

Senate Economics Legislation Committee – inquiry into Managed Investment Trust Bills

TREASURY

SENATE QUESTION

Will the new tax system for AMITs introduce credit risk issues for custodians?

ANSWER

Under the current law, custodians have withholding tax obligations in relation to their non-resident clients. Under the AMIT regime, custodians would also have withholding obligations for amounts attributed to them but not actually paid on AMIT units held for non-resident clients.

Generally, amounts distributed by the AMIT would be sufficient for the custodian to meet these obligations. Stakeholders from the funds management industry have indicated that there is significant commercial pressure on MITs to pay out enough cash to investors, resident and non-resident, to cover any resulting tax liability. Hence, any possible credit risk would only arise where AMITs distribute less income to custodians than is required to meet their client's taxation obligations. This would only occur in rare and exceptional cases.

In the unlikely event a custodian faces a situation where the amount of cash paid is less than the amount of the withholding tax liability, the statutory indemnity included in the new MIT rules would allow it to recover a shortfall amount as a debt from its client, or recover the shortfall by reducing the amount custodians pay to the foreign client in the future.

Custodians typically have indemnity provisions already in their custody agreements that allow them to take action against their clients in certain circumstances. The statutory indemnity is also available to trustees of MITs.

TREASURY

SENATE QUESTION

How will the new tax system work when foreign clients have sold out units prior to the WHT liability arising?

ANSWER

Where a custodian holds units on behalf of a non-resident investor, the investor must go through its custodian to sell the units. That is, it cannot sell them directly or without the knowledge of its custodians.

In respect of custodians, a withholding tax liability under the new MIT rules arises when an amount referable to a fund payment or a dividend, interest or royalty payment from an AMIT is made by the custodian to a foreign resident. This includes both actual and deemed payments.

If the custodian expects that there may be further potential withholding tax obligations, it could trigger clauses in its custody agreement allowing it to retain sufficient funds pending the finalisation of any withholding tax obligations. We understand that these clauses are already commonly included in custody agreements. Custodians can update their agreements to minimise any remaining risk, if required.

TREASURY

SENATE QUESTION

Is it feasible that custodians would be able to seek, and receive, additional funds from clients to recover any shortfall in WHT? Alternatively, is it fair and reasonable to expect custodians to pay the WHT from their own funds where recovery is not practical or not possible?

ANSWER

Yes. As noted earlier, the custodian can trigger clauses in its custody agreement allowing it to retain sufficient funds pending the finalisation of any withholding tax obligations. The custodian is likely to be aware of the timing of distributions and issuing the AMMA statement.

Additionally, the new tax system will provide the custodian with a statutory indemnity which will allow it to recover a shortfall amount as a debt from its client, or recover the shortfall by reducing the amount custodians pay to the foreign client in the future. This statutory indemnity is modelled on existing statutory indemnities in the tax law (e.g. in relation to TFN withholding) and is also available to trustees of MITs.

We understand that custodial agreements already commonly contain similar indemnity clauses. It will be a commercial matter for the custodians on which way it chooses to recover the liability.

If the custodian was seeking to recover an amount from a client for tax paid on the client's behalf, the ATO would take this into account in negotiating arrangements for payment of the relevant amounts.

TREASURY

SENATE QUESTION

Which, if any, of the proposed solutions by ACSA on the bottom of page 4 of their submission would address concerns about custodian liability?

ANSWER

The proposals put forward by the custodians would represent a significant departure from the current withholding tax framework and do not provide a workable approach to dealing with the custodian liability issue. The proposals would impose significant undue ongoing compliance costs and introduce significant complexity in the law. Furthermore, none of the proposals put forward have the support of the funds management industry.

These proposals were raised by ACSA during the consultation process and were debated extensively. All participants except for ACSA agreed that implementing a statutory indemnity would be the best approach to dealing with the unlikely scenario where cash paid is insufficient to cover a withholding tax liability.

The proposal to cap custodian withholding liability to cash could create a perverse incentive for AMITs to pay less cash and would treat residents and non-residents inconsistently (residents on amounts attributed and non-residents on a cash basis).

The proposal to implement a minimum cash payment requirement was explored thoroughly during the consultation process and is not a suitable solution. Complex rules would be required to allow a departure from the standard rate in some cases (e.g. where all investors are superannuation funds) and the requirement could interfere with the commercial decision making processes about how much cash a MIT chooses to distribute.

ACSA's suggested consequence for failing to meet the minimum cash distribution, shifting responsibility for withholding tax to a MIT, is not workable. A MIT will not have access to the information needed to determine the appropriate withholding for non-resident investors who invest through a custodian. This is a key reason why withholding obligations are currently imposed on water's edge entities.

TREASURY

SENATE QUESTION

Is undue burden being placed on custodians to administer WHT arrangements, especially in relation to calculating liabilities in hypothetical situations where trustees are not required to provide the necessary information to custodians to facilitate this to occur?

ANSWER

The new MIT rules do not change the broad framework for non-resident withholding tax and do not place undue burden on custodians. Under the current withholding tax framework, responsibility for collecting non-resident withholding tax is imposed on ‘water’s edge’ entities, such as custodians holding assets on behalf of non-residents or MITs with direct investment from non-residents.

