Australian Government

Collective investment vehicle non-resident withholding taxes

Consultation Paper
November 2016

NOTES TO PARTICIPANTS

The proposals outlined in this paper have not received Government approval and are obviously not yet law. As a consequence, this paper is merely a guide as to how the proposals might operate.

CONTENTS

Consultation Process

Request for feedback and comments

Providing a confidential response

All information (including name and address details) contained in formal submissions will be made available to the public on the Australian Treasury website, unless it is indicated that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain confidential should provide this information marked in a separate document.

A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Next steps

Stakeholder feedback to the public consultation process will inform the Government's consideration of any possible measures to the non-resident withholding tax regime for collective investment vehicles (CIVs) and managed investment trusts (MIT). Once the public consultation process is concluded, further targeted consultation may be necessary to clarify any issues or questions which arise from initial consultations.

Closing date for submissions: Friday, 2 December 2016

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1. Overview

1.1. What this paper is about

The Minister for Revenue and Financial Services announced on 4 May 2016 that the Government will consider collective investment vehicle (CIV) withholding taxes in the coming financial year.

This consultation paper seeks stakeholder views on policy proposals in relation to CIV withholding taxes.

The Government is committed to ensuring that the Australian funds management sector is internationally competitive in an increasingly integrated global market.

Over the past decade the Government has introduced a number of initiatives in the funds management sector to make it easier to invest in Australia through pooled investment. The most recent of these initiatives was the Government's announcement to implement new types of CIVs, being a corporate CIV from 1 July 2017 and a limited partnership CIV from 1 July 2018.

1.2. Paper outline

Part 1 briefly describes the non-resident withholding tax regime, provides some commentary on the funds management sector, and highlights past policy initiatives.

Part 2 illustrates current arrangements in the application of non-resident withholding tax.

Part 3 sets out key policy considerations.

Part 4 describes a number of proposals for consideration.

2. Context

2.1. Australia's non-resident withholding tax regime

Australia's current policy for the taxation of non-residents provides that non-residents are liable for Australian tax on most of their Australian sourced income and exempt from Australian tax on foreign sourced income. Non-residents may be subject to a range of different taxes and rates. These include: company tax; individual taxation (at non-resident rates); withholding taxes for interest, dividends, royalties; tax on managed investment trust (MIT) fund payments; and capital gains tax on Australian property. Refer Appendix A.

Australian sourced unfranked dividends, interest and certain fund payments paid to non-residents are generally subject to withholding tax. Withholding tax is a final tax, generally levied at a flat rate that varies depending on the type of income and whether a tax treaty applies (tax treaties typically reduce the rate of withholding tax payable).

Franked dividends are not subject to withholding tax as they reflect a distribution of profits that have already been subject to company tax in Australia.

2.2. Australia's funds management sector

The Australian funds management services industry has been growing steadily, with revenue estimated to have increased at an annualised rate of 5 per cent over five years through to 2015-16 to reach A$7.8 billion.[1] This growth has largely been driven by growth in Australia's superannuation industry contributions and investment returns. On the international stage, Australia has the third largest pool of funds under management behind the United States and Luxembourg, and currently has the largest pool of managed funds within the Asia Pacific region.[2]

Australia has a strong superannuation industry and a large pool of Australian assets. Australian investors are increasingly diversifying into international investments. Australia's ability to attract foreign investment into Australian funds remains low, with less than 4 per cent of funds under management on behalf of foreign investors.[3]

Demand for funds management services in the Asia Pacific region is expected to grow strongly over the coming decades. By 2030, the Asia Pacific region's middle class is expected to grow to around 3.2 billion people.[4] This is anticipated to lead to increased demand for funds management services as income and wealth grows. Over the long

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1 Lo, B 2016, 'IBISWorld Industry Report K6419a – Funds management services in Australia', IBISWorld, page 4.

2 Investment Company Institute, 'Worldwide Mutual Fund Assets and Flows (Fourth Quarter 2014)'.

3 Australian Bureau of Statistics, '5655.0 – Managed Funds, Australia (June Quarter 2016)'.

4 King, S; Hine, D; Brea, E; and Cook, H 2014, 'Make for Asia – The emerging Asian middle class and opportunities for Australian manufacturing, CSIRO Australia, page 3.

term, population ageing in China and Japan could also lead to increased demand for financial products for retirees to manage their investment and longevity risks.

