16 July 2018

The Treasury
Langton Crescent
PARKES ACT 2600

Via email: CIVreform@treasury.gov.au

AMIT Technical amendments – draft legislation

The Financial Services Council (FSC) is pleased to provide this submission on the draft legislation to make technical amendments to the Attribution Managed Investment Trusts (AMIT) regime.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC's comments on the draft legislation are detailed in the attachment, and largely relate to ensuring the AMIT regime works as intended.

Please contact me with any questions in relation to this submission on (02) 9299 3022.

Yours sincerely

SIGNED

Michael Potter
Senior Policy Manager, Economics & Tax

Attachment – detailed comments

Investment Manager Regime

We note the draft amendments do not address the Government's commitment to consult on legislative amendments to address issues with the Investment Manager Regime (IMR) relating to residency.

On 19 July 2017, the Government indicated it will "consult on whether a legislative amendment is required to ensure that the engagement of an Australian independent fund manager will not cause a fund that is legitimately established and controlled offshore to be an Australian resident. Any legislative amendment would be retrospective to apply from the start of the IMR regime in 2015"[1].

This issue remains unresolved and is an important issue for the FSC. We encourage the Government to increase the priority placed on resolving this issue.

Our previous submission to the ATO raising concerns with the ATO's approach to this issue is attached.

Expansion of AMIT coverage

In the 19 July 2017 announcement, the Government also indicated the following: "While this amendment [relating to single unitholder widely held entities] will not extend to including platforms, wraps or master trusts (commonly referred to as Investor Directed Portfolio Services) in the list of deemed widely-held entities, the Government will consult with industry on broadening the eligibility for these widely held entities to access the concessional tracing rules as part of the Corporate Collective Investment Vehicle public consultation process."[2]

This issue remains unresolved and has not yet been included in the consultation for the Corporate Collective Investment Vehicle. We encourage the Government to progress this issue as well.

Date of effect

We note that the Australian Custodial Services Association (ACSA) has made a submission raising concerns about the date of effect for three components of the draft bill, specifically:

- Aligning the CGT outcomes of MITs with AMITs (item 2)
- AMIT and MIT fund payments calculated only on taxable Australian property gains (items 20-23)
- TFN withholding provisions applying to AMITs (items 15 and 16)

The draft bill proposes that these three measures will apply from the 2017–8 income year. We support ACSA's concerns that it will not be simple to implement these changes and there is insufficient time to make the relevant changes in time for the income year ended 30 June 2018.

We therefore recommend that the changes apply to income years starting after the Bill receives Royal Assent.

Items 15-16 application of the TFN withholding rules to deemed payments

The draft Bill seeks to clarify the application of the TFN withholding rules to "deemed payments" arising under the AMIT regime (i.e. where the attributed tax components to an investor who has not quoted their TFN exceeds the amounts actually distributed to them). The Bill seeks to achieve this

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[1] See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/
[2] See: http://kmo.ministers.treasury.gov.au/media-release/064-2017/

outcome by including a provision that simply provides for “deemed payments” to be included in the “payments” to which TFN withholding applies (see items 15-16 of the Bill).

However, it is difficult to see how the TFN withholding rules can practically be complied with by an AMIT in relation to “deemed payments”. This is because the TFN withholding rules, as their name suggests, imposes obligations on payers to withhold amounts from actual payments that are made. It is difficult to see how an AMIT operator is able to comply with these obligations – that is, withhold amounts – from “deemed payments” that are, as their name suggests, only notional, as they arise due to an excess of the attributed tax components over the amounts actually distributed.

This issue is evident in the approach which was taken in the original AMIT legislation for “deemed payments” to foreign resident investors. As “deemed payments” are only notional, the AMIT legislation provided for there to be instead a tax liability imposed on the trustee of the AMIT (rather than a withholding obligation in relation to the “deemed payment”). The AMIT legislation also included protections for the trustee in respect of such tax liabilities, including the benefit of a statutory right of indemnity against the underlying foreign resident investor.

Accordingly, if the TFN withholding rules are also to be extended to “deemed payments”, it is arguable that a similar approach should be adopted. In particular:

- Statutory guidance should be provided regarding how the trustee of an AMIT is able to “withhold” amounts from “deemed payments”; and
- The trustee of an AMIT should be entitled to be indemnified by the investor who has not quoted their TFN for any tax liability that arises in respect of a “deemed payment”, on the basis that there is no actual payment in relation to these amounts from which an amount can be withheld for the relevant tax.

Item 22 – New subsection 12-405(2A)

The draft amendment in paragraph (a) applies to “a capital loss from a CGT event” which happens in relation to a CGT asset that is non-taxable Australian property (“non-TAP”). As drafted this will only apply to current year capital losses as a “capital loss” arises from an individual CGT event (refer to the definition of a “capital loss” in Section 995-1). However, once a capital loss is not fully recouped in the year it arises (under Step 1 in subsection 102-5(1)) it is subsumed into the calculation of the “net capital loss” of the trust for the income year under Section 102-10(1). As a result, the new subsection 12-405(2A) cannot apply in respect of prior year non-TAP capital losses as currently drafted. Given the draft Explanatory Memorandum states it is intended to apply to carry-forward capital losses (paragraph 1.48), the draft amendment needs clarification to avoid confusion as to its technical application.

