agree with the proposal to deny character retention to investors which might hold their assets on revenue account, other than for investments in debt-like securities, for the following reasons.

- a) Ernst & Young is not aware of any integrity concerns that flows from the practices of investors in widely held collective investment vehicles which will satisfy the definition of a MIT.

There was no widely held trust in the abovementioned *ANZ Savings Bank* case. There is no case, to the knowledge of Ernst & Young, of any MIT has been engaged in any processes to convert the character of revenue income into capital gains. As a result, Ernst & Young cannot see the policy rationale for this exclusion.

If there are ATO or Treasury particular integrity concerns, these should be unambiguously and transparently stated.

- b) Additionally, the reference to 'revenue account unitholders' would create significant new uncertainties for many investors which might diminish confidence in the funds and asset management industry.

Treasury and the government will be aware that the distinction between revenue and capital gains for investors resulted in such a high level of uncertainty that it required the government to institute an express rule in 2010 to allow MITs to elect for irrevocable capital treatment pursuant to Division 275 of the ITAA 1997. This is because there is no clear definition of what is on revenue account.

Unless there was some black letter, unambiguous definition of what is a 'revenue account unitholder' then such a denial of character retention would result in significant new uncertainty for many investors. It would raise concerns for any investor which might be:

- an insurance company holding long term investments
- a bank holding MIT assets on a long-term basis
- unit trusts, individuals or companies holding MIT assets on a long-term basis, where there might be some risk of the ATO future disagreement with their capital characterisation of their assets
- a life insurance company holding investments in respect of its complying superannuation/FHSA class where the investments are deemed to be held on capital account
- unit trusts (other than MITs eligible for irrevocable capital treatment) holding MIT assets on a long-term basis, with the risk of ATO future disagreement with their capital characterisation of their assets.

This would lead to a new wave of litigation and uncertainty.

- c) Any such proposal would, if persisted with, raise significant transitional issues for existing investors which currently have capital characterisation in relation to their investment in MITs. It would require a transitional rule to protect existing investments, otherwise it would be quite inequitable. The reasons are as follows.

Various activities which might be conducted by investor companies or trusts involved in the financial services sector might be on capital account.

Some activities of financial services sector participants will have generated capital losses in the past. Those financial services participants might have other investments, including investments in MITs, which have been correspondingly generating capital gains.

If there were to be some fundamental change of taxation policy which altered the capital gains arising from those investors' holdings of MITs to revenue account treatment, this would be an inequitable policy change in relation to existing investments.

- d) The impact of any such proposal on savings products provided by insurers, banks, listed investment companies and other investors, backed by investments of those financial intermediaries in MITs, would need to be carefully assessed before any such proposal was implemented.

**Consultation Question 21**

Are there any alternative approaches that should be considered?

As noted above in the response to question 20, we do not understand why it is proposed that revenue unit holders are to be excluded from the character and source retention. We consider that this position should be reconsidered and the recommendations of the Board of Tax should be adopted.

**Fixed trusts - Treasury paper section 6**

We welcome the proposal that MITs will eligible for fixed trust treatment, which is an important measure to address long standing uncertainty for the industry. However we submit that the rule should apply for all eligible MITs and CIVs and this entitlement should not be subject to any clearly defined entitlement rules.

We submit that it is appropriate for MITs to have fixed trust treatment because they are already highly regulated, highly compliant and rights to distributions are based on units held.

If concerns remain regarding the potential exploitation of the fixed trust rule, we suggest that specific exclusions be inserted for hybrid trusts or other specific structures that may not be appropriate for fixed trust treatment.

**Repealing corporate unit trust rules and including an arm's length rule in the public trading trust rules - Treasury paper section 7****Repeal of corporate unit trust rules**

We support the repeal of the Division 6B ITAA 1936 corporate unit trust rules. This measure should not be delayed by the development of the other discussion paper measures.

**Public unit trust in Division 6C**

We support the amendments to the Division 6C ITAA 1936 rules to exclude trusts from treatment as a public unit trust solely because 20% or more membership interests are held by (and/or distributions are made to) superannuation funds and tax exempt entities that are entitled to a refund of franking credits.

We submit however that this rule should also be extended to membership interests held by (distributions made to) Government entities.

**Arm's length rule in public trading trust provisions**

In our view, the Treasury proposals in the discussion paper's discussion in section 7.2 (paragraphs 119 to 122), which appear to relate to recommendation 42 of the Board's MIT report, are premature, are unclear and need further development.

Even more significantly, they appear to extract a measure from a package of the Board's recommendations on which the government has deferred its formal response. Therefore, we question why this measure should receive attention in this particular reform package. In particular:

- ▶ Recommendation 42, following the Board report's discussion on Division 6B, proposed the introduction of an arm's length rule as part of the eligible investment business (EIB) rule changes proposed by them under the new MIT regime. However the government deferred consideration of those EIB rule changes.
- ▶ The Board MIT report's discussion at the preceding paragraph 10.4 referred to the report's recommendation 10, which proposed that the arm's length rules should apply to transactions between common interests or related interests of an MIT, including but not limited to subsidiaries and stapled entities, following other proposed changes to the control test, These changes have also been deferred by the Government for further consideration.

