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28 February 2011

Attention: Ms Brenda Berkeley
Secretary to the Board of Taxation

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

Email: taxboard@treasury.gov.au

Dear Ms Berkeley

Review of Tax Arrangements Applying to Collective Investment Vehicles

The Taxation Institute of Australia (**Taxation Institute**) welcomes the opportunity to comment on the Board of Taxation's (**Board**) "*Review of Tax Arrangements Applying to Collective Investment Vehicles*" Discussion Paper (**Discussion Paper**).

Terms not otherwise defined in this submission take their meaning from the terms defined in the Discussion Paper. All legislative references in this submission are to the *Income Tax Assessment Act 1936* (**ITAA 1936**) and the *Income Tax Assessment Act 1997* (**ITAA 1997**) unless otherwise stated.

Our detailed comments on the consultation questions are set out in the attached appendix. We note that we have chosen not to address the consultation questions regarding Listed Investment Companies (**LICs**) and Venture Capital Limited Partnerships (**VCLPs**).

General comments

The Taxation Institute believes it is important that an Australian tax environment is created for foreign investors that delivers certainty and simplicity in order to be able to attract foreign capital. Australia's current tax framework puts the funds management sector at a competitive disadvantage. The Taxation Institute supports the introduction of a collective investment vehicle (**CIV**) regime. The CIV regime should be simple, easily understandable and reflect market practice. Failure to adopt these principles will result in non resident investors simply not using the CIV regime.

Most countries offer a range of CIVs to foreign investors. This permits the investor to choose the type of investment vehicle having regard to their own individual characteristics. The CIV regime should adopt a similar approach if it is to be internationally competitive. The CIV regime should not be based on a single regime that applies to all vehicles (for example, an extension to the MIT regime) but should be an over arching concept that extends to a range of investment vehicles including limited partnerships, corporate vehicles and trusts.

The Taxation Institute also strongly supports the introduction of an Investment Manager Regime (**IMR**). The IMR should provide taxation certainty for foreign investors, be competitive with equivalent overseas regimes and incorporate an exemption from Australian taxation for primarily passive investments made by foreign investors. In terms of commencement date of the IMR, it will be important that the effective date of the IMR coincides with the end date of the “FIN 48” solution. This will ensure continued certainty for foreign managed funds.

If you require any further information or assistance in respect of our submission, please contact me on 03 9288 6677 or the Taxation Institute’s Tax Counsel, Tamera Lang, on 02 8223 0011.

Yours sincerely

Peter Murray
President

Appendix: Detailed Comments on Consultation Questions

Consultation Question 2.1

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***

From a practical perspective, the unit trust is the only vehicle that is available for collective investment as this is the only vehicle that can be widely held, provide for limited liability and be taxed on a flow-through basis.

The tax treatment of unit trusts may be considered to be unattractive on the basis that it is unduly complicated. For example:

- the liability to taxation is based on present entitlement rather than cash distribution. Non-residents may be unfamiliar with the concept of present entitlement;
- the effective Australian tax rate depends on the character of the distribution which means that it is not possible to identify a single tax rate having regard to expected tax receipts; and
- the result is that it is generally difficult for a non-resident investor in a unit trust to estimate their potential Australian tax liability given it depends on present entitlement and the differential tax rates that may be applicable.

In summary, it is submitted that the tax treatment of unit trusts is unattractive from the perspective of a non-resident investor due to its complexities and uncertainties.

It is noted that the VCLP regime relies on a limited partnership structure which is a vehicle that may offer a more attractive tax treatment for non-resident investors. However, from a practical perspective, the VCLP regime is of limited use in practice due to the wide range of legislative restrictions to which the regime is subject.

- ***the specific non-tax factors which may make Australia's CIVs unattractive to non-resident investors***

Whilst there are likely to be a number of non-tax reasons which make Australia's CIVs unattractive to non-residents, one important factor is the manner in which Australian CIVs are regulated.

Currently, the regulation of collective investment is governed by the provisions in Chapter 5C of the *Corporations Act 2001 (Cth)* which apply to a "managed investment scheme" (**MIS**). The MIS regime covers a broad range of investments, from cash management trusts to property trusts to agricultural schemes. It is submitted that non-resident investors may view the MIS regime as a mode of regulation that is too broad having regard to international practice. In this regard, other jurisdictions have more focused regulatory regimes for non-resident CIV investment in that each investment vehicle is generally governed by specific legislation or specific regulations.

Consultation Question 2.2

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 any compelling reasons to have non-widely held vehicles included as CIVs***

The widely held definition currently contained in the MIT regime is not appropriate as a criterion for the new CIV regime. The definition is too restrictive because it will exclude a wide range of wholesale investors, such as other CIVs. Considerable investment in Australian CIVs could be expected to be made by CIVs in other jurisdictions. As such, the widely held definition needs to contain appropriate tracing rules which are simple to apply in practice. Whilst the current widely held test in the MIT definition provides tracing rules for trusts holding interests in MITs, this is inadequate as many CIVs in other jurisdictions operate as corporates or limited partnerships and cannot benefit from the tracing concession. There is no policy basis for excluding these entity types from the tracing concession.

