

MALLESONS STEPHEN JAQUES

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12 December 2008

Copy to:

The Board of Taxation
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir / Madam

Request for urgent legislative changes to the taxation treatment of foreign investment funds in Australia, to remove outdated and unenforced disincentives for them to invest in, or via, Australia.

Attached is a submission requesting urgent legislative changes to the Australian taxation treatment of foreign investment funds. The changes are designed to better enable the Commonwealth Government to achieve one of its key priorities of making Australia a funds management hub in the Asia-Pacific region.

The submission is also intended to complement the Board of Taxation's Review of the tax arrangements applying to Australian Managed Investment Trusts ("MITs").

The submission has been prompted by the serious and genuine concerns of a number of substantial foreign investment funds, which either:

- have invested in Australia in the past, or
- have been and remain unwilling to invest in Australia, or to establish funds management operations here, because of the uncertainties and other problems highlighted in this submission:

The submission:

- shows that foreign funds face a number of specific uncertainties and problems in investing in Australia which they do not face in investing, or establishing funds management operations, in the US, the UK, Singapore, Hong Kong or Japan, and which discourage them from investing in Australia;
- suggests some specific legislative changes that could be made to put Australia on a similar footing to those foreign countries, so as to make Australia a more attractive place in which to invest; and

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- suggests that, in terms of cost/benefits impacts, such changes would not have a materially adverse effect on Australia's tax revenues, and, instead, should have a positive impact on these revenues and on the Australian economy generally.

The suggested urgency of the need to make appropriate legislative changes is driven by several things:

- To our knowledge, the likely imminent withdrawal of many foreign funds from investing in Australia (with the added likelihood that they will not reinvest here until after the identified uncertainties and problems have been remedied).
- The uncertain impact that new accounting standard FIN 48 is having on those funds, because of those uncertainties and problems, the urgent need for that impact to be determined by the fund itself or the fund manager (because it affects their daily, monthly or quarterly net asset values, and therefore share or unit redemption or new issue prices), and the damage that this experience is causing Australia's reputation as a desirable place in which to invest. This is a significant live issue which is presently confronting many foreign funds who have previously invested in Australia.
- The genuine risk that the longer the delay in resolving these uncertainties and problems, the greater the likelihood that foreign funds will choose to establish or expand funds management operations in other overseas jurisdictions (such as Singapore or Hong Kong), rather than Australia. This would undermine the prospects of Australia ever becoming a funds management hub in the Asia-Pacific region.
- The need for some of these uncertainties and problems to be addressed at the same time as the Board of Taxation and the Government consider the tax arrangements applying to Australian MITs, and, in particular, the application of the capital/revenue distinction to them.

For all the above reasons, we (and our clients) would appreciate your urgent consideration of the issues raised, and the suggested solution put forward, in this submission.

We, and possibly one or more of our clients, would be happy to meet with Treasury representatives to further discuss the issues, and an appropriate legislative response, at your convenience. Please also let us know if you require any further information or assistance.

Yours faithfully

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Submission to the Commonwealth Treasury

December 2008

Amendments to make Australia's tax system more
internationally competitive for foreign investment
funds

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Submission

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Request for urgent legislative changes in the taxation treatment of foreign investment funds in Australia, to remove outdated and unenforced disincentives for them to invest in, or via, Australia

1 Purpose of this submission

This submission requests urgent legislative changes to the Australian taxation treatment of foreign investment funds.

The submission suggests some specific legislative changes that could be made:

- to overcome current uncertainties and problems for foreign funds;
- thereby to put Australia on a similar footing to other foreign countries such as the US, the UK, Singapore, Hong Kong and Japan; and
- thereby to better enable the Commonwealth Government to achieve one of its key priorities of making Australia a funds management hub in the Asia-Pacific region.

2 Positioning Australia as a leading funds management hub is a key priority of the Rudd Government

A key priority of the Rudd Government is to make Australia a funds management hub in the Asia-Pacific region.¹

¹ Various detailed statements have been made by the Government, and various symposiums have been held, to emphasise and further this goal. These are listed or referred to in Appendix 7. Note also the

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The reasons for this key priority have been repeatedly mentioned by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, the Hon Chris Bowen (the “Assistant Treasurer”). They are:

- (a) In terms of capitalising on Australia’s strengths and comparative advantages and attracting funds management jobs to Australia:
- We have people residing in Australia with the skills to manage funds.
 - If funds under management in Australia grow, we can retain or regain talented young professionals who would otherwise be working overseas; and we can also create more interesting and well paying jobs in Australia for the next generation of young people.
 - But just 2.5% of the money managed from Australia comes from overseas. (By way of contrast, funds under management in Asia are growing annually by 14%).²
 - The sector makes a substantial contribution to Australia’s economic prosperity.
 - That contribution would increase if Australia could capture the management of even just a small proportion of the inevitable and substantial increase in funds under management raised in Asia (ie become an ‘Asian fund/s house’³).
 - If Australia captures some of these additional funds under management, there would undoubtedly also be more dealings with counterparties in Australia, thereby generating additional taxable income for these counterparties.

But none of these things will happen if uncertainties in the Australian tax system actively discourage foreign funds and foreigners either from putting their moneys under the management of professionals in Australia or from otherwise investing in Australia.

- (b) In terms of harnessing opportunities in the region:
- We should take advantage of our proximity to the Asian region, in terms of overlapping extensively with the Asian time zones.
 - This enables fund managers in Australia:

recent creation of the Australian Financial Centre Forum, announced by the Assistant Treasurer and Minister for Competition Policy, the Hon Chris Bowen, in a keynote speech entitled “Promoting Australia as a Financial Services Centre” to the Committee for Sydney on 26 September 2008. Note also, for example, the *Financial Centres of the Future - What role for Australia?* symposium, which was held on 20 May 2008.

² See the Assistant Treasurer’s keynote speech referred to in footnote 1.

³ *ibid.*

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- To trade on Asian exchanges.
- To enter into Over the Counter (OTC) purchase and sale, derivative and other contracts with counterparties in the Asian region.
- Also, to enter into more OTC purchase and sale, derivative and other contracts, with counterparties in Australia, thereby generating additional taxable income for those counterparties.

But this will not happen if uncertainties in the Australian tax system actively discourage foreign funds and foreigners either from putting their Asian moneys under the management of professionals in Australia or from otherwise investing in Australia.

- (c) In terms of generally attracting foreign investment in shares in Australian listed companies and units or other interests in other listed trusts/entities:
- It is not sufficient that Australia is a safe haven that is a stable and well regulated market in which to invest.
 - It is not sufficient that the Rudd Government has slashed withholding tax rates from 30% to 7.5% over a three year period.

Additional investment will not come, and, to our knowledge, substantial funds will be withdrawn from the Australian market, unless the uncertainties and disincentives highlighted in this submission are overcome.

3 “Scorecard”

Some reforms to Australia’s income tax system have occurred⁴, and others have been announced, to achieve the goals referred to in 2 above.

However, a key impediment to most foreign funds investing in Australia, or establishing discretionary funds management operations in Australia, is their Australian tax treatment under Australia’s current income tax regime.

Importantly:

- (a) **Their treatment (including the uncertainties referred to below) are out of line with international norms in comparable overseas countries either:**
- **in which the funds could be invested; or**
 - **in which funds management operations could be established or expanded, such as the United States, the United Kingdom, Japan, Singapore and Hong Kong. (See further Appendix 3.)**

⁴ Including the changes to the Australian capital gains tax regime which took effect on 12 December 2006, and the reduction in withholding tax rates reference to above.

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- (b) **Therefore, those impediments make Australia uncompetitive and deter foreign investors from investing in Australia, or establishing discretionary funds management operations in Australia.**
- (c) **Those impediments are also out of line with the deliberate trend in Australia's tax regime, away from source based, and towards residence based, taxation.**

In particular, there are several relevant areas of technical uncertainty which, to our knowledge, either:

- have deterred and continue to deter some foreign funds from investing at all in Australia, and from managing any offshore investments from Australia; or
- are an ongoing cause for serious concern on the part of many funds that have invested here, or manage offshore investments from here, and that, for various reasons, are likely to choose to cease to invest here or to manage offshore investments from here, until such time as the relevant uncertainties and disincentives are resolved in a satisfactory manner.

These areas of technical uncertainty are:

- (a) First, there is uncertainty surrounding:
 - (i) whether a foreign fund may be subject to Australian income tax merely as a result of that foreign fund (or the fund manager) having an investment advisory, discretionary funds management or other similar presence (and therefore possibly a "permanent establishment") in Australia; and
 - (ii) the extent of any such exposure (including in relation to offshore investments managed from Australia). In particular, can that presence cause all or some profits or gains to have an Australian source and to be attributable to that permanent establishment?
- (b) A second, independent, risk, even where there is no such presence, is that, despite the substantial reforms that have been made to Australia's capital gains tax ("CGT") regime, with effect from 12 December 2006, gains realised by foreign funds on Australian assets may still be subject to Australian ordinary income tax (on the basis that they have an Australian source under our common law rules).
- (c) A third risk, unique to foreign funds formed as Limited Partnerships ("LPs") rather than companies (usually for reasons connected with US or UK tax), is that, by investing at all in Australia, they might theoretically attract Australian tax on their worldwide income. This is a potentially horrific result, which cannot possibly be intended. Yet it appears to be the effect of explicit wording in our domestic legislation. To our knowledge, foreign LP funds in this position are considering ceasing to invest in Australia, rather than either to continue to be

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exposed to this theoretical risk or to go to the trouble of interposing a foreign company between the foreign fund and the Australian investments.

These uncertainties are outlined in **Diagrams 1 to 4** and are explained in greater detail in paragraphs 2 to 4 in **Appendix 1**.

The tax treatment of foreign funds under current Australian law (including the long standing and continuing uncertainties referred to above) is a serious deficiency in our domestic taxation law, particularly during the current global economic crisis (which involves unprecedented turmoil in financial markets), and in its aftermath, when Australia should have no taxation disincentives (compared to other comparable countries) to foreign funds investing in Australia, or establishing discretionary funds management operations in Australia.

This deficiency needs to be promptly removed if Australia is to become internationally competitive and identify what the Assistant Treasurer called “a silver lining in the longer run⁵”.

The legislative changes suggested below should not have any adverse financial impact on Australia, because, to the best of our knowledge, the ATO has never made any attempt to assess, collect or otherwise enforce against foreign funds the laws which give rise to the uncertainties and risks discussed in this submission. (See further paragraph 6 in **Appendix 1** and paragraph 5.6 and 5.7 in **Appendix 2**.)

4 Suggested specific legislative changes to remove impediments faced by foreign funds

On 13 May 2008, the Government announced a comprehensive review of Australia’s tax system, to be led by the Secretary of the Treasury, Dr Ken Henry.

A further more specific review covering Managed Investment Trusts (“MITs”) is being carried out by the Board of Taxation (“BOT”).

On 26 September 2008 the Assistant Treasurer created a Panel of Experts to be known as the "Australia as a Financial Centre Forum", to attract more foreign funds to come to Australia to be managed and for Australia to position itself as a leading financial services centre in the Asia-Pacific region.

Consistent with the above three developments, and the continuing and relentless drive by the Government to increase Australia’s financial services exports further, changes of the kind suggested in **Appendices 4, 5 and 6** below are urgently needed to:

- (a) clarify the law;
- (b) bring the law and long standing administrative practice by the ATO into closer alignment with each other; and

⁵ Ibid

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- (c) thereby knock down the relevant barriers identified in this submission that stop, or discourage, foreign funds and other foreign investors from investing in Australia, and from setting up offices or related entities in Australia that either manage funds **in** Australia or manage offshore investments **from** Australia.

Such changes would also be more in step with other countries around the world, which specifically design their tax regimes to encourage more investment in their funds management industries. (See **Appendix 3**.)

Further, such changes:

- (a) would bring Australia into closer alignment with the Organisation for Economic Co-operation and Development (**OECD**) position of exempting non-residents with portfolio interests in Australian entities from Australian tax, which is adopted by comparable countries, such as the US, the UK, Japan, Singapore and Hong Kong; and
- (b) would also be consistent with the deliberate trend in Australia's recent tax treaties, which have adopted a more residence-based taxation treaty policy, and moved away from a policy based primarily on the taxation of income at source.⁶

The changes suggested in this submission are quite separate from, and independent of, the consideration being given by a Working Group of the Board of Taxation to changes to the taxation of **Australian Managed Investment Trusts**.

