The Board of Taxation
C/ The Treasury
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CANBERRA ACT 2600

Response to Board of Taxation Discussion Paper December 2010
Review of Tax Arrangements Applying to Collective Investment Vehicles

Introduction

The Australian Private Equity & Venture Capital Association Limited ("AVCAL") is a national association which represents the private equity ("PE") and venture capital ("VC") industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

AVCAL welcomes the opportunity to comment on the Board of Taxation's discussion paper 'Review of tax arrangements applying to collective investment vehicles' (the "Discussion Paper"). AVCAL urges the Board to use the opportunity presented by this review to ensure that Australia presents to local and international investors, an efficient and competitive environment for collective investment management activities, particularly those of in the PE and VC industries. Any perceived risk to the revenue associated with AVCAL's recommendations will be more than offset by increased taxation receipts from bigger and more profitable portfolio companies, and more productive workforces. The assessment of the Deputy Governor of the RBA, Mr Battellino, noted in the Senate Report on the review of private equity in 2007, was that: *"[the] conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base*."

Why clarity and consistent treatment of CIVs matter to PE

Collective investment vehicles (CIVs) are an important mechanism for investment into Australian private equity (PE). They provide a means to aggregate capital committed by investors from many different jurisdictions for investment into Australian PE. They are used both by overseas PE firms to invest in Australia and by domestic PE firms to aggregate capital from their investors including those from overseas. Overseas investors such as pension and endowment funds commit a significant proportion of the capital invested in Australian PE (see Appendix A).

Private equity is a significant provider of equity capital to businesses in Australia with approximately $25B of funds under management. Of that, less than half is sourced from overseas, generally from pension, superannuation and endowment funds. Of those overseas investors some 92% reside in tax-treaty countries. These funds are invested into Australia through collective investment vehicles as a means to aggregate those funds from a variety of jurisdictions.

At a conference held this week in Australia a number of those substantial investors including funds of funds (who, in turn, have pension funds and other similar institutions as their investors) expressed frustration and confusion about their tax obligations under Australian tax law.

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The following demonstrates the inconsistencies that they face:

- if they are from overseas and invest directly into local enterprises their gains are on capital account (with the Div 855 rules applying).
- if they are part of a MIT the managers can elect for their investors' gains to be on capital account.
- if they invest through non-MIT CIVs, the recent tax determinations will have them taxed on either income or capital account, depending on the specific facts of the case; and,
- if they invest through a VCLP, the result for domestic investors other than complying superannuation funds is unclear.

Many such international investors are invested in several Australian managers and are at risk of having different tax treatment in their separate investments due to this confusion and inconsistency. The investment activities of the different managers are all part of the same spectrum of private equity investing, providing capital from early stage start-ups through to expansion capital and to management buyouts.

All these investments add value to the companies in their portfolios, growing their underlying value.

The current path of reform and suggestions in the Board's Discussion Paper seem to support the interests of the hedge funds sector. Conceptually, AVCAL queries why the Board appears to be promoting a policy that would encourage speculative, short term trading, as undertaken by hedge funds, as opposed to patient capital aimed at growing businesses, being the mainstay activity of private equity and venture capital funds.

We attach at Appendix A, an overview of how private equity operates in Australia. AVCAL cannot understand why private equity funds are, seemingly, being discriminated against when numerous studies and reports (including the 2007 Senate report on private equity in Australia) indicate that private equity investment stimulates the economy by increasing the quality and operational efficiency of its investee entities and creating jobs.

Thus far, the rationale for the apparent discrimination put forward by Treasury / the ATO, albeit informally, appears to relate to the facts that: (1) a PE CIV often takes a controlling interest in its investee entities; and (2) the manager's activities are generally directed at increasing the value of the investment made by the CIV. AVCAL submits that neither attribute is unique to PE, and neither provides a sound foundation or policy rationale for the apparent discrimination.

Regarding the first point, a fundamental tenet of a CIV is that investment through one should not alter the taxation outcome for an investor in it, as compared to direct investment. Providing the new CIV regime contains safeguards against "closely held" entities from qualifying; it seems highly unlikely that any investor in a CIV would have a sufficiently large interest in the underlying investment to constitute a controlling interest. Indeed, CIVs operating within VC / PE typically mandate that investors have no control interest in them nor are they able or interested to involve themselves in the conduct of the investment business undertaken by the CIV, as advised by the manager. Penalising PE investors for aggregating their interests through a CIV will most likely lead to an inefficient disaggregation of the investment model. Such an outcome would not only be illogical, but would also be at odds with a policy setting which is directed at allowing the financial services sector to reach its full potential.

Regarding the second point, AVCAL notes that it is not unusual for direct, activist shareholder investors to intervene in the direction an investee entity is taking. Such activity should not alter the taxation characterisation of a profit once made. The thesis also fundamentally misconstrues the role of the CIV, that of the PE fund's manager; and that of the investee entity's board. The activities which cause the improvement in the value of the underlying investment are predominantly those of the investee entity's

board, as advised by the manager. The differentiating feature from a listed public company scenario would appear to be the role of the manager.

In this regard, whilst the CIV might hold the majority of the shares in an investee entity, and which carry sufficient voting rights to spill an investee entity's board and thereby take control of it, AVCAL's strongly held view is that, merely holding such interests or exercising those rights periodically, is not the hallmark of an active business.

In fact, any restructuring of an investee entity, including via the deployment of expansion capital invested into the investee entity, is a direct consequence of the implementation of decisions made by the board of the investee entity. It may be that the manager of a CIV provides advice to the investee entity's board; however, it is just that: advice. Often, the manager is separately remunerated by the investee entity for this advice. Query the basis on which the activities of the board or the separately remunerated activities of the manager may be attributed to the CIV.

In this respect, AVCAL notes that every multinational business invested into Australia via an Australian subsidiary has the same control dynamic. The foreign parent has the ability to appoint directors; and typically foreign representatives of the foreign parent will have an oversight function and regularly provide advice to the Australian subsidiary. That advice would be directed at increasing the value of the Australian business. It is not unusual for the advice to be remunerated. Can one say, as a consequence, that the foreign parent has a taxable presence in Australia?

Australia's Double Tax Treaties contain a clause, supported by the model OECD treaty and commentary thereto, in the following form:

> "The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment of otherwise), shall not of itself make either company a permanent establishment of the other".

The fact that most multinational investment into Australian companies is on capital account is not the point at issue. Indeed, as indicated above, many of the activities undertaken by MITs in the context of their actively traded portfolios would fall to "revenue" characterisation. Those entities appear to benefit from MIT CGT elections, potentially IMR exemptions; and potentially similar status under a broader CIV regime. It is not clear to AVCAL why the addition of a control element changes the potential policy setting.

The fundamental question remains: "*is it appropriate to attribute the activities of the manager to the investors?"* In a direct, disaggregated, investment paradigm, such attribution would seem to be irrelevant. Where the investor is a complying superannuation fund, taxation outcomes are certain and set out in statute. So too where the investor is a MIT which has availed itself of the MIT CGT election. Where the investor is resident of a country with which Australia has concluded a tax treaty (as is the case with 92% of foreign investors into Australian PE) then, absent an Australian permanent establishment, liability to Australian taxation should not arise (direct or indirect interests in land aside). Where the manager is an independent agent acting in the ordinary course, and properly remunerated, it should not ordinarily constitute a permanent establishment of the foreign investor. In a disaggregated world, questions of economic dependency do not arise.

In this respect, one should keep in mind that the CIV's role is simply to act as an efficient aggregator of the collective investments. Disqualification from the proposed CIV regime should not arise merely because of circumstances where the CIV itself has a controlling interest in its investee entities or because of the supposed activities of the manager.

Finally, AVCAL notes that the Board is investigating a recommendation to introduce an arm's length dealing test for qualifying MITs, and suggests such a rule could provide sufficient safeguard to allow abolishment of indirect control (of ineligible business) tests within any CIV regime. Alternatively, AVCAL submits that such an indirect control test, if one is to be retained, should not apply where the CIV is of limited life, calls capital only when an investment is to be made, and is required to disburse the net investment sale proceeds immediately or within a reasonably short period following sale. Such an exception would appear to be justified as it points to the reality of the CIV operating as a mere conduit for the efficient management of the investor's capital.

VCLP/ESVCLP

AVCAL supports the continued operation of the Early Stage Venture Capital Limited Partnerships ("ESVCLP") and the Venture Capital Limited Partnership ("VCLP") regimes. However, AVCAL notes that, since the VCLP/ESVCLP regime was introduced in 2002, only 34 VCLPs (plus 3 conditionally registered) and 3 ESVCLPs (plus 4 conditionally registered) have been brought into operation. It is evident from these low numbers (as compared to the proliferation of MITs) that the regime has not worked as intended. In addition, to the best of AVCAL's knowledge, the restrictions on investing activities of VCLPs have led to only one VCLP being used in a stand-alone manner. All others have an associated trust to carry out investment activities not permitted to be carried out by the VCLP or ESVCLP.

Desired outcomes

AVCAL would like to see as an outcome of this review the introduction of a general CIV regime which:

- allows flow through tax treatment, i.e. source and character retention, either mandatorily or by election. Character and source flow through to investors in CIVs will ensure that tax outcomes for investors will be broadly consistent with tax outcomes of direct investment. Treatment should be extended to other CIVs, in particular limited partnerships, and should not be confined to trusts.

- in line with the MIT regime, provides the ability to elect for mandatory capital account treatment; and

- is simple in design and internationally competitive. Such a regime must be comparable to regimes adopted by other developed countries such as the United States ("USA"), the United Kingdom ("UK"), and our nearest competitor in the global financial services market, Singapore.

AVCAL submits that the introduction of a general CIV will support and stimulate the local financial services sector and lead to Australia becoming a true global financial services hub. AVCAL submits that such a regime will fundamentally be revenue positive, as it will general taxable revenue from the increase in investment managers and advisors.

We would be pleased to discuss our submission further with members of the Board.

Yours sincerely

Dr Katherine Woodthorpe
Chief Executive

AVCAL

The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

REVIEW OF TAX ARRANGEMENTS APPLYING TO COLLECTIVE INVESTMENT VEHICLES

DISCUSSION PAPER RELEASED ON 17 DECEMBER 2010

The following sets out AVCAL's submission on the Board of Taxation's (the "Board") discussion paper 'Review of tax arrangements applying to collective investment vehicles' (the "Discussion Paper"), including a brief description of, and the rationale for, suggested tax law amendments which are necessary in order to make the measures operate in a manner that should reduce uncertainty, complexity and compliance costs for AVCAL's constituent members.

Discussion Paper Chapter 2: Collective Investment Vehicles for the purposes of this review

Q2.1 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.

Summary

- *In AVCAL's view, the fundamental role of a CIV is to efficiently aggregate the capital of investors which, once pooled, is invested into a common cause by leveraging the investment skill of the entity's manager. The efficiency gains through aggregation can be hampered, and potentially eliminated completely, where taxation outcomes of investors deteriorate as a consequence of the collective investment when compared to direct investment.*

- *Relevant to the Australian private equity industry, CIVs operating or investing in Australia include trusts, those trusts which are MITs, VCLPs, and ESVCLPs, foreign limited partnerships, and foreign limited liability companies.*

- *From the perspective of foreign investors, complexity and uncertainty are a common complaint, as are outcomes which appear nonsensical. In particular:*

  - for trusts, including Managed Investment Trusts ("MITs"), the CGT exemption in Division 855 of ITAA, 1997 requires the trust to be a "fixed trust". AVCAL understands the Board to be familiar with the uncertainty in this area;

  - for trusts, eligibility to the MIT CGT election requires "widely held" tests to be satisfied without the benefit of tracing through foreign LPs and other transparent entities (cf the requirement to trace through trusts). For those trusts which do not qualify for the MIT regime, uncertainties and complexities associated with the revenue / capital divide, and therefore source, arise;

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- for trusts, there is considerable confusion and uncertainty relating to the "present entitlement" regime within Division 6 of Part III of ITAA, 1936;

- for MITs, even those that have made the CGT election, Australian tax can arise for income or gains on non-covered assets that are distributed to non-resident beneficiaries, where such income or gains have an Australian source. Examples include foreign exchange income or profits, or income or profits relating to certain derivatives, notwithstanding that the income or gain relates to otherwise covered assets;

- for unit trusts that are public trading trusts as defined in Division 6C of Part III of ITAA 1936, there is uncertainty regarding the concept of 'control' in the context of the 'eligible business' test;

- for VCLPs, the rules pertaining to eligible venture capital investment if applied literally can give rise to nonsensical results; and in any event require modernisation. Refer specifically to AVCAL's response to Question 6;

- for foreign CIVs, uncertainty can arise regarding residence, source of profit, and eligibility for tax treaty relief; and

- for CIVs generally, uncertainty exists regarding source of income, and particularly whether the manager's activities or those of other intermediaries could contribute to Australian source;

- *Specific non-tax factors include, on the one hand, a lack of foreign investor familiarity with, and certainty of foreign tax jurisdiction classification of, trusts; and on the other, foreign investor confidence in, and general preference for, a limited partnership or limited liability company CIV;*

Australia's lack of an internationally competitive flow-through investment vehicle for collective investment, and its reputation for tax and regulatory complexity and uncertainty, represents a significant impediment and disadvantage when considering establishing Australia as an international centre for funds management for global funds.

