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Review of the Tax Arrangements applying to Collective Investment Vehicles
The Board of Taxation
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BOARD OF TAXATION REVIEW INTO COLLECTIVE INVESTMENT VEHICLES

The Financial Services Council (FSC) welcomes the opportunity to provide further comment on the Board of Taxation's discussion paper on the review of the tax arrangements applying to collective investment vehicles (CIVs).

The Financial Services Council represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The Council has over 130 members who are responsible for investing \$1.8 trillion on behalf of more than 11 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalization of the Australian Stock Exchange and is the fourth largest pool of managed funds in the world. The Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

As foreshadowed in our earlier submission of 1 March 2011, we have provided our comments to the specific questions raised in the Board of Taxation's discussion paper below.

If you have any questions regarding the FSC's submission, please do not hesitate to contact Senior Policy Manager, Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely



MARTIN CODINA
Director of Policy

Chapter 2: Collective Investment Vehicles for the Purposes of this Review and Principles for Taxation Treatment

2.1

These issues are addressed in the *Introduction* to our initial submission of 1 March 2011.

2.2

- i. Currently the widely held test gives rise to a number of difficulties where there is a chain of investment vehicles. This has been better addressed in the Managed Investment Trust (MIT) definition in subdivision 12H. An appropriate test would need to address the situation where what is seemingly one investor is actually a vehicle for many investors, such as a pension fund.
- ii. We provide our comments regarding Division 6C later in this submission. Broadly, we believe that any restriction should be limited to domestic investment.
- iii. The 'control' test in Division 6C needs to be clarified, in particular, instances where the withdrawal of some investors passes 'control' to remaining investors needs to be addressed. Additionally, large passive investors, such as retail superannuation funds, need to be accommodated in the test process.

Chapter 3: Australia's Current Range of CIVs

3.1

- i. The principle impediment to investment into Australia by foreign investors has been taxation. The possibility of theoretical extensions of 'source' and 'control' has resulted in many potential foreign investors opting to use proven structures in other jurisdictions. Additionally, the fundamental nature of a unit trust has been a concern to less sophisticated investors.
- ii. When an Australian trust makes a distribution to a non-resident investor, the underlying character of income and profits is retained. Consequently the investor will receive a statement suggesting twenty or more components. This is confusing for foreign investors even before the different types of withholding tax are addressed.

However, the retention of character is fundamental to Australian investors, franking credits and discounted capital gains are of particular value to Australian investors. The challenge is that providing simplified reporting to non-resident investors will disadvantage resident investors. Conversely, if resident investors continue to receive multiple character distributions and their tax attributions then non-resident investors will be discouraged by the confusion. Most managers would prefer to have a common base of reporting for both resident and non-resident investors.

The solution may lie in the proposed Investment Manager Regime (IMR) which will funnel non-resident investors through different entities.

3.2

Matters affecting LICs are best addressed by those relevant interested parties. In principle, there should be no reason why LICs could not be CIVs in the new regime.

3.3

- i. The FSC believes it would be a mistake to prescribe a particular type of entity as the sole entity that could be a CIV. The best regime would be one that is flexible enough to accommodate different types of vehicle. A manager may find it desirable to have a corporate CIV to offer in one jurisdiction, a trust CIV in another jurisdiction and an LP CIV in a third jurisdiction. Accordingly, it is our view that a system not unlike the US 'check the box' system should be implemented. At establishment an entity would need to irrevocably elect that it be treated as a CIV for tax purposes. This would be regardless of its legal form. Having made this election all the features of a CIV would apply, be they flow-through, distribution, exemption or integration.

The advantage of this approach is that it would ‘future proof’ Australia’s CIV regime and align well with the Asian Funds Passport proposal.

Accordingly, it is conceivable that LPs could be CIVs. However, if a LP elects into the regime the existing tax regime for LPs should not apply.

ii. Some LPs may be suitable vehicles, others may be too closely held to be suitable vehicles under the regime. Ultimately, this would be determined by the Government’s decision on the ‘widely held’ test and eligible investments.

iii. See our comments above regarding ‘check the box’.

iv. The ‘widely held’ test or any alternative test that is selected should be consistent for all CIVs.

v. If the ‘check the box’ approach was adopted, we do not envisage that a LP CIV would be able to pass losses to investors. If an operator chose to continue to provide an LP outside the CIV regime the existing framework should apply. It may be that modifications to the existing LP regime would be required, but the FSC believes that other relevant parties would be better placed to comment on these.

