

Tax Brief

24 July 2008

Proposed Amendments for Managed Investment Funds

The Assistant Treasurer released a draft of proposed amendments to Division 6C of Part III of the *Income Tax Assessment Act 1936* (Cth) for public comment on Wednesday 23 July. This Tax Brief examines the scope and operation of the draft amendments.

1. Background

The proposed amendments are the result of consultations conducted on a paper issued by Treasury in March this year which floated some 'interim measures' to improve the operation of Division 6C. These 'interim measures' are a separate project from the concurrent but broader review of Division 6C which the Government referred to the Board of Taxation [see our earlier Tax Brief available at http://www.gf.com.au/477_624.htm].

The Government certainly deserves credit for its obvious desire to improve the operation of Division 6C, and no doubt has some confidence that the proposed amendments will be well received. It may be surprised when it learns that the proposed amendments have many shortcomings. The difficulties arise from:

- provisions which narrow the scope of the range of activities that some trusts can undertake before Division 6C is enlivened, despite the Assistant Treasurer's assurance that the amendments, 'will make it easier for a trust to comply with the eligible investment business rules ...'; and
- the execution of the drafting. It is a common observation in tax law that the execution of the drafting does not always match the claims made about what the law achieves. The proposed amendments continue this unhappy pattern.

2. Thrust of the proposed amendments

The proposed amendments contain 4 distinct elements, 3 of which were foreshadowed in the March Treasury consultation paper:

- The meaning of 'land' in Division 6C will be widened to include fixtures on land and chattels that are customarily supplied, incidental and relevant to the renting of the land and ancillary to the ownership and utilisation of the land.

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- A safe harbour will be created allowing trusts which invest in land for the purpose of deriving rent to earn up to 25% of their gross revenue each year in a form other than rent although this will not extend to revenue from a new category labelled 'excluded rent' (discussed below) nor to revenue from 'carrying on a trading activity on a commercial basis.'
- A trust will be permitted to invest in any financial instrument that is a 'financial arrangement' as that term is defined in the yet-to-be-enacted Taxation of Financial Arrangements ('TOFA') measures. However, there are a number of significant exceptions which significantly wind back the breadth of this measure.
- The new measure, not foreshadowed in the Treasury paper, is an additional 2% per annum safe harbour – a trust may derive up to 2% of its gross revenue each year in a form other than rent although, again, this concession will not apply if the revenue is from 'carrying on a trading activity on a commercial basis.'

3. Some design and execution problems

3.1 *When is a clarification not a clarification?*

One unhappy feature of the draft is that new and constricting policies have been proposed for Division 6C under the guise of 'clarification' and 'expansion.' The best evidence of this (and that the drafters are aware they are introducing restrictions) is in the transitional rules – the draft allows affected trusts not to apply some of the proposed amendments. There is no need for a rule to delay the start of a concession!

3.2 *Locked out of the safe harbour*

One place where the constriction of current law is most evident is in the new class of 'excluded rent' which is used in the 25% safe harbour. It seems clear that Treasury has some visceral dislike for rent based on turnover or profit and this is evident in the definition of 'excluded rent.' Excluded rent is defined to mean:

- rent based on turnover or level of activity where the parties were not dealing at arm's length;
- rent based on profit or net receipts 'that would result in those profits or receipts being transferred wholly or substantially to another party ...'

The problem, of course, is that turnover-based rents are extremely common in the property sector, and the requirements that the parties must deal at arm's length before such rents are permissible gives rise to significant uncertainty for many existing arrangements between related parties or stapled entities. The result is that the promise of a 25% safe harbour will be illusory for many trusts because access to the 25% safe harbour requires that the trust meet two tests:

1. at least 75% of their gross revenue consists of (ordinary) rent; and
2. not \$1 of the remaining 25% of gross revenue is 'excluded rent.'

A second problem with the 25% safe harbour is that none of the 25% of gross revenue can come from 'carrying on a trading activity on a commercial basis on the land.' The March consultation paper noted

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industry concerns with the dangers arising under current law if a trust derives income from a car park, licensing advertising space, providing guarantees or other incidental income-generating activity. The 25% safe harbour, which it had been hoped would obviate these difficulties, will not assist.

The result is that a trust with \$1 of excluded rent or from carrying on a trading activity will, at best, only be able to rely on the 2% safe harbour, and may not even be able to rely on this.

A third problem with the 25% safe harbour is that the revenue streams which are counted are widely defined. The draft says that most capital gains will have to be included in the 25% – the only capital gains which can be ignored are those arising from the direct disposal of land. So, other amounts which might be capital gains – lease premiums, disposing of the units in a land-rich trust, compensation payments, lease surrender amounts, insurance payouts and so on – will have to be counted toward the 25% safe harbour. The problem that the 25% test is meant to address – the unexpected receipt of a large lumpy irregular capital receipt – will not be solved if so many of them have to be counted in the 25%.

