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Dear Mr Emerson

BOARD OF TAXATION – REVIEW OF TAX ARRANGEMENTS APPLYING TO COLLECTIVE INVESTMENT VEHICLES

This submission of the Taxation Committee of the Business Law Section of the Law Council of Australia ('Committee') is in response to the Board of Taxation *Discussion Paper* (December 2010) issued for its *Review of Tax Arrangements Applying to Collective Investment Vehicles (CIVs)*. The submission addresses some aspects of the Discussion Paper, particularly focusing on the principles that may be applicable to a new CIV regime from a tax and regulatory perspective.

The Committee notes that the Board is taking into account the recent reforms to the Managed Investment Trust (MIT) regime in its review. Some of the issues raised in this Review also overlap with the potential reform of the taxation of trusts that has been announced by the Treasury.

1. Collective Investment Vehicles and Principles for Taxation Treatment

Q2.1: Specific reasons for the apparent unattractiveness of Australia's current tax treatment of CIVs to non-resident investors (p. 7).

The Committee notes that there are a number of different reasons that may contribute to the apparent unattractiveness of Australia for foreign investors such as the global funds management industry. Some of these have been highlighted in the Discussion Paper. Ultimately, given the global mobility of capital, fund managers will locate funds and investments into jurisdictions that are competitive. At present, Australia is not perceived by the global investment community as providing a competitive tax regime.

Some of the specific reasons for this include:

- *Use of trusts.* Trusts, due to flow-through tax treatment for income and gains, are generally seen as the preferred form for collective investments in Australia for foreign investors. However, foreign investors are neither familiar with nor "trust" these structures. Australian style trust structures do not exist in civil law countries, not only in Asia, but also in much of Europe. One of the key legal impediments in relation to trusts is that many foreign investors are uncomfortable with the concept that they do not have legal title over the assets, and that legal ownership is held by a trustee, an entity that they do not own or collectively control.

- *Corporate tax treatment of limited partnerships*. Unlike many countries around the world, Australia taxes limited partnerships as companies (Div 5A of Income Tax Assessment Act 1936), rather than as flow-through vehicles. This, together with the concerns with trusts (as expressed above), means that some foreign investors do not have a choice of an investment vehicle that they are familiar with.

- *Perceived complexities in Australian tax regime.* Foreign investors are generally comfortable with the overall regulatory regime (and rule of law) in Australia. However, many foreign investors have expressed concerns about the perceived complexities of the Australian tax regime. For an economy of our size, foreign investors find our tax regime overly complex and this is compounded by a perception that we have a tax administration body with an "aggressive" attitude towards collecting tax in its administration and interpretation of the tax law. Complexity is perceived in respect of the volume and style of tax legislation but also in respect of key concepts which have no clear interpretation (eg, the concepts discussed in the Discussion Paper, such as source and capital/revenue distinction).

- *Wider definition of revenue account*. While Australia's capital gains tax regime for non-residents is clearly defined and is considered relatively competitive as compared to other jurisdictions, foreign investors face uncertainties in relation to the tax treatment of gains on revenue account (eg, issues of source, permanent establishment, treaty benefits). In respect of the line between capital or revenue gains, Australia's case law has developed in a way which arguably includes more amounts as income (and not capital) than most foreign countries. For example, the amounts treated as income under the *Myer Emporium* principle (profits made from property acquired in a commercial transaction with the intention of realising for it a profit)[1] would not be treated as income in many other countries.

[1] *Federal Commissioner of Taxation v The Myer Emporium Limited* (1987) 163 CLR 199.

Q 2.2 The appropriateness of the widely held definition; the appropriateness of the current definition of eligible investment business including control of active businesses; the definition of 'control' in Div 6C (p. 10)

The Committee notes the basic principles set out in the terms of reference in relation to the *Review* and makes this submission on the basis of those principles.[2] Generally speaking, as the Board states, it is accepted that to qualify as a CIV, broadly speaking, an entity must have the following characteristics:[3]

- Widely held (with typically long term portfolio investors)
- Undertake primarily passive investment activities, consistent with the eligible investment rules in Div 6C *Income Tax Assessment Act 1936* (ITAA 1936).

