Archaic rule for super funds to be abolished

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In brief

This article considers the proposed modifications to Div 6C which will allow super funds to invest in trusts without fear of changing the trusts tax profile, and provides opportunities to increase value from existing structure.

On 3 December 2015, the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015 (the Bill) was introduced into parliament. If enacted, the new attribution regime for managed investment trusts (MITs) (ie the AMIT regime) will be implemented, as well as several other changes. These include modifying the public trading trust rules in Div 6C of the *Income Tax Assessment Act* 1936 (Cth) (ITAA36) from 1 July 2016.

The modifications will provide that membership interests held in a trust by certain tax-exempt entities and complying superannuation funds will be disregarded for the purpose of applying the 20% tracing rule that determines whether a trust is a public trading trust.

In detail

The 20% tracing rule

Where a unit trust carries on a trading business or controls the affairs or operations of another person in respect of the carrying on of a trading business, and it is also a "public unit trust", the trust is a "public trading trust" and taxed as a corporate.

The current definition of a "public unit trust" for Div 6C purposes is contained in s 102P ITAA36, which essentially consists of two tests.

Section 102P(1) sets out the first of the tests which deems a unit trust to be a public trust if the units are quoted on a stock exchange, or otherwise publicly offered,[1] or if the unit trust is held by not fewer than 50 persons.[2]

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[1] S 102P(1)(a) and (b) ITAA36.

The second test is found in s 102P(2) and is commonly referred to as the “20% tracing rule”. Essentially, this test examines whether an exempt entity or exempt entities hold an interest in the unit trust that entitle the holders to not less than 20% of the beneficial interests in income or property of the trust.[3]

The critical component of the 20% tracing rule is the definition of “exempt entity” which, for the purposes of Div 6C, is extended by s 102MD ITAA36. Relevantly, s 102MD deems “a complying superannuation fund” (among other entities) to be an exempt entity for the purposes of Div 6C.[4]

When Div 6C was originally enacted in 1985, the application of the “20% tracing rule” to “exempt entities” was intended to achieve tax neutrality in structures. At that time, “complying superannuation entities” were exempt from income tax, pursuant to then s 23F ITAA36. However, from 1 July 1988, “complying superannuation entities” commenced to be taxpayers and therefore ceased to be tax-exempt entities.

As superannuation funds are tax paying entities able to receive refunds for franking credits and many tax-exempt entities are also able to receive refunds for franking credits, the policy rationale for bringing such entities within Div 6C no longer exists.

As such, a superannuation fund that invests in a unit trust and holds an interest of 20% or greater may set up a “blocker company”. This is to protect the “flow-through” status of the unit trust as it is argued the trust would not be viewed as a public unit trust as there is no requirement to trace through the blocker company in applying the tests to determine whether the unit trust is public.

For an infrastructure or property acquisition, maintaining “flow-through” tax status of the unit trust allows project debt to be sized on
pre-tax cash flows, which ultimately allows the consortium to bid a more competitive price. This assumes that a blocker “trust” (as opposed to a company) that owns the interest in the unit trust must be traced through for this purpose. This is discussed further below. However, several valuation and cash flow issues may arise from the use of a “blocker company” within structures. These include:

- the loss of the ability to retain the character matching of distributions, including tax deferred distributions (and/or discounted capital gains)
- the risk of having franking credits “trapped” within the blocker company. This can occur if the accounting treatment within the blocker company does not match the tax/cash character and franked dividends cannot be paid in certain periods
- the need to consider s 45B ITAA36 for returns of capital made to the superannuation fund from the blocker company
- the valuation applied to the face value of the franking credits, which may be less than 100%.

As such, the removal of complying superannuation funds from the definition of “exempt entity” in Div 6C will be welcomed by the industry once the Bill is enacted.

Should BlockerCo be removed from existing structures?

A project’s tax structure may be altered several times over its life as a result of change in the investor profile, change of law or change in strategy.

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[2] S 102P(1)(c) ITAA36.
[3] S 102P(2) ITAA36.
[4] S 102MD(b) ITAA36.

One such situation is where a structure that was preferred by a particular group of investors is not preferred by the incoming investor/investors. This is due to each investor having a different "tax profile" which impacts the underlying structure. For example, under current rules, a non-widely held trust must monitor its register of unitholders to determine whether entities that hold units are tax-exempt entities (including complying superannuation funds). Other (unrelated) unitholders would also be impacted by changes to the unit register which may change a unit trust from a tax flow through vehicle to a tax paying entity.

Consortiums often pool funds into one collective vehicle and invest directly into an entity (see Diagram 1). To prevent the Project Trust from becoming "public", a blocker company is often part of the structure.

As a result of the change in law, many superannuation funds may now contemplate restructuring their existing structures that contain blockers. As discussed above, the use of a blocker can result in sub-optimal valuation outcomes and the potential ability to remove a redundant blocker should be considered carefully by investors. It is important that the superannuation fund considers the blocker as it may have significant income tax and stamp duty implications. benefits/disadvantages of removing the blocker as it may have significant income tax and stamp duty implications.

