Australian Government

The Board of Taxation

REVIEW OF AN INVESTMENT MANAGER REGIME AS IT RELATES TO FOREIGN MANAGED FUNDS

A report to the Assistant Treasurer

the board of taxation

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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review of the design of an Investment Manager Regime as it relates to foreign managed funds. This report forms part of the Board's review of tax arrangements applying to Collective Investment Vehicles which is due for reporting to the Government by 31 December 2011.

The Board has made a number of recommendations that seek to remove tax impediments to international investment into Australia by foreign managed funds and impediments to the use of Australian intermediaries by these funds.

The Board established a Working Group, chaired by John Emerson AM, to conduct the review. The Board held discussions with a range of stakeholders, issued a discussion paper, and received 35 submissions, 16 of which provide input in relation to the Investment Manager Regime. The Board would like to thank all of those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance provided to the Working Group by Michael Brown, Alexis Kokkinos, Andrew Mills, Karen Payne and Ken Woo as members of the Expert Panel, by Richard Vann as a consultant engaged by the Working Group, and by officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board — the Secretary to the Treasury, Dr Martin Parkinson PSM, the Commissioner of Taxation, Michael D'Ascenzo AO, and the First Parliamentary Counsel, Peter Quiggin PSM — have reserved their final views on the recommendations in this report for advice to Government.

Chris Jordan AO
Chairman, Board of Taxation

John Emerson AM
Chairman of the Board's Working Group
Member, Board of Taxation

EXECUTIVE SUMMARY

As requested by the Assistant Treasurer, the Board has brought forward its report on the design of an Investment Manager Regime (IMR) for foreign managed funds.

As noted in the Report of the Australian Financial Centre Forum *Australia as a financial centre: Building on our strengths,* Australia's financial sector comprises a highly skilled workforce and a first class regulatory framework making it '*arguably the most efficient and competitive "full service" financial sector in the Asia-Pacific region*'. Despite these strengths, exports of Australian financial services are low by international standards with perceived tax uncertainties being a key impediment to cross-border activities.

The introduction of an IMR for foreign managed funds should assist in removing tax related impediments to international investment into Australia by foreign managed funds and impediments to the use of Australian intermediaries by these funds.

In view of the Government's announcements of certain elements of an IMR for foreign managed funds in December 2010, January 2011 and May 2011, this report is particularly centred on the future tax treatment of investments by foreign managed funds (that is, for the 2011-12 and future income years). This includes:

- defining foreign managed funds in the context of the IMR;
- defining the type of investments made by foreign managed funds that should be covered by an IMR; and
- considering the potential integrity measures that might be needed to balance the objectives of providing certainty and enhancing the competitiveness of our financial sector with maintaining the integrity of the tax system.

The Board has made 12 recommendations.

The Board is mindful that the terms of reference require it to make recommendations that bring revenue neutral or near revenue neutral outcomes. Accordingly, the Board's recommendations are subject to satisfactory revenue costings.

The Board recommends that an IMR for foreign managed funds should be implemented using an exemption style approach (Recommendation 1).

The Board recommends that foreign managed funds covered by the IMR should:

- comprise a broad set of collective investment vehicle (CIV) structures and arrangements, and should not be limited to particular types of legal entity (Recommendation 2);
- not be an Australian resident (Recommendation 3) — (in this context, the Board also recommends that certain modifications be made to Australia's residence and permanent establishment tests for foreign managed funds accessing the IMR);
- be widely held (Recommendation 4);
- not carry on or control a trading business in Australia (Recommendation 5); and
- not be subject to a 'managed in Australia' requirement (Recommendation 6).

The Board recommends that for foreign managed funds covered by the IMR, gains from the disposal of portfolio investments in a prescribed list of eligible investments should be exempt from tax (Recommendation 7). Portfolio investments will be those investments in which the foreign managed fund has a less than 10 per cent interest.

The Board also recommends that a gain made by a foreign managed fund from the disposal of a non-portfolio investment in non-Australian assets (that is, conduit income) should not be subject to Australian tax if the only reason it is subject to Australian tax is because it uses an Australian intermediary (Recommendation 8).

Regarding the protection of the Australian tax base, the Board recommends that:

- income derived by Australian investors from a foreign managed fund is not made exempt merely by virtue of the income being treated as exempt for the foreign managed fund under the IMR (Recommendation 9);
- integrity rules should not be introduced into the IMR for foreign managed funds to address deferral of taxation that would operate in addition to Australia's foreign source income attribution rules, and that a post-implementation review be undertaken of these rules to ensure that inappropriate outcomes are not arising through the IMR rules (Recommendation 10); and
- foreign managed funds should be required to be resident of an information exchange country and to lodge annual information returns with the Australian Taxation Office (ATO) (Recommendation 11).

Finally, the Board recommends that Australia's transfer pricing rules should continue to operate where appropriate to tax Australian intermediaries on their arm's length fees for services provided to foreign managed funds (Recommendation 12).

The effect of these recommendations is for an IMR to be introduced which provides a definitive exemption from tax for disposals of portfolio investments made by foreign managed funds in listed or non-land rich entities, without the need to consider complex issues in the Australian tax law with respect to these portfolio investments (such as the capital / revenue distinction, permanent establishment and source rules).

The recommendations also provide certainty for foreign managed funds qualifying for the IMR that they will not be taken to be Australian resident, have an Australian permanent establishment or have Australian source income merely by virtue of engaging an Australian intermediary.

Further details on each of the Board's recommendations are set out in this report.

The Board notes that its consideration of an IMR for foreign residents beyond foreign managed funds will be covered in its broader report of the taxation arrangements of CIVs due to the Government by 31 December 2011.

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 On 11 May 2010, the then Assistant Treasurer and the then Minister for Financial Services, Superannuation and Corporate Law announced[1] the Government's response to the Report of the Australian Financial Centre Forum *Australia as a financial centre: Building on our strengths* (the Johnson Report). As part of its response, the Government indicated it had provided in-principle or direct support for nearly all of the 19 recommendations made in the Johnson report. It stated that the recommendations were important reforms that would enhance Australia's status as a financial services centre and help expand exports and imports of financial services.

1.2 These reforms would build on Australia's growing status as a leading regional financial centre and support growth and jobs in the Australian managed funds industry. Australia's managed funds stood at around $1.8 trillion at the end of 2010, equal to around 133 per cent of nominal GDP. With one of the largest pools of funds under management in the world, Australia would be well placed to build up its position as a leading regional financial centre.