However, the Committee would like to emphasise that, in our submission, any reform for a new CIV regime must include wholesale investors, and should be focused on non-resident investors. It is important that wholesale funds be properly incorporated into a new regime, as it may be unlikely that Australia could become a centre for non-resident retail investment by individuals.

The provision in the new Managed Investment Trust (MIT) regime, which includes in a "widely held" MIT, registered and unregistered wholesale funds, may be a starting point for any new or reformed CIV. However, in the context of the MIT regime, there are some inappropriate limitations to the "widely held" definition which make a number of foreign investors ineligible. The Committee submits that if the new CIV regime is serious about attracting foreign investors, the widely held definition needs to be expanded.

A problem with the widely held definition in the MIT rules is that indirect interests held by qualifying widely held vehicles (listed in section 12-402(3) of the *Tax Administration Act 1953*) may only be counted towards the widely held testing if the interest is held through trusts or a chain of trusts (section 12-402(4)). As noted in the Discussion Paper (and see above), trusts are not commonly used by many foreign investors and therefore this is an inappropriate limitation in testing whether an Australian CIV is ultimately widely held. The Committee submits that indirect interests held by qualifying widely held investment vehicles should be counted as widely held, so long as any interposed vehicles (in whatever form) between it and the CIV are controlled by the widely held vehicle. This would produce a more appropriate outcome which achieves the policy intent.

It may be appropriate to have the rules for such investors in a separate regime rather than as part of a reformed Division 6 of the ITAA 1936.

The Committee would also like to make submissions as to the use of Division 6C as the test for determining passive investment activities (and the "control" test in Division 6C). This is included below under section B of "Policy Principle 2".

[2] *Discussion Paper* p. 2-3
[3] Discussion Paper p. 7

Policy principle 1: The tax treatment of a CIV should be determined by the nature of its investment activities rather than the legal nature of the entity through which the funds are pooled

The Committee supports this policy principle as the best approach to achieve the policy objectives of the CIV regime. However, as noted below regarding policy principle 2, this may be achieved by extending the flow-through taxation treatment to a CIV which meets the relevant set of investment activities, no matter its legal form.

Policy principle 2: Tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment (p. 11)

A. *Principle of Flow Through Taxation*

The Committee submits that the best policy approach to achieve the principle of broadly consistent outcomes with direct investors is through a reform that enables flow-through taxation treatment of a CIV, so far as possible (bearing in mind integrity concerns about losses). It is submitted that, whether or not a new legal entity or vehicle is proposed, the basic principle of flow-through taxation should be applied in either case. Flow through tax treatment could be "principles based" in the tax system, rather than entity or vehicle specific. For example, flow-through taxation could be automatic where the predominant numbers of investors are foreign investors or wholesale investors.

The alternative suggestion of an 'integration' model of some kind is not supported (para [2.32]). We already have an effective corporate vehicle that operates on an 'integration' basis (the company subject to 30% company tax), with its existing advantages and disadvantages. A new form of integration system for a CIV entity will add complexity and is likely to raise many of the same issues and limitations that currently apply to companies as used by non-residents, in particular the inability to benefit from franking credits for non-resident investors and rules against streaming and trading of capital and franking credits. Providing other aspects of 'integration' in a company style vehicle can also be quite complex, as is shown in the Listed Investment Company (LIC) structure in respect of capital gains.

If a pure (partnership) flow-through model is adopted, the 'deemed-distribution' approach (para [2.41]) would logically follow, so that investors would be taxable on all income of the CIV whether or not it is distributed. It is noted that this is also the current basic approach for income in partnerships, and in MITs and REITs in Australia. While there is a risk that investors may be subject to tax on income that they have not received, an effect in practice of this flow-through taxation is that it leads to a strong distribution policy by managers, whereby most income is distributed on a quarterly basis to investors.

