Australian Government

Implementation of a new tax system for managed investment trusts

Discussion Paper
October 2010

© Commonwealth of Australia 2010
ISBN 978-0-642-74637-5

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to:

Commonwealth Copyright Administration
Attorney-General's Department
3-5 National Circuit
BARTON ACT 2600

Or online at:
http://www.ag.gov.au/cca

CONSULTATION PROCESS

Request for feedback and comments

The Government seeks your feedback and comments on the issues outlined in this consultation paper. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 15 November 2010

Email: SBTR@treasury.gov.au

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

Enquiries: Enquiries can be initially directed to Raphael Cicchini (02) 6263 3188 or Michael Bradshaw (02) 6263 3323

Contents

Acronyms v

Foreword vi

Overview 7

1. Background and the concept of a managed investment trust 9
   - 1.1 Operation of existing law 9
   - 1.2 Definition of a MIT 9

2. Attribution method of taxation 12
   - 2.1 Clearly defined rights or entitlements 12
   - 2.2 Allocation of expenses against trust income 16
   - 2.3 Ceasing to satisfy the clearly defined rights requirement 16
   - 2.4 Attribution method — guiding principles 17

3. Unders and overs — carry forward arrangements 22
   - 3.1 Meaning of 'under' or 'over' 22
   - 3.2 *De minimis* level 22
   - 3.3 Where an under or over is less than the *de minimis* amount 23
   - 3.4 Over exceeds the *de minimis* amount 25
   - 3.5 Interaction with withholding obligations 26
   - 3.6 Intentional false statements of tax income not exceeding the *de minimis* amount 26
   - 3.7 Application to all MITs 26

4. Cost base adjustments 28

5. Character and source retention 31

6. Fixed trusts 32
   - 6.1 Treating MITs with clearly defined rights as fixed trusts 32
   - 6.2 Relevant provisions 32

7. Repealing corporate unit trust rules and including an arm's length rule in the public trading trust rules 34
   - 7.1 Implications of repealing corporate unit trust rules 34
   - 7.2 Arm's length rule in public trading trust provisions 35
   - 7.3 Public unit trust definition in Division 6C (Board recommendation 7) 35

8. Other issues 36
   - 8.1 Resettlements 36
   - 8.2 Reporting Requirements 36
   - 8.3 Application and transitional issues 36
   - 8.4 Interaction Issues 37
   - 8.5 Product disclosure statements 37

Attachment A 39

Acronyms

Board	Board of Taxation
CGT	Capital gains tax
Commissioner	Commissioner of Taxation
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MIS	Managed investment scheme
MIT	Managed investment trust
TAA 1953	*Taxation Administration Act 1953*

Foreword

I am very pleased to release this discussion paper on the Government's reforms to the tax laws applying to Managed Investment Trusts (MITs).

On 7 May 2010 the Government announced that in response to the Board of Taxation's review of the tax arrangements applying to MITs, we would introduce a new tax system for MITs and implement a number other associated reforms. We also announced that we would seek the public's views on how that could best be implemented.

This discussion paper sets out the implementation and design details of the new tax system for MITs and identifies aspects where stakeholder and industry input is highly desirable.

Assistant Treasurer and Minister for Financial Services and Superannuation
The Hon Bill Shorten MP

OVERVIEW

1. On 7 May 2010, the Government announced it would introduce reforms to the tax arrangements for managed investment trusts (MITs), including a new system of taxation.

2. Broadly, MITs are collective investment trusts that are listed, widely held or held by certain collective investment entities (the definition of a MIT is discussed in more detail at paragraphs 14 to 21). The reforms announced by the Government are in response to the recommendations of the Board of Taxation (Board) in its *Report on the Tax Arrangements Applying to Managed investment Trusts*.

3. In summary, the new taxation system for MITs will have the following features:

   - the trustee of a MIT can choose to apply the capital gains and losses (capital gains tax or CGT) regime to disposal of eligible assets (this is already law);

   - a reduced rate of final withholding tax (of 7.5 per cent) for most foreign investors on fund payments from a MIT (this is already law);

   - a MIT will be able to carry forward to a later income year 'under' and 'over' amounts of net income (called 'tax income' in this paper) up to a five per cent cap, whether the MIT has chosen the new attribution method (discussed below) or the current trust income rules apply;

   - MIT unit holders will be able to make, in certain circumstances, upward adjustments to the cost base of their unit holdings to reduce the extent to which double taxation might otherwise arise; and

   - MIT distributions will generally retain their character in the hands of unit holders, except those who hold the units on revenue account (for example banks and insurance companies).

4. In addition, MITs with clearly defined rights will:

   - be able to choose to use an attribution method of taxation, in lieu of the present entitlement to income method in Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936), where the beneficiaries (or 'unit holders') of the MIT have clearly defined rights or entitlements; and

   - be treated as fixed trusts for various taxation law purposes, such as the trust loss rules.

5. Attachment A is a summary table of the proposed income tax treatment of MITs.

6. As part of this measure, Division 6B of Part III of the ITAA 1936 (corporate unit trusts) will be repealed (subject to any transitional rules to address consolidation and other issues) and an arm's length dealing rule will be added to Division 6C of Part III of the ITAA 1936 (public trading trusts).

7. In addition, the 20 per cent tracing rule for public unit trusts in Division 6C will not apply to superannuation funds and exempt entities that are entitled to a refund of excess imputation credits.

8. Further details of the measure, including a table setting out the Board's recommendations and the Government's responses, are set out in the media release dated 7 May 2010 (No. 86 of 2010) of the former Assistant Treasurer, Senator Sherry. The media release is available on the Treasury Portfolio

Ministers Portal. The Board Report referred to in the press release is on the Board's website www.taxboard.gov.au.

9. This discussion paper sets out in general terms the scope and application of this measure and associated changes as a basis for consultation on the legislative design and implementation of the proposed tax changes.

10. Legislative references in this paper are to the *Income Tax Assessment Act 1997* except where stated.

1. BACKGROUND AND THE CONCEPT OF A MANAGED INVESTMENT TRUST

1.1 OPERATION OF EXISTING LAW

11. Broadly, the income of trusts, including MITs, is subject to trust taxation in accordance with Division 6 of Part III of the ITAA 1936. Under Division 6, the tax liability for the tax income of a trust is generally imposed on the beneficiaries that are presently entitled to a share of the income of the trust for trust law purposes (called the 'trust income' in this paper). The liability of beneficiaries is based on their corresponding share of the tax income and the trustee is liable to pay tax on any part of the tax income not assessable to the beneficiaries.

12. Certain listed, publicly offered, or widely held trusts that are corporate unit trusts or public trading trusts are taxed like companies under Division 6B or Division 6C of Part III of the ITAA 1936 respectively.

13. Distributions of certain types of income (called fund payments in the tax law) by MITs to foreign residents are subject to special withholding tax rules. Dividend, interest and royalty payments to foreign residents are also subject to specific withholding tax provisions. MITs may also elect under Division 275 for capital account treatment to apply to gains and losses on disposals of certain assets.

1.2 DEFINITION OF A MIT

14. The current definition of 'managed investment trust' was recently enacted by the *Tax Laws Amendment (2010 Measures No. 3) Act 2010* and is in section 12-400 in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953). The requirements for a trust to be a MIT are broadly as follows:

    - when the trustee of the trust makes the first fund payment in relation to the income year, or at an earlier time in the income year, the trust has a relevant connection with Australia;
    - when the payment is made, the trust is a Managed Investment Scheme (MIS) (as defined by section 9 of the *Corporations Act 2001*);
    - the trust is not a trading trust (for a unit trust) or carrying on a trading business (for any other trust) for the income year or controlling the carrying on of such a business;
    - a substantial proportion of the investment management activities carried out in relation to the trust in respect of the Australian assets under management are carried out in Australia throughout the income year; and
    - the trust meets certain widely held tests[1] and does not contravene certain closely held restrictions.

15. The current definition of a MIT applies across the income tax law.[2] In particular, the definition broadly applies for both withholding tax purposes (that is for the purposes of Subdivision 12-H of

---

1 The applicable widely held test depends on whether the trust is a registered wholesale MIS (subsections 12-402(1) and 12-402A(1) of Schedule 1 to the TAA 1953), an unregistered wholesale MIS (subsection 12-402(1) of Schedule 1 to the TAA 1953), or a registered MIS that is not a wholesale MIS (subsections 12-402(1A) and 12-402A(1) of Schedule 1 to the TAA 1953).