5 Urgency of the need for appropriate legislative change

Further, given the importance of these changes to making the Australian income tax system internationally competitive and Australia an attractive place to be used as a financial hub in the Asia-Pacific region (particularly in these times of financial turmoil), we believe that it is imperative that the suggested changes be separately considered as a matter of urgency now, with a view to fast tracking appropriate legislative clarifications to the law at an earlier stage than any tax changes affecting MITs.

Any changes affecting foreign funds could conveniently be announced at the same time as the Treasurer and/or the Assistant Treasurer announce their response to the capital/revenue issue for MITs, upon which the BOT is to give informal advice to the Assistant Treasurer before Christmas.⁷

In the meantime, if necessary, the Assistant Treasurer could establish a tri-partite team (comprising Treasury, the ATO and the private sector) of the kind contemplated in the recent Tax Design Review Panel's Report, accepted by the Government on 22 August 2008⁸, to consider the issues raised in this submission, an appropriate policy response and the policy design.

⁶ See Media Release No. 049 of 26 June 2008 by the Assistant Treasurer.

⁷ See in this regard paragraph 1.25 of the BOT's October 2008 Discussion Paper relating to the MITs review.

⁸ See the Assistant Treasurer's Press Release No 069 of that date.

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6 Attachments

To facilitate such a review, we attach the following Appendices:

- **Appendix 1** - Background and overview.
- **Appendix 2** - Current Australian tax regime for foreign funds.
- **Appendix 3** - Unfavourable comparison with taxation regimes in overseas financial centres.
- **Appendix 4** - Exemptions sought in Australia (including some simple draft amending legislation).
- **Appendix 5** - Draft Explanatory Memorandum (to accompany the suggested draft amending legislation).
- **Appendix 6** - Making Australia a Funds Management Hub in the Asia-Pacific Region (a list of 2008 relevant Media Releases and speeches by the Assistant Treasurer).
- **Diagrams 1 to 4.**

7 Concluding comments

We trust that you will find the information contained in this submission to be useful in determining an appropriate policy response to the important issues raised in this submission, and in any policy design.

If you have any questions, please contact either of the authors noted below, or our colleague Matthew Shanahan on ((02) 9296 2462).

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APPENDIX 1 - BACKGROUND & OVERVIEW

1 Background

- 1.1 Australia has one of the most sophisticated managed investment fund industries in the world, with some of the most highly skilled individuals in the world residing in Australia, (or employed offshore by funds or fund managers headquartered in Australia) to support our managed fund industry. However, the ability to capitalise on that expertise and retain it in Australia is being hampered by the manner in which Australia's taxation regime applies to foreign funds.
- 1.2 The former Federal Government made it clear that it was their goal to, as far as reasonable, remove impediments to foreign capital being attracted to Australia and to ensure that Australia has a competitive international tax system.⁹
- 1.3 One of the reforms that was implemented in this regard was the introduction of the capital gains tax ("CGT") exemption for non-residents in Division 855 of the *Income Tax Assessment Act 1997*. That reform was introduced because the then CGT regime that applied to non-residents was seen as departing from international norms and therefore deterred non-residents from investing in Australia. This was seen as preventing Australia from benefiting from foreign capital supplementing local savings, higher rates of economic growth and employment levels and, consequently, higher standards of living for Australians, than otherwise could be achieved.
- 1.4 The introduction of the non-resident CGT exemption undoubtedly has been successful in attracting additional foreign capital to Australia, as it essentially results in **capital gains** realised by non-residents not being subject to Australian tax.
- 1.5 However:
- (a) There is manifest uncertainty between what is a capital gain, and what is a revenue gain, for a managed investment fund (whether formed as a company, an LLC, an LP or a trust).
 - (b) There is no exemption for revenue gains made by non-residents which is comparable to the exemption for capital gains by non-residents.
 - (c) We believe that even more capital would be attracted to Australia if such an exemption was extended to limited revenue gains made by non-residents in Australia.
- 1.6 Another recent development was the introduction of a specific managed investment trust withholding regime (contained in Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953*). Very broadly, the purposes of these reforms were to:
- (a) increase Australia's international tax competitiveness, by making the withholding by the managed investment trust a final tax and reducing the rate of tax on such amounts withheld (ultimately) to 7.5%. It is noted that this rate applies to fund income which includes sales of real property; and
 - (b) legislate an approach to the rate at which Australian tax must be withheld from distributions of Australian sourced income to non-residents by managed investment trusts to which those rules apply, thereby partially addressing an area of great uncertainty.

⁹ See, for example, Media Release No. 044 dated 10 May 2005 entitled "International tax reforms" by the former Treasurer, Peter Costello.

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- 1.7 But, as will be seen, even this significant reform leaves a number of inherent problems for non-resident funds.
- 2 Problems 1 and 2: Australian tax consequences of use of Australian related party adviser or local fund manager (illustrated in the attached Diagrams 1 and 2, respectively):**
- 2.1 The first and second major current problems are that foreign managed funds, or the managers of those funds, which use related party investment advisers or others in Australia to manage either Australian assets (see **Diagram 1**), or offshore assets (see **Diagram 2**), face the risk of exposing the foreign fund to Australian taxation in respect of both classes of assets. To our knowledge, this causes foreign funds to locate management expertise in overseas jurisdictions where, because of legislative exemptions (see **Appendix 3**), the foreign fund is not subject to taxation. As a result, Australia's ability to develop as a financial services hub is being adversely impacted, to the benefit of other regional centres.
- 2.2 Exposing foreign funds to Australian taxation is a clear disincentive for those funds which wish to use the expertise of managers or others located in Australia. It is also a disincentive for the funds to make capital expenditure in Australia in areas such as technology, and has a flow-on effect for brokers and other financial service support providers in related industries.
- 2.3 In most, if not all, major financial centres (such as New York, London, Singapore and Hong Kong - see **Appendix 3**), there are specific legislative exemptions that have been enacted to overcome the above issue. Of perhaps particular interest are the Hong Kong exemption (enacted in 2006), which was introduced to enhance Hong Kong's competitiveness as compared to other regional financial centres (especially Singapore), and the 2007 expansion of the Singapore tax exemption scheme, (both discussed in **Appendix 3**). The Australian tax treatment afforded to foreign funds in Australia stands out as being inconsistent when compared to other jurisdictions in which they do business.
- 3 Problem 3: Possible Australian tax consequences of application of outdated common law source rules (illustrated in the attached Diagram 3)**
- 3.1 The third major problem relates to the simple situation where a foreign fund just makes investments in Australian assets. The problem in this case is that Australia's common law source rules possibly result in profits or gains realised by the foreign funds on the disposal of such assets having an Australian source (see **Diagram 3**).
- 3.2 This result is outdated and may apply in a capricious and arbitrary way, because (among other things):
- (a) some, but not all, such profits or gains may have an Australian source (for example, in the case of an OTC contract, the place of the contract of sale may depend on the mode of communication (electronic or telephone) and which party "accepts" the contractual "offer" of the other party); and
 - (b) there is a technical argument that profits or gains realised on the disposal of any asset listed on an Australian exchange has an Australian source, because the contract giving rise to that profit or gain should be entered into in Australia between exchange participants, even if the exchange participant took the order from a foreign fund outside Australia. (By way of contrast, a possible Australian source can be avoided if the shares of other securities can be traded on a foreign exchange, rather than an Australian exchange: for example, shares in a dual listed company, such as BHP Billiton, which are listed in London, NYSE listed ADRs in Australian companies, or shares in other

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Australian companies which are listed in the UK, Germany, Singapore or New Zealand.)

3.3 The administrative burden of trying to determine the source of profits or gains realised on the disposal of each different type of Australian asset held by a foreign fund, and the technical risk that all profits or gains realised on securities listed on an Australian exchange, are strong disincentives to foreign funds investing in Australian assets. Furthermore, these leave Australia at a competitive disadvantage compared to other competing jurisdictions, because similar issues do not arise in those jurisdictions, particularly due to legislative interventions. (See **Appendix 3.**)

4 **Problem 4: The unique (and presumably unintended) Australian tax exposure of foreign fund LPs (as illustrated in the attached Diagram 4)**

4.1 The fourth problem is that it is easier for a foreign fund that is structured as a **limited partnership** to be classified as an Australian tax resident than it is for a foreign fund that is structured as a **foreign company** (see **Diagram 4**). This is important, because many foreign funds are structured as limited partnerships and it cannot have been intended that, just because they have some investments in Australia, they should be taxed in Australia on their worldwide income, as would be the case if they are Australian tax residents. Yet this is precisely the consequence of explicit provisions in our tax law. Consequently, most foreign funds structured as LPs choose not to invest in Australia at all, in order to completely avoid the possible theoretical risk of being subject to Australian income tax on their worldwide income. This state of affairs is completely at odds with one of the key priorities of the Rudd Government.

4.2 Under the current law:

- (a) a limited partnership is generally a tax resident of Australia if (section 94T of the 1936 Act):
 - (i) it was formed in Australia;
 - (ii) it carries on business in Australia; **or**
 - (iii) its central management and control is in Australia; and
- (b) a company that is not incorporated in Australia is only a tax resident of Australia if (definition of “resident” in section 6(1) of the 1936 Act):
 - (i) it carries on business in Australia; **and**
 - (ii) either:
 - (A) its central management and control is in Australia; or
 - (B) its voting power is controlled by shareholders who are tax residents of Australia.

4.3 The contrasting “or” versus “and” language shows how under current law, it is easier for a limited partnership to be classified as a tax resident of Australia and be subject to Australian tax on its worldwide income. This is because a limited partnership can be a tax resident of Australia if (among other things) either it carries on business in Australia **or** its central management and control is in Australia (in other words, merely carrying on business in Australia is sufficient to make a foreign fund LP taxable on its worldwide income); whereas, a

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company would only be a tax resident of Australia if (among other things) it carries on business in Australia **and** has its central management and control is in Australia.

- 4.4 The particular concern in this case is that the buying and selling of Australian investments by a foreign LP fund (whether directly from offshore or using the services of an Australian based adviser or discretionary fund manager) may amount to the carrying on of business activities by the foreign fund LP in Australia for the purposes of the above test.

5 Overview of suggested legislative changes

- 5.1 The broad thrust of this submission is a proposal designed to overcome all of the problems identified above, and achieve each of the following three key objectives for every foreign fund, wherever established and whatever its form:

- (a) to give foreign funds exemptions from Australian tax where they use Australian managers, to the same extent as if the Australian managers were agents of independent status, acting in the ordinary course of their business, and the foreign fund and its foreign investors were entitled to the protection of a modern comprehensive double tax agreement to which Australia is a party;
- (b) for foreign funds to be exempt from Australian tax in respect of **revenue** gains made by them on certain property; and
- (c) to remove the anomalous and capricious possible adverse consequences of a foreign fund being formed as an LP, rather than a company.

- 5.2 We believe that an exemption similar to that used in the United States of America could provide a workable solution. That exemption is the basis on which we have drafted the proposed amendments in **Appendix 4**. Such exemptions would be entirely consistent with the exemptions granted in other overseas financial centres (see **Appendix 3**) and should remedy the apparent harsh treatment afforded to foreign funds in Australia under the current regime. (We prefer the US approach, because it is simpler and avoids many of the technicalities and complications of, say, the comparable UK and Singapore exemptions.)

6 Assessment of impacts (costs/benefits) of suggested legislative changes

- 6.1 Any exemption for foreign funds along the proposed lines would arguably not have a materially adverse effect on Australia's tax revenues, because:

- (a) no revenue which is currently collected would be foregone;¹⁰ and
- (b) funds which were attracted to Australia as a result of such reforms presently do not use Australia as a financial hub.