AVCAL supports the expansion of the range of available CIVs for investment into and through Australia. The Board's assessment of the issues facing foreign investors is consistent with the concerns of AVCAL's constituent members. Foreign investors investing into Australia or through Australia face the challenge of understanding the intricacies of Australia's rules in relation to trusts and MITs. Division 6 of the Income Tax Assessment Act (ITAA1936) in relation to the tax treatment of trusts is old, complex and relies heavily on case law for its interpretation.

Other OECD 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 and expensive to educate investors in relation to the nature of trusts. In some instances, foreign investors have chosen not to invest in Australia or to do so via foreign limited partnerships ("LPs"). In turn, this can add another layer of complexity in light of the Australian Taxation Office's view of the use of foreign LPs (refer to TD2010/D8).

Pursuant to Division 5A of the ITAA1936, corporate limited partnerships are treated as companies and denied flow-through treatment of gains and losses. Whilst flow-through treatment is achieved for Venture Capital Limited Partnerships ("VCLPs") and Early Stage Venture Capital Limited Partnerships ("ESVCLPs"), the VCLP regime is still heavily constrained by the scope of eligible investments.

The proposed MIT reforms, although welcome, still do not provide a feasible solution for foreign investment into Australia. The Board's suggested reforms, which include the introduction of new concepts though desirable suggest that there will still be complexity involved around the taxation of MITs. For example, 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.

Another issue facing foreign investors in the private equity/venture capital sector is the uncertainty of the character of the gains derived from the disposal of investee entities. The certainty of revenue or capital treatment only applies to qualified MITs as currently defined. However, AVCAL notes that even the MIT regime has short-comings in that the narrow definition of MITs means that it is quite possible for CIVs to fail to achieve MIT status under the Australian tax provisions, where for example there are interposed wholesale entities which do not satisfy the flow-through rules.

The lack of a flexible CIV regime makes Australia unquestionably less attractive. Many fund managers and/or foreign investors are having to implement alternative structures to avail themselves of the MIT regime. Put simply, the more complex a fund structure, the less attractive it is and the less is capital available to make an investment into Australia. Large global funds, who are required to allocate their investment capital based on regional and industrial sectors, are finding it increasingly unattractive to allocate a significant portion of their investment capital to Australia due to:

- a lack of understanding of the trust structure and related complicated trust law and MIT rules;
- lack of certainty in relation to the character of gains for private equity/venture capital investment; and
- a lack of simpler alternative flow-through structures.

AVCAL fully supports the reform of Australia's MIT rules and we believe that the reform will be a useful and significant development particularly for Australian investors. However, the MIT rules merely rectify a significant disadvantage and uncertainty in Australia's trust tax rules. From the perspective of international competitiveness and more importantly to attract foreign capital, the MIT reforms still do not deliver structures calculated to attract foreign investment into Australia. Nor do they provide Australian managers with a level playing field.

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.

AVCAL therefore recommends that the MIT regime be retained together with proposed reforms, and retention of the current LIC regime, with appropriate modifications. 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, which include:

- companies including limited liability companies ("LLCs") with the ability to elect for flow-through treatment subject to integrity rules,
- partnerships including limited partnerships ("LPs/LLPs") with flow-through treatment and with the benefit of being entitled to make a capital gains tax election to treat its investments on capital account only; and
- listed investment companies ("LICs").

Our discussion on CIVs and our recommendations are discussed in further detail below.

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 are 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.

AVCAL recommends:

2.1 The 'tracing provisions' in section 12-402(4), and any similar test included in a general CIV regime, should be expanded to allow a tracing of ownership through entities that are fiscally transparent from the perspective of the country of residence of its investors.

2.2 AVCAL understands that the concept of 'eligible investment business' may need to be retained.

2.3 However, AVCAL submits that the 'control' limb of the test should be repealed, and certainly in the context of 'private equity' CIVs, if not for all CIVs. If necessary, the test could be replaced by a requirement that the CIV deal with its controlled entities on an arm's length basis.

2.4 Alternatively, if it is considered that a control test is necessary, then a 'bright line' test for what amounts to 'control' should be introduced to provide investors certainty.

2.1 Appropriateness of the "widely held" definition contained in the MIT legislation

Section 12-402(3) of subdivision 12-H in the Taxation Administration Act 1953 contains a list of specified widely held entities which can assist a trust to satisfy the requirement to have the required number of members to meet the relevant membership test to be treated as an MIT. Section 12-402(4) supplements this list by providing for tracing through a chain of trusts to the ultimate non-trust investor for these purposes.

This is useful for domestic investors who may invest through an interposed trust. However, offshore "funds of funds", and other offshore funds which have been formed as foreign collective investment vehicles (in corporate or limited partnership forms) and which are typically fiscally transparent from a foreign investor's perspective, make up a very significant part of the total pool of potential foreign institutional investors into Australian private equity and venture capital funds. The ultimate investors in these collective investment vehicles are often the type of 'specified widely held entities' referred to in section 12-402(3), such as sovereign wealth funds and pension funds.

As trusts are the CIV of choice within the domestic funds management industry, requiring a tracing of interests through them for the purpose of determining whether a trust is itself "widely held" is sound. The CIV of choice in the international arena is the limited partnership and limited liability company.

If indeed, it is necessary to introduce a widely held requirement in designing a CIV regime, the legislative defect in the MIT tracing rules should be amended. To illustrate this, under the current law (refer to section 12-402(3)(e)) unless that corporate or limited partnership (which meets the requirements to be treated as a foreign equivalent of a managed investment scheme) itself has 50 members, such an entity will only count as 1 member for the purposes of the member test, even though the investors in that vehicle largely comprise of 'specified widely held entities'.

AVCAL submits that the tracing provisions in the MIT rules should be expanded to also allow tracing through all forms of fiscally transparent collective investment vehicles including limited liability partnerships, limited partnerships and limited liability companies. In this regard, "fiscal transparency" should be determined from the perspective of a particular investor's country of residence. Where not all investors' countries of residence treat the entity as transparent, the intermediary could be transparent only to the extent that it is so regarded.

It is noted that such an approach is consistent with the principle applied by the OECD in its commentary on the availability of treaty relief via interposed fiscally transparent entities. This same principle has also been promoted by the ATO in a different context in relation to applying 'treaty benefits' to investors in foreign limited liability partnerships in draft Taxation Determination TD 2010/D8 where the limited liability partnership is treated as fiscally transparent in the country of residence of the partners.

2.2 Division 6C style "eligible investment business"

AVCAL endorses the submission prepared by Allan Blaikie of Clayton Utz dated 1 March 2011 (attached as Appendix C).

In the context of Australia's refundable franking credit regime, an entity level tax regime makes most sense in the context of entities which have access to permanent capital and an ability to accumulate profits.

Thus, imposing company tax on Australian resident companies generally appears to be sensible, as the profits made by them can usually be retained indefinitely. It also generally appears to be fairer to collect tax from the entity possessed of the income on which it is levied. Similarly, though subject to the following, an entity level tax would appear to be appropriate for entities that have similar qualities to companies (for instance, public trusts with very long life).

An exception to an entity tax rule could apply where the entity distributes its profits at least annually, or in circumstances where the taxable income of the entity is otherwise allocated and taxed in the hands of the entity's owners.

In this regard, AVCAL notes that the typical private equity CIV does not call capital from its investors until the capital is to be invested, and generally immediately returns it to them, together with any profit, as soon as the investment is sold. In these circumstances, the incidence of tax would appear more appropriately to rest with the CIV's owners (ie its investors).

As noted elsewhere in this submission, AVCAL considers that to be successful, a CIV regime must be "flow-through" for tax purposes. For the reasons expressed above, not all entities ought to benefit from "flow-through". An "eligible investment business" test could be retained as a feature to exclude a CIV from entity tax. However, in AVCAL's view, there does not appear to be a logical reason to retain the extension of the test whereby it effectively prohibits control by the CIV of another person which is conducting ineligible business. That rule is particularly inappropriate in the context of private equity.

AVCAL believes an investor's taxation outcome ought not change by dint of investing through a CIV as opposed to investing directly. Given established criteria around ensuring a CIV is widely held, and not closely held, AVCAL notes it would be highly unusual for a particular investor and its associates to hold a controlling interest in the underlying investee entities held by the CIV.

Where the CIV itself restricts its business activities to eligible business, flow-through taxation should result, such that the investment by the investor is, for tax purposes, equivalent to a non-controlling interest in an investee entity.

AVCAL understands that the Board and other stakeholders may be concerned about ensuring that a flow-through CIV is not inappropriately able to strip a corporate tax entity's earnings through its eligible business activities. Should this be a concern, perhaps it is more appropriately addressed by requiring a CIV to transact only on arm's length terms with its associates (including controlled entities), rather than disqualifying the CIV from flow-through taxation.

Should the Board consider that the "control" test should generally be retained, then AVCAL would like it to be limited such that it does not apply in the context of private-equity style CIV; where for instance, the CIV has a limited life, an ability to call capital only when an investment is made; and an obligation to distribute proceeds of investments as soon as they are sold. AVCAL submits it is these features of the typical private equity CIV which dictate that taxation outcomes of investment through the CIV closely align to those which would have transpired had the relevant investor invested directly.

In this context, AVCAL would also like to address the Board's comment at paragraph 2.20 that "… control is the factor which indicates active involvement in the trading business and so funds such as private equity funds would not typically be considered to be undertaking passive investment activities."

In making this comment the Board appears to have disregarded the nature and intention of the ultimate investors in such funds, and the role of the CIV. The investors in private equity funds are typically passive investors. Such investors are for the large part pension / superannuation funds, fund of fund vehicles and sovereign wealth funds all of which have a passive investment intention.

While the manager might be undertaking an active business, the manager's activities should not be attributed to the CIV. The CIV's purpose is simply to provide an efficient aggregation of the investor's capital, as evidence by the fact that capital is drawn only when invested, and immediately returned following realisation. It is more appropriate to attribute the orientation of the investor to the CIV, rather than that of the manager. This is best highlighted by the fact that if an investor invested directly, in the vast majority of cases, gains arising from the sale of investee companies would (in

the domestic context) be statutorily capital gains or (in the international context), exempt from Australian tax by dint of the application of a Double Tax Treaty. Whilst AVCAL concedes such outcome may not be universally true, it would be true in the vast majority of cases. A policy setting which discriminates against the vast majority is not, in AVCAL's view, sound.

Conceptually, AVCAL queries why the Board by dint of its statement at 2.20 appears to be promoting a policy that would encourage speculative, short term trading, as undertaken by hedge funds, as opposed to patient capital aimed at growing businesses, being the mainstay of private equity and venture capital funds.

Finally, if a new CIV regime is adopted which contains a "control of ineligible investment business" prohibition in a private equity context, the policy setting could lead to a push by private equity investors towards a disaggregated investment model. This would introduce additional costs and complexity which ultimately, in AVCAL's view, will prevent the industry, and thereby the Australian economy, from reaching its full potential.

2.3 Concept of 'control' in Division 6C of the ITAA 1936

As indicated above, AVCAL submits that the 'control' test in Division 6C should be removed as the policy reasons for it are no longer relevant. AVCAL see no policy or practical reason to retain the control test currently in Section 102N as it applies to subsidiary or controlled companies in Australia or to offshore investments.

However, in the event that the control test is to be retained, then AVCAL submits that the term 'control' should be clearly defined with a bright line test as the ATO's current interpretation is uncertain and uncommercial.

The ATO's views on this issue have not been clearly set out in a public ruling. Rather the ATO's views have been disseminated via ATO Interpretative Decisions and Extracts of private rulings. These documents provide limited factual background, making it difficult for advisers to provide definitive advice on these issues.

There are no decided cases on the meaning of 'control' or 'ability to control' a company for the purposes of Division 6C. The ATO is of the view that control connotes both:

- 'positive control': as the conduct of the affairs of a company are vested in the Board of Directors, this means the ability to control the composition of the entity's Board of Directors; and

- 'negative control': being the ability to veto decisions that relate to the affairs or operations of the entity.

The most recent ATO ID (ATO ID 2001/11) on this topic was issued on 18 February 2011. The facts in that ATO ID relate to 4 shareholders, one of which is a public unit trust, each holding 25% of the shares in a trading company. Under the shareholders agreement an 80% majority vote of shareholders is required in relation to 'Shareholder Matters', which, according to the ATO, go to "the structure, scope and management of X Co's business and encompass matters which pertain to X Co's capital structure, shareholders' rights, corporate governance as well as business scope and strategic direction."

In the ATO's view the public unit trust's effective veto rights under the Shareholders Agreement provided the trust with the ability to control the trading company. On that basis the trust is therefore a public trading trust. In AVCAL's view an interpretation where a 25% shareholder, with the same

rights as the other 3 shareholders, is considered to be able to control the company is unrealistic and uncommercial. In AVCAL's view any 'control' test, if required (which is disputed), should be limited to the situations where the trustee actually controls the company through an ability to appoint a majority to the board of directors. Veto rights held by a minority investor should not be sufficient to constitute control.

Artificial contrivances to avoid control could be addressed via Part IVA if necessary.

However, as stated above, AVCAL considers that a control test is unnecessary and the test should be repealed.

Chapter 3: Australia's current range of CIVs

Q3.1 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.