1.3 On 11 May 2010, the then Assistant Treasurer and the then Minister for Financial Services, Superannuation and Corporate Law made a separate announcement[2] that indicated it had given in principle support to the Johnson report's recommendation for the introduction of an Investment Manager Regime (IMR) of wide application. The announcement stated that the Government would start consultation on the design of an IMR that will reform and expand Australia's managed funds industry by removing impediments to international investment.

1.4 The Government noted that there is considerable merit in developing a regime that provides a set of comprehensive and clear cross-border taxation rules for a range of entities in the financial sector. It also noted that there are a number of design issues relating to an IMR that will need to be considered, including:

- the scope of the regime;
- aligning the IMR with broader arrangements for taxing collective investment vehicles (CIVs); and

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1 Assistant Treasurer Media Release No 087 of 11 May 2010 - http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/087.htm&pageID=003&min=njsa&Year=&DocType=0

2 Assistant Treasurer Media Releases No 092 of 11 May 2010 - http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/092.htm&pageID=003&min=njsa&Year=&DocType=0

- balancing the objectives of providing certainty and enhancing the competitiveness of our financial sector with maintaining the integrity of the tax system.

1.5 The Government announced a two–stage process to develop the key features of an IMR. As the first stage, the Government released a consultation paper focussed on the taxation of the conduit income of foreign managed funds. As the second stage, the Government noted that other design issues relating to an IMR, including the taxation of non-resident investments in domestic assets, would be referred to the Board as part of a broader CIV review, whose detailed terms of reference were to be announced.

1.6 With respect to the first stage, the Government noted that an important element of the IMR would be to ensure that non-residents investing in foreign assets would not face further Australian tax on their investments when using Australian fund managers (referred to as conduit relief). In this respect, it noted that important reforms could be made to the treatment of conduit income of managed funds in advance of the comprehensive CIV review.

1.7 On 12 July 2010 the then Assistant Treasurer and the then Minister for Financial Services, Superannuation and Corporate Law announced[3] the next stage in the development of an IMR by requesting that the Board consider the design of an IMR as part of its review of CIVs, for which the corresponding terms of reference were announced in a separate press release[4].

1.8 The Government noted that the Board will report on the design of a comprehensive IMR, which will provide a set of clear and comprehensive rules on the taxation of certain non-resident investments into Australian and offshore assets. It also noted that Treasury was engaged in consultations with stakeholders and that it had been asked to consider and report by 31 October 2010, in consultation with the Board, on the scope for early delivery of an IMR.

1.9 The terms of reference for the CIV review, which include the IMR component, are reproduced in the next section.

TERMS OF REFERENCE

1.10 The Board of Taxation was asked to examine and report on the tax treatment of CIVs, having regard to the Managed Investment Trust (MIT) tax framework and

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3 Assistant Treasurer Media Release No 155 of 12 July 2010 - http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/154.htm&pageID=003&min=njsa&Year=&DocType=

4 Assistant Treasurer Media Release No 154 of 12 July 2010 - http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/154.htm&pageID=003&min=njsa&Year=&DocType=

including whether a broader range of tax flow-through CIVs (such as corporate CIVs) should be permitted.

1.11 The review should 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).

1.12 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.

1.13 In making its recommendations, the Board should 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.

1.14 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 had 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 requested to regularly inform the Board of the progress and outcomes of its consultations.

1.15 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.

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

RECENT DEVELOPMENTS

1.17 As part of Treasury's consultations on the scope for early delivery of an IMR, stakeholders advised that the managed funds industry was experiencing considerable difficulties due to Financial Accounting Standards Board Interpretation Number 48 *Accounting for Uncertainty in Income Taxes* (FIN 48). This is now codified into the United States accounting standard ASC 740-10.

1.18 Entities subject to FIN 48 are required to identify any uncertain tax positions and make an assessment as to whether, on the balance of probabilities, that position is sustainable having regard to its technical merits. If the technical merits of the position indicate that it is more likely than not that tax is payable, entities are required to make provision for that tax liability. Therefore, entities required to prepare consolidated financial statements in the United States would need to raise tax provisions for uncertain tax positions taken by them or their subsidiaries in both the United States and any other country. FIN 48 initially applied only to public companies. However, since 31 December 2009, the accounting standard has also applied to private entities including managed funds.

1.19 As a result of the FIN 48 provisioning requirements, and given the perceived uncertainty in the Australian tax treatment of gains made by foreign funds disposing of Australian investments, stakeholders advised that some foreign funds active in the Australian market had started making provisions for uncertain Australian tax positions. Furthermore, these provisions were affecting the fund's net asset value and unit redemption price (where the fund was not exchange traded).

THE GOVERNMENT'S ANNOUNCEMENTS OF ELEMENTS OF AN IMR FOR FOREIGN MANAGED FUNDS

The FIN 48 measure

1.20 On 17 December 2010 the Government announced[5] that it would introduce income tax amendments to restrict the ability of the Commissioner of Taxation to raise assessments against certain foreign managed funds in respect of relevant investment income (broadly, portfolio investment income and certain derivatives) for the 2009-10 and prior income years.

1.21 This announcement was intended to help address industry concerns in relation to FIN 48. Specifically, by restricting the ability of the Commissioner to raise assessments

5 Assistant Treasurer's Media Release No 027 of 17 December 2010 - http://treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/027.htm&pageID=003&min=brs&Year=2010&DocType=0

on foreign managed funds for gains made on certain portfolio investments and derivatives in Australia in prior income years, foreign managed funds covered by the announcement would not need to raise tax provisions under FIN 48 for uncertain tax positions taken in these income years in relation to these gains.

Investment manager regime — the conduit income measure

1.22 On 19 January 2011 the Government announced[6] that it would introduce amendments to exempt income from relevant investments of a foreign managed fund where the income would be taxable only due to the fund being taken to have a 'permanent establishment' in Australia. This exemption is designed to ensure that no tax is imposed on certain gains of a fund by virtue of it engaging domestic investment advisers when the fund has no real presence in Australia. In particular, any gains made by a foreign fund investing in foreign assets through the use of an Australian investment adviser (conduit income) would not be subject to Australian tax.

1.23 The Government noted that the change will align Australia's taxing rules with international practice, such as the United Kingdom's Investment Manager Exemption, and that the Board will continue to progress other aspects of the Johnson IMR recommendation.

Investment Manager Regime — interim arrangements

1.24 On 10 May 2011, the Government announced[7] that it would extend its FIN 48 measure to apply to the 2010-11 income year. In addition, the Assistant Treasurer announced that to address the ongoing treatment of these investments, he had requested that the Board bring forward its report on an IMR as it relates to foreign managed funds to the end of the third quarter of 2011.

