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Ref: AMK

5 March 2011

Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Dear Sir/Madam

Review of Tax Arrangements Applying to Collective Investment Vehicles

We welcome the opportunity to provide comments on the Board's Discussion Paper on the review of tax arrangements applying to collective investment vehicles ("the Discussion Paper").

Pitcher Partners comprises five independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises and high wealth individuals (which we refer to as the "middle market").

Summary of comments

We believe that one of the most important aspects contained in the Discussion Paper is the review of the investment manager regime (IMR) proposed for Australia. We highlight that while Australia has a significant funds management industry as compared to other countries in the Asia-Pacific region, Australia does not manage a significant amount of funds sourced from non-resident investors. As at 31 December 2010, this amounted to only 4.84% of funds under management in Australia.

The focus of the review contained in the Discussion Paper is centred on an IMR that is aimed at foreign widely held funds. However, we highlight that IMR exemptions offered in the Asia-Pacific region by other jurisdictions, for example Hong Kong and

Singapore, are not so restricted. Such IMR exemptions are offered to all types of non-resident investors, including individuals.

We further highlight that a limited approach to the IMR would deny Australia access to a significant pool of funds that could otherwise be managed in Australia. For example, high net wealth individuals, which are defined as those persons having investable assets of US$1 million or more (excluding primary residence, collectables and consumer durables) that were resident in the Asia-Pacific region (excluding Australia), had assets of approximately $9.1 billion that were available for investment in 2009. Furthermore, in some jurisdictions, the number of high net wealth individuals increased by more than 40% in the last 12 months. This is a growing source of funds Australia should be targeting as part of its creation of a financial services hub.

In our view, where Australia is looking to become a financial services hub, Australia cannot afford to overlook other forms of funds that could otherwise be managed in Australia, especially if it is to compete for these scarce resources in the Asia-Pacific region. While the Discussion Paper seems focused on an IMR that is aimed at widely held investors and on integrity issues relating to the IMR, we highlight that other jurisdictions have made it easier and more practical for IMRs to be implemented and managed on a wider basis. We believe that Australia would be out of step as a financial services centre if it did not also follow this trend. Furthermore, Australia could take into account the practical ways in which such jurisdictions have tackled integrity issues, while making the regime available to almost all foreign residents.

In relation to the proposed CIV regime, we support the proposition to expand the CIV regime to various forms of legal entities. We believe that a new CIV regime could be founded on similar principles as the MIT regime, which is currently being developed.

We would welcome the opportunity to meet with you and discuss our recommendations contained in this submission in further detail. Should you have any queries, please contact me on (03) 8610 5170 or Peter Gillies on (03) 8610 5361.

Yours sincerely

A M KOKKINOS
Executive Director

Contents

1 Glossary of terms

Key Term	**Description**
1936 Act	*Income Tax Assessment Act 1936* (Cth)
1997 Act	*Income Tax Assessment Act 1997* (Cth)
Board	Board of Taxation
CIV	Collective investment vehicle
Discussion Paper	The Board's Discussion Paper titled "Review of Tax Arrangements Applying to Collective Investment Vehicles", December 2010
HNWIs	High net wealth individuals
IMR	Investment manager regime
Johnson report	Report by the Australian Financial Centre Forum titled "Australia as a Financial Centre, Building on our Strengths", November 2009
LP	Limited partnership
LLP	Limited liability partnership
LLC	Limited liability company
MIT	Managed investment trust
Subdivision 12-H	The fund payment withholding tax rules contained in Subdivision 12-H of Schedule 1 to the TAA 1953.
TAA 1953	*Taxation Administration Act 1953* (Cth)

2 Investment manager regime

2.1 Overview

2.1.1 We welcome the proposals for an IMR and the recent announcements that have been made by the Assistant Treasurer. However, we believe that such a regime should not be limited to foreign widely held funds.

2.1.2 In summary, we support an expanded IMR exemption being introduced in Australia. We believe that an IMR is a critical step in providing Australian tax certainty for foreign investors and thus is crucial to promoting investment management services in Australia on behalf of such investors.

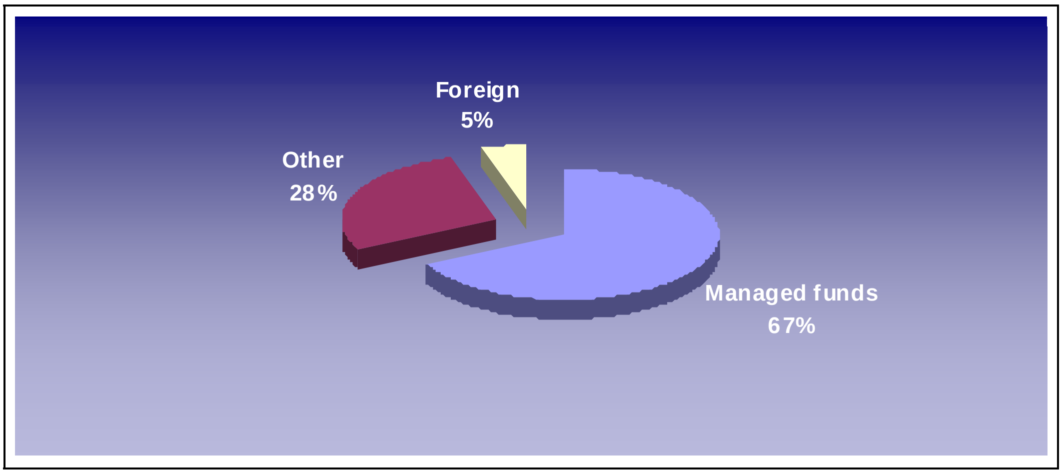
2.2 Management services provided to non-residents

2.2.1 Australia has the largest investment fund assets pool in Asia and is the fourth largest in the world[1]. At December 2010, Australia had consolidated assets under management of $1,793 billion. Of this amount, $1,179 billion was placed with Australian resident investment managers[2].

2.2.2 It is well known that the main driver of the funds management industry in Australia is the compulsory superannuation system. Accordingly, it may not be surprising that only $57 billion[3] of funds under management in Australia represented funds from overseas sources at 31 December 2010. This amount represented only 4.84% of funds under management in Australia.

2.2.3 The following table provides a breakdown of the various sources of funds under management as at 31 December 2010[4].

[1] Benchmark report - 2010
[2] Australian Bureau of Statistics, Managed Funds, December 2010 quarter – Cat 5655
[3] Ibid.
[4] Ibid.