If the Treasury and ATO were to seek the introduction of this integrity rule before other relevant reforms are considered, which we do not consider to be appropriate policy action, then we submit that any integrity rule should be targeted at the specific integrity concern and should be drafted as simply as possible to avoid new complex law which would potentially create uncertainty and could lead to unintended outcomes. For instance, a targeted rule following the Board's recommendation 10 would apply only where a trust deals with another company or Division 6C entity which is not part of its stapled group or a subsidiary of an entity which is member of the stapled group, rather than expanding any related definitional law.

If the Treasury and ATO were to seek the introduction of this integrity rule before other relevant reforms are considered, which we do not consider to be appropriate policy action, then any rules which provide for the substitution of market value could be modelled on the familiar CGT rules in section 112-20.

We further submit that any rules should not be included in the Division 6C EIB rules such that non-compliance with the rule would lead to the breach of that test and the application of the 6C provisions.

The placement of such a rule in the EIB rules could result in very harsh outcomes, in particular for minor breaches of the rules, as determined by the ATO, that would exclude the MIT from the capital election, withholding tax and proposed further MIT reform rules.

We reiterate that any amendment of Division 6C should also only be made as part of the further consideration of all of the Division 6C recommendations of The Board.

**Consultation Question 22a)**

Under the proposed rule about non arm's length transactions in Division 6C:  
Should the market value treatment apply to transactions where a MIT does not deal at arm's length with another entity, transactions between an entity and its associates or both?

If the Treasury and ATO were to seek the introduction of this integrity rule before other relevant reforms are considered, which we do not consider to be appropriate policy action, then the market value rule should only apply to the trust and any company and Division 6C members of a stapled group and their subsidiaries.

**Consultation Question 22b)**

Should the market value treatment also apply to the other party to the transaction?

If the Treasury and Australian Taxation Office were to seek the introduction of this integrity rule before other relevant reforms are considered, which we do not consider to be appropriate policy action, then the market value treatment where applied should affect both parties to the transaction.

**Consultation Question 22c)**

Are any exemptions from the rule appropriate?

We have commented above on the need to constrain any such rule significantly.

**Further refinement of Division 6C**

We submit that further refinements to the Division 6C rules, including the Board of Tax MIT report's recommendations which were deferred for consideration by the Government, should be pursued at the earliest possible time. That would also be the time to introduce the proposed arms length rule.

**Other issues - Treasury paper section 8****Resettlements**

As discussed above, we submit that the MIT attribution and other rules should be drafted to avoid any clearly defined rights/entitlements test or other similar new rules, so that there should not be any need for MITs to amend their constituent documents and there should therefore not be any risk of a trust resettlement.

**Consultation Question 23**

What are the possible types of amendments to deeds that may be required to be made (in particular, to satisfy the clearly defined rights requirement) and would they likely result in a resettlement?

The possible types and extent of amendments made will ultimately be dependent on the breadth of any rules that are introduced.

It is likely that various amendments would be required to fund constitutions in relation to member rules, allocations and issues related to PDSs, forms, marketing material, distribution statements and other reporting requirements. The amendments would likely include changes to address issues with potential investor complaints and actions against the trustee/RE if the tax law objection to allocations rules are adopted.

**Consultation Question 24**

Are many MITs likely to wish to amend trust deeds?

All impacted MITs are likely to amend trust deeds. However considering the costs involved all MITs would prefer not to make any changes if possible.

**Consultation Question 25**

What would be appropriate roll-over relief where a resettlement of a trust occurs as a result of a MIT amending its constituent documents so as to be eligible for the attribution method of taxation?

Should changes to constituent documents be required as a result of a clearly defined rights/entitlement test or other provisions, then a broad rollover relief should be introduced. The relief should apply to all funds in existence at the time of the commencement of the rules or created within say 6 months after that date, and should be available for a least a period of say three years to allow funds to enter the regime later than the first year of operation if they take this option.

The rollover relief could be modelled on section 960-110 of the Income Tax (Transitional Provisions) Act 1997, as follows:

#### **960-110 No taxation consequences to result from changes to managed investment scheme**

Despite the changes made as mentioned in subsection 960-105(1) to the managed investment scheme constituted by an entity to which this Subdivision applies:

(a) the entity is taken, immediately after the changes were made or, if the changes were made at different times, immediately after the last of the changes was made, to be the same entity as existed immediately before the changes were made or, if the changes were made at different times, immediately before the first of the changes was made; and

(b) the legal ownership of the assets of the entity is taken not to have altered as a result of the changes; and

(c) the beneficial ownership of the interests in the entity of a member of the entity to whom, because of a particular change, this Subdivision applies in relation to those interests is taken not to have altered as a result of the change; and

(d) without limiting by implication any other effect of the above paragraphs:

(i) the changes are taken not to have resulted in a CGT event in respect of the entity; and

(ii) in so far as this Subdivision applies to a member of the entity because of a particular change, the change is taken not to have resulted in a CGT event in respect of the member in relation to the member's interests in the entity.