Schedule 1 to the TAA 1953) and for the purposes of the capital account election. However, the capital account election measure also applies to certain trusts that would not otherwise qualify as a MIT, but which are treated as a MIT for Division 275 purposes. Broadly, these are trusts:

- whose only member is a specified widely held entity or a trust treated in the same way as a MIT under Division 275;
- that have not made a fund payment in relation to the income year but would have been a MIT if the trustee had made the first fund payment on either the first or last day of the income year; or
- that would have been a MIT but for certain temporary circumstances outside the control of the trustee.

16. Further, the requirement that a substantial proportion of the investment management activities undertaken in relation to the assets of the fund connected with Australia are to be carried out in Australia does not apply for the purposes of Division 275. The trading trust exclusion is also partially ignored for the purposes of the MIT capital account election. Although a trading trust may still be able to make a capital account election under Division 275, it will not receive deemed capital treatment in an income year that it is a trading trust.

17. Because the definition of a MIT was enacted recently, it is not proposed to re-revisit the meaning of the term.[3] However, two law design issues to be considered are:

- whether any or all of the rules about trusts treated as MITs for the purposes of Division 275 should apply generally to the treatment of MITs for income tax (but not withholding tax); and
- the most appropriate location for the definition.

18. Prima facie, trusts that are treated as MITs for the capital account election could also be treated as MITs for the other features of the new tax system. That is, the concept of a MIT that effectively applies for Division 275 could also apply generally to the income tax treatment of MITs (although not to the already legislated withholding tax provisions). For this not to occur there would need to be a clear reason(s) why a particular feature of the proposed new tax system was unsuitable for a trust that met the Division 275 requirements but not the existing MIT definition in section 12-400. The withholding tax definition of a MIT requires a substantial proportion of the investment management activities carried out in relation to the trust in respect of Australian assets under management be undertaken in Australia, in order to attract the withholding tax concession. This is not necessary for capital account treatment.

19. Australian resident retail and wholesale unit trusts are both eligible to be a MIT. However, Investor Directed Portfolio Services and 'bare trusts' will not be subject to the MIT tax system. The Board recommended that these arrangements not qualify for the MIT tax regime. Under these arrangements, generally the investor is absolutely entitled to a CGT asset and the tax consequences generally fall directly on the investor. The tax income of these trusts will generally be assessed to the investor under the present entitlement system of taxation in Division 6 of the ITAA 1936.

20. The new tax system for MITs will not apply to a public trading trust. Division 6B (corporate unit trusts) is to be repealed.

---

2 In the ITAA 1936, the ITAA 1997 and Schedule 1 to the TAA 1953.

3 The definition as enacted is not the same in all respects as the definition recommended by the Board.

21. The amendments to the definition of a MIT in the *Tax Laws Amendment (2010 Measures No. 3) Act 2010* include a transitional provision which allows a trust that had qualified under the old definition of a MIT in place before 26 May 2010 (or would have qualified as a MIT if it had made a fund payment before 26 May 2010 and it was in existence before that date) to continue to be able to qualify as a MIT under the law as applying before the amendments to the definition made by that Act. The effect of this is that these trusts can continue to qualify as a MIT under the definition as applicable before these amendments for seven years (through to the 2016-17 income year). The new tax system for MITs will apply to such a trust for the period it is considered to be a MIT (although a trading trust does not obtain capital account treatment).

Consultation Question

1. Whether any or all of the rules about trusts treated as MITs for the purposes of the capital account election (Division 275) should be incorporated in the concept of a MIT that applies generally to the treatment of MITs for income tax (but not withholding tax)?

2. Attribution method of taxation

22. MITs will be able to choose to use an attribution method of taxation, rather than use the present entitlement to income method in Division 6 of Part III of the ITAA 1936, where the unit holders of the MIT have clearly defined rights or entitlements.

23. Where a MIT does not choose (or is not eligible to choose), the trustee and its unit holders will continue to be subject to Division 6 (the effect of which will be modified to accommodate the new MIT concession for the treatment of unders and overs) (see paragraphs 65 to 95 below).

24. Both the new attribution system of taxation and existing present entitlement method of taxation will operate in conjunction with the current specific statutory rules for elective capital treatment for MITs, imputation credit flow through and the withholding tax rules applicable to MIT distributions to foreign resident beneficiaries.

2.1 Clearly defined rights or entitlements

25. The Board report recommended that there be no requirement that the rights in a MIT be uniform (Recommendation 4) so, for the integrity of the tax system, it is necessary to ensure that tax attributes are not shifted amongst different classes of units in the trust, in light of the tax performance of the trust or of the tax profile of unit holders from year to year.

26. It is a precondition for an attribution model for determining tax liabilities that unit holders and the Commissioner be able to determine the liabilities in relation to a trust's tax income of different classes of unit holder. As the Board said in its report at paragraph 5.30, 'As the beneficiary will use the taxable income allocation in their tax returns it should be open for the beneficiary to dispute a tax assessment based on the allocation if the beneficiary considers that the assessment is not fair and reasonable, having regards to their rights under the constituent documents and duties of the trustee'. It is from these two requirements that the need for clearly defined rights/entitlements of the unit holder arises as a condition for the attribution method of taxation.

27. A MIT will satisfy the 'clearly defined rights/entitlements' requirement if unit holders' rights to income (including the character of the income) and capital are clearly established at all times in the trust's 'constituent documents'. The rights should only be able to be changed by an amendment to the trust's 'constituent documents'.

28. In its report the Board stated that 'constituent documents' means all documents or instruments that evidence the rights of beneficiaries to income, including the character of the income, and capital. They could include the trust deed, product disclosure statements, and minutes specifying the terms for the issue of units.

29. Requirements akin to those in sections 601FC and 601GC of the *Corporations Act 2001*, which specify the circumstances under which the constitution may be amended and prescribe rules the trustee must follow when dealing with beneficiaries, could apply to MITs eligible to use the attribution method. Under section 601FC a trustee is required to treat members of the same class equally and members of different classes fairly. Under section 601GC a constitution can be modified, or repealed and replaced, by a special resolution of the members, or by the trustee if they reasonably consider the change will not adversely affect members' rights.

30. This is broadly comparable to a 'fixed trust' type requirement. As discussed below, the current definitions of 'fixed trust' in the tax law are generally not well suited to today's current concept of a MIT — it is doubtful whether most MITs are able to qualify as a fixed trust under these definitions. The clearly defined rights requirement for electing to use the attribution method of taxation will be more tailored to today's concept of a MIT.

Beneficiaries' entitlements not discretionary

31. One legislative approach that may provide a basis for the 'clearly defined rights/entitlements' requirement, is the 'no material discretionary elements' approach in Subdivision 126-G (CGT roll-over relief for the transfer of assets between fixed trusts). The following discussion draws heavily from the Explanatory Memorandum to the Tax Laws Amendment (2009 Measures No. 6) Bill 2009, which introduced Subdivision 126-G.

32. In determining whether a MIT is one in which the unit holders have clearly defined rights, it will be necessary to consider the manner or extent to which each unit holder of the MIT can benefit from the trust. If the manner or extent cannot be significantly affected by the exercise, or non-exercise, of a power of a trustee or related entity, then the rights are clearly defined.

- Each beneficiary of a MIT with clearly defined rights must have an interest in the trust that is of a sufficiently definable quality and extent as to be capable of measurement without the exercise or non-exercise of a power (in the sense discussed in *Gartside v Inland Revenue Commissioners* [1968] 2 WLR 277).

- The quality or extent of each beneficiary's interest should not be capable of being defeated or substantively altered by the exercise, or non-exercise, of a power by the trustee or other relevant and related entity.

- For these purposes, a power includes both trust powers (that is powers that must be exercised but which allow discretion as to when or how they are exercised) and mere powers (i.e. discretions), but does not include trustees' duties. A trustee duty is a thing a trustee must do as prescribed, or refrain from doing, to avoid being in breach of trust (refer discussion in *Jacobs' Law of Trusts in Australia*, 7th ed., Heydon and Leeming at [1606]).

33. In effect, beneficiaries' interests should be 'fixed'. The following are examples of powers that may, depending on their context, be capable of significantly affecting the manner and extent to which a beneficiary can benefit from a trust:

- a power to appoint the beneficiary's interest in the income or capital to another beneficiary;

- a power to characterise receipts or expenses as income or capital, or to accumulate trust income to capital (unless those otherwise entitled to the income have the same interests in the capital);

- a power to add new beneficiaries (other than by issuing new units or interests in a way that does not significantly affect the value of existing interests);

- a power to appoint any part of the trust property to a new trust with different beneficiaries or giving different interests among existing beneficiaries;

- a power to issue new interests with rights attached that significantly alter the rights or the value of the rights attached to existing interests (for example a right to a preferential distribution of income); and

- a power to amend the trust deed to include a power capable of materially altering a beneficiary's membership interest(s).

