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Clarity in financial reporting

Impact of electing to be an Attribution Managed Investment Trust – are the units debt or equity?

Background

What is the issue?

Conclusion

Talking Points

- Tax rules for Managed Investment Trusts (MITs) have changed. These changes relate to the new Attribution Managed Investment Trust (AMIT) tax regime (*Division 276* of the *Income Tax Assessment Act 1997* (Cth)).
- To become eligible to elect into the new AMIT tax regime, a number of MITs have changed their constitutions or issued a supplementary constitution as part of the process of becoming eligible.
- The changes being made to the constitutions may alter the MIT's obligation to distribute trust income and consequently, the determination of whether the trust's units are classified as financial liabilities or equity.
- MITs need to assess all relevant facts and circumstances to determine if these changes will result in a reclassification of trust units from financial liabilities to equity.
- The changes in respect of the obligation for a MIT to distribute its income, in isolation, may not cause a change in the classification of its units from financial liabilities to equity. This is because there is a series of accounting requirements that need to be met for units to be classified as equity. Entities should ensure that all other criteria in the relevant accounting standard are met before reclassifying their units from liabilities to equity.

For more information, please see the following websites:

www.iasplus.com

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Background

In May 2016, new AMIT tax rules (*Division 276 of the Income Tax Assessment Act 1997* (Cth)) applying to MITs were enacted. The new tax regime allows MITs that meet certain requirements to make an irrevocable choice to be an AMIT. If an eligible MIT elects to opt in to the new tax rules, it becomes an AMIT for tax purposes. If a MIT does not opt in, the current tax rules continue to apply. In order to take advantage of the AMIT regime benefits, a number of MITs have changed their constitutions to become eligible to be an AMIT.

The constitution of the MIT determines the MIT's obligations to its investors. By amending the constitution for eligibility to be an AMIT, managed trusts may apply a more flexible approach to distributing trust income to investors.

Under the tax law, an AMIT is not required to make distributions, however unitholders are required to have clearly defined rights and consequently the trust constitution should still clearly set out the distribution rights of members. When the trust becomes an AMIT an "attribution" model applies where taxable income is allocated to investors on a fair and reasonable basis rather than the more complex "present entitlement" to income model.

For trust law purposes, however, it is a matter for the trustee to determine what the trust's obligations are under the trust constitution. Therefore, it is possible under AMIT that the trustee will still require distributions to be made (e.g. equal to taxable income), but this may not necessarily be the case and will vary depending on the rights or obligations specified in the constitution.

Amending the MIT constitution means the debt/equity classification of MIT units could be impacted. Therefore, MITs should reassess the classification of their puttable instruments if they have changed their constitutions.

What is the issue?

An issuer of a financial instrument classifies its financial instrument as a financial liability or an equity instrument based on the requirements of AASB 132 *Financial Instruments: Presentation*.

MITs typically issue puttable instruments. A puttable instrument is defined as a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or that is automatically put back to the issuer on the occurrence of an uncertain future event or death or retirement of the instrument holder. Because puttable instruments contain a contractual obligation for the issuer to deliver cash or another financial asset to the holder, such instruments are generally classified as financial liabilities. However, instruments that meet all of the specified criteria must be presented as equity.

In summary, paragraph 16A of AASB 132 requires that a puttable instrument must have <u>all</u> of the following criteria to be presented as equity:

a) It entitles the holder to a pro-rata share of the entity's net assets in the event of the entity's liquidation.
b) The instrument is in the class of instruments that is subordinate to all other classes of instruments.
c) All financial instruments in the class of instruments that is subordinate to all other classes of instruments have identical features.
d) It has no additional obligation apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset.
e) The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity over the life of the instrument (excluding any effects of the instrument).

In addition to the instrument having all the above features, paragraph 16B of AASB 132 requires that the issuer have no other financial instrument or contract that has:

a) Total cash flows based substantially on the profit or loss, the change in the recognized net assets or the change in fair value of the recognised and unrecognised net assets of the entity.
b) The effect of substantially restricting or fixing the residual return to the puttable instrument holders.

