



File Name: 200813

Mr Raphael Cicchini
Manager Trusts
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

14 March 2008

Dear Raphael,

SUBMISSION ON INDUSTRY CONSULTATION PAPER: POTENTIAL CHANGES TO THE ELIGIBLE INVESTMENT RULES FOR MANAGED FUNDS, INCLUDING PROPERTY TRUSTS

The Association of Superannuation Funds of Australia (ASFA) would like to take the opportunity to advise that it supports the broad principles underlying the Board of Taxation examination of options for a managed investments tax regime in Australia.

ASFA also supports the streamlining and simplification of the operation of Division 6C as an interim step within this broader review.

Attached please find a submission prepared by the ASFA in response to the consultation paper prepared by the Commonwealth Department of the Treasury, entitled "Potential changes to the eligible investment rules for managed funds, including property trusts".

The submission focuses on those aspects of the paper directly affecting superannuation entities, primarily:

- Application of the "20% rule" to superannuation entities;
- Review of the definition of "eligible investment business" in light of developments in passive investment by superannuation entities; and
- Technical issues with the present legislation insofar as these affect superannuation entities.

Should you have any queries on the content of the submission please contact our Principal Policy Adviser, Robert Hodge, on (02) 9264 9300.

Yours sincerely,

Dr Brad Pragnell
Director Policy and Best Practice

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

The Association of Superannuation Funds of Australia

Submission

Potential changes to the eligible investment rules for managed funds, including property trusts

14 March 2008

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

CONTENTS

1. Executive summary	4
2. Application of the “20% rule” to superannuation entities.....	4
3. “Eligible investment business”	6
3.1 Nature of present investments undertaken by the superannuation industry ..	6
3.2 “All or nothing” aspects	8
4. Technical issues	8
4.1 Usage of two or more trusts - interpretation of section 102N of ITAA36	8
4.2 Potential reach of section 102N	9
4.3 Absence of a Commissioner discretion	10

1. Executive summary

The Association of Superannuation Funds of Australia (ASFA), as the peak body for the Australian superannuation industry, strongly supports the broad principles underlying the Board of Taxation's examination of options for a managed investments tax regime in Australia, and the streamlining and simplification of the operation of Division 6C as an interim step within this broader review.

Australian superannuation entities may be affected by these issues either directly, in respect of internal structures established to undertake specific activities, or indirectly, through the substantial investments held by superannuation entities in Australian managed funds.

ASFA's comments on the Consultation Paper are grouped under 3 headings:

- Examination of the policy basis for the inclusion of superannuation entities in the "20% test" in section 102P of the Income Tax Assessment Act 1936, as amended (ITAA36);
- The present limitations and issues associated with the definition of "eligible investment business" in section 102M of ITAA36, in light of developments since 1984 in the types of investments undertaken by superannuation entities; and
- Other technical issues associated with the operation of Division 6C of ITAA36 relevant to superannuation entities.

We note that the potential changes to Division 6C of ITAA36 are merely "an interim step while the Board of Taxation undertakes its deliberations" in respect of a broader review.

ASFA stresses that the comments made in this submission are in respect of this interim review and may not be relevant, or may need modification, should the outcome of the broader review significantly change the present taxation regime for managed investment trusts generally.

ASFA requests that its comments within this submission be read in this context.

2. Application of the "20% rule" to superannuation entities

As noted on page 7 of the consultation paper, Division 6C applies:

"...where one or more persons or bodies exempt from income tax (including governments and complying superannuation entities (our underlining)) holds units in a trust carrying entitlement to 20 per cent or more of the beneficial interest in the income or property of the trust..."

The Government inserted Division 6C into ITAA36 by passage of Act No 173 of 1985. At this time, complying superannuation entities were exempt from income tax, pursuant to then section 23F of ITAA36.

Complying superannuation entities commenced to be taxpayers on 1 July 1988.

In the present Division 6C, complying superannuation entities are the only taxpaying entities listed in the definition of "exempt entity" in section 102M of ITAA36 (and thereby subject to the "20% rule" in section 102P).

