

Submission

Review of Tax Arrangements Applying to Collective Investment Vehicles

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Submission

This submission is made in response to the Board of Taxation Discussion Paper on the Review of Tax Arrangements Applying to Collective Investment Vehicles.

Our submissions are set out below following the Consultation questions which we have copied for convenience from the Discussion Paper after an introduction setting out the general approach we believe should be taken by the Board.

We understand that you may wish to discuss submissions directly with interested parties. If this was the case then we would like the opportunity to discuss our submission with you. If you would like to discuss any particular points raised in this submission then please contact either:



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Conditions for a successful funds management hub

Over the last five years we have prepared and lodged many submissions to Government, Treasury and the Board of Taxation on tax rules relating to collective investment vehicles on many specific issues and details. Accordingly although the current consultation raises a number of the same issues we have preferred to deal with them at a broader policy level as we consider that a lack of a clear policy goal, or of the existence of several conflicting policy goals without a clear sense of priorities, has been hampering the more rapid development of policy and law that is required if the Government is to achieve its goal of making Australia an Asian financial hub.

Further before addressing the specific questions raised in the CIV Discussion Paper we would like to make some initial more general comments about the conditions which are necessary in our view for the establishment and management of a successful funds management hub in Australia.

If Australia is to succeed in becoming a Asian financial hub then it must be more proactive in pursuing this goal. We recognise that the government has been pursuing such activities on an ongoing basis but in our view the current timeframes in achieving various objectives are too far into the future. For example the report of the Board of Taxation on Managed Investment Trusts was completed in 2009 and Government decisions were announced in the 2010 Budget. Given the progress made to date in putting policy decisions into effect, in our view it is reasonable to expect that the earliest hard start date for a new MIT regime will be 1 July 2012. Applying a similar timetable to the broader issue of the range of collective investment vehicles available in Australia suggests that it will be 2015 before decisions are fully implemented. In our view this is too slow a timetable to achieve the government's often stated objective.

In that regard it is important to be aware of what is happening in other countries which can be regarded as competitors to Australia in funds management both in Asia and more generally. The main European centres for funds management, Ireland and Luxembourg, have been very successful in attracting offshore funds because they have adopted an approach of finding out what foreign investors need both in the way of regulation and taxation and then modifying their systems accordingly within short periods of time while maintaining appropriate levels of regulation for particular kinds of funds. In Asia, Singapore is pursuing a similar strategy and in recent years has created a number of new fund types including limited partnerships and real estate investment trusts. More generally as the Asian financial hubs strategy is designed to make Australia competitive with other countries in the funds management area, then Australia should not be trying to reinvent the wheel or engineer a different kind of regime compared to an approach that has proved successful overseas. In addition we can shorten the time being taken to implement decisions by taking the best features from overseas experience for attracting foreign funds and then implementing them in Australia.

Another message from the success of Ireland, Luxembourg and Singapore is that there must be a coordinated whole-of-law approach to attracting foreign funds. The areas of law concerned in addition to taxation are investor regulation and prudential controls. In Australia at the moment the tax issues are separated from the investor regulation and prudential control mechanisms with the latter being dealt with by the Financial Centre Taskforce. We consider that there needs to be a single sufficiently resourced unit within Australian Treasury to conduct the implementation of government decisions in relation to the Asian financial hub objective. In our view the separation of taxation from other issues in the funds management area has meant that there has been too much focus on tax integrity without regard to the contribution

that provisions in the regulatory and prudential framework can make in ensuring overall system integrity for funds management activities.

Finally once the system is established the regulators need to have benchmarks set for them based on competitor countries in registering and/or approving and monitoring foreign funds for operation from an Australian base. Both Ireland and Luxembourg are very responsive to the needs of foreign investors in the funds management area and have set up their systems to provide strong regulation but at the same time very speedy service for establishing CIVs and making them operational.

Q 2.1 Issues / Questions

The Board seeks stakeholder comments on:

- *the specific reasons for the apparent unattractiveness of Australia's current tax treatment of CIVs to non-resident investors; and*
- *the specific non-tax factors which may make Australia's CIVs unattractive to non-resident investors.*

In addition to lack of familiarity with trusts and the complexity of their tax treatment for non-residents of income flowing through funds management vehicles in the form of trusts, we consider that a very significant issue in the tax area in relation to the treatment of collective investment vehicles is tax uncertainty. The uncertainty has several sources. First and foremost, in our view it is clear that the Australian Taxation Office (ATO) has been significantly changing well-established positions in relation to taxation of trusts in recent years and similarly in relation to the treatment of non-residents. This has become particularly clear since the "FIN 48" issue emerged for US investors in Australia and led to an increasing nervousness in placing moneys with Australian managers and in funds that invest into Australia. The large auditing firms view Australia as one of the three hotspots of tax uncertainty for offshore investors (in some rather dubious company). Some clients advise that they have likely lost business because of the uncertainty arising particularly from the "source" issue. The December announcement by the Assistant Treasurer while dealing with the FIN 48 issue for the past does not clarify what is a foreign fund and also leaves continuing uncertainty for the future. Secondly, there have been well-known areas of difficulty in the taxation of collective investment vehicles which Board of Taxation has dealt with in its 2009 Report but legislation has not been forthcoming with the result that there is very significant uncertainty arising from transitional delay in bringing in the new regime. Thirdly, Australia's tax treatment of internationally well-recognised vehicles for collective investment has been confusing through a failure to accept international norms, particularly in relation to limited partnerships and corporate CIVs.