Not all MIT units will satisfy the conditions to be classified as equity just as a result of changing from a "present entitlement" model to an "attribution" model. For example, a trust may retain its current distribution obligation or a trust may have multiple classes of units with non-pro rata distribution rights, or another class of instrument that is subordinate and therefore will not qualify for equity treatment on the basis of failing some of the other criteria in Paragraph 16A and 16B.

The table below illustrates the impact of a change in a MIT's constitution on one of the criteria in paragraph 16A as an example. This table does not reproduce all the criteria in paragraphs 16A and 16B.

AASB 132.16A(d)	Before	After
Apart from the contractual obligation for the issuer to repurchase or redeem the instrument for cash or another financial asset, the instrument does not include any contractual obligation to deliver cash or another financial asset to another entity, or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity, and it is not a contract that will or may be settled in the entity's own equity instruments as set out in subparagraph (b) of the definition of a financial liability	MIT units **fails** this criterion where the constitution results in an obligation for the MIT to deliver cash (i.e. obligation to distribute trust income) apart from the contractual obligation related to the puttable unit. Therefore the units would be classified as a financial liabilities.	MIT units would **not fail** this criterion where the constitution does not result in an obligation for the MIT to deliver cash (i.e. there may be no obligation to distribute trust income). Therefore to the extent all the other criteria in paragraphs 16A and 16B are met, the units would be classified as equity instruments.

When a puttable instrument is presented as a liability, but subsequently, meets all of the criteria in AASB 132 paragraphs 16A and 16B, the entity should reclassify it from the date when the instrument meets all of the conditions in those paragraphs.

Entities amend their constitutions in a number of different ways to comply with the AMIT requirements. With regard to distributions, trusts may or may not amend the trust constitution. Careful consideration and analysis is needed of any and all changes to the trust constitution to understand its impact on the accounting. Below, we look at trusts where changes to distribution obligations have been made and the analysis required when such changes occur.

For example, some trusts change their constitutions to simply remove the obligation to make distributions and to allow for discretionary distributions. Others might change their constitutions to link to their AMIT status. For example, constitutions might be changed to state that while the trust is not an AMIT, distributions are obligatory (i.e. no discretion) and while the trust is an AMIT, distributions are discretionary.

The latter scenario makes it important to understand the point at which the trust is an AMIT for the purposes of determining whether the changes to the constitution have taken effect.

Section 276-10 of the *Income Tax Assessment Act 1997* (Cth), states that for a trust to be an AMIT, <u>all</u> of the following criteria should be satisfied:

a) The trust is a MIT in relation to the income year.
b) The rights to income and capital arising from each of the membership interests in the trust are clearly defined at all times during the year.
c) If the trust is a managed investment trust in relation to the income year solely because of paragraph 275-10(1)(b) – the only members of the trust are managed investment trusts in relations to the income year.
d) If the regulations specify criteria for the purposes of this paragraph – those criteria are satisfied in relations to the trust and
e) Either:
(i) the trustee of the trust has made a choice for the trust to be an AMIT in respect of that income year; or

(ii) the trust was an AMIT for an earlier income year.

Section 276-10(2) of the Act further states that, a choice for the trust to be an AMIT cannot be revoked.

Assuming all other criteria are met, a trustee would need to make a choice for the trust to be an AMIT. For accounting purposes, the point at which a trust would be considered an AMIT is the point at which such a choice would be considered irrevocable. Making a choice is normally a series of events such as board resolutions and communication to members.

Consequently, if constitutions are changed to link discretionary distribution with AMIT status, affected trusts should consider all facts and circumstances carefully in determining when an irrevocable choice to be an AMIT becomes effective as this may determine the date at which the units' classification is reassessed.

Conclusion

To become eligible to elect into the new AMIT tax regime, a number of MITs have changed their constitutions or issued a supplementary constitution as part of the process of becoming eligible. Changes to the trust constitution may involve changes to the trust's obligation or discretion to make distributions. Careful consideration is needed in circumstances where amendments have been made to a trust's obligation to make distributions or its discretion to make distributions as it may impact the accounting classification of the units. In doing so, it is important to consider all relevant facts and circumstances surrounding the applicable amendments to the trust constitution.

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