THE BOARD'S REVIEW OF THE DESIGN OF AN IMR FOR FOREIGN MANAGED FUNDS

1.25 In view of the Government's announcements of certain elements of an IMR, the Board's current review of an IMR for foreign managed funds is particularly centred on the appropriate ongoing tax treatment of investments by foreign managed funds (that is, for the 2011-12 and future income years). This includes:

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6 Assistant Treasurer's Media Release No 010 of 19 January 2011 - http://treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/010.htm&pageID=003&min=brs&Year=&DocType=0

7 Assistant Treasurer Media Release No 075 of 10 May 2011 - http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/075.htm&pageID=003&min=brs&Year=&DocType=0

- defining foreign managed funds;
- defining the type of investments made by foreign managed funds that should be covered by an IMR; and
- considering the potential integrity measures that might be needed to balance the objectives of providing certainty and enhancing the competitiveness of our financial sector with maintaining the integrity of the tax system.

1.26 Issues concerning the scope of an IMR for entities which are not managed funds are not covered in this report.

1.27 The Board notes that in the international context, the term IMR (or other similar terms) is often used to refer to a system of rules which cover the tax treatment of domestic investment managers who act on behalf of foreign investors. However, for the purposes of this report, the term IMR encompasses the tax treatment of investments made by foreign managed funds in the case where they engage an Australian investment manager (or other Australian intermediary) as well as the case where the foreign managed funds make investments directly without using an Australian investment manager. This accords with the scope of the Board's current review of an IMR for foreign managed funds.

Review processes

1.28 In developing the recommendations in this report, the Board undertook wide consultation, including:

- preliminary consultations with a range of stakeholders;
- release of a discussion paper on the broader CIV review issues in December 2010 to invite and facilitate submissions; and
- targeted consultation meetings with a number of key stakeholders.

Submissions

1.29 The Board received 35 written submissions in response to its discussion paper, 16 of which provided input in relation to the IMR component of the review.

Board's report

1.30 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the above named members of the expert panel. However, the Board's recommendations reflect its independent judgment.

Chapter 2: Design principles of an IMR for foreign managed funds

Design principles

2.1 Chapter 1 sets out the terms of reference applicable generally to the tax treatment of collective investment vehicles. In designing an IMR for foreign managed funds, the Board considers that the following taxation principles should also be taken into account. These principles (which to some extent overlap with the terms of reference) are commonly used to guide the design of taxation legislation including, in particular, in the modern international context.

Principle 1: Taxation arrangements should reflect the responsiveness of capital to taxation

2.2 Under this principle, mobile capital — for example most portfolio investments, typically the kind of investments made by managed funds — should be lightly taxed or even made exempt. This contrasts with foreign direct investments (or non-portfolio investments), where the more permanent nature of the investment may make it less mobile and less responsive to taxation. In addition, to the extent such investments give rise to location-specific economic rents[8], there is scope to impose Australian tax without deterring the investment.

2.3 This principle has become more significant in the context of an increasingly globalised capital market. The erosion of barriers to international capital flows over the past two decades has resulted in capital becoming increasingly mobile. While investment is affected by tax and non-tax factors, a country's tax settings are important when it comes to attracting and retaining foreign capital due, in large part, to this increasing mobility.

Principle 2: Taxation arrangements should be broadly neutral for economically equivalent investments in order to minimise distortions to investment decisions

2.4 In the context of managed fund investments, neutrality means that:

- investments through a managed fund should be taxed similarly to investments made directly;

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8 'Location-specific rents may arise from exploitation of natural resources, existing fixed investments (such as factories), agglomeration (where businesses obtain benefits from co-location such as economies of scale), attractive local infrastructure, public services and institutions or consumer preference for domestically produced over imported goods.' These are different to investments giving rise to 'mobile rents' which 'can be moved from one jurisdiction to another.' (Australia's future tax system— Report to the Treasurer, page 154.)

- investments using an Australian based intermediary should be taxed similarly to investments using a foreign intermediary (although the arm's length fee for services provided by the Australian based intermediary would be taxable); and
- tax outcomes should ideally be determined by the nature of the investment activities rather than the legal structure of the entity through which investments are made.

Principle 3: The taxation of active business income and resident investors should be appropriately safeguarded

2.5 Australian active business income should continue to be subject to tax. In the context of an IMR, Australian based intermediaries (including investment advisors, fund managers, custodians and brokers) should be subject to tax on their fee income for providing financial services. Where parties are related, the amount subject to Australian tax should reflect an arm's length price.

2.6 Safeguarding the taxation of resident investors may necessitate rules to address 'round tripping'[9] so that Australian residents cannot inappropriately access tax benefits by investing through an IMR foreign managed fund. However, care needs to be taken in designing these rules to avoid unnecessary restrictions or costs.

Principle 4: Tax arrangements should be simple, administrable, enforceable and should conform to international norms and practices

2.7 Ideally, any rules being developed should be:

- simple;
- capable of enforcement and minimise tax administration costs; and
- consistent with international norms and practices and satisfy Australia's international obligations.

2.8 In developing its recommendations in this report, the Board has had to balance these principles and make an assessment of their appropriate weightings.

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9 The practice of round tripping involves Australian residents investing in Australian assets via an offshore fund.

CHAPTER 3: APPROPRIATENESS OF AN EXEMPTION STYLE IMR

3.1 The Board's discussion paper discussed an IMR which operates under an exemption style approach for foreign managed funds. Specifically, a tax exemption would be provided for specific investments undertaken by investors defined as foreign managed funds with particular characteristics. The exemption would cover the foreign managed fund where it makes the investments directly or using an Australian intermediary.

3.2 It was proposed that this approach would obviate the need to provide specific clarification in respect of relevant revenue/capital, source, permanent establishment and attribution issues in the tax law which the Johnson report identified as giving rise to uncertainties.

3.3 Stakeholders were asked to comment on the appropriateness of an exemption style approach for an IMR applicable to foreign managed funds, and whether any other alternatives were more appropriate.

VIEWS IN SUBMISSIONS

3.4 Submissions were broadly supportive of an exemption style approach and suggested that this approach was simpler than amending each problematic area of the tax law in a 'piece-meal' fashion.

> An exemption style IMR would provide an income tax exemption for specified investments by defined investors and if designed appropriately, should largely overcome the tax uncertainties faced by foreign investors as outlined by the Board in the CIV Discussion Paper.
>
> The Institute of Chartered Accountants in Australia

3.5 A number of submissions suggested instituting an exemption regime similar to those found in competing jurisdictions such as Singapore, Hong Kong and the United Kingdom. It was argued that if an Australian IMR was to have similar characteristics to those found in these jurisdictions it would provide investors with a familiar framework, which would encourage utilisation of the regime.

