Greenwoods & Freehills

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Board of Tax review of Managed Funds and interim Division 6C amendments

1. Securing Australia's place as a financial hub

Consistent with the election commitment from the Labor Government "to make Australia the financial services hub of Asia", the Assistant Treasurer, Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen MP, made an announcement on Friday, 22 February 2008, that the Government has asked the Board of Taxation (**Board**) to review the taxation arrangements that apply to managed funds.

For a copy of the announcement, see http://assistant.treasurer.gov.au/

As part of a theme to create wealth in Australia by levelling out the international playing field and removing barriers to growth, the Assistant Treasurer acknowledged that "Division 6C is a prime example of unnecessary complexity and the administrative burden that goes with our tax system". With this in mind, the Government announced that it has issued a consultation paper (**Paper**) on the interim changes to the operation of Division 6C. The interim measures are intended to apply for the period until the Board finalises its review of the taxation arrangements that apply to managed funds.

For a copy of the consultation paper, see: http://www.treasury.gov.au/documents/1347/PDF/Eligible_Investment_Rules_Consultation_Paper.pdf

These announcements have followed a long campaign by industry bodies to reform Division 6C, which creates an administrative burden and a competitive disadvantage for both the property industry and financial services sector, reducing their ability to compete with other countries.

2. Board's review of options for managed investment trust regime

The Board has been asked to:

- Review the current income tax arrangements applying to managed funds that operate as managed investment trusts.
- Develop options for the reform of the taxation treatment of trusts that are broadly consistent with existing policy principles of the taxation of trusts.
- Provide advice on options for introducing a specific regime for managed investment trusts which would reduce complexity, increase certainty and minimise compliance costs.

- Examine reforms to the eligible investment business rules in Division 6C, whilst not compromising the integrity of the corporate revenue base.
- Consider whether there is a continuing need for the tax integrity rules in Division 6B.
- Analyse the costs and benefits of establishing a separate taxing regime for REITs, including by reference to international regimes.

This is a welcome and long overdue review given the current complexity and uncertainty in the tax law surrounding the taxation of trusts. It presents an opportunity for the Board to propose changes that will alleviate many of the taxation issues faced by the managed funds industry on a daily basis which largely arise from the current outdated regime.

It's worth noting that the Board's Terms of Reference includes mention of the REIT regimes in the US, UK and Canada when formulating the options for a specific tax regime for Managed Investment Trusts (**MITs**). These regimes are highly prescriptive (US), generally regarded as unworkable (UK) or still subject to significant amendment well after their introduction (Canada). Therefore, given the relative freedom that Division 6C currently offers, industry participants may need to be careful as to what they wish for (and what the Government has in mind) in terms of wide ranging reform.

The Board will conduct consultations on these measures and has been asked to provide a final report around the middle of 2009 setting out its recommendations on the appropriate tax treatment of managed funds.

3. Interim changes to Division 6C

3.1 Overview

The Paper canvasses:

- Ways to clarify the scope and meaning of investment in land for the purpose of deriving rent.
- A 25% 'safe harbour' test for non-rental income from an investment in land to clarify the meaning of 'primarily' in the context of investing in land for the purpose, or primarily for the purpose, of deriving rent.
- An expansion of the range of financial instruments that a trustee could trade or invest in without triggering company taxation.

These short-term amendments are generally a positive step and mark the commencement of a reform process that the financial services sector, and in particularly the property sector, have been requesting for a number of years. However, the Government's requirement that any amendments be revenue neutral or close to revenue neutral will act as a constraint and therefore it will be critical that all submissions made seek to demonstrate the desired revenue neutrality.

3.2 Observations on potential reforms

It is clear from the Paper that the abolitionists will not get their way and that Division 6C will remain, albeit in a modified form (Division 6B does however seem to be on its way out). Whilst a number of policy reasons are offered for keeping Division 6C, the overriding theme is that Treasury desires neutrality between an active business held by a public trust and a company. The opportunity for a trust to claim the CGT discount and the ability to distribute tax preferred income appears to be Treasury's principal concern.

By implication, the Paper provides some insights into Treasury's view on the operation of a revamped Division 6C including:

- The control test is considered to be fundamental to the operation of Division 6C to maintain the integrity of the corporate revenue base and to also ensure equality between trust and company ownership structures. If a proposal were put forward for the control test to be removed then it could be expected that the Government would require a range of integrity measures to secure the corporate revenue base. In particular, integrity measures aimed at limiting the shifting of income between related trusts and companies could be required (ie domestic transfer pricing).
- Further, it will be necessary for the Board to give consideration as to the interaction of the "top-hatting" provisions, which were introduced by the *Tax Laws Amendment (2007 Measures No.5) Act 2007* (**TLAA 5***)*, and the revised rules, particularly as the "top-hatting" rules effectively already allow a public trust to control a trading business. This appears inconsistent with the stated policy intention.
- Holding property for the purposes of sale is not going to be a permissible activity as it is considered to be too "active". This is an interesting policy position, particularly given the current housing crisis and the opportunity that could be created by allowing residential housing trusts for low-income workers to be established within a managed fund environment. Division 6C currently constrains this type of activity as the feasibility of this type of trust relies (in part) on profits realised from the sale of properties.
- There is a clear implication in the Paper that profit based rentals are not considered to be an appropriate form of return to a passive investment trust on the basis that the trustee is taking on operational risk rather than just property investment risk. This will be a significant issue for the hotel sector in which these types of rental payments are not uncommon.
- If the current concept of 'rent' is modified so that it no longer includes profit based rents and the 25% 'safe harbour' test is introduced there may be winners (retirement village sector) and losers (hotel sector) from this reform.
- The 25% 'safe harbour' test would be considered to be a generous safe harbour. However, whether this will be the case will depend on the whole range of issues that will need to be addressed including:

- the concept of non-rental income will require clarification. Treasury has offered little, if anything, in the Paper as to what they consider this to mean;
- the term 'investment in land' is to be broadened to include investments that are not themselves investments in land but are related to land. A clear boundary will need to be made around this definition to ensure clarity for sectors that have significant non-land investments (hotel sector); and
- the test contemplates an examination of the non-rental income derived on an asset by asset basis. Obviously, this will involve a significant compliance exercise for public trusts. In formulating submissions to the Board on this issue we expect that there will be a strong preference for the 25% safe harbour test to be applied on a group basis (including for non-MIT subsidiary trusts). This would be consistent with the concession contained in TLAA 5 in respect of controlling interests in, or control of, a foreign group whose principal business consists of investing in land primarily for the purpose of deriving rent. It will be interesting to see whether the Government will be willing to align their current policy view in relation to offshore investment with that of domestic investment.

The concerns raised in the Paper are limited and specific and fall well short of addressing the many issues that currently arise when seeking to apply Division 6C to transactions being undertaken by public trusts. Indeed, in many instances taxpayers are currently driven by perceived (but untested) ATO views on the operation of Division 6C, which creates a difficult environment for competitive business activity.

Clearly, there are a range of issues that are not addressed in detail in the Paper that will require consideration. These include the concept of 'land' for the purposes of Division 6C and the future of stapled structures in light of the ultimate changes to be introduced.

Greenwoods & Freehills will be working closely with our clients and industry bodies in the next three weeks in the preparation of submissions to Treasury on these interim measures.

The Government has requested submissions on the issues canvassed in the Paper by 17 March 2008.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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