- 6.2 In fact, there should be a positive impact on Australia's tax revenues, as a result of more foreign funds choosing to use Australian managers and those foreign funds more freely investing in, or out of, Australia, from:

¹⁰ Support for this proposition is found in paragraph 17.A8 of the report of the tax review in the mid-1970s of Australia's taxation system conducted by the Commonwealth Taxation Review Committee headed by Justice Kenneth Asprey and Professor Ross Parsons entitled "Full Report - January 31 1975" that "The Committee understands that the law is not at present administered so as to bring all profits of non-residents to tax where they arise from transactions on Australian stock exchanges". See further paragraph 5.6 in **Appendix 2**.

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- (a) income derived by managers relocated to Australia and the additional income derived by supporting enterprises;
- (b) funds management expertise in Australia not moving offshore to jurisdictions which have a more favourable tax regime; and
- (c) the contributions to the Australian economy arising from the additional investments that are likely to be made by foreign funds in Australia and the additional contracts that are likely to be entered into with local counterparties.

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APPENDIX 2 - CURRENT AUSTRALIAN TAX REGIME FOR FOREIGN FUNDS

1 Form of foreign funds (including place of establishment, and role of Fund Manager)

1.1 Foreign funds often take the form of:

- (a) a company;
- (b) a limited liability company (“LLC”);
- (c) a limited partnership (“LP”); or
- (d) a trust.

1.2 However, we note in passing that foreign funds formed in non-English or American law type jurisdictions (eg Japan and countries in mainland Europe) can take other forms, which may not fit neatly into any one of the above categories. This can make it difficult to determine the appropriate Australian tax consequences for such foreign funds.

1.3 Even though foreign funds are often formed in a “Group of 7”(G7) country, they are increasingly likely to have been formed in a tax neutral jurisdiction, such as the Cayman Islands or Jersey. This is primarily done to ensure that any tax is limited to that payable by the investors in such foreign funds in their country of tax residence and to facilitate investment in the foreign fund by tax residents from different jurisdictions, particularly as the vast majority of investors in such funds are usually not tax residents of Australia. In other words, it is **not** primarily done to avoid or minimise tax in Australia or in the countries of residence of the ultimate investors.

1.4 Foreign funds typically pay fees to an arm’s length investment manager or adviser (“**Fund Manager**”), which usually acts as the promoter or sponsor of the foreign fund. The Fund Manager can be located in the same jurisdiction as the foreign fund. But in practice it is more likely that either the Fund Manager itself, or a related party delegate of the Fund Manager, will be located in a place such as the US, the UK or another G7 or “Group of 20” (G20) country. (The location of the Fund Manager does not affect the place of tax residence of the foreign fund.)

2 Tax residence of foreign funds

Foreign funds that are companies or LLCs

2.1 Many foreign funds are companies, or will be treated as companies for Australian tax purposes (under the definition of “company” in section 995-1(1) of the Income Tax Assessment Act 1997 (“**1997 Act**”), as distinct from under Division 5A of Part III of the Income Tax Assessment Act 1936 (“**1936 Act**”), discussed below).

2.2 Briefly, a foreign company (whether a standard company or LLC) can be subject to Australian tax if it:

- (a) carries on business in Australia through a permanent establishment (see above); or
- (b) is an Australian tax resident, which should be the case if:
 - (i) is incorporated in Australia; or

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- (ii) carries on business in Australia and either has its central management and control in Australia or has its voting power controlled by Australian resident shareholders.
- 2.3 Foreign funds that are companies are unlikely to satisfy these tests for Australian tax residence. Therefore, they are usually not tax residents of Australia.
- 2.4 If a company is a tax resident of Australia, it should be subject to tax in Australia on its worldwide income.
- 2.5 If the foreign company is not a tax resident of Australia (as is normally the case) and is a tax resident of a country with which:
- (a) Australia **has** a double tax agreement (“**DTA**”) (a “**DTA Country**”) - Australia should generally only be entitled to tax the foreign company’s profits to the extent that they have been derived at or through a permanent establishment of the foreign company in Australia; and
 - (b) Australia **does not have** a DTA (a “**non-DTA Country**”) - Australia can tax all the foreign company’s Australian sourced profits (see paragraphs 3.1 to 3.7 below), or other income that is taken to be subject to Australian income tax under Australia’s tax legislation, even if the company does not have a permanent establishment in Australia (sections 6-5(3) and 6-10(5) of the 1997 Act). This is a particular problem for many foreign funds established in jurisdictions such as the Cayman Islands or Jersey, even though (as explained in 1.3 above) the choice of such a tax neutral jurisdiction is completely unrelated to the avoidance or minimisation of Australian tax.

Foreign funds that are LPs

- 2.6 If the foreign fund is an LP, it should essentially be treated as a company for Australian income tax purposes, under Division 5A of Part III of the 1936 Act.
- 2.7 Despite this, it is theoretically easier for a limited partnership (compared to a foreign company or LLC) to be an Australian tax resident. This is because an LP is a tax resident of Australia if (section 94T of the 1936 Act):
- (a) it was formed in Australia;
 - (b) it carries on business in Australia; **or**
 - (c) its central management and control is in Australia.
- 2.8 In other words, it is sufficient if the foreign fund LP merely carries on some business in Australia; in particular, it does not have to have its central management and control located in Australia, unlike the test for a company (refer paragraph 2.2 above). The problems that this situation gives rise to are referred to in paragraph 4 of **Appendix 1** and are illustrated in the attached **Diagram 4**.

Foreign funds that are trusts

- 2.9 A foreign fund that is a trust should only be regarded as a “resident trust” for the purposes of the trust income provisions contained in Division 6 of Part III of the 1936 Act if (section 95(2) of the 1936 Act):

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- (a) a trustee of the trust was an Australian tax resident at any time during the income year;
or
- (b) the central management and control of the trust estate was in Australia at any time during the income year.

In all other cases, it should not be a resident trust for Australian tax purposes.

2.10 Broadly, the trust income rules seek to assess either the trustee or the beneficiaries in respect of any Australian source income of the trust, regardless of whether the trust or the beneficiaries are tax residents of Australia. Conversely, where a foreign (that is, non-resident) trust derives only foreign source income, it is generally outside the Australian taxing regime (see, for example, sections 98(2A)(d) and 98(4) of the 1936 Act and section 6-5(3) of the 1997 Act).¹¹

2.11 The trustee of a foreign trust is liable to be taxed under section 98(3) of the 1936 Act, because of the provisions of section 98(2A) of the 1936 Act. This, in turn, gives rise to a further separate liability to the beneficiary under section 98A(1)(b) of the 1936 Act. However, the provisions are generally drafted such that the primary liability rests with the trustee, with a deduction given to the beneficiary for the amount of tax actually paid by the trustee (section 98A(2) of the 1936 Act).¹²

2.12 Under all these trust provisions, the question arises in the usual case as to whether any of the net income of a foreign trust fund is attributable to sources in Australia. Thus, the two crucial questions for a foreign fund that is a trust are:

- (a) first, whether the foreign fund has a permanent establishment in Australia; and, if not
- (b) whether the foreign fund nonetheless has Australian source income.

3 Source of income and permanent establishments issues

3.1 Under the source of income principles, the question as to the source of income is generally one of a “practical, hard matter of fact”, as stated in *Nathan v FC of T* (1918) 25 CLR 183. However, the source of income may be affected by DTAs and/or special statutory rules.

3.2 To illustrate the source and permanent establishments issues, we will use the following hypothetical (but quite typical) example:

- (a) a foreign fund that is a trust established in Hong Kong, the Cayman Islands, Jersey or another tax neutral non-DTA country¹³ establishes a separate advisory, or discretionary

¹¹ Although a new managed investment trust final withholding regime was recently inserted into Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953* (“TAA”), foreign funds are unlikely to fall within that regime. This is because (among other things) either the trustee of the trust must be an Australian tax resident or the central management and control of the trust must be in Australia, which is typically not the case (Item 1 in the table in section 12-400 of Schedule 1 to the TAA).

¹² Where the foreign trust is formed in a non-DTA country (such as the Cayman Islands or Jersey), this primary liability of the trustee seems to exist even if, under the DTA with the country or countries of residence of the beneficiaries (such as the US or Japan), all of them are exempt from Australian tax on their shares of the net income of the foreign trust. So, theoretically, the trustee must pay tax and then all the beneficiaries must lodge individual Australian tax returns claiming a refund of their respective shares of the tax paid by the trustee. This too is a feature of our tax regime which further deters foreign trust funds from investing in Australia.

¹³ Alternatively (and perhaps more usually), it could be the manager of the foreign fund which establishes the related party entity in Australia. We will not consider this separately, because the issues are essentially the same.

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funds management, related party entity in Australia, which employs managers who have expertise on certain stocks in the region, including China, India, Japan, Singapore and Thailand;

- (b) the Australian related party entity enters into a management services agreement with the foreign fund to advise on, and/or to place buy or sell orders in respect of, the relevant stocks; and
- (c) the foreign fund is the major (or possibly, in an exceptional case, even the only) client of that Australian related party entity. In any event, all the clients of the Australian related party entity are foreign funds which are affiliated with the foreign fund referred to in paragraph (a).

3.3 The Australian related party entity would ordinarily be regarded as a so-called “dependent agent” of the foreign fund. Therefore, the business of the foreign fund, in part, would be regarded as being carried on in Australia.¹⁴ All of the following factors would be important in this regard:

- (a) the place where the advisory services were provided that resulted in a contract to buy or sell assets;
- (b) the place where the contract to buy or sell assets was entered into;
- (c) the location of the property; and
- (d) the place where settlement of a trade occurs (including as regards delivery of the assets (if any) and payment).

3.4 In *Thorpe Nominees Pty Ltd v FC of T* (1988) 88 ATC 4886, the Full Federal Court of Australia found that the source of income is a question of “practical reality” and therefore the place of contract may not be a determining factor as to whether the “real source” of income is in Australia.

3.5 Therefore, it is likely that the presence of a fund manager in Australia as per the example above which has been set up by the foreign fund to manage part of the portfolio of the foreign fund (whether those assets are located in Australia or **outside Australia**) may cause at least part of the income of the fund to have an Australian source.¹⁵ These problems were referred to in paragraph 2 of **Appendix 1** and are illustrated in the attached **Diagrams 1 and 2**.

3.6 The capricious effect of these principles is evident when it is recognised that, in many cases (and especially in the case of the most highly capitalised Australian companies), a foreign fund or any other foreign investor can escape these problems:

¹⁴ If (contrary to our example) the foreign fund was formed in a DTA country, this position may be modified under an applicable double tax agreement. For example, under Article 5(6) of the Australia/US double tax agreement, the fact that a company that is a resident of one contracting state controls a company which is resident in the other contracting state, or which carries on business in that other contracting state, shall not of itself constitute either company a permanent establishment of the other.

¹⁵ For example, an over-the-counter (“OTC”) contract with a Japanese counterparty (whether with respect to Japanese property or by way of a derivative) could have an Australian source, even for a Hong Kong fund, if the contract is entered into in Australia; whereas an order to sell a Japanese stock on a Japanese exchange by that Hong Kong fund through an Australian subsidiary may not have an Australian source for the Hong Kong fund.

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- (a) first by not having an advisory or discretionary funds management related party entity in Australia (or by setting it up in another overseas jurisdiction, with a loss of jobs for Australia); and
 - (b) secondly by only trading equivalent or the same shares listed on an overseas exchange, such as shares in dual listed BHP Billiton or Rio listed in London, or ADRs in Australian companies listed on the NYSE, or shares in other Australian companies listed in the UK, Germany, Singapore, New Zealand or elsewhere.
- 3.7 As noted in paragraph 2.11 above, once there is Australian source income, the trustee of the foreign fund and its beneficiaries are generally separately liable to Australian income tax under the trust income rules contained in Division 6 of Part III of the 1936 Act.