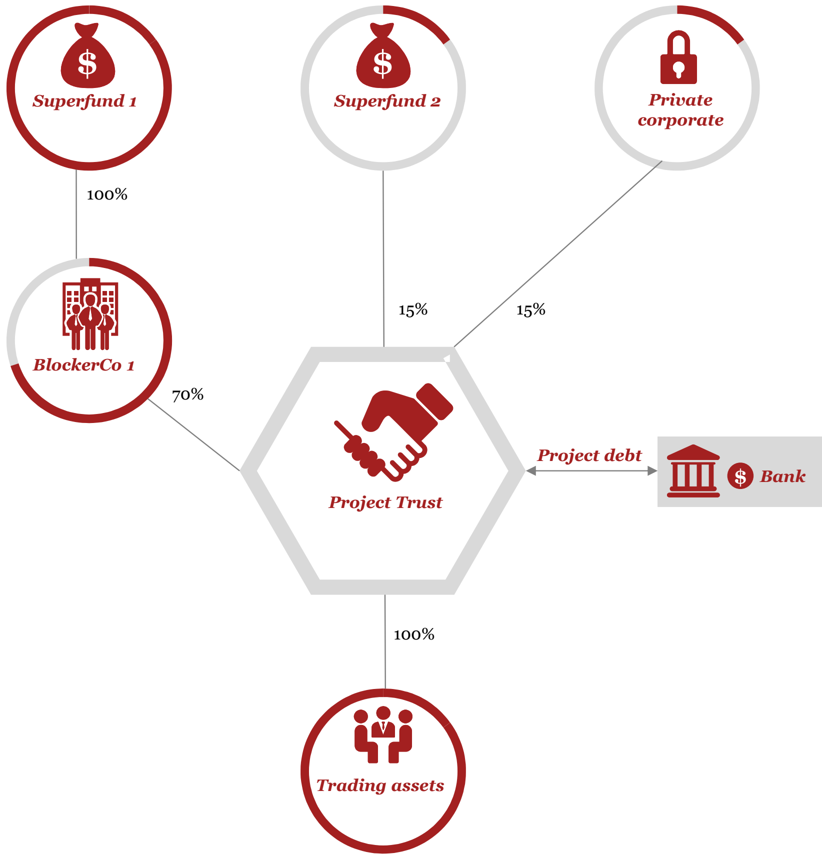
There may be several ways to remove the blocker company from the structure. Described below is what might be considered the most simple or common method:

1. Superfund buys the units in Project Trust from BlockerCo for market value. Payment is made by way of promissory note from Superfund to BlockerCo
2. BlockerCo returns capital to Superfund, satisfied by the promissory note
3. BlockerCo is either liquidated or left asan inactive subsidiary.

As a result:

- broadly, BlockerCo may make a capital gain or loss on the difference between the cost base of the shares in Project Trust and its market value. When calculating the cost base, it is important to note that over the life of the project, there may have been "tax deferred" distributions paid up from Project Trust to BlockerCo, leading to a reduction of the cost base
- the CGT discount will be unavailable to BlockerCo
- any tax payable as a result of a capital gain will need to be cash funded. This may be through the subscription of new equity
- a franked dividend may be payable from BlockerCo to Superfund (subject to the usual dividend and accounting requirements)
- any remaining franking credits in BlockerCo will generally be "trapped". There may be certain strategies to release these
- the cost base in the units of Project Trust for the Superfund should broadly be what the Superfund paid for them (ie the market value at the time). Beneficially, this will "reset" the cost base to market value
- the acquisition of the units in Project Trust may trigger unit transfer duty and/or landholder/trust look-through duty. Unit transfer duty is scheduled to be abolished on 1 July 2016. Whether landholder duty is triggered will depend on where Project Trusts' underlying assets are located and the percentage interest dealt with. For example, if the underlying assets are located in New South Wales, an acquisition of up to 49.99% (tested on an associate inclusive basis) is usually possible

without triggering a landholder duty liability. Some states have a lower acquisition threshold in certain circumstances (for example, Victoria, 20%) and others, no acquisition threshold at all (for example, Queensland).



Section 102P(10) and "tracing"

Broadly, s 102P(10) requires that the beneficial ownership of the units of a unit trust must be traced through any interposed trusts for the purpose of s 102P (ie to determine whether the unit trust is "public").

There is some uncertainty as to when tracing is required through an interposed trust estate to the underlying beneficiaries of that trust. The law is relatively settled post the High Court decision in *CPT Custodian Pty Ltd v Commissioner of State Revenue.*[5] *In CPT Custodian*, the High Court unanimously agreed that for a typical unit trust (at least with more than one unitholder), the trustee of a unit trust holds the legal and beneficial ownership interest in each of the assets of the trust.