Alternative approaches could be to mandate distributions of, say, 90 percent of income each year (as is done in the US REIT regime), or to allow a distribution

deduction at the entity level (this assumes that the entity is taxable). However, the additional regulatory requirement of mandating distributions may not be necessary; more flexibility may be achieved by leaving it up to the CIV to manage investor expectations about distributions, based on a deemed-distribution model. It may be worthwhile for the Board to investigate the different distribution approaches adopted by entities used for investment in other jurisdictions.

We discuss below the issue of whether a new legal entity or vehicle is required, or whether reform in relation to existing entities may be possible. However, the basic principle of flow-through taxation should be applied in either case.

B. Passive or active characterisation

The Discussion Paper refers to the definition of “eligible investment business” in Div 6C, and asks whether that definition is appropriate (Q 2.2, referred to above).

It is accepted that a principle underlying this Review is that CIVs should be undertaking passive investment in line with the Div 6C definition of “eligible investment business”. Presumably the main purpose of this boundary is to ensure that so-called active investments in Australian businesses, for example private equity investment, may be treated as generating revenue profits (as proposed in recent TD 2010/21).

However, if this dividing line is considered necessary, a review of aspects of the Div 6C definition of “eligible investment business” may be appropriate. For example, one issue that has been problematic in the REIT context has been the strict limit on carrying on or control of active businesses (in a subsidiary), even where those businesses are directly connected to real estate rental, such as managing a car park at a shopping centre.

Further, the "control" test in Division 6C should be irrelevant in the context of a widely held CIV in a regime which aims to provide neutral/direct treatment. That is, if the investors of a CIV invested directly in a corporate entity which carries on a trading business rather than through the CIV, the CIV investor would not control the corporate entity and therefore, the aggregation of the investments through a CIV should not trigger the operation of Division 6C (even if the CIV controls a greater than 50% interest in the corporate entity).

C. Losses

The Board’s terms of reference refer to a principle of flow-through tax treatment (except for losses). The use of tax losses by investors is of relevance if those investors are taxable in Australia or elsewhere on income or gains derived through the CIV and where such losses are able to be used by the investor. For tax-exempt non-resident investors such as pension funds, the question of deductibility of losses is generally not relevant.

It is accepted that there may be integrity concerns about flow-through of losses. Nonetheless, it is submitted that it would be appropriate to allow deduction of losses for investors, at least up to the level of their investment in the vehicle. This is currently the case for VCLP losses.

D. Revenue or capital characterisation

The distinction between revenue and capital assets/gains for investment funds has long been an issue, although it has come to the fore recently (eg, in TD 2010/21 as noted above). Uncertainty about this distinction is a concern for investors and managers of LICs; for Australian taxable investors in VCLPs; for REITs (which invest predominantly in land); and, until recent reforms, for investors in MITs. This issue may raise broader tax policy questions than the design of an appropriate entity for non-resident investment in managed funds. However, the significant uncertainty as to this issue generates further issues for non-resident investors, in particular relating to the source of income of revenue gains.

Clearly, income streams such as rent, dividends, interest or royalties will be revenue in character and this character should flow through any transparent CIV entity to the investors. The relevant tax treaty characterisation, and withholding tax provisions, should apply as if this was a direct investment.

In relation to characterising gains or losses on disposal of investments, it is submitted that it will be important to the success of any new CIV regime to establish certainty for non-resident investors.

A number of different approaches may be adopted. The MIT approach of deemed-capital treatment is one option. This would have the advantage of consistency with an existing regime. Obviously, for non-resident investors, flow through capital gains will be exempt from Australian tax, unless land-rich. In the VCLP context, eligible non-resident investors are exempt from taxation on both capital and revenue gains, and so are indifferent to this characterisation question. A third option could be a bright line test, eg, related to the length of time that an investment is held (a long-term investment, however defined, could generate capital gain).

2. Australia’s current range of CIVS and proposals for one or more new CIV entities [Ch 3]

The Discussion Paper identifies three main legal entity vehicles that could potentially meet the definition of a CIV in Australia (p. 17):

- MITs (including property trusts – REITs)
- Listed investment companies (LICs)
- Limited partnerships (LPs), especially as used for venture capital (VCLPs and ESVCLPs).

