Australian Government

The Board of Taxation

REVIEW OF TAX ARRANGEMENTS APPLYING TO COLLECTIVE INVESTMENT VEHICLES

Discussion Paper

the board of taxation

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Board of Taxation

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FOREWORD

The Board of Taxation has been asked by the Government to review the taxation of collective investment vehicles. This review arises from the report of the Australian Financial Centre Forum, *Australia as a Financial Centre – Building on our Strengths* (the Johnson Report), which recommended that the Board of Taxation review the scope for providing a broader range of tax flow-through collective investment vehicles.

The review is to have regard to the following broad principles:

- collective investment vehicles are defined as widely held investment vehicles (with typically long term portfolio investors) that undertake primarily passive investment activities;
- the tax treatment of a collective investment vehicle should be determined by the nature of its investment activities rather than the structure of the entity through which the funds are pooled; and
- tax outcomes for investors in a collective investment vehicle should be broadly consistent with the tax outcomes of direct investment, other than flow through of losses (subject to limited special rules for their utilisation).

The Board has also been asked, as part of this review, to examine and report on the design of an investment manager regime and on the effectiveness of the special tax regime accorded under the Venture Capital Limited Partnership regime.

This paper provides an outline of the current range of collective investment vehicles and examines the extent to which they deliver on the principles set for the review. Topics relevant to the examination of the investment manager regime and Venture Capital Limited Partnership regime are also canvassed.

Consultation with industry and other affected stakeholders and submissions from the public, will play an important role in shaping the Board's recommendations to the Government.

The Board requests submissions regarding this review be made by 28 February 2011 to enable the Board to finalise its report in the timeframe requested by Government.

Richard Warburton AO
Chairman of the Board of Taxation

John Emerson AM
Chairman of the Working Group

CHAPTER 1: INTRODUCTION

1.1 A recent OECD Report[1] on collective investment vehicles (CIVs) states that nearly US$20 trillion is invested through CIVs worldwide, with this number expected to grow due to the numerous advantages provided to small investors who invest through CIVs.

1.2 The Johnson Report made several findings in respect of Australia's funds management sector which included:

- some of the features of Australia's tax and regulatory frameworks applying to the funds management sector inadvertently put the sector at a competitive disadvantage in terms of managing funds for offshore clients;
- many potential non-resident investors in Australian funds, particularly in the Asia-Pacific region, are not in common law jurisdictions and neither they nor investment advisors in the region are typically familiar or comfortable with trust structures; and
- based on discussions held with a range of funds management companies, it is strongly indicated that if Australia had access to a broader set of appropriate vehicles to sell into Asia which were taxed on a flow-through basis, then more funds management vehicles would be managed and administered out of Australia.

1.3 Against the above background, the Johnson Report recommended that the Board of Taxation review the scope for providing a broader range of tax flow-through CIVs, including the possibility of a corporate CIV.

BACKGROUND

1.4 On 11 May 2010, the then Assistant Treasurer and the then Minister for Financial Services, Superannuation and Corporate Law announced that the Government would ask the Board of Taxation to:

- review the tax treatment of CIVs, having regard to the new Managed Investment Trust tax framework and including whether a broader range of tax flow-through

1 The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles (OECD April 2010).

vehicles should be permitted, consistent with the Government's objective of developing Australia as a leading financial centre; and

- as part of the CIV review:
  - examine the treatment of Venture Capital Limited Partnership (VCLP) vehicles; and
  - consider the issues raised by the recommendation by the Australian Financial Centre Forum (AFCF) that an investment manager regime (IMR) be introduced into the tax law.

1.5 This reference by the Government follows a review already undertaken by the Board of the tax arrangements applying to Managed Investment Trusts (MITs). The review was undertaken against certain central features of the MIT framework, particularly that:

- the tax treatment for investors that derive income from the MIT should largely replicate the tax treatment as if they had derived that income directly; and
- MIT tax treatment covers widely held trusts undertaking primarily passive investment, consistent with the eligible investment rules in Division 6C of the *Income Tax Assessment Act 1936* (ITAA 1936).

1.6 Under this framework, the review included an examination of potential reforms to the eligible investment rules.

1.7 On 7 May 2010, the Government announced its response to this review, which includes the establishment of specific new tax rules for MITs.

TERMS OF REFERENCE

1.8 Against this background, the Board of Taxation was asked to examine and report on the tax treatment of CIVs, having regard to the MIT tax framework and including whether a broader range of tax flow-through CIVs (such as corporate CIVs) should be permitted.

1.9 The review is to have regard to the following broad principles:

- CIVs in this context are widely held investment vehicles (with typically long term portfolio investors) that undertake primarily passive investment activities, consistent with the eligible investment rules in Division 6C of the ITAA 1936.
- The tax treatment of a CIV should be determined by the nature of its investment activities rather than the structure of the entity through which the funds are pooled.

- The tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment, other than flow through of losses (subject to limited special rules for their utilisation).

1.10 As part of the review, the Board was asked to examine the effectiveness of the special tax treatment accorded under the Venture Capital Limited Partnership regime in a way that recognises its policy objectives.

1.11 In making its recommendations, the Board was asked to consider:

- the nature and extent of, and the reasons for, any impediments to investment into Australia by foreign investors through CIVs;

- the benefits of extending tax flow-through treatment for CIVs, including the degree to which a non-trust CIV would enhance industry's ability to attract foreign funds under management in Australia;

- whether there are 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.

1.12 The Board was also asked to examine and report on the design of an IMR for investments by foreign residents managed in Australia. The Government has asked the Treasury to consult on issues relating to the taxation of conduit income of managed funds as recommended in Australia's Future Tax System review (Assistant Treasurer's Media Release No. 92 of 11 May 2010). Having regard to the likely overlap between certain issues in the Treasury consultations and the IMR, the Treasury was asked to regularly inform the Board of the progress and outcomes of its consultations.

1.13 The recommendations should seek to enhance Australia's status as a leading regional financial centre and support growth and employment in the Australian managed funds industry while maintaining the integrity of the tax system and revenue neutral or near revenue neutral outcomes.

1.14 The Board was asked to report to the Assistant Treasurer by 31 December 2011.

THE REVIEW TEAM

1.15 The Board has appointed a Working Group of its members comprising John Emerson AM (Chairman), Chris Jordan AO, Annabelle Chaplain and Richard Warburton AO to oversee the review. The Working Group is being assisted by members of the Board's Secretariat, the Treasury and the Australian Taxation Office (ATO).

1.16 The Board has also received assistance from Professor Richard Vann (The University of Sydney) and a panel of experts comprising Michael Brown, Alexis Kokkinos, Andrew Mills, Karen Payne and Ken Woo.

REVIEW PROCESSES

Consultation

1.17 The Board has conducted targeted preliminary consultations with a range of stakeholders.

Submissions

1.18 The Board is inviting written submissions to assist with its review. Submissions should address the terms of reference set out in paragraphs 1.8 to 1.14 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix A). It is not expected that each submission will necessarily address all of the questions raised in the discussion paper. The closing date for submissions is 28 February 2011. Submissions can be sent by:

Mail to: The Board of Taxation
c/ The Treasury
Langton Crescent
CANBERRA ACT 2600

Fax to: 02 6263 4471
Email to: taxboard@treasury.gov.au

1.19 Stakeholders making submissions should note that Board members, the review team, and those assisting it, will have access to all submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board's website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.

The Board's report

1.20 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board's report and its recommendations will reflect the Board's independent judgement.

1.21 The Board has been requested to provide its report to Government by December 2011.

CHAPTER 2: COLLECTIVE INVESTMENT VEHICLES FOR THE PURPOSES OF THIS REVIEW AND PRINCIPLES FOR TAXATION TREATMENT

BACKGROUND TO CIVS AND THE FUNDS MANAGEMENT SECTOR

2.1 Nearly US$20 trillion is invested through CIVs worldwide, with this number expected to grow.

2.2 As at the end of June 2010, Australia had A$1,351 billion in consolidated funds under management, including A$292 billion invested in MITs as public unit trusts and cash management trusts.[2] Only 5 per cent of the funds under management were sourced from overseas investors.[3]

2.3 CIVs in the context of this review are widely held investment vehicles (with typically long term portfolio investors) that undertake primarily passive investment activities. CIVs refer to the vehicles through which investors funds are aggregated and used for investments. They enable funds to be used to participate in a wider range of investments than feasible for most individual investors.

IMPEDIMENTS TO INVESTMENT INTO AUSTRALIA BY FOREIGN INVESTORS THROUGH CIVS

2.4 The Johnson Report noted that many potential non-resident investors in Australian funds, particularly in the Asia-Pacific region, are not in common law jurisdictions and neither they nor investment advisors in the region are typically familiar or comfortable with trust structures. Other commentators have noted though that a number of civil law countries in the Asian region, such as Japan, South Korea and most recently China, have adopted the use of trusts to enhance their financial

2 Managed Funds, Australian Bureau of Statistics (ABS) June quarter 2010 – Cat 5655.0. Out of a total of $295 billion of unconsolidated assets of public unit trusts at 30 June 2010, $129 billion correspond to property trusts, $145 billion to equity trusts and $21 billion to other trusts, including mortgage trusts.

3 ibid. This figure is the level of unintermediated investment by foreign residents in Australian managed funds and does not include investments held by Australian nominees on behalf of foreign investors ($6 billion at 30 June 2010, ABS unpublished).

infrastructure. Therefore, there is a potential for MITs to progressively become more attractive for non-resident investors in the region.[4]

2.5 Although Australia's MIT regime has recently undergone fundamental change aimed at increasing tax certainty for investors in Australian MITs, these structures may remain at a comparative disadvantage to attract investments from non-residents due among other things to their reliance on the use of a unit trust.

2.6 There may also be a potential bias in portfolio investments which leads non-resident retail investors to invest in a local CIV which in turn invests directly or in CIVs in other jurisdictions. This may result from regulatory investment guidelines which make it practically difficult for non-resident retail investors to invest in CIVs not covered by investor protection regulations applicable in their jurisdiction. One exception is the Undertakings for Collective Investment in Transferable Securities (UCITS) framework introduced in the European Union (EU) which provides a recognised framework of investment guidelines and investor protection regulations for retail investors across the EU. A number of territories outside the EU have also recognised UCITS in their local investment regulations making them open to international retail investors.

2.7 Australia's tax system does offer a corporate CIV structure in the form of the Listed Investment Company (LIC) regime. As of 31 August 2010 there were 62 Listed Investment Companies and Trusts traded on the ASX with a combined market capitalisation of $18.0 billion.[5]

2.8 LICs can be attractive for resident investors due to the franking credits attached to dividends distributed by the LICs, and the ability for resident investors to access the benefit of the capital gains tax (CGT) discount where the dividend received includes a 'LIC capital gain' component. As explained further at paragraph 3.17 below, the resident investor is able to obtain a tax deduction that enables the benefit to flow-through a LIC to the investor. Non-resident investors are unlikely to be attracted to LICs as they do not obtain the same level of effective benefits.

2.9 Apart from a lack of familiarity with trusts, another reason why non-resident investors in the Asia-Pacific region may prefer to invest in CIVs domiciled in jurisdictions such as Luxembourg and Ireland, rather than through Australian CIVs, is that the income and capital gains of funds domiciled in those jurisdictions is exempt from tax and there is no withholding tax imposed on distributions to non-residents.[6]

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4 Ho, Lusina 'The Reception of Trust in Asia: Emerging Asian Principles of Trusts?' *Singapore Journal of Legal Studies*; December 2004.

5 Listed Managed Investments (LMI) Monthly Update - August 2010 http://www.asx.com.au/products/pdf/lmi/lmi_monthly_update_201008.pdf. There is no separate amount stated for LICs on their own. Listed trusts in this context do not include listed property trusts or infrastructure funds.

6 Note, income is subject to tax when distributions are made from Irish funds to Irish residents.

This broad exemption outcome is facilitated as the CIVs in these jurisdictions are established as funds which invest predominantly if not solely in offshore assets, not giving rise to source taxation issues applicable to investments in those jurisdictions. This feature is in addition to the benefits of a recognised regulatory regime, as that provided by the UCITS framework.

2.10 The Johnson Report noted that if Australia had access to a broader set of CIVs which were taxed on a flow-through basis, more capital could be attracted from the Asian region into Australian managed and administered funds. Any CIV regime offered in Australia would benefit greatly from adopting, where possible, attributes that are more attractive to global investors.

Q 2.1 Issues / Questions

The Board seeks stakeholder comments on:

- the specific reasons for the apparent unattractiveness of Australia's current tax treatment of CIVs to non-resident investors; and
- the specific non-tax factors which may make Australia's CIVs unattractive to non-resident investors.

CIVS FOR THE PURPOSES OF THIS REVIEW

2.11 In conducting this review, the terms of reference require the Board to have regard to the newly established MIT tax framework. In addition, the terms of reference broadly establish the characteristics that an entity must possess to be a CIV within the scope of this review. Broadly, to qualify, an entity must be:

- widely held (with typically long term portfolio investors); and
- undertake primarily passive investment activities, consistent with the eligible investment rules in Division 6C of Part III of the ITAA 1936.

2.12 This is broadly consistent with the Organisation for Economic Co-operation and Development (OECD) definition of what constitutes a CIV. In its recent report on CIVs, aimed at achieving agreement on proposed treaty language applicable to CIVs[7], the OECD has limited the term CIV to funds that:

- are widely held;
- hold a diversified portfolio of securities; and

7 op cit.

- are subject to investor protection regulation in the country in which they are established.

Widely held

2.13 Broadly, Australia's income tax concepts of widely held require the entity to be listed on an approved stock exchange, or have, directly or indirectly, greater than 50 members which meet certain specified requirements, depending on whether the entity is a company or trust.

2.14 The term 'widely held company' is defined in section 995-1 of the ITAA 1997.

2.15 In addition, the Board discussed the concept of 'widely held' in its Report to Government on the *Review of Tax Arrangements Applying to Managed Investment Trusts* (the Board's MIT Report), including recommending a definition of what constitutes a widely held MIT.

2.16 The Board recommended that an MIT will be considered 'widely held' if it:

- satisfies the definition in Subdivision 12-H of Schedule 1 to the *Taxation Administration Act 1953* (TAA);

- is a wholesale trust which has 50 or more members directly (or indirectly, for example, through a trust or superannuation fund) and that wholesale trust is subject to a suitable regulatory regime; for example, it is operated or managed by the holder of an Australian Financial Services Licence (subject to regulation under the *Corporations Act 2001*); or

- is a wholesale trust which is wholly-owned directly or indirectly by one or more trusts which satisfy the definition in Subdivision 12-H or by a wholesale trust, as above.

2.17 The Government agreed to the Board's recommendation and in the context of recent changes to the definition of an MIT, Parliament legislated a broadly equivalent definition. Accordingly, Australia's MIT regime now explicitly defines what constitutes a 'widely held MIT' and includes registered and unregistered wholesale funds that have at least 25 members or are held by certain widely held collective investment entities, such as superannuation funds. To preserve tax integrity, widely held trusts with concentrated ownership or 'closely held trusts' are excluded.

Primarily passive investment activities

2.18 The Board's MIT Report contained detailed discussion on the meaning of 'primarily passive investment', including recommendations for changes to the eligible investment business rules contained in Division 6C of Part III of the ITAA 1936. In its response, the Government has deferred any immediate action in relation to the Board's

recommendation to alter the eligible investment business rules. The Government will further examine the benefits of this recommendation, relative to their revenue impact.

2.19 Under current legislation an 'eligible investment business' means one or more of:

- investing in land for the purpose, or primarily for the purpose, of deriving rent; or
- investing or trading in any or all of the following:
  - secured or unsecured loans (including deposits with a bank or other financial institution);
  - bonds, debentures, stock or other securities;
  - shares in a company, including shares in a foreign hybrid company (as defined in the ITAA 1997);
  - units in a unit trust;
  - futures contracts;
  - forward contracts;
  - interest rate swap contracts;
  - currency swap contracts;
  - forward exchange rate contracts;
  - forward interest rate contracts;
  - life assurance policies;
  - a right or option in respect of such a loan, security, share, unit, contract or policy;
  - any similar financial instruments; or
- investing or trading in financial instruments that arise under financial arrangements, other than arrangements excepted by section 102MA of the ITAA 1936.

2.20 It is important to distinguish between passive investment activity and trading activity (as mentioned in the preceding paragraph) on the one hand, and control of a trading business by the CIV on the other. Control is the factor that indicates active involvement in the trading business and so funds such as private equity funds would not typically be considered to be undertaking passive investment activity. That said,

some stakeholders have noted that the meaning of 'control' in the context of the Division 6C rules creates potential uncertainty for non-residents which may be a disincentive for investment into Australia.

2.21 The OECD definition specifically excludes both private equity funds and hedge funds from its discussion. However, trading in financial instruments such as shares and units may still be considered to be primarily passive investment activity for the purposes of determining a CIV in the context of this review, as it is part of the eligible investment business rules contained in Division 6C.