Outside the field of taxation, we consider that the main problem in relation to CIVs has been failure to develop a purpose designed regulatory and prudential framework. At the moment the regulatory framework is controlled generally via the managed investment scheme provisions of the *Corporations Act* but those provisions extend far beyond the kind of collective investment at which the Asian financial hub objective is directed. For example agricultural tax shelters are subject to the same regulation as normal CIVs. We consider that a purpose designed system for collective investment of the kind being sought by Australia should be established. Similarly for prudential regulation, there is no special treatment of CIVs but rather they form part of the general prudential regulation of the financial sector. This can be contrasted with Ireland, for example, where the vehicles designed for collective investment have their own special regulatory and prudential regimes. We are not suggesting that there should be a separate regulator but rather that the rules for CIVs should be stated clearly and separately in the regulatory and prudential regimes.

Q 2.2 Issues / Questions

The Board seeks stakeholder comments on:

- *the appropriateness of the widely held definition contained in the MIT legislation as a characteristic for a wider range of CIVs, and whether there any compelling reasons to have non-widely held vehicles included as CIVs;*
- *the appropriateness of the current definition of eligible investment business in Division 6C of the ITAA 1936 as a prerequisite for a wider range of CIVs, and whether there are any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs; and*
- *whether there is a need to further define 'control' in Division 6C of the ITAA 1936 to provide greater certainty for investors in MITs and other CIVs, and if so, how this could be achieved.*

We consider that the questions here contain an underlying premise with which we disagree. The premise is that the general boundaries of what is a CIV should be drawn by a single set of rules both as to the entity being widely held and as to its activities. CIVs overseas come in all manner of forms from funds which are closely held in the sense that they may be constituted by a small number of very wealthy investors and/or sovereign wealth funds, to funds which are extremely widely held. Similarly the activities of collective investment vehicles cover a wider range which goes beyond the general description being applied in Australia of long term primarily passive investment.

That is not to say that there should be no rules dealing with these particular topics but rather that there should be a modulated approach, instead of one size fits all. This modulation can be achieved in the regulatory area, in the prudential area, or in the taxation area as appropriate. We consider, however, that there is only one significant policy that it is purely a taxation matter which is to preserve the corporate tax levied on active businesses conducted by foreign and domestic widely held entities in Australia. Outside that area we consider that the tax policy articulated for collective investment is the appropriate one: that the tax outcome should generally be the same for an investment through a collective investment vehicle as for an investment directly.

Accordingly we consider that the implications of a fund being closely held or widely held, or of being engaged in more or less risky activities should be matters for regulation in the first case and prudential controls in the second case. Issues of this kind should not be dealt with through the tax system. Similarly the fact that an investor is quite active in the activity of investing should not mean that it is excluded from CIV tax regimes – significant parts of the investment management industry are based on a view that more active management of investments can increase returns without increasing risk, and one important purpose of the CIV industry is to provide ordinary investors with professional investment management. This approach generally describes the model that has been adopted by Ireland, Luxembourg and Singapore and is the one that we consider is necessary here if Australia is to be competitive as a funds management hub.

One particular area where Australia may need to draw distinctions with its competitors (which are much smaller countries in population and economic terms) is in distinguishing the operation of the corporate tax borderline as between domestic business operations and foreign business operations. The corporate tax is inherently a source based tax as is evidenced in Australia (and virtually all other countries) by the effective exemption from Australian tax of foreign business income derived by Australian multinational companies. The corporate tax base that needs to be protected from an Australian perspective is the Australian tax base – other countries are responsible for drawing the line appropriately to protect their domestic corporate

tax base. This means that the Australian requirement where corporate tax treatment should apply should affect Australian activities only (whether of a resident or of a non-resident). It does not matter to Australia if another country permits a CIV to access effective tax flow through treatment for activities which Australia would regard as appropriately covered by a corporate tax at source.

Similarly in relation to the activities of private equity funds in Australia we do not consider that CIV effective flow through treatment should be denied to the fund, provided that corporate tax treatment is being applied to the underlying active Australian businesses that are acquired by private equity funds. The activities of such funds ultimately relate to maximising the return on the investment in the company but that is true of all investments in companies by CIVs.

This overall policy view forms the framework for our answers to the questions. In relation to the first question we do not consider that there should be a single widely held definition which controls entry to all CIV regimes in the tax area. We consider that there should be room within the regimes for closely held vehicles, even though those vehicles may be subject to different regulatory or prudential rules. For example, closely held funds constituted by sophisticated investors probably do not need the same extensive kind of investor regulation as would appropriately apply to a widely held fund. Conversely the kind of prudential regulation that is necessary for a hedge fund would seem to be different to a fund invested in listed equities without extensive use of derivatives to leverage risk.

Our response to the questions relating to the borderline between collective investment vehicles and corporate tax is in the same vein. Firstly, we consider that it is necessary to distinguish Australian activities and foreign activities. In relation to Australian activities it is necessary to have regard to the history of the dividing line which is reflected in the development of Division 6C and mainly concerns the property management industry (since "trading" in financial assets is generally permitted for a CIV).

The difficulties with CIVs engaged in property ownership and management is that their business has both passive elements in the form of receiving traditional forms of rent as well as more active elements in the form of development, construction and management of large property complexes. We consider that a sensible development of the regime in Division 6C for this industry would allow activities which are considered to be too far removed from traditional rental activities to be housed in entities subject to corporate tax and controlled by the collective investment vehicle which owns the properties. The Board of Taxation in its 2009 MIT report has recommendations for refining Division 6C which at the least we think should be implemented. We would prefer to go further in modifying Division 6C, but as we have made many previous submissions on this issue, we will not pursue them further here.

In relation to activities outside the property sector, we do not consider that the control test is necessary in the sense that it will convert what would otherwise be a collective investment vehicle into a company for tax purposes. In that case, all we consider is necessary is a rule to ensure that pricing between the collective investment vehicle and an entity being taxed as a company is on a market value basis so that profit is not stripped out of the company and tax thus avoided. It follows from our previous comment that we would also accept such a market value rule for CIVs in the property sector. We emphasise that this is a market value rule and is not intended to require anything akin to a transfer pricing analysis, simply a market valuation if the amount paid is contested by the ATO.