Chapter 4: Design of a New Corporate CIV Regime

4.1

Paragraphs 4.3-4.27 of the Discussion Paper recognise the need to determine the appropriate taxation model for an Australian CIV vehicle which is internationally competitive. Four alternative international taxation models are canvassed:

- flow-through,
- exemption,
- distribution, and
- integration.

The FSC believes the model, or combination of models, or variant chosen should be that which best fulfils the Government’s relevant policy objective as listed in the foreword to the Discussion Paper; namely:

“tax outcomes for investors in a [CIV] should be broadly consistent with the tax outcomes of direct investment, other than flow through of losses (subject to limited special rules for their utilisation).”

The FSC would add to this a preference for:

“the chosen model to facilitate the transition of existing MITs and other CIVs – their structures and processes – to the new internationally competitive CIV regime with minimal disruption.”

It is relevant to note in this regard that most (but not all) CIVs in Australia currently take the form of a trust subject to Part 3, Division 6 of the *Income Tax Assessment Act 1936*. For convenience, we use the term MITs (Managed Investment Trusts) in the following discussion to describe Australian CIV trusts governed by the Division 6 taxation rules, although we note in practice that there are a wider set of vehicles to consider here, including MITs which are subject to Division 6C, rather than Division 6 (property trusts), CIVs which are trusts but not MITs and CIVs that take a corporate or partnership, rather than trust, form.

There are advantages and disadvantages to each of the taxation models. The FSC’s view is that the flow-through model should be adopted, in conjunction with an additional recommendation relating to treaty status in order for the flow-through model to effectively position Australian CIVs in the international market.

Flow-through is a model which is similar in practice to the current Division 6 taxation model underpinning MITs. It is also the taxation model underpinning Irish CCFs. This would formally make

the CIV a non-taxpaying entity. All income and realised gains (net of losses) of the CIV would be fully attributed to investors in the CIV, along with tax credits/offsets received by the CIV.

The FSC's view is that the flow-through model of taxation of CIVs most closely fulfils the policy criteria listed above. That is, flow-through most closely replicates what would be the CIV investor's tax position if the investor had directly invested into the relevant global investment strategy rather than through an Australian CIV. This minimises the potential for distortion when a non-resident investor chooses to use an interposed Australian investment vehicle to access a global strategy – the very outcome that the Government is seeking to encourage.

This streamline solution will be important to the positioning and marketing of the new CIVs in regional and global markets. FSC members believe it will be relatively easy to communicate and provide certainty around the tax treatment of the new CIVs to offshore investors who are new to the Australian market, because flow-through is fairly simple to understand and (subject to our comments about loss quarantining below) free from conditions.

This is a real advantage over the alternative taxation models suggested, all of which would require conditions to be met and assumptions to be made. This introduces complexity into the discussion with prospective non-resident investors as well as risk concerns for Australian fund managers who would naturally be reluctant to provide assurances that conditions will always be met. For example, the theoretical possibility of a distribution error would make a fund manager unwilling to guarantee that the CIV would never pay Australian tax under the distribution taxation model. The experience of FSC members is that matters like the perception of risk (however theoretical) and conditions pertaining to taxation status are enough to make a non-resident investor choose not to invest into Australian funds management products and services.

Importantly, a taxation model which is similar to how Division 6 taxation of CIV trusts works in practice today would allow existing MITs to use current systems and practices as a platform for launching the MITs into the new, internationally competitive regime. This minimises time, costs and other disruptions that might otherwise be faced by transitioning existing MITs into a regime which more radically changes the tax treatment of the vehicle and its underlying investors. This also avoids the possibility of fund managers having to create separate product sets for Australian resident investors (serviced adequately by the existing rules) and non-resident investors (penalised under the existing rules), which would be an inefficient and more complicated outcome.

The Government has indicated to the Board of Taxation that only limited flow-through of losses be allowed under whatever taxation model is chosen. This would be achievable under the flow-through taxation model by introducing specific loss quarantining rules where certain conditions are met. The FSC does not support losses being “carved out” of the flow-through model as this would preserve a distortion that currently exists in the MIT (Division 6) rules and is not easily explainable on policy grounds, other than as a revenue measure. It also creates complexity in the new rules.

Additional FSC recommendation –secure treaty status of CIV

One important issue in relation to current MIT CIV taxation relates to the unclear taxation status of MITs – as trust vehicles - for withholding tax (WHT) purposes. Australia's network of double tax agreements typically requires the Australian investing entity to be a taxpayer and/or beneficial interest-holder in order to claim concessional WHT treatment. It is important for an internationally competitive CIV to have clear WHT status and for the CIV to be able to assert this status in claiming (or reclaiming) concessional WHT on offshore investments on behalf of investors. Currently, many MITs assert this status (and claim the concessional WHT treatment), notwithstanding the technical uncertainty.

