Applying the 'substance test' for withholding MITs

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In brief

As a net importer of capital, Australia has developed as a leading financial services centre. One aspect of the policy settings to encourage foreign investment in Australia is the availability of tax concessions such as Australia's managed investment trust (MIT) regime.

The MIT regime seeks to attract foreign capital and secure Australia's position as a financial services centre.

The first policy goal — attracting foreign capital — is achieved by offering a concessional withholding tax rate (generally 15 per cent) on returns to foreign investors in an MIT. This concessional withholding rate provides a material saving compared to Australia's company tax rate and the top marginal rate for individuals. This concessional tax rate is a key driver of investment decisions made by foreign capital as it directly affects an investor's net returns after tax.

The second objective — ensuring that Australia retains its financial services expertise — is achieved by mandating that a "substantial proportion" of the investment management activities relating to the MIT be performed in Australia. This aspect of the regime essentially requires foreign investors to reinvest part of the savings generated from the MIT withholding rate into Australia's financial services sector through employment or services.

The obligation to reinvest part of the savings creates an inherent tension between an investor's overriding objective to maximise after-tax returns and achieving the second policy objective above. This is because the greater an investor's expenditure on investment management activities in Australia, the lower its overall returns. It is not unreasonable to expect the natural resolution of this tension to be a decline in the level of activities performed in Australia in favour of reduced costs and higher after-tax returns.

The purpose of this article is to help investors and advisers understand the Australian Taxation Office's (ATO's) approach to the MIT substance test and the level of investment management activity that is required to secure the concessional withholding tax rates on offer.

In detail

Background to the MIT regime

The concessional withholding tax rates available to MITs are a significant advantage to foreign investors in Australia's alternative asset classes such as infrastructure, real estate and agribusiness. Reasons for this include:

1. investors in these asset classes are typically nil or low-taxed entities in their home jurisdiction (such as pension or sovereign wealth funds) meaning Australian taxes are generally non-creditable and therefore a permanent impact on investor's returns, and
2. assets in these classes generally involve medium to long-term passive investments for rent and capital gains. These returns do not ordinarily qualify for the concessional interest, dividend or royalty withholding tax rates available under Australia's tax treaties (meaning that they are prima facie subject to a 30 per cent headline corporate tax rate).

The concessional MIT rates also serve to level the playing field between the tax paid by Australia's domestic superannuation funds and equivalent foreign pension funds — which is an important policy setting for a net "capital importer" such as Australia.

An MIT is essentially an Australian resident trust that:

- has a particular investor composition (in the context of this article, usually wholesale investors),
- qualifies as a managed investment scheme under the Corporations Act 2001 (Cth),
- is operated or managed by the holder of an Australian financial services licence (AFSL), and
- makes passive investments.

To qualify for the concessional withholding tax rates where the assets are connected to Australia, the MIT substance test in s 12-383(b) of the *Taxation Administration Act 1953* (Cth) (TAA53) requires that a substantial proportion of the investment management activities be carried out in Australia. By inserting this requirement into the MIT regime, Australian policy makers have put a condition on the availability of concessional withholding tax rates — being the partial re-investment of savings into Australia's financial services sector. Foreign investors must therefore ensure that the activities of the trust have adequate substance in Australia should they seek to access the concessional MIT withholding rates.

Ambiguity with the MIT substance test

There is some uncertainty, and potential difference of opinion, as to the minimum level of investment management activity required to satisfy the MIT substance test. Essentially, there are three particular issues which generate the uncertainty:

1. Are the "relevant activities" those performed in a year when a fund payment is made, or over the life of the investment?
2. What activities comprise "investment management activities"?
3. What is required by "substantial proportion"?