2.2.4 For the purpose of this diagram, investment through managed funds comprised life insurance companies, superannuation funds, retail trusts, friendly societies, common funds and cash management trusts. Investment through other vehicles included Government funding, wholesale trusts, general insurance, charity, and other fund managers.

2.2.5 There is little doubt that Australia will continue to develop its domestic funds management industry through the expanding compulsory superannuation system. However, these statistics highlight a significant potential growth opportunity for Australia, in terms of potential to export investment management services to foreign resident investors.

2.3 Comparison to alternative IMRs

2.3.1 We agree with the conclusions drawn in the Johnson report that uncertainty in the operation of the Australian taxation law creates a significant barrier of entry for foreign investors that wish to use Australia as a conduit investment region. Issues are appropriately identified in both the Johnson report and the Discussion Paper and include the determination of residency, whether a permanent establishment exists, source issues, capital versus revenue issues, and anomalies in the operation of certain provisions in Australia. Importantly, these uncertainties are not limited to foreign widely held funds, but are uncertainties that are encountered by all non-residents entities investing through Australia.

2.3.2 As highlighted in this submission, if an IMR is appropriately designed, we believe that Australia could obtain access to (and therefore provide appropriate management services to) a significant pool of offshore funds from different sources. These sources would include widely held entities and closely held entities, as well as other sources as identified by the Johnson report.

2.3.3 In the Asia-Pacific region, there is strong competition for these mobile capital resources. Tax incentives and investment manager exemptions are offered by many of our trading partners in those regions, including Hong Kong, Japan and Singapore. Accordingly, if Australia is serious about becoming a regional financial services hub (and thus competing for the exportation of investment management services in the Asia-Pacific region), our IMR would need to be both comparative and competitive.

2.3.4 In our view, this requires an IMR exemption that is available to a broad range of foreign investors, both widely and closely held. Furthermore, it must be a system that promotes certainty and does not introduce new significant uncertainties in its own right. Finally, we believe it must balance any proposed integrity provisions with an ability to practically administer such a regime.

2.4 Scope beyond foreign managed funds

2.4.1 Question 5.8 of the Discussion Paper requests submissions on whether it would be appropriate to expand the IMR exemption to foreign investors other than widely held funds (in line with the recommendations contained in the Johnson report). The report requests "justification" to relax the requirements.

2.4.2 There are two main justifications for a relaxation of the proposed widely held rule. The first is the ability to access a significant pool of non-resident investment funds for management. The second is the ability to increase our competitiveness in the Asia-Pacific region for the exportation of funds management services, whereby our IMR would be on par with those countries also seeking to develop a financial services hub in the region.

<u>Access to other significant sources of foreign funds</u>

2.4.3 There are many other significant sources of foreign funds for investment management purposes, other than widely held funds, that Australia should be seeking access to – in line with the objective of becoming a financial services hub.

2.4.4 To demonstrate, consider the investment pool of funds held by the group of individuals known as high net wealth individuals (HNWIs). This group is defined as those persons having investable assets of US$1 million or more, excluding primary residence, collectables and consumer durables[5].

[5] Source: Capgemini and Merrill Lynch, Asia-Pacific Wealth Report, 2010

2.4.5 As at 2009, the pool of funds held by HNWIs in the Asia-Pacific region amounted to US$ 9.7 trillion[6]. If Australian HNWIs were excluded, this would have totalled approximately US$ 9.1 trillion. This total pool of funds can be broken down geographically into the following locations.

Country	Asia-Pacific HNWI Wealth 2009 (US$ billion)	Annual Change 2008–2009
Japan	3,892	22.4%
China	2,347	40.4%
India	477	53.8%
Hong Kong	379	108.9%
Singapore	369	35.6%
South Korea	340	23.2%
Taiwan	264	49.6%
Thailand	232	22.2%
Indonesia	80	30.6%
Other Markets	749	11.6%
Total	9,129	

2.4.6 HNWI wealth (being approximately US$ 9.1 trillion of investable assets as at the end of 2009) represents a significant pool of offshore funds that could otherwise be managed in Australia. As at 31 December 2010, this represents approximately 160 times the amount of total foreign funds under management in Australia and represents close to eight times the amount of total funds under management in Australia.

2.4.7 Furthermore, as outlined in the table above, there has been a significant growth in HNWI wealth in many of our major Asia-Pacific trading partners. In many cases, this growth has increased by more than 40% in the 12 months to 2009. This is clearly a significant growing source of funds available for management.

[6] Source: Capgemini and Merrill Lynch, Asia-Pacific Wealth Report, 2010

2.4.8 For example, a HNWI based in Hong Kong may hold a portfolio of Australian investments through a trust established in the same location, through which all of the foreign assets of the HNWI are held. If this HNWI decides to use Australian investment managers to directly look after the Australian assets held via the trust, we do not see any compelling policy reason why such an investor should be exposed to Australian tax - if Australia is serious in its desire to have access to the significant and growing pool of funds in the Asia-Pacific region then any IMR exemption regime must be broad enough to cover investment vehicles such as trusts (including both unit trusts and discretionary trusts).

2.4.9 Many of the HWNI investors are considered sophisticated investors and may not seek investment opportunities through widely held managed funds investing indirectly through Australia. Accordingly, in order to obtain access to the management of this significant and growing pool of funds in the Asia-Pacific region, we believe it would be critical for Australia to consider having a broad based IMR exemption regime that would allow such investors to have their portfolio managed directly by Australian investment managers.

Competitiveness in the Asia-Pacific region

2.4.10 Many of our trading partners in the Asia-Pacific region already provide an IMR exemption to foreign investors, including Hong Kong, Singapore, and Japan. Furthermore, many of these regimes are open to foreign investors that include natural persons, corporations, trustees and partnerships (see for example the Hong Kong profits tax exemption for offshore funds and the Singapore offshore funds exemption).

2.4.11 In order for Australia to remain competitive and attractive as a regional financial services hub in the Asia-Pacific region, a proposed IMR exemption in Australia should provide for a scope of investors that at least matches the scope of our trading partners in the Asia-Pacific region.

2.4.12 On this point, as at 31 December 2010, we reiterate that Australia held only $57 billion of foreign investment funds under management. While this amount is large in its own right, it is a small figure as a comparison to total funds under management. This clearly represents a significant area of potential growth to our funds management industry.

2.4.13 In order to remain competitive with our Asia-Pacific trading partners, and to help increase our management of foreign investment funds, we believe it is critical that the Board consider an expanded IMR regime (rather than a narrow interim regime) which is at least on par with other countries in the Asia-Pacific region.

