

## Tax Brief

22 May 2008

### Final Withholding for Managed Investment Trust Distributions

The Government has made further progress toward delivering one of its election promises, repeated in last week's Budget – to change the regime for taxing distributions to foreign residents who invest in Australian managed funds. This Tax Brief examines the recently released Exposure Draft of the provisions to accomplish this measure. This will be very significant for the managed funds industry, especially listed property trusts, although wholesale funds and funds in sectors other than property will need to monitor their exposure. In addition, any distributions from the property sector will now have to be carefully monitored if they flow through several trusts before leaving Australia.

#### Background

This measure has been in gestation for some time. In a speech by Wayne Swan on 3 April 2007 and in Kevin Rudd's reply to the 2007-08 Budget, Labor committed to a 15% flat withholding on distributions of income made by fund managers, rather than the 30% rate which the then Government had announced. Labor also proposed making the withholding a final tax, eliminating the need for foreign investors to lodge a tax return where their income was subject to withholding. This was in contrast to the Government's proposal for withholding to be an interim collection only.

This measure was re-announced in a slightly modified form in last week's Budget. Under the revised version, the Government would still replace the 30% withholding with a final tax at a lower rate, but:

- access to the lower rate of tax would now be qualified according to whether the foreign investor is resident in a jurisdiction with which Australia has an effective exchange of information arrangement;
- the lower rate would eventually be 7.5%; and
- the transition to the new final rate would be staggered.

In addition, it appears that the Government has taken the opportunity to change some design aspects of the withholding regime and these will potentially have significant impacts on the systems only recently put in place for dealing with managed fund distributions.

#### Proposed legislation and regulations for payers

So far as the position of payers is concerned, the proposed legislation replaces the current legislation for taxing distributions by Managed Investment Trusts ("MITs") with an entirely new regime. The detail of the new regime follows the existing rules quite closely, except for a few

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significant modifications. The existing provisions, which have been in operation for less than 1 year, are described in our earlier Tax Brief available at [http://www.gf.com.au/477\\_551.htm](http://www.gf.com.au/477_551.htm). Readers are referred to that Tax Brief for more detail on some of the issues that the existing rules pose; the important changes are highlighted here.

The proposed rules establishing the new withholding regime will still depend on three key concepts:

- the paying entity is a “managed investment trust,” custodian or other entity;
- the payment is a “fund payment;” and
- the payment is made to a certain type of recipient.

## ***Payers***

The liability to withhold an amount is imposed on a MIT, defined in the same terms as under the current rules.

The proposed legislation makes some important design changes to the provisions that apply where a fund payment is made by the MIT to a resident who receives it for a foreign resident. Some of the difficulties with the current provisions were described in our earlier Tax Brief. The new version proposes rules to address three different situations:

- if the payment is made by the MIT to a resident “custodian,” the custodian is obliged to withhold from a payment it makes to its client. An entity is a custodian if it is carrying on business which consists predominantly of providing custodial or depository services pursuant to an Australian financial services licence;
- if the payment is made to a resident “agent,” the legislation applies as if the agent were the principal. This means, the MIT is not obliged to withhold from the payment it makes, but the agent will be obliged to withhold from the payment it makes; and
- if the payment is made to some other resident entity (other than a company), and a foreign resident is or becomes entitled to receive some or all of the payment from the resident entity, the entity is obliged to withhold an amount from the payment it receives. This part of the test appears principally to be directed to payments made to resident trustees, although the drafting is capable of broader interpretation. The regime shifts responsibility from the MIT to the other entity, but the “withholding” effectively occurs at the time the MIT makes the payment, not when the other entity eventually pays an amount to the non-resident.

This extension of the withholding regime to all other resident ‘entities’ is significant; the current withholding regime only requires withholding by MITs or custodians. Requiring other resident ‘entities’ to withhold has important ‘feed-back’ effects for MITs which are discussed below. Notice that this appears to be an infinite process through chains of trusts – withholding is potentially required by any entity which receives a distribution accompanied by a notice indicating that it contains an element representing an MIT distribution.

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## ***Fund payment***

The new legislation does not propose changes to this notion. As under current rules, the withholding regime applies to the part of a payment that represents a share of the net income of the trust, is attributable to Australian sources or a capital gain made on taxable Australian property, and is not already subject to the existing withholding tax regime for dividends, interest and royalties.

## ***Payment recipient***

The new legislation proposes some changes to the current definition.

Under current law, the requirement to withhold is triggered where the MIT makes a payment to a recipient who is a foreign resident, if the MIT has reasonable grounds to believe the recipient is a foreign resident, or, in some cases, if the MIT has not taken steps to ascertain the recipient's residence. Our previous Tax Brief noted some of the difficulties with this formulation.