34. Powers such as the following that merely facilitate the administration of the trust are not regarded as significantly affecting the manner and extent to which a beneficiary can benefit:

- a power to round distributions or other amounts to whole cents per unit or interest;
- a power to alter the manner in which beneficiary entitlements are paid, for example, to determine that they be credited directly to beneficiaries' bank accounts; and
- a power to pay beneficiary entitlements at any time within a prescribed period.

35. Similarly, a trustee's right to be reimbursed or exonerated out of the trust property in respect of liabilities and expenses properly incurred in the administration of the trust would not be viewed as a power to significantly affect the manner and extent to which beneficiaries can benefit from the trust (see *Chief Commissioner of Stamp Duties for New South Wales v Buckle* (1998) 192 CLR 226). Such a right, supported by a lien over the trust assets, simply represents an interest in the trust assets that ranks ahead of the claims of beneficiaries or the other claims for administration of the terms of the trust.

Example 1: power that could be exercised to affect the value of existing units

A trust has $1 billion in assets and has annual income of around $100 million.

Under the terms of the trust deed, the trustee has the power to issue new units — at an issue price, to persons, and with rights and obligations as determined by resolution. The power could be used, for example, to issue 'preference' units that entitle unit holders to the first $100 million of income of the trust.

This would significantly undermine the value of existing units in favour of new unit holders. Therefore, the extent to which each beneficiary can benefit from the trust is capable of being significantly affected by the exercise, or non-exercise, of a power.

Disregard certain powers if their existence does not affect market value

36. Although the manner or extent to which a beneficiary can benefit from the trust is capable, prima facie, of being significantly affected by the exercise, or non-exercise, of a power, a MIT may still be one in which unit holders have clearly defined rights. This can apply if the power's existence does not significantly affect the market value of *any* of the unit holders' interests in the MIT.

37. In other words, unit holders' interests are effectively 'fixed' if a hypothetical buyer, acting at arm's length in an open market and with reasonable knowledge of the facts, would not discount the value of any interest or consider it has a higher value because of the existence of a power. In that case, the MIT may be considered to have clearly defined rights, notwithstanding the existence of the power.

38. For example, the market value of interests in a MIT might not be significantly affected by the existence of a power that apparently could affect the value of the interest, where:

- prudential or market forces effectively prevent the power from being used in a way that would significantly change the value of any existing interests;

- the power can only be exercised with the consent of all, or almost all, of the affected beneficiaries of the trust and there is no particular beneficiary (or group of associated beneficiaries) who control the voting power; and/or

- more generally, there is little or no likelihood that the power will be exercised in a way that significantly affects the value of each existing interest.

Example 2: existence of a power that does not significantly affect the market value of any interest in a MIT

Further to Example 1, the trust is a MIT that is listed on the Australian Securities Exchange. There has only ever been one class of units on issue.

Various prudential and regulatory forces prevent the trustee from exercising powers in a way that is detrimental to existing unit holders.

The trust meets the condition because the existence of the power to issue new units does not significantly affect the market value of each interest in the trust.

Ability to determine entitlements

39. A variation on the 'no material discretionary elements' approach in Subdivision 126-G could be that a MIT will satisfy the 'clearly defined rights' requirement if the following requirements are met:

    - it is possible to determine at any point in time (for example, on redemption) the entitlements of beneficiaries to income and capital of the trust and the character of these amounts; and

    - 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 these amounts or their character from period to period.

Should some MITs be treated as automatically satisfying the clearly defined rights requirements?

40. In addition to the rules outlined above, it could also be appropriate for some types of MITs to be treated as automatically satisfying the clearly defined rights requirement (that is without needing to consider the clearly defined rights approaches discussed above).

41. A responsible entity of a registered MIS has duties under the *Corporations Act 2001* (in addition to its fiduciary duties) that circumscribe how the entity can exercise its powers and carry out its duties. That entity must (among other things) 'treat the members who hold interests of the same class equally and members who hold interests of different classes fairly' (paragraph 601FC(1)(d)). The constitution of the registered MIS may only be changed by special resolution of the members or by the responsible entity if that entity reasonably considers the change will not adversely affect members' rights (subsection 601GC(1)). Consequently, it is very difficult for the responsible entity to change the rights or entitlements of members in a way that adversely affects any member or class of members.

42. An alternative might be to allow a registered MIS to automatically meet the clearly defined rights requirement where they are listed on an approved stock exchange. The purpose of including automatic qualifications such as these would be to reduce the compliance costs faced by MITs without impacting on the integrity of the requirement.

Power of accumulation

43. A trustee having the power to accumulate income in the trust will not automatically result in the clearly defined rights requirement being breached. There will only be a breach where the existence or exercise of the power will or may materially affect the rights and entitlements of the unit holders. For example, if the trustee had a power to accumulate income of the trust to capital, and the unit holders entitled to the income of the trust were different to those entitled to the capital, then the power would prima facie materially affect the rights and entitlements of the unit holders. However as discussed above, this may not result in a breach of the clearly defined rights requirement where the power's existence does not significantly affect the market value of any of the unit holders' interests in the MIT.

2.2 ALLOCATION OF EXPENSES AGAINST TRUST INCOME

44. The allocation of expenses against trust income is an important matter affecting the entitlement of beneficiaries. One way of ensuring that the clearly defined rights requirement operates effectively would be to have a statutory rule for income tax providing for the allocation of expenses against different classes of income. Such a rule could be simply that the allocation be reasonable or more detailed (for example that expenses directly attributable to a class of income be allocated against that class and other expenses be apportioned between the classes of income to which they relate on a reasonable basis). Trust expenses attributable solely to deriving capital gains would be expected to form part of the cost base of a CGT asset.

45. Another possible issue is the application of section 51AAA of the ITAA 1936 (deductions not allowable in certain circumstances) to those MITs that choose capital account treatment. Some of these MITs may have, for a particular income year, deductions that exceed their income other than net capital gains (for example interest, dividends and rent). The standard treatment in that case is to work out the amount of the revenue loss and carry it forward. However, some MITs may prefer that they could apply some of the excess deductions against capital gains.

2.3 CEASING TO SATISFY THE CLEARLY DEFINED RIGHTS REQUIREMENT

46. A MIT that makes an irrevocable election to use the attribution method must satisfy the clearly defined rights requirement at all times. However, if a MIT would meet the clearly defined rights requirement apart from a particular circumstance, the MIT will still be able to apply the attribution method where that circumstance is temporary and arose outside the control of the trustee of the trust, and it is fair and reasonable for the MIT to use the attribution method. In determining whether it is fair and reasonable for the MIT to use the attribution method in such cases, consideration will need to be given to:

- the nature of the circumstance;
- the actions (if any) taken by the trustee of the trust to address or remove the circumstance;
- the speed with which such actions were taken;
- the likely impact on beneficiaries' rights and entitlements; and
- the taxation impact of such a decision on unit holders and the revenue.

47. Where a trust ceases to be eligible to use the attribution method, the trust will be excluded from attribution method for the income year in which the breach occurs and for a further specified period

(for example the following four income years). This will prevent arbitrage opportunities and complex interactions that would arise if MITs were permitted to move freely in and out of the attribution method.

2.4 ATTRIBUTION METHOD — GUIDING PRINCIPLES

48. In the first instance, the trustee will be required to calculate the tax income of the MIT in accordance with section 95[4] of the ITAA 1936 (or equivalent provisions in the new tax regime).

49. It is expected that the new legislation will be drafted using principle based drafting. The guiding principles of the attribution method for determining tax liabilities of unit holders and the trustee of the MIT will be:

- the trustee must attribute the tax income of the trust to the beneficiaries of the trust on a fair and reasonable basis consistent with their rights and entitlements under the trust's constituent documents and the duties of the trustee:
  - unit holders will be assessed on the amount that is attributed to them by the trustee, as a consequence of the trustee properly exercising a power conferred upon it under the trust instrument;
  - amounts attributed by the trustee to the unit holder will generally retain their character in the hands of the unit holder consistent with the character that applied at the trustee level;
- that part of the tax income of the trust that is not attributed to the unit holders within three months of the end of the income year, is assessed to the trustee at the top individual marginal rate (currently 46.5 per cent, including Medicare levy), unless the income is subject to the 'unders' and 'overs' rules.

50. Requiring that the trust's tax income be attributed on a fair and reasonable basis, consistent with the beneficiaries' rights under the constituent documents and the duties of the trustee, will ensure that the allocation of tax income follows the beneficiary's interest in the trust. The Board's report indicates that this rule should be broad enough to apply to beneficiaries who redeem or sell their units during an income year. For example, an incoming unit holder can be attributed with an amount of tax income which is consistent with their period of ownership and takes into account whether some income or capital gain (where the trust deed permits) has already been actually paid to the previous unit holder.