If the provision is intended to refer to a “net capital loss” a number of further issues arise:

- A “net capital loss” can comprise both capital losses arising from CGT events in relation to TAP or Non-TAP CGT assets (Section 102-10 does not distinguish between the components of a net capital loss).
- Following the above point, there is no basis for identifying the extent to which a net capital loss may relate to a prior year non-TAP capital loss or not. If (2A) is amended to refer “to the extent” a net capital loss includes a prior year non-TAP capital loss, it would be necessary to define how this is to be worked out, including an ordering rule for the priority in which components of a net capital loss are utilised. For example, if a net capital loss of $200 from Year 1 comprised a $100 non-TAP capital loss and a $100 TAP capital loss, when $50 of the net capital loss is recouped in Year 2 there is no basis within Division 102 for determining the

extent to which the net capital loss recouped originated from a non-TAP or TAP capital loss. Accordingly, a policy basis and ordering rules will need to be determined (if this is pursued, a proportionate approach would appear reasonable but any such change will impose substantial compliance and implementation burdens on custodians and fund managers, see next point).

- The compliance burden of tracking components of a net capital loss, both originally and over time as it is utilised, will require substantial systems work (and cost to implement) from fund managers and custodians, particularly to introduce tracking mechanisms for each year a net capital loss remains. Experience from implementing the AMIT regime is that this takes more time than anticipated and the scale of change makes it complicated and expensive to introduce system changes that may appear simple from a policy perspective. The proposed start date of the 2017-18 income year for this measure leaves insufficient time to plan, implement and test changes for this amendment, particularly given it will not be enacted until after 30 June 2018 and this will be exacerbated by the fact that a large number of managed funds across the industry intend on adopting the AMIT regime for the first time in the 2017-18 income year.

Other issues arise from the drafting in subsection 12-405(2A), including:

- The wording in (b) is inconsistent with (a) and we recommend it is amended as follows (changes are marked):

  "(b) in relation to an income year, some or all of the capital loss is applied against a *capital gain from a CGT event that happens in relation to a CGT asset that is taxable Australian property;"

- It is unclear how the final paragraph is intended to apply. Relevantly, the new paragraph (aa) of Step 2 of the method statement in subsection 12-405(2) states that the expected net income of the trust is adjusted to include "…any amounts to which subsection (2A) applies for the income year" (emphasis added). The proposed subsection (2A) does not define what it applies to as it simply states that "If" the conditions in (a) and (b) are met, "…the amount that is so applied is an amount to which this subsection applies….". However, there is nothing which states the amount to which subsection (2A) applies.

Item 23 – New paragraph 12A-110(3)(b)

The same issues with new subsection 12-405(2A) exist for this provision as it refers to each "capital loss" and therefore cannot apply to prior year capital losses that have been included within a carried forward "net capital loss". If changes are made to delineate a "net capital loss" into TAP and non-TAP components the same issues as outlined above will also arise. In particular, the last part of the new paragraph (b) states "…to the extent that each such capital loss has been so applied in the income year". As noted earlier, it is not possible to identify the extent to which a capital loss originating from a CGT event in relation to a non-TAP CGT asset is subsequently applied in a later income year when it no longer retains an individual identity.

Similar to new paragraph 12-405(2A)(b) (above), the wording in paragraph 12A-110(3)(b) also appears to need amending as follows (changes are marked):

> "(b) the total of each *capital loss of the AMIT from a *CGT event that:
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> (i) happened in relation to a CGT asset that is not taxable Australian property; and

(ii) has been applied against a capital gain from a CGT event that happened in relation to a CGT asset that is taxable Australian property;"

Item 25 – New subitem 75(3A) in Part 4 of Schedule 5

The intended outcome of this change is welcome, being to prevent the immediate debiting of the franking account balance for a former corporate unit trust or public trading trust that ceased to have that status on 1 July 2016 due to the amendments in Schedule 5 of the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Act 2016 (this immediate debiting occurred because Item 4 in the table in subsection 205-30(1) was not switched-off under Item 75). However, the proposed new subitem (3A) cannot apply as currently drafted because the existing requirements in paragraphs (a), (b) and (c) of sub-item 75(2) are cumulative and the events listed in paragraph (c) do not include "an event described in item 4 of the table in subsection 205-30(1)". To remedy this issue, a new sub-paragraph 75(2)(c)(v) is required to include an entity ceasing to be a franking entity when its franking account was in surplus immediately before ceasing to be a franking entity. This change would allow paragraph (c) in sub-item 75(2) to apply, hence enlivening new sub-item (3A).

