Attachment

Submission: Review of Tax Arrangements Applying to Collective Investment Vehicles (CIVs)

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

Q 2.1 Some comments on the specific reasons for the apparent unattractiveness of Australia's current tax treatment of CIVs to non-resident investors follow below.

As noted in the Board's Discussion Paper (DP), the lack of familiarity on the part of many potential non-resident investors who are not in common law jurisdictions with trust structures appears to be clearly a problem.

We note also in this regard that a recent Federal Court case dealing with the taxation of managed investment trusts appears to have created even further uncertainty in respect to the treatment of such trusts. The case in question, *Colonial First State Investment Limited* v *Commissioner of Taxation* (2011 FCA 16), involves many issues relating to the trust provisions, particularly those relating to the treatment of capital gains and the ability to stream such gains.

As also noted in the Board's DP, non-resident investors may favour investing in CIVs domiciled in jurisdictions (eg. Ireland and Luxembourg) where there are significant tax exemptions (for both income and capital gains) available for such entities rather than via Australian CIVs. This outcome generally arises because the relevant CIVs in those jurisdictions are established as funds which invest predominantly or solely in offshore assets. This outcome is in addition to the benefits of a recognised regulatory regime provided by the UCITS framework.

The obvious solution to the abovementioned tax issue would be for Australian fund managers to establish a range of Australian domiciled CIVs restricted predominantly or solely to non-resident investors. There may, of course, be cost issues for fund managers in the short term and it is also not clear to us as to how the regulatory issues could be resolved.

In relation to the current problems and uncertainty around the tax rules applicable to trusts, we note that the Henry Tax Review recommended that the current trust rules should be updated and rewritten to reduce complexity and uncertainty in their application.

Q 2.2 We believe that the current 'widely held definition' contained in the MIT legislation is appropriate as we do not believe that there are any compelling reasons to have non-widely held vehicles included as CIVs at this stage.

The current definition of eligible investment business in Division 6C of ITAA 1936 seems appropriate for a wider range of CIVs. We do not see any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs. We also don't see a need to further define 'control' in Division 6C (ITAA 1936) to provide greater certainty for investors.

Australia's Current Range of CIVs

Q 3.1 As noted in the Board's DP, the main impediments to investments into Australia by foreign residents through MITs appear to be the following:

1. the lack of familiarity on the part of many foreign investors (particularly those who are not in common law jurisdictions) with trust structures

2. practical difficulties for non-resident retail investors to invest in CIVs not covered by investor protection regulations applicable in their jurisdiction

3. while listed investment companies (LICs) in Australia can be attractive for resident investors for taxation reasons, they are generally less relevant for foreign investors as the latter do not enjoy similar tax benefits.

4. Australian CIVs generally face higher levels of taxation than those domiciled in certain offshore jurisdictions such as Luxembourg or Ireland.

Q 3.2 As noted in the DP, while the existing tax treatment of LICs goes some way to delivering on the policy principles of flow-through tax treatment applicable to trust structures, there is no adjustment to capital gains derived by an LIC in a situation where the LIC also incurs capital losses. In addition, other than for returns of capital, distributions from LICs are generally assessable to shareholders as compared to tax deferred distributions from MITs to unitholders. In other words, neutral tax treatment is not achieved in a number of cases for investments undertaken directly and indirectly through an LIC.

It would seem desirable to introduce further changes to the current LIC regime to better obtain parity of tax outcome with direct investments in the underlying assets of the LIC. Such an amended LIC regime could be applied broadly to other widely held non-listed investment companies as per the existing rules for MITs.

Our preference would be for appropriate amendments to the existing LIC regime in lieu of a new corporate CIV regime to avoid undue complexity in this area, including the extension of a similar regime to non-listed investment vehicles.

Q. 3.3 Our views on the queries raised in respect to Limited Partnerships (LPs) are as follows:

1. we would be reluctant to support the use of LPs for CIV purposes at this stage in view of the absence of appropriate investor protection and regulatory arrangements for such vehicles, although they may have a role in relation to CIVs marketed at a wholesale level for sophisticated investors.

2. consistent with the above response, we doubt whether LPs are suitable vehicles for widely held, primarily passive, collective investments.

3. the introduction of changes to the LP regime to facilitate their role as CIVs would only seem appropriate if there were problems associated with the use of LICs for this purpose.

4. there would not appear to be a need for LPs marketed at the wholesale level to be widely held if they are restricted to sophisticated investors and are not subject to investor protection arrangements.

5. we would not see a need for further restrictions to apply to a modified LP regime.

Design of a New Corporate CIV Regime

Q. 4.1

We note that the flow-through model discussed in the Board's DP is similar although not identical to the 'trust' model used in Australia for most collective investments as the various types of income or capital gains derived via managed investment trusts (MITs) in Australia are taxed in the hands of unitholders as there is generally no retention of income by MITs as this is discouraged by penal tax rates on undistributed income.

While there are tax advantages in Australia associated with MITs as opposed to LICs which operate through a corporate structure, there are generally higher compliance costs associated with the former.

The Irish Common Contractual Fund (CCF) structure appears to be similar to Australia's MITs. The same appears to be the case for the exemption model used by Variable Capital Investment Companies (VCICs) domiciled in Ireland.

In other words, overseas structures for managed investments seem to be similar to those applicable to MITs in Australia although the former may have higher levels of consumer protection and assurance vis-à-vis MITs.

