

24 December 2009

General Manager
Business Tax Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear General Manager

Re: Release of draft legislation

Tax treatment of managed investment trusts disposals

The Association of Superannuation Funds of Australia (ASFA) is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. Our members include corporate, public sector, industry and retail superannuation funds plus service providers who provide professional services to SMSFs, account for more than 5.7 million member accounts and over 80% of superannuation savings.

ASFA welcomes the opportunity to respond to the release of the draft legislation and associated draft explanatory memorandum, and to contribute to the development of an outcome that will provided investors in managed investment trusts with certainty as to the treatment of gains accruing on their investments.

BACKGROUND

In August 2008, ASFA raised the issue of the appropriate tax treatment of gains in managed investment trusts with the Assistant Treasurer as it had come to our attention that the Australian Taxation Office (ATO) was considering producing a ruling dealing with the following question:

Income Tax: does it follow that merely from the fact that an investment has been made by a trustee, including the trustee of a managed investment fund, that any gain or loss from the investment will be on capital account?

ASFA's concern was that the mere fact that the ATO was asking this question indicated that there existed within the ATO a view that either in all cases or in a broad range of situations a managed investment trust is not entitled to treat gains and losses on capital account.

ASFA noted that, if CGT treatment was not available within all or particular Managed Investment Trusts ("MITs"), this would seriously impair competitive neutrality between larger superannuation funds (which are able to appoint investment managers through direct mandates) and smaller and medium-sized funds (which may only be able to obtain exposure to certain asset classes through MITs).

In response to the concerns raised by ASFA and more broadly in relation to potential changes in long-standing treatment of MITs by the ATO, the Government announced in the 2009 budget that it

would allow MITs to make an irrevocable election to treat gains and losses on disposal of eligible investments in shares, units in unit trusts and real property on capital account for taxation purposes.

The Government released a discussion paper in relation to this announcement, and ASFA made a submission on 10 July 2009 as part of the consultation process following this release.

On 10 December 2009, the Assistant Treasurer released draft legislation and associated draft explanatory memorandum in relation to the proposed measures.

ASFA welcomes and supports these measures.

However, ASFA notes that there are certain issues in the draft legislation of particular relevance to the superannuation industry, which if not amended, would detract from the Government's stated policy objectives of greater certainty for, and competitive neutrality between, investments in MITs by superannuation funds.

In the following section ASFA sets out four issues that are of immediate concern to the superannuation industry. The four issues are followed by a suggested simpler approach to the drafting of the legislation which may facilitate the granting of additional relief to superannuation funds whilst retaining the integrity of the proposal. Finally, the question is raised as to whether, on grounds of competitive neutrality, the relief should be extended to listed investment companies.

COMMENTS ON THE DRAFT LEGISLATION

Issue one: trusts that are 100% owned by a single large superannuation fund

In its submission of 10 July 2009, ASFA noted that there are numerous and increasing circumstances where a large superannuation fund will establish a 100% owned trust to hold a particular investment or group of investments. A superannuation fund typically will do this for reasons of management of specific regulatory or commercial risks.

For example, some foreign limited partnerships allow for the partnership to borrow, and a risk exists that APRA may determine that direct investment by a superannuation fund is in breach of the general prohibition in the *Superannuation Industry (Supervision) Act* against borrowing by superannuation funds. A superannuation fund may address this risk by interposing a 100% owned Australian unit trust between it and the investment in the foreign limited partnership.

ASFA noted concerns in the application of the approach in the discussion paper, and submitted that the group of eligible Australian MITs that can access the election be expanded to include a wholly owned trust of a complying APRA-regulated superannuation entity that has more than 50 members, or a trust owned wholly by a group of such APRA-regulated superannuation funds.

The Government has responded to these concerns within the draft legislation, through the extension of the concept of MIT to entities wholly owned by large superannuation funds and/or other MITs.

However, ASFA notes that the requirement in proposed section 275-5(1)(b) and 275(2)(b) that the trustee of the trust be a financial services licensee (as defined by section 761A of the *Corporations Act 2001*) may still create difficulties in many common current superannuation fund structures.

The trustee of a large superannuation fund is a financial services licensee, and thus would satisfy this condition. However, the trustee of the 100% owned trust is often neither the same entity as the trustee of the superannuation fund nor a subsidiary of that entity.

