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The Board of Taxation
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Review of Tax Arrangements Applying to Collective Investment Vehicles Discussion Paper

Dear Members

Ernst & Young welcomes the opportunity to comment on the Board of Taxation's (the Board) discussion paper "Review of Tax Arrangements Applying to Collective Investment Vehicles" (the discussion paper) released for comment on 17 December 2010.

We welcome the Government's acceptance of recommendations made by the Australian Financial Centre Forum (the AFCF) in their 2010 report "Australia as a financial centre: Building on our strengths" (the Johnston report) and this review by the Board of:

- the taxation of collective investment vehicles (CIVs) and potential introduction of new vehicles;
- the design of an investment manager regime (IMR); and
- the effectiveness of the Venture Capital Limited Partnership (VCLP) and Early Stage Venture Capital Limited Partnership (ESVCLP) regime.

Successful reforms will enhance the Australian financial services sector and employment and can transform Australia into a regional financial services hub. The discussion paper highlights the need to reform Australia's funds management tax laws to be internationally competitive.

The reforms should be designed so that they do not introduce unnecessary complexity, uncertainty and significant compliance costs. The Board should highlight that the reforms must be designed to provide certainty of Australian taxation outcomes, be simple to understand and to apply and must align to international concepts and usage. Otherwise, our ability to attract foreign investment capital will be limited.

We highlight that the previously-identified further reform of the public trading trust rules of Division 6C of the Income Tax Assessment Act 1936 is essential as they are relevant in the proposed reforms for CIVs and IMRs. Many of the Board's recommendations for the review and modernisation of the Division 6C rules in its 2009 "Review of the tax arrangements applying to managed investment trusts" were rejected/deferred by the Government and they should now be acted upon as soon as possible.

We also recommend that the Board should prioritise and the Government should prioritise the development of an Investment Manager Regime (IMR). This initiative is particularly useful in attracting international funds under management as the financial and investment markets continue their recovery, and the opportunity should not be further deferred.

The reason for the IMR priority is that the developed countries are, in a united manner, forcing disclosure requirements onto foreign investment funds, with global trends to Exchange of Information treaties and the US FATCA increased disclosure requirements. The time of the offshore tax haven like Cayman Islands as a location for collective investment vehicles is passing. So, globally, funds managers are considering the best location for their collective investment vehicles, locations which have strong financial centres, strong tax treaty networks and support activities. That could put Australia into a strong position if we had an IME regime like that of the UK or Singapore or other countries.

An executive summary of our specific responses, detailed in the Appendix, is as follows:

The existing range of CIVs should be expanded

- Australia should expand the range of CIVs for investments into and through Australia, as the current complex and uncertain laws put Australia at a strategic disadvantage.
- A single CIV entity for all investors and investor classes is not recommended. Multiple options should be available for investors including the retention of the MIT and LIC regimes, but with improved laws including the specific tax regime for MITs, optional deemed capital treatment for LICs and better treatment of LICs' capital losses.
- All new CIV regimes should include the following features:
  - They should be simple to understand, establish and operate, to provide of outcomes and simplicity of application and compliance
  - They should be coupled with a custom built regulatory regime as appropriate
  - Deemed CGT treatment in line with the MIT capital election
  - Taxable income of a transparent CIV should be attributed to investors
  - Losses should flow through a transparent CIV, at least on a limited basis
  - A widely held test that is improved over that currently available for MITs.
- The proposed reforms of the taxation of managed investment trusts (MITs) and current consultation on these measures should be finalised speedily and a post-implementation review of the overall MIT rules should be undertaken following these changes.
- Limited Partnership CIVs (CIVLPs) should be introduced in Australia as this is the preferred structure of many institutional and sophisticated investors operating around the world. CIVLPs should have optional deemed capital account treatment and flow through of losses
- We agree that a new corporate CIV could be considered to target investment by offshore investors, which should include optional deemed capital account treatment in line with the MIT rules and various other features. Appropriate tax outcomes for this vehicle might take time to design. We note that a corporate CIV would not be attractive to investors unless complete flow through taxation is achieved.
- Uncertain taxation of gains on the disposal of Australian assets must be resolved for foreign resident investors in respect of the full range of CIVs, in line with the policy of the exemption in Division 855 of the Income Tax Assessment Act 1997 (ITAA 1997).
- If Australia's CIVs are restricted to vehicles that undertake primarily eligible investment business (EIB) based on concepts in the Division 6C public trading trust rules as set out in the terms of reference, then it is vital that the EIB rules are improved and modernised. The rule should not prevent ownership of controlled companies and affected entities should be allowed to rectify inadvertent breaches of the rules.

Ernst & Young supports a wide ranging IMR

- The Australian IMR should be wide ranging and extend beyond the recommendations of the AFCF to include Australian assets dealt with through dependent agents or intermediary. The Australian IMR should allow 'in-house' financial intermediaries to be established by either foreign or Australian resident financial services companies. The IMR should apply to banks and other financial institutions managing their own offshore funds.

- The breadth of an Australian IMR should be benchmarked against leading IMR/ investment manager exemption regimes including those in Singapore and the UK.
- The drafting of the IMR regime should not excessively limit the IMR by overlaying multiple eligibility requirements on funds and other foreign investors.
- An exemption approach can provide conduit relief in respect of eligible foreign assets. Eligible foreign assets should be widely defined similar to the existing global leading IMRs in Singapore and the UK.
- The revenue arising from offshore investments under the IMR should be limited to the commercial management fee received by the Australian intermediary funds.
- Access to the IMR should be not be limited by 'widely held' or 'managed in Australia' requirements.
- Any integrity measures should be directed at the underlying Australian investors, rather than the foreign fund. We do not support the insertion of anti-round tripping rules that would require an additional layer of reporting or complex tracing at investor level.

VCLP and ESVCLPs should be further enhanced

- Measures to address the limited take-up of VCLP and ESVCLP investments could include expanding the types of permitted activities, raising the caps on investment and extending optional deemed capital account treatment to these entities.

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Should you have any queries or would like to discuss our submission further please do not hesitate to contact in the first instance Antoinette Elias on (02) 8295 6251, Dale Judd on (03) 9655 2769, Ian Scott on (02) 9248 4775, Peter Janetzki on (03) 8650 7525 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Antoinette Elias, Dale Judd, Ian Scott, Peter Janetzki and Tony Stolarek

cc. Office of the Assistant Treasurer

APPENDIX 1

We respond to the Board's discussion paper relating to the Taxation of Collective Investment Vehicles (CIVs), the Investment Manager Regime (IMR) and the VCLP/ESVCLP segments.

Priorities for reform

Our preliminary submissions relate, however, to the need to prioritise the action by government in relation to these wide-ranging reforms. A comprehensive modernisation of Australia's CIV rules, introduction of an IMR, development of a separate "Asian passport" regulatory reform to enable greater international marketing of managed funds, and reform of Australia's venture capital regimes will take time.

Therefore, the Board and government should prioritise the measures which have the greatest potential to enhance Australia's development as a regional financial centre, specifically the investment manager regime to be applied to attract investment of foreign investors' funds. As we see it the IMR regime can be developed quite distinctly from the broader reform of Australia's managed investment trusts (MITs) and the broader alignment and streamlining of CIVs which is the subject of this Board review.

The reason to prioritise the IMR is that, as the world's financial markets are recovering and investable funds are on the increase, and as the Asian passport has the potential to enhance international competition for managed funds and funds management activities, Australia will continue at a disadvantage as other Asia Pacific and OECD financial centres compete for cross-border funds management mandates and activities. If the IMR (and Asian passport) is not prioritised, Australia will continue to miss out on this opportunity to become the Asia Pacific regional hub.

As well, the design of the IMR is needed to implement the legislation dealing with the announcements by Assistant Treasurer Mr Bill Shorten:

- in December 2010, proving limited tax protection to foreign funds, focusing on US accounting treatment of uncertain Australian tax positions under US accounting standard FIN48
- in January 2011, relating to the treatment of Australian investment management activity supporting foreign funds.

These require early definition of eligible foreign funds and investment management activities. More importantly December 2010 announcement only protects foreign funds from Australian tax risks in relation to the year ended 30 June 2010 and prior. That announcement has no effect in relation to the current financial year and the future and further reforms need to be settled.

It is clear that the IMR must therefore be introduced speedily, and must be announced within the next few months otherwise the tax uncertainties will continue. The IMR is therefore the priority measure for development.

Taxation of Collective Investment Vehicles (CIVs)

We support the AFCF's recommendations for the review of the taxation of CIVs and welcome the Government's acceptance of this recommendation and the Board's discussion paper.

Our comments are provided at a high level reflecting the early stages of consultation and the complexity of the issues.

In particular, the proposed reforms of the taxation of managed investment trusts (MITs) and current consultation on these measures should ideally be completed and the lessons of these changes considered before the more detailed rules around new CIV entities are finalised. We understand exposure draft law for these MIT changes, proposed to commence 1 July 2011, is expected soon.

1.1 Why the further reforms are critical

Q 2.1 Issues / Questions

The Board seeks stakeholder comments on:

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

Q 3.1 Issues / Questions

The Board seeks stakeholder comments on:

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

We agree broadly with the discussion paper's assessment of issues associated with the current range of CIVs which make these vehicles less attractive to non-resident investors. Further we agree that potential benefits should be obtained from an expansion of the range of available CIVs for investment into and through Australia.

In particular, we recommend that the uncertain taxation of gains on the disposal of Australian assets must be resolved for foreign resident investors in respect of the full range of CIVs, in line with the policy of the exemption in Division 855 of the Income Tax Assessment Act 1997 (ITAA 1997).

In short, foreign investors investing into Australia or through Australia are relatively unfamiliar with the intricacies of Australia's rules in relation to trusts and managed investment trusts (MITs). Other developed countries do not, typically, use trust structures for their managed investment funds. As a result where fund managers seek to develop products to appeal to overseas investors, it is more complex to educate investors in relation to the nature of trusts.