2.22 In principle, there are a range of existing vehicles in Australia that could be considered to satisfy the CIV criteria as outlined in the terms of reference, including MITs and LICs. A more detailed analysis of Australia's current range of CIVs is contained in Chapter 3.

2.23 Collective investments that undertake primarily 'active business' activities, regardless of the type of entity utilised, are not considered as part of this review unless they come within the scope of the specific venture capital limited partnership regime (see Chapter 6).

Q 2.2 Issues / Questions

The Board seeks stakeholder comments on:

- the appropriateness of the widely held definition contained in the MIT legislation as a characteristic for a wider range of CIVs, and whether there any compelling reasons to have non-widely held vehicles included as CIVs;
- the appropriateness of the current definition of eligible investment business in Division 6C of the ITAA 1936 as a prerequisite for a wider range of CIVs, and whether there are any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs; and
- whether there is a need to further define 'control' in Division 6C of the ITAA 1936 to provide greater certainty for investors in MITs and other CIVs, and if so, how this could be achieved.

PRINCIPLES FOR TAXATION TREATMENT OF CIVS AND INVESTORS IN CIVS

2.24 The following could be taken as guiding policy principles for the taxation treatment of CIVs and their investors, consistent with the terms of reference for this review.

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

2.25 Managed funds can be seen as providing a service of managing the domestic and foreign savings of a number of individual investors and investing them across a range of domestic and offshore equities, property and bonds.

2.26 Managed funds can take a variety of legal forms. In Australia, managed funds are most commonly established as unit trusts, which have, historically, been taxed on a flow-through basis except in certain cases (for example, public trading trusts which are taxed like companies).

2.27 In overseas jurisdictions, managed funds can be established as companies, trusts, partnerships, jointly held property or contractual arrangements. In most jurisdictions, to be taxed as a CIV the entity must be subject to and meet established regulatory requirements related to investor protection such as investment guidelines and disclosing and reporting obligations. In many instances, the CIV must be registered under a relevant authority.

2.28 In Australia, public trading trusts and limited liability partnerships are taxed similarly to companies to protect the corporate tax base, prevent the inappropriate use of losses and to achieve a level playing field between widely held businesses trading as a company or operating through other structures.

2.29 Entity taxation arrangements in Australia are often driven by the legal form of the entity used rather than the nature of the entity's activities. While Australia taxes certain trusts and partnerships like companies there is not a converse exception from company taxation for entities carrying on the same activities as an MIT.

Policy principle 2: Tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment — achieving tax neutrality

2.30 A neutral tax regime is one that does not influence investors' choices between investing directly or through a CIV in the same underlying investments. The ability of a tax regime to achieve neutrality between direct and indirect investment outcomes varies depending on the legal form in which CIVs are established, the characteristics of the prevailing income tax regime, the different jurisdictions involved in the chain of taxing a CIV investment (as a general rule, the more taxing jurisdictions, the more difficulty in achieving full neutrality) and the range of investors.

2.31 Transparent tax treatment or flow-through taxation is one way of achieving consistent outcomes between direct and indirect investment.[8] Tax flow-through broadly enables a CIV to be 'looked through' for tax purposes so that income and gains from an underlying investment of the CIV would flow-through the CIV to be taxed in the hands of the investor, with the amounts retaining all of their tax characteristics. In practice, tax jurisdictions may offer partial flow-through vehicles where some tax characteristics may not pass through to the investor (for example, MITs in Australia are generally considered to be tax flow-through entities, but losses are not passed through to the investor).

2.32 Aside from using tax flow-through, there are other methods of achieving tax neutral outcomes between direct and indirect investment. An example is an 'integration model' where a CIV is subject to tax, but where the investor receives tax credits to offset the tax already paid by the CIV. A number of models are set out in more detail in Chapter 4. A decision on which model or models to implement would depend on a number of factors including the feasibility of each model, whether the model aligns with existing tax rules to a particular legal structure, the complexity in the tax rules and other laws which would need to be implemented, the level of compliance burden imposed on the CIV, and other costs and benefits of the model.

2.33 It is not necessary that the same form of taxation be used for the different types of legal entities. What is important is that the tax outcomes for investors in a particular type of CIV are broadly similar to the tax outcome that the investors would obtain through direct investments in the underlying assets of the CIV.

2.34 The following represent the key tax attributes that arise for investors undertaking a direct investment, and will be critical to achieving tax neutrality in the design of a broader CIV regime in Australia.

Resident investors

2.35 Under an investment made directly, a resident investor broadly:

- remains subject to tax on their worldwide income;
- is able to offset tax payable by the franking credits attached to dividends from Australian resident companies;
- retains the right to access the CGT discount in relation to the disposal of a CGT asset, where the relevant conditions have been satisfied;

8 In the context of this discussion paper, references to direct investment or investments made directly refer to investments undertaken by investors directly in the underlying assets rather than indirectly through investments in CIVs. Non-portfolio investments are referred to as such rather than as direct investment.

- is able to offset capital losses against capital gains made on the disposal of investments held on capital account;
- is able to offset revenue losses made on the investments, such as those that may arise from funding costs or share trading, against assessable income; and
- receives an offset for any foreign tax paid on foreign income, broadly up to the lesser of the foreign tax paid and the investor's marginal rate of tax.

Non-resident investors

2.36 Under an investment made directly, a non-resident investor broadly:

- is subject to a final withholding tax on Australian sourced dividend, interest and royalty income applicable on a gross basis;
- is not subject to Australian tax on any capital gains derived from the disposal of assets, except for the disposal of taxable Australian real property (TARP) assets or assets used by a permanent establishment of the non-resident in Australia;
- is subject to Australian tax by assessment on a net basis on any other Australian source income (at graduated non-resident tax rates for individuals); and
- is not subject to Australian tax on any foreign source income.

2.37 Australia has a special regime of 7.5 per cent final withholding tax rate applicable on a gross basis for fund payments by an Australian MIT to foreign residents in an information exchange country or 30 per cent for residents in other countries. This regime, particularly relevant to property trusts, provides a more favourable tax outcome than direct investments by non-residents and is consistent with the emerging international norm based on the different character of investments in Real Estate Investment Trusts (REITS) compared to direct investments in land.

2.38 The tax neutrality objective does not operate in the same way for non-residents as for residents. The foreign resident's ultimate tax outcome depends on the tax treatment in their country of residence (which Australia cannot control). The main objective for Australia is to set out tax rules that aim to provide similar tax outcomes whether the foreign residents invest directly into Australia or through a CIV. The objective is to collect an appropriate amount of revenue on a source basis without discouraging or creating tax impediments to mobile foreign investment in Australia.

Policy principle 3: Any recommendations should seek to enhance Australia's status as a leading regional financial centre while maintaining the integrity of the tax system and revenue neutral or near revenue neutral outcomes

2.39 This principle highlights the need for the Board to consider in its recommendations an appropriate balance between the objectives of enhancing Australia's status as a leading regional financial centre and protecting (or not adversely affecting) the revenue. With respect to investments by non-residents in Australian CIVs the objective is to ensure the tax regimes do not constitute a barrier to investments in Australia while at the same time ensuring that Australia collects source taxes on a timely basis. With respect to investments by residents, the objective is to ensure that the integrity of the tax system is preserved, with the worldwide income of residents being taxed on an appropriate and timely basis.

Preventing accumulation of income

2.40 Tax flow-through models require that the fund investor is considered to have earned the income in the same tax year in which the CIV earned the income, that is, with no (or limited) accumulation of income at the CIV level. Where no or little tax is levied at the CIV level, accumulation of income in the CIV could result in the income earned by the CIV not being subject to any tax until it is ultimately distributed to investors.

2.41 Accumulation of income could be prevented through a 'deemed-distribution' approach, where investors are taxed as if the corporate CIV income is distributed to investors in the year of income, regardless of the actual distribution made by the CIV (in the case of non-resident investors, this would apply to any Australian source income of the CIV).

2.42 Such an approach crystallises a tax obligation to investors who may not be funded from distributions made. However, if this possibility is disclosed to investors, who choose to invest or maintain their investment, it is an option that can be considered.

Creating CIVs for non-residents

2.43 Another possibility to address the issues raised by policy principle 3 is to create specific CIVs for non-resident investors which are limited in use to such investors. This would allow providing a tax regime for the CIVs that is consistent with the tax regime and concessions applicable to investments made directly by non-residents.

2.44 However, experience suggests that it is preferable to make regimes available for both resident and non-resident investors. Otherwise, domestic capital could round-trip to a foreign entity which then invests back into Australia to obtain advantages available to non-residents. Apart from the potential problem of round-tripping, the creation of CIVs limited in use to non-residents could lead to the creation of mirror

funds for resident investors that are willing to invest in similar investment opportunities as those available for non-residents. This could add uncertainty and regulatory or tax compliance costs, and detract from the objective of establishing Australia as a leading regional financial centre.

2.45 Different models to achieve tax neutrality and the significance of tax treaties and foreign tax on CIVs are explored further in Chapter 4. A high level summary of the tax treatment of CIVs in other jurisdictions is contained at Appendix B.

CHAPTER 3: AUSTRALIA'S CURRENT RANGE OF CIVS

3.1 This chapter examines the current tax treatment of the existing range of CIVs to identify issues in achieving the desired outcomes established by the terms of reference.

3.2 Currently, there are a range of vehicles in Australia that could potentially meet the definition of a CIV. These include:

- MITs (which include property trusts for which the generally accepted international name is REITs);
- Listed Investment Companies (LICs); and
- Limited Partnerships (LPs).[9]

MANAGED INVESTMENT TRUSTS (MITS)

3.3 The Board's discussion paper on the review of the tax arrangements applying to MITs described them as widely held CIVs which allow individuals to pool together their capital to enable investment in larger and more diversified assets than would otherwise be the case.

3.4 MITs in Australia are taxed under the general trust provisions of Division 6 of Part III of the ITAA 1936 and related provisions. Flow-through taxation (including retention of character and source of income) is generally provided for MITs under the current rules, although not in all circumstances.

3.5 Division 6C was introduced by the *Taxation Laws Amendment Act (No. 4) 1985* as an anti avoidance regime to address the increasing use of trusts to avoid company taxation on widely held active business activities. Division 6C extended company tax arrangements to public unit trusts but only to those which operate a trade or a business, as distinct from those that are vehicles for investing in property, equities or securities.

3.6 Division 6C applies to public unit trusts that operate as a trading trust, whose business activities go beyond investing in land for primarily rental purposes or investing or trading in shares, units, loans and other securities (that is, eligible

9 Subject to potential changes to the current corporate limited partnership regime as raised in discussion questions below.

investment business). A trust will be treated for this purpose as a public unit trust if its units are listed on a stock exchange, are held by 50 or more persons or are offered to the public (trace through rules also apply).

3.7 MITs were defined as 'widely held CIVs undertaking primarily passive investments' in the terms of reference given to the Board for the review of tax arrangements applying to MITs. Division 6C eligible investment business rules effectively provide rules as to the meaning of passive investment which exclude, if the MIT is to retain trust taxation, the possibility of the MIT being able to carry on or control a trading business.

3.8 The Board made a number of recommendations as part of its review of tax arrangements applying to MITs that sought to improve certainty and reduce compliance costs, while retaining flow-through taxation treatment. These included the option for funds to make an irrevocable election to apply the CGT regime to disposal of eligible assets (which has now been legislated as Division 275 of the ITAA 1997). Trusts that do not meet the eligible investment business rules cannot access the benefits of this measure. This is consistent with the policy that the MIT tax treatment be confined to widely held trusts that undertake primarily passive investments as defined under Division 6C of the ITAA 1936. Based on the recommendations made by the Board, the Government has agreed to legislate the degree to which character and source flow-through to MIT investors.

Investor protection

3.9 In addition to specific tax provisions, MITs which operate as managed investment schemes attract special regulation under Chapter 5C of the *Corporations Act 2001*. The core emphasis of Chapter 5C is on investor protection. As noted above, investor protection and similar regulatory controls are essential features of CIV regimes in other jurisdictions.

3.10 The definition of collective investment schemes in Chapter 5C of the *Corporations Act 2001* is much broader than the MIT definition. It extends the definition to collective investments in business activities such as forestry managed investment schemes and other agribusiness schemes.

To what extent do MITs deliver on the policy principles?

3.11 It has been submitted that flow-through taxation is paramount to creating a successful Australian CIV regime as flow-through taxation ensures that tax outcomes for investors who invest through a CIV is broadly consistent with the tax outcomes where the investment was undertaken directly.

3.12 However, as acknowledged in the Board's MIT review, the flow-through taxation offered by Australia's MIT regime, combined with the different rates of withholding

tax levied by Australia on non-residents, results in MITs having to issue complex distribution statements to investors, detailing the different types and source of income and the differing rates of tax applied to the various income streams. The complexity of MIT distribution statements resulting from flow-through treatment is a particular issue for non-resident retail investors.

Q 3.1 Issues / Questions

The Board seeks stakeholder comments on:

- the nature and extent of, and the reasons for, any impediments to investments into Australia by foreign investors through MITs; and
- suggestions on how the complexity of character and source retention under flow-through taxation could be alleviated through alternative CIV vehicles that are more attractive or user-friendly to non-resident investors.

LISTED INVESTMENT COMPANIES (LICS)

3.13 A LIC is a structure for a collective investment scheme to which the investing public is invited to subscribe by buying shares (either in the primary or in the secondary market). LICs are defined under the income tax law and are subject to corporate regulation in much the same way as other companies. As noted earlier, as of 31 August 2010 there were 62 LICs and trusts on the ASX with a combined market capitalisation of $18 billion.[10]

3.14 Generally, if an assessable dividend is paid to a resident investor the investor will receive a franking credit for company tax paid to the extent that the dividend is franked. Income distributed by LICs does not retain its character and this can simplify distributions and provide greater flexibility for the LIC in managing its investments.

3.15 A tax concession is available to resident investors for dividends that include capital gains components and satisfy certain conditions. The concession applies to dividends paid on or after 1 July 2001 that include a 'LIC capital gain' made by a LIC. This treatment enables certain shareholders in LICs to benefit from the CGT discount in respect of assets owned by those companies for at least 12 months and in respect of which a LIC capital gain is realised on or after 1 July 2001. To qualify for the concession the company in question must meet the definition of 'LIC' in section 115-290 of the ITAA 1997.

10 Listed Managed Investments (LMI) Monthly Update – August 2010 http://www.asx.com.au/products/pdf/lmi/lmi_monthly_update_201008.pdf. There is no separate amount stated for LICs on their own. Listed trusts in this context do not include listed property trusts or infrastructure funds.

3.16 The permitted investments under section 115-290 of the ITAA 1997 are comparable to the eligible investment rules under Division 6C of the ITAA 1936. That is, they are primarily passive investments. Permitted investments for LICs are:

- shares, units, options, rights or similar interests; or
- financial instruments (such as loans, debts, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract); or
- an asset whose main use by the company in the course of carrying on its business is to derive interest, an annuity, rent, royalties or foreign exchange gains unless:
  - the asset is an intangible asset and has been substantially developed, altered or improved by the company so that its market value has been substantially enhanced; or
  - its main use for deriving rent was only temporary; or
- goodwill.

3.17 The concession does not operate in the same manner as it does for MITs. Investors in LICs are entitled to an income tax deduction where dividends are paid to them that include a LIC capital gain to achieve a similar effect to the CGT discount. Furthermore, LICs do not have deemed capital account treatment for their investment assets.

3.18 LICs provide investors with exposure to a professionally managed and diversified portfolio of assets. These assets may include Australian shares, international shares, fixed income securities, property and shares in unlisted private companies. Some funds offer 'packaged strategies'.

3.19 Most LICs distribute income in the form of fully franked dividends. For LICs with a dividend reinvestment plan, investors can choose to increase their investment rather than receiving cash.

3.20 In the Board's MIT Report it was noted that LICs are similar to eligible MITs, in that they are widely held CIVs and undertake primarily passive investment activity.

3.21 For a company to qualify as a LIC under subdivision 115-D of the ITAA 1997, at least 90 per cent of the market value of its CGT assets must consist of 'permitted investments'. In addition, a LIC cannot own more than 10 per cent of another company or trust except where it is another LIC.

3.22 As noted above, the definition of 'permitted investments' for LICs (subsection 115-290(4)) is broadly similar to the 'eligible investments business' test in Division 6C of the ITAA 1936.

Australia's corporate tax framework

3.23 In considering the scope for reforming the taxation of LICs or developing a new corporate CIV, it is necessary to consider the existing corporate tax framework.

3.24 In the case of a corporate CIV, there is no character preservation (except for LIC capital gains), with its distributions classified as dividends (or a return of investor capital), irrespective of the character or source of income received by the corporate CIV. This lack of character preservation of income is avoided in the case of MITs through the use of a trust structure which, once the new MIT regime is legislated, will clarify the degree to which the underlying character of the income passes through to the ultimate investors.