2.5 Types of fund exemptions

2.5.1 Other jurisdictions, such as Hong Kong and Singapore, offer exemptions to non-resident investors investing through either a resident fund or by investing through an investment manager. It is noted that, this is not dissimilar to the regime being examined by Australia, being:

- **Resident fund exemption –** Non resident investors can currently obtain an exemption for indirect investments through a resident fund[7], utilising current exemptions provided and the fund payment rules contained in the Subdivision 12-H withholding tax rules. This is otherwise known as the conduit approach.

- **Non-resident direct exemption –** Non-resident investors would obtain an exemption for direct investments through the proposed IMR exemption.

2.5.2 Accordingly, we believe that an IMR should be seen as complimenting a resident fund exemption model, by providing certainty on the ability to claim exemptions on a direct investment through Australia (rather than on an indirect investment). On a policy level, it is only appropriate to ensure that such exemptions are available to all non-resident investors, and that certainty is provided irrespective of whether the investment is carried out directly or indirectly.

2.6 Dealing with round-tripping and compliance issues

2.6.1 At Question 5.6, the Board has outlined its concern with the potential for anti-avoidance behaviour to occur through an IMR. Namely, the Board has referred to the possibility of Australian residents potentially obtaining access to the concessions through round-tripping (i.e. by investing in foreign funds that obtain access to the Austrian IMR) or through the use of offshore accumulation funds. Accordingly, we understand the Board is considering whether integrity provisions should be inserted to deal with these potential issues.

[7] For example, through the application of Division 855 for CGT assets, or through the treatment of foreign source income derived by the Australian MIT.

Balance between integrity and administration

2.6.2 We highlight that there are a number of anti-tax deferral provisions that are currently in place or are the subject of consultation: namely, the controlled foreign companies (CFC), the transferor trust and the foreign accumulation fund (FAF) provisions.

2.6.3 The objective of the proposed anti-tax deferral provisions was clearly stated by the (then) Assistant Treasurer in his press release dated 12 May 2009[8] titled "Next Major Steps to Promote Australia as a Regional Financial Hub":

[8] No.049

> *"The reforms will also improve the competitiveness of Australian businesses which have offshore operations by modernising and simplifying the attribution rules to <u>better target areas at risk</u> of inappropriate tax deferral, while <u>substantially reducing compliance costs</u>."*

2.6.4 That is, the aim of the reforms was to better target integrity risks, taking into account specific compliance issues. Unless appropriately developed and targeted, integrity provisions dealing with possible round tripping issues have the potential to drastically increase the compliance costs of an IMR exemption in Australia and thus make the system unattractive for foreign investors.

2.6.5 We would have serious reservations going down a path that would require onerous tracing and record keeping to be maintained. Accordingly, we *prima facie* do not support an early adoption of the proposed OECD tracing requirements.

2.6.6 Furthermore, it would be disappointing if integrity provisions are developed in a manner that is inconsistent with the redevelopment of the anti-tax deferral regime, as outlined by the Assistant Treasurer. That is, on one hand the Government has indicated its intention to more appropriately target the scope of both the controlled foreign companies (CFC) and foreign accumulation fund (FAF) provisions[9]. This approach would be inconsistent with a broad ranging "round tripping" integrity provision that required both foreign funds and resident Australian investors to apply onerous record tracing provisions in order to determine whether the Australian entity has a tax liability through the foreign fund.

2.6.7 If the Board considers additional integrity provisions are necessary, we recommend that the Board ensure that any such provisions are appropriately targeted and take into account the compliance issues, especially the extent to which Australian resident investors are likely to have access to information of the foreign fund. In this respect, we would recommend that the Board take into account the integrity rules found in other jurisdictions.

<u>Comparison to other jurisdictions</u>

2.6.8 The Board's discussion paper states that Singapore and Hong Kong have *de minimis* beneficial ownership tests of 20% and 30% respectively. We highlight that the IMR provisions contained in those jurisdictions are not as

[9] Through the release of exposure draft legislation in February 2011.

onerous as that suggested in the Board's discussion paper, which appears to oversimplify the integrity provisions contained in those regimes.

2.6.9 That is, in Singapore, the 20% beneficial interest test (or the 80:20 rule) was removed in 2007[10]. This was replaced with a 30 percent / 50 percent test, which looked at the holding of single investors (together with their associates). Essentially, this integrity rule only applied a 30 percent or 50 percent associate inclusive investment limit (based on number of investors) to resident non-individual investors of a qualifying fund[11]. Furthermore, this integrity rule was removed where the "qualifying fund" satisfied the requirements of being an Enhanced-Tier Fund Tax Incentive Scheme.

2.6.10 The relaxation of these rules in Singapore was to encourage Singapore as a financial services hub. The modifications broadly brought Singapore in line with the lower round-tripping threshold tests contained in the Hong Kong IMR regime. In Hong Kong, the exemption is denied where a single resident person (alone or with its associates) has an interest in 30% or more of the equity in the offshore fund that is seeking access to the IMR. Of importance, it is noted that these tests are based on an associate inclusive investor test, and are not based on whether non-associated residents (on aggregate) meet such thresholds (which is different to that contained at a high level in the Board's report). These tests do not require a strict tracing of all unit holders and a grouping of all underlying resident unit holders to determine whether a *de minimis* threshold is satisfied.

2.6.11 We also highlight that there are other measures contained in those IMRs that help to reduce the compliance with a round-tripping provision. This includes a bona-fide widely held funds exemption and exemptions for bona fide non-resident non-individual investors (where such investors already have a presence in those countries).

2.6.12 The above discussion is not provided to suggest how Australia may deal with perceived integrity issues. However, it is highlighted solely to demonstrate that other IMR regimes have focused on a more targeted approach to round-tripping issues, taking into account compliance issues as well as the purpose of attracting investment into the various countries.

[10] Refer to the Monetary Authority of Singapore, Circular No: FDD Cir 04/2007.
[11] For the purpose of those provisions, a qualifying fund included an entity not resident in Singapore, where the value of issued securities is not 100% beneficially owned, directly or indirectly, by investors in Singapore (including investors who are resident individuals, resident non-individuals and permanent establishments in Singapore), and where the entity does not have a permanent establishment in Singapore (other than a fund manager) and does not carry on a business in Singapore.

2.6.13 Should the Board consider it appropriate to introduce a round-tripping integrity provision, we would recommend that the Board closely consider the provisions contained in other jurisdictions. We would request that the Board consider the balance between integrity and compliance with the provisions, to ensure that the IMR remains attractive to foreign investors.