As noted by the Board, the above existing vehicles are well known, used and attractive for different segments of the investor market, in particular for resident Australia investors. Given the large domestic pool of capital under funds management in Australia, existing entities in particular MITs and LICs should be retained in the tax system. Consequently, the main focus of the inquiry and this submission is on the usefulness of the above entities for non-residents.

The Committee submits that a flow-through regime may be principles-based for non-residents and wholesale investors. Consequently, it may not be necessary to specify a particular CIV legal entity.

The Committee makes some comments below on each of the types of entity considered in the Discussion Paper.

A. MITs

Q 3.1 The nature and extent of and reasons for any impediments to investments into Australia by foreign investors through MITs; How can the complexity of character and source retention under flow-through taxation be alleviated through alternative CIV entities that are more attractive or user-friendly to non-resident investors (p. 19)

The Discussion Paper, and our letter above, sets out a number of reasons why unit trusts are not an ideal vehicle for a CIV entity, in terms of both taxation and regulatory requirements. The issue of how tax treaties apply to trusts can also be complex and uncertain.

Therefore, in spite of the fact that MITs are well understood by Australian investors, the adoption of a reformed MIT entity specifically as a CIV vehicle is not recommended.

This is even more important, given the proposal to reform the Division 6 taxation of trusts. It is recommended that the Treasury separate out any reform and future operation of Division 6, with the goal of confining it to primarily domestic operations with a majority of taxpayers are locals and who are not wholesale investors.

B. LICs

The Discussion Paper in Q3.2 raises the possibility that the LIC regime may be broadened and amended to enhance its usefulness as a CIV entity.

As noted in the Discussion Paper, LICs are predominantly used by and attractive to Australian resident investors who seek imputation credits and capital gains treatment of gains on sale of investments. The LIC regime, especially regarding capital gains tax, is complex and specifically targeted to those Australian investors. It is also not a flow through entity, but provides two different modes of integration

in relation to profits (imputation credits) and capital gains (the CGT gain deduction provision).

If a corporate CIV entity is considered desirable, it is submitted that it would be more appropriate to design a new corporate CIV on the basis of principles of flow-through akin to partnership treatment, rather than an integration model.

C. Limited Partnerships (LPs) (p. 24)

Qn 3.3 What changes could be made to the LP regime to provide an appropriate LP CIV; are LPs suitable vehicles for widely held, primarily passive, collective investments; is it desirable to amend the LP regime to provide flow-through taxation for widely held CIVs that restrict investment activities to primarily passive investments; should it be limited to wholesale or sophisticated investors; would there be a need, both to limit flow-through of losses for integrity reasons, to apply further integrity and investor protection restrictions?

It is submitted that the Board should seriously examine as an option, changing Australia's current tax treatment of limited partnerships (LPs) to allow LPs to be used as a flow through for investment purposes.

Div 5A of ITAA36 was introduced in 1992, as a response to legislative innovations at State level that introduced a new kind of LP form. The purpose of Div 5A, which taxes these entities as a company, was to stop the use of flow-through LPs in leveraged loss schemes. It is accepted that as a matter of integrity, it would not be appropriate to allow unlimited flow-through of losses.

The Discussion Paper asks whether a LP would be more suited to active investment than passive investment. It is not clear to the Law Council why this distinction should necessarily be made; an LP flow-through form may be utilised for either kind of investment. An LP may also be structured as a hybrid corporate vehicle with separate legal personality. In the US, the use of LPs has been widespread for both active and passive investment, and the LP form has facilitated the development of private equity and venture capital markets. Various US States have led the way in enacting corporate LP entity forms. Losses are limited in a variety of ways, including through non-recourse and passive loss rules. In the UK, incorporated LPs were introduced some years ago, primarily for the purpose of enabling active businesses (such as professional firms) to incorporate. Loss limitation rules (essentially limiting deductibility to capital contributed) were incorporate into the new regime.

More recently, LPs have been adopted as a vehicle for collective investment at an international level.

