

**Email**

1 March 2011

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Our ref 201/80116754

Dear Members

**Submission - Review of Tax Arrangements Applying to Collective Investment Vehicles**

Clayton Utz welcomes the Board of Taxation's (**Board**) Discussion Paper, released in December 2010, on the *Review of Tax Arrangements Applying to Collective Investment Vehicles (Discussion Paper)* and appreciates the opportunity to make a submission in relation to some of the issues raised in the Discussion Paper. We have focused on Question 2.2 in the Discussion Paper, which asks for stakeholder comments on the use of the "eligible investment business" and "control test" definitions in Division 6C as a prerequisite for a range of Collective Investment Vehicles (**CIVs**) to access relevant commissions.

**1. Executive Summary**

- 1.1 We believe that the use of the "control test" in Division 6C of Part III of the *Income Tax Assessment Act 1936 (Cth) (ITAA 36)* to determine whether an investment vehicle should be treated as a CIV and therefore exempt from the public trading trust rules is inappropriate, and contradicts the policy intent of the current Australian Government, which is to encourage inbound investment.
- 1.2 Further, where an investment vehicle can show it satisfies the OECD definition of a CIV, then it should be allowed to access the concessional tax treatment afforded to those engaging in eligible investment business.

**2. Introduction**

- 2.1 The purpose of CIVs is to allow long-term portfolio investors to invest in vehicles which undertake primarily passive investments. The figures provided in the Discussion Paper on worldwide investment in CIVs show that such investments will only continue to grow. For Australia to have its share of overseas investor funds, the Government must reform the tax system to encourage such investments.
- 2.2 In Chapter 2, the Board refers to the OECD definition of a CIV as a fund which:
- is widely held;
  - holds a diversified portfolio of securities; and
  - is subject to investor protection regulation in the country in which it was established.

2.3 We endorse the OECD's definition. The Board believes that the definition of a CIV as stated in its terms of reference is broadly consistent with the above. However this definition, as stated at paragraph 2.11 of the Discussion Paper is that a CIV "undertakes primarily passive investment activities, consistent with the eligible investment rules in Division 6C of Part III of the ITAA 36". This is a more restrictive definition than the OECD's, which simply focuses on diversification of investments.

### 3. Eligible Investment Business and the Control Test

3.1 In the previous Board of Taxation *Review on Tax Arrangements Applying to Managed Investment Trusts*, a number of submissions recommended that the control test in Division 6C be abolished. We are concerned that the "control test" in Division 6C is being used as a proxy for determining whether a vehicle is a CIV. We do not believe that the current definition of "eligible investment business" in Division 6C is appropriate for ascertaining whether a vehicle is a CIV.

3.2 In the context of its discussions on CIVs, the Board seeks to apply the definition of trading trusts in section 102N of the ITAA 36 to determine whether a vehicle holds a diversified portfolio of securities. Section 102M of the ITAA 36 presently defines "eligible investment business" as including investing or trading in shares in a company and units in a unit trust.

3.3 However, under section 102N, a trust will be treated as a trading trust where it either:

- carries on a trading business; or
- *controlled, or was able to control*, directly or indirectly, the affairs or operations of another person in respect of the carrying on by that other person of a trading business (emphasis added).

3.4 This means that a unit trust such as a CIV is, at first glance, carrying on an "eligible investment business" by owning shares in a company. However if, for example, it owns more than 50% of those shares it is excluded from being a CIV. It will be treated as though it is carrying on a trading business and will be taxed like a company. At paragraph 2.20, the Discussion Paper further elaborates on Division 6C, noting that it is important to distinguish between so-called passive investment activity and "trading activity":

It is suggested that control is the factor that indicates active involvement in the trading business and so funds such as private equity funds would not typically be considered to be undertaking passive investment activity. This statement does not acknowledge that a majority shareholding in a company does not necessarily equate to "active involvement in the trading business".

#### *Legislative history*

3.5 The Explanatory Memorandum to the Taxation Laws Amendment Act (No. 4) 1985, which introduced Division 6C, states that section 102N:

is a safeguarding provision against arrangements to circumvent the operation of Division 6C, by having activities that would constitute a trading business of a public unit trust carried on by an associated entity. By taking income from the associate in the form of eligible investment income, the trustee could otherwise ensure that the

relevant trust did not qualify as a trading business and so avoid the operation of Division 6C.