In drawing the border between the corporate tax and collective investment vehicles, as well as developing a control test, we consider that the matter should not be approached in the abstract but the line should be drawn having regard to where similar lines are drawn in other major economies. As already noted, with regard to foreign activities we should leave this line drawing, especially in relation to the property sector to the country concerned and not seek to impose it in Australian law.

To some extent this policy has already been reflected in Australian law, for example, by removing American Regulated Investment Companies (RICs or mutual funds) and Real Estate Investment Trusts from the CFC and former FIF regimes and is reflected in the proposal in the recently released draft CFC legislation to remove rent entirely from the CFC regime.

Q 3.1 Issues / Questions

The Board seeks stakeholder comments on:

- *the nature and extent of, and the reasons for, any impediments to investments into Australia by foreign investors through MITs; and*
- *suggestions on how the complexity of character and source retention under flow-through taxation could be alleviated through alternative CIV vehicles that are more attractive or user-friendly to non-resident investors.*

Although the current system for taxing MITs in Australia is often complex for non-residents, particularly the variation of the overall tax rate on distributions received (depending as it does on the make up of the distribution in a number of ways: as between domestic and foreign source income; the elements of franked or unfranked dividends, interest, royalties, capital gains and other income; and the application of tax treaties), we do not consider that the status quo should be disturbed for MITs apart from implementing the Board of Taxation 2009 MIT recommendations. A number of existing foreign investors in MITs are familiar with the tax regime and there is a very significant amount of investment by Australian residents in MITs who also understand the tax treatment and for both groups the current tax treatment is important in achieving a tax outcome close to that for investment directly. As indicated above the major priority at the moment is to remove the overhanging uncertainty resulting from the progress in implementation of the Government announcements in relation to the outcome of the Board report.

In the future the work being done by the OECD and the possibility of using specific treaty provisions or mutual agreements to assist in the international administration of the tax treatment of MITs will make them relatively more attractive for non-residents while not detracting from their current attractions for residents and those non-residents who are familiar with investing in them.

We consider that the major issue arising from complexity is that discouragement of various groups of non-residents from investment through Australian managers. This problem (and others) can be overcome by a three pronged strategy: the creation of a range of CIVs that are more familiar to non-residents; dealing with the tax issues (and uncertainty) that can arise from using Australian based fund managers (the IMR issue); and fully participating in international efforts to make the international tax treatment of CIVs clearer and more administrable, while improving integrity, so that Australian concerns are addressed in that process.

We comment more fully on these issues below but to summarise on the first two, we consider that Australia should ensure that it has a corporate CIV vehicle and an internationally standard LP regime available for non-resident investors and a comprehensive IMR regime. In relation to the corporate CIV vehicle we consider that the vehicle should be exempt provided it meets certain conditions, distributions should be treated as dividends with effective conduit treatment of foreign income and retention of character for certain capital gains, and a capital account election should be available as for MITs. The tax rate on dividends for non-residents should be 30%, 15% for countries with which Australia has a comprehensive tax treaty and 0% for franked dividends (that is, redistribution of franked dividends received by the CIV).

Q 3.2 Issues / Questions

The Board seeks stakeholder comments on:

- *whether the existing definition of LIC capital gains should be restricted to gains made on direct investments only and whether there are reasons to extend this definition to include all gains made in respect of permitted investments by LICs;*
- *whether it is desirable to introduce further changes to the LIC regime to better obtain parity of tax outcome with direct investments in the underlying assets of the LIC? If so, what changes would be required;*
- *should an amended collective investment company regime be limited to listed vehicles or applied more broadly including other widely held non-listed investment companies defined in a similar way as the widely held rules for MITs;*
- *instead of amending the LIC regime, should a new corporate CIV regime be introduced that provides parity of tax outcome with direct investments and how would that regime operate? What transitional rules may be required;*
- *is there a trade-off between preserving character and source of income and simplifying distribution statements for investors that are more familiar with a dividend distribution statement? Are there minimal tax outcomes that would meet non-resident investor expectations without requiring complete tax flow-through? Is there any way to preserve character and source of income under a new corporate CIV regime? If so, how would that operate?*

As there is an existing, not insubstantial, market segment for LICs we consider that the current vehicle should be retained so as not to disturb that market. The market size, however, in our view does not justify changing the current regime significantly to match more closely the tax treatment of MITs and/or the proposed corporate CIV discussed below. The design of the proposed corporate CIV, has, however, been fashioned so that existing LICs may find it attractive to convert into the new form and they should be able to do so by election. We address the issues raised in the last three bullet point questions below.

Q 3.3 Issues / Questions

The Board seeks stakeholder comments on:

- *generally, what changes could be made to the LP regime to provide for an appropriate LP CIV;*
- *whether LPs are suitable vehicles for widely held, primarily passive, collective investments;*
- *whether it is desirable to introduce changes to the LP regime, so that flow-through taxation is allowed for those widely held LPs that restrict their investment activities to primarily passive investments;*
- *if flow-through were allowed for LPs marketed at the wholesale level or for sophisticated investors that restrict their investment activities to primarily passive investments, would it be appropriate not to require these LPs to be 'widely held' (as defined in the MIT regime)? What would be the rationale for allowing this when compared to MITs which are required to be widely held; and*
- *apart from limiting the flow-through of losses, would there be a need, in light of integrity and investor protection considerations, to apply further restrictions to that modified LP regime? If so, what would be the nature of those restrictions?*

We consider that Australia is being considerably disadvantaged in the international investment management market at the moment by its tax treatment of LPs which is out of line with international norms which treat LPs on a flow through basis for tax purposes. The problem that was dealt with by Division 5A which treats LPs (with the exception of foreign hybrid partnerships and certain venture capital partnerships) as companies can be dealt with by rules ensuring that the losses available to a limited partner do not exceed their investment as occurs overseas, for which there are variants in relation to the current exceptions to Division 5A.