AVCAL recommends:

3.1 The flow-through treatment that is currently limited to MITs be expanded to other types of CIV entities which can elect to be treated as tax transparent (e.g. similar to a "check the box" in a US context). This treatment can be supported by a robust integrity rule, requiring the CIV to make annual distributions of net income for each year of income within a reasonable time after year end.

3.2 The characterisation of gains should flow through CIVs.

3.3 The rules regarding capital treatment be expanded and clarified.

3.4 The presence of a local manager should not of itself give rise to an Australian source or permanent establishment for a foreign investor.

3.5 There should be clear rules ensuring Australian investment alone should not cause deemed residence issues.

Background

While Australia has one of the most sophisticated investment fund industries in the world however the ability to capitalise on that expertise and attract foreign investment capital in a private equity context has been hampered by the uncertainty in how Australian taxation laws apply to foreign investors (and, on occasion to domestic investors as well) and the interpretation of that law by the Australian Taxation Office in relation to private equity style investments[1].

Foreign investors into Australian collective vehicles such as MITs historically have faced a number of issues which discourage investment. These are noted below.

3.1 The Type of Entity Issue

It is a well recognised proposition that investors invest via a CIV for the following reasons[2]:

[1] The issue was initially recognised in 2005 when the former Federal Government made it clear that it was their goal to, as far as reasonable, remove impediments to foreign capital being attracted to Australia and to ensure that Australia has a competitive international tax system - se Media Release No. 044 dated 10 May 2005 entitled "International tax reforms" by the former Treasurer, Peter Costello.

[2] Comments made by the Informal Consultative Group (the "ICG") on the Taxation of Collective investment Vehicles ("CIVs") and procedures for tax relief for Cross-Border Investors released a report considering treaty entitlements to CIVs themselves and that of their investors in 2009 CIV report are particularly useful as it represents an accepted international view of how and why investors choose to invest via a CIV. These have since been formalised in a 2010 OECD report.

- The function of a CIV is to allow a small investor to achieve investment goals that they would not ordinarily be able to achieve because of economies of scale – this is recognised by the OECD as being a primary economic benefit of investing via a CIV.

- By the pooling of funds, the investor is able to invest in something much larger than its allocable share of the underlying assets.

- An investor is able to rely on investment expertise of advisors that it may not ordinarily have access to on its own.

- For a CIV with a diversified portfolio, the small investor is able to enjoy a greater choice of investments with simplified compliance (legal and tax) procedures.

For the above reasons, foreign individual investors, for regulatory and/or liability reasons, often choose (or in the context of social security or pension regimes are required) to invest via a separate legal entity (a CIV) which may take the form of (the following are collectively referred to as "funds"):

- a company;

- a limited liability company ("LLC");

- a limited partnership ("LP"); or

- a trust.

However, foreign funds formed in non-English or American law type jurisdictions (e.g. Japan and countries in mainland Europe) can take other forms, which may not fit neatly into any one of the above categories.

AVCAL notes that its constituents raise their capital predominantly from these 'first level' aggregation vehicles, that is, in wholesale markets, rather from the small individual investors themselves. Often they also raise their funds from other intermediary entities known as "funds of funds". The most common fund structure used is a limited liability partnership. Internationally, such a structure affords investors the benefits of a limitation of liability and flow-through treatment of income.

Foreign funds typically pay fees to an arm's length investment manager or adviser ("Fund Manager"), which usually acts as the sponsor of the foreign fund. The Fund Manager can be located in the same jurisdiction as the foreign fund. But in practice it is more likely that either the Fund Manager itself, or a related party delegate of the Fund Manager, will be located in the US, the UK or other countries with which Australia has DTAs.

In a global context therefore the nature of the CIV or "fund" entity is more often than not something other than a trust. More often LLCs or LPs are the basis for the CIV structure due to their flexibility and limited liability nature. Australian trust law issues, including those concerning the limitation of liability, are complex and not well understood by foreign investors.

As such, trusts which have been the vehicle of choice in an Australian context are largely unknown overseas in a CIV context. Foreign investors, when looking at Australia and the limited type of CIV on offer, may move away from investing here to another jurisdiction in which a more familiar CIV vehicle is available and one where the limitations of liability are clear. This is particularly so in the context of large investment funds who only allocate a small portion of their capital to the Australasian region. The use of an unfamiliar CIV vehicle adds an unnecessary layer of complexity,

due diligence and administrative costs. When choosing which country to invest in, such considerations are extremely relevant to the investment manager or advisor to a sovereign fund/pension fund/superannuation fund when determining allocation of their capital.

Other considerations detracting from the use of MITs are noted in our submission answer to Question 2.

3.2 Character and Source Retention

AVCAL notes that certainty of character and source retention are critical components of the successful implementation of an effective CIV regime. AVCAL's favoured approach is to require the CIV to allocate its income / loss on a character and source retention basis to its investors in a manner consistent with the clearly defined rights as set out in the CIV's constitution, and other documentation relevant to the fund's administration.

For domestic investors in PE funds, the critical consideration is access to discount capital gains upon the disposal of interests in qualifying assets. AVCAL submits this is most easily achieved by extending the CGT election to all forms of qualifying CIV.

For foreign investors, the exemptions within Div 855 of ITAA 1997 should extend to gains distributed to non residents through qualifying CIVs. The role and functions of the CIV's manager, and other intermediaries, should specifically be excluded from considerations relevant to determining whether the property sold is Taxable Australian Property; that is, the relevant property should not by dint of these roles or functions be considered to be property that has been used in carrying on a business through a permanent establishment in Australia for the purposes of subsection 855-15 of ITAA, 1997.

As regards source, and in the absence of codification of general source rules, the CIV regime should specifically contemplate that Australian taxation jurisdiction does not arise:

- in respect of interest and dividends paid by non-resident investee entities other than in respect of the existing interest and dividend withholding tax regime;
- in respect of profits made on investments in foreign entities. Where a CGT election is made available to the CIV, perhaps this requirement is not necessary.

Chapter 4: Design of a new corporate CIV regime

Q4.1 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.

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?

AVCAL recommends:

That Australia adopts a globally familiar CIV structure (e.g. a corporate limited partnership structure) which is tax flow-through and capable of general use as, at minimum, an investment vehicle for private equity and venture capital investment (i.e. not limited in its investment horizon to the extent that a VCLP, for example, is limited).

Such a CIV regime would involve:

4.1 an ability to elect for flow-through tax treatment where the CIV is an Australian resident (central management and control of the CIV is in Australia) and the fund manager/responsible entity either holds an AFSL or is an authorised representative of a AFSL holder;

4.2 as an integrity rule, the CIV should be subject to a widely held and closely held test complemented by a rule to accommodate tracing through not only trusts, but also foreign limited partnerships and those limited liability companies which are treated as tax transparent from the investors' jurisdiction of residence;

4.3 As an integrity rule, perhaps the CIV should invest only in certain assets. In this regard, reliance on the list of eligible investments in Division 6C should not increase complexity,

though note our observations regarding eligible business test and control at Question 2.2 and elsewhere in this submission; and

4.4 An ability to make a CGT election regarding certain covered assets, as currently contemplated by Division 275 of ITAA, 1997.

Background

In designing a CIV regime, the legal form and residency of the investors should not in itself be determinative of the tax treatment of the CIV. Instead, the overriding principle underlying the design of a CIV regime should be that it provides certainty, is easy to understand and to implement. It should also provide a comparable tax treatment to Australia's global competitors for capital, where the gains to the underlying investors from private equity investment activities, are deemed as being on the capital account. In addition, AVCAL submits that instead of focusing solely on the nature of the CIV and manager/advisor' activities, entity taxation should only be relevant where:

- the CIV has or intends to have permanent capital; and/or
- to a lesser extent, the CIV has rights to accumulate income.

Private equity/venture capital funds do not accumulate income or gains from investments. At a minimum, annual distributions are made from the annual net income of the funds. Further, it is fairly common that the funds' constituent documents are drafted such that proceeds from the disposal of investments must be, as soon as reasonably practical, distributed to the investors. On this basis, the private equity/venture capital funds, regardless of legal form, operate in a manner similar to trusts i.e. trusts typically distribute yearly net income and/or the beneficiaries of the trusts are deemed presently entitled to the income thereby achieving the flow-through effect.

For further detail on a proposed preferred limited partnership CIV, see our proposal as set out in our response to Question 6 below.

Chapter 5: Investment Manager Regime

Q 5.1 - 5.8 Issues / Questions

AVCAL recommends:

> *5.1 the IMR operate as an exemption system; providing a clear and unambiguous safe harbour for foreign investors;*
>
> *5.2 the IMR be available for widely held foreign managed funds operating in the managed financial services sector. A determination of whether a foreign managed fund is widely held should be made after tracing through intermediary fiscally transparent entities including limited partnerships and limited liability companies;*
>
> *5.3 the IMR be available for both portfolio and non-portfolio investment; and also for controlling interests. In this regard, AVCAL again emphasises that the status of a non-portfolio or controlling stake as such in the hands of a foreign widely held managed fund should be analysed from the perspective of investors in it. Where the fund passes the widely held, and not closely held, tests; the investments of the fund ought not to be considered "non-portfolio";*
>
> *5.4 the IMR be supported by an integrity measure requiring that the Australian manager receive fees which are customary in the context of the services which it is providing to the foreign managed fund.*

AVCAL supports in-principle the wide ranging IMR recommendations made by the Australian Financial Centre Forum's ("AFCF") report. We encourage the implementation of full range of measures to ensure that any Australian IMR is internationally competitive.

However, we note that the Board's review will need to interact with:

- the Treasury conduit income paper and the report made by Treasury to Government by 31 October 2010 which was not publicly released;
- the Assistant Treasurer's announcement of 17 December 2010 concerning an amnesty in respect of 2010 and earlier years for certain foreign funds; and
- the Assistant Treasurer's announcement of 19 January 2011 concerning amendments for certain foreign funds with an Australian permanent establishment.

Application

We refer to our June 2010 submission to Treasury in response to their May 2010 discussion paper "Developing an Investment Manager Regime: Improving conduit income arrangements for managed funds" (the "Treasury Consultation Paper"). In this regard, AVCAL reiterates its belief that it is vital

that all aspects of the AFCF's recommendation for an IMR as set out in the "Australia as a financial centre" (the "Johnson Report") be considered.

We note that many Australian fund managers managing money on behalf of offshore investors do so in the form of global portfolios, incorporating both $A and non-$A assets. Treating conduit (non $A) and non-conduit aspects of global portfolios through separate mechanisms, as would appear to be the approach under consideration, is very likely to lead to unnecessary complexity and confusion, and runs the risk of simply introducing new forms of uncertainty for fund managers. Furthermore, history suggests that trying to deal with conduit income aspects simply by adjustments to certain tax concepts or minor changes to existing legislation will not succeed in providing the degree of tax certainty that is necessary to encourage more activity in this area of managing assets on behalf of offshore clients.

AVCAL does not in-principle agree with the Board's statement in paragraph 5.125, namely "*typically the private equity or venture capital fund would itself undertake active investment activities* (our emphasis). *Such activities would not be primarily passive in nature and fall outside the eligible investments rules in Division 6C of Part III of the ITAA 1936*".

This statement illustrates a general misconception of the private equity/venture capital fund model. It is a misconception that can be easily dispelled on enquiry. Any "active type" activity is conducted purely by the fund manager or its adviser/s; and by the investee entity's board. The investors (beneficiaries of the investment returns) are purely passive, as they are in most investment funds which employ CIVs, including listed equities funds. For reasons set out more fully in other parts of this submission, AVCAL strongly believes it is not appropriate at a policy level to attribute the activities of the manager to the CIV. Rather, it is more appropriate, in the context of the principles of collective investment, to attribute the status of the investors in the CIV to the CIV.

The 2007 Senate Inquiry found that: "*The general consensus among organisations with acknowledged expertise in the likely impact of PE activity on taxation revenue was that the impact on revenue appears to be low and concerns about it overstated. The assessment of the Deputy Governor of the RBA, Mr Battellino, was that: My conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base" and "While increased gearing and shifting capital gains tax liability to parties who are not liable to pay it may affect revenue, offsetting effects also have to be taken into account, and it appears credible that these may reduce the extent of revenue losses or even result in additional revenue."*

It is also important to note that the fund managers, in general, are appropriately remunerated through management fees and carried interest 9where applicable) which are themselves subject to tax.

5.1 Design of the law (Q 5.1)

AVCAL would to like to express a preference for an exemption approach to provide conduit relief in respect of certain foreign assets as such an approach would appear to have a number of advantages over the development of some other (new) approach and is therefore favoured by us.

Such an approach:

- Would be a simpler approach than amending each problematic area of the tax law, and should therefore side step complex amendments to deal with technical issues identified including with source, permanent establishment and capital/revenue issues;

- Would potentially offer some non-resident investors a level of familiarity as exemption systems are used in other jurisdictions (as noted in the paper). This should assist marketing by funds (or at a minimum would be a neutral factor);and

- Should try to match features of leading IMR approaches taken in:

  - the United Kingdom where the Investment Manager Exemption applies in relation to investment transactions carried by the investment manager on behalf of the non-resident if these conditions are met:
    - 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 investment manager acts in relation to the transactions in an independent capacity;
    - broadly, the investment manager cannot have a more than 20% beneficial entitlement to the profits of the transactions it is carrying out on behalf of the non-resident;
    - the investment manager receives remuneration for the provision of the services at not less than the rate that is customary for such services; and
    - the investment manager is not the non-resident's UK representative in relation to any other income or transaction otherwise chargeable to UK tax for the same period

  - Singapore, where a qualifying offshore fund is exempt from Singapore tax on specific income from designated investments managed by fund managers who are either licensed in Singapore or exempt from such licensing in Singapore.