Australia has no true flow through collective investment entities, such as foreign jurisdictions' limited liability companies and limited liability partnerships and mutual funds, all of which have various flow-through tax treatments. As noted, Australia's corporate limited partnership rules deny flow through treatment of gains and losses, and companies have no flow through treatment.

The legal complexity of Australia's trust rules is magnified by the uncertain tax position arising from the complexity of Australia's trust taxation rules. We recognise that the government is currently engaged in continuing tax reform of these rules, including reform of Australia's MIT rules. Even these desirable reforms will continue to result in significant uncertainty which will continue in the system. For example:

a) the MIT reforms do not provide full flow-through tax treatment for tax exempt or non-taxable foreign investors. In particular, foreign foundations, foreign pension funds, and some similar tax exempt entities, which are exempt in their home countries, are not attracted to the taxation of gains in Australian MITs, even though the distributions from the Australian MITs can be distributed by MITs with reduced withholding taxes pursuant to recent reforms.

   Flow-through treatment is achieved for VCLP investments and entities but they are heavily constrained by the scope of eligible investments.

b) revenue-capital treatment and the certainty of tax characterisation will apply only for MITs as currently defined. That narrow definition means that it is quite possible for collective investment vehicles to fail to achieve MIT status under the Australian tax provisions, for example because there are interposed wholesale entities which do not satisfy the flow-through rules;

c) the rules for "unders and overs" as currently framed provide only a very narrow range of tolerance in relation to distributions.

So, when fund managers and foreign investors review the options available to them for global investment, they cannot use investment structures typically offered by global fund managers involving well-known concepts of flow-through LLPs, flow-through LLCs and flow-through mutual funds. It is unquestionably less attractive for Australia to have no such offerings and to structure CIVs through MIT structures.

We reiterate that we support the reform of Australia's MIT rules and these will be a useful and significant development particularly for Australian investors. However, the MIT rules merely rectify a significant disadvantage in Australia's tax rules, a reduction in the significant uncertainty surrounding funds management in Australia. From the perspective of international competitiveness and more importantly the attraction of international funds, the MIT reforms do not deliver attractive structures calculated to attract foreign investment into Australia.

Australia's lack of internationally competitive flow-through investment vehicles for CIVs, and its reputation for tax complexity and uncertainty, is a strategic disadvantage when considering establishing Australia as an international centre for funds management for global funds.

1.2 An integrated design approach to the law is needed

We highlight that the focus for reform and the key messages from the government and Treasury need to be on reform that enhances the Australian asset management and broader financial services industry while providing certainty, without introducing unnecessary complexity, uncertainty and significant compliance costs. Reforms must be simple to understand and to apply and must balance integrity concerns with the benefits sought to be obtained.

We highlight also that, for Australian funds to offer attractive investment products to foreign investors, the tax reforms should allow the maximum use of product offerings which are well understood in OECD and other financial markets. As mentioned above, this includes investments in companies including limited liability companies (LLCs), partnerships including limited partnerships (LPs/LLPs) and listed investment companies (LICs).

To operate efficiently, the reforms should be structured around a set of common principles applying across different legal entities including:

- types of investor (resident/non-resident)
- definitions of foreign asset funds
- investment classes (equities, debt, property, alternative investments)

They should incorporate common rules, with modifications to each sector and legal form entity etc as needed.

Modification will be needed to achieve policy principles 1 and 2. That is, the tax treatment of the CIV should be determined by the nature of the investment rather than the structure. Secondly, the tax outcomes for investors in the CIV should be broadly consistent with the outcomes had they invested directly.

We recommend that, in addition to the common principles identified in the terms of reference, including:

- a widely held requirement
- undertaking primarily passive investment activities
- determining tax treatment by the nature of investments and
- broadly aligning tax outcomes for investors in a CIV with the tax treatment of direct investment other than for losses

the common principles should also include clear unambiguous principles of:

- providing certainty of outcomes and
- simplicity of application and compliance.

We agree with the broad principle of the review and reform approach not to overly focus on the legal form of a CIV as driving the tax outcomes for investors, but rather to focus on the nature of the investment activities (and/or the nature of the income and gains derived) to drive the tax outcomes. We also support tax neutral treatment where the costs of compliance and other tradeoffs do not outweigh the benefits of such treatment.

We highlight also, as discussed below, that new forms of CIVs will require a custom built regulatory regime as appropriate, not simply adopting the current Corporations law regime.

This will need to be considered separately; in particular it needs to maintain separation of regulatory rules for retail investors and rules for sophisticated investors.

1.2.1 Transitional conversion rules will be necessary

We see that the creation of new more tax-efficient CIV entities will result over time in some existing CIVs wishing to convert to the new reformed entities. This process is desirable, as part of the strategic improvement of Australia's CIV tax environment.

The Board should recommend, in our view, a comprehensive transitional regime to allow for the likelihood of existing CIVs converting over time into CIVs under the new potential rules – for both taxation and regulation . The transitional regime will need at minimum optional rollovers for investors and assets in current CIVs into the new regime, as the existing array of rollovers might not be sufficient to allow the eventual transition. However we cannot see any reasons to force a change of tax regimes on an existing LIC or MIT.

1.3 A single CIV entity for Australia is not recommended

We do not support the creation of a single CIV entity to cover all investors and investor classes, as the driving force of the reforms, if this reduces the opportunities for continued use of MITs, LICs, partnerships and other funds management entities.

The fundamental legal, regulatory and commercial differences between the advantages to be sought from each CIV type dictate the need for the continuation of multiple CIV options. Even if one single form of CIV would suffice for all tax purposes, which we doubt, the non-tax regulatory issues would represent a major task. We note also that multiple choices of structures for CIVs are a feature of other jurisdictions, as identified in Appendix B of the discussion paper.

We therefore recommend retention of the MIT regime together with proposed reforms, and retention of the current LIC regime, with appropriate modifications.

We note also that the transitional issues in creation of a new CIV regime to replace existing regimes would be major. The replacement of these CIVs with a new single CIV model would create uncertainty, a new transition obligation and significant costs of compliance. A transition from existing forms of CIVs to a different form would result in major transitional tax issues, applicable to the CIV entities and their assets, and state taxes issues including stamp duties, which would reduce any potential benefit from such an initiative.

The proposed reforms to the tax regime for MITs have the potential, when implemented, to provide Australian investors with increased certainty and greater tax neutrality of outcomes. The proposed reforms will also increase the certainty of MITs, provided that various concerns raised in submissions in response to Treasury's October 2010 discussion paper can be satisfactorily addressed.

We recommend that a post-implementation review of the MIT laws and adjustment should be separately undertaken following the introduction the proposed MIT distribution tax reforms. The review should consider, for example, the practical operation of the widely held tracing rules for the capital election and MIT withholding tax law as well as the withholding tax connected with Australia requirements.

1.4 Improving tax laws relating to Listed Investment Companies (LICs)

Q 3.2 Issues / Questions

The Board seeks stakeholder comments on:

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

We recommend that the LIC regime should be retained, with adjustments including to include optional deemed capital treatment in line with the MIT capital/revenue election rules.

LICs are valuable CIV structures as they provide the ability to retain income and smooth distributions over more than one year. No tax avoidance applies, as LICs pay tax at company tax rates. In our view, this flexibility is a critical feature of LICs and should continue.

However we agree that the LIC structure does not achieve certain aims in respect of foreign investors.

However reform of the LIC rules is also needed to align the treatment of LIC capital gains with gains distributed by flow through vehicles, to allow the offset of capital losses of LIC shareholders against those gains.

In the long term, it is possible that a new corporate CIV might naturally replace LICs, if it was available to resident investors and addressed the existing tax shortcomings of this vehicle in an acceptable and simple way.

However a new corporate CIV designed to target investment by offshore investors, to address flow-through tax treatment including characterisation of gains and losses for these investors, would potentially increase complexity and associated reporting to investors. The benefits of this flow through treatment may generally not be needed by current resident LIC investors satisfied with the (adjusted) LIC rules, therefore, the current LIC integration regime (as adjusted) might continue as a CIV designed predominantly for residents.

1.5 What new forms of CIVs might be required

Q 4.1 Issues / Questions
The Board seeks stakeholder comments on: ► the appropriateness of any of the taxation models (including variants) to achieve tax neutrality for designing a corporate CIV regime that would enhance industry's ability to attract funds under management in Australia; ► the appropriateness of any of the models (including variants) to achieve tax neutrality for designing a limited partnership CIV regime that would enhance industry's ability to attract funds under management in Australia; and ► whether there are any critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes, including by rationalisation of the regimes where possible.

In our view any new tax flow-through CIVs:

- should be simple to understand, establish and operate
- should be coupled with a custom built regulatory regime as appropriate, not simply adopting the current Corporations law regime. This will need to be considered separately; in particular it needs to maintain separation of regulatory rules for retail investors and rules for sophisticated investors and should tie in with the development of the Asian passport

It is difficult to select a single taxation model for the new CIV particularly where there is a mix of assets and income (eg taxed Australian income and exempt foreign income).

The CIV regimes in Luxembourg or Ireland regimes appear at first to be attractive, but part of their success is due in our view to:

a) those regimes' focus on facilitating non-resident investors without revenue integrity concerns for resident investors;
b) the conciliatory approach of the taxation authorities in dealing with foreign funds investors; and
c) application of common rules of the UCITS Directive across the EU. As noted in the discussion paper, these rules provide cross country investors with a degree of certainty.

We note that these jurisdictions still have multiple choices of structure and some legal structures are still complex.

Australia's new CIV regimes should include these features:

- deemed CGT treatment in line with the MIT capital election
- taxable income of a transparent CIV should be attributed to investors
- income so attributed should retain its source and character
- notwithstanding the terms of reference, losses should flow through a transparent CIV, at least on a limited basis

We note that the design of dual resident and non-resident CIVs might be problematic, as it may be difficult to deal with the different tax outcomes for each in a simple manner.