As previous submissions from the private sector to have Division 5A removed from the legislation as a means of dealing with this issue have been unsuccessful, we consider that another substantial exception for LPs should be included in Division 5A so that it operates as a residual regime like Division 6C which is designed to protect the corporate tax base, that is, it should only apply where an investment is widely held and there are substantial activities in Australia not conducted in the form of a company for tax purposes which constitute active business. LPs, like CIVs, should be able to control an entity which is a company for tax purposes, subject to an arm's length test for dealings between the controlled company and the LP. It should be possible to construct a general corporate borderline for both MITs and CIVs, though as we have noted above, there is a history attached to Division 6C that has special relevance to the property industry which may require special rules for that industry.

This broad view conditions our responses to the specific consultation questions on LPs. In relation to the first, we consider in the light of the failure of previous submissions to have Division 5A removed from the legislation, that an LP CIV exception should be created to sit alongside existing exceptions. To the extent that existing LPs would be affected by such a new exception, we consider that they should have a significant period of say 5 years to change their structure with a rollover where necessary (including to the new corporate CIV proposed below) in the event that they would change status from being taxed as a company and there should be rules for spelling out the tax consequences if a change happens (unlike the complete dearth of rules in Division 5A).

In relation to the remaining questions we consider that an LP is a suitable vehicle for a CIV, especially because it is an international norm to allow this form of investment, but that the exception to Division 5A recommended above should not be conditioned on the LP being widely held or that it should satisfy some definition of passive investment, apart from the rules dealing with the need to protect the Australian corporate tax base outlined above. To the extent that is necessary to deal with investor protection or prudential matters, for example, in relation to hedge funds structured as LPs, we consider that this should not be a matter for tax rules. As emphasised above, if Australia significantly limits the use of LPs for CIVs then this will be detrimental to the objective of making Australia a managed funds hub.

We also consider that the current residence rule for LPs should be changed as discussed in the Paper.

Q 4.1 Issues / Questions

The Board seeks stakeholder comments on:

- *the appropriateness of any of the taxation models (including variants) to achieve tax neutrality for designing a corporate CIV regime that would enhance industry's ability to attract funds under management in Australia;*
- *the appropriateness of any of the models (including variants) to achieve tax neutrality for designing a limited partnership CIV regime that would enhance industry's ability to attract funds under management in Australia; and*

- *whether there are any critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes, including by rationalisation of the regimes where possible.*

Q 4.2 Issues / Questions

The Board seeks stakeholder comments on:

- *what would be the most appropriate method to achieve an outcome similar to tax flow-through for a corporate CIV;*
- *what would be the most appropriate method to determine the tax liabilities of investors in a corporate CIV;*
- *under what circumstances would it be appropriate to assess tax on a corporate CIV, at what rate, and what should be the tax consequences of the payment of the tax for investors;*
- *what special rules would be necessary to mesh the corporate CIV appropriately with the rest of the Australian tax system; and*
- *would it be appropriate to extend the MIT regime to a corporate entity, by deeming qualifying corporate entities to be trusts for tax purposes? What modifications would be required for corporate entities under such a regime, and would this be feasible without adding undue complexity to the tax and company law?*

We have dealt with the issue of an LP CIV regime under the previous heading. We have also indicated above that we consider that Australia should introduce a corporate CIV in order to offer a range of vehicles to foreign investors which international experience shows is necessary to suit the varying needs of foreign investors in the CIV area. We have given a broad indication of the nature of that regime and here spell out the details and the reasons for them.

We consider that an exemption system is the most appropriate option for effecting the flow through treatment rather than the other alternatives of a deduction or integration system as outlined in the Board's Discussion Paper for the following reasons. In relation to integration the LIC system is built on the Australian imputation system and for the reasons outlined in the Discussion Paper does not work well for non-residents. We have noted above that we do not consider that the LIC rules can be modified so as to overcome its problems in terms of non-resident investors and a major reason for this view is the difficulty of adapting imputation to produce flow through treatment for non-residents. The problem with the deduction system is that problems can arise when deemed income is created by the tax system which particularly arises under arm's length pricing rules and various attribution regimes and the deemed income is unmatched by cash-flows. An exemption system can deal with this problem and focuses the attention on the right policy issue, namely, what should be the conditions which attach to entry into the regime though a distribution system could probably be fashioned to produce a similar result.

With regard to the conditions for the exemption, we consider that they could include the following:

- (a) that the CIV is constituted by a corporation which is a resident of Australia for tax purposes under the definition for residence of companies and under tax treaties;
- (b) that the CIV does not breach the tests adopted for determining when company tax treatment should apply for Australian purposes as discussed above;

- (c) that the CIV distributes as a minimum annual dividend a substantial proportion (given as a fixed percentage) of what would be its taxable income but for the exemption; and
- (d) that the CIV satisfy whatever regulatory and prudential rules are considered appropriate depending on the nature of its activities.

The purposes of the conditions are as follows. Condition (a) is designed to ensure that the CIV will be a treaty resident of Australia (and if a dual resident which was allocated to another country under a tax treaty it would be denied CIV status). This allows Australia's tax treaties to apply and confer treaty benefits on the corporate CIV and its distributions. Condition (b) is designed to align the corporate CIV closely to a MIT in qualifying conditions and as part of the protection of the Australian corporate tax base. Condition (c) ensures that corporate CIVs are not created specifically to derive deemed income which is then sheltered from tax in Australia while in effect allowing small amounts of such income to be derived without prejudicing corporate CIV status. Condition (d) emphasises that the CIV issue is a system wide one; it may not be considered necessary as there will be other consequences for failing regulatory or prudential rules. It has been assumed that a widely held definition would be part of the regulatory regime. Alternatively as such a rule would be in the tax law relating to drawing the line between company and CIV tax treatment as discussed above, it could be used also as a positive requirement for CIV status.