3.25 The non-preservation of character of income is particularly relevant if different types of income are subject to different taxation treatments, as could be the case when corporate CIVs undertake cross-border investments that are taxed at source.

3.26 Also, as noted by the Board in its report on the MIT review, any foreign tax credit for tax paid by a corporate CIV at the country of source may not be passed through to investors if their country of residence does not recognise the corporate CIV as fiscally transparent. This can lead to situations of double taxation and departs from the attainment of neutrality of investment decisions by such an investor.

Imputation regime

3.27 Australia taxes its resident corporate entities at a flat rate of 30 per cent. The imputation system avoids the double taxation of domestic corporate profits in the hands of resident shareholders. Under the imputation regime, an Australian resident company maintains a franking account that is credited whenever it pays Australian corporate tax or receives a franked dividend from another company. These 'franking credits' represent the Australian tax already paid in the hands of the corporate taxpayer, which can be distributed to shareholders as part of a 'franked distribution'.

3.28 An Australian resident individual shareholder who receives a franked distribution is generally required to include the dividend in their assessable income grossed up to include the franked portion, but is then entitled to a refundable tax offset for the franking credit. Franked dividends paid to non-residents are not subject to dividend withholding tax. Various anti-avoidance rules exist to prevent the manipulation of the imputation system.

Conduit foreign income rules

3.29 The Board recommended — in its 2003 report on International Taxation — that the government proceed with the foreign income account rules recommended by the Review of Business Taxation as they apply to direct investment. In response to this recommendation, conduit foreign income rules were introduced in 2005 in *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005.*

3.30 Conduit foreign income is foreign source income received by a foreign resident via an Australian corporate tax entity. The conduit foreign income rules allow certain foreign source income that is not subject to tax at the corporate level, including non-portfolio dividends, to flow through an Australian company to foreign shareholders free from Australian dividend withholding tax. The current conduit foreign income rules provide greater concessionary tax treatments than the previous foreign dividend account rules enacted in 1994.

Non-resident CGT only for taxable Australian property

3.31 A non-resident person is subject to tax on capital gains in Australia only if the CGT event happens to a CGT asset that is taxable Australian property. Taxable Australian property includes non-portfolio interests (direct or indirect) in Australian real property, and assets that have been used by the non-resident in carrying on a business through a permanent establishment situated in Australia.

To what extent do LICs deliver on the policy principles?

3.32 LICs go some way to delivering on the policy principles outlined in Chapter 2. The imputation regime provides a credit for company tax paid and a deduction is provided for certain distributions that include a LIC capital gain. However, if a resident investor in a LIC has capital losses, there is no adjustment to the LIC capital gain that is claimed by those investors as a deduction. This contrasts with an MIT where the capital gain is effectively reduced if the investor in an MIT has capital losses. In addition, distributions from LICs apart from returns of capital are generally assessable in the hands of shareholders, as compared to tax deferred distributions from MITs to unitholders.

3.33 At the entity level, LICs are taxed the same as any other corporate. This is even though the investment activity of LICs is largely the same as for MITs. As a result, neutral tax treatment is not achieved in a number of cases for investments undertaken directly and indirectly through a LIC.

3.34 LICs do not achieve neutral tax treatment between investment directly and indirectly via LICs for investors. Resident investors are not provided with franking credits where the LIC has received a foreign income tax offset (that is, the income is distributed as an unfranked dividend to the shareholder).

3.35 Non-resident investors are not able to fully utilise dividend imputation credits for tax paid at the corporate level in Australia. Although fully franked dividends received by non-residents are not subject to dividend withholding tax, non-residents are subject to dividend withholding tax on unfranked dividends. Credit for withholding tax paid in Australia may be provided in their residence country but it is unlikely to be provided for corporate tax paid by LICs.

3.36 Similarly, the conduit foreign income rules do not eliminate Australian tax on all conduit foreign income distributed to non-resident investors. The current conduit foreign income rules exempt a LIC from paying dividend withholding tax on any conduit income that is not subject to corporate tax in Australia. Where Australian corporate tax is paid in Australia on foreign source income, a distribution of this income as a fully franked dividend will not be subject to withholding tax. However, non-resident investors are not able to receive a refund for any Australian corporate tax paid by the LIC on this foreign source income. This contrasts with conduit income passing through an MIT which will not be subject to any withholding tax or tax at the entity level in Australia.

3.37 Non-resident investors are not subject to CGT if they sell their shares in a LIC and their shares are not taxable Australian property. However, non-residents are effectively taxed at the corporate level on capital gains made by the LICs on disposal of assets that are not taxable Australian property. Non-residents would not be taxed on these capital gains if they had invested directly or through an MIT due to the flow-through treatment of MITs. Non-resident investors in MITs retain access to the CGT treatment for non-residents where the MIT disposes of an asset that is not taxable Australian property.

3.38 The Board considered in its MIT review that given the similarity in investment restrictions between LICs and eligible MITs and that arguably they compete for the same investor dollar, particularly from individuals, it would be reasonable for the tax treatment to be the same. In line with this, the Board recommended that consideration be given to extending any capital account treatment provided to MITs to LICs. The Government decided to defer consideration of this issue to further examine the benefits of this recommendation, relative to its cost to revenue.

3.39 However, extending the capital account treatment provided to MITs to LICs would not be sufficient to achieve, in the case of non-resident investors, parity of treatment with direct investments or with investments through an MIT. Further changes would be needed to achieve this outcome.

Q 3.2 Issues / Questions

The Board seeks stakeholder comments on:

- whether the existing definition of LIC capital gains should be restricted to gains made on direct investments only and whether there are reasons to extend this definition to include all gains made in respect of permitted investments by LICs;
- whether it is desirable to introduce further changes to the LIC regime to better obtain parity of tax outcome with direct investments in the underlying assets of the LIC? If so, what changes would be required;

- should an amended collective investment company regime be limited to listed vehicles or applied more broadly including other widely held non-listed investment companies defined in a similar way as the widely held rules for MITs;
- instead of amending the LIC regime, should a new corporate CIV regime be introduced that provides parity of tax outcome with direct investments and how would that regime operate? What transitional rules may be required;
- is there a trade-off between preserving character and source of income and simplifying distribution statements for investors that are more familiar with a dividend distribution statement? Are there minimal tax outcomes that would meet non-resident investor expectations without requiring complete tax flow-through? Is there any way to preserve character and source of income under a new corporate CIV regime? If so, how would that operate?

LIMITED PARTNERSHIPS (LPS)

3.40 The structure of a LP is similar in two respects to that of a company limited by shares in that (i) limited partners, like shareholders in a company, do not take part in the management of the business and (ii) limited partners have their liability generally limited to the extent of their investment. A LP has a general partner who has unlimited liability as a partner.

3.41 *Taxation Laws Amendment Act (No. 6) 1992* amended the law to treat limited partnerships as companies for tax purposes under Division 5A of the ITAA 1936.[11]

3.42 The corresponding Explanatory Memorandum noted that if limited partners were treated in the same way as partners in any other partnership, they may benefit from distributions of losses that exceed their limited liability. Those losses could be used to reduce their taxable income, even though the limited partners are not exposed to any risk of having to meet obligations or make good on those losses.

3.43 The following modifications to the tax law apply:

- a reference to a company or body corporate in ITAA 1936 also includes a reference to a limited partnership while a reference to a partnership does not include a reference to a limited partnership;
- a dividend includes distributions by a limited partnership;

11 However, Division 830 of the ITAA 1997 provides for foreign hybrid limited partnerships to be treated as partnerships for the purposes of that Act. Similar treatment applies under the venture capital limited partnership regime as discussed in Chapter 6.

- drawings by partners of a limited partnership are deemed to be dividends;
- a share includes an interest in a limited partnership and a shareholder includes a partner in such a partnership;
- a change in the composition of a limited partnership does not affect the continuity of the partnership for tax purposes;
- a limited partnership is a resident of Australia if it was formed in Australia, carries on a business in Australia or has its central management and control in Australia; and
- obligations that would be imposed on a limited partnership are imposed on each of the partners but may be discharged by any one of them.

3.44 It is important to note that partnerships are regulated by the respective State or Territory in which the partnership is established. Broadly, partners of a partnership have a fiduciary obligation to the other partners.

3.45 The appeal of a LP may be that it can be used for more active investments (not subject to restrictions under Division 6C) and can therefore be used for more risky collective investments such as those in new business ventures.

3.46 It should be noted that LPs are a vehicle of choice internationally for a variety of activities by CIVs, most significantly hedge funds, venture capital and for CIVs marketed at the wholesale level. Investors in these vehicles are usually sophisticated investors that do not require the same level of investment protection as retail investors.

To what extent do LPs deliver on the policy principles?

3.47 For tax purposes a limited partnership is treated in Australia similarly to a company, so from a tax perspective, will have the same or similar issues as that of a company in delivering on the policy principles.

3.48 While not within the scope of this review, investor protection and regulatory systems are an important element of a CIV regime. The fact that LPs do not come within corporate or Managed Investment Scheme regulation distinguishes LPs from CIVs marketed at the retail level, such as MITs and LICs. However, LPs could have a role to play in CIVs marketed at a wholesale level or for sophisticated investors.

Q 3.3 Issues / Questions

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?

CHAPTER 4: DESIGN OF A NEW CORPORATE CIV REGIME

4.1 The previous chapter considered whether changes can be made to the existing CIV regimes. This chapter considers the desirability of a wider range of CIVs, in particular a new corporate CIV regime, and the design issues that would need to be addressed should such a change be implemented.

4.2 The terms of reference ask whether a broader range of tax flow-through CIVs (such as corporate CIVs) should be permitted. In making its recommendations, the Board is asked to consider:

- the nature and extent of, and the reasons for, any impediments to investment into Australia by foreign investors through CIVs;
- the benefits of extending tax flow-through treatment for CIVs, including the degree to which a non-trust CIV would enhance industry's ability to attract foreign funds under management in Australia; and
- whether there are 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.

DESIGN OF A NEW CIV REGIME

4.3 Internationally, most countries seek to promote neutrality, that is, the outcome from investing in the CIV aims to replicate, as far as possible, the outcomes that would arise as if the investor had directly acquired the underlying investment. However, the mechanism by which this outcome is achieved can vary from country to country.

4.4 Which model is ultimately adopted will depend heavily on the tax framework of the respective country, taking into consideration issues such as the country's treatment of capital (as opposed to income) gains, the tax treatment of companies, the tax treatment of other entities, the regulatory environment for different kind of entities including CIVs and how the country taxes non-residents.

4.5 Details of the main CIVs used in the UK (authorised investment funds, authorised unit trusts, open ended investment companies and real estate investment trusts), Ireland (collective investment funds, variable capital investment companies,

common contractual funds, investment limited partnerships and qualifying investor funds) and in the US (real estate investment trusts, regulated investment companies, limited partnerships and entities using the check-the-box rules) are set out in Appendix B.

4.6 Drawing on international analysis, it is understood that a typical structure of a CIV comprises:

- the investment fund (comprising the financial assets purchased with the funds provided by investors, together with available cash reserves);
- the management company (the entity that collects the money from investors, invests in accordance with the objectives and policies of the fund, calculates the net asset value per unit of the fund and issues and redeems units, shares or other interests as requested by the investors);
- the fund manager (engaged by the management company to advise and manage the portfolio of investments);
- the custodian, trustee or depositary (entrusted with the assets of the fund and with the exercise of any rights in respect of the entrusted assets, including overseeing that the issuance and redemption of units etc are carried out, and the value of units etc calculated, in accordance with the law and fund rules); and
- the investors, who provide the money for investments in the fund and in consideration receive one or more securities (such as units in a unit trust) that entitle them to the income or gains generated by the fund, net of expenses.

4.7 Open-ended funds refer to CIVs in which the units (or shares etc) can be redeemed upon an investor's request at a value corresponding to the net asset value of the unit. Most open-ended funds continually offer new units to investors. They are open in the sense that through the issuance and redemption of units, the number of units may change on a daily basis. Only open-ended CIVs can qualify as Undertakings for Collective Investments in Transferable Securities (UCITS) under the EU Directives[12].

4.8 By contrast, closed-ended funds have a fixed capital and are not obliged to redeem units etc upon an investor's request. Their units, shares or other interests are typically traded on a stock exchange and their total value does not necessarily correspond to the net asset value of the fund, instead being determined by ordinary stock market forces. Australia's LICs are examples of closed-ended funds.

4.9 Some closed ended funds are not traded on a stock exchange. These may be designed for a specific set of investments that require patient capital. In these cases the

12 See Appendix B for further discussion and background on UCITS.

fund's assets are sold after a pre-determined period and the proceeds distributed to investors.

4.10 CIVs can also operate through a variety of legal structures offered within a jurisdiction. These include a corporation, trust, partnership, co-ownership of property or contractual arrangements.

4.11 Depending on the jurisdiction, different legal structures will be governed by differing levels of regulation. For example, partnerships in Australia are governed by state laws, whereas most corporations are governed by federal corporations law. Some jurisdictions may also have overarching regulation which governs the operation of CIVs which may be dependent or independent of the legal form the vehicle may take.

4.12 For example, the UCITS Directive imposes regulations across CIVs operating in the EU. Common basic rules are set for such things as the structure of investment funds, management companies, investment policies, information disclosures, and authorisation and supervision requirements. These rules will apply despite the legal form of the investment fund, giving a consistency of protection and assurance to investors.

4.13 In the case of UCITS, some governance remains subject to the particular laws of each EU member state. This includes marketing and advertising rules. It is important to note that taxation of UCITS is governed by the particular tax laws of each member state, and is not part of the overarching EU UCITS regime.

4.14 Broadly, there are four generic models for taxation of CIVs that are utilised throughout the world.[13] These are set out below.

4.15 In principle, the taxation models discussed could apply to CIVs regardless of their legal form. However, the appropriateness of a particular taxation model for the purposes of enhancing Australia's status as a regional financial centre will depend on a number of factors, including the existing tax and other legal frameworks which apply to each legal structure in Australia, the complexity of the tax rules which would need to be created and the compliance burden placed on CIVs and investors.

Flow-through model

4.16 In its purest form, this model treats the CIV as fully transparent and allocates all the different items of income and losses to the investors. Investors are treated as if they earned the income directly and are taxed accordingly, even if the CIV does not distribute the income.

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13 This section follows the discussion by Eric Zolt (Victor Thuronyi, ed) in *Tax Law Design and Drafting*, 1998, International Monetary Fund, Chapter 22, Taxation of Investment Funds and by the OECD in *Taxation of Cross Border Portfolio Investment*, 1999.

4.17 The CIV is disregarded for tax purposes, that is, tax effects occur at the level of the investor and the CIV is merely a conduit by which the individual derives the income or loss, comparable to the way in which partnership income is treated in many countries.

4.18 The Common Contractual Fund (CCF) in Ireland is an example of a transparent CIV. The CCF is exempt from Irish tax, and income and gains arising or accruing to the CCF are treated as arising or accruing to the unit holders. Each investor receives an annual breakdown of income on investments by type and source.

The exemption model

4.19 The CIV may be recognised as a taxable entity, but be wholly exempt from tax on any item of income or capital gain if it meets certain conditions.

4.20 Variable Capital Investment Companies (VCICs) domiciled in Ireland that are established in accordance with the conditions established in the UCITS Directive can be described as an example of an exempt CIV. No tax is imposed at the fund level and non-resident investors are exempt from withholding tax on distributions[14]. Appendix B provides further details of the tax treatment of CIVs in Ireland.

The distribution model

4.21 The CIV is subject to tax at normal rates, but usually the tax is nil or close to nil because of the way the tax base is constructed (usually featuring a deduction for distributions, often again subject to criteria specifically designed for CIVs).

4.22 Under this model the CIV is taxed on any undistributed income and investors are taxed on any income distributed to them. Countries that follow this model generally require funds to distribute a substantial portion of their income each year.

4.23 US REITs and mutual funds or regulated investment companies are examples of CIVs whose taxation regime is structured under a distribution model. US REITs are treated as corporations for tax purposes but receive deductions for dividend distributions of current year income and capital gains. US REITs must annually distribute at least 90 per cent of their ordinary taxable income.

4.24 A distribution model could also be implemented under a 'deemed distribution' approach, whereby CIVs are not required to actually make the required minimum distributions to access the deduction, and investors are taxed as if they had received the distributions and reinvested the corresponding amounts.

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14 Irish resident investors are subject to a withholding tax on distributions from the VCIC. A similar taxation treatment operates for the equivalent open ended or variable capital investment companies that operate in Luxembourg and France (denominated SICAVs).

The integration model

4.25 The CIV is recognised for tax purposes and subject to tax at normal rates, with full integration of the tax on the CIV and tax on the investor in the CIV by way of an exemption for the investor or through the provision of full imputation credits.

4.26 Australia's corporate taxation regime, with franking credits attached to any Australian source dividend received by resident investors and withholding tax exemption for any fully franked dividends paid to non-residents, has elements of a partial integration model, although it is not a model specifically designed for CIVs.