In response to the VCLP reforms, Australian States have recently reformed and enhanced their existing LP statutes.[4] New Zealand has also reformed its LP

[4] Eg, Partnership Act 1892 (NSW) Part 3 Division 2; Partnership Act 1958 (Vic) Part 3 and Part 5; see further http://www.fairtrading.nsw.gov.au/Businesses/Business_structures/Incorporated_limited_partnerships.html

statute. Singapore recently reintroduced a LP regime to attract global funds management.

The Committee submits that there may be some merit in utilising an entity form that already exists in Australian law (and has been tested, to some extent, in the VCLP context), perhaps with additional tax or regulatory conditions attached at the federal level. This approach may also have the advantage of familiarity, and avoiding potential Constitutional issues.

3. Design of a new corporate CIV [Ch 4]

Q 4.1 The appropriateness of any of the taxation models (including variants) to achieve
tax neutrality for designing a corporate CIV regime….
Q 4.2 What would be the most appropriate method to achieve an outcome similar to tax
flow-through for a corporate CIV and 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?

The Committee makes some general comments here regarding the above questions.

The Committee submits that whether the Treasury decides to establish either a new CIV or a set of principles that can be applied to existing corporate entities or structures to entitle them to have flow through status, a standard regulatory regime for CIVs should be applied. The regulatory regime should not be more onerous than the regulation that wholesale and non-resident investors may be facing overseas. This is an issue that is separate from the tax outcomes. However, it could imply that for wholesale and foreign investors, a specific principles-based regime for both taxation and regulation is worthy of consideration.

In this regard, it would be helpful for the Board to review the regulatory and tax regimes applying under various popular CIV regimes overseas, in order to determine what features of these regimes are suitable for implementation in an Australian context (the Board refers to the Irish model in the Discussion Paper – others worthy of consideration include Singapore, Luxembourg and Cayman Islands for conduit international funds).

It is submitted that deeming a corporate entity to be a trust would introduce undue complexity into the tax law (and possibly entity law). As one of the concerns of

non-resident investors is the difficulty of understanding trust legal or tax principles, this approach may not be overcome that concern.

4. Investment Manager Regime (Ch 5)

The Committee submits that the exemption system outlined in Chapter 5 is the most appropriate approach in implementing the Investment Manager Regime. It provides clarity in tax treatment and therefore helps reduce the perceived complexity of the Australian regime.

In relation to what types of funds should qualify as a "foreign managed fund", the Board has included "widely held" and "does not carry on or control a trading business in Australia". We refer to our submissions above regarding certain issues with the current definition of "widely held" in the MIT regime and "control" in Division 6C.

The Board asks the question whether there should be a "managed in Australia" requirement or minimum spend requirement in Australia requirement for the investment manager regime. The Board raises a pertinent point of whether economic benefits and growth in the Australian financial services industry can be maximised without such a requirement. The Committee is not in a position to comment on the economic cost/benefit comparison. However, we note that, in order for Australia to be internationally competitive, fewer hurdles are preferred given Australia is not a currently a natural choice for the global funds management industry.

The Committee submits that, given the uncertainties around capital and revenue characterisation, also discussed above, the Investment Manager Regime should adopt one tax outcome for foreign managed funds, regardless of whether the gain is considered a capital gain or ordinary income in nature. The taxing regime for non-residents in relation to capital gains is relatively clear. It is submitted that it is appropriate for the capital gains taxing regime (in Division 855 of the Income Tax Assessment Act 1997) to be adopted as the taxing regime for non-residents in respect of revenue gains.

The Committee acknowledges the integrity concerns with "round tripping" by Australian investors. The Discussion Paper considers complicated ownership tracing and reporting requirements to prove no Australian or de minimus Australian investors before the Investment Manager Regime applies. Ownership tracing is often not practical in widely held funds - for example, because investors are often themselves funds with a wide range of investors. Therefore, there is doubt as to whether the underlying ownership of the fund can be determined with any degree of certainty. In addition, proper tracing, even if practically possible, is often an expensive exercise and therefore an impediment to using the regime.

