



TECHNICAL UPDATE

MANAGED INVESTMENT TRUST TAX REFORMS - DISCUSSION PAPER RELEASED

▶ ON 18 OCTOBER 2010, THE ASSISTANT TREASURER RELEASED A DISCUSSION PAPER ON THE DESIGN AND IMPLEMENTATION OF THE NEW INCOME TAX SYSTEM FOR MANAGED INVESTMENT TRUSTS (MITs). THE DISCUSSION PAPER FOLLOWS THE GOVERNMENT'S ANNOUNCEMENT OF ITS PLAN TO UPDATE THE TAXATION TREATMENT OF MITs ON 7 MAY 2010.

The Discussion Paper outlines a number of principles that will guide the design of the proposed new laws, and calls for feedback from stakeholders on the issues and questions raised in the Discussion Paper.

The changes to the MIT regime outlined in the Discussion Paper are proposed to commence from 1 July 2011, and will include a number of key reforms.

Choosing the "attribution" system of taxation

Trustees of MITs will be able make an irrevocable choice to use an "attribution" system of taxation, instead of using the present entitlement system which currently applies.

Under the attribution system, the trustee will attribute the taxable income of the trust to beneficiaries on a "fair and reasonable basis" consistent with their rights and entitlements under the trust's constituent documents and the duties of the trustee. Beneficiaries would be assessed on the amount that is attributed to them by the trustee. Taxable income that is not attributed to beneficiaries will be taxed to the trustee at 46.5 per cent (unless the income is subject to the "unders and overs" rule below).

Beneficiaries would have rights of objection and review against an assessment if the attribution of taxable income was not on a fair and reasonable basis.

Clearly defined rights/entitlements as a pre-requisite for choosing the attribution system

Importantly, the Discussion Paper states that as a precondition for eligibility to apply the attribution method of taxation, the MIT will need to satisfy a "clearly defined rights" requirement, such that the tax liabilities in relation to the MIT's taxable income can be determined for each beneficiary.

SECTOR

Corporate & International Tax

CONTACT

GREG THOMPSON

National Tax Technical Director

Tel: +61 3 8320 2102

Email: greg.thompson@bdo.com.au



The Discussion Paper canvasses two possible models for implementing the “clearly defined rights” requirement:

1. A “no material discretionary elements” approach, which would require that the extent to which each beneficiary can benefit from the MIT must not be capable of being significantly affected by the exercise (or non-exercise) of a power of the trustee or related entity.
2. An “ability to determine entitlements” approach, imposing a requirement that it must be possible at any point in time to determine the entitlements of beneficiaries to income and capital of the trust and the character of those amounts, and that having regard to the trust’s constituent documents, it is highly unlikely that the trustee would exercise a power to materially affect the beneficiary’s entitlements to those amounts or their character from period to period.

The Discussion Paper also canvasses whether certain registered Managed Investment Schemes (MISs) should be treated as automatically satisfying the “clearly defined rights” requirement.

Anti-streaming rules

The Discussion Paper elaborates on the Board of Taxation’s recommendation that the MIT regime include specific integrity rules to address the streaming of tax benefits or value shifting arising from changes to a MIT’s constituent documents during the income year.

In this regard, the Discussion Paper states that the application of the anti-streaming rule would be somewhat limited:

“The anti streaming rule would not apply to streaming that happens under the clearly defined rights in the trust’s constituent documents, without any change to those rights. For example, where the constituent documents provided at all relevant times that class A unit holders were entitled to dividend income and class B unit holders were entitled to capital gains and unit holders acquired their units on that basis, the anti streaming rule would not apply. Also, because the rule would apply only to streaming resulting from a change in a MIT’s

constituent documents, the potential application of the rule is likely to be narrow.”

Resettlements

The Discussion Paper canvasses whether a CGT roll-over relief should apply in the event of a resettlement arising from the amendment of a MIT’s constituent documents in order to satisfy the “clearly defined rights” requirement.

Division 6 to apply where the attribution system is not chosen

Where a MIT does not choose, or is not eligible to choose, to use the attribution method, Division 6 of the *Income Tax Assessment Act 1936* (i.e. the existing system) will apply to determine the tax liabilities of the trustee and beneficiaries. However, Division 6 will be modified to reflect the “unders and overs” concession outlined below.

Dealing with “unders and overs”

The Discussion Paper canvasses some of the administrative issues associated with the proposed *de minimis* carry forward approach to dealing with “unders and overs”. Broadly, “unders” and “overs” arise where the distribution statements issued to beneficiaries either under-report or over-report the correct amount of taxable income.