It would be necessary to specify what regime applies if conditions are breached. Breach of the rules for drawing the line between company and corporate CIV status for tax purposes would lead to taxation as a company for the offending income and probably breaches of the other conditions would be suitably treated by this approach. It would be appropriate to provide mechanisms for addressing inadvertent breaches, including under and overs and start up and wind down phases and to limit the penalty of being taxed as a company for breaches of other conditions to the income year in which the breach occurs. To avoid capital-revenue issues at the level of the CIV creating potential disputes with the ATO that may prejudice corporate CIV status and to align tax treatment with MITs the corporate CIV should be able to elect capital account treatment in the same way as a MIT (see further below).

Once the qualifying conditions are met and the corporate level exemption is available, the critical design features are then the treatment of distributions and disposal of shares in the corporate CIV. Treating distributions as dividends for tax purposes (other than distributions from share capital account as made clear in domestic tax law in 2010) subject to withholding tax is more transparent to investors than the existing MIT system but in order to attract foreign investors to use Australia as a base for offshore investment, it will be necessary to add some qualifications which will make the system somewhat more complex though much less so than the MIT regime. The qualifications are:

- (a) foreign income as defined under the current conduit foreign income rules would give rise to an exemption from dividend withholding tax for non-residents¹ (the difference would be that no corporate top up tax would arise at the corporate CIV level as can occur for companies under that regime); foreign income would be designated as having foreign tax attached at the election of the corporate CIV;
- (b) capital gain treatment would be preserved for shareholders in corporate CIVs to the extent that capital gains are distributed; that is, the distributed amount would be treated for Australian purposes as a capital gain of the investor in the CIV and not as a dividend; investors would fall into two categories for this

¹ References here to non-residents means non-residents without a permanent establishment (PE) in Australia to which the investment in the corporate CIV is effectively connected; non-residents with a PE to which the investment is effectively connected would be taxed similarly to Australian residents as under current law.

purpose (i) non-residents who would receive capital gain treatment on non-TARP property² which as a result would not be subject to dividend withholding tax to that extent; and (ii) residents who would receive capital gain treatment on all distributed capital gains (for which purpose the distribution statement would designate to what extent the gains are discount capital gains);

- (c) to the extent that the corporate CIV received full or partially franked dividends from its investments, the franked part of the dividends received would be exempt from withholding tax on redistribution and would carry franking credits at the corporate rate for resident shareholders.

The distribution statement would thus have a number of components similar to MIT distribution statements so far as resident shareholders are concerned. As these investors are used to dealing with MIT distribution statements, they should not be affected unduly by the complexity of a corporate CIV distribution statement. The distribution statement would, however, be much simpler for non-residents as showing only two components effectively – a part exempt from dividend withholding tax (foreign income, capital gains on non-taxable Australian assets and the franked part of dividends redistributed) with the rest subject to dividend withholding tax at the normal rate.

The normal dividend withholding tax rates would apply, that is, 30% for residents of countries with which Australia does not have a full tax treaty, 15% for treaty countries. At the moment some Australian treaties would create the possibility of lower rates in certain cases particularly where a non-resident company holds more than 10% of the voting power of the corporate CIV. This could be dealt with by a number of mechanisms such as limiting the proportion of the corporate CIV that could be held by a corporate investor to 10% of the voting power (either generally or for the particular countries where there is an issue under tax treaties). The Australia Japan tax treaty would also limit the tax rate to 10% more generally but this could be accepted on the basis that Japan accords reciprocal treatment for Australian investors in its corporate CIVs. Indeed the 10% treatment could become the Australian standard treaty negotiating position generally on dividends or at least for investments in corporate CIVs on a reciprocal basis. Indeed as Australia has unilaterally granted a 7.5% rate for MITs in domestic law, the treaty policy preferred rate could be set at 7.5%. Other configurations of the dividend withholding tax rate in domestic law could be constructed depending on how closely it was desired to reflect the current position of MITs, for example, a 7.5% rate could be specified in domestic law for residents of information exchange countries.

The outcome of this system would not perfectly reflect the outcome of investment directly by a non-resident but it would go a considerable way to that end while simplifying tax treatment for non-residents compared to MITs. It would be possible to further refine the outcome closer to investment directly (and MIT outcomes) depending on what is seen as the right balance with respect to complexity in dealing with non-resident investors in corporate CIVs.

With respect to the last bullet point question in Q4.2, the Board of Taxation 2009 MIT report did not consider it necessary to have a special regime for real estate investment trusts in the current setting where the predominant form of CIV in Australia is a MIT, with which we concur. Nonetheless we consider it would be appropriate to allow a company (not in the capacity of trustee) to elect to be a MIT

² That is, property which is not taxable Australian real property (TARP). Expressing the treatment of the non-resident in this way would ensure that capital gains are not treated as taxable Australian property on the basis that the corporate CIV has a PE in Australia. It may be considered necessary to remove the current dividend withholding tax exemption from foreign superannuation funds and some other bodies such as foreign charities for investment in corporate CIVs as a broader range of income than is currently the case (for example, gains on TARP by the CIV) would be exempt through treating the distribution of CIV income as a dividend.

under the MIT regime that will be implemented following Government response to the Board's recommendations, rather than to be taxed under the proposed corporate CIV regime. This would be of particular relevance to the property sector where it would allow fund managers to overcome the issue of lack of familiarity in Asia with the trust structure while retaining full MIT tax treatment, though the issue of complexity would be present.