51. The flexibility provided by the 'fair and reasonable' requirement will enable the fair allocation of extraordinary capital gains/income to a redeeming beneficiary, where the redemption triggers the sale of underlying trust assets in order to fund the redemption. It will also allow the trustee to consider whether the proceeds for redemption of a unit part way through an income year includes an amount representing income derived, but undistributed at the time the unit is sold, when attributing the tax income of the trust.

52. As suggested by the Board (at paragraph 5.30 of its Report) it is proposed that a beneficiary will have standard rights of objection and review against an assessment if the beneficiary considers that the tax income attributed to them was not attributed on a fair and reasonable basis consistent with their rights and entitlements under the trust's constituent documents and the duties of the trustee.

---

[4] The relevant definition is net income in relation to a trust estate.

53. In determining what is fair and reasonable, consideration would need to be given to the following factors:

- the entitlement of the beneficiary under the trust's constituent documents;
- the period in which the beneficiary owned the interest in the MIT; and
- whether disproportionate tax benefits flow to certain classes of beneficiaries.

54. Examples of the application of the attribution method to a MIT are as follows.

Example 3: attribution with one class of unit holders

The MIT has 100,000 issued units. The deed provides that each unit holder is entitled to the distributable income of the trust in proportion to the number of units they hold.

The distributable income for the year is $270,000 and the tax income for the year is $245,000. The trustees must attribute up to $2.45 per unit to each unit holder. If unit holder A has 25,000 units, they would include $61,250 in their assessable income. The trustees may attribute less of the tax income pro rata per unit and would be themselves assessable on the balance of the tax income.

Example 4: attribution with two classes of unit holders

The MIT has two classes of unit holders. The MIT has issued 120,000 units to Class A unit holders and they are entitled to the income from shares (including realised capital gains) and interest in proportion to their unit holding. The MIT has issued 100,000 units to Class B unit holders and they are entitled to the income from other sources, including property rent and realised gains on property in proportion to their unit holding. The issue price for the Class A units was $10 per unit and the issue price for the Class B units was $5 per unit.

The distributable income for the year is $270,000 and the tax income for the year was $245,000, made up as follows:

	Distributable income	Tax income	Assessable tax income amount attributed to unit holders
Class A — Shares and interest	$170,000	$200,000	$1.66 per unit
Class B — Other income	$100,000	$45,000	$0.45 per unit
	$270,000	$245,000	

55. A key design issue for consideration is the approach that may be taken for MITs with multiple classes of unit holders where one of those classes has losses.

56. The attribution model requires the trustee to attribute the tax income of the trust on a fair and reasonable basis consistent with their rights and entitlements under the constituent documents. If, for example, one class of unit holders (class B) is entitled to a positive amount in the net tax income and the other class (class A) has a negative amount (tax loss) included in the tax income, how should the trustee deal with this situation when trust losses are quarantined in the trust?

57. The following example demonstrates the application of the attribution method of taxation in such circumstances:

Example 5: attribution between two classes of unit holders where there is an overall trust loss

Continuing on from example 4, in the income year for Class A units there is a loss of $170,000 (rather than distributable income). The distributable income for Class B units is $100,000 and the tax income for the year was $25,000, made up as follows:

	Distributable income or loss	Tax income	Assessable tax income (after offsetting loss) attributed to unit holders	Net cost base adjustment per unit after distribution
Class A units	($170,000)	($20,000)	nil	nil
Class B units	$100,000	$45,000	$0.25 per unit[5]	-$0.75 per unit[6]
	($70,000)	$25,000		

This example assumes that the trust can distribute $100,000 without impacting on the entitlements of other unit holders and that anti-streaming and value shifting rules (discussed below) do not apply.

Under the attribution method, Class B unit holders will be taxed on the tax income after offsetting the loss attributable to Class A unit holders.

An issue for public comment is whether the trustee should instead be required to attribute the full amount of the tax income attributable to Class B unit holders ($45,000) and quarantine the tax loss of $20,000 to Class A unit holders.

Integrity rules for the attribution method

58. The Board recommended (Recommendation 21), and the Government accepted, specific integrity rules to address:

- the streaming of tax benefits or value shifting arising from changes to a MITs' constituent documents during the income year; and
- rights attaching to units in a MIT being structured such that the tax income of the trust is attributed to a tax exempt entity while other unit holders receive tax deferred or tax exempt distributions.

An anti-streaming rule

59. 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.

60. In terms of the types of benefits that might be streamed, the rule could be expressed as a principle to prevent problems that typically arise with integrity provisions that use a listing approach. For example, the benefits covered could be those where the allocation of certain types of amount to a class of beneficiaries results in that class obtaining a greater benefit for income tax purposes than another class of beneficiaries would have obtained from that type of amount. This could be supplemented by examples of the types of amount, for example, capital gains, franked distributions, interest and foreign source income.

---

5 ($45,000 - $20,000) /100,000 units.
6 $100,000 - $25,000/100,000 units.

61. Where streaming results from a change in a MIT's constituent documents, the Commissioner of Taxation could be given a power to determine that amounts allocated by the trustee to a group of beneficiaries are to be treated as having a different tax character from that determined by the trustee (see discussion of character retention at paragraphs 104 to 108).

Value shifting

62. Similarly to the proposed anti-streaming rules, the value shifting rule would only apply to the streaming resulting from a change in a MIT's constituent documents.

63. The current value shifting regime may not be effective in addressing value shifting arising from changes to a MIT's constituent documents. In particular, given the widely held nature of a MIT, it may be difficult to identify a relevant 'controller' as is required to engage the operation of the current rules. One possible approach might be to design rules which are principle-based and do not require as a precondition to their operation the need to establish a scheme and the existence of a controller. This would be similar to the approach taken in the design of the rules that address value shifts in a demerger context.

MITs automatically eligible for the attribution method

64. If certain types of MITs (e.g. registered MISs) were to be treated as automatically eligible for the attribution method (as discussed above at paragraphs 40 to 42), it may be necessary to consider whether the anti-streaming and/or value shifting rules might need to apply beyond changes in a MIT's constituent documents. For example, if the trustee of a registered MIS were to exercise a discretion to stream types of income for a particular year in a way that was fair to different classes of unit holders but resulted in a substantial loss of revenue.

Consultation questions

Clearly defined rights

2. Should the core clearly defined rights rules be supplemented by tests which would allow some types of MITs (e.g. registered MISs) to automatically satisfy the requirement in situations where rules already operate to prohibit a MIT from acting in a manner inconsistent with the core rules? If yes, in which situations should these tests apply?

3. Would it be possible for the clearly defined rights rules to accommodate trustee powers to accumulate income in the trust or issue units at a significant discount without impacting on the integrity of the rules?

4. Is it appropriate to describe 'constituent documents' by way of a general principle, similar to the approach adopted by the Board in its Report, or should specific rules which list those documents that form part of a MIT's constituent documents be adopted?

Attribution principles

5. Are specific rules required to ensure that amounts of tax income are appropriately attributed where a unit in a MIT is sold or redeemed during an income year? If so, what rules would be appropriate?

Consultation Questions (continued)

6. Would compliance issues be raised by a requirement under the attribution method that tax losses in respect of one class of unit holders cannot be used to reduce the tax income of another class of unit holders?

7. Are any modifications to the proposed attribution rules needed for trustees of trusts where units may be traded on a more regular basis (compared to unlisted trusts), such as listed property trusts or exchange traded funds?

Integrity rules

8. What would be an appropriate principle for the proposed anti-streaming provision?

9. If certain types of MITs (e.g. registered MISs) were to be treated as automatically eligible for the attribution method, would it be necessary to consider whether the anti-streaming and/or value shifting rules might need to apply beyond changes to a MIT's constituent documents?

3. Unders and overs — carry forward arrangements

65. A general carry forward approach is to apply for correcting net ‘unders’ and ‘overs’ below a *de minimis* level.

3.1 Meaning of ‘under’ or ‘over’

66. An ‘under’ arises where the trustee of a MIT reports the tax income of the trust on which the trustee bases the distribution advices it gives to the beneficiaries after the end of the income year and the total tax income reported is less than the actual tax income of the trust. Correspondingly, an ‘over’ arises where in the same circumstances the total tax income on which the trustee of a MIT bases its distribution advices is more than the actual tax income of the trust. Although the Board’s report focused on tax income, an under can also arise where tax offsets have been over claimed and an over can arise where tax offsets have been under claimed.