Item 27 – New paragraph 75(4)(c) in Part 4 of Schedule 5

The new paragraph should be amended as follows (changes are marked):

> "; and (c) the distribution is not made out of income derived <u>in respect of income years starting</u> on or after 1 July 2016."

This change is needed to ensure that trusts with substituted accounting periods are able to distribute franking credits arising from tax paid on income derived during the entire income year in which they were treated as a corporate unit trust or public trading trust. Relevantly, the amendments in Schedule 5 of the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Act 2016 applied to assessments for income years starting on or after 1 July 2016 (Item 1(2) Schedule 8). Accordingly, the new paragraph 75(4)(c) needs similar application wording. By way of example, a 31 December early balancing trust which was a public trading trust and ceased to be treated as such from 1 January 2017 would have incurred income tax and generated franking credits in respect of income derived until 31 December 2016 (whereas the current drafting on paragraph (c) would prevent the franking of a distribution to the extent that it comprised income derived from 1 July 2016 to 31 December 2016.

FSC FINANCIAL SERVICES COUNCIL

Mr. Andrew Mills
Second Commissioner
Law Design and Practice
Australian Taxation Office

11 May 2017

Sent via email to: Andrew.Mills@ato.gov.au

Dear Andrew

RE: ATO Audit Activity and the Investment Manager Regime

I am writing to you to inform you of recent ATO audit activity which is of significant concern to the FSC members and which we believe is contrary to the policy of the Investment Manager Regime (IMR) contained in Subdivision 842-I of the ITAA 1997.

Background

In 2016 the ATO commenced auditing the tax affairs of a Cayman Limited Partnership (with only non- resident investors (and primarily US based)) which had appointed an Australian investment manager. The ATO has focused on the issue of whether the appointment of the Australian manager and its funds management activities in Australia has resulted in the Cayman LP becoming a resident of Australia for tax purposes thus subjecting its entire taxable income to 30% Australian corporate income tax.

The ATO issued a Position Paper in April 2017 arguing that the Cayman LP was a tax resident of Australia under s 94T of the ITAA 1936 and therefore it was subject to Australian income tax on its worldwide taxable income in relation to the 2010 -2012 years of income. The audit has reached the stage that negotiations have commenced as to how the ATO can take a security interest over the Cayman LP's assets.

It should be noted that but for this "residence issue" the Cayman LP and its investors (whom as noted above are all non-resident investors) would not be subject to any Australian income tax in relation to 2010-12 years by virtue of the fund's income consisting solely of gains on NTAP assets. Had the investors in the Cayman LP directly invested in the same assets, they also would not have been subject to any Australian income taxation. Furthermore, but for the issue of residence of the fund, it would satisfy the requirements of the IMR concessions in s 842-215 of the ITAA 1997.

The ATO's audit activity also appears to be contrary to the policy behind ATO TD 2011/24 in relation to the private equity industry. This Tax Determination provides guidelines under which offshore private equity funds would not be subject to Australian tax provided certain tests were satisfied. This Cayman LP does carry on private equity type investment activities and should but for the "residence issue" satisfy the tests to qualify for the protection from tax offered by ATO TD 2011/24.

The fact pattern of this Cayman LP is very similar to that of many of the offshore funds established by our members and we expect that the issue of income tax assessments to the fund will have the following adverse consequences:

- Negating the benefits achieved to date under the IMR, with adverse international publicity as to the sovereign risk associated with making Australian investments, particularly for foreign funds that appoint Australian investment managers.
- Encourage Australian investment managers of foreign funds to move offshore, with the consequent loss of Australian jobs and associated tax revenue.
- Create uncertainty for auditors of such foreign funds as to whether provisions for Australian tax should be raised under ASC 740-10 and other similar accounting standards.
- Cause foreign funds to reassess whether they should continue with their existing, or indeed undertake any future investments in Australia.

IMR Consultations

The Board of Taxation's August 2011 Report recommended that the IMR address 3 separate issues being (i) the permanent establishment issue, (ii) the residence issue and (iii) the source of income issue.

The IMR as enacted dealt with issues (i) and (iii) but did not address the residence issue, despite numerous submissions that it do so, including those in the FSC's IMR submissions to Treasury dated 1 July 2010, 29 April 2013 and 14 February 2014. The industry took a pragmatic approach at the time of consultations to avoid delaying the implementation of the IMR and did not insist that the residence issue should be dealt with in IMR stages 1-3. However there was a clear policy intent behind IMR that the appointment and use of Australian managers should not create a residence issue.

This gap in the IMR coverage is now creating significant uncertainty for the industry which we wish to resolve as soon as possible. Further the audit of foreign funds, such as the case in point has the potential to significantly raise an alarm to the broader industry. Already we are aware of foreign funds making enquiries as to the ATO approach and whether the Government has now changed its approach.

We would welcome the opportunity to discuss this matter with you at your earliest convenience and will contact you shortly in this regard.

Yours sincerely

SIGNED

SPYRIDON PREMETIS
Senior Policy Manager
Tax and Economics
Financial Services Council