The main disadvantage of the flow-through taxation model is that it would make it difficult (if not impossible) for the CIV to qualify for concessional WHT treatment under most treaties. It is a serious issue for CIVs to not qualify for treaty (concessional) rates of WHT given it will not be clear whether the WHT will be creditable to non-residents. This may make the CIV especially unattractive to large non-resident institutional investors (who have large amounts of capital to invest) if the investor is tax exempt or “lightly taxed” in the investor's home jurisdiction. Even for creditable investors, the additional WHT will represent a drag on investment performance which a treaty country-resident investor would not sustain if the investor invested directly. The additional WHT will also erode the size of the funds management pool in Australia because many investors will not reinvest the WHT they claim back from their revenue authorities back into Australian CIVs.

We note that the WHT status of a new internationally competitive CIV would potentially remain problematic under the alternative exemption and distribution taxation models; that is, it is an issue exacerbated by, but not unique to, the flow-through taxation model. In the FSC's view, only the full integration taxation model is likely to provide clarity as to the status of the CIV under Australia's double tax agreements. This is a radically different model with no obvious international CIV example and, in solving the WHT issue, would raise a number of other serious issues and so is not a favoured approach by the FSC.

Accordingly, the FSC recommends that, in combination with the adoption of the flow-through model of CIV taxation, a parallel initiative be pursued under Australia's network of double tax agreements to make the new internationally competitive CIV form eligible to claim concessional WHT treatment. A straightforward way would be for the CIV to be deemed to be an Australian resident taxpayer just for the purposes of determining entitlement to treaty WHT concessions. There are other ways in which this could be achieved and the FSC would be happy to assist in exploring the options for resolution.

If Australian CIVs are to be internationally competitive, this issue must be addressed.

4.2

The FSC believes that a CIV should be an entity or an arrangement as defined. The definition should be inclusive of all entity types recognised and accepted as CIVs internationally, including companies, trusts, limited partnerships etc.

Entities with features such as compartmentalisation or segregation of share classes or units (to track specific assets and protect against bankruptcy) and multi-currency structures should also be allowed.

Eligible entities should be able to irrevocably elect into the Australian CIV regime, similar to the European UCITs regime.

An Australian CIV should have the following features:

1. Widely held

The FSC believes that an Australian CIV need not necessarily be widely held. Such a requirement is at odds with other international regimes (such as that in the United States) and its absence would better allow for interactions under the Asia Region Funds Passport initiatives.

However, on the basis that CIVs must be widely held, the current trust based rules in the MIT provisions should be expanded to cover all other CIV types. It is important that this requirement is the same for all CIVs, regardless of legal form.

The definition of 'widely held' needs to have the flexibility to deal with foreign investment regimes, in recognition of the fact that many underlying international investors into Australian CIVs may not have the same legal interests in their conduit vehicles that Australian investors have (eg. Sovereign funds or government pension plans).

Importantly, the widely held rules must be flexible, simple and certain, such that a proper assessment of the status of a CIV can be made at any time without conducting a costly and time consuming tracing exercise.

2. Satisfy regulatory and governance requirements

Internationally competitive CIV regimes have simple and effective systems of regulation and governance and also recognise all commonly used legal structures as eligible CIVs.

3. A connection with Australia

In a MIT context, a trust has to be an Australian resident, have an appropriately qualified responsible entity or manager, and satisfy the investment management test.

This requires a significant connection with Australia which may be more justified in the context of investment in real property. This policy seems to focus on the use of Australian managers, rather than on creating an internationally attractive CIV regime.

To the extent that these requirements reflect integrity concerns, it is important that an investment management or connection test is clear, simple and is appropriately balanced against the policy aim of making Australia a leading financial centre.

4. Types of investments

Australian CIVs should make only passive investments (based on the EIB test in Division 6C) to the extent that such investments are Australian. The FSC suggests that control of 'ineligible assets', where the assets are foreign should not be limited.

The FSC believes that the core investment rules in Division 6C need to be modernised. The Australian funds management industry needs a workable framework that is modern, clear and simple, which addresses current investment constraints.