4.27 Any recommendations on appropriate CIV vehicles should provide investors, particularly those at the retail level, with high levels of consumer protection and assurance (such as those afforded by existing corporations law or other regulations).

Q 4.1 Issues / Questions

The Board seeks stakeholder comments on:

- the appropriateness of any of the taxation models (including variants) to achieve tax neutrality for designing a corporate CIV regime that would enhance industry's ability to attract funds under management in Australia;
- the appropriateness of any of the models (including variants) to achieve tax neutrality for designing a limited partnership CIV regime that would enhance industry's ability to attract funds under management in Australia; and
- whether there are any critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes, including by rationalisation of the regimes where possible.

THE SIGNIFICANCE OF TAX TREATIES AND FOREIGN TAX ON CIVS

4.28 International issues of relevance to the taxation treatment of CIVs often arise under tax treaties and the impact of foreign tax laws. Australia needs to take account of these issues in designing its domestic tax and regulatory laws for CIVs.

4.29 Tax treaties as a whole cannot be changed in the short to medium term due in part to the need to negotiate them on a bilateral basis. Moreover, Australia can only have minimal influence on the shaping of foreign tax laws relating to CIVs (generally on a country specific basis through Australian private sector efforts to make sure their concerns are taken account of by the foreign country and on a broader basis through Australian public sector efforts at the OECD).

4.30 Because of the numerous tax treaties with different rules and the various foreign countries concerned, it is not possible to discuss all the issues that may arise nor deal with them in detail. Accordingly, some of the benefits and detriments of transparent or flow-through CIVs compared to those of non-transparent corporate CIVs are outlined in this section in general terms only.

4.31 In designing options for CIVs in Australia it is necessary to identify which countries' laws are of greatest relevance and what particular issues cause the greatest impediment to cross-border investment into Australian CIVs.

4.32 With respect to transparent or flow-through CIV forms, the following general issues can be noted:

- For tax treaty purposes, an Australian MIT is regarded by most countries as transparent with the result that treaty benefits (such as reduced withholding taxes at source for foreign income derived by the MIT) have to be claimed by investors in the MIT.

- The tax treaty complexities remain unless special provision is made in treaties to allow Australian MITs to claim treaty benefits in their own right (subject to conditions) as under the recent Australian / New Zealand treaty.

- Differing tax treatments apply under the corresponding bilateral treaties to the various forms of Australian source income derived by the MIT. Foreign resident investors can find it difficult to understand the Australian withholding tax regime.

- On the other hand, foreign investors who have preferential tax treatment under Australian law, such as foreign resident pension funds and sovereign wealth funds, benefit from the transparent nature of the MIT.

- To the extent that a transparent Australian MIT derives foreign income, that income can often flow through Australia without any tax and there are no tax impediments of the kinds that can arise with corporate CIVs (see below).

4.33 With respect to corporate CIVs the following general issues, which in a broad sense are the converse of the position of transparent CIVs, can be noted:

- For tax treaty purposes, an Australian corporate CIV would in most countries generally be entitled to claim treaty benefits in its own right and would be subject to the dividend article of tax treaties with respect to its distributions, giving Australia generally the right to levy 15 per cent withholding tax on the distributions. This creates more certainty for foreign investors as to the Australian tax rate on distributions and can be more user friendly for foreign resident retail and wholesale investors.

- However, it may be necessary for Australia to impose portfolio or 10 per cent investment limits in such corporate CIVs because of the more beneficial treaty tax rates that are available under some existing Australian treaties for investors holding 10 per cent or more voting interests in Australian companies.

- Foreign resident investors who are entitled to more beneficial treatment under Australian treaties or domestic law for direct investment may be disadvantaged unless a treaty provides similar beneficial treatment for dividends derived by them from a corporate CIV (as also in the recent Australia New Zealand treaty for sovereign wealth funds in relation to dividends).

- To the extent that an Australian corporate CIV derives foreign source income it will generally be able to benefit from tax treaties as the CIV is an Australian resident in its own right (subject to any treaty shopping safeguards in the relevant treaty). However, it may be difficult for the CIV to pass through to foreign resident investors the benefit of a foreign tax credit received by the CIV against foreign withholding tax levied on its foreign source income.

4.34 The Board has recommended, as part of its MIT review, that Australia be an active participant in work undertaken by the OECD on the granting of treaty benefits with respect to CIVs. The Board has also recommended that Australia ensures in future treaties that treaty language is flexible enough to accommodate both an MIT regime and a potential flow-through corporate CIV regime.

A NEW CORPORATE CIV

4.35 In the terms of reference, the Board has been specifically asked to consider the degree to which a non-trust tax flow-through CIV would enhance industry's ability to attract foreign funds under management in Australia.

4.36 At the time of the Board's review of the MIT regime, a number of submissions made to the Board recommended the introduction of a new corporate CIV whose characteristics were similar to those of an MIT.

Tax flow-through for a corporate CIV

4.37 The Board recognises that a key issue in designing a new corporate CIV is how tax flow-through to investors can be best achieved using a corporate structure. There will be a trade-off between achieving a full tax flow-through while also achieving tax rules which are not overly complex and which do not impose excessive levels of compliance issues for a CIV, its investors and the ATO.

4.38 As part of their submissions to the Board during the MIT review, some stakeholders suggested that the components of a distribution of a potential flow-through corporate CIV should be kept to a minimum. For cash items there would

be a distinction between foreign and Australian source income, capital gains and return of capital. For non-cash items, a distinction would be made between franking credits and foreign tax credits. Under this proposal, the concept of tax deferred distributions would be removed.

4.39 There might be categories of foreign resident investors (such as foreign resident pension funds and sovereign wealth funds) for which the above treatment would not provide the same beneficial tax outcome as if they had invested directly. Rather, they may require an alternative legal form vehicle such as the Irish Common Contractual Fund.

Determining tax liabilities and preventing accumulation of income

4.40 Another key issue in designing a new corporate CIV is what approach should be taken to determine the tax liabilities of investors in the corporate vehicle and how to prevent the accumulation of profits in the vehicle.

4.41 As part of the submissions to the Board on the CIV review, some stakeholders suggested that corporate CIVs be treated as non-tax paying corporate entities with a certain level of flow-through treatment. Under this suggestion:

- CIVs would calculate their taxable income in accordance with the general provisions of the Income Tax Assessment Acts.
- Their cash distributions would be required to be, as a minimum, their taxable income on a yearly basis.
- While the corporate CIV would not be entitled to the CGT discount, the investors would be entitled, upon distribution of the taxable income, to claim the relevant CGT discount attributable to their distribution.
- Investors in CIVs would be assessed on the distributions received on a 'receipts basis'.

4.42 If the above tax treatment were to be achieved by a dividend deduction model as applied in the US, corporate tax could still be levied if dividends did not equate with taxable income (disregarding offsets). In that case, as under an exemption model, it would still be necessary to determine rules to preserve appropriate taxation of non-residents on Australian source income derived by the CIV and of Australian resident investors on their income derived from the corporate CIV. An attribution method of taxation could be used to achieve this outcome.

Other issues

4.43 Interaction with existing tax rules governing corporations such as imputation credits would depend on the design of the regime. If the normal corporate tax rate were applied to any income taxable at the corporate level, then the franking system

could probably deal adequately with distributions of that income (taxable with imputation credits for residents and exempt from withholding tax for non-resident investors). If the corporate tax rate were different, it would be more difficult to apply the imputation system.

Q 4.2 Issues / Questions

The Board seeks stakeholder comments on:

- what would be the most appropriate method to achieve an outcome similar to tax flow-through for a corporate CIV;
- what would be the most appropriate method to determine the tax liabilities of investors in a corporate CIV;
- under what circumstances would it be appropriate to assess tax on a corporate CIV, at what rate, and what should be the tax consequences of the payment of the tax for investors;
- what special rules would be necessary to mesh the corporate CIV appropriately with the rest of the Australian tax system; and
- would it be appropriate to extend the MIT regime to a corporate entity, by deeming qualifying corporate entities to be trusts for tax purposes? What modifications would be required for corporate entities under such a regime, and would this be feasible without adding undue complexity to the tax and company law?

CHAPTER 5: INVESTMENT MANAGER REGIME

5.1 This Chapter outlines the background to the investment manager regime (IMR) aspect of the Board's review, including the recommendation of the AFCF.

5.2 Some issues with Australia's existing approach to the taxation of certain non-resident investments into Australia are examined.

5.3 Work has already been done by Treasury, in consultation with industry, on the scope for early delivery of an IMR.

5.4 In the next section a brief background is provided on the history of proposals for an IMR. This is followed by a brief summary of the main issues raised by Australia's current tax treatment of foreign funds, which were mainly explored through Treasury's consultation paper on improving conduit income arrangements for managed funds.[15] The design of an IMR is then discussed as a potential response for issues affecting foreign funds. The chapter concludes with an examination of the potential application of an IMR beyond foreign funds to other areas of the financial sector.

BACKGROUND

5.5 The Board has been asked, as part of this review, to examine and report on the design of an IMR for investments by foreign residents managed in Australia. The design will seek to provide a set of clear and comprehensive rules on the taxation of certain non-resident investments into domestic and offshore assets.

5.6 The proposal for an IMR arose from recommendation 3.1 contained in the report from the *Australian Financial Centre Forum Australia as a financial centre: Building on our strengths* (the 'Johnson report').

5.7 The Johnson Report found that Australia has a strong, innovative and well regulated financial sector and it should be taking full advantage of our strengths in this area by exporting skills and experience. While the Report found there are a number of reasons why this had not occurred to a significant extent, it stated a critical reason

15 *Developing an Investment Manager Regime, Improving conduit income arrangements for managed funds*, consultation paper at http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1806

which government could address is widespread uncertainty surrounding the taxation of cross-border financial transactions.

5.8 The Johnson Report found a major reason for the high level of tax uncertainty was that many tax concepts central to the treatment of foreign income, such as 'permanent establishment', 'source', 'capital/revenue' and 'central management and control' (relevant for establishing residence), were inherently nebulous. Specifically, the Johnson Report identified the following main areas of concern regarding the clarity and scope of the tax system as it applies across the financial sector:

- what determines, for tax purposes, the level of activity at which a foreign fund or foreign entity will be considered to have a taxable presence in Australia (permanent establishment);
- what determines where an organisation earns its income (source);
- what determines what types of income an organisation is deemed to have earned, in particular whether that income is a capital gain or revenue (capital/revenue distinction); and
- the tax implications of where management decisions are taken (residence).

5.9 The Johnson Report proposed the introduction of an IMR as the most effective and efficient means of improving current taxation arrangements, arguing such a regime would make Australian fund managers more attractive to foreign investors and also encourage both Australian and international financial services companies to establish their regional headquarters in Australia.

5.10 In essence, the Johnson Report recommended that the IMR (Johnson IMR) comprise the following:

- for non-resident investors using an *independent* resident investment adviser, fund manager, broker, exchange or agent — conduit relief (in the case of investments in foreign assets) and neutral treatment[16] (in the case of investments in Australian assets);
- for non-resident investors using a *dependent intermediary acting at arm's length* — conduit relief (in the case of investments in foreign assets) and current taxation treatment (in the case of investments in Australian assets), subject to an agreed de minimis exemption to cater for global investment strategies that may include a nominal portion of Australian assets. Any Australian assets under the de minimis exemption would be treated as if the investment had been made directly without the use of any Australian intermediary (that is, neutral treatment); and

16 In this context, neutral treatment means that a foreign investor investing in an asset indirectly (for example, through an intermediary) should broadly be taxed as if the investor had invested directly.

- changes to the central management and control test so that a foreign entity covered by the IMR is not considered an Australian tax resident solely because central management and control is in Australia.

5.11 *The Australia's Future Tax System Review* (the AFTS review) also examined Australia's taxing arrangements as they applied to managed funds and found that the current arrangements could result in uncertainty concerning the taxation of conduit income — the foreign source income earned by non-residents through investing via Australian funds.

5.12 The AFTS review noted the ease with which savings can be reallocated between managed funds in different jurisdictions. Any Australian tax on conduit income — or even the risk of tax — can have a significant impact on the investment decisions of a non-resident investor. Taxes on such income, can reduce the competitiveness of Australian intermediaries (that is, Australian fund managers, investment advisers and brokers), discouraging their use.

5.13 The AFTS review recommended that the taxing arrangements of managed funds be improved to provide greater certainty that conduit income was not subject to tax (Recommendation 35).

5.14 On 11 May 2010 the Government announced the process for developing the key features of an IMR and that, as a first stage in the process, it had asked the Treasury to consult on issues relating to the taxation of conduit income of managed funds. Concurrently with that announcement, Treasury released its consultation paper on improving conduit income arrangements for managed funds.

5.15 On 12 July 2010 the Government announced a further stage in developing an IMR by requesting the Board to consider the design of an IMR as part of its review of CIVs. It also asked Treasury, in consultation with the Board, to report by 31 October 2010 on the scope for early delivery of an IMR.

5.16 Treasury received a number of submissions from industry in response to the consultation paper on the taxation of conduit income of managed funds. Submissions were generally wide-ranging and comprehensive. Key messages from submissions were that:

- while the Johnson Report recommendation for an IMR was that it should apply more broadly than funds management, most of the current issues/problems arose in relation to the funds management sector, particularly foreign managed funds;

- Australia's taxing arrangements for managed fund investments were out of step with a number of overseas jurisdictions;

- a clear and specific legislative regime was a superior means of improving the tax treatment of cross border investment over 'piece-meal' changes (such as clarifying or providing source rules), which may result in additional complexity; and
- the specific legislative regime should take the form of an exemption model, similar to that implemented in the United Kingdom (UK).

5.17 The following objectives may be appropriate to address foreign funds management issues:

- ensure taxing arrangements for foreign managed funds are appropriately designed so that highly tax sensitive income is lightly taxed, enhancing Australia's ability to attract non-resident portfolio capital;
- more closely align Australia's taxing arrangements for managed fund investment with international financial centres such as the United Kingdom, Hong Kong, Singapore, and the United States;
- reduce the complexity of taxing arrangements for foreign managed funds; and
- remove disincentives to engaging Australian based intermediaries (which arise under the current arrangements).

ISSUES RAISED BY AUSTRALIA'S CURRENT TAX TREATMENT OF FOREIGN FUNDS

5.18 Australia's international tax arrangements revolve around the basic concepts of residence of the taxpayer and source of the income. Australian residents are, as a general rule, taxable on their world-wide income. Non-residents are only taxable on their Australian source income.

5.19 As noted above, this section draws from Treasury's consultation paper and considers the current tax arrangements for certain non-resident investment in domestic and offshore assets. The consideration specifically focuses on issues affecting foreign managed funds investing in or via Australia. It details problems with the existing tax arrangements for foreign managed funds and how they may impede Australia's development as a leading regional financial centre. The issues identified may be relevant to foreign investment beyond the managed funds industry.

Responsiveness of capital to taxation

5.20 Globalisation has increased the mobility of capital, with important implications for tax policy. While investment is affected by tax and non-tax factors, a country's tax settings are increasingly important when it comes to attracting and retaining international capital.

5.21 Taxing mobile capital may see:

- the incidence of the taxation shifted to less mobile factors (for example, a reduction in wages for labour or lower rents for land); or
- capital relocating to jurisdictions with a more favourable tax treatment.

5.22 Foreign capital flows are generally segmented into two categories: non-portfolio and portfolio investment. Non-portfolio investment confers a significant degree of influence in the management or control of the entity in which investment is made, while portfolio investment does not.

5.23 In Australia, a foreign portfolio investment is generally defined as one where the non-resident investor has an equity interest in the entity of less than 10 per cent.

5.24 As portfolio investments are typically more liquid in nature compared with non-portfolio, they are more likely to be mobile and responsive to source taxation. For these reasons, many countries do not tax, or only lightly tax, portfolio investments on a source basis.

5.25 To the extent that Australia's tax arrangements are uncompetitive — either because they result in higher effective tax rates or increased complexity — mobile investment may move from Australia to other countries or may not come to Australia in the first place.

Conduit income

5.26 Broadly, conduit income refers to foreign source income derived by a non-resident from investments structured through or facilitated by an entity resident in a third country ('the conduit country'). From a practical perspective, one approach to identifying when tax is being imposed on conduit income is to consider whether the income in question would have been subject to tax had the foreign residents derived it directly or through an interposed foreign entity.

5.27 In general, Australia does not seek to tax conduit income, consistent with the principle that non-residents should be taxed on their Australian source income only.

5.28 Conduit income may be taxed where there is an application of the residence or source rules.

- Taxing resident entities on a world-wide basis may have the effect of taxing non-resident owners in respect of foreign source income. To the extent branches or permanent establishments are treated like residents, similar issues may arise.

- Source taxation may give rise to conduit taxation issues where income is treated as being Australian source for tax purposes but has a limited economic connection with Australia.