Q 5.1 Issues / Questions

The Board seeks stakeholder comments on:

- *the appropriateness of an exemption-based approach for an IMR applicable to foreign managed funds;*
- *whether an alternative approach would be more appropriate?*

By way of preface we reiterate our earlier comment that an important objective of the current Board review is to make Australia competitive with other countries operating as fund management hubs and that this requires Australia to have rules comparable to such countries for dealing with particular tax issues thrown up by funds management. Accordingly we consider that Australia in this area is well advised to reflect overseas practice both in law and in compliance systems. For example, the UK has in place a relatively simple method for funds managers to demonstrate that they satisfy the UK IMR. We consider that Australia should look closely at the UK system in its law, interpretation (found in HMRC Statement of Practice 1/01 as revised 2007 available at <http://www.hmrc.gov.uk/manuals/intmanual/INTM269190.htm>) and administration. We consider that similar guidance should be provided by the Explanatory Memorandum for any legislation in Australia.

The one caveat to following overseas practice is that Australia potentially would tax more cases than the UK (or Hong Kong or Singapore) in similar circumstances apart from the IMR and so the Australian regime has to be framed to deal with all such cases. This concerns all three of the identified areas of uncertainty in the law, the permanent establishment issue, the capital/revenue/source issue and the residence issue.

We consider that an exemption based IMR is the appropriate way to proceed as in the UK and elsewhere. Tax issues that may arise from conferring an exemption on the investor where the investor is a fund taxed on a transparent basis and may have Australian resident investors can be dealt with in other ways discussed below. We consider that a conduit approach proposed by the 2010 Report of the Australian Financial Centre Forum would not provide as clear an outcome and so not give the same certainty to investors which is critical if the IMR is to be a success. At the moment the December 2010 and January 2011 announcements by the Assistant Treasurer, while a good start, will not provide the necessary certainty on all the relevant issues, and while some issues remain unresolved it is not clear that resolving others will provide the necessary comfort for foreign investors. We consider that this matter requires speedy resolution on all issues. Because it is relatively free-standing in our view from the rest of the Discussion Paper, we would encourage that this issue overall be expedited by the Board.

Q 5.2 Issues / Questions

The Board seeks stakeholder comments on:

- *if the option of taxing Australian intermediaries of foreign managed funds only on their arm's length fees was to apply, what are the types of intermediaries to which this option would apply; and*
- *recognising the need to maintain the integrity of the tax system, what would be the required ring-fencing provisions that would ensure this feature of an IMR is appropriately targeted?*

We consider that the IMR should be potentially applicable to all investment intermediaries in Australia whether they execute contracts for non-residents as part of the investment advisory and management function or whether they simply provide advice in one of the many possible forms. The basic conditions of the UK IMR in this regard should be sufficient:

- the investment manager is in the business of providing investment management services (broadly defined to cover the wide range of activities undertaken by the industry for non-residents investors); and
- the transactions are carried out in the ordinary course of that business;

Moreover, it should not matter that the Australian adviser is related to the non-resident (for example, a subsidiary) so long as the fees received by the adviser for its services are arm's length in accordance with international transfer pricing norms and what would be expected as normal or customary in the business in question. The UK effectively interprets these two conditions as one in the normal case, although we see the latter as requiring that the manager be able to point to other participants in the industry using similar remuneration structures. We think this may be a useful check when unusual remuneration structures are found to prevent lengthy debates as to whether the remuneration is arm's length.

Although the UK rules refer to the adviser being independent, the UK interpretation makes clear that this means in effect that the adviser does not perform virtually all its services for the non-resident and so is dependent in the sense of not having any other clients. We agree with this approach and consider that provided the adviser is rewarded at arm's length in a customary way, the exemption should only be denied where the adviser effectively does all of its work for the non-resident. In this respect the UK threshold of 80% of the business of the adviser being constituted by work for the non-resident provides a sensible bright line test for independence subject to appropriate start up and averaging over time qualifications though the manager should be able to demonstrate independence as a factual matter if outside this test. The fact that the IMR test may be failed on this account does not mean that the investor would be automatically be taxed on gains on investments derived through activities of the investment manager – it would still be necessary to satisfy the normal Australian taxing rules for that to occur.

The final general limitation that the UK provides which may be suitable for Australia concerns cases where the investment adviser or manager has a significant stake in the investment and may be regarded in that sense as managing it on its own behalf (the UK threshold being a holding of 20% directly or through related parties but without an overbroad interpretation of what is a related party, for example, not treating all the partners in a partnership as related as would generally occur under Australian law). We also consider that the UK approach of only disqualifying the investment held by the related party from enjoying the benefits of the IMR is appropriate.

We consider that no further ring-fencing of the regime is required other than as indicated in relation to our responses to following consultation questions.

Q 5.3 Issues / Questions

The Board seeks stakeholder comments on:

- *do the above features of a foreign managed fund encompass all funds that should be covered by an IMR;*
- *should there be a 'managed in Australia' requirement or a minimum spend requirement as per Singapore's regime? Can the economic benefits and growth in the Australian financial services industry be maximised without such a requirement; and*
- *what are reasonable reporting and approval processes that are necessary to ensure that the IMR exemption is being appropriately claimed by qualifying foreign managed funds?*

We do not consider that the IMR should be limited to foreign funds as defined but that Australian advice should be available to foreign sovereign wealth funds, investor directed portfolio services type activities, and other closely held situations, that is, the IMR should apply to foreign residents generally, including the types of investor just listed. If the exemption is limited to widely held foreign funds, that will not only create a border of uncertainty around the meaning of widely held but more importantly deny Australian advisers work for important segments of the foreign investor population without any gain in integrity so far as the Australian tax base is concerned or significant revenue loss (as the business of the non-resident likely will not come to Australia or will be withdrawn if the clear exemption is denied and the matter is cast back on the uncertainties in current law). The most tax effective method of investment for foreign institutional investors using an Australian investment manager is often through an investment management agreement or investment mandate. Some foreign institutional investors which currently invest use Australian managers may not be widely held under the current MIT CGT tests such as life companies. We expect additional business to be undertaken by foreign institutional investors in this form in future if the IMR provides the necessary protection against uncertainty.