Chapter 5: Investment Manager Regime

5.1

The FSC considers that an appropriate IMR should achieve the following objectives:

- provide taxation certainty for foreign investors investing into Australia whether that investment is on revenue or capital account based on a set of clear statutory rules;
- generate significant employment and economic benefits for Australian fund managers by providing more funds under management;
- allow more capital to be attracted to Australia which is crucial for a capital importing nation such as Australia;
- provide liquidity for Australian markets which is essential in a tight monetary environment; and
- should be Revenue positive as the income of fund managers will increase and be taxable in Australia.

Further, and importantly, an IMR should be internationally competitive especially as global capital is now extremely mobile. In this regard, the FSC believes that to capitalise on the domestic managed funds skill base and tap into Asian economic growth the Australian IMR must adopt the best features of foreign IMR regimes. An essential aspect of those regimes is the *exemption-based approach*.

The FSC submit that an exemption-based approach for an IMR is the most appropriate approach in addressing the above objectives in an Australian context. This is not only because it is needed to be internationally competitive, but also because as noted in the Johnson Report unless there is tax certainty foreign investors will not invest capital in the Australian market. Specifically, the provision of a bright line test is integral in removing uncertainty as a fundamental competitive disadvantage currently faced by Australian fund managers.

We consider that an exemption-based approach should have the following features:

- subject to integrity measures, the IMR should incorporate an exemption from Australian taxation for portfolio investments of foreign investors (including foreign CIVs) whether on capital account (as is currently the case) or on revenue account;
- the use of a local manager or agent should not cause the exemption from Australian taxation to be lost or compromised. In this regard, an IMR should allow a wide range of management scenarios to qualify so as to not unduly restrict how managers choose to manage assets;

- the asset class of IMR qualified assets should be broad but generally confined to marketable securities (such as listed securities) and investments in Australian CIVs (such as local funds). We have listed an example of the class later in the submission;
- there should be targeted integrity provisions built into the IMR. For example to ensure that fee and similar income derived by local managers and agents in managing funds are arm's length and that Australian resident investors are restricted in their access to IMR concessions; and
- the IMR should be competitive with and draw on the best features of overseas regimes where IMRs are operating. The UK regime is one that may form an appropriate base to work with in Australia.

The FSC do not believe an alternative to an exemption regime would be acceptable because:

- it would not be internationally competitive - faced with taxation, foreign investors would use other financial centres defeating the purpose of seeking to capitalise on the Australian expertise;
- an exemption system is easily understandable and removes administration and compliance issues for foreign investors that would otherwise apply; and
- taxation would be applied to the managers of assets in respect of fees earned which together with other increased economic activity would ensure the IMR is revenue positive.

5.2

There are a number of intermediaries via which the management of offshore funds may occur. These range from dependent agents such as dedicated subsidiary members of the foreign fund to independent brokers.

Typically they will include:

- Investment managers - *these form a broad class of managers whose income stream is primarily management fees (eg as a percentage of funds under management). In addition, a management agreement may also provide for performance fees, which will be derived where relevant investment return benchmarks are met.*
- Australian brokers - *Australian brokers will act as agents in transactions typically involving Australian listed shares. The type of income which Australian brokers will derive is usually commission income where they are contracted (either directly by an offshore fund manager, by an Australian manager, or via an offshore broker) to buy or sell securities. The type of service may span from simply undertaking the buy/sell to involvement in advising on the assets.*
- Australian financial institutions - *Australian financial institutions may also act as a counterparty in transactions involving offshore funds where components of the return arising from the investment of offshore funds are to be hedged in full or in part.*
- Dependent Agents - *Foreign investors may establish wholly owned subsidiaries that manage the local and / or foreign assets of the overseas fund.*

Ringfencing provisions

We submit that Australia can look to overseas regimes for guidance on appropriate ringfencing provisions which can be applied to the IMR. In the UK, the Investment Manager Exemption (“IME”) regime has been in place for a number of years and applies in relation to investment transactions carried out by a UK investment manager on behalf of non-residents provided the investment manager meets the following tests:

- The UK investment manager is in the business of providing investment management services;
- The transactions are carried out in the ordinary course of that business;
- The UK investment manager acts in relation to the transactions in an “independent capacity”;
- The requirement of a “20 % test”¹ is met; and
- The UK investment manager receives remuneration for provision of the services at not less than the rate that is customary for such business.

We consider that similar tests can be considered for the IMR regime. In regard to the 20% test we note that some allowance for seed capital by managers should be provided. Thus it is typical when a fund is commencing for an investment manager to put in their own capital to start the fund. As such the test might well be breached in early stages but become rectified once further investors come into the structure. Some concession for a start up period (eg 2 years) should be allowed during which the threshold can be breached - as long as it is subsequently reduced (to the threshold) by the end of the concessionary period.