Under the carry-forward approach, trustees of MITs will not be required to reissue distribution statements, and beneficiaries will not be required to amend their tax returns, in respect of “unders and overs” below a *de minimis* level, which is proposed to be 5 per cent of the MIT’s taxable income for an income year (or a prescribed dollar value per unit as an alternative). The Discussion Paper notes that there are some practical issues associated with setting an appropriate dollar value per unit, and seeks feedback on this issue.

The “unders” or “overs” will be carried forward into the next income year following the identification of the “under” or “over”. No interest or penalties would be payable by the trustee or the Commissioner for any “under” or “over” below the *de minimis* level.

“Trustees of MITs should discuss the implications of the regime with their BDO adviser and consider whether or not to elect into the attribution system of taxation, and whether amendments to the constituent documents of the MIT will be required in order to make the election.”

Where the “under” or “over” exceeds the *de minimis* threshold

Where the trustee becomes aware of an “under” that exceeds the *de minimis* threshold, the trustee may, within a specified period, reissue distribution statements to beneficiaries and undertake a revised attribution of taxable income. Failing this, the trustee may instead be assessed on the relevant amount at the rate of 46.5 per cent.

Where the trustee becomes aware of an “over” that exceeds the *de minimis* threshold, the trustee will be required to reissue distribution statements to beneficiaries within a specified period. The Discussion Paper suggests that an appropriate administrative sanction should apply where the trustee fails to reissue distribution statements to beneficiaries within the specified period.

Cost base adjustments

To address the potential for double taxation of unit holders that may arise where a unit holder is assessed on a share of the taxable income of the trust, but sells the units before receiving the corresponding distribution, the CGT cost base/reduced cost base of units in a MIT will be subject to both upward and downward adjustments.

Where taxable income is attributed to a beneficiary, the cost base of the beneficiary’s units will be increased by the amount attributed (subject to certain adjustments). The cost base will be reduced by the amount of any distribution of taxable income that has been previously attributed, and the distribution of tax deferred amounts.

These arrangements will not apply to unit holders holding the units on revenue account, nor will they apply to carried interest holders (i.e. interests acquired because of services to be provided to the MIT).

The Discussion Paper notes that the proposed cost base adjustment arrangements would apply to MITs using the attribution system and to those that continue to use Division 6 of the *Income Tax Assessment Act 1936*.

Other issues canvassed in the Discussion Paper

The Discussion Paper outlines a range of other proposals including the following:

Character and source flow through

The Government proposes to legislate a rule to provide for a general principle of character and source flow through. This would apply to all MITs, whether or not they have clearly defined rights. However, the rule will not apply to carried interest distributions, and the current tax treatment of tax deferred distributions to revenue account holders will remain.

Classification as a fixed trust

MITs satisfying the “clearly defined rights” requirement will be treated as fixed trusts for other purposes of the income tax law. This would provide more certainty in relation to the rules associated with carrying forward tax losses, flow through of franking credits and the application of certain CGT provisions.

Abolishing the corporate unit trust provisions

Division 6B of the *Income Tax Assessment Act 1936* will be abolished. However an arm’s length rule will be introduced as part of the eligible investment business rules under the new MIT regime.

BDO comment

As the commencement date for the new MIT regime is 1 July 2011, trustees of MITs should discuss the implications of the regime with their BDO adviser. In particular, consideration should be given to whether or not to elect into the attribution system of taxation, and whether any amendments to the constituent documents of the MIT will be required in order to make the election.

Although the introduction of the MIT regime will be welcome, the fact that the MIT regime is needed in order to provide certainty on two fundamental difficulties that arise in trust taxation (that is, the allocation of tax liability on the trust’s taxable income between the trustee and beneficiaries, and the

flow through of character and source of income), highlights the urgent need for reform of trust taxation more generally.

On this front, the Henry Review noted that the rules that set out how trusts are taxed are “complex and give rise to uncertainty and should be updated and rewritten”. It is disappointing that, in the context of trusts more broadly, the Government has not yet acted on this recommendation.

19 October 2010

MORE INFORMATION

1300 138 991

www.bdo.com.au

**ADELAIDE • BRISBANE • CAIRNS
CANBERRA • DARWIN • HOBART
MELBOURNE • PERTH • SYDNEY**

BDO (Australia) Ltd, an Australian company limited by guarantee, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO in Australia, is a national association of separate entities (each of which, has appointed BDO (Australia) Limited ACN 050 110 275, to represent it in BDO International. Liability limited by a scheme approved under Professional Standards Legislation (other than for the acts or omissions of financial services licensees) in each State or Territory other than Tasmania.

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact the BDO member firms in Australia to discuss these matters in the context of your particular circumstances. BDO (Australia) Limited and each BDO member firm in Australia, their partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.