The current widely held definition in the MIT legislation is not an appropriate feature of a CIV regime in terms of international competitiveness. The other key CIV jurisdictions (e.g. the Ireland, Luxembourg, the UK) do not limit their CIV regimes in the manner that the current definition of widely held in the MIT regime does. The adoption of this approach in Australia would put Australia at a comparative disadvantage.

- ***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***

The Board recommended a number of changes to Division 6C in their report in relation to the Review of the Tax Arrangements Applying to Managed Investment Trusts. Many of these recommendations were not supported by the Government. It is submitted that these recommendations should be implemented and that when implemented, the Division 6C test should apply to all CIVs. The implementation of the recommendations made by the Board, including the ability to hold a 100% interest in a single taxable wholly owned subsidiary, will modernise Division 6C and will make investment in Australian CIVs more attractive.

It is submitted that other than for the introduction of an ability to wholly own a single taxable subsidiary company, there are no compelling reasons why vehicles undertaking investment activities involving control of businesses should be included as CIVs.

- ***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***

It is considered that the current definition of 'control' in Division 6C is adequate and that there is no immediate need to define this concept further in the legislation.

Consultation Question 3.1

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.***

We believe it is important that an Australian tax environment is created for foreign investors that delivers certainty and simplicity in order to be able to attract foreign capital.

The nature and extent of the reasons for impediments to investments into Australia by foreign investors through MITs has been well articulated in *Australia as a Financial Centre, Building on our Strengths, Report by the Australian Financial Centre Forum* (the **Johnson report**). Australia's current tax framework puts the funds management sector at a competitive disadvantage. Some of these impediments include the following:

- The range of commercial vehicles that can be used in Australia to manage funds is narrow. That is, a unit trust is effectively the only vehicle that provides flow through treatment of tax attributes to an investor. However, many foreign investors not from common law jurisdictions (e.g. Asia) are unfamiliar with Australian trust structures which acts as an impediment in attracting foreign capital.
- The widely held test in the current MIT regime is also problematic because its narrow scope and tracing issues (e.g. a bias towards the retail funds) and limited recognition that a large portion of capital may not come from retail investors.
- There are also complexities and uncertainty on the extent to which funds structured as units trusts can benefit under Australia's tax treaties.

Some suggestions on how the complexity of character and source retention under flow through taxation could be alleviated through alternative CIV vehicles might include:

- Corporate or limited partnership structures such as a US style LLP/LLC regime
- The different tax treatment of different types of income in a CIV leads to unnecessary complexities and consideration should be given whether a single withholding tax rate should be imposed on all income to achieve simplicity (with the exception to foreign source income that should be exempt from withholding tax).

Consultation Question 3.3

The Board seeks stakeholder comments on:

- ***generally, what changes could be made to the LP regime to provide for an appropriate LP CIV;***
- ***whether LPs are suitable vehicles for widely held, primarily passive, collective investments;***
- ***whether it is desirable to introduce changes to the LP regime, so that flow-through taxation is allowed for those widely held LPs that restrict their investment activities to primarily passive investments;***
- ***if flow-through were allowed for LPs marketed at the wholesale level or for sophisticated investors that restrict their investment activities to primarily passive investments, would it be appropriate not to require these LPs to be 'widely held (as defined in the MIT regime)? What would be the rationale for allowing this when compared to MITs which are required to be widely held; and***
- ***apart from limiting the flow-through of losses, would there be a need, in light of integrity and investor protection considerations, to apply further restrictions to that modified LP regime? If so, what would be the nature of those restrictions?***

As noted above, in the global environment, limited partnerships are familiar vehicles for collective investment purposes. Expanding the type of flow through vehicles that could be used to by investors in the funds management industry would remove some of the impediment to attracting foreign capital into Australia.

In particular, limited partnerships that are widely held and involved in passive investment activity should be able to access the flow through benefits of a new CIV regime. However, there is no reason to limit a flow through limited partnership structure to a widely held structure. Non widely held entities should also benefit from flow through taxation as this would be consistent with the overarching principle that focus is on the investment entities rather than the nature of the entity.

In adopting a limited partnership CIV regime, there are some issues that need to be considered:

- If a widely held criteria is to be imposed on limited partnerships, the rules must contain adequate tracing provisions that can be applied in practice that address the nature of typical foreign investors in limited partnerships (including other limited partnerships , foreign government and pension plan investors and foreign corporate bodies)
- As limited partnerships are currently regulated by the respective State or Territory legislation in which the limited partnership is established, the question arises as to whether a federal limited partnership is required for simplicity and certainty reasons.