5.29 Conduit relief is a response to the potential over inclusion of foreign source income in the Australian tax base.

5.30 Australia already has a number of rules that provide conduit relief. Some rules only apply in respect of non-portfolio interests. For example, Australian resident companies are not subject to Australian tax on most income from non-portfolio offshore investments whether retained offshore, paid as a dividend to the company or realised as a capital gain (the dividend exemption regime). When dividends are paid to non-residents from this exempt foreign source income, no dividend withholding tax is imposed (the conduit foreign income regime).

5.31 Conduit relief is not necessary to the extent that an entity is transparent for tax purposes. For example, for partnerships, foreign income that flows to a non-resident partner is not taxed in Australia. For trusts, a non-resident beneficiary is not assessable on foreign source income derived by the trust. Of course, in these cases, the question of what is foreign source income remains.

5.32 Where existing rules providing conduit relief are in place, consideration could be given to how their operation could be improved.

5.33 Consistent with Australia's general international tax principles, if a non-resident invests in offshore assets through an offshore managed fund, Australian tax generally does not apply unless:

- the returns from the offshore assets are sourced in Australia; or
- the fund itself is treated as a resident of Australia or is deemed to have a permanent establishment in Australia.

Source

5.34 Australia currently has a mix of common law and statutory source rules (under domestic law) and treaty source rules. The Johnson Report and industry submissions to Treasury have expressed concerns predominantly about the clarity and operation of the common law source rules.

5.35 As noted in Treasury's consultation paper on conduit income, source rules should reflect the location of the economic activity generating the income and any legal protection facilitating the earning of that income. Ideally, these rules would be clear and minimise case by case determination on the facts, they would reflect any international consensus on such rules and they would apply neutrally in determining Australian and foreign source.

5.36 A mixture of rules support the exercise of source taxation. Some of these are explicitly expressed in the income tax statutes; while others are implied in specific taxation arrangements (for example, withholding taxes for payments of unfranked dividends, interest, and royalties).

5.37 Where statute does not determine the source of income, source is determined according to case law. While the source of income is said to be 'a practical hard matter of fact' and to be determined by considering all the facts and circumstances of the particular case[17], decisions have indicated that a number of factors may be important to establishing source.

5.38 For example, the source of gains from the sale of securities depends on a range of factors, including the:

- essence of the taxpayer's business;
- activities that actually realise the profit, that is, the sale of securities;
- place where the contracts for purchase of securities are concluded;
- location of the stockbroker who concludes the buy or sell order; and
- location of the entities whose securities are traded.

5.39 Where the place of contract is a relevant factor in determining source of income, there are challenges for businesses that need to establish the source of income where a large volume of financial transactions are undertaken electronically. In addition, reliance on case law may result in income being given an Australian source merely because a contract is executed in Australia, notwithstanding this may not reflect the location of the economic activity generating that income. Such a source rule may discourage the use of Australian financial services intermediaries (fund managers, investment advisers or brokers).

5.40 The Johnson Report expressed concerns regarding the clarity and operation of the case law source rules, stating 'there can be considerable uncertainty as to what constitutes Australian sourced income, for two main reasons. The first is the lack of any statutory rules in this area, and the complex and at times antiquated set of common law principles that are relied on. The second and related factor is the continuous innovation and internationalisation of financial markets. The interaction of these factors means that the determination of source can depend on where key investment decisions were made or just on the place where the contract was concluded, which may in turn depend on whether a local broker, manager or agent has been used'.

17 *Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183.*

5.41 An example of issues of concern is the case where currency profits from hedging in regards to currency exposure from investment in foreign shares could at present be subject to tax in Australia due to investment decisions being made in Australia. It is understood similar issues exist regarding futures contracts.

5.42 Industry has indicated, in consultations with Treasury, that providing neutral treatment would not resolve these issues completely. An alternative to address these issues is to take an exemption approach.

Revenue gain or capital gain

5.43 A related cause of tax law complexity is determining the character of gains (and losses) arising from the disposal of investment assets.

5.44 The character of the gain (or loss) is important because the tax law generally treats gains and losses from capital differently from gains and losses from revenue:

- if the gain (or loss) is on 'revenue account', it is treated as ordinary income, and will be assessable to non-residents if sourced in Australia; or

- if the gain (or loss) is on 'capital account', it is treated as a capital gain (or a loss), and will be disregarded to non-residents unless they arise from taxable Australian property. Broadly, this comprises direct interests in land, non portfolio interests in land rich entities, or business assets of an Australian permanent establishment.

5.45 Due to the relatively few statutory rules in this area, the character of the gain is determined according to case law principles applied to the facts and circumstances of the particular case.

5.46 The Johnson Report identified the distinction between revenue and capital gains as being a 'major issue for the financial sector, and the funds management sector in particular'.

5.47 Legislation recently passed by Parliament permits Australian MITs to make an irrevocable election to apply the capital gains tax (CGT) regime to disposals of certain assets (predominantly, shares, units and real property).

5.48 These changes arose from a finding by the Board that 'the existing approach of applying case law principles in order to determine the character of gains and losses made on the disposal of assets by MITs created a material level of complexity and uncertainty for the funds and for certain investors, as well as administrative costs for the ATO.' These changes only affect the treatment of disposals by Australian MITs.

5.49 Those MITs that make an irrevocable election into the CGT regime will largely have certain outcomes both in terms of the revenue/capital distinction and the source

of income (because of the significantly greater clarity of the operation of the CGT 'source' rules).

5.50 However, the revenue/capital distinction and related source issues continue to be an issue for foreign managed funds.

5.51 It appears that this is particularly of concern to the alternative asset management market, such as foreign hedge funds, due to the more active nature of their investment strategies. Some submissions to Treasury noted that this issue also arose for other investments, for example disposal of investment-linked notes, certain derivatives and debt interests held by non-residents.

Residence

5.52 The Johnson Report argued that, as having central management and control in Australia could result in an offshore entity being treated as an Australian resident, it was 'standard practice … [that] for offshore entities … all important board decisions not be made in Australia and that only a minority of board directors are Australian residents'. The Johnson Report recommended that 'the location of central management and control in Australia of entities that are part of the regime will not of itself give rise to Australian tax residency of those entities'.

5.53 The Johnson Report 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.

5.54 In the case of corporate limited partnerships, the fact that a corporate limited partnership can be treated as an Australian resident solely because it carries on business in Australia appears to result in inconsistent treatment between companies and corporate limited partnerships, which are meant to be taxed as companies.

5.55 A foreign company is treated as an Australian tax resident if it carries on business in Australia and either has its central management and control in Australia or has its voting power controlled by Australian resident shareholders. This contrasts with the status of a foreign fund that is a limited partnership which is considered an Australian tax resident if it carries on business in Australia or has its central management and control in Australia.

5.56 In the context of Treasury's consultation on an IMR, in particular in relation to the impact of US Accounting Standards Code 740-10, industry opinions differed as to the urgency (and scope) for any changes to the residence rules for collective investment vehicles, particularly for limited partnerships (LPs).

Permanent establishment

5.57 The Johnson Report indicated that 'depending on the level of activity in Australia, a foreign fund or a foreign entity may be deemed to have a "permanent establishment" in Australia … if it uses an Australian investment adviser or fund manager … [which may result] in the fund paying Australian income tax or losing the benefit of the capital gains tax exemption for non-resident investors'.

5.58 Foreign managed funds may engage or deal with a number of entities (or intermediaries) based in Australia. For example, a broker or investment adviser in Australia may provide services to a foreign managed fund. Alternatively, a foreign managed fund may establish an investment adviser in Australia and contract investment management functions to that adviser. These situations may result in the foreign fund being taken to have a permanent establishment in Australia which so far as relevant involves a fixed place of business in Australia of a taxpayer or a dependant agent habitually concluding contracts in Australia on behalf of the taxpayer.

5.59 In general, once a non-resident entity is taken to have a permanent establishment in Australia and is found to be carrying on business through that permanent establishment, Australian tax may apply to business profits attributable to the permanent establishment. The attribution of profits is generally determined with reference to the functions, assets and risks of the permanent establishment.

5.60 In relation to capital gains of a non-resident, the tax law operates differently. Taxable Australian property is defined to include assets used in carrying on business through a permanent establishment. It may be that the use of an asset in carrying on a business is a different threshold when compared with the functions, risks and assets approach.

5.61 Where an amount greater than an arm's length fee for services becomes subject to Australian tax through the existence of a permanent establishment, there normally is a disincentive to use Australian based intermediaries.

5.62 Submissions to Treasury reflected a concern that the permanent establishment rules may result in over taxation on the basis that a foreign fund with a permanent establishment in Australia could be taxed on gains from assets that were not taxable Australian property (including conduit income) due to CGT exemptions in Division 855 of the ITAA 1997 not applying if a non-resident was taken to have used the assets in carrying on business in an Australian permanent establishment.

5.63 Submissions argued that the lack of a bright line test for the financial sector as to when they will be found to have a dependent agent permanent establishment is of particular concern to industry.

5.64 Submissions agreed that the activities undertaken by the fund manager located in Australia should be captured by taxation of the fees.

CONSIDERATION OF THE ISSUES

5.65 Creation of certainty of tax treatment for international investors is an important part of addressing portfolio capital mobility as well as having an internationally competitive system.

5.66 The Board is not addressing in this review substantive changes to the general tax system in terms of competitiveness. This review by the Board is confined specifically to CIVs, the IMR and venture capital and mobility of capital, and competitiveness is considered only so far as relevant to those issues.

5.67 Several countries have enacted specific IMR provisions intended to create such certainty even though in some cases the same result would follow under the normal rules.

5.68 Normally Australian taxing rights arise if local activities constitute an Australian permanent establishment, residence or source presence for foreign investors. Those norms are concerned essentially with the taxation of non-portfolio investment and are important in that context to maintaining the integrity of the Australian corporate tax base. The funds management area, however, is arguably often different from more active forms of investment.

5.69 Funds management spans a range of activities from making an initial investment and monitoring that investment which may involve very little activity, to very active management of portfolio investments, to direct involvement in the management of the ultimate companies and other entities in the real economy in which investments are made.

5.70 Funds management may also take a variety of legal and economic forms from the ultimate investor making the investment in their own right and receiving investment advice in doing so to the ultimate investor placing funds completely at the discretion of a CIV or other investment vehicle.

5.71 The mobility of portfolio capital principle suggests that Australian taxing rights over foreign investors (putting aside withholding taxes) should generally be confined to the non-portfolio case. For portfolio investments where funds management activities occur in Australia, this principle suggests that Australia should be taxing the separate profits of the fund manager only and not the profits of the investor.

5.72 The permanent establishment rules can lead to mobile portfolio investment through CIVs and funds management more broadly having permanent establishments despite the investor not having a real presence in Australia. This may be an inappropriate outcome.

5.73 Similar results can occur from the central management and control test for very passive investments unless careful attention is directed to the residence of directors or

trustees and of the location of meetings where strategic management decisions are taken. Australian domestic source rules that apply outside the tax treaty context can on one interpretation give an Australian source for investment profits just because a transaction is effected on the Australian Securities Exchange.

5.74 An IMR may be able to set a specific Australian tax border for foreign investors using Australian based funds management services, without disturbing the operation of the general rules for taxing non-portfolio investment.

DESIGN OF A FOREIGN MANAGED FUNDS IMR

5.75 One option for the design of an IMR is an exemption style IMR that is applicable to portfolio income of foreign managed funds. The potential key design features of such an IMR are set out below:

Potential key design features of an IMR for foreign managed funds

An exemption style IMR could provide:

- a tax exemption from Australian tax (other than withholding tax) for foreign managed funds in respect of eligible investments (generally, portfolio investments, other than in Australian land); and
- if an Australian based intermediary is used by the foreign fund, the intermediary would be subject to tax only on the arm's length fees for their services.

5.76 The appropriateness of an exemption style IMR, how to determine the appropriate amount of Australian tax on Australian intermediaries, the definition of foreign managed fund, the precise nature of eligible investment, and appropriate integrity measures are discussed below.

Exemption style IMR

5.77 Under an exemption style IMR, a tax exemption is provided for specific investments by defined investors. The exemption regime could largely bypass current revenue/capital, source, permanent establishment and attribution issues identified in the Johnson Report. Such an approach may have simplicity benefits by removing the need for investors to work through a series of, at times, uncertain provisions in the law.

5.78 Though in some respects the exemption may operate more broadly in limiting Australian taxing rights than is the case under current law, its main purpose could be to provide certainty as to the operation of Australian taxing rules in the funds management area and consistency of treatment to foreign investors. It could also be consistent with the approach used in a number of competing jurisdictions that have

introduced an IMR (including the United Kingdom, Singapore and Hong Kong – Appendix C provides a summary of the main features of these regimes).

5.79 Submissions to Treasury indicated that a clear and specific legislative regime is important and tax issues concerning cross border investment should not be addressed in a 'piece-meal' fashion (for example, through providing source rules).

Q 5.1 Issues / Questions

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?

Arm's length fee of Australian based intermediary

5.80 If an amount greater than the arm's length fee for the management function becomes subject to Australian tax, it could discourage the use of Australian based funds management intermediaries by foreign managed funds. This may constrain the expansion of the Australian funds management sector and its ability to attract foreign capital. One option is for such Australian intermediaries used by foreign managed funds to be taxed only on their arm's length fees.

5.81 The UK has addressed this issue through its Investment Manager Exemption rules, which effectively exempts investment income and requires that the income derived by a UK investment manager from providing management services remain taxable in the UK. The rules also provide that the UK investment manager must receive remuneration at a rate not less than what is 'customary' for the services provided. Transfer pricing rules in Australia's domestic law and tax treaties may be sufficient to address issues regarding the manipulation of management fees.

5.82 In designing a regime which seeks only to tax Australian intermediaries used by foreign managed funds on their arm's length fees, a number of ring-fencing issues arise. These include how the arm's length treatment would apply in the case of an Australian branch office of a foreign managed fund undertaking both funds management and other active business activities in Australia.

5.83 The case of a foreign managed fund with an Australian branch office managing Australian and non-Australian assets or portfolio and non-portfolio assets would also need to be considered.

Q 5.2 Issues / Questions

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?

Definition of foreign managed funds

5.84 A foreign managed fund is likely to have the following features:

- it is not an Australian resident;
- it is widely held;
- it undertakes passive,[18] typically portfolio investment; and
- it does not carry on or control a trading business in Australia (except to the extent that its dealings in securities may amount to trading).

5.85 As foreign managed funds may take a variety of legal forms, including companies, trusts, limited partnerships or even contractual arrangements, it seems important that eligibility for an IMR not be affected by the legal structure of the foreign managed fund. This would be consistent with the policy principles in the terms of reference. The IMR could include hedge funds or other foreign collective investment vehicles whatever their legal form, to the extent that they have the above features. The case of Australian residents investing into a foreign fund covered by the IMR exemption is discussed further below in the section discussing appropriate integrity measures.

5.86 The requirement that the fund be widely held reflects the terms of reference. The widely held requirement should be designed so a wholesale fund that has member funds that are widely held should be able to qualify as widely held.

5.87 The requirement to not carry on or control a trading business in Australia is intended to ensure taxation of 'active' business income from Australia is maintained and the tests in Division 6C of the ITAA 1936 are an appropriate starting point for

18 As defined under Division 6C of Part III of the ITAA 1936, which includes trading in financial instruments such as shares and units.

consultation. This requirement ensures a foreign managed fund does not have a competitive advantage over other entities engaged in 'active' business and safeguards the Australian corporate tax base.

5.88 Some comments were received by Treasury during consultation proposing that funds covered by an IMR should avoid the 'managed in Australia' requirement that was recently included in the definition of an MIT for the purposes of the MIT withholding tax. The managed in Australia requirement was introduced in conjunction with a concessionary withholding tax rate for fund payments made by MITs to non-residents.

5.89 Other industry participants have noted that Singapore has a minimum advisory service spend amount to ensure the local financial services industry and economy achieve greater benefit and that there is some value adding functions performed in Singapore. This requirement appears to be designed as part of a regime to provide concessionary tax treatment for foreign funds utilising Singaporean intermediaries.

Q 5.3 Issues / Questions

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?

Portfolio, passive investments

5.90 The terms of reference require that the tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment. An exemption style IMR is one option to achieve this outcome.

5.91 The exemption could potentially provide that income from the specific portfolio, passive investments of a foreign managed fund be exempt from tax other than final withholding tax on dividends, interest, royalties and MIT fund payments.

5.92 Australia's taxing rights that turn on the residence, permanent establishment and source rules may operate as a relatively blunt instrument in drawing a line between funds management that is portfolio and non-portfolio. The mobility of portfolio capital

might suggest that Australian taxing rights over foreign investors (except final withholding taxes) should generally be confined to the non-portfolio case.

5.93 Investments eligible for an IMR exemption might be broadly consistent with the eligible investment business rules in Division 6C of the ITAA 1936. The range of investments that could potentially be covered by an IMR include gains or losses from the disposal of:

- portfolio equity interests in companies;
- portfolio interests in other entities (including units in a unit trust);
- bonds; and
- derivatives.