Account Segmentation

A further aspect is that funds coming into the IMR may need to be managed within the same legal entity as other funds. Such an approach would provide an efficient management structure rather than require a separate legal entity for each IMR established.

In this regard, account segmentation should be possible (similar to statutory accounts in life companies) which would allow one legal entity to manage IMR and non-IMR assets without the need for separate legal structures. Rules regarding tainting with Australian non-IMR funds would be needed (eg similar to the OBU rules).

5.3

Consistent with the broader policy objectives of establishing Australia as a financial centre, the type of funds to be covered by the IMR should be wide and inclusive. As such, we concur that the eligibility of an IMR should not be affected by the legal structure of foreign managed funds as long as they are of a type which falls broadly as a collective investment vehicle. As foreign funds formed in non-English or American law type jurisdictions (e.g. Japan and countries in mainland Europe) can take other legal forms to the current forms of foreign funds in Australia (i.e., companies, limited liability companies, limited partnerships or a trust) a broad classification is needed.

Further, the FSC submit that the imposition of a “managed in Australia” requirement or a “minimum spend requirement” for an IMR runs against the inherent benefits sought under such a regime and should not be prerequisites to qualifying under the IMR. The “managed in Australia” requirement was previously considered in relation to MIT changes and we are of the view that the use of a local manager or agent should not cause the exemption from Australian taxation to be lost or compromised. Further, we consider that in order for Australia to remain competitive against countries in the region (many of which have broad regimes), Australia needs to keep up with the

¹ The requirement is that the investment manager and persons connected with it, including connected charities, must not have a beneficial entitlement to more than 20% of the non-resident’s chargeable profits arising from transactions carried out through the investment manager. Where the 20% threshold is exceeded, the part of the income of the non-resident to which the investment manager and connected persons are beneficially entitled is excluded from the limitation of charge.

flexibility offered for foreign managed funds by various foreign IMRs, drawing on their best features, as well as being cautious in adopting restrictions applied by other countries to limit the scope of application of their IMRs.

Finally, we accept that targeted integrity provisions need to be put into place to ensure that fee and similar income derived by local managers and agents in managing funds are arm's length and that Australian resident investors are restricted in their access to IMR concessions.

In terms of the arm's length requirement, we submit that a similar principle such as the arm's length principle adopted in the context of transfer pricing may be applied to the IMR and fund managers should have proper processes to determine arm's length fees using acceptable methodologies.

5.4

The FSC considers that the main consideration in deciding on the range of investments that could be covered by an IMR should be a balance between the potential revenue costs of an IMR applying to a wide range of transactions and having the IMR applying to a sufficient range of investments such that Australia's funds management industry achieves a globally competitive position. In essence the FSC therefore believe a portfolio class of exemption would be appropriate.

In order to understand the scope of an effective IMR, it is useful to first consider the scope of other countries' IMRs as a guide.

If the IMRs of both Singapore and the UK are considered, the current range of investments that could potentially be covered by an IMR as identified in paragraph 5.93 of the Discussion Paper may be sufficient.

Singapore

Singapore's IMR is generally considered to have the widest operation. It 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.

Singapore also provides only a small number of exclusions from the IMR where they relate to real property in Singapore. Exclusions also exist for shares of private companies that are mainly in the business of trading or holding of Singapore immovable properties.

UK

UK's Investment Manager Exemption regime covers eligible investment transactions being transactions relating to²:

- shares;
- stock;
- futures contracts;
- options contracts;
- financial swap transactions (except transactions relating to land or insurance);
- tradeable emissions allowances;
- securities of any other description (but excluding futures contracts or options relating to land); and
- buying and selling of any foreign currency or in the placing of money at interest.

Specific exclusions from the UK definition of investment transactions include:³

- 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-

² Definition of "Investment Transaction" is in section 1150(1) of the Corporation Tax Act 2010.

³ HM Revenue & Customs Statement of Practice 1/01 as revised on 20 July 2007

resident, the investment manager or persons connected with the non-resident or the investment manager;

- contracts of insurance; and
- 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 light of the above, the primary focus of the IMR should be attending to the tax treatment of mobile non-resident portfolio investments which can easily move from Australia to other countries, or indeed, may not come into Australia in the first place due to unfavourable tax treatment. This is consistent with the objective that an IMR should ensure the taxing arrangements for foreign managed funds are appropriately designed so that highly tax sensitive income is lightly taxed, enhancing Australia's ability to attract non-resident portfolio capital.