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

In part at least, this would appear to be an accident of history. An ASFA concern is that the Government has not formally enunciated the policy reasons for the continued inclusion post 1 July 1988 of complying superannuation entities as an “exempt entity”.

As noted on page 3 of the consultation paper, the broad policy basis for Division 6C is that:

“managed funds should not be actively involved in trading businesses because of competitive neutrality”

There would appear to be no clear basis for the extension of the competitive neutrality argument to trusts owned wholly by one superannuation entity, or by a small pool of superannuation entities. The provisions of the Superannuation Industry (Supervision) Act 1993, as amended (SIS), and in particular, section 62 of SIS (the “sole purpose test”), would appear to address all relevant issues in respect of the direct conduct of trading businesses by superannuation funds.

If policy makers have concerns with activities by superannuation funds in this regard, it is ASFA’s view that such issues are best addressed as prudential matters within SIS, rather than within income tax legislation.

In any case, since complying superannuation entities became taxable, the operation of Division 6C does not deliver the desired competitive neutrality position. This is because the effective tax rate on the Division 6C trust owned by a superannuation fund or funds remains at 15%, after the trust makes (fully franked) distributions of its after-tax income to the unit holders. The only additional tax imposts are typically the loss of the one-third discount on capital gains, and loss of access to the benefits from certain tax deferred amounts and foreign tax credits.

Indeed, the key present impact of Division 6C to complying superannuation entities in respect of closely held unit trusts is the additional administration issues associated with:

- Annual determination as to whether the trust is subject to Division 6C or not;
- Potential confusion within the Australian Taxation Office when the trust files returns in some years as a trust and others as a company (following this determination);
- Maintenance of franking account for the trust; and
- Preparation of advice to unit holder(s) in respect of the deemed “dividend” that would otherwise be a distribution, and of any attached franking credits.

Absent the enunciation by Government of clear policy reasons for the ongoing inclusion of complying superannuation entities in the definition of “exempt entity” in section 102P of ITAA36, ASFA considers that the application of Division 6C to complying superannuation entities should be on the same basis as that for other taxpayers, that is, where the normal “widely held” tests in that section are satisfied.

If this were done, the only time Division 6C would affect complying superannuation entities would be in respect of managed funds where the units were held by 50 or more persons (with any particular superannuation fund counting as one person).

On this basis, the Division 6C rules would not apply to trusts wholly owned by a single complying superannuation entity, or by a small group of complying superannuation entities. The SIS legislation would continue to provide the basis to address any issues in respect to the conduct of trading businesses (for example, the extent of Board and management time

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

within the complying superannuation entity occupied by management issues associated with the trust and its business).

Recommendation 1

ASFA recommends that, as part of the present review, the Government enunciate the policy reasons for the continued inclusion of complying superannuation entities in the definition of “exempt entity” in section 102P of ITAA36.

Recommendation 2

In the absence of a sound policy reason, ASFA submits that the application of Division 6C to complying superannuation entities should be on the same basis as that for other taxpayers, that is, where the normal “widely held” tests in that section are satisfied.

3. “ELIGIBLE INVESTMENT BUSINESS”

3.1 Nature of present investments undertaken by the superannuation industry

As noted in section 2, the Government inserted Division 6C into ITAA36 in 1985, more than 20 years ago.

During this period the size and nature of Australia’s superannuation industry has changed virtually beyond recognition. For example, the entire industry fund sector did not exist in 1985, and the combined assets of complying superannuation entities in Australia are now more than \$1 trillion. Some individual superannuation funds are required to invest more than \$200 million in new moneys monthly.

As the large funds have grown, the nature of investments undertaken has also changed. ASFA considers that this trend is likely to continue into the future, as the assets under management by funds continue to increase, and as the global marketplace introduces new types of investments in response to market demands.

Due to the prudential requirements within SIS, many of the newer types of investments cannot be directly held by a complying superannuation entity. Therefore, it has become common for these entities to establish wholly owned or closely held unit trusts in which to undertake the investment.