2.7 Appropriateness of an exemption model

2.7.1 Question 5.1 of the Discussion Paper has requested stakeholder comments on the appropriateness of an exemption-based approach for an IMR applicable to foreign managed funds and whether an alternative approach would be more appropriate.

2.7.2 We agree that an IMR exemption type model can help to provide certainty, while requiring very little in terms of change to existing provisions in the taxation regime. Accordingly, we believe it is preferable that Australia adopt such a model.

2.7.3 Furthermore, given that IMRs are already used in many jurisdictions (under various different names), its concepts are well known by many of our trading partners. Thus, utilising a consistent model with our trading partners would also help to promote understanding and certainty in investment transactions through Australia that are carried out by investors familiar with those concepts.

2.7.4 However, we highlight that care needs to be taken when implementing an IMR, so that we do not introduce other significant tax uncertainties into the regime. A number of these types of issues have already been encountered in other jurisdictions that have implemented an IMR. Accordingly, Australia could learn from the lessons of those countries.

2.7.5 For example, uncertainties have included whether a fund is in fact a foreign fund for the purposes of having access to the rules (i.e. its residency status), whether the foreign fund is owned by non-residents (i.e. tracing to investors), whether the investments are eligible / qualifying investments, whether the management of ineligible investments can taint the whole exemption (i.e. ring fencing issues), and whether and in what circumstances an investment manager is considered independent in order to access the provisions.

2.7.6 It is noted that a number of these issues of uncertainty have been dealt with in those jurisdictions by providing for rules of thumb or safe-harbours. It is therefore our preference that (for the purpose of promoting certainty) that the

Board consider recommending bright line tests to be used in satisfying the conditions of the IMR.

2.8 Australian based intermediaries

2.8.1 At Question 5.2, the Board has requested submissions on certain propositions involving Australian based intermediaries. We believe that the scope of the intermediary and the determination of whether a party qualifies as being an intermediary are important issues that, at a high level, should be considered by the Board.

<u>Who should qualify as an intermediary?</u>

2.8.2 The Discussion Paper does not appear to discuss the requirements to be an Australian based intermediary. We believe that this will be an important question for the Board to consider in formulating its recommendations on an IMR.

2.8.3 In the United Kingdom, an investment manager is defined broadly to include any person in the business of providing investment management services. In our view, a broad definition should also be followed in Australia.

2.8.4 Furthermore, to promote certainty in the application of this type of provision, a person could be deemed to satisfy such a requirement if they are licensed (or authorised) to provide financial services under Division 2 of Part 7.6 of the Corporations Act. It is noted that such provisions cover a person who carries on a financial services business in this jurisdiction.

2.8.5 As outlined earlier, such a recommendation would help to provide a "safe harbour" type test that would remove the need for objective / subjective testing, and thus would help to provide certainty in the application of the IMR.

<u>Independent versus dependent</u>

2.8.6 As outlined at paragraph 5.2 of the Discussion Paper, the Johnson report recommended that the IMR exemption should be available where investments are made through either independent or dependent investment managers.

2.8.7 We agree with this proposition, and see no reason why the scope of investment managers should be limited under an IMR.

2.8.8 While many jurisdictions have limited their IMR to foreign investments made through an "independent agent", we do not see why this limitation needs to be made if appropriate integrity provisions are put in place (i.e. a requirement that an arm's length fee or a rate that is at least customary for services provided is to be charged by the investment manager).

2.8.9 If the Board considers it appropriate to expand the IMR to non-resident investors that are not widely held funds, it is highlighted that such investors may not invest through investment managers in Australia unless they can exercise some degree of control over the investment manager's decisions. Furthermore, a foreign fund may also seek to establish a representative arm in Australia to carry on the investment manager services.

2.8.10 Finally, as outlined earlier, whether an investment manager is dependent or independent will require a degree of objective analysis. If the final IMR differentiates between independent and dependent managers, it is recommended that the Board propose bright line tests, as contained in Japan and the United Kingdom, such that the investment manager is deemed to be independent if certain tests are satisfied.

2.9 Arm's length fee

2.9.1 In relation to the requirement to charge an arm's length fee for investment management services, we do not believe that onerous substantiation requirements should be in place if the investment manager is "independent" of the foreign investor. If the two parties are truly independent, then it is expected that the investment manager would charge a fee that is not less than customary.

2.9.2 It would seem anomalous to require the application of the transfer pricing provisions in the case where (a) the fee charged should already be comparable, and (b) where the parties are already dealing at arm's length (i.e. they are independent parties). Accordingly, we believe that the parties should be deemed to be "arm's length" in the case where the investment manager is independent and that no further substantial work should be required in that case.

2.9.3 Where the investment manager is held to be dependent, it is likely that this would generally (already) result in the application of the Australian transfer pricing provisions. However, as the intention of the proposal would be simply to determine a customary fee to be charged in Australia for such services, we believe that there is scope for simplifying this substantiation process (rather than resorting to transfer pricing provisions). That is, we believe it would be far simpler to provide benchmark rules for determining a comparable rate of remuneration to be charged in Australia by an investment manager. This would be no different to benchmark rules provided in respect of other tax provisions. We believe that this approach may make it easier and more efficient from an administrative perspective, as compared to a transfer pricing exercise to be undertaken by each investment manager for each portfolio administered.

2.9.4 If the benchmark rules are set appropriately, then we believe this would maintain the integrity of the provisions, by appropriately taxing the management fee in Australia.

2.10 Qualifying investments

2.10.1 Question 5.4 of the Discussion Paper requests submissions on the range of investments that should qualify for an IMR.

2.10.2 It is noted that the two Assistant Treasurer press releases relating to the proposed IMR have indicated a definition that would (prima facie) appear quite broad (e.g. it is proposed to apply to all financial arrangements, unless they are used to hedge an otherwise non-qualifying investment). In this respect, all shares are defined to be financial arrangements[12].

2.10.3 However, the press release also states that it would only apply to portfolio shares, whereby an investment in non-portfolio shares (e.g. a 10% interest) would seem to be outside of the proposed IMR[13].

2.10.4 The Assistant Treasurer's press release is slightly ambiguous in relation to whether non-portfolio investments would be within the scope of an IMR. Furthermore, we note that the Discussion Paper does not provide a view as to whether non-portfolio investments should be covered by an IMR (however, the discussion paper implies that the IMR should be limited to portfolio investments at paragraph 5.92 and 5.93).