We recommend that a limited partnership (LP) CIV should be introduced, discussed below.

Although a corporate CIV tax flow through vehicle should be considered, our initial view is that appropriate tax outcomes for this vehicle might be difficult to design and access to the IMR might be a better option for foreign investors, at least initially.

1.6.1 Limited partnerships law must be reformed

We submit that limited partnership (LP) CIVs should be introduced.

Q 3.3 Issues / Questions

The Board seeks stakeholder comments on:

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

In our view, Australia's limited partnership (LP) rules were a tactical revenue response to revenue concerns of the 1980s, and are a significant impediment to an efficient and attractive CIV regime. In particular, the LP rules treat LPs as companies not only when they conduct active operational business activities but also where they hold long term investment assets of the type owned by MITs. As a result the LP deemed-company rules overreach and need reform.

It is important to note that LPs are the vehicle of choice around the world for institutional investors and for sophisticated investors. They are simple, well understood, have low levels of regulation and accepted flow through tax status.

New Zealand introduced a LP tax regime in 2008. This LP regime, discussed below, provides flow through tax treatment to investors, however with restrictions relating to losses.

Australian limited partnership reform for CIVs might operate as follows:

a) The preferred approach would be to exclude a class of LPs which we call Collective Investment Vehicle LPs (CIVLPs) from the existing LP corporate treatment. This might be achieved by carving out LPs, meeting certain widely held and investment tests, from the current company tax treatment for LPs.

b) A more limited reform approach might be to create Foreign Investor Limited Partnerships' (FILP), as 'fiscally transparent' CIVs acceptable to foreign funds.

An Australian CIVLP taxed broadly in line with foreign investors' experiences in other jurisdictions should overcome many perceived barriers to understanding the treatment of investments made through Australian CIVs. The CIVLP structure should be familiar in style to non-resident investors which do not wish to understand unit trusts. It also should provide both character and source flow through taxation, potentially allowing neutral tax treatment to be achieved.

In our view LP state/federal regulation issues should not be a fundamental impediment to the introduction of a CIVLP regime (as similarly they are not, for example, for Delaware LPs in the US).

LPs will not be attractive where accumulation of income is sought. Therefore it is crucial that the current concept of a LIC be maintained.

- **Flow through of losses and deemed capital treatment**

The current Australian LP tax consequences include an inability to flow through losses, which are a major impediment to their use as an investment vehicle.

The restriction against distribution of losses restriction should be relaxed for CIVLPs notwithstanding comments to the contrary in the terms of reference.

Appropriate integrity around the use of losses might be introduced using rules such as the approaches of other jurisdictions. For example losses in UK LPs and UK LLPs can be deducted but limited to the capital contributed.

The CIVLP might be restricted to institutional and sophisticated investors under an appropriate regulatory regime. The taxation rules should not attempt to apply rules as a proxy for appropriate regulation.

The CIVLP should be able to elect to have capital treatment for tax purposes in line with other CIVs (MITs and, as proposed above, LICs and the proposed new corporate CIV).

The capital/revenue treatment of carried interest holders might be aligned with the deemed revenue treatment under the MIT capital election rules.

We reiterate the worldwide trend towards offering effective LP structures for investments and that New Zealand introduced a LP regime in 2008. The NZ LP regime provides flow through tax treatment to investors, with restrictions for the ability of a limited partner to claim a tax loss to the extent it exceeds their economic loss. NZ LPs' investments are not restricted to any particular types of investment.

1.6.2 Corporate CIV should be considered

Q 4.2 Issues / Questions

The Board seeks stakeholder comments on:

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

We agree that a new tax flow-through corporate CIV regime should also be considered.

We agree that a corporate CIV could be designed so as to appeal to foreign investors, by offering flow-through treatment or other incentives such as those offered in Ireland and Luxembourg, which also offer exemption or other incentives to provide foreign investors with outcomes not resulting in the imposition of domestic taxation. The flow through of non-Australian sourced income to a foreign investor without the imposition of Australian tax would be consistent with MIT treatment.

The corporate CIV would be designed to enable **Australian-registered funds** to offer an internationally-attractive mechanism for foreign investors to invest.

The Corporate CIV should not replace the current corporate LIC regime, but would be designed to address the specific issues raised in the discussion paper which prevent tax neutrality for foreign investors. An appropriate single regulatory regime to cover all CIVs including this corporate CIV would need to be separately developed.

- **Treatment of non-resident investors in Collective Investment Company**

There is no reason to limit access to the Corporate CIV to foreign investors only. A mixed resident/non-resident investor CIV would promote greater market efficiencies than maintaining separate resident and non-resident funds, as the regulatory costs of establishing multiple funds are significant and there is a trend for fund managers to consider consolidating their offerings into a smaller number of funds. It also allows better risk diversification and management. We note that the VCLP/ESVCLP rules contain rules dealing with mixed Australian and foreign investors.

We recognise however that a mixed resident and foreign investor Corporate CIV would be more complex than a mechanism limited only to foreign investors. Such complexity is not desirable but would be a function of maintaining taxing rights over Australian residents while achieving the benefits of larger scale of funds.

The detailed operation of a Corporate CIV should be considered in detail in a consultative manner, drawing not only on Ireland and Luxembourg experience but also on US limited liability company (LLC), Cayman Islands and other experience. That further design work will allow final decisions including whether to allow mixed resident and non-resident investors.

A key benefit of the Corporate CIV is to provide an Australian CIV for non-resident investors not understanding unit trusts. Therefore we do not recommend that the law should refer to a Corporate CIV as being deemed to be or being similar to a trust.

Investors in a Corporate CIV might be taxed on an attribution basis, potentially similar to the proposed MIT attribution rules. Attributed income should retain its source and character. We highlight that a Corporate CIV for Australia would not be attractive to foreign investors unless complete flow through taxation or attribution is achieved. That is:

- capital gains of the Corporate CIV would need to be treated in the same way as if they had been made by the foreign investors
- there should be no source or other taxation overlays which would cause the Corporate CIV to have different outcomes to those which would apply if the investor had made the investment directly.

A simple method for taxing non-residents on the Corporate CIV income may be to apply a single rate of withholding tax, similar to the approach taken for MITs, adopting a distribution model approach. Requirements to disaggregate distributions into components to also apply interest and dividend withholding tax would add complexity.

Issues will arise in a mixed resident/non-resident member Corporate CIV if income is not attributed, for example in respect of capital gains on assets that are not taxable Australian property. If these gains are taxed in the year of accumulation then in the year of distribution to a non-resident investor that investor should receive a refund of the tax paid by the Corporate CIV in order for there to be tax neutral treatment. If there are both resident and non-resident investors in the fund the allocation of these gains and the increased tracking and reporting will be problematic.

The Corporate CIV should be able to make a CGT election in line with other CIVs (MITs, proposed extension of the election to LICs and proposed LP CIV).

- **Integrity rules should not be cumbersome or inefficient**

Any resulting integrity measures must be balanced between the desire to improve the international investment use of Australia and its funds management expertise and the benefits sought with concerns of Australian resident tax treatment. Integrity measures are a constraint/deterrent on any measure due to the uncertainty and costs of compliance they create. Rather the rules must be functional, simple to understand and straight forward to apply.

In our view, any integrity rules should be focused on the Australian investor and not on the fund. The MIT rules are constrained by their complex integrity rules which continue to cause uncertainty, for example in respect of the qualification of foreign equivalent CIVs, and such issues should be sought to be avoided.

The Corporate CIV structure should allow the use of:

- multiple class structures
- multi-currency structures

without complex integrity rules or other restrictions/compliance impediments.

These are allowed for example in Luxembourg (eg using a Protected Cell Company) and introduce potential significant advantages of marketing flexible and efficient funds.

The tax treatment of foreign investors in their home jurisdiction must also be considered.

Alternative home jurisdiction structures and structuring investments through other countries may result in low or no tax in some circumstances (including for tax exempt pension funds).

As noted in the discussion paper, some other jurisdictions offer tax incentives and/or exemptions in order to help attract foreign investors, including Luxembourg and Ireland.

Foreign tax authorities would need to satisfy themselves as to the flow through nature of the Australian CIV vehicle, including the extent that credits for tax paid will be allowed. The Australian Treasury might seek to confirm this including potentially through tax treaties (noting the difficulties outlined in the discussion paper) and the Australian Taxation Office might also be asked to seek confirmation from foreign tax authorities.

- **Introduction of IMR pending development of Corporate CIV**

Given the issues outlined above including taxation of unattributed income and dealing with non-resident and resident investment, the development of a Corporate CIV might require a further design process.

We recommend therefore that the introduction of an IMR should be a first step, applicable to dependent and independent agents. This could attract investment management activity, in a way which is acceptable to foreign investors, and which develops Australia's international reputation for international funds management.

1.7 Widely held definition should be improved

Q 2.2 Issues / Questions

The Board seeks stakeholder comments on:

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

We recommend that the widely held rules that would apply for a broader range of CIV structures should be improved as compared with the widely held definition provisions in the MIT rules. The widely held test should also be standardised for all CIVs.

In particular, the current MIT rules' tracing tests should be improved as they are currently constrained to tracing through trusts and tracing strict legal ownership (requiring the proving of beneficial ownership). The widely held rules must allow for ownership of CIVs by other widely held CIVs, whether controlled or not, including to allow foreign "fund of funds" access to the CIV regimes. The tests must allow for:

a) the different foreign structures used for investment, for example to allow tracing through foreign limited partnerships, limited liability partnerships and foreign limited liability companies to their underlying investors, where this information is available

b) tracing through foreign custodians and foreign entities in multiple jurisdictions and allow reasonable approaches to testing to be taken.