In an Australian context a defined list of portfolio investments would provide some certainty as to when the IMR would apply. One appropriate listing would be to take the definition of "eligible investment business" in section 102m of part iii of the *Income Tax Assessment Act 1936*.

That section states:

"eligible investment business" means one or more of:

- (a) investing in land for the purpose, or primarily for the purpose, of deriving rent; or
- (b) investing or trading in any or all of the following:
 - (i) secured or unsecured loans (including deposits with a bank or other financial institution);
 - (ii) bonds, debentures, stock or other securities;
 - (iii) shares in a company, including shares in a foreign hybrid company (as defined in the *income tax assessment act 1997*);
 - (iv) units in a unit trust;
 - (v) futures contracts;
 - (vi) forward contracts;
 - (vii) interest rate swap contracts;
 - (viii) currency swap contracts;
 - (ix) forward exchange rate contracts;
 - (x) forward interest rate contracts;
 - (xi) life assurance policies;
 - (xii) right or option in respect of such a loan, security, share, unit, contract or policy;
 - (xiii) any similar financial instruments; or
- (c) investing or trading in financial instruments (not covered by paragraph (b)) that arise under financial arrangements, other than arrangements excepted by section 102ma."

A modified version for use in the Australian IMR context could state:

"Investing or trading in any or all of the following:

- (i) secured or unsecured loans (including deposits with a bank or other financial institution);
- (ii) bonds, debentures, unsecured notes or other similar securities;
- (iii) portfolio interest in shares in a company, which are traded on an approved stock exchange as defined in section 995-1(1) of the *income tax assessment act 1997*;
- (iv) portfolio interest in units in a unit trust;
- (v) futures contracts;
- (vi) forward contracts;
- (vii) interest rate swap contracts;
- (viii) currency, commodity, credit default and index swap contracts;
- (ix) forward exchange rate contracts;
- (x) forward interest rate contracts;
- (xi) right or option in respect of such a loan, security, share, unit, or contract and any stapled security; and

(xii) any similar financial instruments”.

In this regard, the two main variations are interests in land and insurance contracts which would seem inappropriate to include, as they are not market traded instruments. This is also consistent with the UK position. As is stated in the UK Statement of Practice 1/01 - 20 July 2007 & the *Investment Manager (Specified Transactions) Regulations 2009*, the following securities are considered to be covered under the UK IMR:

“For the purposes of the Investment Manager Exemption investment transactions include shares, stock, commercial paper and warrants, futures (including forward) contracts, options contracts or securities of any description, any foreign currency, carbon emission credits, 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, but not contracts relating to land, or contracts of insurance.”

The listing could be included as a regulation to make it easier to add new financial instruments as the markets evolve.

It should be noted that the list refers to portfolio interests (in essence no more than 10%) - however that restriction may not be appropriate in relation to investments in foreign entities. That is, arguably there should be no restriction as Australia wishes to encourage foreign investors to invest via Australia and there is no Australian tax issue so far as investments in foreign companies are concerned (as these could have been made directly by the foreign fund in any case).

5.5

As stated above, foreign funds can take various legal forms such as companies or LLCs, LPs and trusts. The treatment of each under Australia’s current residence rules and some suggested amendments are considered below.

Foreign funds that are companies or LLCs

Foreign funds may be companies, or may be treated as companies for Australian tax purposes (under the definition of “company” in section 995-1(1) of ITAA 1997⁴).

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

- carries on business in Australia through a permanent establishment; or
- is an Australian tax resident, which should be the case if:
 - is incorporated in Australia; or
 - carries on business in Australia *and* either has its central management and control in Australia or has its voting power controlled by Australian resident shareholders.

Foreign funds that are companies are unlikely to satisfy these tests for Australian tax residence. Therefore, they are usually not tax residents of Australia.

As such it is unlikely special rules will be required for companies in an IMR.

Foreign funds that are LPs

If the foreign fund is an LP, it should essentially be treated as a company for Australian income tax purposes, under division 5a of part iii of ITAA 1936.

⁴ cf Division 5A of Part III of ITAA 1936

Despite this, it is theoretically easier for a limited partnership (compared to a foreign company or LLC) to be an Australian tax resident. This is because an LP is a tax resident of Australia if⁵:

(a) *it was formed in Australia:*

- it carries on business in Australia; or
- its central management and control is in Australia.

