Trust ruling leaves investors in limbo - Australian Financial Review, The [3 Day Embargo] (Australia) - January 27, 2011 - page 3

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Tens of thousands of investors could be affected by a Federal Court ruling that has thrown into doubt tax laws surrounding managed investment trusts.

The case considered two issues that have already been flagged as problem areas by industry: streaming income and classifying the vehicles as fixed trusts.

The government has previously promised to fix both issues, in new laws due to come into force in July this year regarding managed investment trusts, in addition to a review of the complex trust tax laws to be conducted this year.

But experts are sceptical that the government's changes will overcome all the shortcomings of the law.

Federal Court judge Margaret Stone ruled in favour of the commissioner of taxation last Tuesday, after she was asked to determine the tax effect of redemption by some unit holders in a Colonial First State managed investment trust (MIT). The judgment makes it unclear whether trusts of this kind can allocate or stream particular components of income, for example capital gains, to some unit holders without resulting in adverse tax consequences for other unit holders.

Institute of Chartered Accountants tax counsel Yasser El-Ansary said the case "confirms that major challenges exist in trying to apply our current tax laws to trusts".

The federal government's reforms would "potentially resolve some of the issues that emerge from cases like this".

"Taking steps towards reform of Australia's outdated trust tax [laws] . . . is important in putting in place a stable tax environment for businesses and for our capacity to attract investment funds from offshore," Mr El-Ansary said.

A spokesman for Financial Services Minister Bill Shorten said that "the government's proposed MIT changes directly address issues highlighted by the case".

"For example, MITs with clearly defined rights will be treated as a fixed trust for the income tax law," the spokesman said.

National Institute of Accountants senior tax manager Tony Greco said the government review of trust tax law was welcome but it was unrealistic to expect a rewrite of the laws before year's end. He said it was vital for the government to follow through on its announcement in December that it would consider providing certainty to taxpayers in the meantime. In particular, this meant leaving intact Australian Taxation Office administrative rulings that related to streaming dividends and capital gains.

Pitcher Partners executive director Alexis Kokkinos said: "Unfortunately, the decision provides little by way of guidance and further highlights the uncertainty and ambiguity of the application of the trust taxation provisions."

Justice Stone also ruled the trust was not a fixed trust, because it had a power of amendment. A trust is "fixed" if the beneficiaries' interests are unable to be defeated: this means the trustee does not have the power to change the interest.

The court's finding that the trust was a "non-fixed" trust meant it was barred from accessing valuable tax benefits available to fixed trusts, including the ability to pass franking credits to investors.

"The trust was held to be "non-fixed" merely because the trustee had power to amend the deed in certain circumstances – a power which many practitioners would regard as conventional and practically necessary," Nicole Sammel of Nicole Sammel Tax Lawyers said.

"As far as I know, the trustees of virtually all funds would have the same power," Ms Sammel said.

She said the decision highlighted the need for urgent reform of the tax laws dealing with trusts.

"It shows that the present laws are not appropriate for modern-day trusts, including managed funds."

Ms Sammel said it was possible for funds to obtain a private ruling from the Tax Office in certain circumstances, treating the fund as a fixed trust regardless of the deed, in which case it might not be affected by the case.

Mr Greco said it was disappointing that the case – as the first major trust case to follow the - Bamford case – did not provide clarity on the streaming issue. The landmark case dealt with the taxation of trust income.

Because the flawed trust deed failed to give the trustee the power to make the distributions, the court did not need to decide whether or not the streaming was permissible. "That's a worry, that a major trust doesn't have that ability in this deed," he said.

Colonial had tried to stream its capital gains according to the category of investor: it wanted to channel short-term capital gains, which carried no tax discount, to short-term investors who traded the fund within the year, while long-term capital gains that carried valuable discounts would go to long-term investors who held the fund.

KEY POINTS

The case considered streaming income and classifying the vehicles as fixed trusts. The government has previously promised to fix both issues.

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