Happily, the proposed legislation is much more realistic. The obligation to withhold will now be triggered in just two cases:

- if the recipient has advised an address or place for payment outside Australia; or
- the payer is authorised to make payment at a place outside Australia.

There is also an exception if the payment is made to a non-resident but is attributable to the Australian branch of the non-resident.

## ***Rate of withholding***

One of the key modifications to the original announcement was the decision announced in last week's Budget to reduce the withholding rate. The new legislation proposes a two-tier rate structure, but with a delayed and phased introduction.

For recipients who are residents of countries listed in the regulations, the rates will be:

- 22.5% for payments made in relation to the first year of income starting after the proposed legislation receives the Royal Assent – presumably, payments made in relation to the 2008-09 income year;
- 15% for payments made in relation to the next year of income; and
- 7.5% for payments made in relation to subsequent income years.

The list in the regulations (which have not yet been released) will set out the countries with which Australia has an exchange of information agreement, presumably in either a bilateral income tax treaty or an exchange of information-only agreement (such as the agreements with Bermuda and Netherlands Antilles).

For recipients who are residents of other countries, the withholding rate will remain at 30%.

## ***Administration***

One area which has changed significantly is the rules governing the administration of the withholding system.

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Under current law, MITs or custodians are permitted to give notices to investors about the amount and composition of fund payments. The new system contains much more stringent notification rules (enforced by penalties) which arise principally because of the incorporation of other entities into the withholding regime.

- The new system requires that notices must be given by MITs, custodians and other “entities”.
- Notice must be given on each occasion that an MIT, custodian or other entity makes a payment (which will often mean quarterly).
- The notice must be given if the distribution is made to a resident investor, not non-resident investors. (In other words, the MIT, custodian or entity either withholds from the payment, or sends out the entire amount without withholding but accompanied by a notice.)
- The notice must set out the amount from which withholding was **not** made because the payment was made to a resident, and the year of income to which the payment relates. This is because the notice is designed principally to inform each succeeding entity of the amounts involved so that it can meet its own withholding or notification obligation (depending on whether its income goes to residents or leaves Australia).

## Rules affecting the position of investors

The Bill also addresses the other side of the coin – the recipients’ (typically, the unitholders of the MIT) position with regard to fund payments and the potential exposure of the trustee of the MIT.

So far as the unitholders are concerned, the proposed legislation will remove their exposure to Australian income tax in order to deliver the Government’s promise that the withholding would be final. Under current law, the beneficiary is liable to include the amount from which withholding was collected in its assessable income and then claim a refundable tax credit. Under the new regime, a fund payment is made non-assessable non-exempt income of the unitholder – this is intended to ensure that the non-resident is not liable to Australian income tax on the amount. Secondly, the unitholder is made liable to a new tax – Managed Investment Trust Withholding Tax. The amount withheld by the payer is then treated as a credit against this liability. By this method, the amount withheld by the MIT is intended to eliminate the unitholder’s Australian tax liability.

A further complication arises because the unitholder is a non-resident. Because a trustee is assessed in respect of the share of the net income of a resident trust to which a non-resident beneficiary is presently entitled, the current law eliminates this exposure where the withholding regime is triggered. The proposed rules will continue that system.

The proposed rules also continue the current system where the MIT does not distribute within 3 months of the end of the income year – the income will be treated as income to which no beneficiary is entitled, thus re-imposing tax on the trustee.

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## Commencement

These measures are currently in the form of draft legislation. Industry was given until 16 May for consultation on the text, so this process is already over. The next step will be for a Bill to be presented to Parliament.

Once enacted, the measures will apply to payments made in relation to the first year of income starting after the proposed legislation receives the Royal Assent. Assuming the Bill receives Royal Assent before 30 June of this year, that will mean the income year commencing on 1 July 2008 (for trusts with a 30 June year end).

There is one further complication for distributions representing income of the 2008-09 income year. For some reason, it has been decided that residents of countries with which Australia has an exchange of information arrangement will be assessed to tax at the rate of 22.5%, but the tax will be imposed on their net distribution – that is, on the gross fund payment reduced by any expenses incurred in earning the fund payment. (For subsequent years, the distributions will be assessed on the usual gross basis.) The potential impact on the tax burden for 2008-09 income will be adjusted in the hands of the beneficiary, rather than by changing the withholding system. This means the withholding at source will be excessive for taxpayers with deductions, which will necessitate some type of application by them to the ATO for a refund of tax.

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