67. An under or over can be due to the trustee obtaining new or revised information after it has reported to beneficiaries, but is not limited to those cases. For example, it may be attributable to a trustee error (e.g. an error in applying the law to the facts or an error in calculation). Commonly, the trustee itself will discover the under or over but its existence may only be revealed following compliance action by the Commissioner. This is consistent with the Board’s Recommendation 30, agreed to by the Government, which refers to ‘all unders and overs, however, arising’.

3.2 *De minimis* level

68. The Board recommended that the *de minimis* level should be either five per cent of the tax income of the trust for an income year or a prescribed dollar value per unit (Recommendation 30, which the Government accepted). In the Board’s report the five per cent test is the primary test and the prescribed dollar value per unit is described as an alternative test that should be the subject to further stakeholder consultation.

69. A significant practical issue is how to set a suitable prescribed dollar value per unit. One example that illustrates some of the difficulties is that two MITs, A and B, have the same net worth but MIT A has 10 times the number of units as MIT B. As the actual net worth per unit for B is 10 times that for A, a prescribed dollar value per unit test is likely to be much more generous for A than for B. As the dollar value per unit could be readily manipulated (for example by a unit split), an integrity rule could be needed to support the prescribed dollar value per unit test.

70. Another issue is how the two tests should interrelate. One straightforward approach would be that the *de minimis* level is the greater of:

- five per cent of the tax income of the trust; and
- an amount per unit (if any), prescribed by regulation, multiplied by the number of units held in the MIT at the end of the income year.

71. Providing for the amount per unit to be prescribed by regulation would give the Government some flexibility in changing the value per unit (subject to the normal disallowance procedures for Legislative Instruments). Of course, the amount calculated based on the prescribed amount per unit would have no effect if it is less than five per cent of tax income.

3.3 Where an under or over is less than the *de minimis* amount

The year the under or over arises

72. The policy objective is that where the amount of an under or over is less than the *de minimis* level, the trustee does not need to issue revised distribution statements to unit holders and assessments made in accordance with distribution statements do not need to be amended.

73. One way of achieving this objective would be for the law to provide that, despite the other rules about working out the tax income of the MIT, the liability of beneficiaries and the trustee in relation to the tax income of the MIT is to be worked out as if the tax income of the MIT were the total tax income upon which the trustee based the distribution advices.

74. The objective might also be able to be achieved by an operative mechanism that does not change the amount of the tax income of the MIT. For example, an under or over could be dealt with as follows:

- they do not affect the amount assessable (under the attribution method or Division 6 of Part III) to the unit holders in the year the under or over arises;
- for an under, the amount is not assessed to the trustee; and
- they are carried forward into the MIT's tax income calculation for the next income year following identification of the error and affect amounts assessable to unit holders in that year.

75. Another option for an operative rule might be to limit the power of the Commissioner to amend an assessment made in accordance with a distribution statement. However, there would be a number of difficulties with this option:

- in practice the Commissioner does not raise an original assessment for some beneficiaries, so a rule about limiting amendment powers would not suffice;
- the trustee could be liable for a tax shortfall penalty (under Division 284 in Schedule 1 to the TAA 1953), which is contrary to Recommendation 30 of the Board, to which the Government agreed; and
- as it is necessary to adjust the way the tax income of the trust is worked out for a later income year (discussed below), it would be consistent to adjust the tax income of the trust for the income year the under or over arises.

76. Appropriate review rights are necessary to ensure that the unders and overs rule does not create an incontestable tax liability because that would not be a valid exercise of the Commonwealth's taxation power. It is proposed that a taxpayer have rights of objection and review as to whether:

- an under or over exceeds the *de minimis* amount;
- the trustee calculated net income in good faith on the basis of information available to the trustee at time of calculation; and
- attribution is fair and reasonable for a trust using the attribution method.

77. The rights of objection and review would not extend to whether the trustees' calculation of net income was actually correct, within the *de minimis* margin. If it did, the effect of the unders and overs rule could largely be negated by unit holders challenging assessments based on the net income figure, either in the year the under or over arose or in the year to which it was carried forward.

Later income years

78. The carry forward approach would allow for net unders and overs arising in a year of income to be carried forward into the MIT's tax income calculation for the next income year following identification of the error (as recommended by the Board). The 'adjusted' tax income figure, reflecting the over or under carried forward, is then used in determining the amount (if any) of an over or under for that income year.

79. Where a trustee discovers an under or over (of less than the *de minimis* amount) for an income year (very early) in a later income year, but before it issues distribution statements for the immediately preceding income year, it may be convenient and more timely to include the under or over in working out the tax income for that immediately preceding income year. That inclusion would be instead of carrying it forward to the next income year.

80. The Government accepted the Board's Recommendation 31 that for the purposes of applying the carry forward, the trustee may need to determine a separate under or over figure for:

- discounted capital gains;
- other capital gains;
- Australian source income;
- foreign source income;
- franking credits;
- foreign tax offsets;
- interest (this will be necessary because of the Government's proposed 50 per cent interest discount); and
- franked and unfranked dividends.

81. To the extent that it would not prejudice beneficiaries of a particular class of units, the unders or overs may be netted off against each other to determine if the *de minimis* level is satisfied.

82. A significant issue here is whether, in applying the carry forward in a later income year, constituent amounts (for example capital gains; franking credits) should be applied specifically (or quarantined) against an amount of the same type. This could cause unfavourable outcomes for the trust, for example, where there is an over for a particular type of amount there might not be a sufficient amount of that type in the next year to absorb the over carried forward (for example there is an over-allocation of capital gains of $10,000 in year 1 but in year 2 no capital gains or losses were made). As the total amount carried forward is less than the *de minimis* threshold, a simple approach would be preferred here. Industry comment may assist with the development of a suitable simple rule.

Under exceeds the *de minimis* amount

Action by trustee on unders

83. Where an under exceeds the *de minimis* amount, the trustee may reissue distribution statements to beneficiaries and undertake a revised attribution of tax income. No specific rule is needed in the tax law to enable the trustee to do this.

84. However, if the trustee does not reissue distribution statements to beneficiaries or re-attribute within a specified period after becoming aware that there is an under exceeding the *de minimis* amount, then the trustee will be assessed on the amount of tax shortfall at the top marginal tax rate (currently 46.5 percent, including Medicare Levy). The Commissioner would have power to extend the period in special circumstances. In determining a suitable specified period some relevant factors are:

- unit holders should be advised as soon as practicable that the earlier distribution advice is incorrect;
- the trustee should have sufficient time to do the necessary calculations and send out the revised distribution statements; and
- the due dates for lodgment of income tax returns of MITs.

85. The assessing of the trustee will need to be integrated with the self assessment system. Where the specified period ends before lodgment of the relevant income tax return of the MIT, the assessment of the trustee could be incorporated into the normal lodgment and assessment process. Where the specified period ends after lodgment of the relevant income tax return, it could be necessary to require the trustee to notify the Commissioner so that a trustee assessment can be raised.

86. Where the trustee does not become aware of the under until after the normal time for amending assessments of unit holders[7], there would be no point in the trustee reissuing distribution statements and the trustee will not be required to do so. The standard period for amending an assessment of a unit holder is four years[8]. Consequently, the trustee will not be assessed at the top marginal tax rate if the trustee first becomes aware of an under more than four years after the end of the year to which the under relates[9].

87. Where the trustee distributes an amount that has been assessed to it at the top marginal rate, this amount will be non-assessable non-exempt income of the beneficiary. This is consistent with the treatment that currently applies where a trustee has been assessed to income tax at the top marginal rate under section 99A of the ITAA 1936 (subsection 99B(2) of the ITAA 1936).

3.4 OVER EXCEEDS THE *DE MINIMIS* AMOUNT

88. Where a trustee becomes aware that there is an over greater than the *de minimis* amount, the trustee will be required to reissue distribution statements to beneficiaries within a specified period. This period could be the same as that for a trustee advising of an under exceeding the *de minimis* amount without being assessed at the top marginal rate (see discussion above). Where the trustee fails to issue statements to beneficiaries within the specified period, there would need to be an appropriate sanction. For example, Division 286 of Schedule 1 to the TAA 1953 could be amended to apply the standard administrative penalty rules for failing to give returns, notices, statements or other documents on time.

---

7 The trustee will not normally know whether the amendment period has expired for any particular unit holder.

8 For an individual unit holder, the four year period starts on the day on which the Commissioner gives notice of the assessment to the unit holder. For a company or superannuation fund that is a unit holder, the four years starts on the day on which they lodge their income tax return (subsections 170(1) and 166A(3) of the ITAA 1936).