In the context of the tax Acts, and the MIT substance rules more specifically, we know that the ATO is likely to settle any ambiguity in the text using the "purposive approach".[1] Under this approach, the ATO will look to the policy underlying the law, as it is evidenced in the Act and extrinsic materials (such as the

[1] Section 15AA of the Acts Interpretation Act 1901 (Cth) mandates that, when interpreting Australian statutes, "the interpretation that would best achieve the purpose or object of the Act (whether or not that purpose or object is expressly stated in the Act) is to be preferred to each other interpretation". In other words, s 15AA mandates the "purposive approach" as the pre-eminent method of ascertaining statutory meaning in Australia.

explanatory memorandum, second reading speeches etc), to resolve any ambiguity. This approach to statutory interpretation in the MIT rules is evident from the way the ATO has responded to private ruling requests on these three particular issues.

In this instance, the authors would agree that the "purposive approach" is an appropriate method of statutory interpretation. Accordingly, the likely outcomes to each of these issues in the MIT substance rules using this method of statutory construction are addressed below.

Uncertainty regarding annual activities or whole of investment

When applying the MIT substance test, the first issue that arises is whether:

- the relevant activities are those performed in the specific income year, or
- the relevant activities are those performed over the life of the investment.

This uncertainty stems from the fact that the MIT test in s 276-10 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) is assessed annually, and s 12-383(b) TAA53 requires that the investment management activities are carried out in Australia "throughout the income year". These aspects of the MIT rules suggest that the relevant activities are limited to those carried out during the relevant income year.

However, this is not how the ATO has construed the test in numerous private binding rulings: PBR 1012119087422, PBR 1012386145619 and PBR 1012387344596. In these cases, the ATO has taken the view that the investment management activities need to be "examined holistically", having regard to the life of the investment. The ATO has cited specific commentary in the explanatory memorandum in favour of this interpretation.

This difference can be a significant factor in the context of passive assets as the degree of investment management activities are likely to be skewed to the front and back end of the investment cycle (with routine activities performed during the intervening period). The ambiguity between the legislation and the policy intention inevitably creates scope for a difference in opinion between advisers and regulators. This, in turn, could lead to materially different outcomes between investors and ultimately an unequal playing field.

The authors agree with the ATO's view that the policy intent would be promoted through an interpretation that considered investment management activities over the whole of the investment, and that meaningful activities must be performed each year. In addition, the authors consider this to be an aspect of the MIT regime that would benefit from ATO public guidance to ensure consistency in approach.

Limiting the investment management activities performed in Australia to the year in which a fund payment is made is not a recommended course of action — regardless of perceived cost savings that could be achieved.

Defining "investment management activities"

The task of defining the "investment management activities" should be a simple one. However, due to the awkward approach to explaining this concept in the explanatory memorandum, this is not the case.

The explanatory memorandum firstly establishes a category of activities involved in "operating and managing a fund", which consist of activities that are necessarily carried out from the making of an investment in Australia.[2] Next, the explanatory memorandum goes on to compare these activities with

[2] Para 5.60 of the supplementary explanatory memorandum to the Tax Laws Amendment (2010 Measures No. 3) Bill 2010 (EM).

"investment management activities".[3] The natural overlap between these two sets of activities creates a degree of confusion.

Essentially, the difference is:

1. operating and managing activities includes those activities that would ordinarily occur in Australia by virtue of making an investment, such as custodian services, asset management services and professional services in connection with due diligence or regulatory compliance. These are all activities which could be expected to happen without the existence of the MIT substance rule in s 12-383(b)TAA53, and
2. investment management activities are those activities described above, plus the regular performance of market analysis, identification of potential investments, making of recommendations, the final investment decision, the preparation and provision of regular reports on the performance of the investment, attendance at investment committee meetings etc.

It follows that the scope of "investment management activities" goes beyond those activities which typically accompany the management of assets situated in Australia, meaning a further level of activity needs to be carried out.

This view is consistent with the fundamental reason for the MIT substance requirement, and finds support in the explanatory memorandum which reiterates that it is investment management activities, and not merely activities incidental to the fund management activities, which are central to the policy objectives of the MIT regime.[4] A review of the private binding rulings on this particular issue confirms that the ATO also subscribes to this view.

Before moving on to examine "how much" of the above activities need to be performed in Australia, it is worth highlighting at this point that the ATO is very unlikely to accept that custodian services, asset management services and professional services, alone or together, achieve the minimum level of activity required by the MIT substance test. Accordingly, investors need to be doing more than the requisite operational activities in Australia in order to secure the benefits of the MIT concessional withholding tax rate.