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

THE INTERNATIONAL CONTEXT

3.6 In considering the appropriateness of an exemption style approach for an IMR, the Board considered tax treatments in other jurisdictions.

3.7 Broadly, most jurisdictions do not tax the gains of foreign investors from the sale of shares, bonds and other marketable securities, particularly given their portfolio nature. Such jurisdictions generally consider that marketable securities held by foreign funds (that are collective investment vehicles) are passive investments and are often capital in nature. Where a foreign investor has a substantial interest in a resident company or holds real property in the investment country, some jurisdictions impose tax.

3.8 Gains arising from the disposal of a range of market-traded securities are exempted in different jurisdictions. The United Kingdom, United States, Hong Kong and Singapore all consistently exempt the disposal gains from sale of equities, bonds, debentures and futures. It is not uncommon for any dealing with interests in real property to remain taxable in these jurisdictions.

3.9 In addition, other jurisdictions allow foreign funds to establish discretionary management advisory businesses in their jurisdiction without creating a taxable presence there.

3.10 These jurisdictions have recognised the mobility of the relevant capital, and responded to competitive pressures with other jurisdictions seeking to attract foreign capital.

3.11 The Board notes, however, that the tax rules introduced in some jurisdictions are designed taking into account the particular characteristics of their economies. For these reasons, although it is appropriate to compare Australia's tax rules with the tax regimes operating in other jurisdictions, Australia's tax rules will need to take into account the particular characteristics of the Australian economy.

3.12 Further details on tax treatments under regimes comparable to an IMR operating in other jurisdictions are set out in Appendix B.

BOARD'S CONSIDERATION

3.13 The Board considers that an exemption style IMR provides advantages over other methods of providing foreign managed funds with the same tax outcomes.

3.14 Adopting an exemption style approach provides a clear signal to industry that Australia has removed significant impediments to foreign managed funds investing in Australia or using Australian intermediaries. Signalling this by instituting a clear legislative regime may support greater entry of foreign managed funds into the

Australian capital market than would otherwise be the case if an IMR were introduced in the form of a number of 'piece-meal' adjustments to existing tax rules.

3.15 An exemption style regime would provide the funds management industry with a clear tax framework and the tax certainty required to support increased levels of foreign portfolio investment into Australia and increased use of Australian intermediaries for conduit investments. The Board considers that this will enhance Australia's status as a leading regional financial centre and support growth and employment in the Australian managed funds industry.

3.16 Under an exemption style regime, tax outcomes for the investor would be set out in the specific regime so the investor would not need to work through the multiple tax issues under the current law. This approach is consistent with that adopted in the United Kingdom, Hong Kong and Singapore.

3.17 The Board also considers that introducing an exemption style IMR should be less complex to implement and administer than piece-meal changes to existing concepts in the tax law such as the revenue/capital distinction, permanent establishment, residence and source. Such tax concepts have been established based on both statute and case law — attempting to amend the operation of these rules to guarantee certain outcomes for foreign managed funds would likely be very difficult.

Recommendation 1:

The Board recommends that an IMR for foreign managed funds should be implemented using an exemption style approach.

CHAPTER 4: DEFINITION OF FOREIGN MANAGED FUNDS

4.1 Under an exemption style IMR, only foreign managed funds which meet certain qualifying requirements would be eligible for tax exemptions on particular investments.

4.2 To date, the Government's announcements of elements of a foreign managed funds IMR have proposed that a foreign managed fund would broadly have the following features:

- it is not an Australian resident;
- it is widely held (and not closely held);
- it undertakes passive investment; and
- it does not carry on or control a trading business in Australia.

4.3 This chapter sets out a discussion of the requirements which a foreign managed fund must meet in order to be eligible for an IMR.

4.4 Once funds meet the eligibility criteria, the Board recommends they be exempt only on particular types of transactions or investments they make. A discussion of the types of exempt transactions and investments is set out in Chapter 5.

LEGAL FORM OF THE FUND

4.5 The Board considered what types of legal structures for foreign managed funds should be eligible for an IMR.

Views in submissions

4.6 A number of submissions state that there should be a wide definition of 'foreign managed fund' for the purposes of the IMR. Specifically, the definition should cover a wide range of legal structures.

> ... the eligibility of an IMR should not be affected by the legal structure of foreign managed funds as long as they are of a type which falls broadly as a collective investment vehicle. As foreign funds formed in non-English or American law type jurisdictions (e.g. Japan and countries in mainland Europe) can take other legal forms to the current forms of foreign funds in Australia (i.e., companies, limited liability companies, limited partnerships or a trust) a broad classification is needed.
>
> Financial Services Council

Board's consideration

4.7 The Board agrees with stakeholders that the foreign managed funds IMR should apply to a broad set of CIV legal structures and arrangements. The Board notes that this is consistent with one of the design principles of the terms of reference with respect to the design of a CIV regime, which states that '*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*'. One of the design principles of an IMR was for the regime to be aligned with broader arrangements for the taxation of CIVs (noted in paragraph 1.4).

4.8 A wide range of structures and arrangements are commonly used as CIVs in foreign jurisdictions.

4.9 For example, the Undertakings for Collective Investments in Transferable Securities (UCITS) regime in the European Union covers a broad range of CIVs and is widely used by fund managers internationally. CIVs under the UCITS regime are not confined to legal entity structures, but also include CIVs which comprise common contractual arrangements among investors and an investment manager. An example is a Common Contractual Fund commonly used in Ireland as a CIV.

4.10 It is important for Australia's IMR to be compatible with a wide range of international CIV structures and arrangements in order to attract both investments from these funds into Australia and to facilitate the use of Australian financial services intermediaries.

4.11 For these reasons, the Board recommends that the scope of the IMR for foreign managed funds should cover a broad set of CIV structures and arrangements, including common contractual arrangements, and should not be limited to particular types of legal entity.

Recommendation 2:

The Board recommends that the scope of the IMR for foreign managed funds should cover a broad set of CIV structures and arrangements, including common contractual arrangements, and should not be limited to particular types of legal entity.

RESIDENCE AND PERMANENT ESTABLISHMENT CONSIDERATIONS

4.12 A requirement for a managed fund not to be Australian resident is an important prerequisite in order for the fund to be eligible for the IMR.

4.13 However, in applying Australia's tax rules to determine the residence of a managed fund, the Johnson Report found that the residence rules could potentially

deem foreign managed funds to be Australian resident entities if their 'central management and control' was based in Australia. The report noted that foreign managed funds were incurring additional transaction costs to ensure that board decisions were made outside Australia and that only a minority constituency of Australian resident board directors were kept in order to avoid the 'central management and control' of the fund being deemed to be located in Australia.