Questions

1. To what extent do you expect growth in funds and the funds management sector to come from:

    1.1. increased investments by non-residents in foreign assets (conduit investments); and

    1.2. increased investments by non-residents in Australian assets?

2.2.1. POLICY INITIATIVES

The Government has undertaken a number of tax and regulatory initiatives over the past decade to support the development of the funds management sector, as summarised in Appendix B.

2.2.2. CONDUIT FOREIGN INCOME EXEMPTION AND INVESTMENT MANAGER REGIME

Key initiatives include the introduction of the conduit foreign income exemption[5] and the investment manager regime (IMR).

The conduit foreign income regime provides an exemption from withholding tax for non-residents investing in foreign assets via an Australian fund.

The IMR clarifies the tax treatment of gains made by foreign funds and non-resident investors who invest through Australian fund managers. It provides tax exemptions for widely held foreign funds investing in certain Australian portfolio investments and ensures that unintended tax liabilities are not triggered for foreign investments from use of an Australian funds manager.

These initiatives have provided support for Australian managed funds competing with other fund managers in the Asia Pacific region.

Conduit income is likely to be relatively sensitive to domestic tax settings and conduit investments are a key feature of global funds management hubs in the region and around the world. For example, fund managers in Singapore and Hong Kong have a significant proportion of their funds under management held by non-resident investors and held in foreign assets.[6]

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[5] Conduit foreign investments are arrangements where the fund receives funds from investors in one foreign country, to invest in assets in another country. The country of the fund's residence is seen as a 'conduit' jurisdiction, as investments are merely passing through that country.

[6] Le Leslé, V; Ohnsorge, F; Kim, M; and Seshadri, S 2014, 'IMF Working Paper (WP/14/119): Why Complementarity Matters for Stability – Hong Kong SAR and Singapore as Asian Financial Centers', International Monetary Fund.

2.2.3. Collective investment vehicle regime

As noted earlier, the Government has also announced the introduction of corporate and limited partnership CIVs which will assist Australian fund managers to compete with other funds management hubs (by providing 'flow-through' income tax treatment using a legal and regulatory structure that is familiar to non-resident investors).

2.2.4. Asia Region Funds Passport

The ARFP is a multilateral arrangement that aims to facilitate cross border trade in managed funds between member countries by either waiving or diminishing key regulatory impediments to trade. It enables fund operators in member countries to offer eligible schemes to retail investors in other member countries under a streamlined process. A Passport Fund can only hold a narrow range of investments, including cash, deposits, equities and bonds.

Once it commences in late 2017, the ARFP will benefit consumers by opening up the Australian market to increased inbound competition from offshore fund managers from member countries. It will also provide Australian fund managers greater access to key markets in Asia and better position them to increase exports of their funds management services.

Question

2. What is the likely impact of past and announced initiatives on attracting inbound investment?

3. Current Arrangements

Set out below are four scenarios illustrating the application of withholding tax to investments through CIVs.

These scenarios are also set out in in Appendix C.

3.1.1. Scenario 1 – Conduit arrangements

Scenario 1 covers conduit foreign investment. Conduit foreign income is not subject to Australian withholding tax.

3.1.2. Scenario 2 – Indirect investment through Australian funds into Australian assets

Scenario 2 covers arrangements where non-resident investors invest through an Australian fund into Australian assets. These may be subject to Australian withholding tax on dividend, interest and other income (such as gains from derivatives or from disposals of certain assets). This consultation paper examines the policy proposals for taxation of this type of investment. For the purposes of this paper, Scenario 2 does not include the tax treatment of property assets.

3.1.3. Scenario 3 – Indirect investment through foreign funds into Australian assets

Scenario 3 covers arrangements where non-resident investors invest through a foreign fund into Australian assets. These may be subject to Australian withholding tax on dividend and interest but may be exempt on other income (such as gains from derivatives or disposals of certain assets) following the introduction of the IMR.

3.1.4. Scenario 4 – Direct investment into Australian assets

Scenario 4 describes arrangements where non-resident investors invest directly into Australian assets.

