Draft legislation for the Managed Investment Trust Regime released – what will it mean for the Real Estate industry?

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In brief

The public release of the draft legislation for the proposed new tax regime for managed investment trusts (MITs) is a significant step towards realisation of a regime that has been in development for almost five years). The draft legislation released on 9 April 2015 reflects the previously announced start date of 1 July 2015 for the new regime. However, it is understood that the Government intends to defer the start date for another year, such that the new regime will apply to income years starting on or after 1 July 2016 with an option to elect in one year earlier (for income years commencing on or after 1 July 2015).

Again, whilst not addressed in the draft legislation, it is understood that existing MITs will need to exercise a choice to adopt the new MIT regime.

The new regime will apply to trusts that are Attribution Managed Investment Trusts or AMITs, which are broadly managed investment trusts under the existing definition in the tax law (with some minor changes) where the interests of members in the trust are clearly defined. Under the new regime, trust components (which include both taxable income and some non-taxable amounts) will be allocated or attributed to members of the trust on a fair and reasonable basis, rather than based on present entitlement to "income" of the trust as per the current tax law. A detailed overview of the proposed new regime can be found in PwC's TaxTalk Alert *Draft legislation for proposed new Managed Investment Trust regime released*.

The draft legislation not only seeks to implement the new attribution regime for AMITs, but also proposes some changes to the existing definition of MIT contained in the tax law, and makes some other minor related amendments.

While the proposed new regime goes some way to addressing the difficulties in applying the current trust tax law provisions to managed investment trusts, the proposed rules are complex and feature a range of new obligations and potential penalties that must be carefully considered.

In detail

The vast majority of Australian real estate is held via trusts and at the institutional level most ‘passive’ investments are held via managed investment trusts. As such the introduction of the MIT Regime and accompanying changes will impact upon the Real Estate sector more heavily than any other sector.

The following are some observations that we consider will be of interest to many industry participants.

In or Out? (Clearly defined rights and resettlements) – the first point of action for all existing MITs will be to determine whether or not they want to be an AMIT. Regardless of the answer to that question, the second point of action will be to review their constituent documents to align them with their desired outcomes.

The nature of the changes that may be needed to the constituent documents, in particular if there are changes to be made to allow for attribution of income without the existence of present entitlement raises the prospect of a resettlement of the trust. The income tax and stamp duty consequences of a resettlement may be dire and as such trustees must tread very carefully in this area. Taxation Determination TD 2012/21 will be of relevance in an income tax context.

AMIT as a code? – one of the great hopes for the MIT Regime was that it would act, at least from the perspective of MITs, as a code. That is, the trust would determine whether it was a MIT and if so its obligations would be to provide the required information to beneficiaries and withhold from payments to non-residents at the applicable rate. This is consistent with the treatment of interest, dividend and royalty withholding.

It would appear that this outcome is broadly achieved for AMITs as Division 6 is turned off for these trusts and their beneficiaries.

However for withholding MITs that are not AMITs, there are still circumstances where the MIT has to make detailed enquiries as to the nature of its beneficiaries and their tax outcomes in order to determine the MITs reporting and withholding obligations. This is unfortunate and an area which should be raised during the public consultation phase.

Arm’s length income test – the transitional rule for the ALR is relatively short when compared to transitional rules from other recent law changes. Where the non-arm’s length arrangement is one that cannot be restructured without material costs before 1 July 2017 (for example where the arrangement relates to the financing of a long term construction arrangement especially one that involves external debt), the penalty rate of tax applicable to this income appears unnecessarily high. We would recommend to Government that this transitional period be extended to at least 1 July 2018.

The arm’s length rule is going to lead to a large increase in compliance costs.

There are a number of important matters of relevance to the Real Estate sector that will require clarification either via amendment to the Exposure Draft or guidance in the Explanatory Memorandum or ATO pronouncements. These include the following:

- the safe harbour interest rate is measured by reference to the base rate at the time of the interest payment. As such, the safe harbour will not provide ongoing protection where the fixed rate on a loan is below the safe harbour at the time the loan is advanced but the base rate falls;
- the Explanatory Memorandum states that the focus of the arm’s length rule is the pricing of loans and not the quantum of the loan. The Exposure Draft is not clear on this point and as such without further clarity this risk remains; and
- whether the arm’s length rule applies on a net basis. That is, can the arm’s length rule apply where the AMIT has an amount of non-arm’s length income but also has a reduction in other income. For example, if an AMIT lends funds to a sub-trust at above the safe harbour rate and this results in a reduction in the distribution from the sub-trust to the AMIT, will the arm’s length rule apply to the

interest income and ignore the reduction in the trust distribution. This would seem to turn of the breadth of the concept of ‘reflected in’ contained within proposed subsection 276-670(5)(4)(a).

Additionally, arrangements entered into by entities owned by the AMIT (e.g. non-AMIT sub-trusts) may fall within the rules as the income distributed by these entities to the AMIT may be seen to be non-arm’s length income derived by the AMIT.

Whilst, the stated policy of the arm’s length rule is to apply only to income of an AMIT, as this income can include distributions from sub-trusts, the current draft wording means that sub-trusts must also ensure their expenses are on an arm’s length basis otherwise the distributions from the sub-trusts to the AMIT may be non-arm’s length income. This dramatically expands the scope of the rule and the resulting compliance costs and risk level.