4.14 Furthermore, engaging an investment manager and conducting investment activities in Australia may create further uncertainty as to whether the fund has a permanent establishment in Australia in respect of investments not covered by the IMR.

4.15 As a result, the Johnson Report recommended that an IMR be introduced with the principle 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.

4.16 The Johnson Report further recommended that the IMR be introduced with the following fundamental principle:

> For non-resident investors investing in Australian assets through an independent investment adviser, the investors should not be deemed to have … an Australian permanent establishment, merely as a result of using an Australian intermediary.

4.17 The Board therefore considered Australia's residence rules and permanent establishment rules to see whether changes were appropriate in the context of foreign managed funds accessing the IMR.

Views in submissions

4.18 Broadly, to ensure that foreign managed funds are not treated as Australian residents in circumstances that would not align with the policy objectives of the IMR, some submissions suggested changes to Australia's residence rules which would link the rules to an entity's eligibility for the IMR. In particular, submissions suggested that foreign funds should be treated as not being an Australian resident where they otherwise qualify for the IMR and would only be treated as Australian resident by virtue of having central management and control in Australia.

> We recommend that changes to ensure that a foreign managed fund is not inappropriately taxed in Australia as a resident where central management and control may be in Australia, should be linked to an entity's eligibility otherwise for the IMR.
>
> Ernst & Young

4.19 Submissions also said Australia's current residence rules do not encourage the development of regional head offices in Australia.

> ... the Board must consider whether the IMR will simply be used to encourage investment management practices in Australia, or whether it will also be used as a consistent tool for encouraging regional offices and headquarters to be established in Australia.
>
> Pitcher Partners Advisors

4.20 Some submissions suggested other targeted modifications to Australia's residence rules to ensure foreign managed funds would not be taken to be Australian resident where the fund engages an Australian intermediary.

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

Board's consideration

4.21 The Board recommends that a foreign managed fund must not be an Australian resident in order to be eligible for the IMR.

4.22 The Board agrees with the Johnson Report and comments made by stakeholders that there are a number of difficulties that arise in the application of Australia's residence tests as they would apply to foreign managed funds seeking to access the IMR.

4.23 Under the current tax law, a company will be taken to be Australian resident if:

- it is incorporated in Australia; or
- 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.

4.24 Also under the current tax law, a limited partnership will be taken to be Australian resident if:

- the partnership is formed in Australia; or
- either:
  - the partnership carries on business in Australia; or
  - the partnership's central management and control is in Australia.

4.25 A trust will generally be taken to be Australian resident if either the trustee of the trust estate was a resident at any time during the income year, or the central management and control of the trust estate was in Australia at any time during the income year[10].

4.26 Alternative residence tests apply to unit trusts for capital gains tax (CGT) purposes[11] and to unit trusts under the public trading trust rules[12]. These alternative residence tests require the tracing of beneficial interests in the trust.

4.27 The Board considered a number of options to address the residence related difficulties raised in the Johnson report and raised by stakeholders.

4.28 In developing these options, the Board was of the view that changes should not be introduced broader than what would be necessary to address these difficulties. Consequently, the Board considered that changes should not be made to Australia's residence rules as they apply generally. These residence rules are long standing principles in Australia's tax law whose interpretation has been developed over many decades. Instead, for these difficulties to be addressed, the Board considered that a targeted adjustment should be made to the residence rules only for the purposes of applying the IMR rules. The Board considers, however, that a more general change is appropriate for the residence test of limited partnerships (see paragraphs 4.38 to 4.41 below).

Central management and control and the location of board meetings and residence of directors

4.29 The Board considered options for adjustments to be made to Australia's residence test so that a foreign managed fund would not be taken to be Australian resident only by virtue of it holding board meetings in Australia or having a majority of directors resident in Australia.

4.30 The Board considered the option of adjusting the residence rules such that the holding of board meetings in Australia would not be taken into account in assessing the location of central management and control for a managed fund. However, the Board reached the view that such an adjustment would not be desirable. Determining the location of central management and control requires a weighing together of a number of indicia of which the location of board meetings is one consideration. The Board considered that it was inappropriate to disregard the location of board meetings as this is a relevant factor in assessing the location of central management and control of an entity.

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10 Subsection 95(2), Division 6 of Part III of the ITAA 1936.
11 Definition of a "resident trust for CGT purposes", in Section 995-1 of the ITAA 1997.
12 Definition of a "resident unit trust", in Section 102Q, Division 6C of Part III of the ITAA 1936.

4.31 For the same reason, the Board considered it inappropriate to adjust the residence rules such that the residence of the directors of a foreign fund would not be taken into account as part of the indicia in assessing the location of the fund's central management and control.

4.32 The Board considered other options which could replace the central management and control test in the case of foreign managed funds accessing the IMR. These included deeming foreign managed funds not to be Australian resident on the basis of where the fund is 'established', 'registered', 'regulated', or 'marketed'. However, the Board considered these options problematic for a number of reasons. The terms 'established', 'registered', 'regulated', or 'marketed' would each give rise to questions as to the scope of those terms. This would create new threshold requirements specific to foreign managed funds accessing the IMR. Furthermore, it may be problematic to assess the location where some funds are 'established' — for example a common contractual arrangement may be entered into by multiple parties resident in different jurisdictions. Funds may also be registered, regulated or marketed in multiple jurisdictions.

4.33 Therefore, the Board was of the view that it was not appropriate to recommend a new residence requirement that would replace the central management and control test for foreign managed funds under an IMR.

Residence and the use of an Australian intermediary

4.34 After considering a number of options, the Board came to the view that any adjustment to the residence rules for the purposes of the IMR should deal with the problem that a foreign managed fund could be taken to be an Australian resident merely by virtue of engaging an Australian intermediary.

4.35 The Board considers that the decision of a foreign managed fund whether or not to engage an Australian investment adviser or other Australian intermediary should not influence the eligibility of the foreign fund for the IMR.

4.36 Accordingly, the Board recommends that the operation of Australia's residence test be modified, only for the purposes of it applying to a foreign managed fund under the IMR, such that a foreign managed fund will be deemed not to be an Australian resident if the only reason it would be an Australian resident is because it uses an Australian intermediary. This modification should apply to the residence tests for companies, limited partnerships and trusts.

4.37 The Board considers that the meaning of an Australian intermediary should be broad, and should include the case of foreign managed funds using Australian investment managers, brokers, custodians, legal advisers, and dependent agents.