Examples of present investments held by complying superannuation entities through unit trust vehicles include:

- 1 Agricultural land, where relevant State Government legislation now separates a variety of “water rights” associated with the land as a separate legal asset from the land;
- 2 Water rights acquired without acquiring any associated land, where those water rights are then leased to other entities for moneys economically equivalent to “rent”;
- 3 The holding of “carbon rights” or “carbon credits” as part of the broader holding of certain land (for example, forestry land). Depending on the design of any Commonwealth and/or international systems for carbon trading, instances

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

may arise in future of other carbon-related assets that funds may be able to purchase for which passive income may be obtained.

- 4 Development of land, including road works and other facilities, and construction of housing stock or other buildings, for the long term ownership and rental by the unit trust of the resultant housing or other buildings (this may become more and more relevant in respect to the industry's response to the Government's measures to encourage building and investment in affordable rental accommodation);
- 5 Investments in foreign or domestic limited partnerships that, whilst treated as "deemed" investment in companies, may not strictly satisfy the definition of "shares in a company" in paragraph (b)(iii) of the definition of "eligible investment business" in section 102M of ITAA36;
- 6 Investments in fixed trusts in Australia or overseas, that may not strictly satisfy the definition of "units in a unit trust" in paragraph (b)(iv) of the definition of "eligible investment business" in section 102M of ITAA36;
- 7 Infrastructure assets, still involving the long-term passive ownership of land, or fixtures on land, where the revenue generated is from tolls or licences rather than rent per se;
- 8 Investment in certain property assets, for example, car parks, where the nature of the revenue stream is not rent but licence fees or similar;
- 9 Investment in intellectual property, where the rights to use that property are then provided to other entities for royalties or similar passive income streams;
- 10 Investments with similar commercial effect to any of these, where the investor remains broadly in a passive capacity in respect of the investment and has no influence in the day-to-day decision making pertaining to any business activities that may attach. For example, the difference between the landlord of a building charging a licence fee to the car park operator (wholly passive) versus the car park operator itself (potentially active).

In all such cases, the present definition of "eligible investment business" in section 102M may prohibit unit trusts from undertaking part or all of these investments without Division 6C applying to the trusts.

This is so, notwithstanding that the nature of the assets actually owned by the relevant unit trust are fundamentally passive in the same manner as the existing items in that definition.

Recommendation 3

ASFA recommends that the definition of "eligible investment business" be updated to reflect the types of passive investments presently undertaken by trusts used within the superannuation industry, and that the scope of the new definition either:

- Be framed broadly so as to contemplate likely future investments by the industry (such as "carbon rights"); or
- Be monitored annually, and modified following industry submissions that demonstrate the relevance of new passive investment types.

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

3.2 “All or nothing” aspects

In order for Division 6C to not apply, it is required that the business undertaken by the particular trust consists wholly of eligible investment business. This conclusion results from the definition of “trading business” within section 102M of ITAA36.

This leads to an “all or nothing” aspect to the present rules that may be inappropriate in the context of investments presently undertaken or contemplated by the superannuation industry.

For example, if a trust undertakes some re-development of a building that it nonetheless intends to hold into the longer term, there is the risk that this activity may not satisfy paragraph (a) of the definition of “eligible investment business”.

Similarly, if a trust were to undertake a broad acres development, and sell a small portion of the resultant buildings (for example, affordable housing stock), whilst nonetheless retaining the bulk of the development for long-term rental, it is unlikely that this combination of activities would satisfy the definition.

In this context, some modification of the present definition of “trading business” would appear appropriate, so as to allow some degree of non-eligible activities to be undertaken within a primarily passive investment framework.

ASFA is aware that representatives of some other industries propose a 25% test in this regard.

ASFA does not have a view on the specific percentage, but considers that any test needs to be simple to apply and not result in significant compliance costs. ASFA is aware that similar tests in the United States REIT regime incur significant compliance costs, and is a key factor why many investment opportunities in real estate in the United States offered to Australian superannuation funds are through limited partnerships. This is the case even though the REIT regime may produce a simpler taxation outcome for Australian investors, including greater certainty in respect to foreign tax credits for related US taxes.

ASFA considers that it would not be appropriate, and indeed would be counter-productive, to establish rules where the compliance costs become a significant factor in the decision by Australian property or other relevant trusts to undertake particular activities within trusts.