5.94 Broadly, the rules could ensure that the exemption would not extend to disposals of taxable Australian property. This is consistent with the current foreign resident CGT exemption. The proposed IMR exemption would also not affect existing withholding tax provisions.

5.95 In determining what investments should be made exempt by an IMR, the following considerations should be taken into account.

5.96 The broader the range of exempt transactions, the higher the potential revenue costs of an IMR. It appears that the following may be priority areas:

- gains or losses from disposing of portfolio equity interests in companies and other entities; and
- gains or losses from disposing of bonds.

5.97 While there is likely to be a potential cost in removing Australian tax from, in particular, listed portfolio equity investments, it should be noted that there has been a long standing observation of the difficulties in collecting tax from stock exchange transactions in the Asprey Report of 1975. Asprey found that difficulties in collection could only effectively be overcome through exempting such transactions. While it did not directly support such an exemption, Asprey recognised its potential as a way of attracting to Australia financial operations by non-residents.

5.98 A broad ranging IMR exemption may potentially result in foreign managed funds having a competitive advantage over Australian managed funds (this may occur because under the MIT regime, the capital account election does not extend to, broadly, debt interests or financial arrangements covered by Division 230). However, it should be noted that there are other tax benefits that are only available to MITs (for example, the reduced withholding rates for MIT 'fund payments', which can include income and capital gains from Australian land).

5.99 In overseas countries it is common to have rules to deal with cases where the relevant non-resident has other activities in the country, for example, a permanent establishment carrying on other activities outside the scope of the IMR. It is possible in such cases to carve the IMR activities out from those other activities and to maintain the exemption or to turn off the exemption in whole or in part depending on the situation (for example, depending on whether the activities which would otherwise attract the IMR are or are not part of a larger permanent establishment).

5.100 Submissions to Treasury also raised the possibility of an IMR applying to foreign managed funds holding non-portfolio interests in non-Australian assets.

Q 5.4 Issues / Questions

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?

Residence considerations

5.101 As discussed above at paragraphs 5.52 to 5.56, the Johnson Report found that due to Australia's residence rules, foreign entities including foreign managed funds were in the practice of making all important board decisions outside Australia and had a minority constituent of Australian resident board directors so as to ensure central management and control would not be located in Australia. It therefore recommended that the residence rules be modified so that foreign entities within an IMR would not become resident merely by having central management and control in Australia.

5.102 If an exemption style IMR were designed which applied to foreign managed funds, it would be important to consider how to amend Australia's residence rules such that the rules are appropriately targeted only to foreign managed funds under an IMR.

Q 5.5 Issues / Questions

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?

Appropriate integrity measures

5.103 As Australia taxes its resident investors on their world wide income, income received by resident investors from investing via foreign managed funds should remain subject to Australian tax.

5.104 Safeguarding the taxation of resident investors may necessitate rules to avoid 'round tripping' so that Australians cannot defer or avoid tax on investments through investing via foreign managed funds. However, care needs to be taken in designing the IMR rules so that unnecessary restrictions and compliance costs are not imposed on foreign funds.

5.105 A particular challenge in enforcing residence taxation is the limited information that tax authorities have on offshore investments undertaken by their residents.

5.106 This could be addressed by limiting the extent resident investors can participate in a foreign managed fund. A number of overseas IMRs have adopted this approach. Such rules would need to be expressed in terms of direct or indirect ownership by residents. The major issue is how such rules are to be enforced — if the onus on the fund to prove its ownership is applied very strictly, it may be impossible for funds to satisfy the onus and so defeat the purposes of the IMR. On the other hand if the fund is not subject to any effective disclosure mechanism, the IMR will be prone to abuse.

5.107 It may be appropriate to allow access to the IMR where a de minimis level of ultimate Australian ownership is not exceeded. In Singapore the threshold is 20 per cent and in Hong Kong 30 per cent. To the extent that an Australian resident would otherwise be currently assessed on income derived by the fund (that is, the fund is transparent, or a series of funds are transparent for Australian purposes) or an Australian resident receives a distribution from the fund that would otherwise be assessable, the IMR would not protect the resident from assessment (and the same would apply for any controlled foreign company or transferor trust in respect of which an Australian resident is assessable). A de minimis threshold could be relatively high in the light of these protections of the Australian residence tax base.

5.108 An alternative method of addressing the limited availability of information could be to restrict the exemptions under an IMR to foreign managed funds that provide information to the ATO on income and gains derived by Australian resident investors. Information requirements should ideally reflect the natural business systems of the foreign funds.

5.109 A promising medium term option of achieving this is likely to be participation in and adoption of the current mechanism that the OECD is developing in its TRACE project (Treaty Relief and Compliance Enhancement) to trace ultimate ownership of CIVs. Draft documentation to this end was released in early 2010, but it remains as a medium term time frame. This project is intended to allow identification of the ultimate ownership of CIVs on a pooled basis by passing information from one fund to

another when investments are made. The relevant output of the process for current purposes would identify the Australian ownership percentage of a foreign fund.

5.110 Other options are to align requirements such as 'know your client' used for the Financial Action Task Force against Money Laundering, or provisions for exchange of information under tax treaties and tax information exchange agreements (TIEAs).

5.111 While such information gathering approaches have the potential to support the taxation of resident investors, they should be weighed against their potential to impose significant information requirements or other restrictions on foreign funds.

5.112 Consideration should also be given to how to safeguard residence taxation where resident investors invest in foreign funds that do not distribute income. Prior to 1 July 2010, portfolio investments in foreign entities were subject to the foreign investment fund (FIF) rules, which targeted Australian residents who accumulated passive income in foreign funds and thereby deferred taxation and possibly converted income into capital gains. While the FIF rules have been repealed, an 'anti roll-up' rule — to apply in those cases where investments in foreign funds are made with the motivation of deferring Australian tax — is being developed. This rule may go some way to safeguarding the taxation of residents investing in foreign managed funds that accumulate income which is derived from Australia.

5.113 Where the foreign managed fund is a trust, special rules may be required to ensure that Australian resident investors remain assessable on income earned from the foreign fund. This is because under the current rules, beneficiaries of a trust are taxed on their share of the net income of the trust. Income which is made exempt to the fund by the IMR will not form part of the net income of the fund and will therefore not be taxable to resident beneficiaries under normal rules. Alternatively where a foreign fund is transparent it may be appropriate to confer the IMR at the investor level.

5.114 It is important to stress that the discussion above sets out a suite of options that could be considered in addressing these issues. Consideration will be needed in choosing / designing the most appropriate measure to ensure integrity is maintained. The option(s) chosen will depend to a certain extent on the revenue risks associated with the investments covered under the IMR.

Q 5.6 Issues / Questions

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?

Q 5.7 Issues / Questions

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?

SCOPE OF AN IMR BEYOND FOREIGN MANAGED FUNDS

5.115 The Johnson Report recommended that the IMR 'have wide application, to both retail and wholesale funds and to other areas of financial services beyond funds management, but … be confined to entities operating within the financial sector'.

5.116 The Johnson Report recommendation (and the submission from Ernst & Young to Treasury on an IMR) was for an IMR to apply more broadly than to foreign managed funds. The Board understands that many of the issues raised in relation to the funds management sector (set out in paragraphs 5.18 to 5.64) apply also to financial services entities apart from foreign managed funds.

5.117 In the sections below the potential for an IMR to apply to other areas of financial services beyond funds management is discussed.

Separately managed accounts

5.118 An issue for consideration is whether there is a case for an IMR exemption to apply to separately managed accounts of non-residents. Under separately managed accounts, the non-resident investor retains the beneficial ownership of underlying securities. An example is Investor Directed Portfolio Services (IDPS), often used by high net worth individuals. For IDPS, the foreign resident investor may be taken to have a permanent establishment in Australia to which the investment returns are attributable. In addition, gains made by the foreign resident investor may be taken to be on revenue account and sourced in Australia in particular circumstances. This could result in Australian tax applying and could create disincentives to utilise Australian fund managers.

5.119 Similarly, families with significant private wealth often invest through a vehicle that is closely held by the family but use various third party financial services providers in doing so (investment advisers, custodians, brokers etc) and experience similar problems.

5.120 Such accounts and private vehicles, by their very nature, are not widely held and are frequently made through nominees. A requirement for funds to be widely held limits the extent to which funds can be established as accumulation vehicles to defer taxation through deferring distribution of income (which can compromise the ability to tax resident investors). In the absence of this rule greater reliance would need to be placed on anti-deferral 'roll-up' and anti 'round tripping' rules.

5.121 Therefore consideration should be given to whether tax integrity would be compromised by permitting investments of Australian residents in IDPS or foreign private vehicles to be eligible for an IMR exemption. The problem of round-tripping by Australian residents has already been discussed above at paragraphs 5.103 to 5.114.

5.122 The Board notes that IMRs in other jurisdictions, such as in the United Kingdom, are not restricted to 'widely held' investment funds.

Sovereign wealth funds

5.123 At present, Australia generally refrains from taxing foreign sovereign passive investments as a consequence of the doctrine of sovereign immunity. Income from commercial activities is not exempted. The exemption reflects international practices related to sovereign immunity, rather than economic policy considerations, though to the extent that sovereign portfolio investment is sensitive to taxation, similar policy issues may be raised.

5.124 The Board understands that the tax treatment of sovereign wealth funds is being considered by Government in the context of a separate review which was announced

on 20 August 2009,[19] and does not intend to discuss these issues further in the context of the IMR review.

Private equity and venture capital

5.125 While investors into private equity and venture capital who do not have management responsibilities may be passive investors with portfolio investments into the fund, typically the private equity or venture capital fund would itself undertake active investment activities. Such activities would not be primarily passive in nature, and would fall outside the eligible investments rules in Division 6C of Part III of the ITAA 1936.

5.126 Typically, investments made by private equity and venture capital funds are also of a non-portfolio nature. In this regard, non-portfolio investments are potentially linked to generating economic rents (where rents are capitalised in the value of the business) and are generally less mobile and less responsive to source taxation. By contrast, portfolio investments are generally more mobile and responsive to source taxation, such that many countries will exempt or only lightly tax these investments.

Other parts of the financial services sector

5.127 The Johnson Report considered that mobility of financial services and competitiveness also justified similar IMR treatment for treasury and similar operations within Australia by Australian and foreign multinational financial institutions. The justification for such treatment extends beyond the giving of certainty and appropriate operation of permanent establishment, residence and source rules, and involves tax concessions for such financial activities conducted in Australia.

5.128 While recognising the inherent difficulties of profit allocation in this sector, the extension of an IMR to the financial sector raises risks to the Australian tax base in departing from internationally accepted transfer pricing arrangements. If concessions are to be provided such as occurs for offshore banking units (OBUs), they should perhaps be subject to a separate process which can view the financial sector in its entirety.

19 The tax treatment of sovereign wealth funds is being considered in the context of an ongoing project (announced 20 August 2009) to codify the existing tax practice of exempting income earned by foreign governments.

Q 5.8 Issues / Questions

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?

CHAPTER 6: VENTURE CAPITAL LIMITED PARTNERSHIPS

6.1 The terms of reference for the review require the Board to examine the effectiveness of the special tax treatment accorded under the Venture Capital Limited Partnership (VCLP) regime in a way that recognises its policy objectives.

THE OBJECTIVES OF THE VCLP AND ESVCLP REGIMES

6.2 The VCLP regime was introduced under *Venture Capital Act 2002* and *Taxation Laws Amendment (Venture Capital) Act 2002*. The regime was introduced 'to provide Australia with a world's best practice investment vehicle for venture capital.'

6.3 The objective of the VCLP regime is to encourage new foreign investment into the Australian venture capital market, particularly through increased support to tax-exempt foreign investors.

6.4 The Explanatory Memorandum (EM) asserted that while Australia has strong research capabilities, it has been less successful in attracting the necessary venture capital to commercialise this research. The incentives are aimed at attracting venture capital to commercialise R&D results in Australia and to fund the growth of expanding businesses so as to facilitate economic growth and job creation. As noted in the EM, the objective of the measure is:

> To facilitate non-resident investment in the Australian venture capital industry by providing incentives for increased investment which will support patient equity capital investments in relatively high-risk start-up and expanding businesses that would otherwise have difficulty in attracting investment through normal commercial means.

6.5 The rules for VCLPs are exceptions to the rules that apply to other limited partnerships (which are taxed as companies) and contrast with the passive investment rules that apply to other CIVs. They are aimed at addressing a particular (or perceived) market failure in relation to the ability of risky ventures to attract capital investment.

6.6 The EM noted that 'active management of the investee companies distinguishes the venture capital industry from the passive funds management industry'. It asserted that treating the carried interest of venture capital managers as a capital gain should encourage leading international venture capital managers to locate in Australia and facilitate the development of the venture capital industry.

6.7 In *Tax Laws Amendment (2007 Measures No. 2) Act 2007,* an Early Stage Venture Capital Limited Partnership (ESVCLP) regime was introduced effective from the 2007-08 income year.

6.8 The objective of the ESVCLP regime is to further encourage investments in start-up enterprises with a view to commercialising their activities and enhance the development of skills and the formation of capital in the early stage venture capital sector. The ESVCLP regime provided additional tax concessions to those already offered to VCLPs in order to attract increased funds to the early stage venture capital sector.

6.9 The Board understands that the main driver for the introduction of the ESVCLP regime under *Tax Laws Amendment (2007 Measures No. 2) Act 2007* was a review of the venture capital industry undertaken in 2005. The review was undertaken by an Expert Panel appointed by the then Minister. At that time, it was found that venture capital activity at the seed, early stage and expansion stage in emerging, higher risk / higher return companies (the venture capital sector or VC sector) was limited with minimal institutional investor support. This contrasted with the later stage private equity sector (the LSPE sector) which was mature, stable and receiving significant investor support in the Australian market. The LSPE sector was dominated by leveraged buyout and management buyout activity of existing established businesses.

6.10 Investment in Australia's VC sector was also found to be low in comparison to other developed countries and in comparison to the substantial amount of research and development (R&D) undertaken in Australia that could potentially be commercialised. Increased investment in the VC sector was considered important to stimulate technological innovation and to ultimately spur economic growth.

6.11 Accordingly, the ESVCLP regime was designed to support earlier stage venture capital vehicles by providing income tax exemptions to both resident and non-resident partners on all income or gains derived from eligible investments made through the vehicle.

6.12 To further encourage investment into the early stage and expansion stage venture capital sector, *Tax Laws Amendment (2007 Measures No. 2) Act 2007* also brought minor amendments to the VCLP rules to expand the eligibility for tax concessions to a broader range of non-resident investors and to expand the types of eligible VCLP investments.

THE VCLP AND ESVCLP REGIMES

6.13 The VCLP and ESVCLP regimes apply to limited partnerships established in Australia or a country with which Australia has a double tax agreement. The general partner (manager) must be a resident of Australia or a country with which Australia

has a double tax agreement. Limited partners may be resident in any foreign jurisdiction.

The VCLP regime

6.14 The VCLP legislation provides tax flow-through treatment for partners investing through the VCLP. It also provides tax exemption for foreign limited partners.

Taxation of partners

6.15 Foreign partners in a VCLP are exempt from tax for capital and revenue gains made by the VCLP on eligible venture capital investments where the partner is:

- exempt from tax in their territory of residence;
- a foreign limited partnership or foreign entity with tax flow-through status (a foreign venture capital fund of funds) which does not hold more than 30 per cent of the VCLP; or
- a holder of less than 10 per cent of the VCLP (only where that partner is a limited partner).

6.16 A VCLP must be registered with the Venture Capital Committee before its foreign partners can access the tax exemption.

6.17 The exemption from capital and revenue gains does not extend to foreign general partners in a VCLP. Their gains are taxed on a capital or revenue basis according to their particular circumstances. A capital gain would generally be disregarded under Division 855 of the ITAA 1997 as long as it does not relate to taxable Australian property.

6.18 The tax treatment of gains made by domestic partners through a VCLP is not specifically covered by the VCLP regime. These gains are taxed on a capital or revenue basis according to the particular circumstances.

6.19 The tax exemptions also extend to eligible venture capital partners in a limited partnership registered as an Australian Venture Capital Funds of Fund (AFOF) which invests in VCLPs, ESVCLPs, or in their investee companies.

Carried interests of general partners

6.20 Once the level of profits specified in a partnership agreement has been attained for the limited partners of a VCLP, the general partners who act as venture capital managers in the VCLP may have an entitlement to distributions known as a carried interest. These carried interests are deemed to be capital gains under the VCLP regime. This capital account treatment is only available to foreign general partners if they are resident in a country with which Australia has a double tax agreement.

6.21 The capital gain is a discount capital gain if the carried interest arises under a partnership agreement that was entered into at least 12 months before the CGT event happened and the other requirements for the discount are met.