Residence test for limited partnerships

4.38 The Board agrees with stakeholder comments that it is inappropriate for a limited partnership to be treated as an Australian resident merely by virtue of it conducting business in Australia. This would prevent a number of limited partnerships established overseas from accessing the IMR for foreign managed funds where they carry on a business in Australia without having central management and control in Australia — such limited partnerships would be treated as being Australian resident.

4.39 The Board recommends that the residence test for limited partnerships should be amended, only for the purposes of it applying to a foreign managed fund under the IMR, such that a limited partnership will be taken to be Australian resident if:

- the partnership is formed in Australia; or
- the partnership carries on business in Australia *and* has its central management and control in Australia.

4.40 The Board recommends the Government investigate whether the amendment to the residence test for limited partnerships should apply for all limited partnerships in the general tax law, and not only to limited partnerships seeking to access the IMR. This would align the residence test for limited partnerships in the general tax law and under the IMR, and would also more closely align the residence test for limited partnerships to the residence test for companies. In making this investigation, the Board suggests that due consideration be given to the potential implications of such changes.

4.41 The Board also notes that if the Government decides to amend the residence test for limited partnerships in the general tax law, a transitional rule should be implemented to ensure that any limited partnerships which change from being Australian resident to foreign resident as a result of the modification to the limited partnership residence test will not become taxable under CGT Event I1. Transitional rules should also be considered in the case of a limited partnership that is a member of a Australian tax consolidated group changing residence as a result of the modification to the limited partnership residence test.

Residence test for trusts

4.42 The Board recommends that the general residence test for trusts (in subsection 95(2) of Division 6 of Part III of the ITAA 1936) be applicable in testing whether a trust is not a resident of Australia for the purposes of accessing the IMR for foreign managed funds.

4.43 Under this test, a trust will be taken to be Australian resident if either the trustee of the trust estate was a resident at any time during the income year, or the central management and control of the trust estate was in Australia at any time during the

income year. This should apply whether or not the trust is a unit trust or a public trading trust.

4.44 The CGT residence test for unit trusts and the residence test for public trading trusts require the tracing of beneficial interests which the Board considers would impose undue compliance and administrative costs for foreign managed funds seeking to access the IMR.

Foreign managed funds with no residence

4.45 The Board understands that there may be cases where a foreign managed fund is not strictly resident in any jurisdiction. This may arise, for example, where the foreign managed fund is not a legal entity but comprises a common contractual arrangement among investors and an investment manager. It may also arise where the particular domestic tax residence rules in a jurisdiction do not apply to the type of arrangement used as a managed fund.

4.46 For the avoidance of doubt, the Board considers that where it can be demonstrated a foreign managed fund is not an Australian resident under Australia's residence rules (that is, the foreign managed fund is a 'non-resident'), this should be sufficient for that foreign managed fund to access the IMR. As a general rule, the foreign managed fund should not be required to demonstrate that it is a resident of another jurisdiction under that jurisdiction's residence rules in order to access the IMR.

4.47 The Board does note that, for integrity purposes, it has recommended in Chapter 6 that a foreign managed fund should be resident in an information exchange country as a prerequisite for accessing the IMR (Recommendation 11). If this recommendation is introduced, a foreign managed fund would technically need to be resident in a particular jurisdiction in order to qualify for the IMR. In this respect, the Board notes there are provisions that will deem residence for entities or other CIV arrangements which are not resident in any jurisdiction (discussed at paragraphs 6.43 to 6.44 below).

Foreign managed funds to be treated as non-resident for all purposes of the tax law

4.48 The Board also acknowledges that once a foreign managed fund is eligible for the IMR under the modified residence test, it would be important that the fund also be treated as non-resident for the purposes of applying all other provisions in the tax law. If this were not the case, a foreign managed fund could be treated as a non-resident for IMR purposes, but be treated as a resident for the purposes of other provisions in the tax law. The Board considers this an undesirable outcome which would create unreasonable complexity.

4.49 Undesired tax distortions could also arise. A foreign managed fund could be treated as a non-resident under the IMR and be exempt on disposals of eligible investments, but be taxable as a resident on receiving dividend income on those investments. The same distortion would arise where a foreign managed fund receives interest income on tradable bonds. In these cases, the appropriate outcome would be

for the foreign fund to be treated as a non-resident so that any dividend and interest income would be subject to withholding tax.

4.50 The Board noted that if a foreign managed fund is treated as a non-resident for all purposes in the tax law, this may enable other tax concessions available to non-residents to also be made available to foreign managed funds, including the non-resident CGT rules. This placed an additional emphasis on ensuring that any funds that were appropriately 'Australian funds' were not allowed to be treated as non-resident under a modified IMR residence test — thus, any modifications to the residence rules should not be broader than necessary. The Board considered that its recommended modification to the residence test (set out above) is sufficiently narrow to ensure that funds which are in effect based in Australia are not allowed to access the IMR and other non-resident tax concessions.

4.51 Accordingly, the Board recommends that a foreign managed fund eligible for the IMR under the modified residence test should be taken not to be an Australian resident for the purposes of applying all provisions in the tax law.

Permanent establishment considerations

4.52 There are a number of provisions in the tax law that operate if a non-resident is taken to have a permanent establishment in Australia. For example, the CGT provisions provide Australia with a (*prima facie*) taxing right in respect of any assets where the non-resident has used the asset at any time in carrying on a business through a permanent establishment.[13]

4.53 Generally, a non-resident will be taken to have a permanent establishment where the non-resident has a place at or through which the person carries on any business in Australia[14]. As highlighted in the Johnson Report, the Board considers it inappropriate for a foreign fund to be taken to have a permanent establishment simply by virtue of the fund engaging an investment manager in Australia. Accordingly, the Board recommends that the IMR should also clarify that a foreign fund will not be taken to have a permanent establishment in Australia if the only reason it would have a permanent establishment is because it uses an Australian intermediary.

Goods and Services Tax (GST) considerations

4.54 The Board has primarily focused on the income tax implications of an IMR. Nevertheless, in the course of its review, the Board has been apprised of the fact that any changes made to the meaning of permanent establishment for foreign managed funds under the IMR may have implications for GST purposes.

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13 Section 855-15, Item 3 of the Income Tax Assessment Act 1997.
14 See subsection 6(1) of the Income Tax Assessment Act 1936 and various Tax Treaties.

4.55 Under the GST law[15], the supply of services to a non-resident is GST-free. Whether or not a foreign entity is regarded as a 'non-resident' for GST purposes depends on a range of factors. However, where a foreign fund engages a fund manager in Australia to provide funds management services, the transaction may not be GST-free. This could be the case where the nature of funds management services involves the fund manager acting as an agent on behalf of the foreign fund — in this case, the fund could be taken to have a permanent establishment in Australia for GST purposes. As the fund is 'in Australia', it will not be a non-resident for the purpose of the GST-free export rules[16], and the fund manager would need to charge GST on its services to the fund.