4 Capital gains tax (“CGT”) consequences

Introduction

- 4.1 To date, except in the case of local Listed Investment Companies, the ATO has accepted in practice that profits or gains by Australian Managed Investment Trusts and, it seems, all foreign managed funds (whatever their form) are only liable to tax under the CGT provisions, and are not liable to tax as ordinary income. (See further paragraph 5 below.)
- 4.2 Importantly, capital gains or capital losses in relation to a CGT asset that is not taxable Australian property (see paragraph 4.5 below) that are realised by:
- (a) a foreign fund which is a company, an LLC or an LP and which is not a tax resident of Australia (see paragraph 2 above); or
 - (b) a trustee of a foreign trust for CGT purposes (see paragraph 4.3 below),
- just before the relevant CGT event happened are not liable to Australian tax (section 855-10 of the 1997 Act).
- 4.3 A trust is a foreign trust for CGT purposes if it is not a “resident trust for CGT purposes”. A trust is a “resident trust for CGT purposes” for an income year if (definition of “resident trust for CGT purposes” in section 995-1 of the 1997 Act):
- (a) for a trust that is not a unit trust - either a trustee of the trust is an Australian tax resident, or the central management and control of the trust is in Australia; and
 - (b) for a trust that is a unit trust and:
 - (i) any property of the trust is situated in Australia - the central management and control of the trust is in Australia; or
 - (ii) the trustee carries on business in Australia - Australian tax residents hold more than 50% of the beneficial interests in the income or property of the trust.
- 4.4 Accordingly, foreign funds that are not tax residents of Australia (eg companies, LLCs or LPs), or trustees of a foreign trust for CGT purposes, should only be subject to Australian CGT in respect of assets that are taxable Australian property.
- 4.5 “Taxable Australian property” includes (section 855-15 of the 1997 Act):

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- (a) real property situated in Australia;
- (b) a mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry materials are situated in Australia;
- (c) membership interests in an entity whose assets are principally direct or indirect interests in the assets described in paragraphs (a) and/or (b) above, if the foreign trust holds a “non-portfolio interest” (broadly, at least 10%) in the entity, either:
 - (i) at the time of the relevant CGT event; or
 - (ii) throughout a 12 month period in the 24 months before the CGT event happened;
- (d) a CGT asset that has been used at any time in carrying on a business through a permanent establishment within the meaning of section 23AH; and
- (e) an option or right to acquire a CGT asset covered in any of the above paragraphs.

Significance of foreign fund having a permanent establishment in Australia

- 4.6 As noted in paragraph 4.5(d) above, taxable Australian property includes a CGT asset used at any time in carrying on a business through a permanent establishment within the meaning of section 23AH of the 1936 Act . If a relevant DTA does not apply (such as in respect of a Hong Kong, Cayman Islands or Jersey tax resident), “permanent establishment” for these purposes is defined in section 6(1) of the 1936 Act as follows:

“permanent establishment”, in relation to a person (including the Commonwealth, a State or an authority of the Commonwealth or a State), means a place at or through which the person carries on any business and, without limiting the generality of the foregoing, includes:

- (a) a place where the person is carrying on business through an agent;
- (b) a place where the person has, is using or is installing substantial equipment or substantial machinery;
- (c) a place where the person is engaged in a construction project; and
- (d) where the person is engaged in selling goods manufactured, assembled, processed, packed or distributed by another person for, or at or to the order of, the first-mentioned person and either of those persons participates in the management, control or capital of the other person or another person participates in the management, control or capital of both of those persons--the place where the goods are manufactured, assembled, processed, packed or distributed;

but does not include:

- (e) a place where the person is engaged in business dealings through a bona fide commission agent or broker who, in relation to those dealings, acts in the ordinary course of his business as a commission agent or broker and does not receive remuneration otherwise than at a rate customary in relation to dealings of that kind, not being a place where the person otherwise carries on business;

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- (f) *a place where the person is carrying on business through an agent:*
 - (i) *who does not have, or does not habitually exercise, a general authority to negotiate and conclude contracts on behalf of the person; or*
 - (ii) *whose authority extends to filling orders on behalf of the person from a stock of goods or merchandise situated in the country where the place is located, but who does not regularly exercise that authority;*

not being a place where the person otherwise carries on business; or
- (g) *a place of business maintained by the person solely for the purpose of purchasing goods or merchandise.*

Application of these provisions to foreign funds

- 4.7 We return to the hypothetical example in paragraph 3.2 above. Given the functions of the manager in Australia as a dependent agent and that they would habitually contract in Australia on behalf of the foreign fund:
- (a) The foreign fund is unlikely to fall into any of the exclusions in the definition of permanent establishment. In particular, they are unlikely to be regarded as a bona fide commission agent.
 - (b) Therefore, the foreign fund may have a permanent establishment (as defined), by virtue of the operations of its Australian related party entity.
 - (c) Accordingly, the foreign fund could be subject to Australian tax in respect of capital gains and capital losses it realises in respect of assets that it has used at any time in carrying on a business through that deemed Australian permanent establishment. Significantly, this could result in the foreign fund being subject to Australian tax in respect of any capital gains or capital losses realised by the foreign fund through the Australian related party entity manager, on the basis that such assets may be regarded as being used by the foreign fund at or through a permanent establishment in Australia that is deemed to have been created by the Australian related party entity manager.
- 4.8 Only in very limited circumstances might the foreign fund not be subject to Australian income tax, as a result of a recent decision of the Federal Court of Australia. In *Virgin Holdings SA v FC of T* [2008] FCA 1503 (10 October 2008), Edmonds J decided that the Commissioner does not have a right to tax capital gains made by a foreign resident (broadly) from sources in Australia where a pre-CGT double tax agreement (“DTA”) denies Australia the right to tax foreign residents on their business profits or on the gains made from the alienation of certain property. Accordingly, based on this decision, if (contrary to our hypothetical example) a foreign fund is a resident of one of the relatively few countries that has a relevant favourable DTA with Australia, Australia should not be entitled to tax capital gains realised by that foreign fund from sources in Australia.¹⁶ But, typically, foreign funds are not formed in any of those countries. So, the decision is not likely to affect many foreign funds.

¹⁶ The ATO has not yet announced whether it will appeal this decision. Therefore, there is a possibility that this decision may yet be overturned by a higher court.

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5 Capital versus revenue distinction

- 5.1 Another separate risk faced by foreign funds that either do, or do not, have deemed permanent establishments in Australia is the capital versus revenue distinction. This issue is presently the subject of urgent consideration by the Board of Taxation in relation to Australian Managed Investment Trusts. But **this critical contentious issue is equally relevant for all foreign funds.**
- 5.2 Importantly for all foreign funds, the mere fact that a profit or gain realised by a foreign fund is disregarded under the CGT exemption in Division 855 of the 1997 Act (because the relevant asset (if any) is not “Taxable Australian property”) [see paragraph 4.2 to 4.5 above] does not mean that the profit or gain realised by the foreign fund cannot still be subject to Australian income tax as **ordinary income**, if it is regarded as ordinary income of the fund that has an Australian source.
- 5.3 Accordingly, should any of the Australian or offshore assets of the foreign fund be managed from Australia, there is a risk under current law that any gains in respect of those assets realised by the foreign fund through the Australian fund manager may have an Australian source. This could be the case even if there is a relevant DTA, because such gains may be regarded as being derived at or through a permanent establishment in Australia arising from the presence of the Australian manager in Australia. These problems were referred to in paragraph 2 of **Appendix 1** and are illustrated in **Diagrams 1 and 2.**
- 5.4 Further, even if the foreign fund is not managed from Australia (ie there is no separate related party entity in Australia), there may be Australian source income under the traditional source rules. For example, technically there may be an Australian source in respect of either:
- (a) an order that is placed from offshore to sell shares on an Australian exchange; or
 - (b) an over-the-counter (“**OTC**”) contract that is entered into with an Australian counterparty, if acceptance occurs in Australia.

This problem was referred to in paragraph 3 of **Appendix 1** and is illustrated in **Diagram 3.** Again, the current consideration of the capital/revenue distinction by the Board of Taxation has heightened the awareness of foreign funds in relation to the significant potential theoretical exposure that this issue may create for all of them and is a continuing significant deterrent to them investing in Australia, or establishing or using related entity discretionary fund management operations in Australia.

- 5.5 The issues of:
- (a) profits realised by non-residents on shares or other investments listed on an Australian exchange technically having an Australian source;
 - (b) the difficulties of the ATO collecting taxes on such profits; and
 - (c) the tax laws not being administered so as to collect such tax in any event, right up until the present time,
- are ones that have been recognised for many years.

- 5.6 In particular, these issues were identified in the review of Australia’s tax system carried out in the mid-1970s by the Commonwealth Taxation Review Committee, which was headed by Justice Kenneth Asprey and Professor Ross Parsons. In the final report from that review,

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entitled “Full Report - January 31 1975” (commonly referred to as the “Asprey Report”), the following was stated in this regard:

*“17.A7. Income from sale of shares. ... A profit on the realisation of shares acquired by a non-resident abroad and sold in the Australian market should, in the Committee’s view, be regarded as having a source in Australia if the non-resident has a place of operations in Australia and action through that place of operations was instrumental in bringing about the sale. **Where, however, the shares have been both purchased and sold in the Australian market in the sense that acts by the non-resident personally, or by his agent or representative, in Australia were instrumental in bringing about both the purchase and the sale, the resulting profit should be regarded as having a source in Australia. In this case whether or not the non-resident has a place of operations in Australia will be irrelevant.**”*

*17.A8. **Under these principles many stock exchange transactions would generate profits which would have an Australian source.** Where a number of sales are made on an Australian exchange the stock broker or agent instructing the sale of the shares may constitute a place of operations sufficient to give an Australian source. Where the taxpayer buys and sells on an Australian exchange there will be an Australian source. **The Committee understands that the law is not at present administered so as to bring all profits of non-residents to tax where they arise from transactions on Australian stock exchanges.** There is, of course, great difficulty in establishing that a non-resident has engaged in transactions which, either because he is a trader or by the operation of section 26(a) and 26AAA, give rise to profits which are income. This is especially so when the non-resident has given instructions through a broker or agent in the foreign country, who has in turn instructed an Australian broker. In many cases a non-resident operates through a nominee company and his identity is not known to the broker or resident agent acting in Australia. In addition, he may buy through one broker and use another for the sale of the securities. If a liability to tax can be established the Commissioner will very likely have to rely on the agency provisions...to collect the tax, at some inconvenience and risk of loss to the Australian broker, or other agent, who is constituted the agent for the non-resident under those provisions.*

*17.A9. **The difficulties for the Revenue in ascertaining and enforcing the liability of the non-resident to tax and the related difficulties for the stock broker or other agent could only be overcome by a general provision exempting from tax all profits by non-residents arising from stock-exchange transactions in Australia. The Committee would not support such an exemption as a way of dealing with these difficulties, though it could understand an exemption in these terms, or even wider terms, as a way of attracting to Australia financial operations by non-residents.**” [Emphasis added]*

- 5.7 Although the Asprey Report refrained from recommending that a general exemption from tax for profits by non-residents arising from transactions in shares on an Australian exchange should be implemented, the Committee also said that “it could understand an exemption in these terms, or even wider terms, as a way of attracting to Australia financial operations by non-residents”.
- 5.8 It is now a stated goal of the Government to make Australia the financial hub of the Asia-Pacific region. Therefore, among other things, now is the time to introduce an exemption from Australian tax for profits of non-residents arising from transactions in interests in Australian

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exchange traded entities and from related OTC transactions, particularly as we understand that the tax laws are still not administered to tax such profits in any event. This would remove an impediment that currently discourages non-resident funds from investing in Australian exchange traded entities, or from entering into related OTC transactions, and would provide the certainty that such non-residents will not be subject to Australian tax on profits realised on such transactions.

- 5.9 It is also absolutely critical that, contemporaneously, profits of non-residents arising from transactions in **offshore** exchange traded entities, or with **offshore** OTC counterparties, entered into or managed by an Australian related entity adviser or local fund manager be taken completely outside the Australian tax net. This problem was referred to in paragraph 2 of **Appendix 1** and in the attached **Diagram 3**.
- 5.10 Only by doing both of these things will Australia's regime for taxing foreign funds be in any way comparable to that in other overseas jurisdictions such as the US, the UK, Japan, Hong Kong and Singapore.

6 The effect of DTAs and the International Tax Agreements Act 1953 ("ITAA") on foreign funds

Introduction

- 6.1 As indicated in paragraph 4 above:
- (a) the presence of a related entity adviser or fund manager in Australia may result in the foreign fund having a permanent establishment in Australia under our domestic law definition described in paragraph 4.6 above; and
 - (b) the existence of a permanent establishment of the foreign fund in Australia will usually result in it having income that is sourced in Australia.
- 6.2 Various DTAs have similar business profits exemption articles which may apply to a foreign fund and/or to some or all of the investors in the foreign fund. On the other hand, there will be many situations (such as for a fund established in Hong Kong, the Cayman Islands or Jersey) where no DTA will apply.

