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Division Head
Corporate and International Tax Division
The Treasury
Langton Crescent
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By e-mail: CIVwithholdingtax@treasury.gov.au

Dear Sir/Madam

**COLLECTIVE INVESTMENT VEHICLE NON-RESIDENT WITHHOLDING TAXES**

Thank you for the opportunity to provide comments on Treasury's Consultation Paper regarding collective investment vehicle non-resident withholding taxes ("**the Consultation Paper**").

We welcome Treasury's review of the non-resident withholding taxes ("**WHT**") that apply to investors in Australian collective investment vehicles ("**CIVs**") and managed investment trusts ("**MITs**"), including consideration of how these impact on Australia's international competitiveness.

We note that we have not specifically addressed the Consultation Paper's questions in any detail. Instead we have provided some general comments which we hope will be beneficial to the ongoing consideration of the application of non-resident WHT to CIVs and MITs.

By way of background, Pitcher Partners Advisors Proprietary Limited ("**Pitcher Partners**" or "**we**") comprises five independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively, we are one of the largest accounting associations outside the Big Four.

We predominantly focus on servicing the middle market. The typical CIV or MIT in this space would have net assets of between $20 million to $500 million. These funds are generally operated by Australian private company businesses[1] that conduct fund management operations in Australia. They would generally have between approximately 5 to 30 staff members.

[1] Excluding ownership of AFSL entities.

## A. Summary of submission points

We believe that Australia's international competitiveness in the funds management industry would not be materially enhanced through the adoption of either of the Proposals B or C in the Consultation Paper.

Rather, we submit that the aim of stimulating overseas investment could be more efficiently achieved by affording non-resident investors with a reduced single WHT rate on all forms of investment through an Australian MIT or CIV. It should not be limited to funds within the Asia Region Funds Passport ("**ARFP**") (unlike Proposal B) and investments in property (including rental income) should not be excluded (unlike in Proposal C).

We further submit that this could be achieved by adopting a uniform WHT rate for all non-residents in MITs and CIVs on amounts that would otherwise be assessable. This would be regardless of their residence or the nature of their return (e.g. unfranked dividends, interest, or rental income).

We believe the strengthening of Australia's fund management industry can also be enhanced by focusing on those areas which have the highest potential for growth, such as construction and infrastructure.

## B. Australia's funds management industry and the construction industry

We agree with Treasury's background material provided in Section 2.2 of the Consultation Paper. Statistically, Australia's managed funds industry is a very important part of our economy and continues to grow rapidly.

There is currently approximately $2.6 trillion of funds under management[2] ("**FUM**"), which is the third largest pool of contestable funds in the world. However, compared to other jurisdictions in the Asia-Pacific region, Australia does not manage a significant amount of funds sourced from non-resident investors (comprising approximately 9.9% of funds under management)[3].

We estimate that if Australia were to increase its' levels of funds sourced from non-resident investors from 9.9% to 65.0% (i.e. to a level equivalent to Hong Kong), Australia's total FUM would increase by approximately $4.1 trillion.

In addition, Australia's construction industry has displayed positive growth trends and could benefit from further overseas investment over the long term.[4] In light of the strong correlation between interest rates and demand for services in the construction industry, managed funds could provide an alternative avenue for the funding of such projects.

Whilst it is important that Australia maintains a robust tax regime that ensures that non-residents are subject to tax on Australian-sourced income, there exists some key growth

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[2] FSC/UBS Asset Management: State of the Industry 2016.
[3] IBISWorld Industry Report K6419a Funds Management Services in Australia (September 2016).
[4] IBISWorld Industry Report E Construction in Australia (August 2016)

areas within the Australian economy which provide unprecedented opportunities for foreign investment.

## C. The case for lower withholding tax rates

Australia has tax treaties with most of the Asia-Pacific countries. Furthermore, most Asia-Pacific countries have an Exchange of Information ("**EOI**") agreement with Australia. Accordingly, most of these jurisdictions allow access to reduced treaty WHT rates. This does not currently include Hong Kong (however, there may be future developments in this area).[5]

It is therefore possible to achieve the following reduced WHT rates when using a CIV or MIT.

| Item | Ordinary WHT rate | CIV / MIT rate |
|---|---|---|
| Capital gains – non-TAP | Up to 47% | 0% |
| Capital gains – TAP | Up to 47% | 15% |
| Rental income | Up to 47% | 15% |
| Interest | 10% | 10% |
| Franked dividend | 0% | 0% |
| Unfranked dividend | 30% | 15% |

Based on the above, an equity fund can generally provide for a (next to) zero WHT result for non-residents when returning franked dividends and capital gains (which are the predominant types of income of such funds). Accordingly, at a high level, a reduced rate of WHT may not have a significant impact on the growth of such funds.

A property fund can also generally cap WHT at 15%, while a debt fund is typically taxed at a WHT rate of 10%. Accordingly, a reduced WHT rate would therefore likely be more relevant to property funds and debt funds, rather than being as relevant for equity funds.

To the extent that a lower WHT rate is provided for fund payments and interest, we believe that this would provide a significant additional source of funding to infrastructure and property related arrangements and thus could provide a significant incentive for the growth of such funds.