2.10.5 In our view, we believe it is important that an IMR exemption model provide a level of certainty in relation to investments that would otherwise qualify for exemption if a direct investment were made by the investor. Therefore, it would seem appropriate that non-portfolio investments in shares, other than taxable Australian property (TAP), should qualify for the exemption.

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[12] Section 230-50 of the ITAA 1997

[13] This can be compared to the UK investment manager regime, which includes "any investment in stock or shares", per Regulation 6 of *The Investment Manager (Specified Transactions) Regulations 2009*.

2.10.6 In this regard, we believe it is important that the proposed definition of a qualifying investment is certain and that it provide for an appropriate exemption that is at least similar to the exemption that would otherwise be obtained through a direct investment by the foreign investor in their own name.

2.10.7 On this aspect, we believe that there is significant merit in considering the definition of a financial arrangement contained in the Income Tax Act as the base for an IMR. This definition is broad and allows for growth in new synthetic arrangements that have the same qualities as other investments in debt or equity instruments. Furthermore, it would be relatively easy to then carve out the arrangements that should not be subject to an IMR, for example investments in TAP assets or returns that are otherwise subject to withholding tax. Such a definition would therefore automatically exclude non-portfolio investments where the underlying investment is TAP.

2.10.8 We highlight that this is similar to the way in which Division 6C has been expanded to encompass the definition of "passive investments", whereby section 109M(c) was introduced to include all forms of financial arrangements as being eligible investments. It would also overcome the issue that has been encountered in both the United Kingdom and Hong Kong, where subsequent regulations and practice notes have been released expanding the list of investments subject to the IMR.

2.11 Ring-fencing investments

2.11.1 Where the investment manager invests in non-qualifying investments, it raises the question as to how the non-qualifying investments would be treated. That is, would the excess taint the exemption in whole, or would a ring-fencing approach be taken?

2.11.2 We highlight that many other jurisdictions contain a *de minimis* approach to the ring-fencing issue. For example, in Hong Kong, the exemption is not denied where there is only an incidental proportion of income derived from non-specified transactions[14]. In the United Kingdom, the exemption is not denied where a non-qualifying transaction was minor or made inadvertently (provided the profit from the transaction is charged to UK tax[15]).

2.11.3 It is noted that the same issue is also encountered in applying the definition of a qualifying investment for the purpose of Division 6C of the

[14] This threshold is based on 5% of the trading receipts of the non-resident from the exempt and incidental transactions.
[15] Refer to Statement of Practice 1/01, para 31.

ITAA 1936. We highlight that a number of safe harbour provisions were introduced to deal with incidental income derived by the trust to which that Division may otherwise apply. Accordingly, we believe that the issue of ring-fencing will be a practical issue that will need to be managed in the development of an IMR.

2.11.4 In dealing with this issue, we believe that the Board should recommend that the exemption would be considered unaffected if a *de minimis* threshold is satisfied. That is, the exemption should still apply where incidental gains are derived on non-qualifying transactions.

2.11.5 Where the foreign investor does not satisfy the *de minimis* threshold, we believe that the additional investments should be ring-fenced and that the exemption not be taken to apply to such investments. In that case, the ordinary Australian taxation rules would have application to the residual investments that are not covered by the IMR.

2.12 Residency of the foreign investor

2.12.1 The Board's Discussion Paper and the Assistant Treasurer's press release discuss an IMR as applying to widely held "foreign funds". If, *inter alia*, the condition of being a "foreign fund" is satisfied, then the exemption would apply.

2.12.2 However, it is noted that the IMR is intended to provide certainty in relation to many taxation issues, such as whether a fund has a permanent establishment in Australia and the residency of a fund. Accordingly, if the term "foreign" is linked to concepts that are akin to the tests contained in the residency or permanent establishment tests, this will not provide certainty to foreign investors seeking to apply an IMR.

2.12.3 Paragraph 5.53 of the Discussion Paper acknowledges this issue, by reference to the Johnson report, where it was recommended that the residence rules be modified so that entities covered by the IMR do not become resident merely by having central management and control in Australia. Furthermore, Question 5.5 requests submissions on how the residency requirements could be modified, while maintaining integrity.

2.12.4 It is highlighted that this is a real issue that has been encountered in other jurisdictions that have an IMR. For example, in February 2010, the Inland

Revenue Department (IRD) of Hong Kong revised its guidance in DIPN 43[16] to address concerns of funds about the residency requirement for directors of offshore funds. The DIPN holds that central management and control will not be taken to be in Hong Kong simply because the directors are Hong Kong resident. Nonetheless, this DIPN does not overcome the issue of determining the location where central management and control rests. Accordingly, the approach taken in Hong Kong has been stated as not necessarily providing certainty to foreign funds on this issue.

2.12.5 Furthermore, we highlight that a central management and control test does not encourage the development of regional offices in Australia, where this would deem the fund to be a resident fund. Accordingly, the Board must consider whether the IMR will simply be used to encourage investment management practices in Australia, or whether it will also be used as a consistent tool for encouraging regional offices and headquarters to be established in Australia.

2.12.6 While this is an issue for the Board to consider, we believe that resolution of this "policy issue" would help to develop the principles for determining the appropriate threshold modifications to the residency test.

[16] Departmental Interpretation and Practice Notes No. 43, Profits Tax Exemption for Offshore Funds

3 Collective investment vehicles

3.1 Unattractiveness of the Australian regime

3.1.1 Question 2.1 seeks submissions as to tax and other factors that may have resulted in the Australian funds management regime being unattractive to foreign investors.

3.1.2 While Australia has a significant funds management industry by comparison to our trading partners in the Asia-Pacific region, this has been mainly catering to domestic superannuation type investment, rather than offshore investment into Australia.

3.1.3 There are a number of reasons for this, other than tax related issues. For example, while Australia is located close to Asia, its location is still further from that of Hong Kong and Singapore. Accordingly, Australia may not be seen as readily accessible as some of these other jurisdictions in Asia.

3.1.4 However, from a tax perspective, there are many reasons why the Australian taxation regime may be seen as unattractive. The Australian funds industry has predominantly been managed through trust vehicles. Not only are these vehicles unknown to non-common law jurisdictions, but also are hard to difficult to understand by those from common-law jurisdictions, with many of the concepts of trust law dating back as far back as the 13th century.

3.1.5 It is noted that the current review of the taxation regime applying to MITs is aimed at providing more certainty on the taxation provisions. However, it is likely that implementation of this regime will not occur for some time. It may also take some period time before the system is bedded down. Furthermore, it is also unclear whether treaty benefits can be claimed by a beneficiary (or the trust) in respect of income derived directly by the managed investment trust. It is unlikely that the review will address this issues which has been grappled with at an OECD level.