However to deliver the desired outcome of an attractive regime the exemption approach 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 – including for start up and wind down phases of funds for their qualification for IMR treatment so that complications do not arise for foreign fund investors in that year and increasing the potential range of foreign funds that would use the regime.

5.2 Arm's length fee - Q 5.2

We recommend that an exemption from the arm's length test, similar to the start-up fund exemption provided under the MIT regime, be provided to smaller funds. The arm's length test may be based on:

- a start up phase period similar to the 18 months period in the MIT regime;

- the size of the fund e.g. 2% of funds under management up to a maximum amount of AU$ 50m; and

- the existing Australian transfer pricing principles.

The type of intermediaries which would be taxed on their arm's length fees should not be restricted to any narrow category of approved service providers.

In addition, AVCAL recommends that the conduit rules should benefit the Australian asset management industry generally and should apply to any genuine Australian asset management intermediaries.

We note however that the AFCF's recommendations for neutral treatment for Australian investment assets differentiated between the use of independent and dependent Australian intermediaries. In this respect, we recommend that in determining whether an Australian intermediary is an independent or dependent intermediary, the existing concepts of independent and dependent agents as discussed the commentary to the OECD Model Tax Convention should be adhered to. These are existing concerns and their application would potentially offer some non-resident investors a level of familiarity. In this regard, an Australian manager ought not be considered legally or economically dependent of a single foreign fund client, or majority foreign fund client, where that foreign fund in an eligible, widely held foreign fund. The investigation should focus on dependency on a single or concentrated class of investors in the CIV. Simply put, the CIV itself, if eligible, should be disregarded in determining dependency.

A simple "commercial management fee" rule based on established transfer pricing principles should negate the need for further complexity where new legislation is introduced. The rule may require that the Australian intermediary funds manager receives 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.

5.3 Definition of foreign managed funds - Q 5.3

AVCAL agrees with the AFCF that although the IMR should have a wide application it should be confined to entities within the financial sector (see recommendation 3.1 at page 59 of the Johnson Report). Further, we believe that the IMR ought to apply to:

- foreign investors as well as foreign funds;
- foreign funds using any commonly used legal structure; and
- to all genuine foreign collective investment vehicles not just widely held funds.

Widely held requirement

In the Board's review, it was recommended that the IMR is applied to a foreign managed fund that is 'widely held'.

In this regard, AVCAL refers the Board to those parts of this submission that call for the relevant tracing rules to be modified to allow a tracing of membership through intermediary entities which are themselves transparent entities from the perspective of the jurisdiction of the investor's residence.

5.4 Portfolio, passive investments - Q 5.4

AVCAL does not understand the policy rationale for excluding from the IMR:

- non-controlling though non-portfolio investment;
- controlling investment.

As regards the private equity industry, AVCAL refers the Board to those parts of this submission that have sort to highlight the role of a CIV (as a passive aggregator of investor capital) and that of the manager and the investee entity's board; and the inappropriateness of attributing these latter "active" roles to the passive investors.

To be eligible for the IMR regime, it is proposed that the foreign fund be widely held, and not closely held. Where the fund meets this criteria, and the fund is operating appropriately as a CIV, one should not lose sight of the principle that an investor's tax position ought not to be impacted by dint of the collective investment. On this principle, the fact that the CIV itself holds an investment of the type described above should not preclude access to the regime. The critical question, as in under the UK's IMR, should be whether the foreign fund is appropriately widely held.

Where the Board continues to believe that a controlling investment (say greater than 50%) is suggestive of activities which preclude access to an IMR style exemption; AVCAL submits that such principle should not apply where the relevant investment is non-controlling, albeit non-portfolio.

Chapter 6: Venture Capital Limited Partnerships

Q 6.1 Issues / Questions

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

AVCAL recommends:

6.1 Extending the deemed capital account treatment to domestic limited partners investing in VCLPs.

6.2 Broadening the scope of “ineligible activities”

6.3 Removal of the 30% restriction on committed capital in paragraph 118-420(1)(b) to bring the VCLP regime into line with the MIT regime

6.4 20% cap on committed capital to be invested in non-Australian entities to be increased to 50%

6.5 Increase “permitted entity value” of VCLP investments to $500 million to ensure growth of the industry can continue as we move out of a GFC environment.

6.6 Clarify definition of “committed capital

6.7 Clarify scope of the 12 month rule

A greater level of detail regarding these recommendations can be found at the end of this section.

Background

The VCLP regime was introduced in 2002 with the following policy objectives:

- to provide Australia with “a world’s best practice investment vehicle for venture capital”;
- to encourage new foreign investment into the Australian venture capital market;
- to attract venture capital to support the growth of niche or emerging state-of-the-art research and development (“R&D”);
- to address a perceived market failure to attract capital investment to high-risk and expanding businesses; and
- to fund the growth of expanding Australian businesses to facilitate economic growth and job creation, including to encourage venture capital managers to move into the sector.

Since its introduction, the VCLP legislation has undergone a number of amendments which sought to further encourage the use of the regime. For example, the expansion of the rules to allow for investment into foreign entities and the removal of the list of eligible foreign countries in determining whether investors are eligible venture capital partners.

The ESVCLP regime was introduced with effect from the 2007-2008 income year to encourage investments in start-up enterprises at the seed and early stages with a view to commercialising their activities, enhance skill development and increase competition in the venture capital sector to reduce the costs of capital for small businesses. Increased investment in the venture capital sector was considered to be important in stimulating technological innovation and ultimately economic growth.

Since the VCLP/ESVCLP regime was introduced, to date there are only 34 VCLPs (and 3 conditionally registered VCLPs), and 3 ESVCLPs (and 4 conditionally registered).[3] It is apparent from these low numbers that the regime has proved in practice difficult to implement and thus undesirable. In addition, to the best of AVCAL's knowledge, only one VCLP is operating as a stand-alone fund and all others use companion trusts or similar additional structures. This is largely due to the numerous restrictions imposed under the VCLP rules, which AVCAL believes hinder the policy objectives of the regime.

These restrictions include:

- uncertainty in relation to the treatment of VCLP investments for some domestic investors (it is noted that the ATO has recently in confirmed that complying superannuation limited partners of a VCLP retain their statutory CGT treatment on gains and losses on the disposal of the partnership's investments – ATO ID 2011/7) but this still leaves a number of investors in an uncertain tax position;

- restrictions on the activities of an investee entity – in this respect, AVCAL submits that the list of "ineligible activities" is outdated, inflexible and is ineffective in serving the national interest;

- on a literal interpretation of the law, there are restrictions on undertaking "bolt-on" acquisitions after the initial acquisition of an investee entity, a practice that is often necessary to get an investee company up to a self-sustaining critical mass;

- restrictions on the amount of "committed capital" that can be contributed by an otherwise eligible venture capital limited partner (i.e. less than 30%) which discourages foreign investors from investing in a VCLP;

- restrictions on the "committed capital" that can be invested into any target investee entity (i.e. must not exceed 30% of the partnership's committed capital)

- permitted entity values of $250 million (for VCLP investments) and $50 million (for ESVCLP investments) are outdated and place unnecessary limits on potential foreign investment into high-risk and expanding companies; and

- a continuous requirement to ensure that registration requirements under the Venture Capital Act 2002 are met.

AVCAL submits that each of these above restrictions hinders the development and growth of the VCLP industry in its current form.

What are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime

[3] These numbers are current as at 1 March 2011

It has become necessary to utilise companion structures for investing alongside or instead of VCLPs. More often than not where the majority of the investor base is domestic, Australian unit trusts are employed. Where there is a significant foreign investor base, a parallel structure is used because such foreign investors are often not comfortable with the mechanics of a unit trust (refer to comments above in relation to Q 2.1).

The restrictions identified by AVCAL are as follows:

i. Uncertainty in relation to the treatment of VCLP investments for domestic investors

- The current VCLP regime does not provide certainty on whether an investment is on capital account. This issue is relevant for domestic limited partners. The current VCLP regime operates to exempt income or capital gains from the disposal of eligible venture capital investments. This lack of legislative certainty is particularly problematic given the Commissioner's conclusion in Taxation Ruling TR 2010/21 that the type of investments commonly made through a VCLP are likely to be taxed on revenue account.

- Whilst foreign limited partners are exempt on gains on disposal, regardless of whether those gains are on capital or revenue account, domestic limited partners eligible for the CGT discount may lose their eligibility if their gains on disposal are treated as being on revenue account. Whilst AVCAL acknowledges that the policy intent behind the introduction of the VCLP regime was to attract foreign capital, AVCAL notes that the majority of private equity and venture capital investment is backed by complying superannuation funds. In this regard, AVCAL submits that the regime should not discriminate against local investment particularly where evidence shows that the investment is coming from complying superannuation funds and/or pooled superannuation trusts (only approximately 10% comes from overseas)[4].

ii. Restrictions on the activities of an investee entity – list of "ineligible activities "

The restrictions on the types of activities that can be carried out by the investee entity are inappropriate for a number of reasons:

1. They hinder the growth and development of the finance sector (e.g. non-bank finance entities) given that investments in the sectors are ineligible. This clearly is in contradiction to government's policy intention to promote Australia as a global financial services hub and to see more competition in the industry;

2. Whilst the legislation allows for ancillary or incidental "ineligible activities", it is possible that otherwise eligible activities which may have a tangential "ineligible" element (e.g. the provision of aged care services, accommodation services and the hospitality industry which also entail significant land ownership) would satisfy the VCLP regime. In such circumstances, the fund manager may seek a decision from Innovation Australia to determine if such an element would taint the status of the VCLP/ESVCLP under the *Venture Capital Act 2002*;

3. Entities carrying on a trading business through the leasing of machinery or equipment under standard operating leases might fail the prohibition on leasing and do not clearly fit into the VCLP regime; and

4. Expanding technology-focused businesses that develop intellectual property and earn royalties might fail within the prohibition on investing to earn royalty income.

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[4] Board of Taxation "Review of Tax Arrangements Applying to Collective Investment Vehicles" December 2010, Discussion Paper at p. 66.

Such ambiguity in the scope of ineligible activities creates an unnecessary impediment to foreign and domestic investment into the very companies/unit trusts which are intended to benefit from increased access to venture capital markets. The consequences of prohibiting such investments not only acts as a deterrent for venture capitalists considering investing in Australia, which prima facie contradicts the objectives of the VCLP regime, but additionally inhibits the growth, expansion and overall international competitiveness of the Australian finance and economic sector.

The position in relation to investment into foreign entities is unclear

Furthermore, the ineligible activities restriction does not operate appropriately where an investment is made in a non-resident holding company with operating subsidiaries. In such a case, while the non-resident group would qualify as conducting eligible activities the consolidation rule that permits the group's operations to be taken into account does not apply, with the consequence that the test only focuses on the investee entity. If the initial investment is made via a holding company, the investment it will not satisfy the eligible activity test as it will only be deriving passive income. A similar issue was encountered with the earlier version of the law which was subsequently amended in 2004 to accommodate investments via a holding company. It is not unusual for acquisition structures to involve a holding company and a subsidiary as the acquirer for legal reasons (e.g. often the acquirer is the entity that is the borrower of third party debt). The current prohibition on foreign investment via a foreign holding company is clearly an unintended consequence of the existing drafting of the VCLP legislation.

iii. Restrictions on undertaking additional share "bolt-on" acquisitions after the initial acquisition of an investee entity

The current VCLP legislation prevents "bolt-on" investment in companies or unit trusts from being eligible venture capital investments. As currently worded, the VCLP/ESVCLP may only contribute capital to its initial investee company/trusts for organic expansion where the entity to be acquired already is "connected" with the initial investee entity. This requirement for a "connection" as defined in section 328-125 of ITAA 1997 (and section 152-42) which broadly states that the initial investee entity must have at least a 40% interest in the entity to be acquired.

This means that once a company (or trust) is acquired by a VCLP, there is limited scope for the acquired entity to make additional complementary acquisitions of third party targets on arms-length commercial terms. This is an undesirable outcome that further complicates the use of a VCLP structure and causes increased operational transaction costs. AVCAL submits that this requirement for a "connection" unintentionally prohibits expansion into entities operating in like industries or sectors. For example, an investee company operating in the life sciences sector may wish to acquire another business that is complementary to its operations. This restriction forces the investee company to undertake the acquisition by way of an asset deal which may lead to increased stamp duty costs (due to the transfer of business assets) and potentially makes the transaction structurally inefficient in respect of collapsing old corporate structures. Once again, no such restrictions exist in the MIT regime.

iv. Restrictions on who may be an "eligible venture capital partner" due to the "committed capital" restrictions

The 30% restrictions imposed in the definition of eligible venture capital partner in section 118-420 of the ITAA 1997and in particular, the limit on the percentage of committed capital that a foreign venture capital fund of funds can invest, places an undue restriction on the ability of a VCLP to attract the required foreign investment. This same restriction was imposed in the Pooled Development Funds ("PDF") regime. In the PDF regime, this requirement was implemented to

prevent the use of PDFs as wholly owned special purpose vehicles. AVCAL notes that this requirement is unnecessary in relation to the VCLP/ESVCLP regime as funds are generally widely held and investment is not concentrated in any particular investor.