The rules should also avoid/modify the problematic to comply with 10% foreign individual rule in the MIT rules.

1.8 Passive income (eligible investment business income) requirements

Q 2.2 Issues / Questions

The Board seeks stakeholder comments on:

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

We highlight that other countries allow CIV-type entities such as limited partnerships to invest in a broad range of business activities. In our view this is a strong reason for Australian practice to align to that of other leading countries' tax practices.

Even if Australia's CIVs were to be restricted so that tax transparent entities did not directly undertake trading business activities such as the conduct of a mine or manufacturing process, the current eligible investment income (EIB) based on concepts in the Division 6C public trading trust rules must be adjusted and modernised.

As set out in earlier submissions, the Division 6C EIB rules operate inconsistently with the policy setting of Australia's dividend imputation system, they are complex and the rules impede Australian funds' participation in infrastructure investment and global investment.

In particular the EIB definition should be adjusted to permit a broader range of investments. Ernst & Young has previously submitted to Treasury and the Board the required modifications including:

a) allowing broader property, infrastructure and similar investments in the EIB rules

b) the control rule should not apply to controlled companies, and

c) affected entities should be allowed to rectify inadvertent breaches of the rules

We make further comments in the segment relating to the IMR rules.

1.8.1 Australian Companies controlled by CIVs should be permitted

As stated in our previous submission to the Board in respect of the MIT review, as a matter of taxation policy we see no reason why ineligible activities could not be conducted in a controlled subsidiary company that is taxed at 30%. This structure meets the objectives of Division 6C as well as the design of new CIVs (and an IMR) to apply the company tax system to non-passive activities.

If a control test is to be retained in respect of trusts or CIVs controlling Australian companies, then the rule must apply to Australian controlled companies only and not to foreign companies: that is, it should have a "water's edge" limit . Control of foreign entities that may carry on activities considered to be trading should not cause an Australian trust or CIV to become a trading trust, or an entity to become ineligible for CIV treatment or a foreign fund or investor to fall outside of the IMR.

For an Australian trust to monitor whether an underlying entity owning rental property overseas is carrying on any activities which could constitute trading is unrealistic. The 2008 amendments to "rent" in this regard (made by Tax Laws Amendment (2008 Measures No.5) Act 2008) do not address this issue.

1.8.2 Rectifying inadvertent short term breaches

The consequences of a breach of the EIB rules is inequitable and inefficient, particularly if the breach might occur for a short time and might be rectified. Notwithstanding the 2008 amendments the risk of the rules applying following an inadvertent breach of allowed activities remains a real risk for funds.

In our view, if a breach of a CIV/IMR/unit trust's permissible range of investment activities is identified by the entity or the Commissioner, the entity should not be treated as a "trading trust" provided that:

- the breach is due to inadvertence rather than deliberate or reckless disregard of the relevant rules; and
- the relevant entity takes steps to rectify the breach as soon as practical once the breach is identified.

We recommend that the exclusion in the MIT capital election which allows for rectification if the public trading trust rule is breached (Section 275-110(2) of the Income Tax Assessment Act 1997) should therefore also be adopted for the LP CIV and Corporate CIV rules.

1.9 Terminology should not use the terms 'passive' or 'portfolio'

There are two descriptions of investments in the discussion paper which might cause confusion, and which might be retitled. The intentions of the Board appear clear to us but the Board's recommendations and their potential implementation in law will involve many people, and we want to eliminate any uncertainty.

In particular:

a) the discussion paper refers to 'passive investments. This refers to investments which do not represent the active undertaking of business activities, that is they do not involve the active conduct of a business of farming or mining or production facility. However the term 'passive investment' is often used in the investment sector to describe a 'set and forget' long term holding of the index or selected companies as distinct from 'active investment' which involves a greater frequency of trades – see for example the discussion at this link.

   We suggest that the references to passive investment might be retitled as 'property and financial assets' or similar.

b) the discussion paper refers to 'portfolio investment.' This is used, we suggest, to refer to minority investments such as investments on stock markets, as distinct from investments in controlled entities such as a company wholly owned by a private equity investor or a managed fund. However, the term ‘non-portfolio dividends’ referred to in sections 23AJ and 317 of the Income Tax Assessment Act 1936 is used to refer to dividends on holdings of 10% or more in an investee entity, with the implication that for section 23AJ a portfolio dividend requires a less than 10% holding. To avoid confusion about the policy settings in relation to MITs, CIVs and IMR, it might be useful to add a footnote to distinguish the terminology from the 10% threshold in s.23AJ, or to adjust the references to ‘investments in a portfolio.’

2. Investment manager regime (IMR)

The AFCF Johnson Report recommendation 3.1 was for an IMR to comprise:

- for non-resident investors using an independent resident investment adviser, fund manager, broker, exchange or agent
  - investments in foreign assets to be subject to conduit relief, that is, freed from any Australian tax impost, and
  - investments in Australian assets would be treated as if the investment had been made directly without the use of any Australian intermediary;
- for non-resident investors using a dependent intermediary acting at arm's length
  - investments in foreign assets to be subject to conduit relief
  - investments in Australian assets subject to a de minimis exemption for global investment strategies, to be treated as if the investment had been made directly without the use of any Australian intermediary
  - for other investments in Australian investments, current taxation treatment
- changes to the central management and control test so that a foreign entity covered by the IMR is not considered an Australian tax resident solely because central management and control is in Australia. Aspects of this recommendation are covered by the January 2011 announcement by Assistant Treasurer Bill Shorten.

2.1 Overview

Ernst & Young supports the IMR recommendations made by the AFCF, and implementation of the IMR in a wide-ranging manner to ensure that any Australian IMR is internationally competitive.

We broadly agree with the AFCF, Treasury and Board's assessment of the broad income tax issues impacting non-resident investment using Australian fund managers and the need for a legislative IMR solution. We attach as an Appendix our June 2010 response to the Treasury May 2010 discussion paper "Developing an Investment Manager Regime: Improving conduit income arrangements for managed funds" (the Treasury conduit income paper).

However in our view the AFCF Johnson Report recommendations do not go far enough and should be extended in respect of their application to the treatment of Australian assets dealt with through dependent agents.

2.1.1 Prioritising the IMR reform

As noted earlier, the Board's review of IMR rules and government implementation must be prioritised, to interact with the Assistant Treasurer's announcement of 19 January 2011 concerning amendments for certain foreign funds with an Australian permanent establishment, and also the announcement of 17 December 2010 concerning an amnesty in respect of 2010 and earlier years for certain foreign funds. These involve terms such as what is a "foreign fund" and the scope of the investments to which they apply.

We submit that a design principle of an Australian IMR is to benchmark it against other leading IMR/investment manager exemption (IME) regimes, including those in Singapore and the UK, to ensure it can attract offshore funds under management. An Australian IMR regime which is not internationally competitive would not achieve the objectives of the government in considering the Johnson report of the AFCF.

The developed countries are, in a united manner, forcing disclosure requirements onto foreign investment funds, with global trends to Exchange of Information treaties and the US FATCA increased disclosure requirements. The time of the offshore tax haven like Cayman Islands as a location for collective investment vehicles is passing. So, globally, funds managers are considering the best location for their collective investment vehicles, locations which have strong financial centres, strong tax treaty networks and support activities.

That could put Australia into a strong position if we had an IME regime like that of the UK or Singapore or other countries.

2.2 Application

The IMR should have a broad application and be designed to apply in a straightforward manner, be easy to understand and simple to implement and comply with, recognising that it will be studied by global funds managers and, in future, by investors looking to invest through Australia. Thus excessive complexity is not desirable.

The IMR should, in accordance with the recommendations of the AFCF Johnson report, apply widely to:

- foreign investors in Australian funds as well as foreign funds;
- foreign funds using any commonly used legal structure;
- all genuine foreign collective investment vehicles, including both retail and wholesale funds, not just widely held funds;
- the use of Australian fund management entities as well as to other Australian intermediaries, including an investment adviser, broker or agent;
- foreign investment in a wide range of transactions and foreign assets (conduit relief); and
- Australian investment through independent and dependent agents (neutral treatment)

We submit that care should be taken to avoid creating multiple eligibility restrictions on funds and other foreign investors. Eligibility restrictions will be problematic to comply with, will likely lead to material costs of compliance and uncertainty which will detract from the measures and should therefore be limited. That includes restrictions in respect of:

- widely held rules
- managed in Australia requirements
- reporting by foreign funds and investors
- passive, typically portfolio investment constraints

- conditions based around not conducting nor controlling a Division 6C type trading business in Australia
- limitations of extent that Australians can be investors in foreign funds including proposals for reporting to the ATO.

The eligibility restrictions should not exceed the restrictions operative in other leading financial centre countries such as Singapore and the UK. Otherwise Australia's IMR will be uncompetitive.

We recommend, as noted above, that the treatment of Australian investment through dependent agents should be expanded beyond the recommendations of the AFCF. In particular, the IMR and conduit income rules should also apply to local and international banks and other financial institutions in respect of managing their own offshore funds and not just the funds of other investors.

2.3 IMR treatment for investments using a dependent intermediary

We recommend that neutral treatment for the taxation of investments in Australian assets should apply to non-resident investors using a dependent intermediary acting at arm's length in the same manner that the AFCF recommended for non-resident investors using an independent resident investment intermediary.

Foreign financial institutions and foreign CIVs will be more attracted to an Australian regime that allows them to manage their own investments in non-Australian assets as well as their Australian assets in the same entity, without the risk of Australian taxation on their investment gains on an Australian PE or residency basis. This is driven by a desire to add scale to their Australian operations, to help justify the cost of setting up new operations in Australia and to retain existing operations in Australia.

In our view, similar economic benefits to Australia and the Australian asset management and financial services industry should arise whether offshore investment is managed by independent Australian fund managers or if they are managed by dependent funds managers of those offshore investors, provided an appropriate amount for these funds management services is taxed in Australia.

