

**Deemed capital gains tax
treatment**

This edition looks at the proposed 'capital election' to allow capital gains tax (CGT) to be the primary code for taxation of managed investment trusts (MITs) – and the changes that could result. This is the first of a number of MIT announcements expected to arise as a result of the Board of Taxation review.

Funds

Managing tax





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Welcome to the first edition of **Funds - Managing Tax**, providing you with insights into the very latest developments and industry issues. The inaugural **Funds - Managing Tax** looks at the proposed 'capital election' to allow capital gains tax (CGT) to be the primary code for taxation of managed investment trusts (MITs) – and the changes that could result. This is the first of a number of MIT announcements expected to come out of the Board of Taxation review.

Background

In 2008, the Australian Taxation Office (ATO) was working on a confidential draft Taxation Ruling dealing with the treatment of gains on the disposal of property by trusts. While the contents of the ruling were never publicly released, the ATO expressed an indicative view in National Tax Liaison Group (NTLG) meetings that was consistent with Taxation Ruling TR 2005/23 on listed investment companies (LICs). Taxation Ruling TR 2005/23 generally concludes that disposals of property by LICs are on revenue account rather than on capital account. If the ATO had released this view on MITs publicly, it could have had significant implications for the funds management industry; the ATO's view may have meant an investor would not have been entitled to the CGT discount for gains derived through an MIT.

In the May 2009 Federal Budget, the Government announced that it would introduce legislation to provide MITs with the opportunity to elect to apply CGT treatment exclusively to certain gains and losses. In June 2009 Treasury released a Discussion Paper setting out the general terms, scope and application of this measure as a basis for consultation on design and implementation.

Submissions to Treasury on the Discussion Paper were due by 10 July 2009. Deloitte made a submission, as did many industry bodies. We expect Treasury to release the draft provisions over the upcoming months as a public exposure draft.

On 21 July 2009, the ATO issued guidance on the administrative treatment the ATO will apply in the period between the Federal Budget announcement and enactment of the proposed measure. The ATO stated that it will not undertake specific compliance activity to enforce existing law during this period.

October 2009, No. 1
Funds – Managing Tax

For information about this newsletter, please contact:

Mark Ekkel

Tax partner

Tel: +61 (0) 3 9671 7436

mekkel@deloitte.com.au

Melbourne office

Tel: +61 (0) 3 9671 7000

Fax: +61 (0) 3 9671 7001

www.deloitte.com.au



Main features of the measure

The Discussion Paper details a proposal for a 'capital election' for a qualifying MIT to allow CGT to be the primary code for disposals of 'eligible assets'. The Paper includes two alternative approaches for determining 'eligible assets'.

Prescribed assets approach: Election only applies to eligible assets, (i.e. shares, units, property) as listed, with specific exclusions, (e.g. possibly units that have debt characteristics). The design of the press release - the title of the document and the discussion of 'eligible assets' in the body of the document - suggests that the provision may be limited to these assets.

Superannuation approach: Adopt similar approach to superannuation funds, with CGT provisions being the default position. This appears to be the commonly preferred position in submissions, as it ensures consistency with the approach taken by superannuation funds, and no arbitrage or disadvantage exists by investing through MITs. If this approach is adopted, it would mean that arrangements such as SPI future would probably receive CGT treatment (as is currently argued for superannuation funds).

The capital election should provide certainty about the treatment of gains and losses derived by MITs on the disposal of eligible assets. The changes should ensure MITs continue to hold assets on capital account, and that investors are entitled to CGT concessions on distributions of capital gains.

The capital election is to apply where *all* of the following are satisfied:

- The MIT is an eligible Australian MIT
- The gains and losses arise on disposal of eligible assets (e.g. shares, units, property)
- The disposal is an eligible disposal
- The trustee of the MIT makes or has made an irrevocable election to apply the CGT regime to all eligible disposals.

Potential outcomes of the measure

The measure is elective, allowing a choice to remain under the current law.