Foreign funds that are companies, LLCs or LPs

- 6.3 Generally speaking, a foreign fund that is a company, LLC or LP should be treated as an entity for DTA purposes (if one applies) and may be entitled to the business profits exemption article contained in the DTA (if one applies and if the entity is entitled to benefits under the DTA).
- 6.4 However, many foreign funds that are companies, LLCs or LPs are not residents of countries with which Australia has a DTA. Consequently, they must instead apply the less generous permanent establishment definition in Australia's domestic law in determining whether they have a permanent establishment in Australia (see paragraph 4.6 above). This can make it easier for such funds to be regarded as having a permanent establishment in Australia and to be regarded as deriving Australian sourced income, all to the detriment of the foreign fund.

Foreign funds that are trusts

- 6.5 Most DTAs are silent about trusts. Nonetheless foreign funds that are trusts are often regarded as entities for DTA purposes. Furthermore, the business profits exemption may extend to the

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beneficiaries of foreign funds that are trusts. But overall, the position is less clear for trusts than for companies.

6.6 However:

- (a) The DTAs will not cover the foreign fund itself, unless it is itself tax resident in a DTA country, for the purposes of the DTA.
- (b) In any case, the DTAs generally have permanent establishment definitions which are similar to the definition of that term as described in paragraph 4.6 above.
- (c) Consequently, the trustees of foreign trust funds will generally not be able to avail themselves of the business profits DTA exemption.

6.7 As regards the beneficiaries of the foreign trust, under section 3(11) of the ITAA, a foreign beneficiary deriving income via a trust that has a permanent establishment in Australia is regarded as carrying on the business of the trust. Accordingly, such a beneficiary should also have an exposure to Australian income tax. However, this deeming provision is somewhat constrained by section 3AA of the ITAA, which deals with the source of income from funds management activities in the case of widely held trusts. The Explanatory Memorandum that accompanied the legislation introducing this section states the following in this regard:

2.5 The interaction of the deemed source rules and the permanent establishment rules for beneficiaries of business trusts can have the effect that income derived by non-resident beneficiaries from funds management activities of the trust is deemed to have an Australian source even though the income arises from funds invested offshore. The amendments proposed by this Bill will ensure that, where such income has a source outside Australia under the ordinary rules for determining source of income for domestic law purposes, the income will continue to have a foreign source. [Emphasis added]

6.8 Therefore, section 3AA of the ITAA does not assist a taxpayer beneficiary of a foreign trust where the outdated and sometimes capricious ordinary rules deem a source in Australia, due to the advisory or funds management functions performed in Australia: see problem 2 referred to in paragraph 2 of **Appendix 1** and the attached **Diagram 2**. In other words, section 3AA of the ITAA does nothing to clarify the uncertain, and sometimes entirely capricious, allocation of source in respect of offshore investments. For example, an OTC contract entered into by the Australian related entity on behalf of the Hong Kong fund with a Japanese counterparty can still have an Australian source if acceptance occurs in Australia, whereas this should not be the case if acceptance occurs in Japan or if the contract involved an order to sell a security listed on the Japanese stock exchange.

6.9 Furthermore, the beneficiary needs to be in a DTA country to have the benefit of the section.

6.10 In any case, the section would not appear to address the CGT exposure of the trust and it is not clear how that provision could protect the trustee of the foreign trust from an Australian income tax exposure.

6.11 For all the above reasons, the DTAs and ITAA would appear to have very limited benefit to foreign trust funds that seek to establish a management presence in Australia.

7 Limited scope of the offshore banking unit (“OBU”) concession

7.1 A fund manager in Australia may qualify as an OBU.

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- 7.2 Furthermore, funds management activities may qualify as OB activities under section 121D of the 1936 Act.
- 7.3 However there are a number of limitations on the use of the OBU provisions in the context of a foreign fund having an Australian advisory agent, including:
- (a) to qualify as an OBU under section 128AE(2) of the 1936 Act, the company providing the funds management services cannot provide them solely to a related party (which would usually be the case);
 - (b) there are various restrictions on the nature of the investment advisory activities; and
 - (c) the status of an OBU in Australia does not remove the exposure of the foreign fund to having profits or gains on part of their portfolio as Australian sourced income.

8 Onerous and inflexible new US accounting requirements

- 8.1 Under *Financial Accounting Standards Board Interpretation No. 48 - Accounting for Uncertainty in Income Taxes* ("FIN 48"), from fiscal years beginning after 15 December 2006, persons who are required to comply with FIN 48 must undertake an analysis of all their material tax positions in determining their tax benefits and disclosures for all fiscal years which are subject to assessment or challenge by the relevant taxing authority. We understand that the imposition of this regime has been deferred until 2009 for some entities.¹⁷ However, foreign funds must still take all possible theoretical tax liabilities into account in determining their daily, monthly or quarterly net asset value, which in turn drives share or unit redemption or new issue prices.
- 8.2 We are aware that auditors from large accounting firms have recently been considering whether, under the strict FIN 48 technical requirements, foreign funds that are subject to FIN 48 should be required to raise some tax accruals or make some disclosures under FIN 48 in respect of possible technical Australian income tax liabilities in respect of past transactions (including for prior years) as a result of the uncertainty surrounding whether foreign funds may be subject to Australian income tax either:
- (a) if they have a presence in Australia (either directly or through a related entity); or
 - (b) even if they do not have a presence, on the basis that some of their income could possibly be regarded as having an Australian source.
- 8.3 Given the technically very strict disclosure requirements of FIN 48 where there is any element of doubt as to the fund's obligations under FIN 48, any such technical requirement to make an accrual or provision has the potential to seriously misprice redemptions and new issues, and thereby damage investors and the reputation of the fund manager. For that reason, any such requirement is viewed as seriously unfavourably by foreign funds. Relevantly, and more importantly for Australia, to our knowledge, many foreign funds at the moment consider that their FIN 48 predicament is incomprehensible, because Australia is the only developed market in the world which gives rise to such a problem. For that reason, they are seriously considering totally ceasing to invest either in, or via, Australia. This will result in a loss of jobs in the Australian market, loss of revenue to local brokers, and loss of liquidity for shares in ASX listed companies. Moreover, once they decide to cease investing in, or via, Australia, the chances of them later increasing their investments in, or via, Australia in the short to medium term will be

¹⁷ The application of FIN 48 has been deferred for all non-public entities until the income years beginning after 15 December 2008 (refer http://www.fasb.org/news/SDR_10-15-08.pdf).

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substantially reduced. That is a serious detriment to our market and permanently damages Australia's reputation, completely in conflict with the key aims and priorities of the Rudd Government.

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APPENDIX 3 - UNFAVOURABLE COMPARISON WITH TAXATION REGIMES IN OVERSEAS FINANCIAL CENTRES

1 Introduction

- 1.1 Most, if not all, of the major financial centres (such as Hong Kong, Singapore, New York and London) have specific legislative exemptions that have now been enacted to overcome the issues faced by foreign funds in Australia as described in **Appendix 2**.
- 1.2 Set out below is a brief description of the relevant exemptions that are available in the United States of America (“US”), the United Kingdom (“UK”), Singapore, Hong Kong and Japan. The descriptions of the particular regimes that are available to foreign funds in those jurisdictions highlight the fact that Australia has not kept pace with this reform for foreign funds and it now stands out as being inconsistent with how foreign funds are treated in these jurisdictions.

2 US

- 2.1 The US tax exemption has been in place for many years and extends to all foreign investors and is not merely limited to foreign funds.
- 2.2 The US has the common exemption found in treaties, namely that trading in stocks via an independent agent in the US is not a US trade or business, provided that the non-resident does not have any other fixed place of business in the US.
- 2.3 However, for foreign funds (and indeed all taxpayers other than dealers in securities), no trade or business results from trading in stocks, securities, or commodities in the US for the taxpayer’s own account, even if the transactions are consummated directly by the taxpayer or by an agent with full discretionary authority to make decisions.¹⁸ This protection applies (except for dealers) whether or not the trading is carried out through an office of the taxpayer in the US. The Regulations note the following in this regard:

The term “engaged in trade or business within the United States” does not include the effecting of transactions in the United States in stocks or securities for the taxpayer’s own account, irrespective of whether such transactions are effected by or through -

- (a) The taxpayer himself while present in the United States,*
- (b) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions; or*
- (c) A broker, commission agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is (1) dependent or independent, or (2) resident, non-resident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions.¹⁹*

¹⁸ See sections 864(b)(2)(a)(ii) and 864(b)(2)(B)(ii) of the US Revenue Code. Furthermore, as noted in the regulations, it does not matter whether an agent is dependent or independent.

¹⁹ Regulation 1.864-2(c)(2)(i).

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2.4 As such, foreign funds which establish management advisory businesses, or businesses with full discretionary authority to make decisions, in the US to manage their portfolio do not expose themselves to US taxation.

3 UK

3.1 The UK Investment Manager Exemption (“IME”) allows, within prescribed circumstances, UK-based investment managers to manage non-resident funds without their activities bringing those funds within the scope of UK taxation.

3.2 Currently, the key conditions which must be met in order for the IME to apply are:

- (a) the transaction must be an “investment transaction”. Broadly, this covers ‘standard’ investments, such as stocks, shares, futures, options, and swaps, but does not cover transactions in land and physical commodities. Furthermore, HM Treasury can designate additional “investment transactions”, but only by way of Statutory Instrument;
- (b) the manager must act in the ordinary course of a business of providing investment management services;
- (c) the manager must act on behalf of the non-resident fund in an independent capacity;
- (d) the manager (and connected parties) must not be entitled to more than 20% of the overseas investor’s chargeable profits arising from transactions carried out through the investment manager;
- (e) the manager must not receive less than a customary rate of remuneration for its services; and
- (f) the overseas investor must not transact through the investment manager otherwise than in circumstances where the IME conditions are met.

3.3 The *Finance Act 2008* (which received Royal Assent on 21 July 2008) introduced changes to the IME. The two main changes are the following:

- (a) The approach to defining “investment transaction” has been simplified. A single list of qualifying transactions for the purposes of the IME will now be maintained and the statutory process for adding transactions to the list has been simplified, so that appropriate updates can be made quickly and easily. This should give early certainty to non-resident investors and UK investment managers as to whether a transaction is a qualifying transaction.
- (b) Failure to satisfy the requirements of the IME in respect of one transaction will no longer jeopardise the fund’s ability to benefit from the IME more generally. Under these changes, where the investment manager undertakes a transaction which falls outside the definition of investment transaction, thereby resulting in the fund failing the IME, only that transaction will fall within the scope of UK tax. Under the old IME regime, that would potentially result in the whole fund being subject to UK tax. The change not only mitigates the risk of UK tax on the inadvertent undertaking of non-qualifying transactions, but also introduces the scope for non-residents to enter into taxable transactions through the same investment manager, without subjecting the qualifying transactions to UK tax.

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4 Singapore

- 4.1 Singapore has had a number of rules in place over many years which effectively exempted foreign funds where 80% of the fund was owned by non-residents and the fund did not have a permanent establishment in Singapore. Furthermore, management companies located in Singapore were taxed at concessional rates.
- 4.2 However, the rules were substantially changed in September 2007 to provide further concessions: see new section 13CA (replacing the former section 13C) of the Singapore Income Tax Act and the regulations under that section. Under the new Tax Exemption Scheme, a qualifying fund managed on a discretionary basis by a fund manager in Singapore is exempt from Singapore tax on specified income derived in respect of designated investments.
- 4.3 So, as a general rule, foreign funds without a “substantial” presence in Singapore are now not taxed in Singapore. Furthermore, individual beneficiaries of those funds (who do not own more than 50% of the total value of the fund) and non-resident companies that are beneficiaries of those funds are exempt from Singapore tax.