4.56 Where the foreign fund is registered for GST it may be entitled to claim input tax credits for the GST paid. However, to the extent that the funds management services relate to dealings in Australian financial investments, generally no input tax credits will be claimable — rather, a reduced input tax credit may be claimed in particular circumstances.

4.57 There may also be other GST implications which need to be considered prior to implementing the above recommendations regarding modifications to Australia's residence tests.

4.58 The Board considers that, to support the policy objectives of the IMR for foreign managed funds, it would be desirable that there be consistent permanent establishment and residence tests for income tax and GST purposes. This would reduce complexity for foreign managed funds accessing the IMR. Otherwise, they could be treated as non-resident for income tax purposes, while treated as being 'in Australia' for GST purposes.

4.59 However, the Board is mindful that extending IMR related income tax recommendations to GST law may be inconsistent with existing GST principles, and may result in a potential additional cost to the revenue. Further, any changes to GST law require the agreement of the States and Territories.

4.60 Having regard to these considerations, the Board recommends that the Government consider whether there should be consistent permanent establishment and residence tests for income tax and GST purposes, but only for the purpose of applying to foreign managed funds under the IMR.

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15 A New Tax System (Goods and Services Tax) Act 1999.

16 Section 38-190 of the GST Act.

Recommendation 3:

The Board recommends that:

- in order to be eligible for the IMR, a managed fund must not be an Australian resident;
- the operation of Australia's residence test be modified, only for the purposes of it applying to a foreign managed fund under the IMR, such that a foreign managed fund will be deemed not to be an Australian resident if the only reason it would be an Australian resident is because it uses an Australian intermediary;
- the residence test for limited partnerships should be amended, only for the purposes of it applying to a foreign managed fund under the IMR, such that a limited partnership will be taken to be Australian resident if:
  - the partnership is formed in Australia; or
  - the partnership carries on business in Australia *and* has its central management and control in Australia;
- the Government investigate whether the amendment to the residence test for limited partnerships should apply for all limited partnerships in the general tax law, and not only to limited partnerships seeking to access the IMR;
- the general residence test for trusts (in subsection 95(2) of Division 6 of Part III of the ITAA 1936) should be applicable in testing whether a trust is not a resident of Australia for the purposes of accessing the IMR for foreign managed funds;
- a foreign managed fund eligible for the IMR under the modified residence test should be taken not to be an Australian resident for the purposes of applying all provisions in the tax law;
- a foreign managed fund should not be taken to have a permanent establishment in Australia if the only reason it would have a permanent establishment is because it uses an Australian intermediary; and
- the Government consider whether there should be consistent permanent establishment and residence tests for income tax and GST purposes, but only for the purpose of applying to foreign managed funds under the IMR.

WIDELY HELD REQUIREMENT

4.61 The Board's discussion paper sought comments from stakeholders as to whether it was appropriate to require foreign managed funds to be widely held in order to be eligible for an IMR.

Views in submissions

4.62 Some submissions proposed that the foreign managed funds IMR, whilst confined to the financial services sector, should not be limited to widely held funds. These submissions suggested that the regime should cover a wide spectrum of investment entities, including closely held vehicles.

4.63 However, the majority of submissions appeared to be in favour of having a widely held requirement for foreign managed funds, as long as the widely held test could appropriately take into account not only the direct investors in the fund but also look through those investors in determining widely held ownership.

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

4.64 Some submissions also stated that the widely held requirement would be an appropriate means of helping ensure that the IMR did not provide benefits to Australian residents through round tripping.

> The risks for round tripping are limited substantially by limiting the application of IMR to widely held foreign funds as it restricts the extent to which funds can be established as accumulation vehicles to defer taxation through deferring distribution of income.
>
> Financial Services Council

Board's consideration

4.65 The Board considers that it would be appropriate to include a widely held requirement for an IMR for foreign managed funds.

4.66 The basic character of a CIV as a widely held vehicle is emphasised in the Board's terms of reference for its CIV review, and was a principle behind the design of the MIT regime. The Board was also specifically asked by the Government to consider the alignment of the design of an IMR with broader arrangements for taxing CIVs. The

Organisation for Economic Co-operation and Development (OECD) Report on CIVs also included a widely held requirement in defining a CIV.[17]

4.67 A widely held requirement also broadly aligns with the commercial nature of most foreign managed funds which operate as collective investment vehicles. These entities will generally pool the funds of many investors who do not have responsibility for the management of the fund. Instead, fund managers are responsible for managing the funds of investors in these CIVs.

4.68 In addition, the Board agrees with the views by certain stakeholders that the widely held requirement can assist in safeguarding the misuse of the IMR by Australian residents for tax deferral purposes through round tripping.

4.69 Round tripping in the IMR context refers to the potential for Australian investors to use non-resident interposed entities to inappropriately access the benefits of the IMR exemption. There is the potential for the Australian investor to defer taxation on investments in Australian assets through the IMR which would not have arisen if the investment had been made directly. Imposing a widely held requirement, together with potential other integrity measures, would operate to reduce the ability of Australian investors to influence the decision of a foreign fund to accumulate income so as to defer Australian taxation. The Board acknowledges, however, that round tripping could still occur despite Australian investors not having the ability to influence the decisions of a foreign fund if those Australian investors chose to invest into a fund which accumulates and reinvests profits as part of its investment policy.

4.70 Further details on the risks of round tripping and other integrity issues relevant to the design of an IMR for foreign managed funds are set out in Chapter 6.

4.71 In implementing a widely held requirement, the Board agrees with stakeholders that the test should capture not only direct investors in a foreign managed fund but should also be able to look through those investors to assess whether the fund is widely held. The Board also considers that the look through or tracing rules should be as simple as possible to create certainty and to not impose undue compliance burdens on foreign managed funds.

4.72 In designing these tracing rules, an appropriate starting point may be the widely held requirements in the definition of an Australian MIT. However, the MIT tracing rules would need to be modified to ensure that the widely held test can trace through entities with different legal structures which may invest into the foreign managed fund. The Board understands that the current MIT tracing rules may not allow tracing through entities apart from trusts.

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17 The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles (OECD April 2010) ("the OECD Report on CIVs"), paragraph 4.

4.73 Apart from the principles recommended above, the Board acknowledges there are also many detailed issues which would need to be considered in the design of a widely held test appropriate for foreign managed funds accessing the IMR. The Board considers that the Government should consult on the detailed design on the widely held test prior to the introduction of the IMR.