Flow through taxation treatment for limited partnerships should be achieved by attribution of the taxable income arising from the activities of the limited partnership to the limited partners with appropriate withholding tax rules applying with respect to the taxable income attributed to non-resident limited partners.

Consultation Question 4.1

<u>*General comments in relation to the questions asked by the Board in section 4.1*</u>

Most countries offer a range of CIVs to foreign investors. This permits the investor to choose the type of investment vehicle having regard to their own individual characteristics. It is submitted that the Australian CIV regime must adopt a similar approach if it is to be internationally competitive. In this regard, the new CIV regime should not be based on a single regime that applies to all vehicles (for example, an extension to the MIT regime) but should be an over arching concept that extends to a range of investment vehicles including limited partnerships, corporate vehicles and trusts.

If the new CIV regime is a single regime the current provisions within the Tax Act that apply to trusts (Division 6), partnerships (Division 5) and companies will continue to operate for non-CIVs. Thus, if investors wished to access the tax profiles offered by these entity types, including differential tax rates, they could simply ensure that they fail one of the requirements to be a CIV (or simply not elect if the regime is elective). As such, it could be expected that investors will practically always have the choice of investment vehicle and the accompanying tax treatment even if the CIV regime is designed to operate as a single regime.

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***

Having regard to international practice, the key objective in designing a taxation model for a corporate CIV is to ensure that the tax burden should be shifted to the investor on a current basis. This outcome would be achieved under the flow-through model, the exemption model and the distribution model. Other countries which offer a corporate CIV regime generally apply either the exemption or distribution model to achieve tax neutrality. Accordingly, It is submitted that the exemption or distribution model would be the more appropriate given that non-resident investors will likely be more familiar with these models.

It is submitted that the integration model is not appropriate. Under this model, the CIV is recognised for tax purposes and subject to tax at the applicable rates. As noted above, the approach taken by other countries is to exempt the CIV from tax and to shift the tax burden to the investor on a current basis. Adopting an integration model would be at odds with international practice and would not enhance Australia's ability to attract foreign investment.

It is noted that the existing LIC regime achieves tax neutrality to some extent. However, it is submitted that the LIC regime should be kept separate from a new corporate CIV vehicle that is intended primarily for foreign investment as the objectives are different. In this regard, the LIC regime is primarily concerned with ensuring the flow through of capital gains to Australian resident investors. In contrast, the purpose of adopting a corporate CIV vehicle is to encourage foreign investment in Australia by offering CIV investment opportunities that are consistent, or more attractive, than the opportunities available in other countries.

- ***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***

International practice suggests that the flow-through model is the most common method of taxing limited partnership investment. Further, the advantage of adopting a flow-through model is that Australia's existing tax law contains principles which permit the taxation of partnership income on a flow-through basis (i.e. Division 5). This means there would be no need to design new provisions or new law to apply a flow-through taxation model to a limited partnership CIV. Rather, this outcome could be achieved by simply introducing an appropriate exemption from Division 5A (i.e. which would otherwise apply to tax the limited partnership CIV as a company) for those limited partnerships that meet the CIV requirements such as the passive investment and widely held requirement.

- ***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***

As discussed above, in order for Australia to be internationally competitive the CIV regime needs to offer a 'menu' to non-resident investors – that is, there should be a range of investment vehicles that are each able to achieve tax neutrality for non-resident investors so that the investor can select the type of CIV based on their own individual profile. Further, it is submitted that there are a number of advantages to having multiple CIV regimes:

- this approach is consistent with international practice;
- as discussed in section 2.1 above, non-resident investors may consider the MIS regime to be too broad as a regulatory regime as they may be more used to more focused regimes. This issue could be dealt with by establishing a number of CIV regimes each of which is subject to separate regulation (e.g. different parts of the C*orporations Act 2001 (Cth)*, or different legislation if required); and
- the taxation model can be designed to ensure it is appropriate given the nature of the legal form vehicle and the category of investor.

Consultation Question 4.2

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***

As discussed in the responses to question 4.1, the appropriate taxation model should operate so that the CIV is not subject to tax and to shift the tax burden to the non-resident investor on a current basis. This outcome is achieved under both the exemption model and the deduction model. It is submitted that these are the appropriate models given they are consistent with international practice which means that non-resident investors are likely to be familiar with these models.

- ***what would be the most appropriate method to determine the tax liabilities of investors in a corporate CIV***

As discussed above, either an exemption model or a deduction model is the appropriate taxation model for 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***

It is submitted that it is not appropriate to levy tax on an entity qualifying to be a CIV in any circumstances. In order to enhance foreign investment into Australia, Australia needs to offer CIV regimes that are comparable to what foreign investors can obtain in other countries. Accordingly, the primary objective in adopting a taxation model adopted for a corporate CIV vehicle is to adopt a model that is comparable to and consistent with international practice. For this reason, it would not be appropriate to subject the corporate CIV to tax.