Conditions of the VCLP regime

6.22 VCLPs must satisfy a number of conditions, including:

- the fund must have capital commitments of at least $10 million from its partners (investors) in order to be registered as a VCLP;
- VCLPs must only invest in eligible venture capital investments made by the VCLP;
- eligible venture capital investments are shares, convertible notes (that are equity interests), units or options in Australian businesses with assets of not more than $250 million at the time of investment;
- eligible venture capital investments must be at risk and must be held for at least 12 months;
- if the investment is made by a VCLP or an AFOF, its interest, together with any connected entities, in the venture capital investee company must not be more than 30 per cent of the VCLP's or AFOF's committed capital (that is, the VCLP or AFOF is required to make a spread of investments);
- a loan, including convertible notes, cannot be an eligible venture capital investment. There are also limitations on the amount of a loan a VCLP or an AFOF may make to a venture capital investee company in which it has made an eligible venture capital investment;
- the investee company must be an Australian resident, have more than 50 per cent of their employees performing their services primarily in Australia and more than 50 per cent of its assets (determined by value) situated in Australia for at least 12 months after the investment;
- the predominant activity of the investee company (75 per cent) must not relate to property development or land ownership; finance or insurance; construction or acquisition of infrastructure activities; or investments that generate interest, rents, dividends, royalties or lease payments;
- at the time an investment in company shares is made, the shares may not be listed on an Australian or a foreign stock exchange. If the shares are listed, the investment can be an eligible venture capital investment if the company is delisted within 12 months of the initial investment; and

- non-Australian investments are permitted to be treated as eligible venture capital investments as long as they do not exceed 20 per cent of the VCLP's committed capital and meet the remaining eligible venture capital investment requirements.

The ESVCLP regime

6.23 The ESVCLP regime provides similar tax concessions as the VCLP regime, but extends the tax exemption for capital and revenue gains to domestic and foreign partners. General partners will also qualify for the tax exemption, but must be Australian resident or resident of a country with which Australia has a double tax agreement.

6.24 Gains made by general partners on carried interests are still deemed to be capital gains.

Conditions of the ESVCLP regime

6.25 The ESVCLP regime imposes the same conditions on investment as the VCLP regime, and includes a number of additional conditions:

- the ESVCLP fund must have capital commitments of at least $10 million and a maximum of $100 million from its partners in order to be registered;
- eligible venture capital investments can only be new shares, convertible notes (that are equity interests), new units or options in Australian businesses with assets of not more than $50 million at the time of investment;
- the ESVCLP must divest once an investee company has grown to $250 million in assets; and
- the ESVCLP must have an investment plan approved by Innovation Australia, and must report to Innovation Australia on an annual basis on the progress of implementing its approved investment plan.

RECENT DEVELOPMENTS

6.26 At September 2010 there were 33 active registered VCLPs and a further four conditionally registered VCLPs.[20] At 30 June 2009 VCLPs had total committed capital of $3.8 billion, of which $1.4 billion has been invested in eligible venture capital investments. During 2008-09, VCLPs reported making 95 investment deals, with

20 http://www.ausindustry.gov.au/VentureCapital/EarlyStageVentureCapitalLimitedPartnershipsESVCLP/Documents/Public%20ESVCLP%20list.pdf. Conditionally registered VCLPs have 24 months from date of conditional registration to raise investment funds, otherwise their VCLP registration automatically lapses.

$296 million invested into 63 businesses (24 initial investments and 71 follow-on investments). The primary source of capital continues to be domestic institutional investors, with around 10 per cent coming from foreign investors.

6.27 Following the introduction of the ESVCLP regime in *Tax Laws Amendment (2007 Measures No. 2) Act 2007*, each of the Australian states have had to follow with amendments to their respective state partnership laws to provide for the ESVCLP vehicle. These state legislative amendments were enacted over 2007 and 2008.

6.28 At September 2010 there were three active registered ESVCLPs with total capital of $80 million and a further four conditionally registered ESVCLPs seeking capital.[21] $3 million has been invested under the ESVCLP program to September 2010.[22]

6.29 No AFOFs have been registered at 30 June 2010.[23]

6.30 The ABS has published an annual survey of venture capital since 1999-2000. The latest available survey is the 2008-09 Venture Capital and Later Stage Private Equity (VC&LSPE) Survey[24]. Key results from this survey for 2008-09 are:

- As at 30 June 2009, investors had $17.4 billion committed to venture capital and later stage private equity investment vehicles (compared with $6.2 billion at 30 June 2002), of which $11.7 billion had been drawn down.

- Of the total funds committed by investors, 15 per cent were in earlier stages comprising pre-seed, seed and start-up stages ($2.6 billion); 37 per cent ($6.5 billion) were for businesses in expansion and 48 per cent ($8.3 billion) was for later stage private equity businesses, related to mature investee companies that may require financing for turnarounds (because of flat or declining revenue), consolidation and sales.

- Most of the committed funds (91 per cent) were sourced from Australian investors. Resident superannuation funds continued to increase their contribution to total commitments, with $9.8 billion of committed funds (56 per cent of total funds committed).

- Of the $9.1 billion of total funds committed to the early and expansion stages[25], $8.2 billion (91 per cent) were sourced from Australian investors and $4.9 billion (54 per cent) were from Australian superannuation funds.

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21 http://www.ausindustry.gov.au/VentureCapital/VentureCapitalLimitedPartnerships VCLP/Documents/Public%20VCLP%20list.pdf.
22 AusIndustry preliminary consultation.
23 AusIndustry preliminary consultation.
24 ABS Catalogue 5678.0 – Venture Capital and Later Stage Private Equity, Australia, 2008-09.
25 Note, the $9.1bn of funds committed to the early and expansion stages are in relation to activity in both the VC and LPSE sectors. The ABS statistics do not provide further details.

6.31 The ABS statistics show that domestic superannuation funds are the main drivers of the growth of venture capital and private equity activities, there is not a significant presence of non-resident investors and the majority of investments are concentrated in later stage private equity investments rather than in the early stages of venture capital.

PREVIOUS COMMENTS ON THE EFFICACY OF THE VCLP REGIME

6.32 During the consultation process for the Board's review of the MIT regime in 2008 to 2009, and while VCLPs were outside the scope of the MIT review because they are not unit trusts, a comment was provided to the Board that the restrictions applicable to the VCLP regime had made the regime difficult to utilise in practice.

6.33 The submission stated the following:

> The original policy intent was, as we understand it, to provide a simple vehicle for investment in private equity and venture capital for international and domestic investors alike, and to provide qualifying international investors, in particular, with some certainty regarding Australian taxation outcomes in the context of a familiar form of investment vehicle. However, the implementation resulted in a vehicle that has proved to be very impractical and has all but been abandoned for new funds raised. Of the current funds utilising this vehicle, only one manages to use it in a stand-alone capacity. All the other fund managers that use it have some sort of companion structure associated with it in order to overcome its shortcomings.[26]

6.34 On this basis, it called for a change to a number of restrictions which applied to the definition of eligible venture capital investment:

- The permitted entity value of $250 million — it was proposed that there should be no threshold.
- Anti–aggregation provisions — through these provisions a company that a VCLP has invested in may not invest any VCLP moneys in any other entity unless that entity is already a connected entity of the company. It was proposed that the provision of additional funds to an investee company to make a second (unrelated) acquisition should not disqualify the investee company from being an eligible venture capital investment.
- Non-Australian investments — it submitted that the 20 per cent threshold for allowing non-Australian investments was an arbitrary hurdle, with no rationale adequately explained.

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26 AVCAL's submission to the Board dated 6 July 2009, a copy of which is at the following address: http://www.avcal.com.au/sites/default/files/uploads/news/AVCAL%20additional%20material%20VCLP.pdf.

- Multiple tiered structures — an investment is not an eligible venture capital investment if its sole asset is shares in a subsidiary company, as 75 per cent of the company's assets must be used in activities that are not ineligible. Ineligible activities include investments held for deriving dividends. (There is one narrow exception that permits a VCLP to invest in a holding company for the purposes of acquiring a target entity.) It was submitted that many acquisition structures require a dual-tier acquisition structure (enabling debt finance being provided to the second tier entity) and that the number of tiers should not be relevant to whether an investment by a VCLP is an eligible venture capital investment.

- Requirement for delisting within 12 months — it was submitted that the imposition of a time frame as short as 12 months puts VCLP investors at a disadvantage and risk of losing their concessions due to potential minority shareholders being unwilling to cooperate with a privatization process.

- Ineligible activities — the submission queried the rationale for excluding activities related to finance and insurance, noting that private equity had made a number of investments in these industries in Australia.

6.35 The submission proposed that the VCLP regime should be available to both the VC and LSPE sectors, noting that the limited partnership structure is the globally recognised structure for the VC and LSPE sectors. The submission stated that alternative vehicles such as trusts are not well understood by overseas investors or their taxation regulators and as a consequence their use introduces taxation uncertainty for investors in their home jurisdiction.

OTHER OBSERVATIONS

6.36 As mentioned above, the Board has been asked to review the effectiveness of the special tax treatment provided through the VCLP regime in achieving its policy objectives. The Board notes that the key policy objective underlying the establishment of the VCLP regime and later the ESVCLP regime, was to encourage new foreign investment into the venture capital industry at the seed, early and expansion stages where there was a pre-existing lack of foreign investment. It was for this reason that the incentives offered under the VCLP regime were capped at companies with a permitted entity value of $250 million.

6.37 An extension of the application of the VCLP regime to the LSPE sector (through, for example, removing the $250 million permitted entity value restriction) may potentially dilute any incentives for foreign or domestic investment into companies at the seed, early and expansion stages. In particular, foreign investors may prefer investments in the LSPE sector over the early stage VC sector given the lesser degree of commercial risk in investing in existing established businesses.

6.38 The VCLP and ESVCLP regimes have only been introduced very recently into Australian tax legislation. By contrast, the venture capital industry in the US has developed over the past 50 years with long term government support. The Small Business Investment Company (SBIC) program in the US was introduced in 1958 and is credited with the formation of the strong venture capital industry in the US. This industry is not just one of financiers, but extends to specialist service providers such as patent attorneys, legal firms and data providers.

6.39 The Board understands that in the early days of the SBIC program, the program was criticised for low rates of return and wastage. It took 20 years before the industry started to attain critical mass in the US. In 2005, firms initially backed by venture capital made up a disproportionately large 14 per cent of publicly listed companies in the US, with a total market value of $2 trillion.

6.40 Using the US as an example, it may be premature to determine the appropriateness of the restrictions placed on the VCLP and ESVCLP regimes in supporting the Australian venture capital industry. The global financial crisis may also play a large role in the limited use of these regimes by foreign residents to date.

Deemed capital account treatment for VCLP domestic limited partners

6.41 During initial consultations, it was proposed to the Board that a deemed capital account treatment apply for domestic limited partners in a VCLP.

6.42 In the Board's MIT Report, the Board recommended a deemed capital account treatment election be available for MITs. The reasons for this were:

- existing complexity and uncertainty for investors, and administrative costs for the ATO, in applying case law principles in order to determine the character of gains and losses made on the disposal of investment assets by MITs;
- to specifically provide non-residents with certainty on the distribution of gains made on the disposal of investment assets by MITs which would only be subject to tax if the assets were taxable Australian property; and
- a significant percentage of funds invested into MITs are from superannuation funds which received capital account treatment if they invested directly into investments rather than investing through MITs.

6.43 The existing complexity and uncertainty in applying the capital / revenue distinction rules also affect domestic limited partners investing into VCLPs. While foreign limited partners are exempt on gains on disposal regardless of whether those gains are on capital or revenue account, domestic limited partners eligible for the CGT discount may lose their eligibility if their gains on disposal are treated as being on revenue account. Given the complexity and uncertainty in applying the capital /

revenue distinction rules, domestic investors may therefore be detracted from investing through the VCLP regime.

6.44 Furthermore, of the $9.1 billion committed to the early and expansion stages of the Australian venture capital industry at 30 June 2009, 54 per cent ($4.9 billion) was sourced from Australian superannuation funds.[27] These funds would be disadvantaged by investing into a VCLP as compared to investing directly into an investment asset as they may lose their eligibility for the CGT discount. The capital account treatment of many forms of direct investments by superannuation funds was one of the considerations taken into account in the Board's recommendation to introduce the capital account election in the MIT context.

6.45 The Board notes that limited partners investing into a VCLP may be similar to investors in an MIT — both are generally passive investors holding portfolio interests in a vehicle. However, the activities of the VCLP vehicle differ to the activities of an MIT. MITs undertake primarily passive portfolio investment activities, consistent with the eligible investment rules in Division 6C of Part III of the ITAA 1936. By contrast, VCLPs are not constrained by Division 6C and may undertake active non-portfolio investment activities.

6.46 However, the VCLP and ESVCLP regimes were established by the Government to correct a perceived market failure in the venture capital industry. Given the Government's objective of attracting both foreign and domestic investment into the VC sector, it could be argued that it may be appropriate to provide a deemed capital account treatment to give certainty, similarity of treatment for investment directly by superannuation funds in VCLPs, and a tax concession for other domestic limited partners investing in VCLPs. As mentioned above, domestic partners already receive full tax exemption for gains and income on investments in ESVCLPs.

Q 6.1 Issues / Questions

The Board seeks stakeholders comments on:

- whether the restrictions imposed on the VCLP and ESVCLP regimes are consistent with their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;
- what are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime;

27 ABS Catalogue 5678.0 – Venture Capital and Later Stage Private Equity, Australia, 2008-09.

- suggested amendments to the tax treatments under the VCLP and ESVCLP regimes that would enhance their effectiveness in achieving their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;

- are the current levels of investment through VCLPs and ESVCLPs consistent with what would be expected normally for these types of programs compared to similar programs in other jurisdictions;

- would the introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP contribute or detract from its policy objectives? What other considerations would be relevant to introducing such a deemed capital account treatment;given the carried interests of general partners are already deemed to be on capital account, should general partners receiving gains made by a VCLP on the disposal of eligible venture capital investments also be deemed to be on capital account; and

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

GLOSSARY

AFCF	Australian Financial Centre Forum
AFOF	Australian Venture Capital Fund of Funds
The AFTS Review	The Australia's Future Tax System Review
ATO	Australian Taxation Office
The Board	Board of Taxation
CCF	Common Contractual Fund (Ireland)
CGT	Capital gains tax
CIV	Collective investment vehicle
ESVCLP	Early stage venture capital limited partnership
EU	European Union
FIF	Foreign investment fund
IMR	Investment manager regime
IDPS	Investor directed portfolio services
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
Johnson Report	Report of the Australian Financial Centre Forum, *Australia as a Financial Centre — Building on our Strengths*
LIC	Listed investment company
LP	Limited partnership
LPSE sector	Later stage private equity sector
MIT	Managed investment trust
OECD	Organisation for Economic Co-operation and Development
REITS	Real estate investment trusts
TAA 1953	*Taxation Administration Act 1953*
TARP	Taxable Australian real property
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
US	United States
VC sector	Venture capital sector
VCIC	Variable Capital Investment Companies (Ireland)
VCLP	Venture capital limited partnership

APPENDIX A: QUESTIONS

Chapter 2: Collective investment vehicles for the purposes of this review

Q 2.1 Issues / Questions

The Board seeks stakeholder comments on:

- the specific reasons for the apparent unattractiveness of Australia's current tax treatment of CIVs to non-resident investors; and
- the specific non-tax factors which may make Australia's CIVs unattractive to non-resident investors.

Q 2.2 Issues / Questions

The Board seeks stakeholder comments on:

- the appropriateness of the widely held definition contained in the MIT legislation as a characteristic for a wider range of CIVs, and whether there any compelling reasons to have non-widely held vehicles included as CIVs;
- the appropriateness of the current definition of eligible investment business in Division 6C of the ITAA 1936 as a prerequisite for a wider range of CIVs, and whether there are any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs; and
- whether there is a need to further define 'control' in Division 6C of the ITAA 1936 to provide greater certainty for investors in MITs and other CIVs, and if so, how this could be achieved.

Chapter 3: Australia's current range of CIVs

Q 3.1 Issues / Questions

The Board seeks stakeholder comments on:

- the nature and extent of, and the reasons for, any impediments to investments into Australia by foreign investors through MITs; and
- suggestions on how the complexity of character and source retention under flow-through taxation could be alleviated through alternative CIV vehicles that are more attractive or user-friendly to non-resident investors.

Q 3.2 Issues / Questions

The Board seeks stakeholder comments on:

- whether the existing definition of LIC capital gains should be restricted to gains made on direct investments only and whether there are reasons to extend this definition to include all gains made in respect of permitted investments by LICs;
- whether it is desirable to introduce further changes to the LIC regime to better obtain parity of tax outcome with direct investments in the underlying assets of the LIC? If so, what changes would be required;
- should an amended collective investment company regime be limited to listed vehicles or applied more broadly including other widely held non-listed investment companies defined in a similar way as the widely held rules for MITs;
- instead of amending the LIC regime, should a new corporate CIV regime be introduced that provides parity of tax outcome with direct investments and how would that regime operate? What transitional rules may be required;
- is there a trade-off between preserving character and source of income and simplifying distribution statements for investors that are more familiar with a dividend distribution statement? Are there minimal tax outcomes that would meet non-resident investor expectations without requiring complete tax flow-through? Is there any way to preserve character and source of income under a new corporate CIV regime? If so, how would that operate?