The withholding tax provisions in the MIT Bills before Parliament merely ensure that the withholding framework works in an attribution context.

TREASURY

SENATE QUESTION

Would changing the definition of 'pre-AMMA actual payment' to include payments made at the time of issue of the AMMA statement reduce the likelihood of 'deemed payments'?

ANSWER

No, as the ATO anticipates it can administer the law such that most payments which are made on the date the AMMA statement issues would be treated as pre-AMMA actual payments in any event.

TREASURY

SENATE QUESTION

Why does the new tax system for AMITs adopt a unique approach to WHT collection that departs from the OECD standard?

ANSWER

As outlined above, the new MIT rules do not change the broad framework for non-resident withholding. The withholding tax provisions in the MIT Bills before Parliament merely ensure that the withholding framework works in an attribution context.

Investors in Attribution MITs are taxed on amounts attributed to them by the trustee, on a fair and reasonable basis, in accordance with their clearly defined interests under the constituent documents of the trust. This occurs even in the absence of a cash payment. It is necessary to align the withholding tax framework to ensure that both resident and non-resident investors are taxed on an attribution basis.

The attribution model of taxation, which applies to both resident and non-resident taxpayers, has been sought by the managed funds industry for many years. The managed funds industry considers that these reforms are critical to enabling the industry to become more competitive and efficient.

TREASURY

SENATE QUESTION

Why is it essential that there be a legislative codification in section 276-115 of the 'look-through' approach for custodian units of behalf of clients?

ANSWER

Section 276-115 was inserted for the benefit of custodians to ensure that the new MIT rules interact properly with the existing tax law, where a custodian is interposed between an AMIT and an investor. Without the provision, there is an increased risk that the tax liability of amounts attributed by an AMIT could arise for a custodian under the general trust tax rules, where they would not otherwise arise. This provision also ensures that characters of amounts attributed by an AMIT can flow through to a custodian's client.

TREASURY

SENATE QUESTION

Will section 276-115 create a look-through precedent for custodians in other areas?

ANSWER

The operation of section 276-115 is restricted to where a custodian is a member of an AMIT and will not create a look-through precedent for custodians in other areas.

TREASURY

SENATE QUESTION

It appears that the provisions dealing with cost base adjustments under different CGT event types produce different outcomes. Is it the intention of government to change the rules around cost base adjustments for CGT concession amounts?

ANSWER

The new AMIT regime will allow both downwards and upwards adjustments to the cost base (CGT event E10) and is intended to operate differently to CGT event E4. This will prevent circumstances of double taxation.

As the new tax system for AMITs is a significant change, Treasury and the ATO will monitor the operation of the new rules to identify and rectify any unintended consequences.

We will consider this issue further in consultation with industry and the ATO. There has been insufficient time to fully consider this issue prior to submitting our responses to the Committee's questions.

TREASURY

SENATE QUESTION

How large will be the complexity and administrative burden for custodians which may have to develop and implement parallel systems for calculating and tracking cost base adjustments?

ANSWER

The new cost base adjustment will benefit investors and reduce the scope for double taxation. The new cost base adjustment rules are available to investors in MITs that have elected to apply the new MIT tax rules. There is potential for custodians to have to deal with both the new and existing cost base adjustment rules as not all MITs will elect to apply the new MIT tax rules.

ACSA is better placed to comment on the resulting implementation and administration costs involved. Our understanding is that the custodians are developing new reporting systems to deal with a number of operational changes that will result from the new MIT rules. We would expect that custodians would seek to recoup any additional cost from their clients.

We understand that ACSA has raised some concerns regarding the operation of CGT Event 10 and how they should design their systems given the potential for a change in law on this issue in the future.

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TREASURY

SENATE QUESTION

What amendments would be required to align the cost base outcomes?

ANSWER

The cost base adjustment provisions in the new MIT rules address a double taxation issue that arises under the current law for investors in MITs. The new rules (CGT event E10) achieve this by allowing both upward and downward adjustments to the cost base of a unit in a MIT, whereas the existing cost base rules (CGT event E4) only allow for downward adjustments.

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TREASURY

SENATE QUESTION

Is it the government's intention to have a divergence in the definition of 'fund payment' for AMITs than that for existing MITs?

ANSWER

As outlined above, the new MIT rules are not intended to change the broad framework for non-resident withholding tax. The withholding tax provisions in the MIT Bills before Parliament merely ensure that the withholding framework, including the fund payment concept, works in an attribution context.

As the new tax system for AMITs is a significant change, Treasury and the ATO will monitor the operation of the new rules to identify and rectify any unintended consequences.

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SENATE QUESTION

What amendments would be required to align these definitions?

ANSWER

As outlined above, the new MIT rules are not intended to change the broad framework for non-resident withholding tax. The withholding tax provisions in the MIT Bills before Parliament merely ensure that the withholding framework, including the fund payment concept, works in an attribution context.

As the new tax system for AMITs is a significant change, Treasury and the ATO will monitor the operation of the new rules to identify and rectify any unintended consequences.

We will consider this issue further in consultation with industry and the ATO. There has been insufficient time to fully consider this issue prior to submitting our responses to the Committee's questions.