We note that measures may be required to cater for the situation where an entity ceases to satisfy the requirements to be a CIV. In these circumstances, the CIV may be subject to tax. A simple solution may be that an entity no longer qualifying as a CIV is taxed in the manner normally applicable to that entity type.

- ***what special rules would be necessary to mesh the corporate CIV appropriately with the rest of the Australian tax system***

It is submitted that further industry consultation should be undertaken to determine the extent of any special rules that are required to ensure that the corporate CIV regime interacts appropriately with the existing Australian tax law. Some examples of the issues that need to be addressed are:

- capital gains – if tax neutrality is to be achieved then the taxation model must incorporate a mechanism to deal with the taxation of dividends/distributions that are referable to capital gains. One option would be that in the hands of non-residents the dividend/distribution is treated as a return of capital to the extent it relates to capital gains on assets other than "taxable Australian property". Although this would erode the investor's cost base in the shares, this would be irrelevant provided the interest in the corporate CIV vehicle is not taxable Australian property (i.e. such that the receipt of the dividend/distribution triggers a CGT event G1 and the consequent cost base adjustments); and
- tax treaties – consideration should be given to the interaction between the corporate CIV regime and the dividend articles in Australia's tax treaties. Importantly, many of Australia's new/renegotiated tax treaties offer a 5% rate of dividend withholding tax in circumstances where the non-resident shareholder holds 10% more of the shares in the Australian company paying the dividend.

For completeness, it is noted that a consideration of the interaction between the CIV regime and Australia's tax treaties will also be an important issue in developing a limited partnership CIV regime. In this regard, there are a number of recognised difficulties and uncertainties in terms of determining whether investors in a flow-through vehicle are eligible to obtain treaty benefits. Consideration would also need to be given to the issue of how to ensure/clarify the ability of investors in a limited partnership CIV to access treaty benefits.

- ***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?***

It is submitted that it would be inappropriate to extend the MIT regime to a corporate entity. As discussed in detail in the Taxation Institute's responses to the questions asked by the Board in section 2.2, there are a number of reasons why the taxation treatment of unit trusts is unattractive from the perspective of a non-resident investor. Further, in order for a new corporate CIV vehicle to encourage foreign investment, the taxation model should be similar to the practices adopted by other countries. As discussed above international practice demonstrates that tax neutrality is obtained for investors in a corporate CIV by adopting either an exemption model or distribution model. In summary, regardless of the difficulties and complexities that may arise under both company and tax law in terms of treating a company as a trust, we do not recommend this approach as we do not expect that it is the kind of corporate CIV regime that would attract foreign investment.

Chapter 5: Investment Manager Regime – general observations

The Taxation Institute strongly supports the introduction of an IMR in Australia.

In order for the IMR to achieve its objectives, we consider that the IMR should have the following key features and objectives:

- There should be taxation certainty for foreign investors, including foreign collective investment vehicles, that invest into Australia, regardless of whether that investment is on revenue or capital account.
- How foreign investors are assessed on their Australian investments must be based on a set of clear and objective statutory rules as opposed to case law.
- The IMR should be competitive with equivalent overseas regimes.
- Subject to integrity measures, the IMR should incorporate an exemption from Australian taxation for primarily passive investments made by foreign investors. This should be the case regardless of whether the investments are assessed on capital account (as is currently the case) or on revenue account.
- The use of any form of Australian intermediary by a foreign investor (e.g. whether adviser, manager, broker, agent or exchange) should not cause the foreign investor's exemption from Australian taxation to be compromised.
- The IMR should cover a broad range of investments. A modified definition that is based on the investments listed in the definition of "eligible investment business" in section 102M of Part III of the ITAA 1936 could be adopted for these purposes.
- Relevantly, the IMR should provide an exemption from Australian tax for foreign investors for all income that arises from:
    - non-Australian securities and financial instruments (whether represented by portfolio or non-portfolio interests). This is consistent with the principle that all conduit income should be exempt from Australian tax and the objective of establishing Australia as a regional financial centre; and
    - all Australian securities and financial instruments, except those which constitute taxable Australian property.
- Given the breadth of the exemptions provided, it is appropriate that the IMR should contain appropriate integrity provisions. This could include:

- an arm's length fee option for financial intermediaries, and
- a cap on the extent of ultimate Australian ownership of a foreign investor above a certain de minimis level, to address any integrity concerns that could not be overcome by the widely held requirement.

In terms of commencement date of the IMR, it will be important that the effective date of the IMR coincides with the end date of the "FIN 48" solution, where the Australian Taxation Office was prevented from raising any assessment in respect of relevant income and gains for the 2009-2010 and prior tax years (see Media Release No.27 of 2010 issued by the Assistant Treasurer). This will be an important aspect to manage in order to ensure that there is continued certainty for foreign managed funds. In this regard, we would recommended that the IMR be made effective on a prospective basis (as the final details will not be known until after the Board delivers its report), and that the "FIN 48" solution be extended (where needed) in order to ensure that there are no transitional issues.