We submit that such a proposal would not create revenue costs or integrity risks. The reason is that, currently, foreign banks limit the activities of their Australian subsidiaries to purely domestic business and tend not to conduct international funds management activities, including in respect of their own funds, from Australia. Foreign banks have significant investment pools available to them and we submit it would be in Australia's interest to have Sydney, Melbourne and other cities being able to operate as bases for the management of the longer term investment of such foreign banks.

2.4 Design of the law

Q5.1 Issues / Questions (design of foreign funds IMR)

The Board seeks stakeholder comments on:

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

We recommend that an exemption approach to provide conduit relief in respect of certain foreign assets should be adopted.

Such an approach:

- would be simpler than amending each problematic area of the tax law, which would involve complex amendments to deal with technical issues including source, PE and capital/revenue issues
- would be more familiar to non-resident investors as exemption systems are used in other jurisdictions, which should assist marketing to non-residents, which is the objective of the IMR
- should be aligned to the approaches taken in the UK; and Singapore.

To deliver an attractive regime we recommend that the drafting should:

- avoid too many investment limitations – this would create difficulties in complying with the law, leading to increased costs of compliance and uncertainty
- limit the number of testing times – this would over complicate eligibility testing, leading to increased costs of compliance and uncertainty
- provide some flexibility for changes in circumstances of the relevant funds. In particular it should allow for IMR funds' start up and wind down phases, without endangering their qualification for IMR treatment, so as not to create impediments for the potential range of foreign funds that would use the regime

2.5 Taxation of Australian intermediaries of foreign managed funds

Q 5.2 Issues / Questions

The Board seeks stakeholder comments on:

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

We recommend that the Australian intermediaries of foreign managed funds for these purposes should not be restricted to any narrow category of approved service providers.

The conduit rules should benefit the Australian asset management industry generally and should apply to any genuine Australian asset management intermediaries.

A simple "commercial management fee" rule should tax Australian intermediaries including fund managers only on their arm's length fees for investment management services conducted on behalf of foreign funds and other foreign investors. These fees are typically calculated as a percentage of assets under management, or on a fee for services rendered basis (ie calculated on the amount of time spent managing the investments) or as otherwise negotiated between the parties, in accordance with accepted industry practice.

The rule may require that the Australian intermediary funds manager receive remuneration for provision of the services at not less than the rate that is customary for such business, determined on arm's length principles under the guidance of the Australian and OECD Transfer Pricing Guidelines.

2.6 Foreign managed funds

Q 5.3 Issues / Questions

The Board seeks stakeholder comments on:

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

2.6.1 Widely held requirements are not appropriate

We recommend that the IMR should apply to:

- foreign investors in Australian funds as well as foreign funds
- foreign funds using any commonly used legal structure
- all genuine foreign collective investment vehicles not just to any limited concept of "widely held" funds

In our view, this would be in compliance with the AFCF recommendations that "The IMR would have wide application, to both retail and wholesale funds and to other areas of financial services beyond funds management, but would be confined to entities operating within the financial sector" (recommendation 3.1 page 59).

A widely held restriction, including any MIT type approach to determining what is widely held, would be complex, would restrict access to the Australian IMR and create uncertainty. Such a restriction was not recommended by the AFCF and should be avoided. The terms of reference are too narrow in this regard.

This approach also gives rise to further issues when applied to funds that are operated through non-trust structures, in attempting to trace their ultimate ownership, noting the acceptance at paragraph 5.85 of the discussion paper that the IMR should not be restricted by legal structure.

In our view, a widely held test imposes an artificial constraint on the potential for success of the IMR reforms. If any ownership restriction is to apply it should at the most restrict access of funds representing a narrow group of individuals and their associates. However that being said we do not believe any such restriction should be included. We do not see the justification for excluding the wealth of foreign private investors and of their families pooled through closely held vehicles from the IMR conduit income measure.

Similar to our comments in respect of a widely held test for CIVs, any tracing tests must not be restricted to tracing through trusts and tracing strict legal ownership (proving beneficial ownership). The tests must recognise the different foreign structures used for investment, for example to allow tracing through foreign limited partnerships, foreign limited liability companies, foreign custodians, trustees and foreign corporate bodies in multiple jurisdictions.

2.6.2 Managed in Australia requirements

We recommend against any requirement that links access to the IMR to a formal 'managed in Australia' requirement. Nor are we attracted to a minimum spend requirement.

Over time many foreign funds using the IMR might actually be managed in Australia, and would incur significant funds management expenditure in Australia. But it is clearly undesirable to have mandatory management in Australia or minimum spends.

In our view, the policy underpinning of an IMR is to attract funds management and intermediary activity to Australia, in relation to existing foreign funds as well as new foreign funds, in circumstances where there is currently no intermediary activity in Australia. As a result we cannot see the benefit in restricting eligibility for the IMR to apply.

Further, any such rules would create risks of failure of the conditions, resulting in denial of exemption for investors and adverse consequences for funds and Australian funds managers or intermediaries. This risk of failure of restrictions and resulting failure of investors' IMR exemption would defeat the objective of the IMR unless the eligibility rules had remediation rules and special rules for start-up and wind-down phases, all of which would add complexity to the law.

Minimum dollar spend rules would result in ATO compliance activities and controversies, especially in relation to Australian intermediaries performing multiple functions, creating continuing risks.

The ATO would be unlikely to be able to rule on the application of this test before an investment is made and such a requirement for ATO sign off would place foreign funds and investors in a similar position as they are now in dealing with Australia's taxation rules, with uncertainty and costs of compliance which they would be unlikely to be prepared to incur.

Therefore, such rules are unwarranted and would impede the potential success of the IMR.

We highlight for the Board that, in our experience, the 'Australian connection' integrity rule in the MIT withholding rules is seen by potential foreign investors as a complex barrier to engaging with Australian MITs.

2.6.3 Reporting

We recommend that there should be minimal reporting requirements on foreign funds and investors, required only on an annual basis.

We recommend that eligibility for the IMR should be self assessed. Entities entitled to use the IMR should be required to maintain records on this basis to prove their eligibility.

Further, such eligibility should be determined on a reasonable basis, for example determining their widely held status (if required) after making reasonable enquiries as to their ultimate foreign ownership.

2.7 Investment requirements

Q 5.4 Issues / Questions (portfolio, passive investments)
The Board seeks stakeholder comments on: ▸ the range of investments that could be covered by an IMR; ▸ whether other activities of a non-resident would affect their access to the IMR; and ▸ whether an IMR could also cover non-portfolio interests in non-Australian assets?

We recommend that the IMR conduit income rules should apply to a broadly defined definition of eligible foreign assets and income. Such a wide definition is in accordance with the AFCF recommendation that "investments in all foreign assets would be exempt from any tax liabilities in Australia" for both independent and independent intermediary cases (recommendation 3.1 page 59-60).

We emphasise that, in order to be competitive globally, Australia should consider establishing a similar wide ranging IMR to those of Singapore and the United Kingdom (UK), which include the full range of investment products. Otherwise the Australian initiative will not be competitive in attracting foreign investment management activities.

Further, restrictions on eligible portfolio investments will be difficult for foreign funds/investors to comply with. Such constraints add costs of compliance and uncertainty, detracting from the regime.

Foreign funds operating through an IMR should not be subject to the narrow eligible investment business concepts of the Division 6C ITAA 1936 public trading trust rules and the restrictions on eligible assets and income. We see no policy reason for the EIB assets rules to apply to foreign assets of a foreign fund entitled to the IMR conduit income or Australian assets neutrality regimes.

The IMR conduit income rules should be drafted to include for example swaps and other derivatives rather than being limited to foreign securities. The rules should allow for the development of the services offered and types of investments made over time.

- **Singapore equivalent**

The Singapore IMR, generally considered to be the IMR with the widest operation, allows IMR treatment for specified income from eligible (designated) investments being investments in structured products, units in business trusts, emission derivatives, stocks and shares of unlisted companies, liquidation claims, and qualifying Islamic investments.

The Singapore IMR list of specified income includes:

- income realized in other forms (other than through sale) from designated investments, such as holding to maturity, redemption, or any other forms of realization where the realization leads to a transfer of both economic and legal ownership of the designated investment concerned
- other income directly attributable to Qualifying Debt Securities ("QDS") as may be prescribed by regulations, for QDS issued on or after a prescribed date
- amounts payable on any Islamic debt securities which are QDS issued on or after 22 January 2009

Singapore excludes only a small number of assets from their IMR concession, where the assets relate to real property in Singapore. As well, the tax concessions are not available in respect of investments in shares of private companies that are mainly in the business of trading or holding of Singapore immovable properties. However, investments in private companies engaged in the business of developing properties are not covered under this exclusion.

- UK equivalent

The UK IMR regime covers eligible investment transactions being transactions relating to:

- shares, stock or units in a collective investment scheme,
- warrants, futures (including forward) contracts, options contracts, interest rate swaps, equity swaps, currency swaps, commodity swaps and commodity index swaps, credit default swaps, whether settled physically or by cash, and other contracts for difference,
- securities of any other description,
- debt and debt instruments or a transaction related to such debt,
- foreign currency,
- carbon emission trading products.

Specific exclusions from the UK definition of investment transactions include:

- transactions in futures and options or contracts for differences relating to land except where the option, future or contract for differences uses a land index, provided the index is publicly accessible, comprised of a significant number of properties and not maintained by the non-resident, the investment manager or persons connected with the non-resident or the investment manager
- contracts of insurance
- transactions in physical commodities including warrants which give the holder title to the commodity. However, futures and options contracts which provide for physical delivery qualify provided physical delivery does not occur.

2.8 Residency issues

Q 5.5 Issues / Questions The Board seeks stakeholder comments on: ▸ recognising the need to maintain the integrity of the tax system, how could Australia's residence rules be amended such that the rules are appropriately targeted only to foreign managed funds under an IMR?