3.1.6 Accordingly, in our view, a CIV regime based on trusts is unlikely to be attractive to a broad range of foreign investors, unless the regime can be expanded to other vehicles.

3.2 Definition of a CIV

3.2.1 At Question 2.2, the Board has asked for submissions on the appropriateness of the principles proposed for CIVs in Australia.

3.2.2 The three principles put forward are broadly consistent with the regime that applies to MITs in Australia. As MITs are the main form of CIVs in Australia, one would expect that the definition proposed is broadly consistent with what we would understand to be a CIV.

3.2.3 However, it is highlighted that the proposed definition is more restricted than that contained in section 12-400(3)(e) of Schedule 1 to the TAA 1953. That provision requires one to determine whether a foreign entity is a foreign CIV. Australian Taxation Office Interpretive Decision (ATO ID) 2010/143 and ATO ID 2011/4 provide a definition of foreign CIV which is more broadly based than that proposed by the Discussion Paper.

3.2.4 That being said, we agree that a CIV should invoke concepts such as widely held and should involve certain eligible passive investments. Furthermore, there is merit in linking to a regulatory framework, such as the Corporations Act, to ensure that there is investor protection for funds covered by the regime.

3.2.5 However, we are unsure why the concept of control cannot exist in relation to shares or units held by a CIV. Provided that there is integrity in relation to that investment holding (i.e. protection of the corporate base by virtue of an arm's length fee charged in respect of services provided to an Australian controlled company carrying on non-eligible activities), we support the propositions contained in the MIT Position Paper of the Board that proposed a relaxation of the control test for MITs. While this proposition was not accepted by the Government, we still agree with the policy principle put forward in that Position Paper.

4 Taxation treatment of MITs

4.1 General comment

4.1.1 While MITs have existed for a substantial number of years, statistically they have not successfully resulted in an increase in foreign managed funds in Australia.

4.1.2 That is, over the last five years, foreign investment through Australian investment managers has consistently been between $60 billion in 2006/07 and $57 billion at 31 December 2010[17].

4.1.3 While MITs provide a number of conduit tax incentives to non-residents (e.g. the flow through of foreign source income, the flow through of non-TAP capital gains assets, and the reduced withholding tax on fund payments), these tax incentives have not been overly successful (to date) in encouraging significant non-resident investment through Australia.

4.2 Dealing with Australian tax uncertainty

4.2.1 As outlined earlier, the review of MITs and the new regime for MITs may, or may not, provide certainty to the taxation of managed trusts in Australia. It will be difficult to measure the success of this new regime until some time after its final implementation. This may not be possible until 2014 or 2015.

4.2.2 Accordingly, it is not clear whether the amendments to the regime will have any effect on foreign investment through investment managers in Australia.

4.2.3 The new MIT regime will seek to address many of the issues relating to the treatment of non-resident investors, including deeming the trusts to be fixed trusts for the purpose of claiming capital gains tax flow through exemptions, providing certainty to the character of income and the application of the withholding tax provisions contained in Subdivision 12-H for fund payments.

4.2.4 However, the new regime will unlikely address all uncertain tax issues associated with the taxation of foreign investors. For example, it is noted that the “source rules” are still based on common law principles and accordingly the new MIT regime will not provide any certainty on whether income derived

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through a foreign fund will be regarded as foreign or Australian sourced income.

4.2.5 Furthermore, it is still uncertain how issues such as “unders” and “overs” will be treated under the withholding rules, especially in respect of non-residents and the application of the fund payment rules contained in Subdivision 12-H.

4.3 Recommendations

4.3.1 Australia is currently implementing a new regime for MITs. There are a number of international issues that have not been given due consideration to date, that may require further consideration on implementation. For example, as outlined above, the MIT regime would benefit from a statutory source rule being implemented within the regime.

4.3.2 However, other taxation issues, such as the determination of the source of income, are issues that are relevant to all non-residents in general under the Australian taxation regime. Accordingly, it would be preferable if some of these outstanding international issues are further examined to help provide certainty for non-resident investors investing through Australia.

4.3.3 As highlighted in Section 7 of this submission, given the inherent issues that may go with using a trust, and whether it is an attractive vehicle for non-resident investors, we believe that it is critical that the Board consider an Australian CIV regime that is available for a wider range of vehicles other than MITs, including corporate structures and LP type structures.

5 The LIC model

5.1 Different vehicles under a CIV

5.1.1 We believe it is important for the Board to recognise that LICs provide a collective investment function that is very different to other forms of CIVs. That is, a LIC provides certain incentives that are attractive to domestic investors rather than non-resident investors.

5.1.2 From the perspective of an Australian resident taxpayer, a LIC provides access to the discount capital gains and the flow through of imputation, whilst allowing the LIC an easy ability to retain funds for investment purposes. Essentially, these attributes could provide an overall greater effective return (after tax) to resident investors for certain types of Australian passive portfolio holdings.

5.1.3 From the perspective of a resident investing in Australian assets, a LIC would predominantly meet the three policy principles of a CIV. While a LIC can accumulate profits, the imputation system (together with the flow through of CGT discount) provides for an effective flow-through of taxation consequences to the resident investor where the portfolio is Australian assets. From a non-tax perspective, LICs are marketed on the same basis as other forms of CIVs in Australia[18], but with the added advantage of the investment vehicle being a company that can retain cash for future investment. Some investors may see these characteristics as being important.

5.1.4 While the Board's Discussion Paper is seeking opportunities to encourage investment management practices in relation to offshore funds in Australia (i.e. the creation of a regional hub), we also note the importance of domestic investment management and business practices already established in Australia. With our growing superannuation fund industry, it is important to continue to support local fund management practices

5.1.5 Given that up to $18 billion of funds are invested through LICs and LITs, we believe that this represents an important part of the domestic funds management practice that may not otherwise exist if there was a move to a pure flow-through tax structure. Accordingly, while the tax provisions for a LIC are different to those of an MIT and perhaps pure CIVs generally, we believe the Board should recognise that this different structure caters for a very different

[18] Refer to http://www.asx.com.au/documents/resources/listed_investment_companies.pdf

market and investor in Australia, as compared to those that invest through managed trusts.

5.2 Outcomes from the Board review

5.2.1 There are two possible approaches that could be taken in respect of the future tax treatment of LICs. That is, their status as a separate investment type vehicle could be maintained with little change to the structure of the tax provisions. If this were to occur, we believe that the Board should (again) recommend the extension of capital account treatment for qualifying investments (i.e. as contained in Division 275).