In addition, the Government should actively broker the corresponding introduction of stamp duty rollover relief with each of the states and territories.

## **Reporting**

### **Consultation Question 26**

Should the trustees of MITs be required to notify unit holders of the amount of unders and overs identified and to be carried forward? If so, what would be the best way for the notification to occur?

We submit that the tax information needed to be provided to investors should be limited to information necessary for the completion of the investor's income tax return. Disclosure of any additional information including for any unders and overs carried forward should not be required.

Such information may only confuse investors or result in a new line of litigation against the RE from aggrieved investors. Unders and overs less than the 5% threshold are not relevant to investors until such time as they are distributed.

Potential problems may arise for funds required to report carried forward amounts to investors, including:

- New arbitrage opportunities may arise for buying/selling based on adjustment (especially if adjustment made yearly) and this could result in changes to the current unit pricing model

- Greater administrative burden for funds due to the additional report requirement. This would cause more process, systems and reporting changes (especially where the period to report doesn't align with current distribution period)

Tax information should only be provided to investors annually as part of the year end distribution process in line with current practice. The cost of issuing additional statements would otherwise be expensive new requirement for funds with a large number of investors.

As discussed above, Treasury should ensure that the character retention measure recognises the existence of multiple tiers of trusts in MIT structures. In order to protect character retention for the ultimate investors (superannuation funds and individuals, principally), it will be important for the industry to have a standardised distribution statement which clearly separates the capital-character distributions from other distributions. The legislation should allow for and require a MIT to clearly identify the capital-character and other characteristics of distributions, in order to avoid confusion.

We note that the provision of tax information in distribution statements may constitute a tax agent service under section 90-5 of the Tax Agent Services Act 2009. We have expressed our concern separately to Federal Treasury in our submission dated 28 September 2010 that any requirement for fund managers to register as a tax agent due to the provision of ancillary tax information in distribution statements would constitute unnecessary and excessive regulation of the industry.

## Application

### Consultation Question 27

Do some MITs need time before the commencement of the new attribution rules to amend trust deeds and, if so, what would be a reasonable amount of time to allow?

As discussed above, the possible types and extent of amendments made will ultimately be dependent on the breadth of any rules that are introduced.

Taxpayers may require considerable lead time depending on the law requirements, however we consider that a 1 July 2011 mandatory start date for the measures would be unrealistic in any event. Instead, we suggest that a soft start to the regime is most appropriate with an early entry by election to be available in the income year commencing on or after 1 July 2010. A mandatory hard start date should not commence before 1 July 2012.

We have noted above that there is currently a proposal for a harsh 4 year exclusion from fixed trust tax treatment for MITs that fail the clearly defined rights test. If this is a feature of the new tax system for MITs, we consider that it is imperative that funds are given plenty of lead time to ensure that their deeds and constituent documents are in compliance.

We submit that a delayed mandatory commencement, similar to the introduction of the TOFA 3&4 regime, would allow much needed time for funds to consult on the ED to be developed and for appropriate consultation prior to commencement.

### Consultation Question 28

By what date would industry need to implement changes to its systems and how much time would it be likely to take industry to make those changes?

Systems change is an expensive and time consuming activity for financial services organisations, including MITs, but also custodians that service many funds. The recent introduction of the TOFA 3&4 regime has demonstrated that more than 12 month lead time is required to complete IT upgrade projects.

It is unlikely that systems change projects can commence before exposure draft law is released, therefore it would not be appropriate for the mandatory operation of the new tax system for MITs to commence before 1 July 2012 (or alternatively to the commencement of the 2012/13 income tax year to address arrangements for taxpayers with substituted accounting periods).

## Interactions

### Consultation Question 29

What specific interaction issues should be addressed in the legislation and what are possible solutions to those issues?

We agree that there will be interaction issues with the withholding tax regime. The interaction of the withholding tax rules and the taxation of trusts is complicated and penalties and sanctions arising from uncontrollable events should be avoided.

We suggest that Treasury should include the international tax division of Treasury in the development of the new tax system for MITs to ensure that there is a workable system in place when the law is enacted.

There will be potential for overlap between the new tax system for MITs and the TOFA regime. We suggest that there should be clear anti-overlap provisions to ensure there is clarity regarding which provisions will apply if there are that no uncertainty arises for MITs.

We consider that the interaction issues require further detailed consideration as part of the development of the measures. This is one reason why we consider a deferral of the default start date for these measures, to MITs' 2012-13 year of income, is necessary.

### Consultation Question 30

What amendments should be made to the withholding tax (and associated PAYG withholding) provisions to ensure that they mesh appropriately?

This issue should be developed in further consultation. This is one reason why we consider a deferral of the default start date for these measures, to MITs' 2012-13 year of income, is necessary.