We recommend that changes to ensure that a foreign managed fund is not inappropriately taxed in Australia as a resident where central management and control may be in Australia, should be linked to an entity's eligibility otherwise for the IMR.

2.9 Integrity concerns

Q 5.6 Issues / Questions The Board seeks stakeholder comments on: ▸ the required and appropriate integrity measures to deal with round tripping; ▸ where are the integrity risks for round tripping greatest (in terms of investor types and income types)? To what extent are these risks constrained by limiting the exemption to widely held foreign funds; ▸ to what extent are the integrity risks systemic in the sense that integrity issues from limited offshore information apply across a range of tax measures, and to non-disclosure issues generally; and ▸ should there be a de minimis test to allow a degree of ultimate Australian ownership for a foreign managed fund in the IMR regime? If so, what would be an appropriate percentage for the de minimis test?

We recommend that any revenue integrity measures should be targeted at the underlying Australian investors, rather than at the foreign fund.

We do not support complex anti-round tripping rules which require foreign funds to report information in respect of Australian resident investors or to trace all ownership by Australian residents. Such rules would unnecessarily discourage the use of the regime by foreign funds.

Any integrity rules relating to foreign funds which might have Australian resident investors should contain a significant Australian resident ownership de minimis test.

As mentioned, we submit that any revenue integrity measures should be targeted at the underlying Australian investors, rather than at the foreign fund.

We note that there are no anti-round tripping integrity rules in the UK IME. However UK resident investors will be subject to the offshore fund regime in respect of the foreign funds.

Although the Singapore pre-2007 year IMR scheme includes a 20% Singapore resident ownership rule, as noted in the discussion paper, we note that the current "enhanced tier scheme" does not include any residency restrictions. Amendments in 2007 also introduced a revised IMR scheme which replaced the 20% rule with an exclusion in respect of an investor only where 30% or more of a fund with less than 10 investors is owned by that investor together with associates or where 50% or more of a fund with 10 or more investors is owned by the investor together with associates.

We agree that the Singapore and Hong Kong approach, to allow a percentage limit of resident investment, may be an acceptable approach.

In our view, only significant resident ownership stakes in foreign funds should be targeted. In relation to the perceived cost to revenue concerns, if Australian residents invest in foreign funds that in turn access the IMR and do not distribute income, we note that Australian residents can obtain exemptions now on the taxation of income of foreign funds where they do not control the fund, following the repeal of the foreign investment fund (FIF) rules and under the proposed foreign accumulation fund (FAF) replacement rules. As noted in the discussion paper, law changes may be required to ensure residents are taxed on the foreign fund income in respect of Australian sourced income/gains when it is received. Such an approach may be complex and difficult to administer.

We therefore recommend that at a de minimis test based on significant Australian resident ownership in a foreign fund should be adopted. We recommend that the rule should apply to disallow IMR status only where an Australian resident investor together with associates owns 20% or more interests in the foreign fund.

The foreign fund would therefore need to determine that at least 80% of ownership interests are held by non-Australian residents. An Australian-investor cap of less than 20% raises concerns of potential additional costs of compliance (and practical issues with proving ultimate ownership), reducing the potential attraction of the regime.

2.10 Access to the IMR by other entities

Q 5.8 Issues / Questions

The Board seeks stakeholder comments on:

- what financial services sector entities apart from foreign managed funds would it be appropriate to encompass within the scope of an IMR as described above? Are there any other types of financial services entities which should be taken into account in addition to those identified above;

We recommend that the IMR and conduit income rules should also apply to local and international banks and other financial institutions in respect of managing their own offshore funds and not just the funds of other investors.

In our view, this would be in line with the views of the AFCF that the IMR should be wide enough to cover 'in-house' arrangements and so ensure that 'in-house' financial intermediaries of either foreign or Australian resident financial services companies should not be discouraged from operating in Australia as a result of the tax scope and uncertainty issues.

The AFCF stated that one of the potential benefits of the IMR will be to make it a lot easier for such companies to use Australia as a regional base from which to manage offshore assets.

The objective of the regime should be to encourage the delivery of financial services in Australia for the management of non-Australian funds for a broad range of entities. Australian located banks and financial institutions with non-resident branches should therefore also be able to locate their regional headquarters in Australia and not find that their activities in respect of non-Australian funds of those branches causes the branch's income to become Australian sourced.

3. VCLPs and ESVCLPs

Q 6.1 Issues / Questions

The Board seeks stakeholders comments on:

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

In our view, the apparent limited take up of the VCLP and ESVCLP regimes noted in the discussion paper is a function of the narrow targeting of eligible use of the regimes and the many complex elements of the rules.

The limited take-up therefore appears to be a function of a combination of:

- the restrictions on types of permitted activities of the investee entity
- restrictions on contributions of committed capital
- the monetary caps on the level of investment

There has also been uncertainty in relation to the treatment of investments in VCLPs by certain investors which would otherwise have deemed capital treatment, including superannuation funds and MITs. Recent ATO guidance concerning superannuation fund investment may assist in this regard.

The attraction of the regimes includes exemptions for foreign investors' gains and the capital account treatment for carried interest holders. However the VCLP/ESVCLP does not receive deemed capital treatment for its assets which creates uncertainty for other investors.

The permitted activities restrictions and uncertainty of capital treatment have resulted in the use of stapled structures in conjunction with the VCLP in some arrangements, including the use of MITs, with corresponding complexity and increased costs of compliance.

We recommend that measures to consider to expand the use of the regime would therefore include:

- expanding the types of permitted activities;

- raising the caps on investment; and
- extending optional deemed capital account treatment to these entities.

- **Possible eventual trend to CIVLP or IMR**

Over time the introduction of a CIVLP with loss flow through, or an internationally attractive IMR, might attract managers of venture capital funds to those structures instead of VCLP and ESVCLP structures.

For that reason, the Board report should recommend that the CIVLP and IMR rules should allow for a rollover mechanism to enable VCLP and ESVCLP funds to potentially convert their status to more modern Australian CIV structures.

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Developing an Investment Manager Regime (IMR)
Conduit Income Discussion Paper

Dear Mr Potts

Ernst & Young welcomes the opportunity to comment on the Treasury discussion paper "Developing an Investment Manager Regime: Improving conduit income arrangements for managed funds" (the discussion paper) released for comment on 11 May 2010.

We welcome the Government's acceptance in principle of the Australian Financial Centre Forum ("the Forum") recommendation for Australia to establish an Investment Manager Regime (IMR) with wide application to both retail and wholesale funds in the financial sector. This proposal should be regarded as a key future milestone in terms of the establishing Australia as a regional financial hub. As noted in the Forum report, to date the Australian financial services industry has been inwardly focused to a large extent and has not kept pace with the rest of the world in the internationalisation of its markets. This is an opportunity to stimulate the Australian funds management industry and utilise the established skills of the industry, enhancing Australia's growth and employment opportunities.

Ernst & Young supports the wide ranging IMR recommendations made by the Forum and we encourage the full implementation of the measures to ensure that any Australian IMR is internationally competitive. We note that the Australia's Future Tax System review also recommended that improvements should be made to provide greater certainty that conduit income will not be subject to Australian tax (recommendation 35).

We understand from the discussion paper that the consultation approach contemplates that conduit income rules could be introduced earlier than a complete IMR. In other words the plan is for a two-stage approach with the conduit policy development occurring before the IMR.

We appreciate that this approach is intended to allow the early start to some of the Forum's recommendations, which is welcome. However in our view, a piecemeal approach carries a risk of less than optimal policy outcomes. It is also likely to result in the implementation of the Forum's full recommendations being delayed too long into the future, limiting the potential benefits of the IMR.

We submit that the timetable for the implementation of a broad ranging IMR should be accelerated, because that measure, attracting foreign investable funds to be managed by Australian funds managers, will provide the substantial payoff for Australia's economy and financial services sector. This is the key policy driver. Therefore we recommend that the conduit income review should not delay the accelerated development of a complete IMR package by the Board of Taxation.

A standalone IMR may not achieve the policy objectives unless Australia pursues the policy changes speedily. If this is treated as an extended multi-year process, the likely result will be a decrease in inbound conduit investment as competitor countries with established IMRs increase their market share. Treasury and the Government will be aware of vigorous competition from Asian countries to capture international funds management business, to drive the economic development of particular cities and countries.

At a more basic level there is a significant disadvantage for Australia's funds management sector because foreign investors with no Australian presence are exposed to an Australian tax risk that they need to evaluate and quantify in the preparation of their foreign financial statements. This has created a huge disincentive against Australian investment opportunities.

We recommend that the Board of Taxation should examine the IMR and incorporate the input from Treasury's conduit income consultation. We recommend an ambitious timetable for the Board's review, to allow the conduit income rules to be introduced with the broader IMR rather than as two sets of changes.

We understand that submissions have previously been made to Treasury and the Forum outlining the need for an IMR and the underlying technical challenges with the taxation of conduit income which result from the Australian system of taxation by residence and source. We understand that the purpose of the discussion paper is to validate the issues and to seek input on the design of the conduit income rules.

In this submission we recommend:

- the conduit income review should be undertaken in conjunction with the accelerated development of a complete IMR package including implementation of the Forum's full Recommendation 3.1
- the IMR conduit income rules should apply to the full spectrum of investment vehicles including wholesale funds such as hedge funds and private equity funds as well as retail funds
- the IMR rules should also apply to the foreign branch activities of Australian and international banks and financial institutions with operations in Australia
- the conduit income rules should be implemented as a broad exemption for income and gains derived from eligible financial instruments
- the list of eligible financial instruments should be widely defined to include investments other than taxable Australian real property and allow for expansion in response to the development of services offered and types of investments made over time. The list of included and excluded instruments used in the Singapore and UK IMRs should be considered as a starting point for developing Australia's list of eligible financial instruments
- only the Australian sourced fees paid to the Australian intermediary should be taxed in Australia, subject only to integrity rules based on arm's length principles
- the IMR conduit income rules should operate to ensure that a foreign entity (foreign fund or investor) will not be considered to have a permanent establishment in Australia merely because it engages an investment manager located in Australia
- the IMR should be drafted broadly to ensure that even if a foreign entity has an Australian permanent establishment, it should not be taxed on its foreign sourced investment income
- the rules should be drafted broadly so that income and gains from the disposal of eligible financial instruments are not taxable in Australia without reference to characterisation as capital or revenue
- the conduit income proposals should include changes to the residency test for CLPs to include a central management and control requirement, aligned with the company residency test.

