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Committee Secretary
Senate Economics Legislation Committee
Parliament House
Canberra ACT

Email: economics.sen@aph.gov.au

Copy to:

Dear Committee Secretary

Inquiry into Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015 and associated bills

The Australian Custodial Services Association ("ACSA") received an invitation to make a submission to the Senate Economics Legislation Committee regarding package of MIT Bills. We thank the Committee for the invitation and set out below some background information on ACSA and our submission.

About ACSA

ACSA is the peak industry body representing members of Australia's custodial and investment administration sector. Collectively, the members of ACSA hold securities and investments valued at more than AUD \$2.5 trillion in custody and under administration. Members of ACSA include NAB Asset Servicing, JP Morgan, HSBC, State Street, RBC Investor Services, BNP Paribas, Northern Trust, Citigroup and Bank of America Merrill Lynch.

ACSA has been involved from the outset in the industry consultation sessions organised by Treasury in relation to development of the MIT reforms and has provided several submissions on the proposals including detailed written comments on the drafting used to give effect to the various reform objectives. ACSA members provide custody and administration for most of Australia's regulated superannuation funds and large institutional funds and are directly impacted by many aspects of the MIT changes.



Executive Summary

The context of ACSA's concerns needs to be understood in light of the role of custodians primarily to provide safekeeping services and to facilitate investment in securities markets. It is a crucial feature of the safekeeping role that the custodian is not exposed to investment risks or returns.

The efficient operation of custodial activities directly benefits superannuation and investment funds and enhances Australia's position as an investment destination for foreign capital.

As the custodial function involves handling cash flows, the tax law imposes withholding tax collection responsibilities on custodians and are included in our standard custodial processes. To achieve efficiency in this aspect of the custodial function, the withholding tax rules must be clearly defined and connected to the cash flows managed by custodians so that the tax is a final tax without a requirement for recalculation.

A key concern with the MIT Bills is the proposal to impose withholding tax on "deemed payments" by MITs. It is important to note that imposing withholding tax on "deemed payments" is not simply a collection mechanism: it in fact creates a tax liability on the custodian. It is of great concern to custodians that custodians will now become exposed to tax on investment returns (or in fact the 'deemed returns') from the assets held.

The introduction of withholding tax on "deemed payments" is a significant departure from withholding tax processes globally, which are required to be applied to cash payments only. ACSA is not aware of any other country imposing a tax on custodians on deemed payments from significant investment vehicles.

ACSA also has concerns with various technical aspects of the AMIT Bills. The main concerns cover the specific provision addressing the treatment of custodians holding investments in AMITs, the way CGT concessional amounts are treated and the definition of "fund payment" (being the amount on which withholding tax is calculated).

Impact on ACSA members

ACSA members are impacted as:

- A **receiver** of tax information – including annual tax statements, interim statements, fund payment notices – from AMITs on units held by custodians for our clients. This includes non-resident withholding tax information and associated non-resident withholding tax (NRWHT) obligations. A large proportion of units in ASX-listed trusts are held by custodians – for some of the largest listed trusts, the proportion is substantially more than 50%. Of these units held by custodians, a significant percentage is held for foreign clients.
- A **producer** of tax calculations and related tax services for AMIT clients that have engaged a custodian to hold the AMIT's investments and provide custodial services – this includes calculation of taxable income and tax components and tax



return information for the AMIT. Related to this is the provision of registry services to the AMIT for its unit holders (such as processing of distribution payments, annual and interim tax statements for unit holders, NRWHT obligations and AIIR (Australian Investment Income Report obligations).

A diagram outlining tax services provided by custodians is attached as Annexure 1. It is as a receiver of tax information from AMITs that ACSA members have the greatest concerns.

ACSA is generally supportive of the MIT reforms and the certainty created around long standing anomalies and gaps in the current trust tax legislative framework. However, as we have extensive systems and processes that will need to be enhanced to meet the new rules, it is imperative we have clear and workable rules from the outset.

ACSA's main concerns with the MIT Bills are set out below:

1. NRWHT Rules – confusion for foreign investors and custodian liability

Given the large proportion of units in ASX-listed property trusts held by Australian custodians for foreign investors, the implications of the new WHT rules for foreign investors and their custodians will be widespread. The rules are confusing to investors because liability is based on the *attribution process* rather than the payment of distributions. This creates a negative perception for foreign investors in a time when Government is seeking to attract and grow foreign investment. Custodians are also concerned they will have to fund NRWHT themselves where insufficient cash is distributed by the AMIT.

ACSA has raised these concerns with Treasury (and the ATO) on several occasions throughout the course of the project. Over the journey, there have been discussions around:

- the AMIT trustee being required to distribute a minimum amount sufficient to cover the maximum NRWHT that could be payable by a custodian; and
- a transfer mechanism whereby the custodian could 'transfer' any unfunded NRWHT liability to the trustee of the AMIT.