The beneficiary of a unit trust has equitable rights as against the trustee to perform their obligations under the trust deed, and a right to share in the surplus of the trust assets on a winding-up of the trust, but no beneficial interest in any particular asset of the trust.

Against this background, we need to look specifically at the wording in s 102P(10) that governs the issue of tracing. Section 102P(10) states:

> "… for the purposes of this section, where any units in a unit trust … are held by the trustee of another trust estate, a person who has a beneficial interest in property of that other trust estate that consists of those units … shall be deemed to hold those units."

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5 [2005] HCA 53.

There are grounds for reading s 102P(10) as only requiring the tracing through of an upstream trust estate to a beneficiary where the beneficiary has a beneficial interest in the units of the downstream unit trust, by virtue of its unitholding. *CPT Custodian* suggests that this should not be the case for a typical unit trust.

The explanatory memorandum to the Bill which introduced Div 6C[6] does not provide any useful assistance in relation to interpreting s 102P(10). It merely states that:[7]

> "... subsection 102P(10) is designed to allow the beneficial ownership of units in a unit trust to be traced through any interposed trusts to the ultimate beneficiaries."

There is a suggestion from this wording that the drafter intended a tracing through upstream trusts.

The wider view that is generally taken is that a court may interpret words in s 102P(10) more broadly. This would require tracing through any upstream interposed trust estate to the beneficiaries of that trust, but only where the beneficiaries have a "beneficial interest in property of that other trust estate". This is the practical approach that is typically adopted.

Assuming that the requirement is that a taxpayer must trace through interposed trusts, the following questions become relevant.

Do you need to trace through a Div 6C trust?

There is an argument that a "head trust" by virtue of being a Div 6C trust could be seen to be one "person" for the purpose of applying s 102P(1)(c) (ie the entity is a blocker for tracing purposes).

This is based on the modified application of the ITAA36 in s 102T(7) which states that a reference in the definition of "person" in s 6(1) ITAA36 to a company shall be read as including a reference to a public trading trust or, as the context requires, to the trustee of a public trading trust.

However, there is a counter view that, because s 102T(1) states the modifications to the ITAA36 are in relation to the imposition, assessment and collection of tax in respect of:

1. the net income of public trading trust
2. the income or assessable income of a unitholder,

then s 102T should not apply to determine the "downstream" characteristics of the structure (ie the modifications made to the Div 6C "head trust" should be used when determining whether a sub-trust is "public"). The authors note that usual market practice is to insert a corporate blocker to eliminate ambiguity.

Do you need to trace through a superannuation fund?

It is generally accepted that members of a typical Australian superannuation fund do not have a beneficial interest in the property of the fund and could not be said to be the holders of the property of the fund. However, there is likely a distinction between having a beneficial interest in a trust estate and having a beneficial interest in property of the fund that consists of units in the Australian unit trust (ie trust beneficiaries not necessarily having an interest in each investment asset of the fund).

In ID 2006/219, the ATO espoused the view that, at common law, the superannuation fund member has no interest in the assets of the superannuation fund, including its units in the unit trust. In ID 2006/219, that common law position is overridden to treat the superannuation fund member as the "ultimate owner" for the purposes of s 149-15(4) and (5) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

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[6] The explanatory memorandum to the Taxation Laws Amendment Bill (No. 4) 1985.
[7] Ibid p 84.

Helpfully, the introduction of s 102P(10A) in the Bill will clarify that there will not be a requirement to "trace" through a "complying superannuation entity". A "complying superannuation entity" is:

- a complying superannuation fund
- a complying approved deposit fund
- a pooled superannuation trust.[8]

Relevantly, all of the above entities are defined[9] to take the meaning under the SISA. Broadly, the SISA requires that the regulator/APRA notifies the relevant entity that it meets the criteria for the purpose of the ITAA97.[10] These entities are usually Australian-based (ie not foreign).

Accordingly, the treatment of superannuation funds that are not a "complying superannuation entity" (ie foreign superannuation funds not regulated by the SISA) remains uncertain. Therefore, careful consideration must be given to the "status" of the foreign superannuation fund. Where the members of the foreign superannuation fund are construed to have a beneficial interest in the units held by that superannuation fund, then the foreign superannuation fund may need to be "traced through" to the individual members. If there are more than 50 individuals, this would likely deem the underlying trust to be "public".

Final comments

The proposed modifications to Div 6C are well overdue and will allow superannuation funds to invest in trusts without fear of changing the tax profile of the trust and impacting other unitholders. Further, investment via blocker companies, which can have negative valuation and cash flow outcomes, will not be required. There is an opportunity to eliminate existing blocker companies from structures. However, care should be taken as there may be income tax and stamp duty consequences.

Let's talk

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

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8 S 995-1 ITAA97.

9 S 995-1 ITAA 1997 provides that ss 45, 47 and 48 of the Superannuation Industry (Supervision) Act 1993 (Cth) (SISA) define each entity, respectively.

10 Ss 45, 47 and 48 SISA, respectively.