- The measure is elective and so gives MITs the ability to elect for CGT treatment or remain under the current law, which could instead result in revenue treatment
- The election would not remove every aspect that may give rise to revenue treatment for gains and losses arising from disposals. In particular, gains and losses arising from TOFA, the disposal of traditional securities and discounted securities may not change
- MITs with high turnover holding assets on revenue account may be able to move to capital account by making the election, and so obtain CGT benefits, such as the CGT discount. This should enhance the commercial attractiveness of such MITs. In extreme circumstances, where investments are held as trading stock, the CGT election would not be available
- Fund managers need to be less conscious of the effect of high turnover on the capital treatment of the Fund (however, the 12 month rule should still be a relevant factor in trading decisions)
- This measure may also provide certainty for MITs in qualifying for certain CGT roll-over elections, (e.g. scrip for scrip), which may now allow MITs to undertake various restructuring arrangements without necessarily giving rise to immediate gains and losses
- The deemed capital treatment would mean that any losses that are realised on the disposal of investments would be capital losses and would need to be quarantined where they exceed capital gains, (e.g. cannot be used against dividends, interest, rent, etc). A practical consequence is that fund managers may now be able to distribute amounts that they previously could not.

Trusts that are MITs

To be eligible for the capital election, the relevant trust must be an MIT for the whole of an income year and the unit trust must not be a trust taxed like a company (that is a corporate unit trust or public trading trust).

The Discussion Paper suggests that a unit trust will broadly be an Australian MIT where *all* the following conditions are satisfied at the time of the first fund payment for the income year is made:

- The trust has a relevant connection with Australia
- The trust must satisfy certain requirements of the *Corporations Act 2001*
- The trust is either listed or widely held.

The concept of an Australian MIT is similar to that used in the current MIT withholding rules. For the widely-held requirement, however, the Discussion Paper proposes to remove life insurance companies from the list of entities that are relevant members.

Wholesale trusts owned by MITs

The Discussion Paper suggests that a resident wholesale trust can qualify for the CGT election, provided that both conditions are met:

- The trust is owned by one or more eligible MITs
- The trust carries on an eligible investment business (under the current rules in Division 6C).





A resident wholesale trust may qualify for the CGT election, provided they are owned by one or more eligible MITs and carry on an eligible investment business.

Wholesale trusts should continue to monitor the definition of an MIT for the purposes of the election, as they may technically be ineligible to make the election.

For wholesale trusts, their eligibility to access the measure is welcome, given that such trusts are not listed or directly widely held and are also not carrying on managed investment schemes. In practice, wholesale trusts may not be regulated under the *Corporations Act 2001*, and so technically may not be eligible for the election. Accordingly, the definition of an MIT for the purposes of the election should continue to be monitored for wholesale trusts.

Submissions have been made by industry bodies that MIT status should be extended to a broader range of entities.

For example, it is not certain whether the 'superannuation' method will be used or whether Treasury will opt for a specific asset methodology and the impact of the preferred approach on the treatment of options and futures. Submissions have argued that funds should not be required to revisit 2009 distributions because of positions taken. It is hoped that the legislation will also resolve the issue of certainty for prior year MIT returns. For example, if an MIT elects into the capital account regime, it is reasonable to expect that prior year returns should not be open to amendment by the ATO.

ATO administrative treatment

The ATO has stated it will not undertake specific compliance activity to enforce existing law during the period between the Federal Budget announcement and the enactment of the new measure. Once the changes become law, the ATO suggest taxpayers review the actions they have taken.

Industry bodies argue MIT status should be extended to a broader range of entities.

For example, the Property Council of Australia, in its submission, argues that trusts that are not registered under the *Corporations Act 2001*, trusts owned by listed trusts and sovereign wealth funds should also be included as MITs. Deloitte's submission also argues that the election should be available to other collective investment vehicles, such as listed investment companies and foreign hybrid entities that have elected to be treated as flow-through entities.