Whilst a trust in these circumstances may very well satisfy the conditions in ordinary tax principles for treatment on capital account, ASFA considers that it is inconsistent with the policy objectives of the measures that a trust that is 100% owned by a large superannuation fund is required to revert to ordinary tax principles to obtain capital treatment. This creates the potential for the very uncertainty that the measures are designed to ameliorate.

ASFA considers that the Government should amend the draft legislation to extend the certainty of taxation treatment to all Australian resident unit trusts wholly owned by large superannuation entities, and that the requirement that the trustee of the trust be a financial services provider is unnecessary in these circumstances.

Importantly, this would provide the trustees of such trusts with the opportunity to remove any doubt in respect of capital treatment, and thus would provide tax neutrality for superannuation entities between investing through a wholly owned subsidiary trust and an Australia MIT.

Issue two: trusts that are 100% owned by a small group of large superannuation funds

In addition to trusts that are 100% owned by a single large superannuation fund, it is not uncommon for a small group of large superannuation funds to form an Australian resident trust to pool the moneys required for a particular investment.

Again, it is possible that the trustee of such a trust is not a financial services licensee (albeit that the trustee of each and every unit holder is such a licensee).

Again, whilst a trust in these circumstances may very well satisfy the conditions in ordinary tax principles for treatment on capital account, ASFA considers that it is inconsistent with the policy objectives of the measures that a trust that is 100% owned by a small group of large superannuation funds is required to revert to ordinary tax principles to obtain capital treatment. This creates the potential for the very uncertainty that the measures are designed to ameliorate.

ASFA considers that the Government should amend the draft legislation to extend the certainty of taxation treatment to all Australian resident unit trusts wholly owned by large superannuation entities, and that the requirement that the trustee of the trust be a financial services provider is unnecessary in these circumstances.

Importantly, this would provide the trustees of such trusts with the opportunity to remove any doubt in respect of capital treatment, and thus would provide tax neutrality for superannuation entities between investing directly or via a trust.

Issue three: application of the MIT election to “eligible assets”

Where an MIT is entitled to make the election in proposed section 275-20, then pursuant to proposed section 275-10(1)(d), the certainty of capital treatment applies only to the disposal of assets covered by proposed section 275-15.

Proposed section 275-15 covers only assets consisting of shares in companies, units in unit trusts, land or interests in land, or rights to acquire any of these.

In ASFA's view, the restriction of the MIT election to this relatively narrow range of assets means that the certainty of capital treatment is not extended to the assets held by many trusts 100% owned by a single large superannuation fund, or by a small group of large superannuation funds. For example, assets that potentially may not be covered include (a non-exhaustive list that may grow as commercial practices change in future years):

- Interests in limited partnerships (both foreign or domestic);
- Water rights;
- Carbon rights; and
- Directly-held infrastructure assets not consisting of interests in land.

Again, as with issue one above, a trust may be able to satisfy the conditions in ordinary tax principles for treatment on capital account in respect of the disposal of such assets.

However, ASFA considers that it is inconsistent with the policy objectives of the measures that a trust that is 100% owned by a large superannuation fund or small group of large superannuation funds is required to revert to ordinary tax principles to obtain capital treatment for any assets presently covered by the broad "capital code" rule for superannuation funds in present section 295-85. This creates the potential for the very uncertainty that the measures are designed to ameliorate.

ASFA considers that the limitation in proposed section 275-10(1)(d) should not apply to trusts that are 100% owned by a large superannuation fund or small group of large superannuation funds.

Issue four: Division 6B and Division 6C exclusion

Where an MIT is entitled to make the election in proposed section 275-20, then pursuant to proposed section 275-10(1)(e), capital treatment does not apply to trusts that are corporate unit trusts (pursuant to Division 6B of the *Income Tax Assessment Act 1936* ("ITAA36")) or public trading trusts (pursuant to Division 6C of ITAA36).

In ASFA's view, this condition would appear to be redundant in the case of trusts that are wholly owned by a single large superannuation fund or group of large superannuation funds.