9 The result is that no income tax will be paid on the amount of the under.

89. However, similarly to where an under exceeds the *de minimis* amount, if the trustee first becomes aware of the over more than four years after the end of the year to which the under relates, it will not be required to reissue distribution statements to beneficiaries.

3.5 Interaction with withholding obligations

90. If the 'under' is discovered after all distributions for the year have been made, there is nothing in the MIT withholding rules to amend the amount withheld. This is because the determination of whether an amount paid to a beneficiary is a fund payment (and therefore of the amount, if any, to be withheld) is made at the time the actual payment is made. If a trustee discovers an under (that changes the tax income of the MIT) before the final distribution for the year, the amount of the distribution that is a fund payment will be based on this later tax income amount. No change to the law is needed to achieve these outcomes.

3.6 Intentional false statements of tax income not exceeding the *de minimis* amount

91. As explained by the Board in its Report (at paragraph 8.1) the proposed unders and overs treatment addresses current practical problems faced by MITs in preparing accurate end of year trust income and tax income calculations within the time frame required. It is not designed to permit trustees to intentionally (or recklessly) understate (or overstate) the tax income of the trust by less than the *de minimis* amount. For example, it would be serious misbehaviour if a trustee were to systematically understate a trust's tax income (compared to its actual tax income) by four per cent each year (and carry forward the under to the next income year).

92. If the tax income of the trust were treated as the amount stated by the trustee provided it was within the *de minimis* margin (as discussed above at paragraph 73), a statement of the trustee would become true, even if it were actually intentionally false. Consequently, normal tax sanctions (for example administrative penalties and the criminal offences for false or misleading statements in the TAA 1953) would not apply.

93. The Government accepted the Board's Recommendation 30 that 'for under and overs below the *de minimis* no amount of interest or penalty would be payable by the trustee or the Commissioner'. Nevertheless, it would seem that some effective sanction(s) would be needed to deter intentional or reckless false statements by trustees. One possibility would be to clarify that for purposes of the administrative penalty and/or tax offence provisions about making a false or misleading statement intentionally or recklessly, the tax income of the trust estate is its actual tax income (not the tax income reported by the trustee).

3.7 Application to all MITs

94. The Government accepted the Board's recommendation that the proposed treatment of unders and overs should extend to widely held MITs even if they do not satisfy the clearly defined right requirement.

95. It could be argued that if a MIT actually has only a small number of direct unit holders, the policy rationale for the unders and overs approach — avoiding the practical difficulties of issuing revised distribution statements and amending assessments for a large number of beneficiaries — is not present. However, there would be significant additional complexity if those MITs were to be treated differently from others. Consequently, the proposed treatment of unders and overs will extend to all MITs.

Consultation Questions

10. Is it practically feasible to have an alternative test for a *de minimis* amount based on a prescribed dollar value per unit?

11. If so, what would be an appropriate way for the Government to determine a prescribed dollar value per unit?

12. In addition to the proposed rules for overs and unders in relation to the tax income of a trust, should there also be statutory rules for overs and unders relating to tax offsets? If so, what would be an appropriate *de minimis* threshold?

13. For the income year in which an under or over arises that is less than the *de minimis* threshold, what would be a suitable operative mechanism to ensure that the trustee does not need to issue revised distribution statements and that assessments made in accordance with distribution statements do not need to be amended?

14. In applying the carry forward of an under or over not exceeding the *de minimis* amount in a later income year:

(a) should constituent amounts (e.g. capital gains; franking credits) be applied specifically against an amount of the same type?

(b) if so, for what categories of amount should a separate under or over figure be calculated; and

(c) if not, what would be a suitable rule in applying the amount carried forward?

15. What should be the specified period allowed for the trustee to reissue distribution statements to beneficiaries after becoming aware that there is an under exceeding the *de minimis* amount?

16. What would be appropriate sanctions for a trustee intentionally (or recklessly) misstating the tax income of the trust?

4. Cost base adjustments

96. In responding to the Board's Report, the Government agreed that beneficiary cost base adjustments remain, as currently apply, in respect of non-revenue account unit holders (Recommendation 25). It also agreed in principle to Recommendation 26, in so far as it related to addressing potential double taxation that may arise in certain circumstances.

97. The new cost base adjustment arrangements will apply to MITs that choose to use the attribution system of taxation and to those that continue to use Division 6 of Part III of the ITAA 1936.

98. Under the new cost base adjustment arrangements, the cost base (or reduced cost base) of units is adjusted for unit holders when the amount distributed to unit holders is less than the tax income that beneficiaries must include in their assessable income. This will address the potential for double taxation should a unit holder sell units before receiving the distribution (that is the beneficiary would be taxable on the attributed tax income and may also be taxable on a gain on the sale of the units which would reflect the value of the undistributed amount which has already been subject to tax).

99. To address the unit holder-level adjustments, the new cost base adjustment arrangements include a system of upwards and downwards cost base adjustments. In the case of a MIT, the cost base or reduced cost base of a unit holder's units would be adjusted in the following circumstances:

- where tax income is attributed to a unit holder, then the cost base of the beneficiary's units is to be increased by the amount attributed (adjusted upwards for certain amounts that are otherwise disregarded for CGT event E4 such as the discounted component of a capital gain and downwards to reflect the value of certain tax offsets such as the gross up component of a franking credit); and
- the cost base will be reduced by the amount of:
  - any distributions of tax income that have been previously attributed; and
  - distributions of tax preferred amounts to beneficiaries that do not hold their units on revenue account, other than the amount attributable to a CGT discount.

100. Certain distributions/attributions will not give rise to cost base adjustments. Distributions/attributions to carried interest holders[10] will be assessable, except for amounts attributable to capital subscribed by the carried interest unit holder. Distributions of tax preferred amounts to revenue account unit holders (for example banks and insurance companies) will be assessable as ordinary income to these unit holders.

---

10 A carried interest broadly relates to a CGT asset held in an income year in relation to a MIT (or an entity that was a MIT for a previous income year) acquired because of services to be provided to the MIT by the holder of the CGT asset or an associate, as a manager of the entity, an employee of a manager or an associate of such a manager or employee. A carried interest holder is entitled to distributions contingent on the profits of the entity (section 275-200).

101. The following are examples of the operation of the new cost base adjustments arrangements.

Example 6: The MIT distribution exceeds tax income

Income	Trust receipts/income/expenses	Tax income
Rent from properties	$300,000	$300,000
Investment property expenses (deductible)	-$100,000	-$100,000
Interest expense	-$20,000	-$20,000
Building Allowance	0	-$80,000
Net Rent	**$180,000**	**$100,000**
Dividend received	$70,000	$70,000
Franking credits	0	$30,000
Total Dividends	**$70,000**	**$100,000**
Interest received	$20,000	$20,000
Capital gain — sale of land	0	$25,000
Trust income/Tax income	**$270,000**	**$245,000**
Distribution	**$270,000**	

The MIT has 100,000 issued units at a price of $8 per unit. The deed provides that each unit holder is entitled to the distributable income of the trust in proportion to the number of units they hold. The amount of the trust distribution is $2.70 per unit and the tax income of the MIT (tax) attributable to each unit is the $2.45. The cost base (or reduced cost base) of each unit is adjusted to take account of the tax income attributed and the MIT income distributed. Under the new cost base arrangements the following applies:

Purchase price	$8.00
Amount of tax income allocated	+2.45
Franking credit offset	-0.30
CGT Discount amount	+0.25
Amount distributed	-2.70
Reduced cost base per unit	$7.70

The net effect is that the cost base per unit is reduced by $0.30 being the difference between the distributed tax preferred amount of $0.80 (building allowance) and the attributed capital gains of $0.50.

Example 7: The tax income of the MIT exceeds the distribution

Income	Trust receipts/income/expenses	Tax Income
Rent from properties	$300,000	$300,000
Investment property expenses	-$100,000	0
Interest expense	-$20,000	-$20,000
Building Allowance	0	-$80,000
Net Rent	**$180,000**	**$200,000**
Dividend received	$70,000	$70,000
Franking credits	0	$30,000
Total Dividends	**$70,000**	**$100,000**
Interest received	$20,000	$20,000
Capital gain — sale of land	0	$25,000
Trust income/Tax income	**$270,000**	**$345,000**
Distribution	**$270,000**	

Assuming the same units as in example 6 the amount of the MIT distribution is $2.70 per unit. The tax income of the MIT (tax) attributable to each unit is $3.45. The cost base (or reduced cost base) of each unit is adjusted to take account of the tax income attributed and the MIT income distributed. Under the new cost base arrangements the following applies:

Purchase price	$8.00
Amount of tax income allocated	+3.45
Franking credit offset	-0.30
CGT Discount amount	+0.25
Amount distributed	-2.70
Reduced cost base per unit	$8.70

The net effect is an increase in the cost base of each unit of $0.70 being the difference between the attributed capital gain of $0.50 and the non-deductible expenses of $1.00 less the attributed tax preferred amount of $0.80.