That is, we expect that a lower WHT rate could have two significant implications for the Australian economy.

i). Firstly, we believe it could result in a substantial boost to our funds management industry, where offshore FUM (that is managed in Australia by Australian businesses) could significantly increase.

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[5] Mary Swire, *Hong Kong pushes for DTA, Info exchange with Australia* (11 November 2016) Tax-News (Global Tax News) <http://www.tax-news.com/news/Hong_Kong_Pushes_For_DTA_Info_Exchange_With_Australia____72726.html>.

ii). Secondly, access to infrastructure and commercial property related financing could also likely lead to a substantial boost to employment opportunities in the property development and infrastructure sector. Both of these sectors are important growth areas that will help to drive the Australian economy.

Accordingly, we believe that there is significant merit in considering a reduction in the WHT rates for both fund payments and interest payments for CIVs and MITs. Based on the above, we do not believe that there would be a significant change or shift in investments that occur in equity funds through a reduced WHT rate.

**D. Consultation Paper proposals**

In relation to the three Consultation Paper proposals, we question whether Proposal C of the Consultation Paper will materially increase the level of funds under management in Australia. This is because the reduction in the WHT rate will only (effectively) apply to unfranked dividends and interest income.

We also have concerns in relation to Proposal B because the ARFP is a regime that is effectively limited to equity funds. Accordingly, reducing the rate of WHT on rental income and property capital gains is irrelevant because a fund that holds real property is not currently eligible for the ARFP. Furthermore, as it appears that an ARFP is not available for debt funds,[6] the merits of Proposal B seem questionable because the rate of WHT for equity funds is already reduced to (next to) nil.

On the basis of the above, we believe that there is significant merit in considering a reduction in the WHT rate for fund payments and interest payments that may assist with infrastructure projects in Australia. We have not proposed a rate, as we believe this is dependent on the ability of the budget to be able to fund this in the short term (see Section E).

**E. Increasing simplicity and reducing administration.**

We broadly agree with the sentiments in the Consultation Paper at 4.4 that undue complexity in Australia' tax system can be a disincentive for foreign investment. In addition, large Australian funds with numerous overseas investors face a substantial compliance burden in determining the correct WHT rate to apply to their returns. This is because (technically speaking) each investor much be checked for residency, applicability of treaty, and then appropriate treaty rates must be maintained for each item of income distributed to those investors.

Accordingly, in order to increase simplicity, instil certainty, and alleviate the administrative complications which with Australian funds have to deal when they make returns to overseas investors, we believe there is merit in introducing a unified WHT rate for all overseas investment in Australian MITS and CIVS.

Such a regime could reduce significantly the compliance burden imposed on Australia fund managers who are otherwise required to consider the nature of the return, the residency of the investor, and then apply the appropriate WHT rate to each component of income of a

[6] Memorandum of Cooperation on the Establishment and Implementation of the Asia Region Funds Passport, Annex 3, Division 6.2, section 19.

distribution at the end of each distribution period (each time a return in made to an overseas investor). We note

While the adoption of a simplified regime may be attractive to foreign investors (in terms of simplicity), it is unlikely that the single rate will (of itself) result in a significant increase in foreign investors based on simplicity alone.

**F. Investor certainty and costs to revenue**

The Government has previously considered (and tried to implement) a lower WHT rate for fund payments. This has not been successful in the past.

That is, in 2007, the Government agreed to reduce WHT rates on fund payments to 7.5%. However, this was increased in 2012 to 15% due to (what we understand to be) budgetary issues.

We note that while we support the reduction in the WHT rate for fund payments and for interest payments by CIVs and MITs, we are unsure whether the budget has capacity to entertain this proposition.

We are also concerned that a MIT or CIV providing debt financing, or conducting an infrastructure or long term property arrangement would not be (typically) a short-term vehicle (and thus is long-term in nature). Accordingly, if the budget cannot sustain a reduction in WHT rates, we highlight that reversals of such policies (while a Fund has been established) does not help to foster investor certainty.

We believe that if the Government decides to reduce WHT rates for CIVs and MITs, it should be carefully considered and, once implemented, should not be changed for those funds that have already been established. It is absolutely critical that the continual changes do not give rise to sovereign risk issues and the uncertainty created in 2012 where a significant reversal occurred for the WHT rates of property funds.

**G. Additional access to funding infrastructure**

Currently, in the middle market, we are seeing many infrastructure arrangements, including large property developments, seeking sources of alternative financing. In our experience, this has been due to many of the financial institutions reducing their lending and, therefore, exposure in respect of property projects.

As a consequence, we are seeing a larger number of CIVs and MITs being established to facilitate debt financing alternatives. This has ranged from specific project financing, to alternative debt funds providing mezzanine financing, to peer-to-peer funds. To the extent that funding cannot be readily accessed from domestic institutions, we have seen a significant increase in the opportunity to obtain capital from offshore to assist in the funding of such projects.

However, interest paid by Australian CIVs and MITs to non-resident investors is currently subject to WHT tax at a rate of 10%, reducing the cash returns to non-resident investors and increasing the cost of funding.