Where a trust that is 20% or more owned by superannuation funds undertakes activities that are not within the meaning of "eligible investment business" in section 102M of ITAA36, that trust is taxed akin to a company pursuant to Division 6C of ITAA36. This "20% rule" is set out in section 102P of ITAA36.

A trust taxed pursuant to Division 6C of ITAA36 is still entitled to treat certain disposals on capital account (in the same way and in the same circumstances that an actual corporate entity is so entitled). Unlike an actual corporate entity, a trust taxed pursuant to Division 6C of ITAA36 nonetheless is entitled to claim the CGT discount on capital gains. However, such a trust has no mechanism for passing on the benefit of any such CGT discount to the superannuation fund unit holders, as any such distribution will be treated akin to the payment of an unfranked dividend.

ASFA considers that there remains a broader question as to whether the 20% rule in Division 6C should continue to include superannuation funds. ASFA notes that:

- All other entities subject to the 20% rule are exempt from tax, whereas superannuation funds are subject to tax (albeit at concessional rates);

- The inclusion of superannuation funds as entities subject to the 20% rule dates back to 1984, that is, to a time when superannuation funds were also exempt from tax; and
- The Government has never publicly announced the policy reasons (if any) for the retention of superannuation funds within the 20% rule.

ASFA has written submissions in relation to this issue as part of the broader review of the taxation of managed investment trusts, but notes that these issues are outside the scope of the present draft legislation.

Relevant to the present draft legislation, however, ASFA considers that, based on present legislation, there would appear to be no integrity or other issues associated with the availability of the MIT election for capital treatment for a corporate unit trust or public trading trust wholly owned by a large superannuation fund or group of large superannuation funds.

For example, if a public trading trust wholly owned by a single superannuation fund were to make the MIT election, and subsequently derive a capital gain from the disposal of one of its assets, it would be unable to flow through any benefits from capital treatment to the superannuation fund unit holder.

An alternative legislative approach?

In ASFA's view, a simpler approach may be to have two groups of entities to which the MIT election applies:

- Category 1 Australian resident trusts wholly owned by a single large superannuation fund, or by a group of large superannuation funds; and
- Category 2 Other Australian resident trusts.

The legislation could then simply address issues one and two above by extending the MIT election universally to all trusts in category 1, whilst applying the limits in the present draft legislation to all trusts in category 2. In such an approach, the present conditions such as requirement for the trustee of the trust to be a financial services licensee would not apply to a category 1 trust.

Similarly, the legislation could then simply address issue three and four above by applying a rule that, for category 1 trusts, the MIT election applies to all assets covered within present section 295-85. This would ensure that revenue treatment would apply only to those assets where revenue treatment would have applied if a large superannuation fund or funds had directly held the asset. It would also ensure that the present inability to flow through the benefits of capital gains treatment by corporate unit trusts and public trading trusts to superannuation fund unit holders would be maintained.

In this regard, ASFA notes that the rules in section 295-85 of ITAA97 (and in their former guise within the 1936 Act) have existed for many years, and thus their operation is well understood by all relevant industry participants.

In ASFA's view, such an approach would be more consistent with the broad policy objectives of the measures, that is:

- Competitive neutrality between investors holding investments directly versus through trusts; and

- Greater certainty for investors in the application of capital treatment on disposals in a variety of common commercial structures.

Extension of the relief to other entities

ASFA notes that the Budget announcement, the Discussion Paper, and now the draft legislation, deal only with MITs at this stage.

However, ASFA also notes that many superannuation funds invest via pooled vehicles that are not MITs. In particular, listed investment companies (“LICs”) have considerable popularity as vehicles to obtain exposure to certain asset classes.

ASFA would support the extension of the election available to MITs to LICs in equivalent circumstances. The present uncertainty within MITs in respect to whether particular investment strategies or levels of turnover give rise to CGT versus revenue treatment is, if anything, even greater in the case of LICs.

Competitive neutrality considerations would suggest that measures should be introduced to also address this uncertainty for LICs. If this were done, it is possible that LICs may provide greater competition to MITs, and such competition should apply downwards pressure on investment management fees.

If you have any further queries, please do not hesitate to contact Robert Hodge, principal policy adviser, on 02 8079 0806 or by email: rhodge@superannuation.asn.au

Yours sincerely

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