4. Policy Considerations

Assessing the need for further reform of the tax settings that apply to inbound investment raises a number of policy issues.

4.1. Fiscal considerations

Any reductions in CIV withholding tax revenue would come at a cost to the Budget. Tax policy is determined within the context of the Government's overall fiscal strategy, including the aim to repair the Budget and guide it back to a sustainable surplus.

4.2. International approach to taxing non-residents

Internationally, most developed countries apply taxes on the basis of residence (resident or non-resident) and the source of income (domestic or foreign). Most countries do not seek to tax non-residents on their foreign sourced income but do seek to tax domestic sourced income. In line with this, Australia taxes non-residents on Australian sourced income.

Australian sourced income is derived using the infrastructure (including legal and regulatory framework) and assets located in Australia. In addition, the non-resident withholding tax regime reduces the risk that non-residents are able to evade or avoid paying tax on the income derived in Australia, while local residents are taxed on the same income. Withholding taxes are generally applied to gross payments at lower rates than individual or corporate tax rates, in recognition that no deductions are allowed to the non-resident for expenses incurred to earn the income derived.

4.3. International competitiveness

Australia needs to ensure its tax system is internationally competitive to attract and retain investment. Investment is important in a small capital importing country such as Australia as it increases productivity and growth; and over time, it increases real wages, lowers prices and increases returns for investors. Investment may increase overall employment and/or shift jobs between sectors.

As taxes on income from inbound investment can affect the domestic cost of capital, it is generally considered appropriate to tax 'passive' investment income (such as interest and dividends) more lightly than 'active' business income (such as returns from running a business) or immobile income (such as income or gains from real property). Passive investments are generally more internationally mobile.

Australia's international competitiveness relates to the effective tax rate paid by the non-resident investor, which will depend on the amount of Australian tax paid, and which may be sensitive to whether additional tax is paid in the non-resident investor's home country on the investment income (less any foreign tax credits).

It follows that Australian tax reductions may not necessarily increase an investor's rate of return, if it is fully or partially offset by higher tax liabilities in the investor's home country. It may lead to a partial or full transfer of revenue from the Australian government to the foreign government in question through a reduced foreign tax credit for Australian taxes paid in that other jurisdiction. This will also depend on the tax status of the recipient.

The degree to which withholding taxes involve a transfer of revenue will depend on how the resident country treats the non-resident tax paid. For example, some countries use a deduction method (allowing a deduction for foreign tax paid), some use an exemption method (exempting the income) and some use a credit method (where a credit is permitted for foreign tax paid).

Questions

3. How important is tax in determining the international competitiveness of Australia's funds management industry compared to other factors, such as the level of fees, the lack of an internationally recognised investment vehicle and the products offered?

4. To what extent would any reduction in Australian withholding tax rates be clawed back by higher foreign taxes (through reduced foreign tax credits)? Please provide examples in other jurisdictions.

4.4. SIMPLICITY

Exemptions and differing tax rates increase complexity and when taxes are complex, investors may not spend the time and resources to determine the relevant effective tax rate and hence may not invest in the country. This risk is greater for individual investors than for professional or institutional investors. This may require the industry to undertake marketing initiatives to educate potential investors.

Questions

5. What are the key factors that contribute to the complexity of Australia's non-resident withholding tax regime?

6. How important is the principle of simplicity in Australia's non-resident withholding tax regime relative to the importance of the withholding tax rate?

7. What options are there for simplifying Australia's non-resident withholding tax regime? To what extent do exemptions contribute to complexity?

8. To what extent do fund managers rely on marketing or their local distributors to explain the effective tax rates for non-resident investors? Does the approach differ between countries?

5. Proposals for consideration

Views are sought on the following broad proposals, having regard to the policy considerations set out in this paper. Views are also sought on alternative proposals for improving the competitiveness of Australia to attract inbound investment.

5.1. Proposal A: No policy change to the existing tax settings

This proposal involves no policy change to existing tax policy settings. This would allow already implemented policy initiatives and soon to be implemented policy initiatives to take effect to assist inbound investment.

Under this proposal, no new withholding tax concessions would be granted for non-residents.