3.6 In his Statement on the Reform of the Australian Taxation System on 19 September 1985, the then-Treasurer Paul Keating noted his concern that there was an increasing use of trusts to avoid company tax and therefore the Government intended to extend the company tax arrangements to public unit trusts, but only those which operate a trade or business, "as distinct from the great majority which are vehicles for investing in property, equities or securities."

3.7 Unfortunately, neither the Explanatory Memorandum nor the Ministerial Statement give much guidance on what purpose was served with the addition of the control test to section 102N or how the control test would actually apply in reality. Nevertheless, it is clearly a concept that relates to a single business or a series of interrelated businesses.

#### ***Comparison with Venture Capital***

3.8 The criteria for determining whether a vehicle is a CIV should be whether the aggregate of the CIV's holdings results in diversification. For example, at the time of establishment, a vehicle may have a majority investment in an asset as its sole investment. Over the life of a CIV, it will continue to accumulate investments in more assets. In this example, the control test would look at the first asset and automatically exclude the vehicle from being a CIV on the basis that it has "control" of the company and this equates to active involvement. This approach does not take into account the realities that CIVs operate in and therefore the most reasonable and accurate approach would be to focus on whether there is the existence of investments in different unrelated assets, and therefore diversification.

3.9 The proposal to use the Division 6C control test as a proxy can be contrasted to the rules on Venture Capital Limited Partnerships (VCLP) as listed in Subdivision 118-F of the *Income Tax Assessment Act 1997* (Cth) (ITAA 97). Under section 118-425(1) of the ITAA 97, an investment will be considered an eligible venture capital investment where it is an acquisition in shares, options (including warrants) or convertible notes of a company. In addition, the amount invested by the VCLP cannot exceed 30% of its total committed capital.

3.10 Section 118-425(3) of the ITAA 97 only restricts investments where more than 25% of the company's assets are used in activities which are "ineligible activities", as defined in section 118-425(13) of the ITAA 97. Rather than focusing on the size of the stake that the investing entity has in the company, the VCLP rules focus only on the types of investments made. This allows for a broader base of investments and qualifying VCLPs do not need to consider levels of ownership in individual assets. This approach is more reasonable and more reflective of the life cycle of a CIV, which must commence with a larger holding in one company in order build up its diverse portfolio of companies.

#### **4. Recommendations**

4.1 The policy grounds for taxing a trust which controls a trading company as a company is inappropriate because it taxes an otherwise passive investor as though it is engaging in trading activity by virtue of the fact it has a majority shareholding and therefore deemed to satisfy the "control test". Using the Division 6C test as a proxy for determining whether an entity is a CIV will likely prevent many entities with otherwise diversified portfolios from meeting this

requirement. Control does not necessarily equate to carrying on an active business, which is the effect of the current section 102N.

- 4.2 We believe that there are compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs. The "eligible investment business" definition in Division 6C of the ITAA 36 by itself is a sound and reasonable definition, but the existence of the control test in section 102N significantly narrows the scope of what would constitute an "eligible investment business".
- 4.3 In the result, we would submit that the control aspect is irrelevant for the purposes of CIVs. Any legislation governing CIVs should instead focus on defining what constitutes a diversified portfolio of securities as per the OECD definition and refrain from using Division 6C as a proxy for determining whether an entity is a CIV.
- 4.4 This legislation should also clarify that for the purposes of tax law, any investment by a CIV in related entities should be considered as an investment in one entity. Diversity of the shareholdings of a CIV, rather than the size of its shareholdings in each of its portfolio companies, is what should determine whether a vehicle should be treated as a CIV.
- 4.5 Where it can be established that a CIV is using any majority shareholding to engage in more than just passive investment and is in fact carrying on a trading business as per section 102N(1)(a), only then should it be treated as a trading trust.

If you have any queries in relation to this submission, please do not hesitate to contact Allan Blaikie on (02) 9353 4201. We also would be happy to meet with the Board to discuss our submission if required.

Yours faithfully



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