Once more, provided that a CIV is 'widely held', it can hold 100% of the interests in a MIT without any adverse effects. Therefore, the 30% limit on "committed capital" for a foreign venture capital fund of funds is a restriction which necessitates the use of a companion structure.

v. Restrictions on the "committed capital" that can be invested into investee entities

Under the VCLP regime, if an investment is made by a VCLP, its interest, together with any connected entities, in the venture capital investee company must not be more than 30% of the VCLP's committed capital. Whilst it may be the intent of the legislation to impose a requirement for a diversified portfolio, AVCAL strongly disagrees with this approach, as it hinders cost-effective investments into niche industries.

The inherent consequences of being required to make multiple investments as a result of the cap are increased fund, transaction and ongoing management costs. For smaller, early stage venture capitalists, this may cause Australian investments to be uneconomical with the result that the flow of foreign and domestic capital in Australia is diminished.

vi. Restrictions on the "committed capital" that can be invested into non-Australian entities

Currently, investments in entities that do not satisfy the Australian residency/Australian assets test in subsection 118-425(2) are treated as eligible venture capital investments provided they do not exceed 20% of the VCLP's committed capital and meet the remaining eligible venture capital investment requirements.

There does not appear to be an explanation of why the 20% cap is imposed and as such, it appears to be an arbitrary limit. Given the Federal Government's stated ambition to make Australia a regional financial services hub[5], it would make sense to enable VCLPs to take a greater interest in foreign entities (particularly for New Zealand and the Asia Pacific region) to enable them to attract the required domestic and foreign investment so that Australia can capitalise on the obvious economic benefits.

For early-stage investing, particularly in the technology sectors, the cap can lead to the unintended policy consequence of stopping follow-on funding in conjunction with overseas co-investors. Such co-investment with overseas venture capital funds is necessary because (a) there is insufficient capital in Australia to enable many companies to commercialise their technology; and (b) overseas co-investors bring expertise and networks to the benefit of the investee company.

vii. The permitted entity values of $250 million (for VCLP) and $50 million (for ESVCLP) are outdated and discourage foreign or domestic investment into the industry

There is no such limit on permitted entity values for other vehicles nor is there any comparable restriction in any international market. Therefore, it is necessary to set up companion structures to feed capital into higher value investments. Given the level of negotiation often needed to source capital from overseas and domestically, it is necessary to have a companion structure to ensure that

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[5] Treasurer's Press Release No. 43, *Establishing Australia as a Regional Financial Hub,* dated 13 May 2008.

opportunities to such capital for venture capital investments are not lost simply because an investment is greater than $250 million.

The Board's discussion paper expressed the concern that removing the $250 million restriction may dilute incentives for investment into companies at the seed, early and expansion stages. However, it is submitted that applying such a cap to an investment and attempting to direct investment into specific parts of the asset class does not specifically attract the investment required in this sector. If this country aspires to have an early stage investment community which is as vibrant as that of, say the US, then it should also aspire to see nascent businesses moving very quickly to $250 million NTA valuations and well beyond whilst continuing to attract investment capital from early stage investors. Moreover, it is difficult to understand how such a cap encourages investment, especially when the VCLP regime no longer offers a unique tax concession given the following developments in the Australian tax landscape:

1. the introduction of the MIT regime to enable investments to be on capital account for foreign and domestic investors; and

2. the proposed adoption of the OECD practice of 'looking through' transparent vehicles in non-treaty countries to confer treaty benefits on ultimate investors who reside in treaty countries (refer Draft Taxation Determination TD 2010/D8).

This means that the tax benefits from investing in a VCLP can arguably be obtained from other investment vehicles and therefore a companion structure becomes an equally tax effective but highly inefficient option. What is needed is a single limited partnership structure which is recognised and understandable to potential foreign investors.

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

AVCAL submits that the issues outlined above may be overcome by the following amendments:

6.1 Extending the deemed capital account treatment to domestic limited partners investing in VCLPs.

- ATO Interpretative Decision 2011/7 has recently confirmed that the capital gains tax regime is to be the primary taxing code in relation to gains/losses made on disposal of a complying superannuation fund's interest in a VCLP asset.

- It is also worth noting that the MIT regime provides certainty by providing an irrevocable election to treat all passive investments as being held on capital account (subject to integrity rules). As such, it is submitted that it would be appropriate and consistent with policy objectives to extend the deemed capital account treatment to all domestic limited partners investing in VCLPs to provide parity with the treatment given to passive investments made via alternative investment structures.

6.2 Broadening the scope of "ineligible activities" in particular:

- In relation to finance and property ownership – the exclusion should only be applied to wholly passive investments in these areas. Where the activity arises from the investee competing in a market and involves the ongoing use of labour/skill/expertise by the entity, then the activity

should be eligible. We note that the “active income test” contained in the proposed controlled foreign company (“CFC”) rules[6] may be an appropriate basis for this test.

- An investment in a listed company should be permitted provided the investment involves the direct provision of management experience and active contribution at the board level to the public company (i.e. to enable the smaller listed companies to grow and become financially secure through the provision of expansion capital).

- The definition of “leases” should be better defined and restricted to “finance leases”.

- The existing consolidation rules which allow all of the activities of a group to be taken into account should be extended to non-resident companies for the purposes of the eligible activities test.

- Bolt-on acquisitions should be allowed regardless of whether the bolt-on is connected with the initial investment entity, but subject to the permitted entity values and ineligible activities restrictions.

- The rule preventing a two-tier acquisition structure should be modified to make it clear that subsection 118-425(16) will not apply to a consolidatable/consolidated acquisition structure. Further, the subsection should be reworded to clarify that subsection 118-425(11) only ceases to apply following the acquisition of a target company.

6.3 Removal of the 30% restriction on committed capital in paragraph 118-420(1)(b) to bring the VCLP regime into line with the MIT regime.

For completeness, the current 10% restriction on other foreign investors contained in paragraph 118-420(1)(c) should be retained as this is consistent with the 10% rule for foreign individuals in the MIT rules.

Removal of the 30% cap of committed capital in which a VCLP can invest into any particular investee entity will also bring the VCLP regime in line with the MIT regime.

6.4 20% cap on committed capital to be invested in non-Australian entities to be increased to 50%.

This modification should strike an adequate balance between encouraging investment in domestic venture capital investments whilst providing a VCLP and its investors with adequate commercial flexibility to expand offshore particularly in the Asia Pacific region for the economic benefit of investors, the investee company and Australia alike.

6.5 Increase “permitted entity value” of VCLP investments to $500 million to ensure growth of the industry can continue as we move out of a GFC environment.

With the passage of time since 2002, $250M has become manifestly inadequate and it is appropriate that the metric should be reviewed.

6.6 Clarify definition of “committed capital”

“Committed capital” is currently defined as the sum of the amounts that the partners of the partnership may become obliged to contribute to the partnership, irrespective of whether the

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[6] See subsections 960-300(2)(b), (c) of the Exposure Draft to the CFC rules released on 17 February 2011.

partners do actually contribute all those amounts (refer to section 118-445). In companion structures (which are now commonly used due to the regime's limitations), investors may commit funds to a "VCLP" that allocates them to alternate investment vehicles (for example MITs) depending on the type of investment involved. It should be made abundantly clear that such an allocation process does not compromise the "committed capital" of the VCLP.

6.7 Clarify scope of the 12 month rule

Currently under the VCLP legislation, VCLPs must hold eligible venture capital investments for at least 12 months if foreign limited partners (and hopefully in the future domestic investors) are to access the capital account treatment on disposal of the investments. It is uncertain under the current provisions what constitutes holding of a venture capital investment for 12 months. For example, it is unclear if a VCLP that has held shares in a company for 12 months and later acquires further shares in the same company would be treated as having held all the shares in the relevant company for 12 months. Another example where uncertainty may arise is in respect of rights to shares that have been held for less than 12 months before exercise.

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?

In AVCAL's view current levels of investment are below the levels of our global competitors. There are forces other than taxation which serve to constrain investment in this area and taxation should not place an additional burden on VC investment managers. As noted earlier, since the VCLP/ESVCLP regime was introduced in 2002, only 34 VCLPs (plus 3 conditionally registered) and 3 ESVCLPs (plus 4 conditionally registered) have been brought into operation. Based on published information in relation to funds under management by AVCAL's constituent members, the total amount of committed capital for funds using the regime is approximately $5.5 billion.[7] This is as compared to the total private equity investment into Australia of approximately $25 billion. This shows of the total investment, approximately 20% is represented by the VCLP regime

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?

The introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP would not detract from the policy objectives outlined above. It is important to note that the venture capital and private equity market has evolved significantly since the introduction of the VCLP legislation. In particular, there are proportionately more sophisticated investors in the domestic market for example, superannuation funds, MITs, high net worth individuals and general partners, all wanting to invest their own funds on arms length commercial terms into the industry. Further, we note that most of the venture capital and later stage private equity funds are sourced from Australia (see Board of Taxation Discussion Paper at p. 66).

As such, making the VCLP an attractive investment vehicle to these investors by providing certainty in respect of their investments would encourage investment and promote the policy objectives of expanding Australian businesses to ultimately facilitate economic growth and job creation.

[7] This number is based on publicly available information showing funds under management and may understate or overstate the actual figure.

The plight of the VC industry in Australia has been well in recent times. Any changes that might increase the attraction of investing in venture capital through VCLPs has the potential to improve the level of capital available to early stage and expanding companies in Australia.

As noted above, the ATO Interpretative Decision 2011/7 has recently confirmed that the capital gains tax regime is to be the primary taxing code in relation to gains/losses made on disposal of a complying superannuation fund's interest in a VCLP asset. Likewise, flow-through character treatment should be confirmed for MITs, high net worth individuals and general partners that invest in VCLPs.

Further, as above, the MIT regime provides certainty for investors by allowing for an irrevocable election to treat all passive investments as being held on capital account. As such, it is submitted that it would be appropriate and consistent with policy objectives to extend the deemed capital account treatment to domestic limited partners investing in VCLPs to provide parity with the treatment given to passive investors in the MIT regime, further enhancing the sustainability of the VCLP regime compared with an MIT regime. As discussed earlier there has been a market shift towards MITs preferring to co-invest directly into investee companies thereby making the VCLP regime all but redundant. As a result, the concern is that there may also be a direct shift in capital being deployed in the larger scale leverage buyouts as opposed to smaller early stage, high risk start-ups and expanding companies.

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;

The capital account treatment should be retained for carried interests and extended to the disposal of eligible venture capital investments by a general partner.

Carried interests are currently deemed to be capital gains to the general partners under the VCLP regime.

However, to further attract and retain human capital as well as further incentivising local investment managers, it is submitted that the capital account treatment should be extended to the disposal of eligible venture capital investments by a general partner. This will remove the uncertainty and complexity involved for general partners in relation to applying the capital/revenue distinction rules to gains on disposals of investments referred to above. It would also promote the use of the VCLP as an investment vehicle (through promoting skilled human capital as general partners) and contribute to achieving the policy objectives of the VCLP regime.

The desirability of further changes to the tax treatments in the VCLP or ESVCLP regimes to enable them to better achieve their policy objectives?

As outlined above, the current restrictions and shortcomings of the regime hinders the development of the very industries the VCLP and ESVLP regimes were intended to encourage and discourages the use of the VCLP as an investment vehicle to investors, rendering them inconsistent with the policy objectives of the regime. As such, it would be desirable to make the above suggested amendments to the VCLP related regimes to better align them to achieving their policy objectives and to provide Australia with a more effective and efficient investment vehicle for the early stage, high risk start-ups and expanding companies.

Apart from making the changes to remove the existing structural impediments to the VCLP and ESVCLP structures, there should be introduced a general limited partnership structure (**Limited Partnership CIV**) which could be used for all forms of venture capital and private equity investment (at a minimum) irrespective of whether they satisfy the VCLP/ESVCLP criteria. The case for the introduction of such a regime is based on the fact that internationally this is the preferred structure for such forms of investment. Such a vehicle would remove many of the hurdles that currently exist for private equity investors wishing to invest in the Australian private equity market, not the least of which are the significant costs which such investors incur when they procure advice about Australia's unfamiliar and complex CIV taxation regime. It is considered therefore that this would not only improve the efficiency of the market place on the basis that investors would be investing into a familiar structure but may also reduce the need for the multiple companion structures that are currently used in the sector.

The specifics of such a regime from a taxation perspective would be as follows:

- The vehicle would be fiscally transparent and like the VCLP structure gains and losses would flow through to investors.

- As recommended above for investments made by a VCLP, such a Limited Partnership CIV should also have the ability to elect to have its investments held on capital account. This would achieve consistency with other forms of collective investment such as the VCLP and MIT structures. This would also remove considerable uncertainty for foreign investors that are completely perplexed by the complexity of the distinction between revenue and capital gains which uniquely pervade the venture capital and private equity sector in Australia.

- "Carry" derived by manager from the fulfilment of a management role in relation to such a vehicle would not benefit from deemed capital treatment. This is an important distinction.

- The restrictions that currently define concepts applicable to the VCLP such as an "eligible venture capital partner" and "eligible venture capital investment" should not apply to this form of structure. In other words, because essentially there are no material taxation benefits flowing from the structure, the quarantining that currently arises in relation to an ESVCLP and VCLP should not be required.