Our detailed submission is attached.

Should you have any questions or would like to discuss our submission further please do not hesitate to contact in the first instance Antoinette Elias on (02) 8295 6251, Dale Judd on (03) 9655 2769, Ian Scott on (02) 9248 4774, Peter Janetzki on (03) 8650 7525 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Partner

cc. Mr Chris Bowen, Minister for Financial Services
Senator Nick Sherry, Assistant Treasurer
Mr. Wayne Swan, Treasurer

Ernst & Young response to 'Developing an Investment Manager Regime (IMR) - Conduit Income Discussion Paper'

Detailed discussion

Development of the IMR should be accelerated

The apparent plan to defer consideration of integral aspects of the broader framework for the IMR and consider this as part of the Board of Taxation review of Collective Investment Vehicles (CIVs) is problematic, in our view.

In our view, the plan raises a significant risk that the IMR considerations will receive limited attention as part of the Board's broader CIV review.

We note that the terms of reference and timing of the Board CIV Review have not yet been released. It may take several years for the processes to be completed and recommendations implemented. We are therefore concerned that this delay will cause the Australian fund management market for foreign funds to remain comparatively small on a global investment scale.

In addition, until the full IMR is developed, uncertainty will continue for foreign investors using Australian funds management service providers. The tax uncertainty caused by Australia's income sourcing rules is already having an increasingly adverse impact upon foreign investor attitudes and enthusiasm for Australian investment opportunities.

Undesirable impacts for foreign funds arise for example as a result of the need to report uncertain tax positions under relevant accounting standards, including in particular in the United States in accordance with the FIN48 standard.

The result is that international investors are bypassing Australia as a location for management of their international investments, using instead a number of Asian locations and leading to development of those countries' financial services sectors and enhancing their critical mass.

The establishment of a broad ranging and globally competitive IMR is an opportunity to revitalise the concept of Australia as a Financial Services hub.

Australia's total funds under management are dominated by domestic investment, primarily from superannuation funds, and the proportion of international investment accounts for just 3.5% to 11% according to the Forum's findings. In the modern financial environment, financial services are highly mobile and therefore, to attract international investment and increase the size of Australia's funds management industry, a best practice IMR is essential to make Australia internationally competitive as a location to establish a regional base for the management of offshore assets.

Several countries already have sophisticated and highly attractive legal and regulatory IMR frameworks that support foreign investment. Australia should look to the features of the most successful and long established IMRs already in operation such as Singapore and the UK for guidance on the appropriate structure and features.

As identified by the ASFC, these countries have a much higher ratio of foreign funds compared to domestic funds under management than Australia, 31% in the UK and 80% in Singapore. Given the existing concessional regime in Singapore which is clearly attractive to foreign investment has been in existence since 1980, Australia needs to adopt an IMR with a broad scope of application and accessible provisions to be truly competitive and attract foreign investment within the Asia-Pacific region to be managed by Australian funds managers.

We emphasise that, because the IMR is a well-known concept, the implementation does not pose the same risks as an untried or novel tax measure which no other country has adopted.

Recommendation:
We recommend that the conduit income review should be undertaken in conjunction with the accelerated development of a complete IMR package by the Board of Taxation including implementation of the Forum's Recommendation 3.1.

Source

Transactions, structures and activities commonly undertaken

Consistent with the findings of the Forum, the type of transactions and foreign assets to be covered by the IMR conduit income rules should be wide and inclusive.

The IMR should apply to the full spectrum of investment vehicles including wholesale funds such as hedge funds and private equity funds, as well as retail funds.

The IMR conduit income rules should apply to a widely defined definition of eligible assets and income. For instance, the IMR conduit income rules should be drafted to include swaps and other derivatives rather than being limited to foreign securities. The rules should allow for the development of the services offered and types of investments made over time.

The IMR reforms should also introduce exemptions for investments in Australian assets in certain circumstances – consistent with the Forum's recommendation 3.1.

Taxation of remuneration of Australian intermediaries

Australian intermediary funds managers are paid a fee for the investment management services conducted on behalf of foreign funds and other foreign investors. The fee is typically calculated as a percentage of assets under management, or on a fee for services rendered basis (ie calculated on the amount of time spent managing the investments) or is otherwise negotiated between the parties, in accordance with accepted industry practice.

We would expect that the fees charged are negotiated between the parties and that they are an arm's length amount. However we appreciate that there will be integrity concerns where the parties are related to ensure that an arm's length fee is charged.

The remuneration of the Australian intermediary funds managers is the fee paid. The income from and the increase in the value of the investments made is that of the foreign fund and other investors and this is paid to them.

It is therefore appropriate that it is only the Australian sourced fees paid to the intermediary that should be taxed in Australia.

It would defeat the purpose of the IMR conduit income rules if Australia sought to tax an amount of the return to the foreign investors where no part of that amount is paid to the Australian intermediary funds managers in respect of their services.

In order to ensure that this management fee revenue is received in Australia, the IMR may require that the Australian investment manager receive remuneration for provision of the services at not less than the rate that is customary for such business (a "commercial management fee" requirement). Similar to the UK IMR, this commercial management fee may be most appropriately determined on arm's length principles under the guidance of the OECD Transfer Pricing Guidelines.

Areas of Uncertainty

- *IMR source taxation reforms do not require a review of all source rules*

We agree that there is no clear guidance in Australia's tax law as to the source of income from the sale of securities.

The common law source of business profits is determined based on a range of factors. It is generally considered that where the essence of the business is the making of contracts, the source of the profits is usually the place where the contracts are made; or otherwise the place where the contract is performed is usually paramount. The nature of international financial services business may make is difficult to determine where any contract is made. There is therefore uncertainty how the concepts of source applies where the services of Australian investment managers are used in a variety of circumstances to derive trading gains on both Australian and non-Australian investments. This uncertainty may leave open views that such income is sourced in Australia.

The IMR conduit income rules should operate to ensure that the income or gains of a foreign entity (foreign fund or investor) investing in foreign (offshore) assets are not treated as being Australian sourced.

In our view there is no requirement, for purposes of the IMR, for Treasury to develop new source rules of general application, merely to address the issues of appropriate targeting of the IMR.

- we submit that a comprehensive review of the entire source taxation regime for Australia would result in a loss of focus on the objective sought to be achieved under the IMR and therefore would not be the best use of Treasury and Australian business tax policy resources because the development of a comprehensive rework of Australia's source rules will take a long time
- such rules are likely to be complex and in themselves create uncertainty
- any eventual new rules would also need continual update to appropriately deal with the source of income and gains on new types of securities as they are developed.

We submit that the issues with the potential taxation of foreign (offshore) assets on an Australian source taxation basis would be best dealt with by implementing a broad exemption for income and gains derived from certain types of eligible financial instruments that might otherwise be deemed Australian sourced.

- *Our preferred approach*

Our preferred approach, of a specific exemption for certain financial instruments, would be a simpler approach and would be in accordance with other countries' IMRs which would assist the marketing of the Australian IMR to foreign funds and other investors.

In order to understand the necessary scope of a successful IMR, it is useful to consider existing regimes such as Singapore, generally considered to be the IMR with the widest operation.

The Singapore IMR allows IMR treatment for eligible (designated) investments being investments in structured products, units in business trusts, emission derivatives, stocks and shares of unlisted companies, liquidation claims, and qualifying Islamic investments.

The list of specified income for the purposes of the Singapore IMR includes:

- income realized in other forms (other than through sale) from designated investments, such as holding to maturity, redemption, or any other forms of realization where the realization leads to a transfer of both economic and legal ownership of the designated investment concerned
- other income directly attributable to Qualifying Debt Securities ("QDS") as may be prescribed by regulations, for QDS issued on or after a prescribed date
- amounts payable on any Islamic debt securities which are QDS issued on or after 22 January 2009

Singapore provides only a small number of exclusions from the IMR where they relate to real property in Singapore. Exclusions exist for shares of private companies that are mainly in the business of trading or holding of Singapore immovable properties. Gains from the sale or transfer of such shares derived on or after 30 April 2009 will no longer be exempt from tax under the fund tax incentive schemes. Notably, however, investments in private companies engaged in the business of developing properties are not covered under this exclusion.

The UK IMR regime covers eligible investment transactions being transactions relating to:

- shares, stock or units in a collective investment scheme,
- warrants, futures (including forward) contracts, options contracts, interest rate swaps, equity swaps, currency swaps, commodity swaps and commodity index swaps, credit default swaps, whether settled physically or by cash, and other contracts for difference,
- securities of any other description,
- debt and debt instruments or a transaction related to such debt,
- foreign currency,
- carbon emission trading products.

Specific exclusions from the UK definition of investment transactions include:

- transactions in futures and options or contracts for differences relating to land except where the option, future or contract for differences uses a land index, provided the index is publicly accessible, comprised of a significant number of properties and not maintained by the non-resident, the investment manager or persons connected with the non-resident or the investment manager
- contracts of insurance
- transactions in physical commodities including warrants which give the holder title to the commodity. However, futures and options contracts which provide for physical delivery qualify provided physical delivery does not occur.

In order to be competitive globally, Australia should consider establishing a similar wide ranging IMR that includes the full range of investment products with the exception of taxable Australian real property.