In our view the Discussion Paper is adopting the one size fits all approach again which we have advised against above. The UK, for example, does not limit its IMR by requiring that the non-resident be a widely held foreign fund. If the non-resident is widely held then under the interpretation adopted by HMRC that will indicate that the adviser is independent and so satisfy one of the conditions mentioned above, but it does not disqualify other non-residents from enjoying the IMR.

We do not consider that there need be any defined Australian benefit condition to access the exemption. The UK does not have such a requirement. Under the current law the risk of a non-resident inappropriately being drawn into the Australian tax net is most significant when there is substantial activity in Australia but is not limited to that case. When there is significant Australian activity by the investment manager then there will usually be significant income of the manager taxable in Australia which would satisfy any reasonable condition of Australian benefit. To deny the exemption in other cases would mean that the risk of even more inappropriate taxation of the non-resident (because there is little or no activity in Australia) would be present. It is difficult to see what is being achieved by exposing this case to possible Australian taxation (recalling that on one view simple execution of a trade on the ASX is sufficient to attract Australian tax).

It must be remembered in the case of Singapore that the manager itself often enjoys a more beneficial tax regime than normal resident business activities and accordingly it is understandable that some benefit in Singapore be shown before the IMR be available. Similar comments apply to Ireland with its low corporate tax rate.

In terms of compliance we consider that normal self assessment rules should apply, including the facility of obtaining rulings in cases of doubt. There should not be any requirement of prior approval for the IMR (the Australian Financial Centre Forum Report recommended moving away from this approach to OBUs and there the case for pre-approval is much stronger given the reduced tax rate applying to the OBU owner). It may be appropriate to require as in the UK that some relatively simple after-the-event check be undertaken through investment managers operating in Australia filing an appropriate form to signal cases where a non-resident is relying or likely to be relying on the IMR when filing its own tax return or at some other point in the compliance chain.

Q 5.4 Issues / Questions

The Board seeks stakeholder comments on:

- *the range of investments that could be covered by an IMR;*
- *whether other activities of a non-resident would affect their access to the IMR; and*
- *whether an IMR could also cover non-portfolio interests in non-Australian assets?*

We consider that an appropriate list of investments covered by the IMR will be provided by the financial instruments that are dealt with in relation to the border between corporate and CIV taxation discussed above. This should include units in a property trust and derivatives in relation thereto but not investment directly in land or a business (including for example, as the only beneficiary of a fixed trust which holds land or a business) or similar exposure being achieved by derivatives. The UK again provides an illustrative list and way of drawing the borderline.

If the non-resident is otherwise carrying on business through a PE in the form of a branch, then it may be difficult to separate out the branch activities from the investment being managed by an Australian investment manager. Similarly if the non-resident has a related entity carrying out such activities on its behalf which is not independent in the sense discussed above, that again may make separation of activities difficult. In such cases it may be appropriate to deny IMR treatment, though alternatively it might be appropriate only to deny the treatment when the investment management is being dealt with by the PE. Similarly if the investment manager carries out other activities for the non-resident not within the protected class such as assisting with investments in land directly, that would indicate that the relationship goes beyond that of a typical investment adviser and may lead to withdrawal of the exemption. Alternatively it may be possible to exclude one activity from the IMR while maintaining it for the other. We have no strong views on these issues other than that any borderline involved should be clear and easy to apply. Otherwise the kinds of uncertainties that the IMR is intended to deal with may be reintroduced in another form.

In relation to the final question it follows from our earlier comments that we are not generally in favour of carving out control situations from the investment field generally. Not only does this create another borderline which has to be defined and will need considerable protection (for example, dealing with derivatives as a means of obtaining control), it will be another uncertainty risk in the IMR which to that extent will not provide the desired clarity. We consider that whatever rules are adopted in relation to the issues in the previous paragraph and in our answer to Q5.2 should be sufficient to deal with cases where more than investment management and advice is occurring. For example, in the private equity sphere a genuine adviser should be entitled to give the IMR protection to non-resident investors, but if those investors have a fully fledged operation in Australia in relation to the investment the IMR would not be available in any event.

Q 5.5 Issues / Questions

The Board seeks stakeholder comments on:

- *recognising the need to maintain the integrity of the tax system, how could Australia's residence rules be amended such that the rules are appropriately targeted only to foreign managed funds under an IMR?*

As already made clear we consider that the IMR should be available to foreign investors generally and not just widely held foreign funds. However, in dealing with the residence issue we consider that a widely held test has a place, that is, a place of creation (incorporation) of the fund rule should be sufficient to define a widely held fund as a non-resident for the purpose of the IMR (as one but not the only possible beneficiary of the regime). The central management and control rule or control by Australian residents type tests would not be applicable for a foreign created widely held fund in relation to determining if an investor is a non-resident for the purposes of the IMR. Such a rule should extend to widely held funds which may be regarded as tax nothings for Australian purposes so that the income would otherwise be seen as derived by investors in the fund directly (somewhat like the Australian treatment of unincorporated joint ventures for income tax purposes). In some civil law countries CIVs can be constituted purely by contract and such funds should be covered by the IMR. Integrity in this regard is conferred by the widely-held requirement and the round-tripping rule that we discuss below.

For other non-residents, the normal residence rules could apply in determining availability of the IMR (subject to the change referred to in the Discussion Paper for fixing the current anomaly in the LP residence rule).