5 Hong Kong

- 5.1 Changes made to the Hong Kong tax laws in 2006 (“**2006 Exemption**”) mean that non-resident funds are now exempt from tax on qualifying transactions.
- 5.2 By way of background, Hong Kong imposes “profits tax”, both on residents and non-residents, in respect of trading profits derived from securities transactions carried out in Hong Kong if the transactions amount to a trade or business. Relevantly, certain specified investment funds have always been exempt from profits tax. These include mutual funds, unit trusts and similar “authorised” or “bona fide widely held and supervised” investment schemes.
- 5.3 As a result of the 2006 Exemption, other foreign funds are now also exempt from profits tax in respect of “qualifying transactions”. Qualifying transactions include transactions in securities, futures contracts, foreign exchange contracts, deposits, foreign currencies and exchange-traded commodities. The exemption is available provided that:
- (a) the central management and control of the fund is not exercised in Hong Kong;
 - (b) the fund does not carry on any business in HK, other than “qualifying transactions” (and incidental transactions); and
 - (c) the transactions are carried out by ‘eligible’ persons, which include, broadly, banks, dealers, traders and investment advisers.
- 5.4 As the 2006 Exemption is intended for non-residents only, it is subject to certain anti-avoidance provisions which ensure that Hong Kong residents do not take advantage of the exemption.

6 Japan

- 6.1 Until recent amendments were made to Japanese tax laws, a non-resident could be deemed to have a permanent establishment in Japan if it had an agent (specifically, a “contracting agent”, “fills order agent”, or a negotiating agent”) in Japan. There was no exclusion for an agent of an independent status, although such exclusion exists in many tax treaties that Japan has entered into with other countries, including under Article 5(8) of the new Australia/Japan DTA. Furthermore, there was no equivalent of a safe harbour trading rule or investment management

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exemption for the management of funds registered and domiciled funds by advisers based in Japan.

6.2 However, on 21 December 2007, the Japanese Government announced the basic concepts of a plan for strengthening the competitiveness of Japan's financial and capital markets. Part of that plan was to encourage foreign fund managers to participate in Japanese markets by removing taxation risk of the fund in carrying out business through independent agents in Japan. This was in response to a recognition of the detrimental effect that the absence of an independent agent exemption was having on the Japanese funds management industry.

6.3 On 30 April 2008, the relevant reforms were passed by the Japanese Parliament, with retrospective effect from 1 April 2008, by excluding from the definition of an agent:

“...a person who conducts business activities associated with the business of the foreign corporation independently of the foreign corporation...and in the ordinary course of his business...”

6.4 This exclusion is broadly consistent with Article 5 of the OECD Model Tax Convention.

6.5 Whether an agent conducts business independently is a question of fact. However, the following guidance has been provided for determining whether an agent should be regarded as an independent agent:

- (a) Legal independence - the agent must have sufficient discretion to act as an agent, relying on its own skills and knowledge in carrying out the role of agent, and not be subject to detailed instructions or to comprehensive control by the principal. **However, an agent who is a subsidiary of the principal does not, of itself, preclude the agent from being independent of its parent company.**
- (b) Economic independence - an element of entrepreneurial risk must be borne by the agent. In this regard, although not determinative, the number of principals represented by the agent is relevant, as is the dependency on a single principal for the agent's income.
- (c) Ordinary course of business - this is to be considered in the context of the business activities that the agent ordinarily carries out when acting as an agent.

6.6 This exemption should therefore allow Japan-based investment managers to manage client funds without exposing the clients to Japanese taxation from such management.

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APPENDIX 4 - EXEMPTIONS SOUGHT IN AUSTRALIA

Income Tax Assessment Act 1997

1 Section 6-5(3)

Repeal the subsection and substitute:

- (3) If you are a foreign resident, your assessable income includes your income that is effectively connected to the conduct of a trade or business within Australia.
- (3A) For the purposes of subsection (3), the term “trade or business within Australia” does not include *qualifying transactions.

2 Section 6-10(5)(a)

Repeal the paragraph and substitute:

- (a) your *statutory income that is effectively connected to the conduct of a trade or business within Australia.

3 After section 6-10(5)

Add:

- (6) For the purposes of paragraph (5)(a), the term “trade or business within Australia” does not include *qualifying transactions.

4 Item 3 in the table in section 855-15

Repeal paragraph (a) and substitute:

- (a) you have used at any time in carrying on a *business through a permanent establishment (within the meaning of section 23AH of the *Income Tax Assessment Act 1936*) in Australia, other than a CGT asset that has only been used in carrying on a business through a permanent establishment as a result of you entering into *qualifying transactions; and

5 Section 995-1(i)

Insert:

qualifying transaction means investing or trading in any one or more of the arrangements listed in paragraphs 102M(b) and 102M(c) of the *Income Tax Assessment Act 1936* or in commodities for your own account, whether by you or your employee or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has the discretionary authority to make decisions in effecting the transactions.

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Income Tax Assessment Act 1936

6 Section 94T

Repeal paragraph (f) and substitute:

- (f) the partnership carries on business in Australia and the partnership's central management and control is in Australia.

7 Application

The amendments made by this Schedule apply to assessments for the income year in which this Act receives the Royal Assent and later income years.

APPENDIX 5 - DRAFT EXPLANATORY MEMORANDUM

AUSTRALIAN TAX CONSEQUENCES FOR FOREIGN FUNDS AND FOREIGN RESIDENTS

Outline of chapter

- 1 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (“1997 Act”) to clarify that:
 - (a) foreign funds that use an Australian fund manager to manage all, or a part of, the fund will not be subject to Australian income tax; and
 - (b) foreign residents who realise gains on certain Australian assets on revenue account will not be subject to Australian income tax.
- 2 All legislative references are to the 1997 Act, unless otherwise stated.

Context of amendments

- 3 These measures will assist the Government’s desire to make Australia a funds management hub in the Asia-Pacific region.
- 4 More generally, the amendments will encourage investment by foreign funds in Australia, and foreign funds to locate some of their funds management operations in Australia, by aligning Australian law more consistently with the other major financial centres in the world, including the United States of America, the United Kingdom, Hong Kong, Singapore and Japan, which have specific exemptions available to foreign funds. This will make Australia’s tax regime more internationally competitive.
- 5 The current uncertainty over the tax treatment of foreign funds in Australia is keeping funds management activities of foreign funds outside of Australia, and also is inhibiting foreign funds from acquiring or dealing in certain Australian assets or from entering into certain derivative and other contracts with Australian based counterparties. This is acting as an impediment to Australia becoming a financial services hub in the Asia-Pacific region and is having an adverse impact on Australia’s economy. This perceived risk is having a material adverse impact, despite the Australian Taxation Office not traditionally administering the law to subject foreign funds to tax in Australia if they have an advisory or discretionary funds management presence in Australia or where there is uncertainty as to the existence of an Australian source. The adverse impact is being particularly felt by those entities that are required to make disclosures under the *US Financial Accounting Standards Board Interpretation No. 48 - Accounting for Uncertainty in Income Taxes*, which is commonly referred to as “FIN 48”.

Summary of new law

- 6 These amendments will further enhance Australia’s status as a financial hub in the Asia-Pacific region and as an attractive place for business and investment by clarifying the current uncertainty surrounding:
 - (a) whether a foreign fund may be subject to Australian tax merely because it uses an Australian manager to manage all, or a part, of the fund;
 - (b) gains realised by foreign residents on certain Australian assets on revenue account.

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Comparison of key features of new law and current law

New Law	Current Law
Foreign residents are subject to Australian tax in respect of income that is effectively connected to the conduct of a trade or business within Australia.	Foreign residents are subject to Australian tax in respect of income that is sourced in Australia.
Income derived by a foreign resident is not regarded as being effectively connected to the conduct of a trade or business within Australia to the extent that such income is from qualifying transactions.	A foreign resident may be subject to Australian income tax in respect of income derived through investing or trading in qualifying transactions and, because of the uncertain scope of Australia's source rules, even if the investing or trading is in respect of offshore assets or with offshore counterparties.
If an asset of a foreign resident is used at or through a permanent establishment of the foreign resident in Australia, that asset will not be taxable Australian property to the extent that it has only been used in carrying on a business through a permanent establishment as a result of the foreign resident entering into qualifying transactions.	If an asset of a foreign resident is used at or through a permanent establishment of the foreign resident in Australia, it is taxable Australian property and therefore any capital gains realised in respect of such an asset should be taxable in Australia.
<p>A limited partnership will only be a tax resident of Australia if:</p> <p>(a) it was formed in Australia; or</p> <p>(b) it carries on business in Australia and its central management and control is in Australia.</p>	<p>A limited partnership is a tax resident of Australia if:</p> <p>(a) it was formed in Australia;</p> <p>(b) it carries on business in Australia; or</p> <p>(c) its central management and control is in Australia.</p>

Detailed explanation of new law

What does this measure do?

- 7 These measures will amend the law so that foreign residents:
- (a) will be subject to Australian tax in respect of (among other things) income that is effectively connected to the conduct of a trade or business within Australia, except if such income is from investing or trading in qualifying transactions (as defined) on the non-resident's own account, whether by the non-resident or an employee of the non-resident or through a resident broker, commission agent, custodian or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions; and

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- (b) will not be subject to Australian capital gains tax (“CGT”) merely because that asset has only been used in carrying on a business through a permanent establishment as a result of the non-resident investing or trading in qualifying transactions for its own account, whether by the non-resident or an employee of the non-resident or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has the discretionary authority to make decisions in effecting the transactions.

Who will this measure affect?

- 8 This measure will affect all foreign residents, in particular foreign funds that use an Australian manager to manage all, or a part, of the fund, or that otherwise invest, or trade, in relevant Australian assets or that trade with Australian based counterparties.

What is income that is effectively connected to the conduct of a trade or business within Australia?

- 9 Broadly, when a foreign resident engages in a trade or business in Australia, all income from sources within Australia connected with the conduct of that trade or business will be considered to be effectively connected income (“ECI”). *[Schedule 1, item 1, section 6-5(3A) and Schedule 1, item 1, section 2, section 6-10(5)(a)]*
- 10 Although whether a foreign resident is engaged in a trade or business in Australia will be a question of fact and will depend on the nature of their activities, the term “trade or business” will generally include any activity carried on for the production of income from selling goods or performing services. Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other activities. *[Schedule 1, item 1, section 6-5(3A) and Schedule 1, item 1, section 2, section 6-10(5)(a)]*
- 11 However, expressly excluded from the meaning of the term “trade or business within Australia” is investing or trading in qualifying transactions by the foreign resident for their own account, whether by them or their employee or through a resident broker, commissioner agent, custodian or other agent. (“Qualifying transactions” are defined primarily by reference to the latest definition of “eligible investment business” in Division 6C of Part III of the *Income Tax Assessment Act 1936* (“1936 Act”).) This is even the case if the employee or agent has discretionary authority to make decisions in effecting the transactions. This is in contrast to the permanent establishment articles in most double tax agreements that Australia has entered into, in which a foreign resident is usually deemed to have a permanent establishment in Australia if there is a person who has the authority to conclude contracts on behalf of the foreign resident and habitually does so. *[Schedule 1, item 1, section 6-5(3A), Schedule 1, item 2, section 6-10(6), and Schedule 1, item 5, section 995-1(1)]*

CGT amendment

- 12 Broadly, under the current law, any CGT asset used by a foreign resident at any time in carrying on a *business through a permanent establishment (within the meaning of section 23AH of the 1936 Act) in Australia is a taxable Australian asset (Item 3 in the table in section 855-15 of the 1997 Act).
- 13 This raises the unintended risk for foreign funds that use an Australian manager to manage all, or a part, of the fund, that assets that have been acquired or disposed of by the Australian manager may be regarded as taxable Australian property. Consequently, there is a risk that the

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foreign fund may be subject to Australian income tax in respect of any gains realised on such assets.