- *Source Rules do not effectively deal with location of substantive activity*

In international commercial transactions, there are circumstances whereby the current source rules do not effectively identify the location of the substantive economic activity.

Often, the activities that form the substance of the transaction occur overseas but where the entity is currently trading on ASX it may be incorrectly classified as an Australian sourced transaction. This can be seen most clearly where, for example:

- An Australian entity has shares or other securities ('the Australian securities') listed in Australian markets, notably the ASX listing
- A foreign investor located in say mainland Europe or the UK or the USA ('the foreign investor') has a significant operation in that country (the home country) and other global financial centers
- An Australian fund manager or broker or adviser interacts with the foreign investor, for a fee
- The foreign investor executes a trade in relation to the Australian securities, through an Australian broker if the securities are Australian shares. The broker will receive compensation for executing the transaction.

In such a situation the foreign investor will add all or most of their added value through their analysis of potential Australian investments in the home country or other foreign country, through their investment selection teams, and through their investment of their capital in the Australian securities.

Notwithstanding the principal added value arising from the foreign investment selection and management overseas, there is a risk that the foreign investor in this typical example could be exposed to Australian tax in respect of such gains because the trade occurred on the ASX.

This is exactly the scenario that many foreign investment funds are currently facing. This has led to and is continuing to have a significant adverse impact upon Australia's attractiveness as a destination for foreign investment.

In our view the Australian parties in the above transaction are compensated appropriately for the value of their services through their service fees for execution of transactions. But the involvement of the Australian party does not form a basis for exposing the foreign investor to taxation on their profits, which could arise under current law if an Australian agent or broker executes the trade on behalf of the non-resident.

Transactions conducted by a foreign broker on the ASX may similarly risk Australian source and Australian taxation, of an indeterminate amount. Again in this case the activities which form the substance of the transaction occur overseas and there is little or no value added in Australia and this outcome is therefore also not appropriate.

Eligibility of funds managers for the IMR concession

We highlight that the design of the IMR and source rules for funds managers should not be restricted only to managed investment trusts (MITs) as defined currently for purposes of the irrevocable capital election of reduced MIT withholding tax rules.

We highlight that the intended nature of the IMR policy is to encourage the management of funds for non-residents. So the relevant funds management relationships will not typically involve Australian registered or unregistered funds. Therefore it will not be appropriate to limit the IMR to MITs as defined in the current MIT definition, as altered in Tax Laws Amendment (2010 Measures No. 3) Bill 2010.

Eligibility of banks and other financial institutions for the IMR concession

The IMR and conduit income rules should also apply to local and international banks and other financial institutions in respect of managing their own offshore funds and not just the funds of other investors.

This would be in line with the views of the Forum that the IMR should be wide enough to cover 'in-house' arrangements and so ensure that 'in-house' financial intermediaries of either foreign or Australian resident financial services companies should not be discouraged from operating in Australia as a result of the tax scope and uncertainty issues.

The Forum stated that one of the potential benefits of the IMR will be to make it a lot easier for such companies to use Australia as a regional base from which to manage offshore assets.

The objective of the regime should be to encourage the delivery of financial services in Australia for the management of non-Australian funds for a broad range of entities. Australian located banks and financial institutions with non-resident branches should therefore also be able to locate their regional headquarters in Australia and not find that their activities in respect of non-Australian funds of those branches causes the branch's income to become Australian sourced.

Recommendations:

We submit that the IMR conduit income rules should apply to the full spectrum of investment vehicles including wholesale funds such as hedge funds and private equity funds as well as retail funds.

We submit that the IMR rules should also apply to the foreign branch activities of Australian and international banks and financial institutions with operations in Australia.

The rules should be implemented as a broad exemption for income and gains derived from eligible financial instruments.

The list of eligible financial instruments should be widely defined to include investments other than taxable Australian real property and allow for expansion in response to the development of services offered and types of investments made over time. The list of included and excluded instruments for the Singapore and UK IMRs should be considered as a starting point for developing Australia's list of eligible financial instruments.

Only the Australian sourced fees paid to the Australian intermediary should be taxed in Australia, to the Australian intermediary, subject only to arm's length principles surrounding the appropriate pricing of those services (intended only to be integrity rules as occurs in the UK.)

We recommend the immediate implementation of the Forum's recommendation 3.1 to provide a broad exemption for foreign investments that are exposed to Australian tax in respect of gains derived from investments into certain Australian assets and securities simply because they use an Australian intermediary.

Permanent Establishment

Areas of uncertainty

There are currently significant areas of uncertainty that impact both treaty and non-treaty residents. Carrying out activities in Australia that raise a risk of having an Australian permanent establishment can lead to taxation on worldwide income. This is a concern to foreign inbound investors who are reluctant to become Australian residents and lose advantages such as their CGT exemption. Permanent establishments also result in compliance obligations in Australia such as filing tax returns.

Foreign investors which originate in countries with double tax treaties with Australia are generally protected from taxation in Australia, by reference to the treaties' resident taxation rules and a residency tiebreaker test. The residence rules, combined with the limitation on source taxation afforded in the business profits articles, mean that only profits of an enterprise carried on through permanent establishment carried on in Australia can be taxed in Australia.

The definition of permanent establishment relevantly excludes a business carried on through an agent of independent status where such agent is acting in the ordinary course of his business.

However, if the foreign fund has a dependent agent/broker or an Australian resident who has the authority to negotiate and conclude contracts in Australia, then they may be deemed to have a permanent establishment in Australia.

If the foreign fund has a permanent establishment in Australia, the fund may be subject to Australian tax on non-taxable Australian property assets as the CGT exemption in Division 855 will not apply to assets connected with the permanent establishment, irrespective of whether the gains have an Australian source, and there may be a potential for Australian tax on their global assets as well.

The IMR conduit income rules should operate to ensure that a foreign entity (foreign fund or investor) will not be considered to have a permanent establishment in Australia merely because it engages an investment manager located in Australia. This measure is an important part of attracting foreign funds and other foreign investors to use the services of investment managers located in Australia.

Carrying on business through a permanent establishment

Under the current law, the establishment of a dependent related party in Australia to manage the investment of funds in assets around the world is likely to cause a permanent establishment in Australia.

Ernst & Young supports the Forum recommendation that such an arrangement should be included within the scope of the IMR and no Australian tax should be payable on non-Australian (offshore) investments managed by the Australian dependent subsidiary where the parties act at arm's length.

The proposed IMR should be drafted broadly to ensure that even if a foreign entity has an Australian permanent establishment, it should not be taxed on its foreign sourced investment income. This would avoid the inappropriate outcome whereby a foreign holding company is deemed to be taxable on its worldwide income as a result of a small Australian presence that gives rise to a permanent establishment.

Classification as income or capital gains on disposal of shares and other assets

We consider that the introduction of broadly defined IMR conduit income rules would eliminate the problem of determining the capital / revenue nature on the disposal of foreign shares or other foreign assets because conduit income from investment activities would not be taxable in Australia.

This approach would avoid unnecessary complex drafting in any attempt to deal specifically with the capital/revenue classification of a list of assets whose classification is considered to be problematic or uncertain.

Integrity measures

We consider that an effectively designed IMR would not undermine the integrity of section 3AA of the International Tax Agreements Act 1953 because it will define the investors and assets subject to the regime.

Recommendations:
The IMR conduit income rules should operate to ensure that a foreign entity (foreign fund or investor) will not be considered to have a permanent establishment in Australia merely because it engages an investment manager located in Australia.

The proposed IMR should be drafted broadly to ensure that even if a foreign entity has an Australian permanent establishment, it should not be taxed on its foreign sourced investment income.

The IMR conduit rules should be drafted broadly to provide that income and gains from the disposal of eligible financial instruments are not taxable in Australia so that the question of characterisation as capital or revenue does not arise.

Residence

There is a risk that in some cases, where a foreign fund or other foreign investor uses an Australian funds manager, this could give rise to residency in Australia.

Relevantly a company will prima facie be considered to be a resident of Australia where it is carrying on a business in Australian and its central management and control is here. The place of central management and control is wholly a question of fact. The case law concept of central management and control is, in broad terms, directed at the highest level of control of the business of a company and therefore in our view only Australian controlled foreign investors would be taxable in Australia on a residency basis. However the application of the tests is uncertain and there is a risk that a newly-created foreign fund with, say, an Asian investment strategy could have Australian residency if its global investments are managed by an Australian fund manager.

The IMR conduit income rules should operate to ensure that a foreign entity (foreign fund or investor) will not be considered to be resident in Australia merely because it has central management and control in Australia.

We understand this measure will largely be developed by the Board of Taxation.

Corporate Limited Partnerships (CLPs)

We agree that issues with the tax treatment of corporate limited partnerships (CLPs) should be addressed as part of the development of the IMR in advance of the Board of Taxation's consideration of wider residence issues.

The investment requirements of foreign investors have inevitably led to funds commonly being established in various foreign tax jurisdictions that do not have tax treaties with Australia. These include for example Barbados, The Cayman Islands and Luxembourg. The consequences for foreign investors investing through such non-treaty countries are therefore important.

Exposing a non-Australian based CLP, such as a Cayman Islands LP, to Australian taxation on its worldwide income if it has an Australia advisory component is clearly not an appropriate outcome. However, this is exactly the risk that can arise under the current law, because a CLP can be a resident of Australia simply if it carries on business in Australia notwithstanding that its central management and control is elsewhere.

As noted in the discussion paper the current Australian outcome is also inconsistent with the taxation of companies. In our view the relevant Australian tax rules for companies should be adopted as the taxation outcome for CLPs. So CLPs' residency rest should include a requirement for central management and control in Australia, subject to the IMR and conduit income carve outs.

Recommendation:
We recommend that the IMR conduit income proposals should include changes to the residency test for CLPs to include a central management and control requirement, to more closely align the test with the company residency test.