We address each of the questions raised by the Board in respect of the IMR below.

Consultation Question 5.1

The Board seeks stakeholder comments on:

- ***the appropriateness of an exemption-based approach for an IMR applicable to foreign managed funds;***
- ***whether an alternative approach would be more appropriate?***

The Taxation Institute strongly supports an exemption-based approach for an IMR applicable to foreign managed funds.

An exemption-based approach should be preferred as it is simple and effective. Although other alternative approaches may be possible (e.g. clarifying various discrete aspects of the existing tax law such as the source of income rules), this is likely to result in additional complexity and undermine the objective of clarity and certainty.

Further, most, if not all, of the major financial centres (such as Hong Kong, Singapore, New York and London) have adopted an exemption-based approach. Accordingly, if Australia adopts an approach that is any less favourable or any less certain or objective in its application, this is likely to undermine the objectives of the Australian IMR.

Consultation Question 5.2

The Board seeks stakeholder comments on:

- ***if the option of taxing Australian intermediaries of foreign managed funds only on their arm's length fees was to apply, what are the types of intermediaries to which this option would apply; and***
- ***recognising the need to maintain the integrity of the tax system, what would be the required ring-fencing provisions that would ensure this feature of an IMR is appropriately targeted?***

If the option of taxing Australian intermediaries of foreign managed funds only on their arm's length fees applies, we recommend that the arm's length fee option should apply to the following types of intermediaries:

- investment advisers;

- fund managers;
- brokers; and
- agents.

This list of intermediaries is consistent with the recommendations in the Johnson report. (We also recommend the inclusion of a local "exchange" such as the Australian Securities Exchange (ASX) as a relevant intermediary for the purpose of IMR, however, it would not be appropriate to apply the arm's length fee option to the relevant "exchange", for the reasons discussed further below).

We consider that the arm's length fee option is appropriate for the above types of intermediaries on the basis that each of those intermediaries would be expected to charge a market fee for their services.

For completeness, we would expect that Australia's transfer pricing rules and tax treaties would, in any case, require the arrangements between the foreign investor and the Australian intermediary to be based on arm's length terms (including fees).

The "exchange" as a relevant intermediary

The exemption under the IMR should also cover foreign residents that trade on a local exchange (such as the ASX).

As noted at page 48 of the Discussion Paper:

> *"Australian domestic source rules that apply outside the tax treaty context can on one interpretation give an Australian source from investment profits just because a transaction is effected on the Australian Securities Exchange".*

This interpretation arises because the security will be traded, by necessity, on the local exchange. It is therefore also appropriate to include the local "exchange" as a relevant intermediary for the purpose of IMR. The inclusion of the "exchange" is also consistent with the recommendations in the Johnson report. However, it would not be appropriate to apply the arm's length fee option to the relevant "exchange", on the basis that:

- the dealings with the exchange do not constitute a typical service arrangement such that comparable arm's length fees could not be easily identified; and
- in any case, the dealings with the exchange could always be expected to be undertaken on arm's length terms (as it would be subject to the ASX or Clearing House rules).

It is important that the IMR provides greater certainty to non-residents where local Australian intermediaries are engaged to execute trading transactions (e.g. whether as a broker, agent or exchange). In this regard, the IMR regime should generally extend to all non-resident investors (i.e. not limited to foreign managed funds) that invest in Australian securities (except where those securities constitute taxable Australian property) (see discussion at Question 5.8 below).

Consultation Question 5.3

The Board seeks stakeholder comments on:

- ***do the above features of a foreign managed fund encompass all funds that should be covered by an IMR;***
- ***should there be a 'managed in Australia' requirement or a minimum spend requirement as per Singapore's regime? Can the economic benefits and growth in the Australian financial services industry be maximised without such a***

requirement; and

- ***what are reasonable reporting and approval processes that are necessary to ensure that the IMR exemption is being appropriately claimed by qualifying foreign managed funds?***

As noted in the Discussion Paper, a foreign managed fund is likely to have the following features:

- it is not an Australian resident;
- it is ultimately widely held;
- it typically undertakes passive portfolio investments; and
- it typically does not carry on or control a trading business in Australia (except to the extent that its dealings in securities may amount to a trading business).

We submit that the above features of a foreign managed fund encompass all funds that should be covered by an IMR. In this regard, the typical fund structures which arise include the following:

- Limited liability partnerships;
- Limited liability companies;
- Other body corporates; and
- Certain trust vehicles.

Widely held test

However, care will need to be taken when defining the widely held requirement. It will not generally be appropriate to simply adopt the requirement under the MIT rules. These rules will need to be adapted to reflect the typical investment structures adopted by foreign funds.

For example, currently, when applying the widely held test under the MIT rules, there is a very limited ability to look through member funds, notwithstanding that those member funds may, in turn, have members that are widely held. In this regard, the widely held test would need to reflect the typically feeder fund structures adopted by many foreign funds.