Q 3.3 Issues / Questions

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?

Chapter 4: Design of a new corporate CIV regime

Q 4.1 Issues / Questions

The Board seeks stakeholder comments on:

- the appropriateness of any of the taxation models (including variants) to achieve tax neutrality for designing a corporate CIV regime that would enhance industry's ability to attract funds under management in Australia;

- the appropriateness of any of the models (including variants) to achieve tax neutrality for designing a limited partnership CIV regime that would enhance industry's ability to attract funds under management in Australia; and

- whether there are any critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes, including by rationalisation of the regimes where possible.

Q 4.2 Issues / Questions

The Board seeks stakeholder comments on:

- what would be the most appropriate method to achieve an outcome similar to tax flow-through for a corporate CIV;

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

- under what circumstances would it be appropriate to assess tax on a corporate CIV, at what rate, and what should be the tax consequences of the payment of the tax for investors;

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

- would it be appropriate to extend the MIT regime to a corporate entity, by deeming qualifying corporate entities to be trusts for tax purposes? What modifications would be required for corporate entities under such a regime, and would this be feasible without adding undue complexity to the tax and company law?

Chapter 5: Investment Manager Regime

Q 5.1 Issues / Questions

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?

Q 5.2 Issues / Questions

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?

Q 5.3 Issues / Questions

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?

Q 5.4 Issues / Questions

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?

Q 5.5 Issues / Questions

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?

Q 5.6 Issues / Questions

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?

Q 5.7 Issues / Questions

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?

Q 5.8 Issues / Questions

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?

Chapter 6: Venture capital limited partnerships

Q 6.1 Issues / Questions

The Board seeks stakeholders comments on:

- whether the restrictions imposed on the VCLP and ESVCLP regimes are consistent with their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;
- what are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime;
- suggested amendments to the tax treatments under the VCLP and ESVCLP regimes that would enhance their effectiveness in achieving their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;
- are the current levels of investment through VCLPs and ESVCLPs consistent with what would be expected normally for these types of programs compared to similar programs in other jurisdictions;
- would the introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP contribute or detract from its policy

objectives? What other considerations would be relevant to introducing such a deemed capital account treatment;

- given the carried interests of general partners are already deemed to be on capital account, should general partners receiving gains made by a VCLP on the disposal of eligible venture capital investments also be deemed to be on capital account; and
- the desirability of further changes to the tax treatments in the VCLP or ESVCLP regimes to enable them to better achieve their policy objectives?

APPENDIX B: TAXATION OF CIV REGIMES IN OTHER JURISDICTIONS

UNITED KINGDOM

Authorised investment funds

Authorised investment funds (AIFs) are CIVs that invest in a broad range of shares and securities and use professional managers to oversee their investments.

The term AIF applies to both, authorised unit trusts and open-ended investment companies. While an AIF can have two different legal forms, it is authorised and regulated in either case by the Financial Services Authority. The UK tax regulations use 'units' to refer to both units in an authorised unit trust and shares in an open ended investment company. Similarly, references to an AIF include both an authorised unit trusts and open-ended investment companies.

Authorised unit trusts (AUTs) are trusts and have trustees who are the legal owners of the investments constituted by the fund and a fund manager who is responsible for managing the invested funds. The investors own units in the fund. The tax acts apply as if the trustees of an AUT were a company resident in the UK and as if the rights of unit holders were shares in that company.

An **open ended investment company (OEIC)** is a company incorporated under the provisions of the *Financial Services and Markets Act 2000 (UK)*. It is designated by the letters ICVC at the end of its name. These describe its status as an investment company with variable capital. They are regarded as the equivalent of the SICAVs offered in France and Luxembourg. An OEIC must have an authorised corporate director whose role is the same as that of the fund manager for the AUT. An OEIC will also have a depositary to hold the investments on its behalf. The investors own shares in the company.

Main characteristics regarding the taxation regime of AIFs are:

- treated as companies for tax purposes, but a lower rate of tax is applied to the taxable income of the fund;
- interest income, irrespective of source, and dividends received from non-resident companies[28], are included in the taxable income of the fund;

28 Under UK tax law, resident companies generally, including investment funds, are not subject to tax on dividends received from other UK companies.

- relief is provided against the tax liability of the fund for any withholding tax imposed overseas on its foreign source income;
- exempt from corporation's tax on capital gains on disposal of investments, but such gains cannot be distributed to investors except on a liquidation of the units in the fund;
- AIFs also enjoy exemption from tax on trading income derived from futures and options contracts;
- the AIF must withhold tax from distributions to investors (at the lower rate of tax applied to the taxable income of the fund);
- there is a deemed full payout of fund income using an attribution mechanism based on investor entitlements;
- all distributions are deemed to be post tax and investors are given a tax credit for the tax withheld at the entity level against their own tax liability; and
- interest distributions paid by an AIF are deductible in calculating the taxable income of the fund, with those distributions being taxed in the hands of investors.

UK REITs

UK REITs are structured as companies, must be residents in the UK, widely held and listed (they must not be structured as an open-ended investment company). UK REITs may carry on 'exempt activities' and 'residual activities'. Property rental activities are 'exempt activities'.

An 'exempt activities' property rental business must involve at least three properties with no property representing more than 40 percent of the total value of the properties involved in the property rental business. At least 75 per cent of the profits of the REIT must be derived from the property rental business.

Main characteristics regarding the taxation regime of REITs are:

- rental income and capital gains from disposal of rental property from 'exempt activities' are exempt from corporate income tax;
- income from 'residual activities' are subject to corporate income tax;
- at least 90 per cent of the rental income from the 'exempt' property rental business must be distributed annually in the form of dividends; and
- dividend distributions of profits from 'exempt' activities are treated as property income in the hands of resident investors. Withholding tax applies to these distributions to resident individual shareholders and foreign shareholders; and

- distributions of profits from residual activities are treated as taxable ordinary dividends.

Limited partnerships and limited liability partnerships

Limited partnerships (LPs) in the UK (governed by the *Limited Partnership Act 1907*) are partnerships between one or more general partners and one or more limited partners. Limited partners may not take part in the management of the partnership and cannot bind the partnership. LPs must register with the Registrar of Limited Partnerships in London or Edinburgh as appropriate. Failure to register deprives it of its limited liability.

LPs are treated as having flow-through taxation for their general and limited partners. Limited partners are subject to tax loss ('relief') restrictions in certain circumstances.

Limited liability partnerships (LLPs) were introduced in 2000, governed by the *Limited Liability Partnerships Act 2000* (in Great Britain) and the *Limited Liability Partnerships Act (Northern Ireland) 2002* in Northern Ireland. Under UK commercial law LLPs are recognised as corporate bodies and are legal entities separate to their partners. They must be registered with the UK Registrar of Companies. Members of a LLP have limited liability and can take part in the business of the LLP.

LLPs are normally treated as partnerships for UK tax purposes with flow-through taxation for their members. Members are subject to tax loss ('relief') restrictions in certain circumstances.

Pension funds, pension businesses of life insurance companies and the tax exempt businesses of friendly societies are not entitled to their normal taxation exemptions where they are members of a 'property investment LLP'. A property investment LLP is a LLP whose business consists wholly or mainly in the making of investments in land.

LLPs are often used as joint venture vehicles, as the management vehicle for UK managers of private equity funds (and hedge funds), and increasingly as the most common structure for UK professional services firms.

IRELAND

Collective investment funds

The taxation of Irish domiciled funds is governed by Part 27 of the *Taxes Consolidation Act 1997*. Chapter 1A, introduced in 2000, provided a new 'gross-roll-up' regime for the taxation of collective funds categorised as investment undertakings.

'Investment undertaking' is the name given to the 'investment vehicle' which comes within the new collective funds taxation regime. These can be either:

- investment companies authorised and designated by the Central Bank;
- a unit trust scheme authorised under the *Unit Trusts Act 1990*;
- a CIV set up under the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 1989 — known as the 'UCITS Regulations'; or
- an investment limited partnership within the meaning of the *Investment Limited Partnership Act 1994*.

The gross-roll-up taxation regime imposes no tax at the level of the fund but requires tax to be deducted from payments made to resident Irish investors on gains arising on chargeable events. The tax rate varies depending on the chargeable event, distributions are taxed at the standard income tax rate of 22 per cent and other payments, such as redemptions, are taxed at 23 per cent.

Non-resident investors and certain categories of exempt Irish investors are exempt from the withholding tax deduction. These investors can, by use of a declaration procedure, be paid gross.

Undertakings for collective investments in transferable securities (UCITS)

The UCITS regime has enabled open-ended funds authorised in one EU member state to be sold to the public in any other member state without the need for further authorisation — creating a single market for UCITS funds in Europe or a 'European fund passport'.

Basic investment requirements for UCITS are that at least 90 per cent of the fund must be invested in listed or soon-to-be-listed transferable securities, or securities issued by sovereign states or their local authorities with no more than a 10 per cent exposure to any one issuer. Borrowings are restricted to 10 per cent of net asset value (NAV) and may only be made on a temporary basis. Notwithstanding the relatively strict guidelines, the UCITS structure can be used in innovative ways, for example, for investments that are highly liquid as opposed to longer term investments such as bonds.

UCITS come in three forms — variable capital investment companies, unit trusts or as common contractual funds. All three legal structures are subject to the standard UCITS investment and borrowing restrictions. Each must have an Irish Administrator and an Irish Trustee/Custodian.

Variable Capital Investment Companies (VCCs) are public limited liability corporate vehicles, with their own legal personality, that issue shares to investors. Unit trusts issue units to investors, with units representing an undivided beneficial interest in the assets of the unit trust. Unit trusts are generally unable to access double tax treaty

benefits. Because of their tax exempt status, it is rare that VCCs under the UCITS regime can access benefits under Ireland's double tax treaties.

Common contractual fund (CCF)

A common contractual fund (CCF) is a tax transparent vehicle designed for institutional investors like pension funds. The profits (income and gains) arising or accruing to the CCF are treated as arising or accruing to the unit holders in proportion to the value of the units beneficially owned by them, as if such profits did not pass through the hands of the CCF. Key features of a CCF are:

- an exemption from all Irish taxes including withholding taxes on interest and dividends. It is fiscally transparent entity for Irish tax purposes;
- treaty benefits are available to investors on the same basis as if they had invested directly in the underlying assets of the CCF; and
- the character and the source of the income received by the CCF are not re-categorised on distribution to investors, so that such income can benefit from the same treatment at the investor level as if they had received it directly.

To assist in achieving tax transparency at the CCF:

- income derived through the vehicle should be distributed on a mandatory basis annually, pro rata to each participant's investment in the CCF;
- the CCF participant should be provided with an annual breakdown of income on investments by type and source; and
- holdings / units in a CCF are not freely transferable but are redeemable. No redemption charge is levied on participants.

6.47 The CCF is obliged to report annually to the Irish Revenue on profits made and benefits accruing to each unit holder.

Investment Limited Partnerships in Ireland

Investment Limited Partnerships (ILPs) in Ireland (established under the *Investment Limited Partnership Act 1994*) are partnership agreements between one or more general partners and one or more limited partners, the principal business of which, as expressed in its partnership agreement, is the investment of its funds in all kinds of property. ILPs are subject to significant regulatory supervision — for example, changes to the partnership agreement or the admission of additional general partners (which are also subject to regulation) are subject to the Central Bank's approval.

A limited partner's position is similar to that of a shareholder in a corporate fund. A limited partner is not liable for the debts or obligations of the ILP beyond the amount of their investment. An important condition is that the limited partner must remain a

passive investor at all times and may not participate directly in the partnership's business. If a limited partner gets involved, they will be liable for the debts incurred during the period of their involvement if the ILP becomes insolvent.

Unlike a UCITS fund, an ILP is not limited to invest in transferable securities and may be established for private or public participation. An ILP is different from a normal LP which also is provided for in Irish legislation.

An ILP provides flow-through taxation and is often used by property investment firms. If the partner is a company then corporate tax applies to the company. If the partner is an individual then personal income tax applies to the individual.

Qualifying investor fund

Qualifying investor funds (QIFs) are a type of non-UCITS regime open only to sophisticated investors, namely institutional and high net worth individuals (minimum net worth in excess of Euros 1.25 million). They offer flexibility for alternative investments such as hedge funds or private equity funds. The gross-roll-up taxation regime also applies to these regulated funds.

UNITED STATES

US REITS and mutual funds or regulated investment companies

These investment vehicles are treated as corporations for tax purposes but receive deductions for dividends paid and other special tax treatment so that generally they end up not paying any corporate tax.

Ordinary dividends are generally taxed as ordinary income however for capital gain distributions shareholders are entitled to a credit or refund for their portion of tax paid by the mutual fund.

US limited partnerships

US limited partnerships (LPs) are formed under the limited partnership laws of each US state. A LP has one or more general partners and one or more limited partners. Limited partners are responsible for partnership liabilities up to the amount of their individual investments, while general partners are fully liable for all partnership liabilities.

LPs which satisfy certain criteria and do not elect to be taxed as corporations will be treated as having flow-through taxation. One criteria is that the LP is not a 'publicly traded partnerships' which is treated as a corporation for US tax purposes. The tax flow-through status makes US LPs attractive to US tax-exempt entities as income they receive does not suffer tax at the LP level as compared to typical US corporations.

Losses made by limited partners are broadly limited to the amount of their contributions. Other loss limitation rules also apply.

Many US hedge funds, illiquid security funds, venture capital funds and private equity funds use US LPs as fund vehicles. This is mainly on account of the fact that LPs are exempted from many of the regulatory requirements that govern managed investment funds since they are typically marketed to only a limited range of professional or wealthy investors. The reduced regulation enables LPs to utilise a wider range of investment strategies and trading activities and invest in a broader range of assets than managed investment funds. For this reason, hedge funds, illiquid security funds, venture capital funds and private equity funds using US LPs will typically be of higher risk than other more regulated types of investment funds. Flexibility also allows contractual arrangements to be entered to allow management fees to be paid from limited partners to general partners, which is more difficult to regulate in a corporate environment.

Hedge funds established in the US state of Delaware account for approximately 27 per cent of the world's global hedge funds.[29] Most of these use a Delaware LP structure, utilising a Delaware limited liability company (LLC) as the general partner.[30] Delaware has been attractive for hedge fund activity mainly on account of the flexibility and integrity of the Delaware state laws and case law governing the establishment and operation of LPs and LLCs rather than for any special tax treatments offered.

'Check-the-box' regulations

The US tax laws apply default rules to the tax classifications of entities (as companies, partnerships, or disregarded entities). The US 'check-the-box' regulations enable eligible US and non-US entities to elect to be classified differently to their default treatment. Accordingly, eligible corporations may elect to be treated as partnerships and receive tax flow-through treatment; partnerships may elect to be treated as corporations.

The majority of corporations will not be eligible for check-the-box treatment. Publicly traded corporations must be treated as corporations for US tax purposes.

29 International Financial Services London Research, Hedge Funds 2010 - www.ifsl.org.uk/media/2358/Hedge_Funds_2010.pdf.

30 Taxation of U.S. Investment Partnerships and Hedge Funds: Accounting Policies, Tax Allocations, and Performance Presentation, July 2010, Navendu P. Vasavada - http://media.wiley.com/product_data/excerpt/58/04706057/0470605758.pdf.

APPENDIX C: INTERNATIONAL COMPARISON: IMR

Broadly, a number of countries do not tax the gains of foreign investors from the sale of shares (where they are portfolio interests), bonds and other marketable securities. Such countries consider that marketable securities held by foreign funds (that are collective investment vehicles) are passive investments and any gains and losses are capital in nature (except in exceptional circumstances). Where a foreign investor has a substantial interest in a resident company or holds real property in the investment country, source jurisdictions generally impose tax.

Gains arising from disposal of a range of market-traded securities are exempted in different jurisdictions. IMRs in the United Kingdom (UK), United States (US), Hong Kong and Singapore all consistently exempt disposal gains from sale of equities, bonds, debentures and futures. On the other hand, it is not uncommon for any dealing with interests in real property or insurance to be excluded from the IMR.

In addition, a major focus of these IMRs is to allow foreign investors (that is, foreign funds) to establish discretionary management advisory businesses in their jurisdiction without creating a taxable presence there (that is, a permanent establishment of the foreign fund).

These policies have recognised the mobility of the relevant capital, and responded to competitive pressures between jurisdictions seeking to attract foreign capital.

A variety of approaches to eligibility rules have been used in other jurisdictions to ensure resident investors do not take advantage of IMRs. The UK and US appear to rely on Foreign Investment Fund-type attribution rules.