Indeed, there is a more fundamental question about the way that the 25% test has been constructed. Under current law, a trust must invest in land 'primarily for the purpose of deriving rent.' There has long been a technical question about how significant the rental income needs to be in the trust's total revenue – is it sufficient to remain outside Division 6C that the rental income is 51% of the gross revenue or must it be closer to 99%? If the new 25% test is intended to be the exclusive definition of the 'margin-of-error,' then these amendments will make the law *more* difficult for trusts, not less: the new test would be the only available 'margin-of-error' and few trusts will be able to access it. On the other hand, if the new 25% safe harbour test is intended to be an additional definition of the 'margin-of-error,' enacted because it is less contentious and easier to compute, then the fact that it is inaccessible becomes much less significant. The 25% safe harbour will be consigned to the dustbin of history as a failed attempt to assist industry with a difficult issue. At the very least, the text of the draft could be clarified to indicate whether this safe harbour is meant to be exhaustive or supplementary.

3.3 When is an expansion not an expansion?

Another of the measures in the draft will permit a trust to invest in any financial instrument that is a 'financial arrangement' as that term will be defined under the TOFA measures. This amendment is intended to expand significantly the current rules which permit trusts to invest in a variety of financial instruments listed in the legislation. Unfortunately, the apparent breadth of this expansion is significantly wound back by the exceptions contained in the draft. There are at least two exceptions worth attention here.

First, a trust cannot rely on the extended definition to invest in a financial instrument that relates to a specific asset and gives the investor the right to control the asset. One likely example of the operation of this exception is that trusts will not be able to rely on the extended definition to invest in certain property-linked notes – a property-linked note will provide the noteholder a return based on the performance of the property and gives the

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noteholder rights which might, in some cases, amount to 'control' of the property. Indeed, property linked notes are often issued by landholders in order to divest themselves of the income stream, expenses and responsibilities associated with the land – the noteholder steps into the shoes of the landholder for the term of the note. If the trust had simply bought the land, Division 6C would not apply; but if the trust buys the same rights and responsibilities in the form of a property-linked note it seems Division 6C is invoked.

A second exception prevents a trust from relying on the extended definition to invest in other trusts or partnerships. So trusts will not be able to rely on the new definition if they invest in managed funds or use a trust as the means of conducting a joint venture.

The result of the expansion is thus disappointing. It may well prove to be the case that current law – which already permits investment in the financial instruments specifically listed in the legislation and others that are 'similar' to those instruments – will prove a much broader investment power than the new test. As with the 25% safe harbour, the extension to all 'financial arrangements' as defined in TOFA will be an ineffective attempt to assist industry with a difficult issue.

And there are further problems. The expanded definition and the limitations it contains create a number of nuisance technical problems which will have to be resolved during the consultation process. For example, insuring an asset now seems to put a trust in jeopardy and leases to tax exempt or non-resident entities are also dealt with in an odd way. Happily, income from providing guarantees will now not put a trust in jeopardy, but the conditions attaching to this measure are difficult.

Another of these nuisance issues is the way the transitional rule has been expressed. Because the new regime is potentially narrower than current law, trusts are given the option not to apply the new rules. Unhappily, the current draft can be read in two ways – that a trust can opt out of the new rules permanently or a trust can opt out of the new rules until the end of the income year in which these measures receive the Royal Assent.

These kinds of technical difficulties are annoying, unnecessary and will need to be rectified.

Finally, it will be interesting to watch just how nimbly the Government can manage the 'paper shuffle' that its proposal will require. According to the Assistant Treasurer's Press Release, the permitted investments will extend to any 'financial arrangement' as defined in the yet-to-be-enacted TOFA measures. The draft does not explicitly refer to that unenacted definition which is a problem because there is already a definition of 'financial arrangement' in the tax legislation – it just happens to be different to the one they claim they want to use. So it will first be necessary to prevent that definition being invoked. Then it will be necessary to get the new definition enacted which will be no mean feat – TOFA has been 'in the pipeline' since 1983 so there is good reason to doubt that the TOFA definition can be enacted by the time that the Government wants to introduce these Division 6C changes – the Spring sitting, which starts on 26 August! Some fancy footwork will be needed.

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4. What's next

The Government is seeking submissions on the draft by 14 August 2008. Affected clients should consider taking up the invitation to make a submission.

While we have drawn attention to some of the problems with the current measures, there is also an unfinished agenda – several important issues raised in the consultation paper that should be resolved during this process have not been taken up in the draft legislation.

One example is the control test in Division 6C – that is, a trust will be subject to Division 6C if it controls an entity that conducts an active business. Despite the long discussion in the March paper about the difficulties in applying this test, Treasury appears not to want to address this, preferring instead to pass it off to the Board of Taxation's review. This especially disappointing, given that the 2% safe harbour rule only operates by examining the revenue of the trust, not the revenue of an entity controlled by the trust.

Greenwoods & Freehills has been heavily involved in the consultation process to date, both on the interim measures and the Board of Taxation's wider review. We will be communicating to the Government our concerns about the drafting of these measures and can assist affected clients in responding to this important measure.

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