5.2. Proposal B: Single non-resident withholding tax rate of 5 per cent for CIVs and MITs under the ARFP

The Financial Services Council (FSC)[7] is proposing a single 5 per cent non-resident withholding tax rate for Australian CIVs and MITs in the ARFP.

This would replace existing non-resident withholding tax rates on interest, dividend and MIT fund payments and provide for an overall rate of 5 per cent on all withholdable MIT income.

Income currently exempt from withholding tax, including conduit non-resident income and franked dividends, would continue to be exempt.

Non-resident investors in CIVs and MITs outside the ARFP and non-resident investors investing directly into Australian assets would continue to be subject to existing non-resident withholding tax rates.

Questions

9. What are the merits of limiting the concessional rate of non-resident withholding tax to CIVs and MITs in the ARFP?

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[7] Financial Services Council, FSC 2016 Pre-Budget Submission, <http://fsc.org.au/media-centre/media-releases/2012/productivity-review-of-award-super.aspx?year=2016>

5.3. Proposal C: Uniform non-resident withholding tax rate of 5 per cent for all CIVs and MITs excluding property

Proposal C is similar to proposal B but applies the single non-resident withholding tax rate of 5 per cent to all Australian CIVs and MITs (not limited to ARFP funds).

Income from investments in property, including rental income and taxable Australian real property capital gains, would not be covered by this proposal.

Applying a single rate simplifies the withholding tax regime regardless of where the rate is set. That is, the rate could be a higher rate such as 10 percent or a rate determined to be revenue neutral.

Questions

10. What are the merits and likely impacts (for example, compliance costs, revenue from funds management, employment, substitution effects, investment decisions of non-residents) on inbound investment from each of the proposals outlined above?

11. What are the main jurisdictions with which your fund competes in the funds management sector?

    11.1. Are the funds management industries in these jurisdictions predominantly focussed on conduit foreign investments or domestically sourced investment?

    11.2. What are the withholding rates (including any domestic concessions offered) in those jurisdictions for income from domestic shares, bonds and other income?

APPENDIX A: SUMMARY OF TAX RATES APPLYING TO THE AUSTRALIAN-SOURCE INCOME OF FOREIGN RESIDENTS

Type of income	Foreign resident
Business income from corporate tax entities	Assessable at 30 per cent of taxable income
Dividends	Franked dividends: 0 per cent as paid out of profits that have been subject to 30 per cent Australian company tax Unfranked dividends: • No treaty – 30 per cent; or • Treaty – generally 15 per cent but can vary between 0 and 25 per cent
Interest income	10 per cent; or 0 to 10 per cent depending on treaty rates Exempt if debt satisfies the public offer test or another concession applies
Capital gains (excluding from land or land rich assets, or through a permanent establishment)	Exempt
Rental income received through a managed investment trust (MIT)	15 per cent or 10 per cent (for a MIT that only holds newly constructed energy efficient commercial buildings (clean MIT)) if paid to an Exchange of Information (EOI) country resident (30 per cent if paid to an non-EOI country)
Other fund payment income received through a MIT (including gains from disposal)	15 per cent or 10 percent (if a clean MIT) if paid to an Exchange of Information (EOI) country resident (30 per cent if paid to an non-EOI country resident)
Foreign source income received through a MIT	Exempt
Gains from disposal received through a foreign fund under the Investment Manager Regime	Exempt