5.2.2 Alternatively, the Board could seek to expand CIV treatment to companies that meet the definition of a CIV, which would effectively tax the LIC as a MIT.

5.2.3 In our view, we believe that there is a case for the LIC regime to stay in tact, and that the expansion of the CIV regime to encompass companies should occur in addition to the maintenance of a LIC regime.

5.2.4 We understand that LICs are likely to only be attractive to resident investors and that the regime would unlikely help to expand Australia as a regional financial services hub. However, in that regard, it is again noted that up to $18 billion of funds are invested through LICs, and accordingly LICs provide a significant amount to of domestic management investment services to Australian resident investors.

6 Tax treatment of limited partnerships

6.1 Using LPs in Australia (closely held)

6.1.1 Division 5A of the ITAA 1936 treats a limited partnership (LP) like a company for tax purposes.

6.1.2 It is highlighted that the introduction of Division 5A was not aimed at issues concerning protection of the corporate tax base. That is, flow-through taxation for non-widely held businesses was available through the use of private trust structures. Instead, Division 5A was aimed at the protection of losses that would otherwise flow through to investors, where such investors were not at risk of incurring that loss (due to their limited liability). This was clearly stated in the introduction to the measures in *Taxation Laws Amendment Act (No. 6) 1992*:

> *"Limited partners are not at risk beyond the limit of their liability. Generally, their liability is limited to their investment. They are not required to make good losses of their partnership, nor are they liable to meet the obligations of the partnership. If limited partners are treated in the same way as partners in any other partnership, however, they may benefit from distributions of losses that exceed their limited liability. Those losses could be used to reduce taxable income, and so tax paid, even though the loss is not one that exposes the partner to any risk of having to meet obligations or make good losses."*

6.1.3 Accordingly, as an LP is treated as a company under Division 5A, losses of the entity do not flow through to the individual investors.

6.1.4 It is noted that, in a closely held context, this treatment is anomalous, especially given the introduction of Division 830 of the ITAA 1997. That is, a resident of Australia can invest in a non-resident LP, and can effectively treat the LP as a partnership rather than a trust (irrespective of whether the activities of the LP are active or passive). Under Division 830, the issue of losses is catered for by providing for a loss exposure rule[19]. That is, losses of the partner are effectively limited by the amount of their capital contributions into the partnership.

6.1.5 Based on the amendments contained in Division 830, there is an inconsistent policy contained within the scheme of the Act. That is, a resident

[19] As contained in section 830-60 of the ITAA 1997

investor can hold an interest in a foreign LP, which is treated as a partnership, yet if it holds an interest in an Australian LP, the entity is treated as a company.

6.1.6 We believe that there is a clear case for Division 5A to be reconsidered and repealed due to the amendments contained in Division 830. Where the LP is closely held, we do not believe that additional passive investment rules would be necessary, as the use of an LP in that context would be no different to the use of a trust or partnership. The risk to the corporate base would otherwise be negligible in a closely held context, especially if loss limitation rules were simultaneously introduced.

6.2 Using LPs in Australia (widely held)

6.2.1 LPs are used and recognised around the world as collective investment vehicles. Accordingly, if Australia is to market itself as a financial services hub to both non-resident funds and non-resident investors, it would seem imperative that the CIV regime in Australia be extended to LPs.

6.2.2 As a general rule, an LP is considered by many jurisdictions to be a flow-through vehicle. Where the LP is effectively “widely held”, integrity risks could occur in relation to the corporate tax base in Australia. Accordingly, we would expect that a widely held LP would only receive flow through treatment in Australia if it satisfies the relevant CIV requirements currently imposed on trusts, e.g. it would comply with eligible investment activities as contained in Division 6C. It would therefore seem appropriate to apply a Division 6C type regime to LPs that are widely held.

6.2.3 Should the LP carry on a trading business, then Division 6C would treat the CIV as a company for tax purposes. As Division 6C already provides a regime for trading trusts, it would seem fairly straightforward to require the LP to satisfy the requirements of Division 6C before it is treated as a flow-through vehicle.

6.2.4 In our view, there are strong policy grounds for applying a consistent approach to both LPs and trusts in Australia, where they are used for collective investment purposes.

6.3 Difficulties in applying the Australian taxation regime

6.3.1 Amongst other things, there are at least two difficulties that would need to be addressed if LPs were to be treated as flow-through CIVs in Australia. The first is in relation to the treatment of capital gains. The second is in relation to the treatment of losses.

Treatment of capital gains

6.3.2 If Division 5A were relaxed so that an LP could be treated as a flow through vehicle in Australia, the application of Division 5 to an LP may prove to be complicated to administer on a widely held basis.

6.3.3 That is, Division 5, together with the capital gains provisions, tax capital gains in the hands of an individual investor. Accordingly, an investor is required to keep track of its individual interest in the underlying assets of the partnership. Assuming the LP has 10,000 investments in passive assets, and has 5000 investors, each investor would have a separate cost base in each individual investment held by the LP. Accordingly, the disposal of an asset would require individual CGT calculations to be made for each individual investor (i.e. there would be 5000 CGT calculations for each disposal of a CGT asset). This would also require asset valuations at the respective times. Furthermore, the introduction of a new investor, or redemption of an old investor would also change the proportionate interest held by an investor in the underlying CGT assets, thus requiring further calculations to be performed.

6.3.4 While a sophisticated fund manager may be able to perform calculations as outlined above, this may be a difficult compliance issue for a smaller fund manager. This may also be difficult to administer from an ATO perspective.

6.3.5 This issue typically only occurs for CGT assets, as revenue gains and losses are calculated on a partnership level. Furthermore, there is roll-over relief provided for both trading stock and depreciable assets when there are changes in the composition of a partnership.

6.3.6 The CGT issue could be overcome if the LP was instead taxed like a trust. However, if that were to occur, this could give rise to issues about the flow-through of losses through an LP (as discussed below).

6.3.7 Alternatively, the LP could be taxed as a partnership, with capital gains being calculated at the partnership level rather than at the partner level. This would require fundamental changes to the CGT provisions, including the introduction of new rules dealing with investors and their interest in the partnership. New CGT events would need to be introduced to cater for a disposal of such interests and to avoid double taxation issues. Such a change may need to be thought through appropriately before being implemented.

Treatment of losses

6.3.8 Where the entity is an LP, it is arguable that the entity should provide a flow through of losses to the investors, subject to the loss exposure in the entity. Such loss limitation rules are found in Division 830 and section 92(2AA) for LPs that are taxed as partnerships in Australia. Other jurisdictions, including the UK and US have similar loss limitation rules.