- 14 This amendment will exclude from that item of taxable Australian property any CGT asset that has only been used in carrying on a business through a permanent establishment as a result of the foreign resident investing or trading in qualifying transactions for their own account, whether by them or their employee or through a resident broker, commissioner agent, custodian, or other agent. This is even the case if the employee or agent has discretionary authority to make decisions in effecting the transactions. This is in contrast to the permanent establishment articles in most double tax agreements that Australia has entered into, in which a foreign resident is usually deemed to have a permanent establishment in Australia if there is a person who has the authority to conclude contracts on behalf of the foreign resident and habitually does so. *[Schedule 1, item 4, Item 3 in the table in section 855-15]*

Integrity measures

- 15 No specific integrity measures have been incorporated into the amendments contained in Schedule 1 to the Bill. This is because the existing integrity measures contained in the 1936 Act and the 1997 Act are intended to apply to prevent any abuse arising from those amendments.
- 16 As an example, if an Australian resident attempts to avoid or defer Australian tax by interposing a foreign entity, that Australian resident should not be able to avoid or defer such income tax as a result of the operation of the controlled foreign company regime in Part X of the 1936 Act, the foreign investment fund regime in Part XI of the 1936 Act, the transferor trust regime in Part 6AAA of Part III of the 1936 Act, deemed present entitlement rules in sections 96B and 96C of the 1936 Act and/or Part IVA of the 1936 Act.

Tax residence of limited partnerships

- 17 Under current law, a foreign fund that is structured as a limited partnership can be deemed to be an Australian tax resident in circumstances where a comparable foreign fund that is structured as a foreign company would not be deemed to be an Australian resident. This is anomalous, because many foreign funds are structured as limited partnerships and should not be taxed in Australia on their worldwide income (as would be the case if they are Australian tax residents) merely because they are formed as limited partnerships and happen to make some investments in Australia. Consequently, many foreign funds choose to not invest in Australia at all, in order to completely avoid what they perceive to be the arbitrary and capricious technical risk of being subject to Australian income tax on their worldwide income.
- 18 Under current law:
- (a) a limited partnership is generally a tax resident of Australia if (section 94T of the 1936 Act):
 - (i) it was formed in Australia;
 - (ii) it carries on business in Australia; **or**
 - (iii) its central management and control is in Australia; and
 - (b) a company that is not incorporated in Australia is only a tax resident of Australia if it carries on business in Australia **and** either (definition of “resident” in section 6(1) of the 1936 Act):

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- (i) its central management and control is in Australia; or
- (ii) its voting power is controlled by shareholders who are tax residents of Australia.

19 Consequently, under current law, there is an anomalous difference, depending on whether a foreign fund is structured as a limited partnership or is structured as a company. This is because a limited partnership can be a tax resident of Australia if (among other things) it carries on business in Australia; whereas, a company would only be a tax resident of Australia if (among other things) it carries on business in Australia **and** its central management and control is in Australia.

20 The proposed amendment brings into line the tax residency test for limited partnerships and companies, to remove the disadvantage in this regard that is currently suffered by foreign funds that are structured as limited partnerships. This is done by amending section 94T(f) of the 1936 Act so that a limited partnership that was not formed in Australia will only be a tax resident of Australia if both it carries on business in Australia **and** its central management and control is in Australia. *[Schedule 1, item 6, section 94T]*

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APPENDIX 6 - MAKING AUSTRALIA A FUNDS MANAGEMENT HUB IN THE ASIA-PACIFIC REGION

2008 Relevant Media Releases and Speeches by the Assistant Treasurer

Media Releases

Number	Date	Title
081	26/09/2008	<u>Appointment of the Chair and Panel of Experts to Lead the Governments Initiative to Position Australia as a Leading Financial Services Centre in the Asia-Pacific Region</u>
080	25/09/2008	<u>Australia as a Financial Services Hub - Government Introduces Amendments to Reform Division 6C</u>
069	22/08/2008	<u>Release of Tax Design Review Panel's Report Better Tax Design and Implementation</u>
063	01/08/2008	<u>Commonwealth & NSW Work to Advance Financial Services</u>
059	31/07/2008	<u>Government and Industry Set the Agenda for Australia to Become a Financial Services Hub</u>
056	23/07/2008	<u>Australia as a Financial Services Hub - Government Commences Consultation on Draft Legislation to Reform Division 6c</u>
049	26/06/2008	<u>Australia's Tax Treaties - Industry's Message to Government</u>
047	25/06/2008	<u>Sydney to Host Financial Services Hub Summit</u>
045	20/06/2008	<u>First Plank in Place on Road to Australia as a Regional Financial Hub</u>
017	12/03/2008	<u>Board of Taxation Position Paper a Further Step to Making Australia a Financial Hub</u>
010	22/02/2008	<u>Board of Taxation to Review Tax Arrangements Applying to Managed</u>
006	08/02/2008	<u>Tax Design Review Panel to Look at Ways to Streamline Process for Changing Tax Laws</u>
004	25/01/2008	<u>Australia's Tax Treaty Negotiation Policy</u>

Speeches

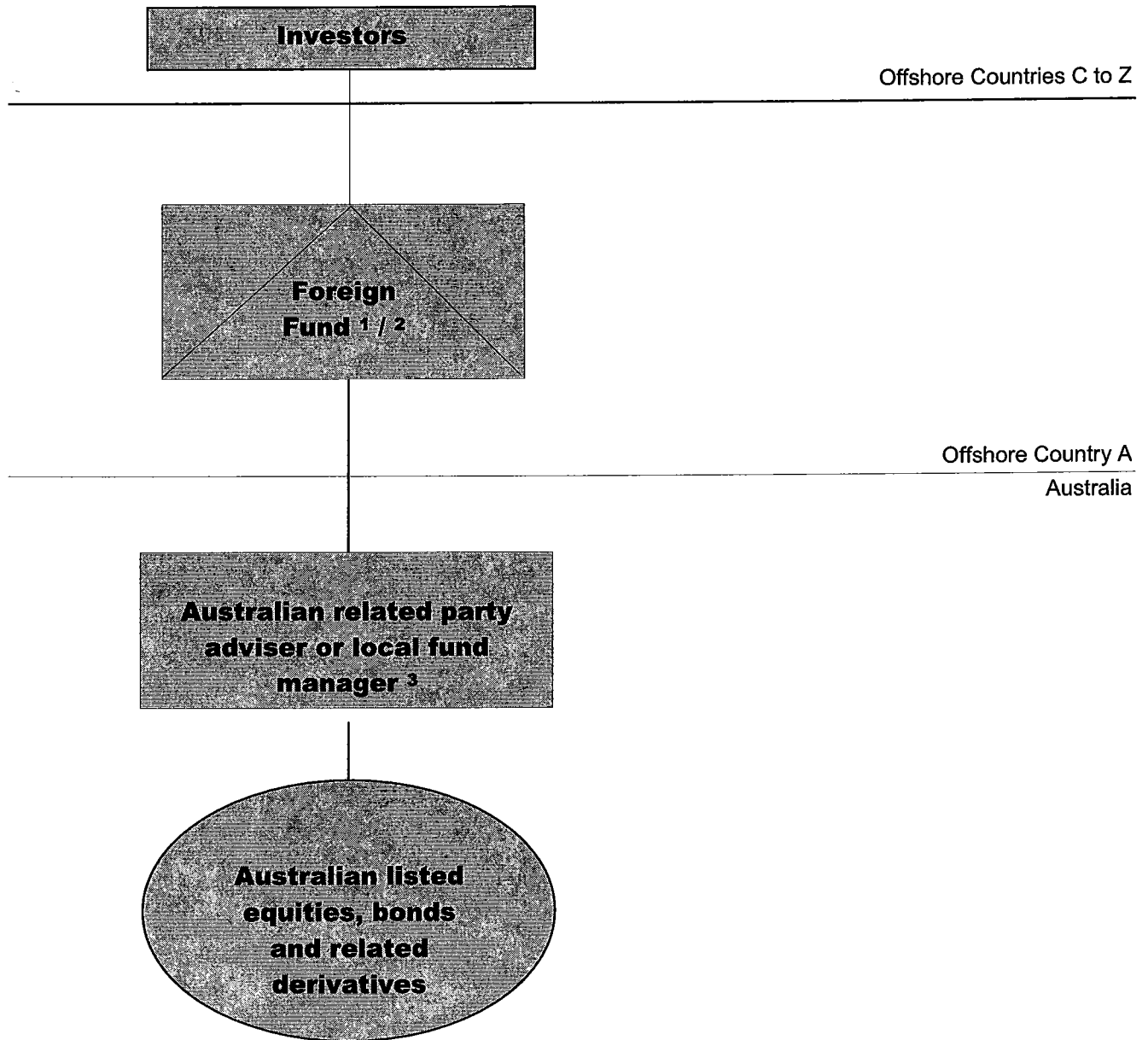
Number	Date	Title
009	26/09/2008	<u>'Promoting Australia as a Financial Services Centre', Keynote Address to the Committee for Sydney, Sydney</u>
008	22/08/2008	<u>Address to the Victorian Tax Bar, Melbourne</u>

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Number	Date	Title
005	07/08/2008	<u>Address to IFSA Conference 'Innovate 08', Gold Coast</u>
001	22/02/2008	<u>Address to IFSA Member Luncheon, Sydney</u>

DIAGRAM 1

The possible significance of the Australian related party adviser or local fund manager (I): Is it a Permanent Establishment ("PE") of the Foreign Fund, so that all profits or gains on the underlying Australian investments are liable to Australian tax? [See paragraph 2 of Appendix 1]



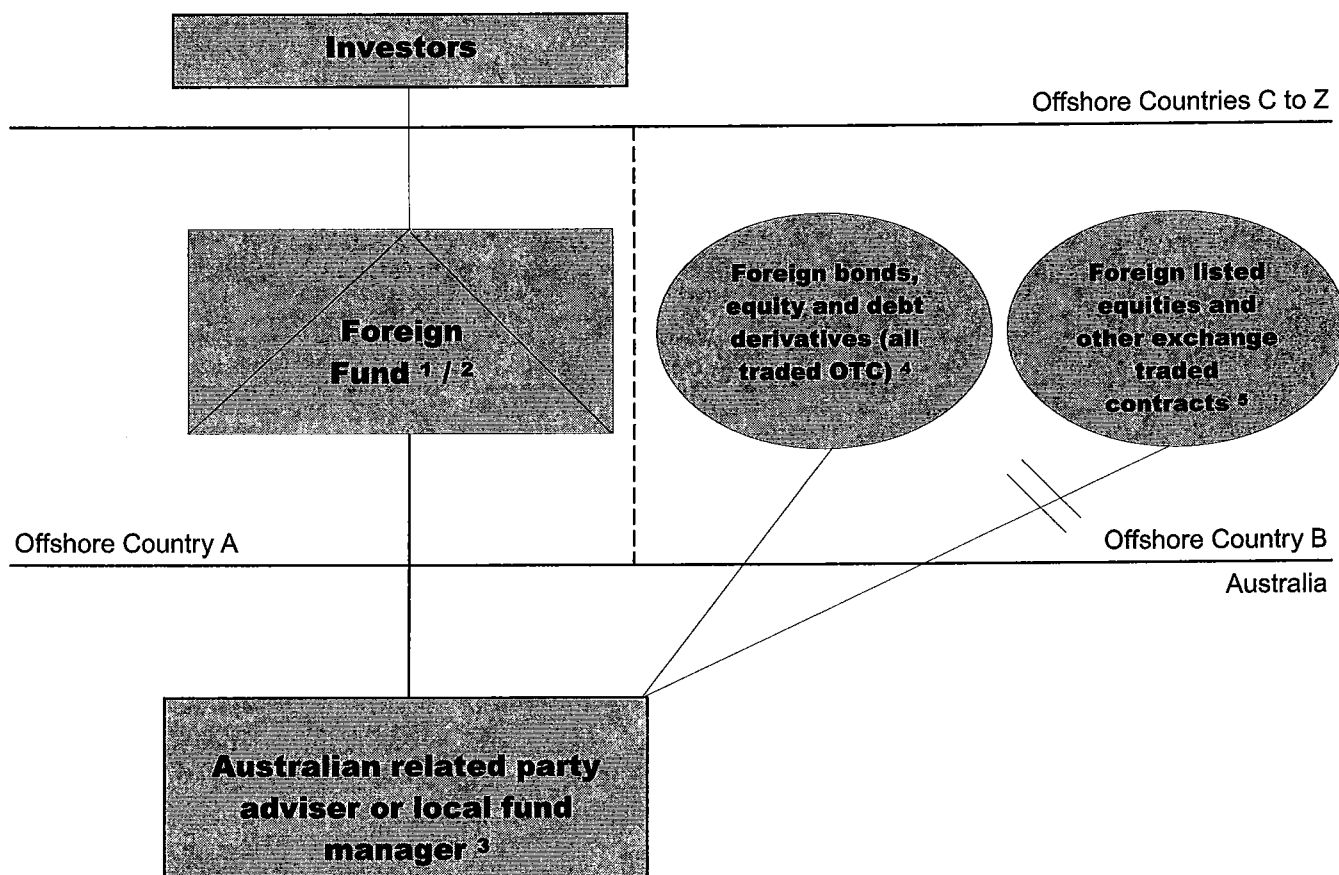
Footnotes:

- 1 The Foreign Fund may be a company, LLC, limited partnership or possibly another type of entity. For convenience, we have only shown it as a pass-through or fiscally transparent entity in its place of establishment, Offshore Country A (eg the Cayman Islands or Jersey), though this will not always be the case.
- 2 For convenience, we have shown the Australian related party as a related party of the Foreign Fund itself. It is more common in practice that the Foreign Fund has a separate Foreign Fund Manager (which promoted or sponsored the Foreign Fund) and that the Australian related party is a related party of the Foreign Fund Manager (and not of the Foreign Fund itself). However, similar issues arise in both cases.
- 3 See footnote 2.