"Substantial proportion" – more than a baseline

The meaning of "substantial proportion" is, by its very nature, a relative (rather than absolute) measure. This type of test contrasts with other tests in the broader MIT regime which are purely quantitative (ie based on a number of investors of a particular type). In practice, the application of this test depends on an objective weighting of the actual investment management activities performed in Australia, compared to those performed elsewhere.

As mentioned above, the critical issue is the extent of the activities required, and apart from the comments in the explanatory memorandum, there is limited guidance available to help investors determine the appropriate benchmark level of activity. In the absence of specific guidance on the "substantial proportion" requirement, inferences have been drawn from the following PBRs which considered this particular question: PBR 1011543866023; PBR 1011544672063; PBR 1012119087422; PBR 1012386145619; PBR 1012387344596; and PBR 1012708528770.

Interestingly, on a review of these PBRs, it became apparent that similar activities were considered by the Commissioner in each case and there was a clear trend to the level of activity required to obtain a positive ruling. When considered in conjunction, this trend could arguably define the minimum level of

[3] Para 5.61 of the EM.
[4] Para 5.64 of the EM.

investment management activity required in Australia in circumstances where foreign investors retained the final investment decision (which was the case in each of these PBRs).

Table 1 illustrates this trend in the activities considered by the ATO and performed by the fund.

Only one of these PBRs found that the investment management activities carried out in Australia were insufficient to satisfy the MIT substance requirement.[5] Interestingly, as illustrated by Table 1, this was the one example where the activities performed in Australia were limited to activities which ordinarily accompany the management of Australian assets (eg reporting, risk management, bookkeeping etc).

Table 1: Summary of the ATO's view on MIT substance

	PBR 1011543866023	PBR 1011544672063	PBR 1012119087422	PBR 1012386145619	PBR 1012387344596	PBR 1012387344596
Commissioner held MIT substance existed	Yes	Yes	Yes	Yes	Yes	Yes
Australian manager had authority to…						
Make final investment decision	-	-	-	-	-	-
Provide market research and economic data	✓	✓	-	✓	✓	✓
Identify investments in line with policy	✓	✓	-	✓	✓	✓
Make recommendations on investments	✓	✓	-	✓	✓	✓
Recommend changes to the policies	✓	✓	-	✓	✓	-
Evaluate and negotiate contracts	✓	✓	-	✓	✓	-
Conclude contracts	-	-	-	-	-	-
Report regularly to the unitholders	✓	✓	✓	✓	✓	✓
Investigate and negotiate claims	✓	✓	-	✓	✓	-
Assisting with the risk function	✓	✓	✓	✓	✓	✓
Ensure assets were adequately insured	✓	✓	-	✓	✓	-
Administer bookkeeping and accounting	✓	✓	✓	✓	✓	✓

The takeaway

It is worth re-emphasising that the MIT substance test requires a consistent level of investment management activity to be performed in Australia, over and above those activities which necessarily flow from investing in Australia assets.

[5] In PBR 1012119087422.

Foreign investors that attempt to reduce costs by limiting the investment management activities to the income year a "fund payment" is made, or limit the activities to those which typically accompany the management of Australian assets, are risking the benefits of concessional withholding tax rates. Investors should therefore exercise caution when determining the level of activity required to satisfy the MIT substance test, or when making any decision to reduce the level of activity performed in Australia.

The final point is that the landscape for MITs is changing. The recommendations of the Board of Taxation's 2009 report have now, largely, been implemented into the MIT regime with the recent enactment of the attribution MIT (AMIT) rules through Tax Laws Amendment (New Tax System for Managed Investment Trusts) Act 2016 (Cth). The ATO has mobilised a dedicated team to deal with the AMIT regime and has flagged the potential for a Senate inquiry into the use of concessionally taxed and transparent vehicles, such as MITs. In light of these developments, the authors expect to see an increase in the ATO's compliance activities for MITs in the near future.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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