In other words, it is sufficient if the foreign fund lp merely carries on some business in Australia; in particular, it does not have to have its central management and control located in Australia, unlike the test for a company.

An IMR would therefore require that a division 5a LP would not be treated as an Australian resident merely because it carries on business in Australia. Otherwise the mere establishment of a management arm in Australia could expose the LP to world wide taxation as a deemed resident.

Foreign funds that are trusts

A foreign fund that is a trust should only be regarded as a “resident trust” for the purposes of the trust income provisions contained in division 6 of part iii of ITAA 1938 if:⁶

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

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

The trust income rules seek to assess either the trustee or the beneficiaries in respect of any Australian source income of the trust, regardless of whether the trust or the beneficiaries are tax residents of Australia. Conversely, where a foreign (non-resident) trust derives only foreign source income, it is generally outside the Australian taxing regime (see, for example, sections 98(2a)(d) and 98(4) of ITAA 1936 and section 6-5(3) of ITAA 1997).⁷

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

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

- (a) first, whether the foreign fund should be regarded as resident in Australia; and, if not;
- (b) whether the foreign fund nonetheless has Australian source income.

⁵ section 94T of ITAA 1936

⁶ under section 95(2) of ITAA 1936

⁷ Although a new managed investment trust final withholding regime was recently inserted into Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953* (“TAA”), foreign funds are unlikely to fall within that regime. This is because (among other things) either the trustee of the trust must be an Australian tax resident or the central management and control of the trust must be in Australia, which is typically not the case (Item 1 in the table in section 12-400 of Schedule 1 to the TAA).

It is generally unlikely for the central management and control of a fund to be in Australia though aspects of the fund's management may nevertheless reside here. In this regard, further clarification would be helpful in an IMR to clarify that aspects of management residing in Australia do not cause the fund's domicile to inadvertently reside in Australia.

5.6

The integrity risks for round tripping is the greatest when individual investor or a small group of individual investors who hold the majority of participation interest in a foreign fund invest through private vehicles. An example given in the Discussion Papers is families with significant private wealth investing using various third party vehicles.

The FSC submit that the risks for roundtripping are limited substantially by limiting the application of IMR to widely held foreign funds as it restricts the extent to which funds can be established as accumulation vehicles to defer taxation through deferring distribution of income. Further, the proposed foreign accumulation fund (“FAF”) rule and the proposed rewrite of the “controlled foreign company” rules (“CFC”) rules also provide some integrity measures to safeguard residence taxation. The proposed new rules introduce a specific anti-avoidance rule to ensure that Australian residents cannot accumulate certain passive income in offshore entities and thereby defer or avoid Australian tax. The new rules will tax residents on an accruals basis on their share of income accumulating in such offshore entities.

We consider that it may be beneficial to have a de minimis threshold of ultimate Australian ownership in the IMR regime. This test is advantageous in preserving the Australian residence tax base, especially given that Australia has a wide base of resident investors as compared with that of other countries such as Luxembourg or Cayman Islands which are just conduit countries. Further, the compliance costs for taxpayers in determining whether the de minimis threshold is satisfied will generally be lower than the compliance cost with alternative methods. We concur with the Board's view that the appropriate percentage of the de minimis threshold should be set relatively high and we consider that 30% to be appropriate (subject to concessionary rules for a fund in a start up phase and perhaps other rules to even out fluctuations - eg the de minimis being applied over a couple of years to cover the sudden removal of a significant foreign investor and provide time to replace them with a new investor). This approach is also consistent with IMR in other jurisdictions.

We also note that the de minimis approach is also consistent with that applied in “passporting” for ASIC type relief when foreign funds sell financial products into the local market.

5.7

An exemption style IMR will broadly address many of the current issues and uncertainties for foreign investors, especially in relation to source and PE issues. However, it is very important that the application of an IMR will not rely on the capital/revenue distinction which is still creating much uncertainty in this sphere.

As stated previously, the FSC recommends that the IMR exemption should apply to Australian sourced gains on portfolio Australian assets (i.e. non-taxable Australian property) without differentiating between revenue and capital assets.

5.8

General

The FSC welcome the Board's investigation into widening the scope of IMR to apply to other areas of financial services sector beyond funds management. We submit that the IMR should be extended to all non-resident investors that undertake portfolio investment in Australian securities (except where those securities constitute taxable Australian property). This is consistent with the scope of IMRs in other jurisdictions and is in line with the Johnson Report recommendation. This scope should be wide enough to encompass non-residents investing through separately managed accounts (such as the IDPS).