APPENDIX B: KEY FUNDS MANAGEMENT INDUSTRY INITIATIVES OVER THE PAST DECADE

IMPLEMENTED

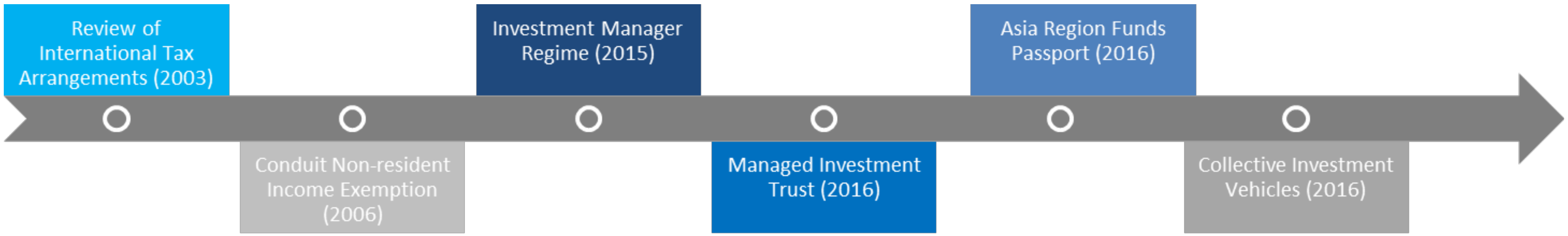
Changes to non-resident investment fund rules, cross-border taxation of trusts under capital gains tax and tax treaty rules, as part of 2003 Review of International Tax Arrangement measures aimed at '[removing] barriers to development as a global financial services centre'.

IMPLEMENTED

Addressing tax impediments identified by the 'Australia as a Financial Centre: Building on our Strengths - Report by the Australian Financial Centre Forum' (Johnson Report) – aimed at clarifying the tax treatment of gains made by non-resident funds and non-resident investors who invest through Australian fund managers (Investment Manager Regime).

COMMENCING IN LATE 2017

Fund managers in participating countries will be able to offer eligible schemes to retail investors in other participating countries in the Asia region under a streamlined process. Recommended by the 'Johnson Report'.



IMPLEMENTED

Withholding and other tax exemptions for conduit investments where Australian fund managers receive funds from investors in one non-resident country, to invest in assets in another country.

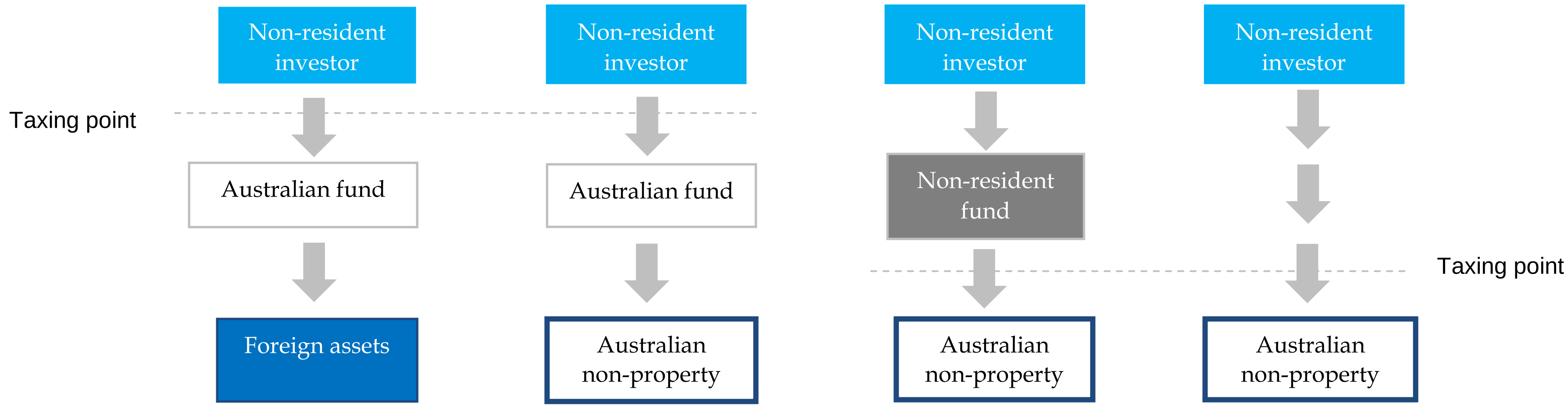
IMPLEMENTED

New tax system for managed investment trusts provides greater certainty, flexibility and reduces compliance costs.

ANNOUNCED IN 2016-17 BUDGET

A new tax and regulatory framework for corporate and limited partnership CIVs to enable non-resident investors to invest through more familiar vehicles (with the corporate CIV commencing from 1 July 2017). Recommended by the 'Johnson Report'.