As a result, arrangements such as long term construction contracts, investment management agreements, property management agreements and financing (including hedging arrangements) may fall within the ambit of the arm’s length rule.

Fund payments: cash distribution vs. taxable distribution: one of the most controversial issues under the existing MIT rules was the application of withholding tax where the cash amount of a distribution was less than the taxable amount of the distribution. This often arose where there was a large capital gain and the trust only wished to distribute the discount capital gain component.

Most MITs that encountered this issue simply withheld based on the taxable component of the distribution so the effective withholding rate exceeded 15/30%. The ATO’s stated view was that MIT withholding should have been applied at 15/30% of the cash amount and any excess taxed under Division 6. The ATO took a non-enforcement approach on this issue as the MIT Regime was pending.

The issue is resolved for AMITs however remains for withholding MITs that are not AMITs. These trusts should expect the ATO to now seek to enforce their view.

Acquiring MITs (retrospectivity?) – the historical approach to income tax due diligence in respect of unit trusts has been a review of the trust deed/constitution and associated resolutions to ensure that the beneficiaries were presently entitled to the trust income of the trust. Once this was confirmed, a purchaser could generally be comfortable that historical income tax risk rested with the prior unitholders.

The introduction of the concept of a discovery year means that prima facie, an issue which is discovered post acquisition will be included in the taxable components attributed to the new beneficiaries.

For trusts which are acquired after the introduction of the AMIT regime, this will dramatically alter the approach to due diligence and may also lead to disputes between purchasers and vendors as to the ability of a new AMIT member annual statement (AMMA statement) to be issued post-acquisition.

However, for trusts that were acquired before the introduction of the AMIT regime, but which become AMITs, subdivision 276-T of the *Transitional Provisions* appears to include the discovered amount in the income of the AMIT but not give any ability for the trustee to reissue a distribution statement (or an original AMMA). This is most unfortunate for acquirers of trusts in the last 4 years as they acted in an appropriate manner given the law and will now be faced with an unknown level of income tax risk. A review of the sale and purchase agreement will be needed to determine whether the acquirer has any other form of recourse in this circumstance.

Qualifying investors: an opportunity missed – whilst it is true that the expansion of the qualifying investor test is welcome, there are a number of changes to the definition which should have been made to recognise the types of international investors that the MIT regime is intended to attract and to protect a trust’s MIT status from greenmailing.

In this regard, the wholly owned subsidiary expansion fails to recognise that the extensive use of limited partnerships in foreign jurisdictions. Limited partnerships are the predominant international pooling vehicle yet, again Australia’s tax law has failed to recognise this, such that a limited partnership which has only qualifying investors as its limited partners will not be treated as a qualifying investor. This could have been resolved by either ignoring the general partner or applying a 75%-90% threshold rather than a wholly-owned test to the trace through rules.

The 10% foreign individual component of the closely held test should also have been amended so as to not require tracing through qualifying investors and to listed entities. At present, listed MITs are at jeopardy of being greenmailed due to this rule. Take for example a listed REIT in which a foreign individual acquires a 9.9% interest on market. That investor could then approach the REIT and ask for their units to be redeemed at a premium to market value or otherwise they will acquire a further 0.1% interest which would result in a loss of MIT status and have severe adverse outcomes for the trust and its investors.

Capital gains and losses – the current treatment of TAP and non-TAP losses for a MIT is relatively straightforward. That is, the trust calculates its net capital gain without regard for the character and only for the purposes of withholding are the components relevant, whereupon the trustee excludes non-TAP gains and losses for the purposes of calculating the fund payment.

For an AMIT, as the trustee now undertakes calculations by component as a starting position, the process is different and whilst the policy intention is no change in outcomes, there does appear to be some potential differences that could arise, particularly due to the ability of trustees to attribute (or not attribute) by component rather than in total.

Multi-class AMIT – the multi-class AMIT rule provides that an AMIT with multiple classes of units is treated (only for the AMIT rules) as if it were more than one trust.

This is likely to lead to an increase in scenarios whereby property trusts have separate classes of units on issue to provide investors with exposure to different property classes (e.g. office vs. retail) or to specific properties within a portfolio. These scenarios may also be more stamp duty efficient.

Transitional MITs – there are a small number of trusts that were established as MITs prior to the second tranche of MIT changes in May 2010. These MITs only require one qualifying investor to hold an interest in the trust, and are not subject to either the trading trust or substantial investment management requirement.

The changes to the qualifying investor tests (in particular the wholly owned entity concession) which are to have effect from 1 July 2014 may mean that such MITs stop being transitional MITs and become 'ordinary' or 'withholding' MITs. This means in the future they will need to observe the trading trust and investment management requirements.

Whilst the number of such trusts is small, the retrospective change to the definition of qualifying investors, which is intended to be beneficial, may have material adverse implications to these trusts and their investors.

The takeaway

Assuming the final law is amended to provide existing MITs with a choice to adopt the new regime, trustees of existing MITs will need to carefully consider the potential implications of the new attribution regime in deciding whether to adopt it. The new attribution regime will also need to be considered when contemplating new real estate transactions.

The benefit of increased certainty afforded by many of the features of the new regime will need to be carefully weighed against the new obligations and possible penalties, including the arm's length rule which is likely to lead to a substantial increase in compliance costs.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact your normal PwC contact or one of the following:

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