As IDPS style accounts are not strictly widely held and are frequently made through nominees, the implementation of a wider scope of IMR exemption will, entail relaxing the “widely held” requirement. This is also consistent with the approach taken in the United Kingdom IME regime. Private vehicles

become more problematic and arguably the constraints applying to these types of vehicles may be higher as they are not collective investment structures.

We agree that integrity issues will arise to the extent that the “widely held” requirement is relaxed, however, we consider that these issues must be balanced against the broader objective of creating a financial centre and the practicalities of tracing ultimate ownership where this is not always possible.

At a policy level many of the ultimate investors reside in treaty countries and as an exemption will usually be found in treaties as regards trading in stocks via an independent agent - we see an IMR as consistent with the broader principle already adopted in an international context. All that an IMR does is recognise and extend the exemption.

The US system has been in place many years, such that for foreign investors, no trade or business results from trading in stocks, securities, or commodities in the US for the taxpayer’s own account, even if the transactions are consummated directly by the taxpayer or by an agent with full discretionary authority to make decisions.⁸ This protection applies (except for dealers) whether or not the trading is carried out through an office of the taxpayer in the US. The early adoption of a broad exemption classification for foreign investors in the US has largely enabled those US markets to establish the volume and depth needed for a successful financial centre. While Australia comes to the table late in the evolution of financial markets - it is still in the FSC’s view timely because of the GFC and Australia’s economic strength in recent times which together with an effective IMR should attract foreign capital flows in a growing Asia-Pacific market.

Timing

The Discussion Paper requires the Board to report to Government by 31 December 2011 with its recommendations regarding the IMR.

The FSC believes the timing of announcements regarding any proposed changes arising out of the Board’s recommendations are a critical aspect of the success of the measures.

FIN 48

The Government’s announcement regarding an exemption for foreign funds for the year ending 30 June 2010 and prior years (the “FIN 48 announcement”) on 17 December 2010 largely removed the issue for foreign funds caused by the US accounting standards covering investments into Australia. However the position going forward post 2010 was not decided upon and the Assistant Treasurer’s announcement suggests that the period post that date is meant to be encapsulated into the proposed IMR regime - presumably by backdating the IMR to 1 July 2010. Further the exemptions noted on 19 January 2011 regarding management of foreign assets only excluded a very limited number of cases and also presumably will require consideration in terms of the IMR.

The issue that arises is that if the Board is to report in December 2011 this will mean that foreign funds will again be left with the same uncertainty for the 31 December 2011 year as existed prior to the FIN 48 announcement and risk again disenfranchising foreign funds from investment in Australia.

The FSC believes the FIN 48 announcement should be extended until such time as the Government announces its position regarding the Board’s recommendations which based on the current schedule would not be until 2012. The FSC would look for the Board’s support in seeking that position.

Interim Reports

The announcements to date, together with the broader regulatory changes being undertaken in the Financial Services Sector (such as ‘passporting’), are strong indicators to foreign investors that the Government is serious about seeking to position Australia as a competitive financial centre. The prospect of a broader CIV regime together with an IMR and effective VCLP provisions are being regarded by foreign investors and local managers as a significant leap forward in bringing Australia up to speed with the rest of the world.

⁸ See sections 864(b)(2)(A)(ii) and 864(b)(2)(B)(ii) of the US Revenue Code.

The present strong Australian economic conditions have provided a window of opportunity to attract foreign investment and the prospect of a broader CIV regime and IMR will likely open up opportunities that to date have been lost to other financial centres.

In this regard we are concerned that the Board's reporting date together with the time the Government will take to confirm its position regarding the changes could be delayed until, at the earliest, the first quarter of 2012.

The FSC understands that due process is required – however:

- The length of time before the Government confirms its position may cause foreign funds to look to other jurisdictions;
- It may dissuade local managers from investing in capital and infrastructure until the measures have been implemented;
- As economic conditions improve overseas, Australia's comparative advantage will diminish; and
- Foreign jurisdictions may themselves take action to improve their attractiveness.

As was demonstrated with the Assistant Treasurer's announcement on 19 January 2011 it is possible to move on those aspects where there greater certainty regarding how a change may operate. However we expect the Government will be reluctant to make many more announcements until the Board reports.

The FSC therefore believes there is significant merit in the Board providing to the Government aspects of its report before the 31 December deadline. For instance, the CIV and IMR regimes to some extent will not be dependent on each other and so the Board could consider releasing aspects regarding the IMR prior to finalising its views on the breadth of the CIV regime.