The integration available for corporate entities in Australia via our dividend franking regime does not appear to be available in other comparable jurisdictions.

In other words, current overseas experience does not appear to provide a clear-cut solution to problems experienced in Australia (other than perhaps in respect to consumer protection issues) and it is presumably up to investors to choose to invest either via MITs or LICs, although a wider range of entities in the collective investments area in Australia appear to be MITs.

Q 4.2 As noted above in our response to Q 3.2, our preference would be for appropriate amendments to the existing LIC regime (including its extension to non-listed widely-held investment companies) in lieu of a new corporate CIV regime to avoid undue complexity in this area. This should include application of the normal corporate tax rate to such an entity to facilitate interaction with the existing dividend imputation regime.

As the proposed MIT regime is elective, any new CIV regime should allow an MIT that has elected into the MIT regime to not be precluded from accessing the CIV regime (ie. there should be no disadvantage to an MIT if a better CIV regime is developed). Appropriate transitional measures should be developed to allow MITs or existing trusts (that are not

MITs), to transition to a CIV regime without adverse tax consequences. For example, by providing a form of rollover relief on transition to any new CIV regime.

Further, uncertainty over ‘fixed trust’ classification raises much uncertainty for the managed funds industry and investors (particularly given the recent *Colonial* decision). This uncertainty also discourages offshore investment. Accordingly, CIVs should be given guaranteed ‘fixed trust’ status to remove this uncertainty.

Investment Manager Regime

Q 5.1 We strongly support the Johnson Report proposal for the introduction of an appropriate investment manager regime (IMR) as the most effective and efficient means of improving current taxation arrangements in respect to cross-border financial transactions. We note that this would make Australian fund managers more attractive to foreign investors and also encourage both Australian and international financial services entities to establish their regional headquarters in Australia.

We also support an exemption-based approach for a IMR applicable to foreign managed funds to effectively resolve the current uncertainties in the application of Australia’s tax laws in this area.

Q. 5.2 We suggest that Australian intermediaries used by foreign managed funds be taxed only on their arm’s length fees. Australia’s transfer pricing rules in its domestic law and tax treaties and other relevant reporting requirements (see 5.3) should be sufficient to address any issues relating to the potential manipulation of management fees

Q 5.3 The features of a foreign managed fund as specified in the DP appear to cover all funds that should be covered by an IMR. As the proposed IMR should result in significant economic benefits and growth in the Australian financial services industry over time, we do not believe that more direct regulation as per Singapore’s regime is warranted at this stage but the issue could be further reviewed further down the track (say, after two years). In respect to reasonable approval/reporting arrangements for qualifying foreign managed funds, such funds could be required to seek approval from the relevant Australian authorities (eg. Treasury) to ensure that they meet the relevant requirements to participate in the IMR (including the requirement to not carry on or control a trading business in Australia) and to provide reports to the ATO annually on any other activities that they may conduct in Australia outside the scope of the IMR (such as a permanent establishment) and their management fees from their IMR activities.

Q. 5.4 The range of investments that could be covered by an IMR include those specified in the Board’s DP (at para. 5.93). Other activities of a foreign fund/non-resident that could affect their access to an IMR would include those mentioned in the DP (such as a PE or trading business). An IMR could also cover non-portfolio interests in non-Australian assets as any income derived by foreign funds from such assets would not ordinarily be subject to Australian tax unless the foreign fund was inadvertently caught by Australia’s residence rules (which should not arise in the future if this potential problem is addressed by appropriate measures canvassed in the Board’s DP).

Q. 5.5 We note that it is proposed that Australia’s residence rules be modified so that foreign entities within an IMR would not become resident merely by having central management and control in Australia. One option canvassed in the DP to achieve this outcome would be to limit the extent that resident investors can participate in a foreign

managed fund. While a number of overseas IMRs have adopted this approach, there appear to be practical difficulties involved with it. A de minimis threshold also appears to have problems. An alternative method would be to restrict exemptions under an IMR to funds that provide relevant information to the ATO. This approach appears to be the most appropriate in the short-term pending the development of a 'trace' mechanism in the medium term by the OECD.

While information gathering/reporting approaches may be required to address IMR integrity, a practically workable IMR should not require pre-approval or a clearance approach. Further, consideration should be given to extending an IMR to entities such as private equity and other specialist asset funds (eg. infrastructure) to further encourage investment into Australia.

Q 5.6 In the short-term, the introduction of a de minimis test re resident investors would appear to be the most appropriate option and we would tentatively suggest that the threshold could be set around the 10-15 % mark.

Q 5.7 We have no further comments regarding any other possible unresolved PE or source issues in respect to this area at present.

Q 5.8 We are not aware of any other financial services entities (other than FMFs) which should be encompassed within the scope of the proposed IMR at this stage.

We believe that the existing OBU provisions are adequate for other financial sector entities (apart from FMFs).

Venture Capital Limited Partnerships

Q 6.1 We are inclined to agree with the Board's view that it may be premature to determine the appropriateness of the restrictions placed on the VCLP and ESVCLP regimes at this stage, particularly in light of the impact of the global financial crisis.

We think it would probably be appropriate in the current circumstances to provide a deemed capital account treatment to give certainty, etc for non-superannuation partners investing in VCLPs.

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