Q 5.6 Issues / Questions

The Board seeks stakeholder comments on:

- *the required and appropriate integrity measures to deal with round tripping;*
- *where are the integrity risks for round tripping greatest (in terms of investor types and income types)? To what extent are these risks constrained by limiting the exemption to widely held foreign funds;*
- *to what extent are the integrity risks systemic in the sense that integrity issues from limited offshore information apply across a range of tax measures, and to non-disclosure issues generally; and*
- *should there be a de minimis test to allow a degree of ultimate Australian ownership for a foreign managed fund in the IMR regime? If so, what would be an appropriate percentage for the de minimis test?*

We consider that the round-tripping risk can be dealt with by a limitation of the amount of investment by Australian residents in a non-resident claiming the IMR exemption coupled by a withdrawal of the IMR exemption when Australian residents derive income from a foreign fund that otherwise enjoys the IMR. The limit on investment can be fairly generous as the backup of withdrawal of the IMR for resident investors takes pressure off the limit. For example, a global property fund may have a fair amount of Australian exposure through investment in Australian property trusts and a reasonable level of Australian investment given the global significance of Australian property trusts and the amount of funds held in CIVs in Australia compared to other significant countries. Hence a limit in the range of 20-30% should be feasible which would also match similar conditions in overseas countries.

So far as the withdrawal of the IMR is concerned that would be automatic to the extent that the non-resident is not a transparent (or disregarded) entity for the purposes of Australian taxation of its residents. The entity would be a company for Australian purposes and so a distributions would be regarded as an assessable dividend unless out of a share capital account and disposals of interests in the entities would give rise to CGT. For transparent entities an exception to the general rule can be created in the Australia's current taxation rules for partnerships and trusts that the exemption at the entity level does not carry through to the partner/beneficiary. For disregarded foreign entities that qualify for the IMR such as contractual funds in some civil law countries, it would probably be necessary to enact a direct assessing rule to overturn the exemption.

With the recent growth of international tax information exchange, the OECD efforts to improve the international integrity of the claiming of treaty benefits especially in the area of CIVs through its TRACE project and the salutary effects of Project Wickenby against tax evasion through foreign entities and tax havens, we consider that, although there may be integrity risks with the IMR they are no more than the normal risks such as encountered in the high wealth individual area and should not be singled out for special treatment. The problem with seeking to impose integrity through a widely held requirement is that legitimate use of the IMR may be prejudiced and uncertainty created in enforcing a widely held test internationally.

As noted previously we consider that Australia should be participating much more fully in these international efforts specifically as they relate to CIVs.

Q 5.7 Issues / Questions

The Board seeks stakeholder comments on:

- *if an exemption style IMR is implemented for foreign managed funds taking into account the matters discussed above, are there any issues that would remain unresolved for foreign managed funds? In particular, would there be any significant source or permanent establishment issues remaining?*

If the IMR is implemented in the way we have described, in particular without a widely held requirement, we consider that all of the source, PE and residence issues can be satisfactorily resolved. If, however, such a limitation is imposed we consider that there will still be a substantial range of investment management activities in Australia where the current uncertainties would weight heavily against the use of Australian investment managers, other things being equal.

Q 5.8 Issues / Questions

The Board seeks stakeholder comments on:

- *what financial services sector entities apart from foreign managed funds would it be appropriate to encompass within the scope of an IMR as described above? Are there any other types of financial services entities which should be taken into account in addition to those identified above;*
- *what justifications would there be to relax the requirements for foreign entities to be widely held before qualifying for IMR exemptions;*
- *what justifications would there be to relax the requirements for foreign entities to undertake primarily passive investments in order to qualify for the IMR exemptions;*

- *what integrity issues would be raised if portfolio investments through IDPS or foreign private vehicles were exempted through an extended IMR? Are there some risks that are higher than others? What can be done to mitigate these risks;*
- *recognising the need to maintain the integrity of the tax system, how could Australia's residence rules be amended so as to apply only to foreign financial sector entities under an IMR? Which foreign financial sector entities should be taken into account, and how could they be appropriately defined in such rules; and*
- *to what extent does the current law (for example, OBU provisions) already adequately provide IMR like concessions for financial sector entities apart from foreign managed funds?*

We have commented on several of these questions above. We do not propose in this submission to deal with the recommendations of the Australian Financial Centre forum report outside the general investment area such as treasury operations of multinational firms.

Q 6.1 Issues / Questions

The Board seeks stakeholders comments on:

- *whether the restrictions imposed on the VCLP and ESVCLP regimes are consistent with their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;*
- *what are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime;*
- *suggested amendments to the tax treatments under the VCLP and ESVCLP regimes that would enhance their effectiveness in achieving their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;*
- *are the current levels of investment through VCLPs and ESVCLPs consistent with what would be expected normally for these types of programs compared to similar programs in other jurisdictions;*
- *would the introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP contribute or detract from its policy objectives? What other considerations would be relevant to introducing such a deemed capital account treatment;*
- *given the carried interests of general partners are already deemed to be on capital account, should general partners receiving gains made by a VCLP on the disposal of eligible venture capital investments also be deemed to be on capital account; and*
- *the desirability of further changes to the tax treatments in the VCLP or ESVCLP regimes to enable them to better achieve their policy objectives?*

Although we consider that the current limitations on venture capital regimes mean that they are unlikely to be very successful, our main interest in this submission is dealing with the investment industry more broadly and so we do not comment generally on venture capital.

We would, however, make two main points. First we would repeat that LPs should be more broadly excepted from Division 5A and that the current LP test of residence should be amended as suggested in the Discussion Paper. These changes would in our view considerably free up venture capital as well as having the benefits outlined

above for investment more generally. Secondly, we consider that a capital account election should be available in the venture capital area as it is for MITs and suggested above for a corporate CIV. Otherwise distortions will occur in how superannuation funds make their investments in the venture capital area.