In particular, a number of foreign funds implement structures where:

- the legal entity in which the relevant foreign investors invest (**Ultimate Fund**) is different from the entity that is used to make the investments (**Investment Vehicle**); and
- the Investment Vehicle is generally owned by an Ultimate Fund, or a number of Ultimate Funds.

It is important that the widely held test be structured such that in determining whether a foreign entity that invests in Australia is widely held, the test allows tracing through the Investment Vehicle to the ownership of the Ultimate Fund.

Managed in Australia

We consider that it would not be appropriate to adopt a “managed in Australia” requirement or minimum spend requirement, for the following reasons:

- The IMR should avoid issues that have occurred in relation to the MIT reforms regarding the capital election and withholding tax concessions and the “Australian investment management” requirement. This should not be a prerequisite to the IMR applying on the basis that any such requirement would unduly restrict how foreign investors choose to manage their assets.

- For foreign fund managers that have never established any presence in Australia in the past, the commitment and investment of relocating their management teams in Australia is likely to be too risky and expensive for the foreign fund managers. It is more effective to frame the concession broadly to encourage the gradual move of resources into Australia.
- The foreign fund will have already engaged a local Australian intermediary in order to access the IMR regime. This should, of itself, result in increased local employment.
- The relevant Australian intermediary will also be entitled to an arm's length fee as consideration for the services provided to the foreign investor (whether under Australia's transfer pricing rules, tax treaties or a specific requirement in the IMR regime). This consideration would be taxable to the intermediary in Australia.
- The investment by foreign investors in Australian securities will also produce a number of attendant benefits. These include increased jobs in the Australian market, increased revenue to local brokers, and greater liquidity for shares in ASX listed entities.

Self-assessment

The IMR regime should generally operate on a self-assessment basis. We consider this to be appropriate for the following reasons:

- Certainty is preferable to the need for formal clearances from government authorities (such as the ATO). This is a key policy aim of the UK regime (see, for example, a description of the "Policy aim" at page 2 of the "Summary of Responses and HRMC comments: UK Investment Manager Exemption").
- In any case, foreign funds will typically engage local advisers in order to confirm that those funds qualify for the IMR concessions.
- The auditing processes of the foreign fund will also require a detailed assessment of the application of the IMR requirements in order to ensure that no accrual or provision is required to be raised on account of an Australian tax exposure. This is consistent with the recent experience surrounding FIN 48.

Consultation Question 5.4

The Board seeks stakeholder comments on:

- ***the range of investments that could be covered by an IMR;***
- ***whether other activities of a non-resident would affect their access to the IMR; and***
- ***whether an IMR could also cover non-portfolio interests in non-Australian assets?***

We submit that the range of investments listed in the definition of "eligible investment business" in section 102M of Part III of the ITAA 1936 would be an appropriate starting point to define the range of investments that should be covered by an IMR.

However, we recommend that one key modification should be made for use in an IMR. This includes the removal of the reference to investing in land.

A modified list of the range of investments that could be covered by an IMR would therefore include investing or trading in the following:

I. secured or unsecured loans (including deposits with a bank, or other financial institution);

II. bonds, debentures, stock or other securities;

III. shares in a company, including shares in a foreign hybrid company;

IV. units in a unit trust;

V. futures contracts;

VI. forward contracts;

VII. interest rate swap contracts;

VIII. currency swap contracts;

IX. forward exchange rate contracts;

X. forward interest rate contracts;

XI. life assurance policies;

XII. a right or option in respect of such a loan, security, share, unit, contract or policy; or

XIII. any similar financial instrument.

We understand that this is consistent with the treatment under the Investment Manager Exemption (**IME**) in the UK. More specifically, the Statement of Practice SP 1/01 (UK IME) states the following (see paragraph 16):

> *Application of the investment manager provisions is restricted to transactions in shares, stock, commercial paper and warrants, futures (including forward) contracts, options contracts or securities of any description (but not futures contracts or option contracts relating to land, although futures or options contracts involving indices of land may qualify), interest rate swaps, equity swaps, currency swaps, commodity swaps and commodity index swaps (but not transactions in physical commodities, including gold, nor warrants on the London Metal Exchange which give the holder title to the metal).*

We recommend that the range of investments to be covered by an IMR should be listed in a regulation. This would enable new financial instruments to be added as financial markets and products evolve.

We would also recommend the adoption of a “safe harbour” in order to ensure that any other (relatively minor, or temporary or inadvertent) activities of a non-resident investor do not adversely affect its ability to access the IMR. This is consistent with the approach adopted in respect of Division 6C of the ITAA 1936 (dealing with trading trusts).

The IMR should also cover all non-Australian assets (whether represented by portfolio or non-portfolio interests). This is consistent with the principle that all conduit income should be exempt from Australian tax.

