New Tax System for Managed Investment Trusts – Update

Managed Investment Trusts

29 September 2011

Exposure draft legislation for the reforms to the taxation of Managed Investment Trusts (MITs) is expected to be released shortly, ahead of the proposed start date of 1 July 2012.

In this flyer we discuss the development of this highly anticipated regime, which represents a significant milestone for the funds management industry.

While there are issues yet to be clarified, a key challenge in the current economic climate is how to manage the risks and required cost of transitioning into the new regime.

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New managed investment trust regime

Update and recent history

For the past few years, the government has been developing new tax rules for managed investment trusts. So far, there have been changes to the MIT withholding rules for payments to non-residents and the deemed capital account election, which have included major revisions (and complexity) to the MIT definition. The most significant change, a new tax regime for MITs, is designed to bring "feudal" tax laws into the 21st century. The new rules are expected to affect operations, service arrangements and deliverables, obligations and reporting to investors and product planning and development. In very challenging times, this change will require a commitment to expenditure. **With exposure draft legislation now imminent, this edition provides a quick summary of the state of play**.

Why does this need to happen?

Longstanding practical difficulty in implementing tax laws for trusts has led to "industry practice". The result is tax uncertainty. The sensible fix is a new tax regime for MITs.

Australia is also seeking to better position itself in global investment markets, in particular as a financial centre. To do this, the Government has proposed a number of initiatives to attract investment. To succeed, the removal of tax uncertainty is essential.

The initiative to create a new collective investment vehicle (CIV) brings the MIT, our most widely used investment vehicle, into focus. If used as a reference point, the tax treatment of MITs needs to be modernised to provide clear and simple rules and remove tax uncertainty.

What are the key changes foreshadowed?

The key changes relevant to all MITs are:

Codified treatment of unders and overs

- To the extent unders or overs represent <5% of net income or 0.4% of net assets, MITs can carry them forward as timing differences, without re-issuing tax statements to unitholders.
- Where an under exceeds the threshold, the MIT may either re-issue tax statements to unitholders or the trustee may agree to be assessed (at the top marginal tax rate).
- Where an over exceeds the threshold, the regime MIT must re-issue tax statements to unitholders.

Cost base uplifts to address double taxation

- In instances where a unitholder may be taxed on amounts not distributed to them and again when they dispose of their unitholding, the cost base of their units will be 'uplifted' by the amount they have been taxed on but did not receive.

Removal of the corporate unit trust rules

- The removal of rules designed to prevent the transfer of businesses taxed at the company tax rate into trusts, to be replaced by a rule that requires transactions to be at arm's length.

The key changes for MITs with clearly defined rights are:

Elective attribution regime

Under the proposed (irrevocable) elective attribution regime, unitholders will collectively continue to be taxed on total taxable income of the trust. However, each unitholder will be taxed on the amount of taxable income the trustee allocates to them on a "fair and reasonable basis", in accordance with the deed, rather than based upon present entitlement.

Treatment as a fixed trust

Trusts with clearly defined rights will be treated as a fixed trust for the trust loss rules and other specified purposes.

Lobbying

Treasury has been in consultation with industry. The codification of existing rules and practice is proving a major challenge. A combined submission to the Assistant Treasurer by industry associations (ACSA, FSC, TTI, AVCAL, PCA) has outlined changes needed on the following issues (broadly stated):

- Arm's length dealing – A carve out for stapled groups and transactions between trusts.
- Unders and overs – Further safeharbours and options when they are exceeded.
- Clearly defined rights – Simplifying when this status is satisfied by a MIT.

In particular, the unders and overs rules have the potential to be far reaching given the adverse outcomes to investors and trustees, where tax attribute reporting doesn't meet required thresholds. This is a very challenging area because the actual practice of unders and overs is often misunderstood. The extent of misunderstanding and inconsistent practice across the industry needs more attention.

What are some of the questions I should consider?

Decision making

- Do I invest in new systems or operational processes, or both?
- How much will it cost?
- When do I commit to investment?

Documents to review

- Will tax disclosures in offer documents change?
- Will trust deeds require amendment?
- Will tax reporting to unitholders change?

Tax risk management

- Do business stakeholders have 'line of sight' to opportunities and risks of the new regime?
- How will my tax risk management framework be affected?
- How will this change the role and responsibilities of my in-house tax function?
- Do tax policies address the early identification and management of material unders or overs?
- Are 30 June 2012 tax reviews scoped and timed to ease transition to the new regime?
- How might class actions from unitholders arise under the new rules?
- When might I need to provision for potential trustee tax liabilities?
- How do I manage tax risk to protect and enhance value, to achieve competitive advantage?

3rd party relationships

- To what extent can I "outsource" compliance with the new rules?
- Do existing third party service level agreements adequately scope the required activity?
- How might platform arrangements change, particularly re year end timing needs?
- How will interim and annual distribution policies and procedures with custodians be affected?

Unders and overs – What do I need to understand about my funds?

- What are our existing practices on unders and overs?
- Would we meet the requirements of the new regime?
- How would we go about complying with the new rules?

- How long would this process take and how much would it cost?

What next?

The release of the Exposure Draft legislation. Once released, we will complete our analysis of the new rules and conduct forums to explain how the new rules will affect industry. In the meantime, we suggest that you be ready for the introduction of the new rules, proposed from 1 July 2012, by first understanding the unders and overs position of your funds, your current year end processes and how you will manage the expectations of investors.

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