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DIAGRAM 2

The possible significance of the Australian related party (II): Are profits or gains on offshore investments (other than perhaps listed or exchange traded investments) regarded as having an Australian source, or otherwise attributed to an Australian PE of the Foreign Fund, and liable to Australian tax? [See paragraph 2 of Appendix 1]



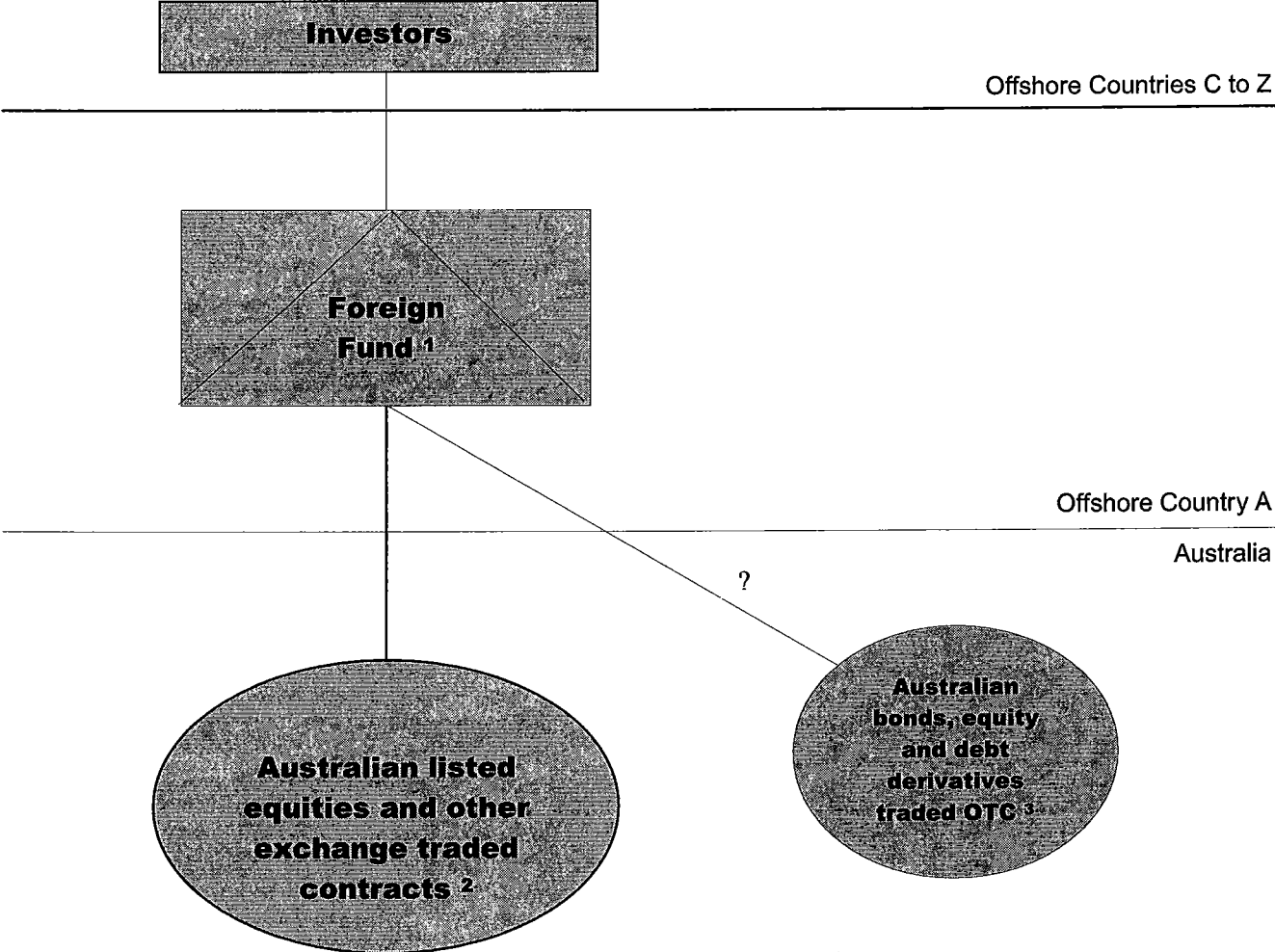
Footnotes:

- 1 As for Diagram 1.
- 2 As for Diagram 1.
- 3 As for Diagram 1.
- 4 Profits or gains on these assets might be regarded as having an Australian source merely because of the arbitrary and capricious application of outdated common law rules regarding the place where the relevant contract is regarded as having been made.
- 5 We assume that, because these investments are listed or traded through an overseas stock, futures or other exchange, the relevant place of contract would be in the foreign jurisdiction where the relevant exchange is located, so that any relevant profit or gain would **not** be regarded as having an Australian source. This would include shares in Australian companies that are traded on an overseas exchange (such as shares in dual listed companies like BHP Billiton and Rio that are listed in London, ADRs in many other Australian companies whose are traded on the NYSE, and shares in other Australian companies which are listed in the UK, Germany, Singapore, New Zealand and elsewhere).

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DIAGRAM 3

The arbitrary and capricious operation of common law source rules [See paragraph 3 of Appendix 1]

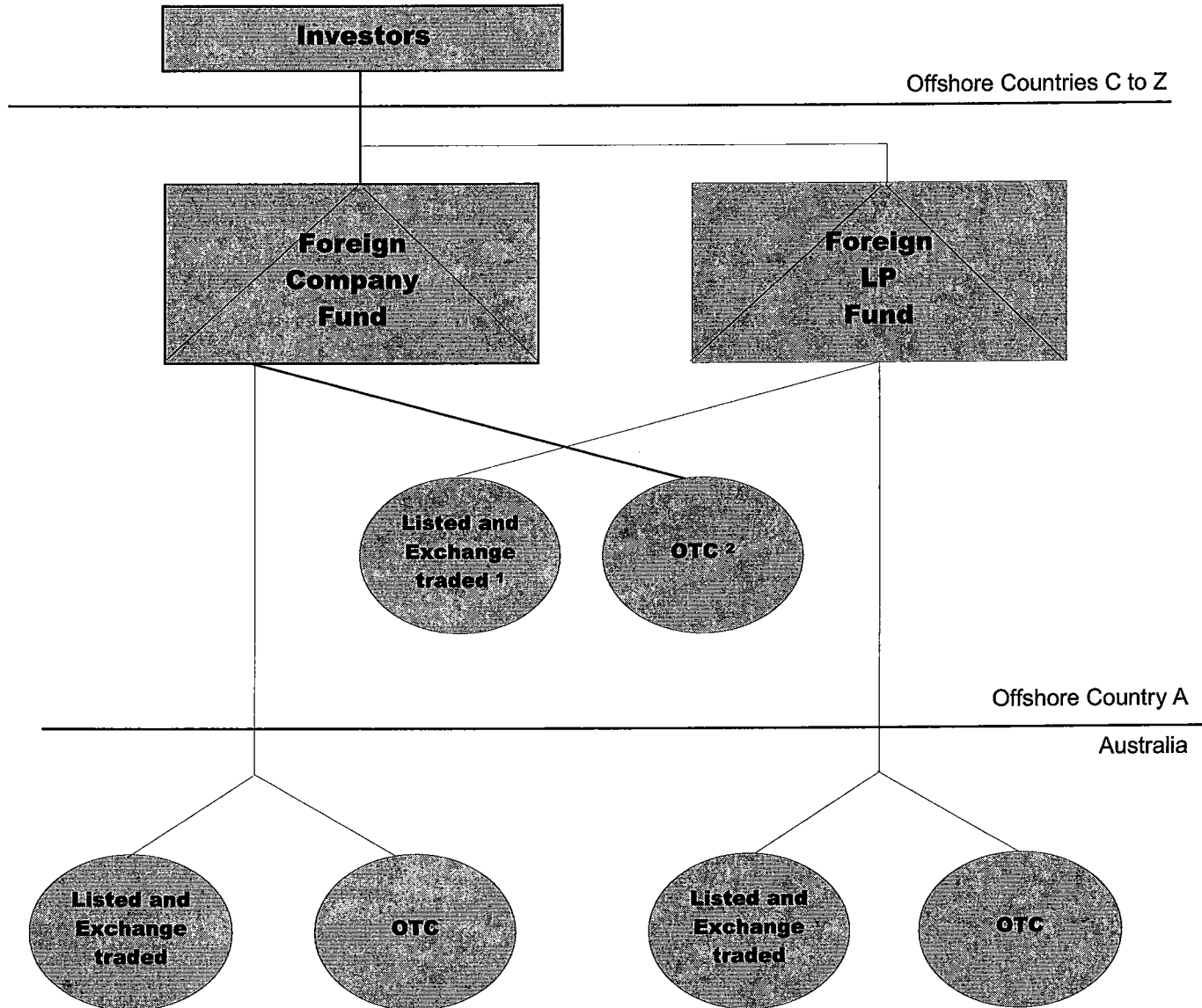


Footnotes:

- 1 As for Diagram 1.
- 2 Common law source rules would seem to give profits or gains related to these investments an Australian source. (Note too that a possible Australian source can be avoided if the shares can be traded on a foreign exchange, rather than an Australian exchange: for example, shares in a dual listed company, such as BHP Billiton or Rio that are listed in London, NYSE listed ADRs in Australian companies, or shares in other Australian companies which are listed in the UK, Germany, Singapore, New Zealand or elsewhere. This highlights how capricious the common law sourced rules are.)
- 3 Outdated common law source rules may apply in a capricious and arbitrary way to deem some, but not other, profits or gains relating to these investments to have an Australian source, by reason of the relevant contract being regarded as having been (or not having been) made here. (The capricious and arbitrary nature of these rules is indicated by the “?” on the diagram.)

DIAGRAM 4

The additional capricious problem for an LP, compared to a company
 [See paragraph 4 of Appendix 1]



Footnotes:

- 1 Profits or gains relating to these foreign investments (which can be in any foreign country):
 - (a) are **not** liable to Australian tax if derived by a **Foreign Company Fund**;
 - (b) but **are** technically liable to Australian tax if derived by a **Foreign LP Fund**, because, under section 94T of the 1936 Act, the Foreign LP Fund is regarded as a tax resident of Australia **merely because it carries on business in Australia**, even though it is formed outside Australia, its central management and control are outside Australia and most of its investments are outside Australia. The uncertain issue is: does merely buying and selling exchange traded investments in Australia, or entering into OTC contracts in Australia (under our capricious common law source rules), amount to “carrying on business in Australia” by the Foreign LP Fund? Even if not, would using an Australian related party adviser or local fund manager, as agent, give rise to the Foreign LP Fund carrying on business in Australia? In either case, the tax consequences for the Foreign LP Fund in respect of its offshore Listed and Exchange traded investments are horrific, albeit presumably not intended.
- 2 As for footnote 1, but in respect of the foreign LP fund’s offshore OTC investments.

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