Consultation Question 5.5

The Board seeks stakeholder comments on:

- ***recognising the need to maintain the integrity of the tax system, how could Australia's residence rules be amended such that the rules are appropriately targeted only to foreign managed funds under an IMR?***

As noted above, one of the assumptions regarding a foreign managed fund which operates under the IMR regime is that it is not an Australian resident.

We consider it is appropriate to modify the application of Australia's residency for IMR purposes within the IMR rules themselves (i.e. to exclude a foreign fund from being an Australian resident on account of the use of an Australian intermediary).

In this regard, the IMR rules should contain a provision to the effect that, when determining whether the central management and control of a foreign entity is in Australia for the purpose of determining whether that foreign entity is or is not an Australian resident for all purposes of the Australian tax law, the use of an Australian intermediary (covered by the IMR) is to be disregarded.

This approach should maintain the integrity of the tax system on the basis that each Australian intermediary who has the potential to affect the central management and control of the foreign entity will be required to be engaged on arm's length terms (e.g. will be subject to the arm's length fee option - discussed above).

We would not consider it appropriate to use a different test of what is "foreign" for the purposes of the IMR, without modifying the application of Australia's residency rules (as this approach would not eliminate the risk that the foreign fund could (independently) be held to be an Australian resident under those rules by virtue of the use of an Australian intermediary).

Consultation Question 5.6

The Board seeks stakeholder comments on:

- ***the required and appropriate integrity measures to deal with round tripping;***
- ***where are the integrity risks for round tripping greatest (in terms of investor types and income types)? To what extent are these risks constrained by limiting the exemption to widely held foreign funds;***
- ***to what extent are the integrity risks systemic in the sense that integrity issues from limited offshore information apply across a range of tax measures, and to non-disclosure issues generally; and***
- ***should there be a de minimis test to allow a degree of ultimate Australian ownership for a foreign managed fund in the IMR regime? If so, what would be an appropriate percentage for the de minimis test?***

We submit that an appropriately constructed widely held test should be sufficient to deal with inappropriate round tripping (being, where Australian residents invest in foreign funds to take advantage of the exemption).

The concern which arises in respect of inappropriate round tripping is that Australian residents may be able to defer or avoid tax on investments through investing via foreign managed funds.

However, we consider that an appropriately constructed widely held test should be sufficient to deal with these concerns, for the following reasons:

- Where the foreign fund is widely held, the resulting spread of investors will mean that there is a broad range of tax characteristics held by those investors (which would, in turn, mean that the tax preferences of each of those investors are not likely to be aligned). This would make it difficult for any one particular investor to influence the fund's affair in order to obtain an inappropriate tax benefit for itself.
- Further, where the foreign fund is widely held, then no individual investor would likely have the capacity to dictate (or amend) the structure of the fund to achieve the purpose of obtaining a tax benefit (e.g. it would be difficult to influence the fund's distribution policy). In this regard, the pre-determined structure and distribution policies of a widely held foreign fund is generally put to a range of prospective investors on a "take it or leave it" basis.

However, given the proposed reform of the controlled foreign company rules (**CFC**) rules (which is likely to require a single controller), and the narrow scope of the proposed "anti-roll-up rules" (which is likely to only apply to non-distributing debt funds), we accept that it may be appropriate to adopt a de minimis level of ultimate Australian ownership that must not be exceeded in order for the IMR to apply. We consider that a 30 to 40 per cent threshold would be appropriate in order to alleviate any residual integrity concerns. In this regard, the de minimis level should be set at this relatively high level, as there will only be an alignment of the tax preferences of investors (and therefore, a risk of a purpose to obtain a tax benefit) where there is a concentration of investors with similar tax profiles (e.g. Australian resident investors). We understand that this would be consistent with the other foreign regimes.

Consultation Question 5.7

The Board seeks stakeholder comments on:

- ***if an exemption style IMR is implemented for foreign managed funds taking into account the matters discussed above, are there any issues that would remain unresolved for foreign managed funds? In particular, would there be any significant source or permanent establishment issues remaining?***

An exemption style IMR should be sufficient to address the current areas of technical uncertainty for foreign investors, particular regarding the "source of income" rules and the permanent establishment (**PE**) issues. However, it will be vitally important for the viability of the regime that its application does not rely on the manifest uncertainty surrounding the capital versus revenue distinction

In this regard, on 19 January 2011, the Government announced that from the 2010-11 and later tax years, income from relevant investments of a foreign fund taken to have a PE in Australia will be exempt from income tax. The Government subsequently clarified the following:

- that this exception would initially apply only to foreign sourced income, and gains from securities that would only have become taxable in Australia because the fund is taken to have a PE in Australia; and
- that the exemption would initially cover income and gains from Australian assets that are held on capital account which similarly could otherwise become taxable in Australia because the fund is taken to have a PE in Australia.

At this point, we understand that any exemption for foreign funds in relation to Australian sourced investment income arising from Australian assets which are held on revenue account is still under consideration as part of the development of the IMR.