- It may be necessary in due course to introduce integrity measures to ensure that the use of such a structure is not exploited more broadly outside the venture capital and private equity sector. In this respect, an effective integrity measure could be to introduce a governing body to provide oversight in relation to the registration and ongoing operation of the structure in much the same way as occurs in relation to the VCLP structure.

Whilst our abovementioned outline of the Limited Partnership CIV structure contemplates a separate stand alone vehicle from the VCLP structure, it is conceivable that the structures could be combined into a single limited partnership structure having an eligible and ineligible pool of investments. The point of distinction between the pools of investment would be that the eligible pool of investments (that is, the investments that meet the eligible venture capital requirements) may generate carry which would be treated on capital account, whereas carry derived from the ineligible pool of investments would be treated as ordinary income to the manager. This would be a simple and useful way of providing investors, both local and international, with a familiar and uncomplicated CIV while also preserving an important policy tool in the form of the concessional tax treatment of carry derived from early stage investments.

Summary of AVCAL Recommendations

Chapter 2

2.1 The ‘tracing provisions’ in section 12-402(4), and any similar test included in a general CIV regime, should be expanded to allow a tracing of ownership through entities that are fiscally transparent from the perspective of the country of residence of its investors.

2.3 AVCAL understands that the concept of ‘eligible investment business’ may need to be retained.

2.3 However, AVCAL submits that the ‘control’ limb of the test should be repealed, and certainly in the context of ‘private equity’ CIVs, if not for all CIVs. If necessary, the test could be replaced by a requirement that the CIV deal with its controlled entities on an arm’s length basis.

2.4 Alternatively, if it is considered that a control test is necessary, then a ‘bright line’ test for what amounts to ‘control’ should be introduced to provide investors certainty.

Chapter 3

3.1 The flow-through treatment that is currently limited to MITs be expanded to other types of CIV entities which can elect to be treated as tax transparent (e.g. similar to a “check the box” in a US context). This treatment can be supported by a robust integrity rule, requiring the CIV to make annual distributions of net income for each year of income within a reasonable time after year end.

3.2 The characterisation of gains should flow through CIVs.

3.3 The rules regarding capital treatment be expanded and clarified.

3.4 The presence of a local manager should not of itself give rise to an Australian source or permanent establishment for a foreign investor.

3.5 There should be clear rules ensuring investment into Australian alone should not cause deemed residence issues.

Chapter 4

That Australia adopts a globally familiar CIV structure (e.g. a corporate limited partnership structure) which is tax flow-through and capable of general use as, at minimum, an investment vehicle for private equity and venture capital investment (i.e. not limited in its investment horizon to the extent that a VCLP, for example, is limited).

Such a CIV regime would involve:

4.1 an ability to elect for flow-through tax treatment where the CIV is an Australian resident (central management and control of the CIV is in Australia) and the fund manager/responsible entity either holds an AFSL or is an authorised representative of a AFSL holder. The ability to elect for flow-through tax treatment allows for introduction without the need for complementary corporate or legal and/or regulatory framework;

4.2 As an integrity rule, the CIV should be subject to a widely held and closely held test complemented by a rule to accommodate tracing through in addition to trusts, foreign limited partnerships and limited liability companies which are treated as tax transparent from the jurisdiction of residence of the investors in them;

4.3 As an integrity rule, perhaps the CIV should invest only in certain assets. In this regard, reliance on the list of eligible investments in Division 6C should not increase complexity, though note our observations regarding eligible business test and control at Question 2.2 and elsewhere in this submission; and

4.4 An ability to make a CGT election regarding certain covered assets, as currently contemplated by Division 275 of ITAA, 1997.

Chapter 5

5.1 the IMR operate as an exemption system; providing a clear and unambiguous safe harbour for foreign investors;

5.2 the IMR be available for widely held foreign managed funds operating in the managed financial services sector. A determination of whether a foreign managed fund is widely held should be made after tracing through intermediary fiscally transparent entities including limited partnerships and limited liability companies;

5.3 the IMR be available for both portfolio and non-portfolio investment; and also for controlling interests. In this regard, AVCAL again emphasises that the status of a non-portfolio or controlling stake as such in the hands of a foreign widely held managed fund should be analysed from the perspective of investors in it. Where the fund passes the widely held, and not closely held, tests; the investments of the fund ought not to be considered “non-portfolio”;

5.4 the IMR be supported by an integrity measure requiring that the Australian manager receive fees which are customary in the context of the services which it is providing to the foreign managed fund.

Chapter 6

6.1 Extending the deemed capital account treatment to domestic limited partners investing in VCLPs.

6.2 Broadening the scope of “ineligible activities”

6.3 Removal of the 30% restriction on committed capital in paragraph 118-420(1)(b) to bring the VCLP regime into line with the MIT regime

6.4 20% cap on committed capital to be invested in non-Australian entities to be increased to 50%

6.5 Increase “permitted entity value” of VCLP investments to $500 million to ensure growth of the industry can continue as we move out of a GFC environment.

6.6 Clarify definition of “committed capital

6.7 Clarify scope of the 12 month rule

Appendix A – “Private Equity in Australia”

Appendix B – Clayton Utz submission to this review

Appendix C– Study showing tax treatment of PE and VC in other jurisdictions

Appendix A: Private Equity in Australia

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Introduction

The purpose of this Appendix is provide an overview of how Private Equity (PE) operates in Australia and globally, and in doing so provide the contextual framework for policy-makers to better assess the implications of key tax and policy issues for Australian private equity fund managers, as well as their investees and investors.

Private equity is equity investment typically in unlisted companies that are considered to have strong growth or turnaround potential. The following sections address some key questions around private equity:

- What are the characteristics of private equity funds?
- Who are the investors in private equity?
- What role does private equity play in the Australian economy?

1. Characteristics of private equity funds

Private equity investments have several characteristics that set them apart from other forms of business ownership, particularly the public markets. These include:

- strong alignment of interests between management and private equity owners;
- strong alignment of interests between private equity owners and investors in private equity funds. The underlying investors in a private equity fund are wholesale investors such as pension funds, sovereign wealth funds and insurance companies; and
- a long term perspective – private equity investment has a 3 to 5 year average holding period (over three times the average holding period of S&P/ASX 200 index stocks) and places long term growth ahead of short term profit considerations.

Private equity targets superior returns to investors as a result of this strategy.

Globally, a typical private equity fund structure involves a collective investment vehicle (CIV), such as a limited partnership or a trust. The managers of the fund are described as “general partners” (GPs) in the fund because they manage the fund and are liable for its legal debts and obligations. The investors are typically described as “limited partners” (LPs) in the fund as their liability for debts and obligations of the fund is limited to the amount of their investment in the fund. LPs are passive investors. They are no more active in the private equity fund’s investment function than investors in a listed equities fund. In fact, the constitutions of private equity funds specifically prohibit LP involvement in investment activities, lest limited liability be jeopardised.

Private equity funds raise capital by securing capital commitments from investors. These are pledges of capital to the private equity fund. The managers (GPs) invest the fund’s capital across a set of investments that fit the fund’s investment mandate or focus. Capital is gradually drawn down from LPs over the life of the fund through a series of “capital calls” as and when investments are made (typically during the first five years).

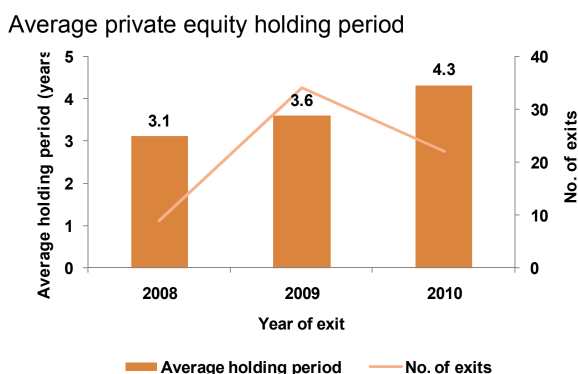
Management fees. Once a fund is raised, GPs begin to receive a management fee based on the size of the fund. The management fee is negotiated between the LPs and GPs at the time the funds are raised and usually calculated as a percentage of the funds committed to the fund. An indicative figure is 2% to 2.5% p.a. for smaller funds and 1% to 2% for larger private equity funds. This figure covers the overheads of the business including salaries and the costs of conducting due diligence on investments.

In the case of local private equity funds, these management fees are included in the assessable income of the GP.

Private equity funds are "closed-end" with a life of typically 10 to 12 years. LPs remain committed to the fund for the life of the fund. Their investments are typically long-term with holding periods of between 3 to 5 years, often longer (Figure 1). To ascertain if they are indeed long term investors, a comparison against other investor types is appropriate. The average holding period of all private equity investments exited over the last three years was 3.8 years: over three times longer than the average holding period of investors in S&P/ASX 200 index stocks at 1.2 years (Figure 2).

Figure 1: Average private equity investment holding period

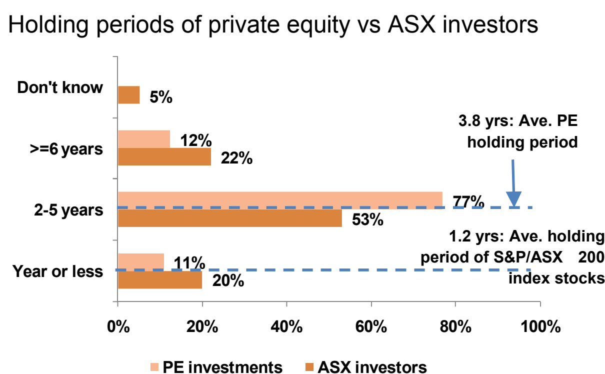
Average private equity holding period



Source: AVCAL analysis of 65 private equity exits from 2008-2010; from year of initial investment to final/partial exit.

Figure 2: Holding periods of private equity vs ASX investors

Holding periods of private equity vs ASX investors



Sources: ASX 2008 Australian Share Ownership Study, AVCAL analysis of 65 private equity exits from 2008-2010

LPs only realise gains when distributions are made. The legal documentation governing each fund requires that all investments of the fund be realised and the funds returned to the LPs within a particular time frame. Capital is only drawn down from LPs when an investment is made, and it is returned to LPs with any additional gains as soon as the investment is realised. LPs may also occasionally receive some interest and dividend income from the private equity fund. These amounts are typically only a small proportion of their investment returns, and may also be reinvested back into the fund.

Alignment of interest between GPs and LPs. If the investment's returns exceed a predefined hurdle rate, GPs receive a share of the realised gains (the "carried interest"). This is only distributed after actual cash returns have been delivered to the LPs. In most funds globally, the carried interest is around 20% of the fund's returns above the hurdle rate or "preferred return". The preferred return is usually similar to the long term bond rate. Globally, LPs are familiar with (and favour) this key feature of private equity funds because it aligns their interests with those of the GPs. Internationally, regulators also recognise that the payment of carried interest as described above is a key "good practice" characteristic in the private equity industry that minimises conflicts of interest between private equity managers and fund investors. GPs often co-invest their own money up to a certain amount (generally 2% to 5% of the fund) to further demonstrate their commitment and alignment of interest with the LPs.

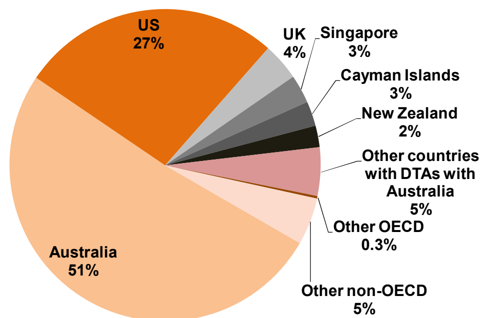
2. Investors in private equity funds

2.1 Composition of investors in Australian private equity funds

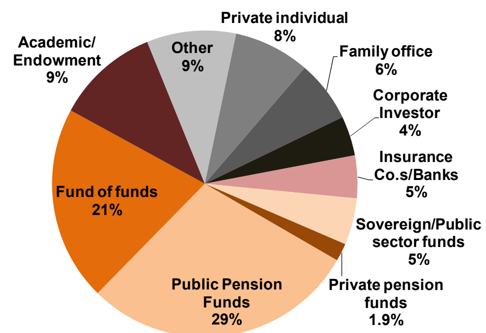
Investors from Australia and countries with Double Taxation Treaties (DTAs) with Australia account for 92% of total commitments. Figure 3 shows the composition of investors in Australian private equity funds with $17.8b in funds under management (representing approximately 70% of the domestic private equity industry) by the investors' country of origin and type of investor. Australian investors account for 51% of the total value of commitments (in AUD terms), followed by US investors with 27% of total commitments.

Figure 3: Profile of investors in Australian private equity funds

By country of origin



By type of investor



Source: AVCAL analysis. Based on AUD value of commitments in Australian private equity funds with $17.8b in total funds under management, as of 30 June 2010.

Investors in private equity funds are wholesale investors. Foreign investors are mainly pension and endowment funds, as well as fund-of-funds (which pool money from pensions, endowment funds, etc). Retail investors are not typically able to invest directly in the fund, but usually have some private equity exposure via their pension or other managed funds' exposures to private equity. Such institutions have high levels of accountability to their stakeholders and/or regulators, and they adopt disciplined approaches their investment allocations.