102. A design issue associated with the proposed cost base rules is whether the cost base requirements should entail only annual obligations on the trustee of a MIT, or a requirement that applies for each attribution and distribution. The Board has recommended that MITs be required to supply beneficiaries with annual statements for the purpose of determining the amount of their cost base adjustments on an annual basis. However, the Board has also proposed that cost base movements occur on each event.

103. Another possible issue arises from the growing popularity of MITs whose units are traded on the Securities Exchange instead of being acquired and redeemed from the trustee. These are referred to as ‘Exchange Traded Funds’. It is likely that some investors will acquire and dispose of their units in Exchange Traded Funds within a single income year, possibly even entering and exiting an investment more than once. Keeping track of attribution amounts and cost base adjustments could be more onerous for trustees of Exchange Traded Funds compared to other MIT trustees. However, it is understood that (where relevant) these funds already advise unit holders of reductions in cost base of units under CGT event E4.

Consultation Questions

17. Are there any significant compliance costs associated with requiring a MIT to track cost base movements on each event?

18. Should the requirement for MITs to notify unit holders of cost base adjustments be an annual requirement, or should MITs be required to notify unit holders more frequently?

19. Are any modifications to the proposals warranted for MITs that are Exchange Traded Funds?

5. CHARACTER AND SOURCE RETENTION

104. In responding to the Board's Report, the Government agreed, in the context of developing a new MIT taxation regime, to legislate the degree to which character and source flow through to investors (Recommendation 24). However, the Government did not agree (Recommendation 25) to change the tax treatment of tax deferred distributions to revenue account unit holders (i.e. they remain on revenue account).

105. There are a number of rules in the tax law that specifically address the extent to which certain tax characteristics flow through a trust. Examples include:

- Division 115-C which operates to treat a beneficiary of a trust that is assessed on an amount of the tax income of a trust that has derived a capital gain as having themselves made a capital gain;
- Subdivision 207-B which specifies the entitlement of a beneficiary of a trust that is assessed on an amount of the tax income of a trust that has derived a franked dividend to a share of the franking credits attached to the dividend; and
- section 6B of the ITAA 1936, which deems income derived by a person to be income of a particular type or attributable to particular sources in certain circumstances.

106. The intent is to introduce into the law a rule which provides for a general principle of character and source flow-through.

107. As noted above, under the attribution method of taxation, trustees will be required to attribute the tax income of the MIT to beneficiaries on a fair and reasonable basis consistent with their rights under the constituent documents and the duties of the trustee. More specifically the trustee will be required to identify the character of the (net) amounts that comprise the tax income and to attribute these (net) amounts to beneficiaries on a fair and reasonable basis consistent with their rights. It is envisaged that the Act will then contain a rule which treats the amount attributed to the unit holder as having a character and source consistent with the trustee's attribution.

- The rule would not apply to 'carried interest' distributions assessable under Division 275.
- A special rule will modify this operation so that the current tax treatment of tax deferred distribution to revenue account holders remains.

108. The Government proposes that the character and source retention principles will extend to all MITs, whether or not they have clearly defined rights.

Consultation Questions

20. Is the proposed approach workable in practice?

21. Are there any alternative approaches that should be considered?

6. FIXED TRUSTS

109. The concept of 'fixed trust' is used in various tax law provisions to provide either concessional taxation treatment or simplify administration and reduce compliance costs for fixed trusts. The Board's recommendation in this regard reflects that the current definition of fixed trust is not ideally suited to today's current concept of a MIT.

6.1 TREATING MITS WITH CLEARLY DEFINED RIGHTS AS FIXED TRUSTS

110. MITs will be treated as meeting the fixed trust requirement for the purposes of the income tax law if:

- all unit holders in the MIT have clearly defined rights; or
- the MIT is treated as having clearly defined rights and therefore qualifies automatically for the attribution method.

6.2 RELEVANT PROVISIONS

111. The provisions that are particularly relevant for MITs are those about:

- deductions for trust losses and debt deduction rules (Schedule 2F to the ITAA 1936),
- scrip-for-scrip roll-over under the CGT rules (Subdivision 124-M);
- capital gains or losses by foreign residents (Division 855); and
- the dividend imputation holding period and related payment rules (former Division 1A of Part IIIA of the ITAA 1936).

112. Other provisions that refer to fixed trusts (or fixed entitlements to income and capital of a trust) but which are usually less relevant for MITs are those about:

- reducing a capital gain under CGT event E4 if you are trustee of another trust (section 104-72);
- denial of discount on capital gains where capital gain from equity in an entity with newly acquired assets (sections 115-45 and 115-50);
- market value substitution rule for capital proceeds where trusts are not widely held (sections 116-30 and 116-35);
- the meaning of 'resident investment vehicle' in Subdivision 118-G (venture capital: investments by superannuation funds for foreign residents);
- changing ownership or control of a company — specific provisions for non-fixed trusts (subdivision 165-F);
- superannuation non-arm's length income rules (section 295-550);
- various consolidation purposes (for example sections 703-40 (treating entities held though non-fixed trusts as wholly owned subsidiaries), note to 705-90(7) (profit accruing to joined group before joining time), note to section 707-130, section 707-325 (modified market value of an entity becoming a member of a consolidated group), section 713-50 (determining

destination of a distribution by a non-fixed trust), section 719-35 (treating entities held through non-fixed trusts as wholly owned subsidiaries));

- value shifting (Divisions 725 and 727);
- definition of 'closely held trust' for the purposes of Division 6D (certain closely held trusts) of the ITAA 1936; and
- roll-over provisions in the research and development provisions (sections 73H to 73L of the ITAA 1936).

7. REPEALING CORPORATE UNIT TRUST RULES AND INCLUDING AN ARM'S LENGTH RULE IN THE PUBLIC TRADING TRUST RULES

113. The Government proposes to repeal Division 6B (corporate unit trusts) of Part III of the ITAA 1936 (Board Recommendation 42) and include an arm's length dealing rule in Division 6C (public trading trusts) of Part III of the ITAA 1936 for transactions between common or related interests of a MIT (Board Recommendations 10 and 42).

7.1 IMPLICATIONS OF REPEALING CORPORATE UNIT TRUST RULES

114. Division 6B and Division 6C in Part III of the ITAA 1936 were designed to protect the corporate tax base. The Board described the purpose of Division 6B as follows (in paragraph 10.2 of its report):

Division 6B was introduced in 1981 to discourage the reorganisation of companies involving the transfer of assets or businesses into a resident public unit trust in which the shareholders would take equity in order to avoid continued company tax and shareholder treatment and to attract trust tax treatment instead.

115. Under Divisions 6B and 6C corporate unit trusts and public trading trusts respectively are broadly taxed like a company for income tax purposes. Division 6B has functioned mainly as a deterrent; few trusts are actually subject to the Division. However, where a trust satisfies the Division 6B conditions for an income year, it remains a corporate unit trust for later income years.

116. The repeal of Division 6B means that if a public unit trust complies with the eligible investment business rules, then it is subject to the trust taxation rules and not corporate taxation. Consequential amendments will be needed to remove references to corporate unit trusts in the consolidation provisions (Part 3-90), including sections 703-25, 713-120 and 713-125.

Transitional issues

117. There are transitional issues about how to treat any trusts that are corporate unit trusts when Division 6B is repealed. One possibility would be to maintain the existing treatment (by continuing to tax like a company) for any trusts that were corporate unit trusts when Division 6B was repealed. However, it would seem more consistent with the repeal of Division 6B that those trusts would be taxed like other trusts and, therefore, only subject to corporate taxation if the Division 6C rules apply.

118. If the latter approach were adopted, there would be further interaction and transitional issues. It is understood that a small number of consolidated groups have a head company that is a corporate unit trust. A corporate unit trust must make a choice to become the head company of a consolidated group (section 713-130). If such a choice has been made, the trust continues to be taxed as a company for the period that it remains the head company of the group, even if it ceases to be a corporate unit trust during that period[11] (sections 713-135 and 713-140).

---

11 The trust that is the head company could also be a public trading trust under Division 6C.

7.2 ARM'S LENGTH RULE IN PUBLIC TRADING TRUST PROVISIONS

119. MITs may enter into transactions with associated entities that may transfer income or value between the associated entity and the trust or have the effect of circumventing the eligible investment business rules in Division 6C by effectively re-characterising income from a business into rent from investing in land. As an integrity measure an arm's length dealing rule is to be introduced into Division 6C.