We recommend that the IMR exemption should also apply to Australian sourced gains on Australian (non-taxable Australian property) assets, without distinguishing between revenue and capital assets. This is because:

- There should be taxation certainty for foreign investors investing into Australia whether that investment is on revenue or capital account based on a set of clear statutory rules as opposed to case law.
- Subject to integrity measures, the IMR should incorporate an exemption from Australian taxation for primarily passive investments made by foreign investors (including, foreign collective investment vehicles) whether on capital account (as is currently the case) or on revenue account and whether the asset is located in Australia or overseas.
- Any persistence with a capital versus revenue distinction would fail to achieve taxation certainty for foreign funds investing into Australia. This would leave unresolved (unacceptably) the manifest uncertainty between what is a capital asset, and what is a revenue asset.

This is consistent with other foreign regimes which exempt foreign investors from taxation in relation to gains sourced in the jurisdiction whether capital or revenue in nature.

Consultation Question 5.8

The Board seeks stakeholder comments on:

- ***what financial services sector entities apart from foreign managed funds would it be appropriate to encompass within the scope of an IMR as described above? Are there any other types of financial services entities which should be taken into account in addition to those identified above; what justifications would there be to relax the requirements for foreign entities to be widely held before qualifying for IMR exemptions;***

- ***what justifications would there be to relax the requirements for foreign entities to undertake primarily passive investments in order to qualify for the IMR exemptions;***

- ***what integrity issues would be raised if portfolio investments through IDPS or foreign private vehicles were exempted through an extended IMR? Are there some risks that are higher than others? What can be done to mitigate these risks;***

- ***recognising the need to maintain the integrity of the tax system, how could Australia's residence rules be amended so as to apply only to foreign financial sector entities under an IMR? Which foreign financial sector entities should be taken into account, and how could they be appropriately defined in such rules; and***

- ***to what extent does the current law (for example, OBU provisions) already adequately provide IMR like concessions for financial sector entities apart from foreign managed funds?***

The Taxation Institute welcomes the comments made in the Johnson report in relation to the extension of various tax concessions (including the IMR) to the financial service sector. However, given the urgency surrounding the need to introduce the IMR for other foreign investors (such as foreign funds), we recommend that the proposals relating to the financial service sector be subject to a separate consultation process. As most, if not all, of the major financial centres (such as Hong Kong, Singapore, New York and London) have already adopted equivalent exemption-based regimes, Australia can not afford to delay the introduction of the IMR any further.

However, for present purposes, we submit that, if it was not going to cause a further delay in the introduction of the IMR regime, that regime should extend to all non-resident investors (i.e. not limited to foreign managed funds) that invest in Australian securities (except where those securities constitute taxable Australian property).

This extension should be sufficient to cover non-resident high net worth individuals investing via IDPSs, as well as the investment in Australian securities made by non-Australian families with significant private wealth (commonly referred to as "family offices").

This is consistent with the recommendations of the Johnson report that the exemption under the IMR should also cover foreign investors that trade on a local exchange such as the ASX (as discussed above).

Where the foreign investor is not a widely held foreign managed fund, we would accept an integrity provision which requires the local intermediary to confirm that the ultimate investor is not an Australian resident (as the intermediary should be able to establish this in a closely held context).

An exemption of this kind has been in place for many years in the US and extends to all foreign investors and is not merely limited to foreign funds which are widely held.

The US has the common exemption found in treaties, namely that trading in stocks via an independent agent in the US is not a US trade or business, provided that the non-resident does not have any other fixed place of business in the US.

However, for foreign funds (and indeed all taxpayers other than dealers in securities), no trade or business results from trading in stocks, securities, or commodities in the US for the taxpayer's own account, even if the transactions are consummated directly by the taxpayer or by an agent with full discretionary authority to make decisions.[1] This protection applies (except for dealers) whether or not the trading is carried out through an office of the taxpayer in the US. The Regulations note the following in this regard:

> *The term "engaged in trade or business within the United States" does not include the effecting of transactions in the United States in stocks or securities for the taxpayer's own account, irrespective of whether such transactions are effected by or through -*
>
> *(a) The taxpayer himself while present in the United States,*
>
> *(b) Employees of the taxpayer, whether or not such employees are present in the United States while effecting the transactions; or*
>
> *(c) A broker, commission agent, custodian, or other agent of the taxpayer, whether or not such agent while effecting the transactions is (1) dependent or independent, or (2) resident, non-resident, or present, in the United States, and irrespective of whether any such employee or agent has discretionary authority to make decisions in effecting such transactions.*[2]

As such, foreign funds which establish management advisory businesses, or businesses with full discretionary authority to make decisions, in the US to manage their portfolio do not expose themselves to US taxation.

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[1] See sections 864(b)(2)(A)(ii) and 864(b)(2)(B)(ii) of the US Revenue Code. Furthermore, as noted in the regulations, it does not matter whether an agent is dependent or independent.

[2] Regulation 1.864-2(c)(2)(i).