6.3.9 It is noted that loss limitation rules would be applied at an investor level. This would require a loss limitation amount to be calculated for each investor, giving rise to additional recording requirements for the relevant CIV. However, given that the loss limitations are based on capital contributions, this may not be difficult to administer and would likely be very similar to the reporting requirements of an MIT in relation to CGT event E4.

6.3.10 Accordingly, if the CIV regime is extended to LPs, the Board would need to consider whether a loss flow-through should be allowed for LPs (or CIVs in general) and whether the loss limitation rules should be included for LPs or CIVs in general (i.e. to the extent that the investor is at risk for their investment).

6.4 Investor protection

6.4.1 Where an entity is marketed as a CIV, we believe that it is important to provide investor protection. The Board has highlighted that LPs may not otherwise meet the definition of an MIS under the Corporations Act.

6.4.2 In our view the basic principles of an MIS as defined in section 6 of the Corporations Act should otherwise be satisfied. That is, the fund would constitute an entity whereby people have contributed money to acquire rights to benefits of the LP, which are pooled and used to acquire property for those people[20]. In substance, there would be little difference between an LP and a MIT being used as a CIV.

6.4.3 Accordingly, if an LP (that is a CIV) does not come within the regulations of Chapter 5C, we believe it would be imperative for the Board to recommend modifications to this requirement and that appropriate investor protection in relation to this form of CIV be provided. For the success of the regime, we believe that this recommendation should be made concurrently with any recommendation to expand the range of CIVs in Australia.

[20] See section 6 of the Corporations Act 2001, definition of managed investment scheme.

6.5 LPs, LLPs and LLCs

6.5.1 As many foreign jurisdictions have limited liability partnerships (LLPs) and limited liability companies (LLCs) in addition to LPs, we believe that the development of a CIV regime should not be limited to LPs and should encompass various other forms and structures that foreign investors may be familiar with.

6.5.2 We note that the relevant Partnership Acts have accommodated the formation of an incorporated limited partnership for the purpose of foreign investment through a (for example) VCLP. We believe that similar practices may occur if an expanded concept of entity is used in the CIV regime.

7 Future CIV regime

7.1 Design of a new CIV regime

7.1.1 While the MIT regime has been effective as a domestic CIV regime, we agree that Australia would require a broader CIV regime to attract the offshore investment and thus the management of international funds.

7.1.2 We believe that this could be best achieved through the development of a universal CIV regime in Australia, which is not based on the legal structure of an entity.

7.1.3 In general, we believe that a proposed CIV regime could be founded upon the current (or proposed) MIT regime, with modifications to ensure that it can operate appropriately for the various alternative vehicles. Essentially, this would enable the creation of a flow-through CIV regime that can be targeted to foreign investors, utilising vehicles that are familiar to the targeted investors.

<u>Structure of CIV regime</u>

7.1.4 We do not believe it should be fundamentally difficult to modify the current (or proposed) MIT regime so that it would become a universal CIV regime.

7.1.5 That is, in 2009, the Board concluded its review on the MIT regime, whereby a proposed framework for the taxation of MITs was accepted by the Australian Government. Many of the issues contained in Chapter 4 of the Discussion Paper were considered in that review.

7.1.6 At this stage, we do not believe that there would be any reason to deviate from those findings in the development of a broader CIV regime. We also believe that the findings of the Board were consistent with a broader CIV regime in mind.

<u>Application to various alternative vehicles</u>

7.1.7 As outlined above, we believe a CIV regime in Australia could equally apply to any legal form of entity, where that entity is used to pool funds for common investment on behalf of the investors. The pooling of funds for investors using various legal forms would likely constitute an MIS for Corporations Law purposes. However, as LPs and other entities may not be subject to the requirements of Chapter 5C, we believe that this issue should be considered more closely by the Board. We believe there are appropriate grounds for the Board to recommend the expansion of Chapter 5C to all types of entities that are to be considered CIVs for the purpose of the CIV regime. We believe that the structure of those provisions and the investor protection provided by Chapter 5C of the Corporations Act would add a significant level of integrity to the CIV regime.

7.1.8 Where this is the case, we note that the definition of an MIT is developed around the definition of an MIS contained in the Corporations Act. Accordingly, if the same basis is used for the definition of a CIV (irrespective of legal form of the entity), we believe that it would be fairly easy to accommodate those various structures in the definition of a CIV (which essentially would be based on the MIT definition as contained Subdivision 12-H and Division 275).

<u>Appropriate method to determine tax liabilities</u>

7.1.9 Under the MIT regime, it is proposed that the trustee will not be assessable on taxable income derived, but instead, the taxable income would be allocated to beneficiaries on a fair and reasonable basis having regard to the rights of the beneficiaries under the constituent documents.

7.1.10 The proposed attribution model is based on the flow-through concept and is consistent with the entity being treated as a CIV. We believe that this proposed attribution rule could also be used for any type entity that is considered a CIV, irrespective of legal form.

7.1.11 For example, in the case of a company, a shareholder typically has rights to income, capital and voting through its shareholding. Should the company be an MIS under the Corporations Act, the company would be required to have constituent documents under Chapter 5C of the Corporations Act. Accordingly, as all of the requirements of the attribution rule would likely be present for the corporate entity, we believe it would be possible to easily extend the proposed attribution rule to a CIV in the form of a corporate entity.

7.2 Future of LICs under a CIV regime

7.2.1 We do not believe that the introduction of a CIV regime, that would include corporate vehicles, should operate to the exclusion of LICs. That is, we believe that Australia should offer a suite of investment products that may cater for different markets.

7.2.2 It is clear that LICs have a role to play in the domestic market. The fact that they attract $18 billion of funds under management indicates that there is a large market of investors that prefer to use LICs over MITs. Going forward, we believe that Australia could offer a range of products, including an IMR for offshore investors, a LIC regime for resident investors, and a CIV regime suited for both resident and non-resident investors.

7.2.3 In our view, this approach appears best suited for a country aiming at becoming a regional financial services hub. Furthermore, it is the approach that is being taken by other countries in the Asia-Pacific region. For example Singapore provides various types of CIVs and IMRs, including an Enhanced-Tier Fund Tax Incentive Scheme (ETFTI) and a Resident Fund Vehicle Tax Exemption (RFVT). The ETFTI is available to all forms of investment structures, including companies, trusts and LPs (however requires a minimum investment spend). The RFTVT does not extend to LP structures.