Recommendation 4

ASFA recommends that some modification of the present definition of “trading business” be made, so as to allow some degree of non-eligible activities to be undertaken within a primarily passive investment framework.

Additionally, ASFA requests that any such modification be designed so as to avoid compliance costs that would be an impediment to actual usage.

4. TECHNICAL ISSUES

4.1 Usage of two or more trusts - interpretation of section 102N of ITAA36

Due to the present application of Division 6C to superannuation entities, it is not unusual for funds to implement structures that split an overall investment activity into two trusts where it is considered there is risk that one or more of the elements of the overall activities may not satisfy the definition of “eligible investment business”.

For example, a superannuation entity that wishes to appoint a manager to undertake forestry activities on its behalf might structure these activities as follows:

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

- The ownership of the land would be purchased in Trust 1 (the “passive” trust); and
- The forestry activities would be conducted through Trust 2 (the “active” trust).

The passive trust would rent the land to the active trust, incur any relevant costs of land ownership, and derive the eventual capital gain on the disposal of the land (perhaps after many years ownership, and after several crops of trees are obtained by the active trust). The active trust would derive all other income, including sales of trees, and incur all operational costs.

Prima facie, the passive trust would be entitled to be taxed as a trust, and Division 6C would apply to the active trust.

However, where a single superannuation fund owns both trusts, it might not be unusual for the same trustee company to be appointed as the trustee of both trusts.

On a strict reading of the provision, if the same trustee is used, present section 102N of ITAA36 would result in the application of Division 6C to the passive trust. However there is a strong argument for an alternative view that the reference to “trustee” in that section can be interpreted in respect to the separate capacities in which the trustee acts. Whilst the above type of structure may be common, the application of such a “capacity” argument is far from clear and requires clarification.

Recommendation 5

ASFA recommends that ITAA36 section 102N be amended, or that publicly available guidance be provided, to clarify whether the reference to “trustee” in that section may be interpreted in respect of the separate capacities that a trustee may perform.

4.2 Potential reach of section 102N

As noted in section 3, it is not unusual for Australian superannuation funds to invest in limited partnerships and similar vehicles both in Australia and overseas.

The nature of these investments is such that the general partner is typically responsible for all of the day-to-day decisions pertaining to the partnership, and that the investment is a wholly passive one from the perspective of the Australian superannuation fund or Australian managed fund investor.

Nonetheless, it is possible that the nature of the activities within the partnership may not strictly comply with the requirement that the trust not conduct a trading business. This would result in the application of Division 6C in circumstances where the Australian trust has no real capacity to influence the partnership or similar vehicle, nor to participate in any decision making relating to potential trading activities that may be undertaken within the partnership or similar vehicle.

Recommendation 6

ASFA recommends that consideration be given to amendment of ITAA36 section 102N to limit its application to situations where the Australian trust has the actual capacity to influence the partnership or similar vehicle, or to participate in any decision making relating to potential trading activities that may be undertaken within the partnership or similar vehicle.

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798

4.3 Absence of a Commissioner discretion

In the commentary on both sections 3 and 4, it is clear that circumstances can occur where the potential application of Division 6C is not clear.

A current example is where trusts may have acquired land at a time when water rights attached to the land, but where the water rights are now a separate asset. In these circumstances, the trust may be uncertain whether it can continue to own the water rights or whether it needs to dispose of the rights to a separate entity to avoid triggering Division 6C.

The availability of a Commissioner discretion to not apply Division 6C would be beneficial in these and other potential circumstances where there may be a gap between the evolution of types of investments and the strict definitions of “eligible investment business”.

Such a discretion could also be useful in cases where the trust’s activities inadvertently breached the strict provisions, or breached the provisions for a short period only and prior to rectification.

Recommendation 7

ASFA recommends that a Commissioner discretion be inserted into Division 6C to provide an avenue for relief where legislation changes the nature of the assets owned by trusts, or where the offending activities were inadvertent (subject to a possible requirement to rectify within a specific timeframe).

SECRETARIAT

Piccadilly Tower
Level 19
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T + 61 2 9264 9300

F + 61 2 9264 8824

outside Sydney
1800 812 798