The first option was rejected by Treasury as being unpalatable to AMITs. The second option was rejected as being too complex and potentially uncontestable by the trustee of the AMIT. Ultimately, Treasury attempted to address our concerns by introducing a custodian indemnity – ACSA believes this is not sufficient because it introduces credit risk issues for custodians and is unlikely to be effective where the foreign client has sold out its units prior to the NRWHT liability arising.

- a) *Custodians should not be directly liable to fund WHT where the cash distribution is insufficient*



Distributions from an AMIT may fall short of the WHT liability payable by a custodian holding units for a foreign investor. See Annexure 2 for an example. As currently drafted, the MIT Bill provides for the custodian to be primarily liable for NRWHT with a right of indemnity from the foreign investor on behalf of who the tax has been withheld. **There are no negative consequences under the current proposals arising for an AMIT that does not pay a sufficient cash distribution to cover the custodian's NRWHT liability.**

If the AMIT cash distribution is not sufficient, the custodian would need to seek additional funds from its client to recover the shortfall or alternatively pay the WHT liability from its own funds where recovery is not practical or not possible. This is a poor outcome for the custodian and for the foreign client.

If the foreign investor has sold out of its holding or is no longer with the custodian at the time the NRWHT liability arises, the custodian will be left having to fund the liability with recovery unlikely in practice.

Furthermore, NRWHT liability can be triggered for 'deemed payments' – as set out in Annexure 2 - this is the amount of the fund payment or DIR payment calculated for the full tax year (at the time the annual tax statement of the AMIT (AMMA statement) is produced) less all interim fund payments and DIR payments associated with cash distributions prior to the AMMA statement. In practice, deemed payments will be very common because the final distribution for the year will not be counted as a prior distribution if paid at the time of issue of the AMMA Statement.

Where the ATO reassesses WHT on audit, this risk is heightened.

Further details of the impact on custodians is set out in the letter and attachments to Treasury (copied to the Assistant Treasurer) dated 6 November 2015 – Annexure 3(a) and (b) to this submission.

ACSA Proposed Solution

- the custodian's NRWHT liability should be capped at the cash distribution received by the custodian at or about the same time that the liability arises.
- alternatively, the AMIT should be required to distribute an amount (Minimum Amount) sufficient to cover the maximum NRWHT that could be liable¹;
- alternatively, where the AMIT pays less than the Minimum Amount the trustee would need to identify all foreign beneficial owners and ensure the correct NRWHT is paid on their behalf;
- alternatively, provide a mechanism where a custodian should not be liable for withholding tax where the custodian advises the AMIT of the proportion of foreign holdings so that the AMIT can manage the withholding tax processes.

¹ ACSA notes this solution has previously been presented to Government but not accepted.



b) The proposed rules relating to 'deemed payments' are confusing and potentially impossible for custodians to administer

The proposed rules require an AMIT to calculate and advise to unit holders a 'deemed payment' amount after year end. Where the unit holder is a custodian, the custodian will need to calculate and pay the correct WHT. A custodian will be told of a single 'deemed payment amount' and will need to allocate this amongst all of its clients for which it has held units for the year – it could have held units for non-resident clients that have bought in or sold out at different times during the year (eg, entitled to all or just some of MIT distributions for the first, second, third or fourth quarters for a year – referred to as Q1, Q2, Q3 or Q4 distributions). Custodians hold units in listed trusts in omnibus accounts – the custodian will be advised a single 'deemed payment' and need to allocate amongst its various clients.

Treasury and the ATO say the custodian needs to calculate the WHT liability by asking itself **'if a payment equal to the deemed payment was to be made by the trustee to the custodian at the time of the issue of the AMIT tax statement, to which of its clients would the custodian be required to pay the amount'?**

Custody agreements simply do not contain provisions dealing with how hypothetical payments received from the trustee of a trust would be dealt with. The custodian would need to ask the trustee to which group of hypothetical investors does the deemed payment relate [Q1, Q2, Q3 or Q4 or for full year investors] – however the trustee is not required to provide such 'hypothetical' information. It will be impossible for the custodian to apply the proposed rules.

This concern can be addressed by the legislation directing the custodian to allocate the deemed payment based on clients holdings at year end (or the final 'record date' (entitlement date) of the year).

ACSA Proposed Solution

Adopt changes previously suggested by ACSA to Treasury – see emails to Treasury in Annexure 4.

To reduce the likelihood of 'deemed payments' – amend the definition of 'pre-AMMA actual payment' to include payments made at the time of the issue of the AMMA statement.

c) MIT WHT liability is to be based on attribution – complexity and disincentive for foreign investors

It is a fundamental tenet of the tax systems of OECD countries that withholding tax is only imposed on income payments received by a resident custodian for a non-resident (see OECD Standard Glossary of Terms – definition of 'Withholding Tax'). Australia, as an OECD country, departs from this definition with the MIT Bill. WHT is not based on payments rather on amounts 'attributed'. This novel approach to WHT collection is unique in the OECD world.