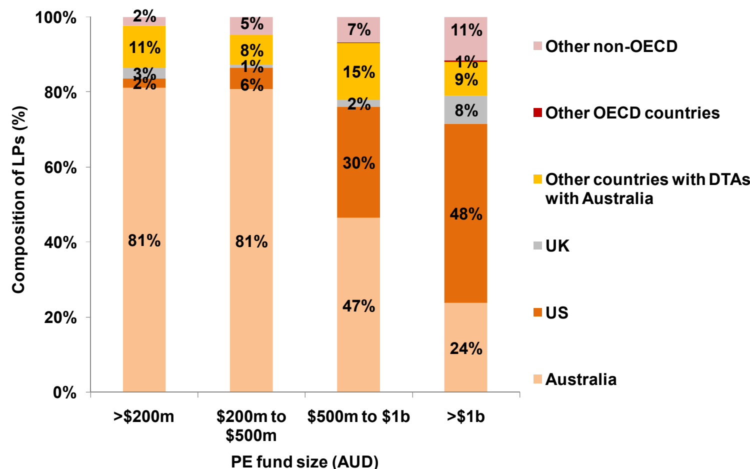
Investments by these institutions are highly sought after and often viewed by other global investors as an indicator of the investment's quality. For example, bellwether investor CalPERS' current target private equity allocation is 14% of its total investments. Its total exposure to private equity is currently US$48b: twice the size of the entire Australian private equity industry.[1] CalPERS notes that the growing maturity of the private equity portfolio and distribution stream is transforming this asset segment into a self-sustaining asset programme.

Foreign investment is vital to the continued growth of the Australian private equity industry. Figure 4 shows the composition of domestic and foreign investors by Australian private equity fund size. While funds with less than $500m in commitments can be raised with predominantly Australian investors, it can be seen that as private equity managers raise successively larger funds the role of foreign investors becomes significant.

[1] Source: www.calpers.ca.gov

Institutional investors are increasingly looking at the private equity universe from a global rather than local perspective. Australian private equity funds that aim to grow to a scale comparable to their major global counterparts will be increasingly less able to do so if relying on a domestic investor base alone.

Figure 4: Composition of investors in Australian private equity funds by fund size



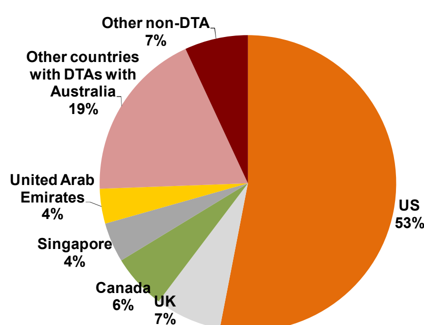
Source: AVCAL analysis. Based on total AUD value of commitments in Australian private equity funds with $17.8b in total funds under management, as of 30 June 2010.

2.2 Composition of investors in global private equity funds investing in Australia

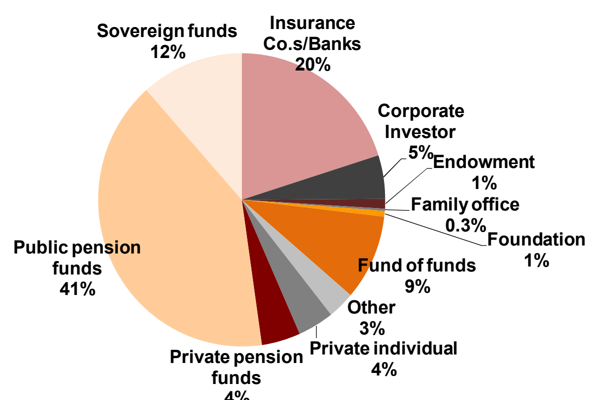
The profile of international funds that invest in Australia is not too dissimilar to that of Australian funds. An analysis of international private equity funds that have invested in Australia (Figure 5) shows that most of their funds come from pensions (45%), sovereign wealth funds (12%), and banks (15%). US investors make up 53% of their total funds under management, followed by the UK, Canada and Singapore. 90% of the funds come from countries with existing tax treaties with Australia.

Figure 5: Profile of investors in global private equity funds investing in Australia

By country of origin



By type of investor



Source: AVCAL analysis. Based on data as at 31 December 2009 from 7 international private equity funds that have invested in Australia, with total global commitments of US$33b.

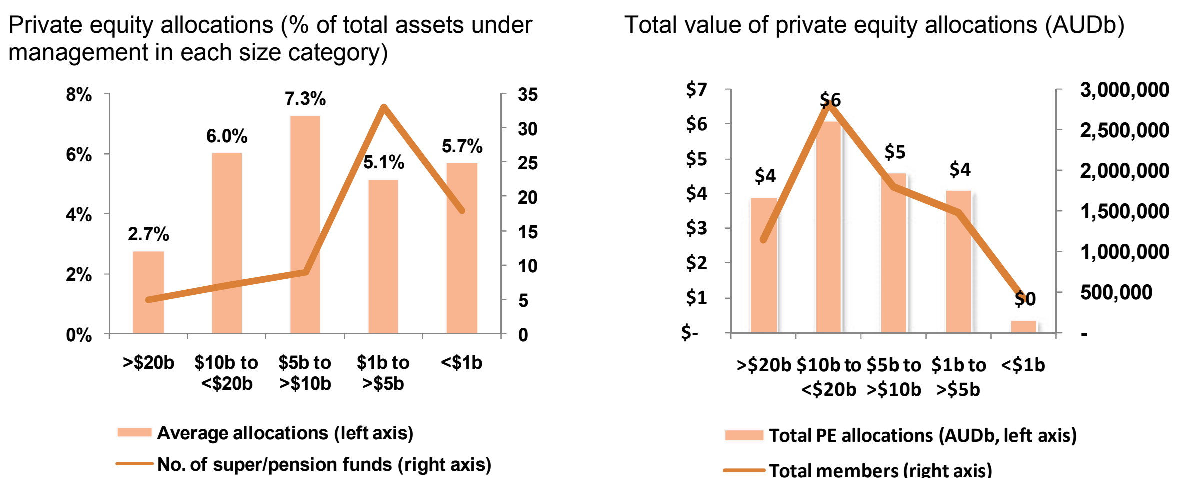
2.3 The role of private equity in Australian institutional portfolios

Australian institutional investors invest actively in both Australian and international private equity. Private equity allocations by major Australian asset management institutions such as the MLC, Victorian Funds Management Corporation, Future Fund and QIC alone are estimated to be close to $10b.[2] For example, the Future Fund allocated 3% ($2.1b) of its total assets to international private equity as of 31 December 2010.[3] This amount alone equals the total amount of private equity investment in Australia in FY2010.

Among Australian institutional investors, superannuation funds are the largest investors in private equity. The superannuation industry's exposure to both Australian and international private equity is estimated to be in excess of $19b.[4] The majority of the superannuation funds that invest in private equity are industry superannuation funds. Figure 6 shows that private equity allocations form between 2% to 8% of total assets under management across various superannuation fund size categories. Despite these generally small allocations, superannuation funds – and indeed pension funds around the world – continue to look to invest in private equity in order to improve portfolio diversification and superannuants' returns. Furthermore, the longer-term investment profile of private equity is consistent with the longer-term investment horizons of superannuation funds.

There should be consistent tax treatment of superannuation investment returns. Superannuation funds that invest directly (or through Pooled Superannuation Trusts) in individual companies are generally eligible for CGT concessions on the returns from such investments. In addition, publicly-listed shares invested and held for longer than 12 months are also eligible for CGT concessions. AVCAL believes that, as a matter of policy, the returns to superannuation funds from investments made through private equity vehicles should be treated in a manner consistent with the tax treatment of returns made on direct investments. To impose less favourable tax treatment on investments made by superannuation funds that invest in private equity would also create a non-level playing field between larger and smaller superannuation funds, by unduly penalising smaller superannuation funds (and, ultimately, their members) for whom investing directly may be both inefficient and costly.

Figure 6: Asset allocations to private equity, by superannuation fund size



Sources: Preqin, AVCAL analysis. Based on 72 superannuation funds with $400b in assets under management, as of 31 January 2011.

[2] Source: Preqin.
[3] Source: www.futurefund.gov.au
[4] Source: Preqin, based on a sample of 72 superannuation funds with combined assets under management of $393b.

3. The role of private equity in the Australian economy

Private equity activity benefits the Australian economy by:

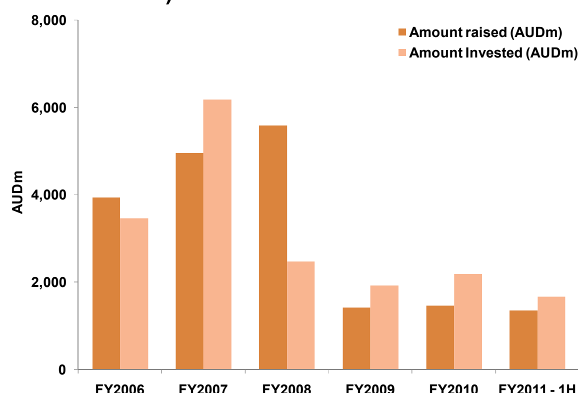
- providing patient capital for businesses
- channelling medium- to long-term foreign investment into Australia
- promoting management performance and productivity
- supporting private sector employment
- generating growth in key sectors of the economy

All of these benefits deliver positive externalities to the broader economy and society, including increasing the pool of tax revenues to the Government.

3.1 Providing patient capital for businesses

Private equity provides much-needed non-bank capital for businesses. From fiscal years 2008 to 2010, private equity invested an average of $2.2b p.a. in Australian businesses. The availability of private equity funding is particularly needed during periods when other sources of capital are unavailable. Figure 7 shows how investment by private equity in Australian businesses has remained relatively steady even at a time when business credit growth was slowing and domestic fundraising remained difficult.

Figure 7: Private equity fundraising and investment (FY2006 to FY2011-1H)



Source: AVCAL. Fundraising figures for Australian private equity funds only. Investment figures include international private equity funds.

Private equity plays a role in financing family businesses. The 2010 Senate Economics Committee's Inquiry into Access of Small Business to Finance recognised that demographic factors may generate an increase in the demand for small business finance, including private equity financing for family businesses.[5] The Inquiry noted current research indicating that with the aging post-war baby boomer generation, 60% of family business owners plan to retire by 2016, but half will be unable to do

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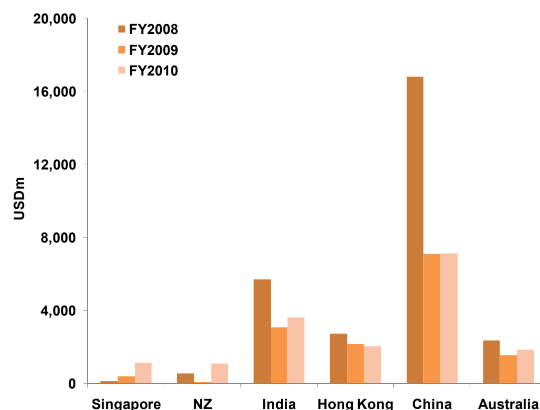
[5] Source: Report of the Senate Economics Committee's Inquiry into Access of Small Business to Finance, June 2010.

so due to a lack of suitable successors.[6] "As a consequence, many family owners will have little option but to sell or close down the business. The scale of this problem suggests that not all family business owners can look forward to traditional exit options such as trade sales, and therefore alternative succession strategies, such as the involvement of private equity, need to be considered" (Seet and Graves (2010)).

3.2 Channelling medium- to long-term foreign investment into Australia

PE investment in Australia still has significant scope for growth. Countries such as China and India have attracted strong inflows of global private equity investment in the past few years, and continue to do so (Figure 8). Australia cannot afford to introduce new measures that will discourage foreign investment at a time when the country is looking to position itself as a regional financial services hub.

Figure 8: Private equity investment in regional markets



Sources: AVCAL (Australian data), ThomsonONE (all other markets), RBA (for AUD exchange rates)

3.3 Promoting management performance and productivity

The majority of global evidence supports the view that private equity firms add value to their investees.[7] Studies of Australian private equity investments over time have also consistently found that the greatest growth in these businesses' value under private equity ownership came from pro-actively growing the core business: more so than through any financial engineering, leverage or cost reductions.[8] Private equity firms were generally able to sell businesses for much more than their original investment using strong management, improved organisational structures and well-aligned incentives. A recent ACSI/MCFS review also concluded that most studies showed that private equity

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[6] Source: Seet P.S. and C. Graves, (2010), Submission 48 to the Senate Economics Committee's Inquiry into Access of Small Business to Finance.

[7] See, for example, Stromberg (2009) for a summary of these studies. Source: Stromberg, P, (2009), "The Economic and Social Impact of Private Equity in Europe: Summary of Research Findings", Institute for Financial Research, Stockholm School of Economics.