120. The tax law contains many integrity provisions about transactions with associates. A common approach is that a transaction where an entity did not deal at arm's length with another entity is treated as occurring at market value (e.g. subsection 40-180(2) (cost of depreciating asset); section 70-20 (acquiring trading stock); section 112-20 (cost base of a CGT asset). Another approach is to treat transactions between an entity and its associates as occurring at market value (for example Division 72 of the *A New Tax System (Goods and Services Tax) Act 1999*). This approach has the advantage that it avoids difficult issues about whether some entities, although associated, were actually dealing at arm's length. It has the disadvantage that it does not cover those unusual arrangements where arm's length parties do not deal at arm's length.

121. Some provisions (in bills that lapsed when the election was called) have proposed a market value treatment where either an entity did not deal at arm's length with another entity or the transaction was with an associate (see formerly proposed sections 420-20 (acquiring registered emission units) and 420-30 (disposing registered emission units) and recently reintroduced section 355-400 (research and development expenditure)). This approach combines the strengths of the two approaches described above.

122. Where the market value treatment does apply, a related detailed design issue is whether the market value treatment should also apply to the other party to the transaction. Some other non-arm's length provisions automatically apply to the other party (for example the trading stock rule in section 70-20) but that is not the usual case.

7.3 PUBLIC UNIT TRUST DEFINITION IN DIVISION 6C (BOARD RECOMMENDATION 7)

123. The Government proposes to amend the definition of 'public unit trust' in Division 6C of Part III of the ITAA 1936 to exclude trusts that are treated as a public unit trust solely because complying superannuation funds and tax exempt entities entitled to a refund of franking credits have a 20 per cent or more membership interest in the trust.

Consultation Questions

22. Under the proposed rule about non arm's length transactions in Division 6C:

(a) Should the market value treatment apply to transactions where a MIT does not deal at arm's length with another entity, transactions between an entity and its associates or both?

(b) Should the market value treatment also apply to the other party to the transaction?

(c) Are any exemptions from the rule appropriate?

8. OTHER ISSUES

8.1 RESETTLEMENTS

124. As discussed above, MITs will only be able to choose to use an attribution method of taxation where the unit holders of the MIT have (or are treated as having) clearly defined rights/entitlements. In order to use the attribution method of taxation it may be necessary for some MITs to amend their constituent documents. In some cases, amendment of these documents may result in the creation of a new trust and/or an alteration to the nature of the beneficiary's interest in the trust that might amount to a resettlement.

125. If certain types of MITs (for example registered MISs) were to be treated as automatically eligible for the attribution method (as discussed above at paragraphs 40 to 42), it is expected that these MITs would be eligible for the attribution method without needing to amend their constituent documents. This could substantially reduce the number of MITs that would need to consider amending their constituent documents.

126. The Government has said that it will consider further whether there should be roll-over relief where the amendment of constituent documents to qualify for the attribution method results in a resettlement (Board Recommendation 41). To assist this consideration, industry views are sought on a number of consultation questions set out below.

8.2 REPORTING REQUIREMENTS

127. The trustee of a MIT must provide the following information to unit holders in an annual statement:

- the amount and character of the attributed or distributed tax income;
- all amounts relevant to calculating a cost base adjustment;
- the value of certain tax offsets; and
- other taxation information necessary for the unit holder to prepare their annual tax return (Recommendation 27).

128. The trustee could also be required to notify unit holders of the amount of unders and overs that the trustee has identified and carried forward. As these amounts would not be identified until after the trustee issues the annual distribution statements to unit holders, this notification could not be included in the statements for the year in which the under or over arose. So, if this notification were to occur, another method of communication would be needed.

8.3 APPLICATION AND TRANSITIONAL ISSUES

129. Consistent with the former Assistant Treasurer's Press Release of 7 May 2010, the changes discussed in this paper are proposed to apply generally to MITs for income years commencing on or after 1 July 2011.

130. Consequently, where a MIT with clearly defined rights (and a standard income year) exists on 1 July 2011 it will be able to elect to apply the attribution method for the 2011-12 income year.

Where a MIT is created in a later income year, the MIT can elect to apply the attribution method from the first year it is eligible. If a MIT does not elect to use the attribution method for the first income year it is eligible, the MIT can still (assuming it is eligible) elect to apply the attribution method from a later income year.

131. Where an eligible MIT has elected and applied the attribution method in an income year the attribution method will also apply to that MIT in later income years so long as the MIT continues to qualify for attribution treatment. If a trust ceases to be eligible for the attribution method in a particular income year, the normal trust tax rules will apply to the trust for that income year and at least the next four income years. This will prevent complexities and potential arbitrage opportunities that could arise if a trust could move freely in and out of the attribution method.

132. The under and overs treatment would apply for under and overs that arise for an income year commencing on or after 1 July 2011. The legislated treatments would not apply retrospectively to previous income years where a similar unders and overs treatment has been a widespread industry practice.

8.4 Interaction Issues

Withholding taxes

133. The proposed attribution method of taxation will need to mesh appropriately with the withholding tax provisions (and the associated PAYG withholding provisions) for dividends, interest, royalties and fund payments (chiefly rent).

134. Under the existing withholding tax provisions a foreign resident beneficiary is liable for withholding tax when the beneficiary derives a dividend, interest or a royalty included in the income of an Australian trust estate. The time at which the beneficiary derives the dividend, interest or royalty income is when the beneficiary becomes presently entitled to it (subsection 128A(3) of the ITAA 1936). Where a MIT with clearly defined rights is using the attribution method, it would seem necessary to modify the withholding provisions to reflect the attribution methods rather than present entitlement. Similar issues arise for managed investment trust withholding tax on fund payments.

8.5 Product disclosure statements

135. The Government agreed in principle to three Board recommendations (Recommendations 20, 28 and 34) that product disclosure statements (or other documents) be required to:

- identify the possibility for the tax income attributed to beneficiaries to exceed the cash distributed;
- alert beneficiaries to the requirements to make yearly cost base adjustments and to maintain records of the adjustments; and
- indicate to beneficiaries the potential for MITs to carry forward tax errors, reissue distribution statements or, in the case of unders above the *de minimis* level, be taxed at trustee level.

136. Product disclosure statements must include certain statements and the information listed in subsection 1013D(1) of the *Corporations Act 2001*, but only to the extent to which the information would be reasonably required by a person for the purpose of making a decision, as a retail client, whether to acquire the financial product. The information includes, among other things, 'general

information about any significant taxation implications of the product that are specific to that kind of product' (paragraph 1013D(1)(h)).

137. It is most probable that the existing provisions of the *Corporations Act 2001* cover these recommendations and, therefore, no specific changes to existing requirements are needed to achieve the disclosures that the Board considered appropriate.

Consultation Questions

Resettlements

23. What are the possible types of amendments to deeds that may be required to be made (in particular, to satisfy the clearly defined rights requirement) and would they likely result in a resettlement?

24. Are many MITs likely to wish to amend trust deeds?

25. What would be appropriate roll-over relief where a resettlement of a trust occurs as a result of a MIT amending its constituent documents so as to be eligible for the attribution method of taxation?

Reporting

26. Should the trustees of MITs be required to notify unit holders of the amount of unders and overs identified and to be carried forward? If so, what would be the best way for the notification to occur?

Application

27. Do some MITs need time before the commencement of the new attribution rules to amend trust deeds and, if so, what would be a reasonable amount of time to allow?

28. By what date would industry need to implement changes to its systems and how much time would it be likely to take industry to make those changes?

Interactions

29. What specific interaction issues should be addressed in the legislation and what are possible solutions to those issues?

30. What amendments should be made to the withholding tax (and associated PAYG withholding) provisions to ensure that they mesh appropriately?

ATTACHMENT A

Summary table of proposed income tax treatment of managed investment trusts (MITs)		
ISSUE	**MITS WITH CLEARLY DEFINED RIGHTS**[12]	**OTHER MITs**
Basis of taxation	Attribution basis of tax may apply to work out liabilities in relation to the tax income of the trust	Liabilities are worked out under the normal trust rules in Division 6 of Part III of the ITAA 1936, subject to the modifications summarised in this table
Trustee can choose to apply the CGT regime to disposals of the MIT's eligible assets	Yes	Yes
Cost base adjustments for units held by a beneficiary (except for tax deferred distributions to a beneficiary holding units on revenue account)	Yes	Yes
Unders and overs less than a *de minimis* amount are ignored	Yes	Yes
Character and source flow through	Yes	Yes
Treatment as a fixed trust for trust loss rules and other specified purposes	Yes	No

12 Any trust treated as automatically satisfying the clearly defined rights requirement would also have the treatment summarised in this column.