Commencement – mandatory 2008/09 start date if election is made

The new measure is intended to apply retrospectively to all disposals of eligible assets in the first income year that commences on or after the 2008-09 income year. For existing MITs, the first income year will be 2008-09. This retrospective start date appears to be an integrity measure to prevent MITs 'cherry picking', such as triggering realisations so as to retain revenue treatment for losses before making the election. The retrospective start date also means many MITs are currently undertaking distributions for the 30 June 2009 year with many uncertainties about how this measure will apply once the legislative details are released.

Taxpayers who

- Anticipated the change correctly will not need to take further action
- Followed the existing law should seek an amendment of their returns once the law is enacted
- Did not anticipate the change correctly will need to amend existing assessments.

The ATO also suggests no tax shortfall penalties will be imposed if a taxpayer acted reasonably in anticipating the change, and if they actively amended their return in a reasonable time, the ATO will remit the general interest charge. Otherwise, the general interest charge will start to accrue from the date the measure becomes law.

Although aspects of the ATO's administrative treatment are welcome, in practice funds are seeking certainty for the 30 June 2009 year, so that amendments are not required at all. If amendments are required, this is likely to have a significant administrative impact on funds and their investors.

One of Deloitte's submission points has been that Treasury should specifically legislate that the position taken by MITs in the 30 June 2009 year (and prior years) will not be able to be amended by the Commissioner on the matter of capital versus revenue.

Action required:

- Monitor the outcome of submissions and final announcements, (e.g. in relation to the treatment of SPI futures and options)
- Critically assess whether to make the election, particularly for funds with hedging arrangements
- Consider communication to investors of this measure and likely impact on the tax treatment of their investment
- Considering the impact of this measure on 2009 distributions, and possible post distribution impact once the legislation is finalised, (e.g. treatment of SPI futures)
- Assess the combined impact of the CGT election with TOFA (where arrangements are on revenue account)
- Critically assess whether the proposed MIT eligibility requirements are satisfied
- Determine which investments may not be covered by the proposed election and the impact of this, such as traditional securities
- As the election is irrevocable, consider appropriate Board minute and/or other documentation required to support the election
- Consider changes that may be required for reporting purposes, such as systems and updating of tax policy manuals, particularly for fund managers that have certain funds that may make the election and other funds that may not
- Consider if amended returns may be required and the impact for investors, having reviewed distribution and tax return information for the 30 June 2009 year.

Contacts

Melbourne



Neil Ward
Tel +61 (0) 3 9671 7444
email: nward@deloitte.com.au



Mark Ekkel
Tel +61 (0) 3 9671 7436
email: mekkel@deloitte.com.au



Helen Fisher
Tel +61 (0) 3 9671 7592
email: hfisher@deloitte.com.au



Patrick Broughan
Tel+61 (0) 3 9671 6606
email: pbroughan@deloitte.com.au



Ryan English
Tel +61 (0) 3 9671 6774
email: english@deloitte.com.au



Peter Bourke
Tel +61 (0) 3 9671 7649
email: pbourke@deloitte.com.au



Colin Fernandez
Tel +61 (0) 3 9671 7765
email: cofernandez@deloitte.com.au

Sydney



Adele Watson
Tel +61 (0) 2 9322 7752
email: awatson@deloitte.com.au



Joe Galea
Tel +61 (0) 2 9322 7591
email: jgalea@deloitte.com.au



Max Persson
Tel +61 (0) 2 9322 7538
email: mpersson@deloitte.com.au



John Giannakopoulos
Tel +61 (0) 2 9322 7827
email: jgiannakopoulos@deloitte.com.au

Perth



Anthony Cipriano
Tel +61 (0) 8 9365 7110
email: acipriano@deloitte.com.au

Adelaide



John Rawson
Tel +61 (0) 8 8407 7158
jrawson@deloitte.com.au

Brisbane



John Bland
Tel +61 (0) 7 3308 7275
email: jbland@deloitte.com.au

Hobart



Tim Maddock
Tel +61 (0) 3 6237 7065
email: tmaddock@deloitte.com.au

Contact us

Deloitte
550 Bourke Street
Melbourne, Victoria
Australia

Tel: + 61 (0) 3 9671 7000

Fax: + 61 (0) 3 9671 7001

www.deloitte.com.au

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