The Committee suggests that, as an alternative to ownership tracing, that there could be a dual test for dealing with integrity concerns (which is at the foreign managed fund's election):

1. An ownership tracing test as suggested by the Discussion Paper; or

2. A maximum Australian exposure test – which allows the exemption to be claimed if the total Australian investments account for less than a specified percentage of the fund's overall investments (eg, 30%). This means that the majority of exposure to the fund is in respect of non-Australian investments, indicating that a 'round tripping' motive of any Australian investor may not be the predominant motive for the investment. The Australian investor is exposed to other factors and overall, the choice of investing into the fund is driven by the skills of the manager rather than the Australian profile of the fund.

This type of dual test (upward or downward testing) is more practical for fund managers because they should be able to obtain sufficient data on their investments even if they are unable to trace through their indirect owners with sufficient accuracy.

5. Venture Capital Limited Partnerships (VCLPs) (Ch 6)

The Committee makes some general comments concerning the questions raised about the VCLP and Early Stage VCLP (ESVCLP) regimes considered in Chapter 6.

These regimes were enacted less than 10 years ago, with the goal of providing a tax incentive to encourage investment in the venture capital industry. The VCLP regime replaced the PDF company regime (which utilised a separate entity instead of flow through tax model, but with some elements of integration). A particular goal of the VCLP regime was to facilitate non-resident venture capital investment into Australia and also to encourage leading international venture capital managers to locate in Australia. Some features of the VCLP regime were overtaken by events, in particular on enactment of the exemption for capital gains of non-residents (apart from land rich gains) from tax.

As experience with VCLPs is still at an early stage, it seems premature for the government to drastically change this investment entity form, or associated tax treatment.

It is important to remember that "venture capital" is only a very small portion of the managed funds sector, and it is distinct from private equity investment.[5] While the numbers quoted as to the number of active VCLPs and amount of capital under management appear small (Discussion Paper, para [6.26]), the number of VCLPs and capital managed under VCLPs has in fact increased three-fold since 2005, in spite of the intervening global financial crisis. This suggests that, in spite of their various limitations, VCLPs are performing a useful function for some kinds of investment. The statistics show that only a small proportion of this investment is

[5] Although the main industry body, AVCAL, is now called the Australian Private Equity and Venture Capital Association.

from non-residents. However, it is important to be realistic about how much Australian venture capital investment we can expect from non-resident investors.

The current model of tax concessions for VCLP and ESVCLP investors and managers is to provide flow through treatment enabling exemption or discounted CGT treatment for capital gains, including on carried interests, and to enable flow through of losses for taxable investors. This basic model should be maintained.

The Committee submits that, while the current VCLP regime should not be abandoned, it is appropriate for the Board to review the layered, and complex investment, activity, employment and capital restrictions that are currently imposed on VCLPs. These restrictions may be causing investors and managers to design "parallel" entity structures, in particular so that some investments that are ineligible for the VCLP concessions may be maintained. Such structures add complexity, but in general may be used to overcome limits in the statutory regime – in this case, a question arises as to whether those limits are really necessary or appropriate to encourage non-resident venture capital investment.

In relation to losses, it may be useful for the Review to investigate how the VCLP flow-through loss limitation rules have been working (if there is any evidence in this regard), as these loss rules may provide a model for limitation of losses in a broader CIV flow through entity.

The Committee recognises that if the government accepts a recommendation for a flow-through IMR regime for non-residents, it might be more attractive than the current restricted VCLP concession and might cause managers to use the IMR regime thereafter for new investments. The Board might therefore recommend to the government that the VCLOP concession should be reviewed again after the final IMR regime is implemented, including the potential for conversion of VCLPs to IMR structures. It is premature however to consider this in detail at this early stage.

The Committee would be happy to provide further assistance, or discuss any of the above proposals, if that would assist the Board. In the first instance, please contact the Committee Chair, Ms Teresa Dyson, on 07-3259 7369 or via email: teresa.dyson@blakedawson.com

Yours sincerely

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Secretary-General