APPENDIX C: WITHHOLDING TAXES (WHT) ON NON-RESIDENT INVESTORS INVESTING THROUGH CIVS

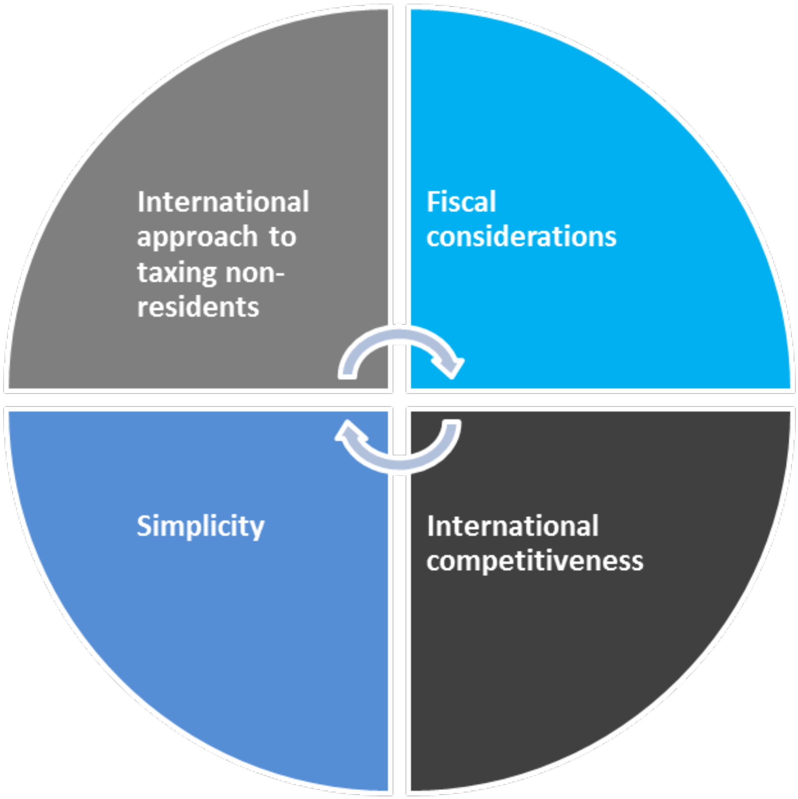


	Scenario 1. Conduit foreign investments	**Scenario 2. Inbound through Australian fund**	**Scenario 3. Inbound through foreign fund**	**Scenario 4. Direct investment**
Dividend, interest	Exempt from WHT	WHT applies – with limited exemptions	WHT applies – with limited exemptions	WHT applies – with limited exemptions
Other income	Exempt from WHT	WHT applies – with limited exemptions	Exempt from WHT – with conditions	Income tax applies

APPENDIX D: POLICY CONSIDERATIONS

Jurisdictions typically tax non-residents on domestic source income – on the basis that income was derived using infrastructure and assets located in the domestic jurisdiction.

Policy proposals need to be considered in a fiscal context



When taxes are complex, investors may not spend the time and energy to determine the relevant effective tax rate and hence may not invest in the country.

Australian tax rules for non-resident investment should be internationally competitive.

APPENDIX E: AUSTRALIAN WITHHOLDING TAX RATES ON INCOME PAID TO NON-RESIDENTS FROM SELECTED JURISDICTIONS[1]

	Unfranked dividends	Interest
Singapore	15 per cent	10 per cent
Hong Kong	30 per cent	10 per cent
Japan*	10 per cent[2]	10 per cent
South Korea*	15 per cent	15 per cent
New Zealand*	15 per cent	10 per cent
Thailand*	20 per cent[3]	25 per cent

1. Withholding tax rates are for income from Australian sources paid to non-resident retail investors in widely held pooled funds.
2. Unless the beneficial owner of the dividends is a company which owns shares representing at least 10 per cent of the voting power of the paying company, then a 5 per cent limit applies.
3. If the paying company engages in industrial undertakings and the recipient of the dividend holds directly at least 25 per cent of the capital of the paying company, then a 15 per cent limit is applied instead.

* Australia and these countries are signatories to the ARFP Memorandum of Cooperation.

Source: Australian Treasury, Income Tax Treaties, <http://www.treasury.gov.au/Policy-Topics/Taxation/Tax-Treaties/HTML/Income-Tax-Treaties>