The WHT proposals will cause *great confusion* to foreign investors. The existing MIT WHT rules are already *complex* for them to understand – the proposed system is likely to be a significant *barrier to entry* to foreign investors and make Australia *less attractive* compared to ‘simple’ WHT countries (based on cash). Foreign investors see Australia as a first and final tax market expect tax to be deducted at source at the time of an income payment, this is in-line with international best practice. The AMIT legislation significantly deviates from the best practice and creates unequitable taxation for current investors and will create confusion discourage future foreign investment.

2. Tax treatment of custodians holding units in AMITs

The treatment of the relationship between custodian and client has been a long-standing issue in the custodian industry. ACSA has consistently submitted that the ‘look-through’ approach that is adopted by custodians and their clients in practice for client investments should specifically be endorsed in the broader tax framework.

The MIT Bill – in section 276-115 – contains a specific ‘look-through’ for a custodian holding units on behalf of a client. ACSA believes this is not necessary and would create confusion in the tax legislation for the tax treatment of custodians in broader context noted above.

This issue has been raised with the Assistant Treasurer – for details see the correspondence set out in Annexure 5(a)-(c).

ACSA proposed solution

Remove section 276-115. The Explanatory Memorandum should clarify that it is the client or clients (for omnibus or commingled units) that is to be treated as being the member of members of the AMIT and having the taxable member component attributed by the AMIT. This can be done by deleting paragraphs 7.62 and 7.63 of the Explanatory Memorandum. The current wording in paragraph will confirm the intended outcome.

3. Cost base adjustments for AMIT units

The introduction of upward cost base adjustments on units in AMITs where the cash distribution is less than the taxable components attributed to a member is one of the significant features of the AMIT package.

However, the provisions dealing with cost base adjustments for units in AMITs in section 104-107 of the MIT Bill (CGT Event E10) produce a different outcome than the current provisions (section 104-70, 71, CGT Event E4) relating to certain non-assessable amounts paid by a unit trust to a unit holder. There has been no intention announced by Government to change the rules around cost base adjustments.

MITs (and other types of unit trusts) can distribute certain types of components that are not assessable to unit holders, such as:



- tax deferred amounts
- return of capital (ROC) amounts
- CGT concession amounts
- Tax exempt amounts
- Tax-free amounts

Tax deferred and ROC amounts reduce the cost base of units under CGT Event E4 and will do so under Event E10 – there is no change here.

However, for CGT concession amounts (a very common part of distributions by a trust – ‘CGT Concession amounts’ represent the non-assessable part of a gain on an asset held for more than 12 months) and tax exempt or tax-free amounts (much less common but seen occasionally in trust distributions), the treatment is to be different under Event E10. Under Event E10, these amounts will *reduce* the cost base whereas under Event E4, these amounts *do not reduce* the cost base.

For the component Discount Capital Gain (the assessable part of a gain on an asset held for more than 12 months) distributed to a unit holder of an AMIT, there will be an upward cost base adjustments of the amount of the gain.

This outcome – the upward adjustment for a discount capital gain – was identified by ACSA in email correspondence to Treasury relating to an earlier version of the MIT Exposure Draft as an unusual result. Treasury agreed the outcome was unusual and responded by saying the outcome was no intended and would be changed. However, the final MIT Bill was not changed in this respect. A copy of the relevant emails is set out as Annexure 6.

ACSA suggested solution

The policy for cost base adjustments should be specifically clarified by Government. One potential approach is for Event E4 to apply to units in AMITs in the same way as it does currently to units in trusts. Event E10 could then be confined to upward cost base adjustments for units in AMITs.

4. Divergence in definition of “fund payment”

For completeness, we note that there appears to be a divergence in the definition of “fund payment” for AMITs than that for existing MITs. ACSA has raised this issue with Treasury and understands that this divergence was not intended and that the definition for AMITs will be amended to align with the existing definition for MITs.

This is a core issue as, the definition of “fund payment” is the base amount on which withholding tax is calculated.



The definition of fund payment is broadly intended to cover distributions by AMITs of Australian source income other than dividends, interest or royalties (for which there is a separate withholding tax). The definition of fund payment is also intended to include net capital gains from the disposal of taxable Australian property.

It is important to ACSA that this issue is clarified as soon as possible so that withholding tax systems processes can be developed based on the correctly defined base amount.

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Attached to this submission is a summary document and a list of annexures.

Please contact the Chairman of ACSA's Tax Working Group, Mick Giddings on to discuss any of the issues raised in this letter.

Yours sincerely

Gordon Little
Director, Australian Custodial Services Association

✓ **Mick Giddings**
Chairman, ACSA Tax Working Group