[8] Sources: PricewaterhouseCoopers/AVCAL, (2006), "Economic Impact of Private Equity and Venture Capital in Australia"; Ernst & Young, (2008), "How do private equity investors create value? An Australian study of 2007 exits"; Ernst & Young, (2009), "Challenges in a new world: how do private equity investors create value? An Oceania study of 2008 exits".

ownership was associated with "improvements in operational margins as well as total factor productivity; the latter implies a capacity to carry the additional debt burden".[9]

In 2009, a World Economic Forum report on the role of private equity ownership in management practices in 4,000 manufacturing firms in Asia, Europe and the US found that:[10]

- Most private equity-owned firms appear to be consistently well-managed. The study found that very few private equity-owned firms are really badly managed.
- Private equity-owned firms have strong people- and target-management practices. They adopt merit-based hiring, pay and promotions practices. They tend to have tough evaluation metrics, which are integrated across the short and long run, are well understood by the employees and linked to firm performance.
- Private equity-owned firms perform well across a wide range of management practices, operational management practices, such as the adoption of modern 'lean manufacturing' practices, using continuous improvements and a comprehensive performance documentation process.

3.4 Increasing private sector employment

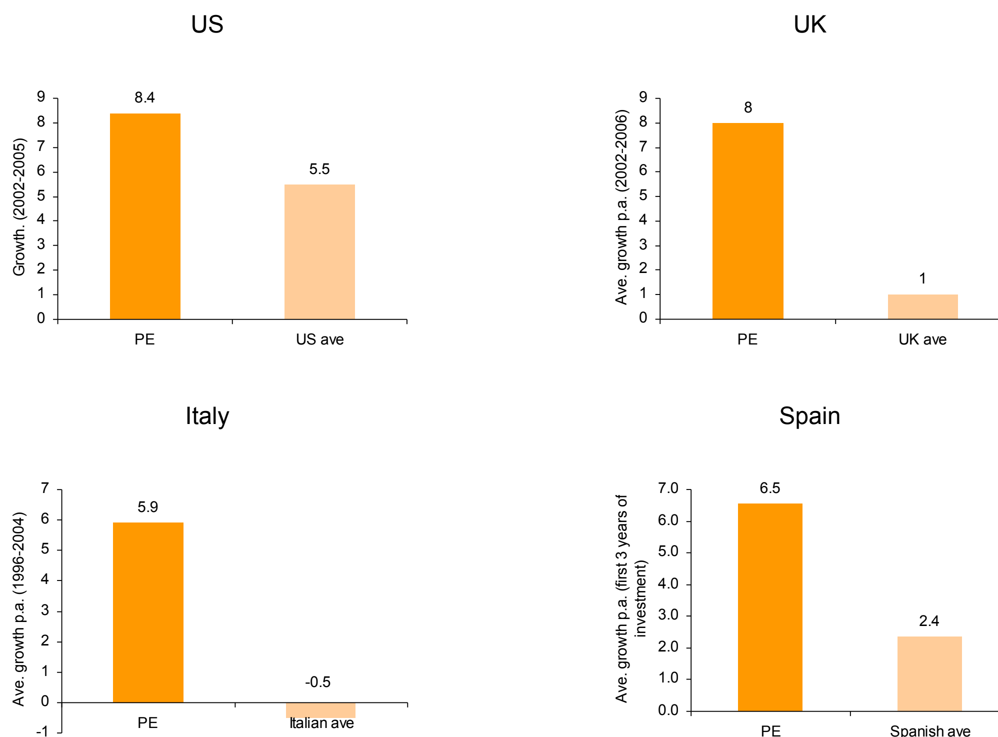
Private equity-backed companies are major employers. In Australia, companies that are, or have been, private equity-backed are major employers. They include household names such as Publishing and Broadcasting Ltd, Healthscope, Stella Group, Rebel Sports, JB Hi-fi and Hoyts.

Private equity ownership is associated with long-term employment growth and productivity. Empirical research points to a strong positive relationship between private equity ownership and long-term employment growth (Figure 9).

In one of the most comprehensive studies to date examining this issue, a large-scale World Economic Forum study of US private equity buyouts from 1980-2005 found that most businesses invested in by private equity tended to have lower net employment growth even before private equity investment, and this trend remains up to the second and third years post-transaction.[11] By the fourth and fifth years, jobs growth in these firms tended to rise slightly above that of comparable non-private equity businesses. Offsetting the lower job creation rates in the earlier years, however, was the finding that private equity-owned business tended to have higher rates of greenfield job creation in the first two years post-transaction (at 15% of employment compared to 9% for comparable non-private equity-owned businesses), suggesting that private equity groups tend to accelerate the expansion of the business in new, higher-value directions.

[9] Source: Australian Council of Super Investors and Melbourne Centre for Financial Studies, "Public companies being taken private: a research report into private equity", Aug 2009, p.5.
[10] Source: Bloom, N., van Reenen, J. and R. Sadun, "Do private equity-owned firms have better management practices?", in The Global Economic Impact of Private Equity Report presented at the World Economic Forum, 2009.
[11] Source: Davis, S.J., J. Haltiwanger, R. Jarmin, J. Lerner and J. Miranda, "Private equity, jobs and productivity", in The Global Economic Impact of Private Equity Report presented at the World Economic Forum, 2009.

Figure 9: Growth in employment under private equity ownership vs comparable benchmarks



Sources: Shapiro and Pham (2008), BVCA/IE Consulting (2007), AIFI/PwC (2008), ASCRI (2009), AVCAL analysis

3.5 Generating growth in key sectors of the economy

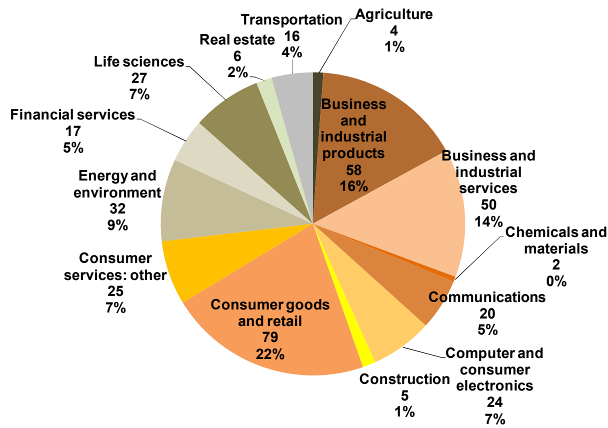
Private equity is a provider of capital to a diversified range of sectors. As of end-2010, the Australian private equity industry had an estimated $25b in total funds under management, with investments in 365 companies in sectors ranging from agriculture to transportation services (Figure 10).

Private equity is an important source of business to the financial, professional and business services sector. In doing so, its activities increase tax revenues from this sector. In the UK, for example, the private equity industry generated fee revenues of over £5.4b per annum in 2006 (up from £3.3b in 2005), equal to over 12% of the total annual turnover of the UK financial services industry.[12]

85% of private equity investments are expansion financing for small- and medium-sized enterprises. In FY2009 and FY2010, private equity investment in small- and medium-sized enterprises valued under $50m made up 85% of all private equity investments (Figure 11) even though they only accounted for 17% by value of all transactions. Businesses valued at between $50m and $250m made up 13% of all transactions, while larger buyouts accounted for only 3% of all transactions. Small- and medium-sized businesses that received expansion capital from private equity funds came from a wide range of sectors and included well-known home-grown brands such as Boost Juice, Aesop and Adairs. Among the larger buyouts were companies such as MYOB and FleetPartners.

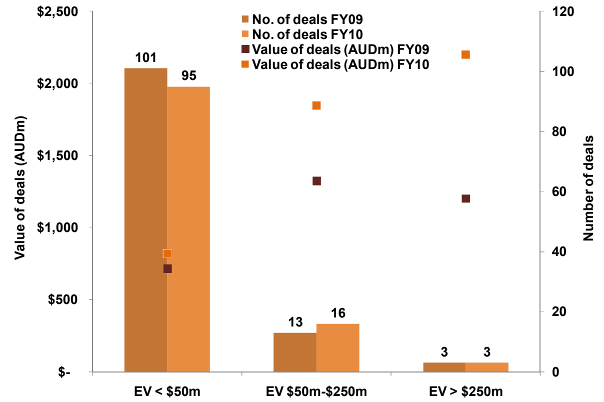
[12] Source: British Private Equity and Venture Capital Association, "The Impact of Private Equity as a UK Financial Service", Jan 2008.

Figure 10: Number of companies receiving investment from private equity, by sector (as at 31 December 2010)



Source: AVCAL

Figure 11: Number and value of private equity deals, by enterprise value (EV)



Source: AVCAL.

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Dear Members

Submission - Review of Tax Arrangements Applying to Collective Investment Vehicles

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

1. Executive Summary

1.1 We believe that the use of the "control test" in Division 6C of Part III of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 36**) to determine whether an investment vehicle should be treated as a CIV and therefore exempt from the public trading trust rules is inappropriate, and contradicts the policy intent of the current Australian Government, which is to encourage inbound investment.

1.2 Further, where an investment vehicle can show it satisfies the OECD definition of a CIV, then it should be allowed to access the concessional tax treatment afforded to those engaging in eligible investment business.

2. Introduction

2.1 The purpose of CIVs is to allow long-term portfolio investors to invest in vehicles which undertake primarily passive investments. The figures provided in the Discussion Paper on worldwide investment in CIVs show that such investments will only continue to grow. For Australia to have its share of overseas investor funds, the Government must reform the tax system to encourage such investments.

2.2 In Chapter 2, the Board refers to the OECD definition of a CIV as a fund which:

- is widely held;
- holds a diversified portfolio of securities; and
- is subject to investor protection regulation in the country in which it was established.

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

3. Eligible Investment Business and the Control Test

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

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

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

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

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

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

Legislative history

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

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

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

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

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

Comparison with Venture Capital

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

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

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

4. Recommendations

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

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

4.2 We believe that there are compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs. The "eligible investment business" definition in Division 6C of the ITAA 36 by itself is a sound and reasonable definition, but the existence of the control test in section 102N significantly narrows the scope of what would constitute an "eligible investment business".

4.3 In the result, we would submit that the control aspect is irrelevant for the purposes of CIVs. Any legislation governing CIVs should instead focus on defining what constitutes a diversified portfolio of securities as per the OECD definition and refrain from using Division 6C as a proxy for determining whether an entity is a CIV.

4.4 This legislation should also clarify that for the purposes of tax law, any investment by a CIV in related entities should be considered as an investment in one entity. Diversity of the shareholdings of a CIV, rather than the size of its shareholdings in each of its portfolio companies, is what should determine whether a vehicle should be treated as a CIV.

4.5 Where it can be established that a CIV is using any majority shareholding to engage in more than just passive investment and is in fact carrying on a trading business as per section 102N(1)(a), only then should it be treated as a trading trust.

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

Yours faithfully

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Appendix C: Global tax treatment of PE investment proceeds

	Domestic funds			International Funds		
Country	Capital Gain	Revenue Profit	Relevance?	Taxable?*	If taxable; Is treaty protection available	Comments
Canada	√	X	Capital gains subject to tax at lower rate	X	N/A	Limited Partnership regime operates in Canada.
China	X	√	No relevance	√	Yes	Withholding tax on gains unless treaty relief. China Revenue currently focusing on substance of treaty claimant. Typical structure is Cayman Islands Limited Partnership into British Virgin Islands into HK, Singapore, Mauritius, or Barbados, then into target.
Cyprus	X	√	No relevance	X	N/A	No tax on Cypriot shares and/or non-Cypriot listed shares.
France	√	X	No relevance	X	N/A	Participation exemption is available. Typical structure is Cayman Islands into Luxembourg/ Dutch company into target.
Germany	X	√	No relevance	X	N/A	Participation exemption is available. Typical structure is Cayman Islands into Luxembourg into target.
Ireland	√	√	Depends on individual circumstances	X	N/A	Domestic fund management exception ("IME"). Typical structure Irish CIV or Luxembourg CIV.
Italy	X	√	No relevance	X	N/A	Gains realized by foreign vehicles on disposal of shares are usually exempt from taxation in Italy. Typical structure is Cayman Islands into Luxembourg / Netherlands into target.
Korea	X	√	No relevance	√	Yes	Typical structure is Cayman Islands into Luxembourg into Dutch Co into target. Note: market not operative because of "unions".
Malaysia	X	√	No relevance	X	N/A	No preferred foreign location.
Malta	√	X	No relevance	X	N/A	International investors are not subject to tax provided that a number of conditions are met.
Philippines	X	√	No relevance	√	Yes	Typical structure is Cayman Islands into Netherlands/Singapore into target.

	Domestic funds			International Funds		
Country	Capital Gain	Revenue Profit	Relevance?	Taxable?*	If taxable; Is treaty protection available	Comments
Singapore	X	√	No relevance	X	Yes	Taxable in Singapore only if Singapore sourced. Normally structured for exemption available under the Tax Exemption Scheme. Domestic fund management exception ("IME") available. Typical structure Cayman Islands LP.
South Africa	√	X	Capital gains subject to tax at lower rate	X	N/A	Typical structure is a Limited Partnership.
Spain	√	X	Capital gains subject to tax at lower rate	√	Yes	Typical structure is Cayman Islands Limited Partnership into Luxembourg/Netherlands into target.
UK	√	X	Capital gains subject to tax at lower rate	X	N/A	Domestic fund management exception ("IME"). Typical structure is Limited Partnership in UK, Jersey or Cayman Islands.
US	√	X	Capital gains subject to tax at lower rate	X	N/A	Typical structure is US or Cayman Islands Limited Partnership or LLC.

* Assumes that:

(i) gain derived by a non-resident fund which does not operate through a permanent establishment / branch in the source country, and which does not operate a trade or business in that country.

(ii) investee is not land-rich.