To assist with this, we note that our tax system already provides an exemption under sections 128F[7] and 128FA[8] (i.e. the public offer test). In particular, section 128FA provides an exemption where the widely held MIT raises debt financing. However, in our view, the exemption is not appropriately drafted for Australian managed debt funds. This is because the exemption can only apply if debt is raised by the MIT rather than equity (which is then on-lent to the borrowers).

As a MIT is a flow-through vehicle, we believe that having an Australian intermediary CIV entity should not be an impediment to accessing the section 128F and section 128FA exemption. However, due to the limitation of the current rules, this can result in the capital raising occurring offshore, with the maintenance of an offshore facility or offshore CIV.

Due to the growth of alternative financing, we believe that it is opportune to re-examine and reconsider the interaction of the CIV and MIT regime with the section 128F and section 128FA WHT exemption. Alternatively, a reduced WHT rate on the payment of interest to non-residents through a CIV or a MIT may also address this issue.

## H. Interaction of other withholding provisions through a CIV for debt financing

We highlight that there are additional tax impediments that can occur when investing through an Australian MIT for debt financing. For example, where a debt instrument is issued directly to a non-resident, the current WHT rules only require interest to be withheld when it is "paid". For infrastructure financing, where interest and capital payments can be subordinate to financial institutional debt, this provides for an appropriate rule that ensures that WHT is only paid when the amounts are remitted to the offshore investor.

However, where a MIT is used, the requirement to distribute (or attribute) "unearned[9]" amounts on an annual basis can result in a deemed payment and thus a requirement to withhold at an earlier time. Under the AMIT provisions, the deemed payment is taken to occur under Subdivision 12A-C of Schedule 1 to the TAA[10] and requires WHT to be paid on attribution to the non-resident. Outside of the AMIT provisions, Division 11A[11] treats a trust distribution (or creation of present entitlement) to members as potentially being a payment to a beneficiary[12] and the derivation of income by the beneficiary[13]. Accordingly, using an Australian MIT to raise debt financing can bring forward the WHT point, which can operate as an impediment to using the CIV.

As previously noted at Section G, we believe that it is opportune to re-examine and reconsider the interaction of the CIV and MIT regime with the timing of withholding for non-residents with respect to interest income.

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[7] *Income Tax Assessment Act 1936* (Cth) s128F.

[8] *Income Tax Assessment Act 1936* (Cth) s128FA.

[9] Unearned is used to refer to "accruals" interest under Division 16E or Division 230.

[10] *Taxation Administration Act 1953* (Cth) Schedule 1 sd12A-C.

[11] *Income Tax Assessment Act 1936* (Cth) div 11A.

[12] Section 128A(2)

[13] Section 128A(3)

### I. Availability of foreign tax credits

Some of Australia's key trading partners, such as Hong Kong and Singapore, impose income tax on a territorial basis in relation to income derived by their resident individuals.

Accordingly, as income received from other countries may not be taxable in the resident's home country, there may be little or no entitlement to foreign tax credits in those jurisdictions with respect to foreign tax paid. Where this is the case, WHT (or any tax) paid by an Australian MIT or CIV can represent a "final tax" on income derived by investors located in such jurisdictions.

Therefore, in response to Question 4, in many cases the reduction of the Australian WHT rate will not result in a "claw back" in many jurisdictions and thus can result in a direct increase in the overall returns to non-resident investors.

Furthermore, some tax regimes in the Asia-Pacific jurisdiction generally operate only on a remittance basis, such as Singapore's corporate tax regime. Accordingly, accumulation of income in Australia under the AMIT regime may result in no tax in those jurisdictions.

The rate of WHT in Australia can therefore result in a real impediment for investment in Australia where, for example, the Australian WHT rate is higher as compared to the WHT that would result from investing in other jurisdictions.

As many non-resident investors are subject to considerably lower tax rates than that of Australia, we believe that offering a lower WHT rate could help to address this issue.

### J. Growth in the ASEAN funds management market

By 2020, the size of the Asia-Pacific middle class comprise approximately 1.74 billion people, or approximately 54% of the global middle class. This is estimated to grow to 3.23 billion people, or approximately 66% of the global middle class by 2030. [14]

Accordingly, we agree with the Consultation Paper that investors in the Asia-Pacific region are likely to require a number of important services as their collective wealth grows. In particular, we agree that the major areas are likely to be healthcare, aged care, education and infrastructure. In addition, we also agree that it is likely that investors will seek opportunities to accumulate wealth in jurisdictions that are considered politically and economically stable.

However, as noted earlier, we do not believe that the reduction of WHT is likely to have a significant impact on equity funds, as the WHT rates applicable to such funds can be next to nil.

However, the ability to offer reduced WHT rates related to infrastructure (i.e. fund payment rates and interest payments), will in our view, help to support the growth and development of these types of infrastructure assets.

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[14] DKSH and Roland Berger Strategy Consultants, 'Market expansion services: Taking outsourcing to a new dimension', Zurich, October 2011, p41.

We would welcome the opportunity to discuss our submission in further detail. Should you have any queries, please call me on (03) 8610 5170.

Yours faithfully

A M KOKKINOS
Executive Director