4.74 The Board notes that issues concerning the scope of an IMR for entities which are not managed funds are not covered in this report.

Recommendation 4:

The Board recommends that:

- a widely held requirement be included as part of the eligibility criteria for a foreign managed fund to access the IMR;
- the widely held test should be able to look through direct investors in the foreign managed fund to assess whether the fund is widely held; and
- the look through rules for the widely held test should be as simple as possible to create certainty and to not impose undue compliance burdens on foreign managed funds.

Requirement not to carry on or control a trading business in Australia

4.75 In its discussion paper, the Board suggested that the definition of a foreign managed fund should also include a requirement that the fund not carry on or control a trading business in Australia (except to the extent that its dealings in securities may amount to trading). This requirement would be broadly consistent with rules in Division 6C of Part III of the ITAA 1936.

4.76 The Board sought stakeholder comments on the appropriateness of this requirement.

Views in submissions

4.77 Submissions generally supported the requirement that a foreign managed fund not carry on or control a trading business in Australia.

4.78 In its submission, the Australian Private Equity & Venture Capital Association Limited (AVCAL) submitted that the requirement for a foreign managed fund not to carry on or control a trading business in Australia was not appropriate. It submitted that although a private equity or venture capital fund may have control over an Australian trading business, generally no particular investor into the fund would have control. For this reason, AVCAL submitted that each investor into a private equity or

venture capital fund would be passive in nature, and that this should entitle the fund in which they invest to access the IMR.

Board's consideration

4.79 The Board considers that it is appropriate as a qualifying condition for access to the IMR that foreign managed funds not carry on or control a trading business in Australia (as defined in Division 6C of Part III of the ITAA 1936). This is consistent with the principles covering the taxation arrangements applying to CIVs provided in the terms of reference for the Board's CIV review, the requirements of the MIT regime, and the requirements of a foreign managed fund for the purposes of the Government's announcements of elements of an IMR for foreign managed funds (referred to in paragraphs 1.20 to 1.24).

4.80 The Board also notes that it has been requested to consider as a design principle that the IMR be aligned with broader arrangements for the taxation of CIVs (noted in paragraph 1.4). In particular, the CIV terms of reference refer to CIVs undertaking primarily passive investment activities. In contrast, it is common for a private equity fund to directly or indirectly actively manage a business. This is made possible by having control of the relevant business. Exempting the income arising from that active involvement in the relevant business would be inconsistent with the international tax principles set out in Chapter 2.

4.81 Whether or not an individual investor in a private equity fund itself has control, it shares in the benefits of control held by the fund which, as indicated above, can come from the ability of the fund to have an active role in the relevant business. Consistent with the CIV terms of reference (at paragraph 1.11), it is the nature of the fund's activities that should determine its tax treatment, not the nature of the investor's investment in the fund.

4.82 The Board also notes that stakeholders indicated during targeted consultations that managed funds generally do not carry on a trading business (as defined in Division 6C of Part III of the ITAA 1936), and do not acquire interests in investments large enough to confer control.

4.83 The Board therefore recommends that in order to qualify for the IMR, foreign managed funds should not carry on or control a trading business in Australia (as defined in Division 6C of Part III of the ITAA 1936).

Recommendation 5:

The Board recommends that to be eligible for the IMR, a foreign managed fund should not carry on or control a trading business in Australia (as defined in Division 6C of Part III of the ITAA 1936).

MANAGED IN AUSTRALIA REQUIREMENT

4.84 In addition to the above design features, the Board also sought comments on the appropriateness of a 'managed in Australia' requirement, such as that in the MIT regime.

Views in submissions

4.85 Most stakeholders were not in favour of 'managed in Australia' or minimum spend requirements. They found such requirements could curtail the regime's potential for success and increase complexity and compliance activities. Furthermore, the submissions suggested that a 'managed in Australia' requirement would limit investors' flexibility in managing assets and discourage utilisation of the IMR.

> We submit that there should not be a "managed in Australia" requirement in the IMR. Such a requirement would restrict the way in which foreign funds choose to manage assets and generally distort decision-making. Furthermore ... to the extent that such tests include general, undefined terms such as "investment management", uncertainty is created which deters investment.
>
> The Institute of Chartered Accountants in Australia

Board's consideration

4.86 The Board agrees with stakeholders that a 'managed in Australia' requirement should not be incorporated into the IMR for foreign managed funds.

4.87 The Board considers that one key objective of the IMR for foreign managed funds is to provide certainty for the tax treatment of portfolio investments made by these funds in or through Australia. Specifically, the Board is proposing that such investments be exempted under an IMR. This is regardless of whether these foreign managed funds engage an Australian fund manager or not. Therefore, it is unnecessary and would be inappropriate to impose a managed in Australia requirement for the IMR.

4.88 The Board also agrees with stakeholders that a 'managed in Australia' requirement would limit investors' flexibility in managing assets and potentially discourage utilisation of the IMR.

4.89 Furthermore, the Board acknowledges that there are benefits in attracting mobile portfolio investment into Australia by providing exemptions under an IMR, even where an Australian intermediary is not engaged. Direct investments from foreign managed funds into Australia would provide business to other financial service providers, and would assist in deepening Australian capital markets.

Recommendation 6:

The Board recommends that a 'managed in Australia' requirement not be incorporated into the IMR for foreign managed funds.

CHAPTER 5: TYPES OF EXEMPT INVESTMENT INCOME

5.1 Foreign managed funds which meet the qualifying conditions become eligible for the IMR. The next question is whether all investments made by these qualifying funds should be granted exemptions under the IMR, or whether exemptions should be restricted only to certain types of investments.

PORTFOLIO INVESTMENT AND ELIGIBLE INVESTMENT BUSINESS REQUIREMENTS

5.2 The Board's discussion paper suggested that the exemptions offered under a foreign managed funds IMR should only extend to the disposal of investments that are of a portfolio nature and are consistent with the eligible investment business rules in Division 6C of Part III of the ITAA 1936.

5.3 The Board sought stakeholder comments on this suggestion.

Views in submissions

5.4 The majority of submissions supported the focus of an IMR on portfolio investments.

5.5 Submissions also broadly agreed that it would be appropriate to define investments with reference to the eligible investment business rules in Division 6C of Part III of the ITAA 1936, subject to certain modifications.

> ... the range of investments listed in the definition of "eligible investment business" in section 102M of Part III of the ITAA 1936 would be an appropriate starting point to define the range of investments that should be covered by an IMR. However, we recommend that one key modification should be made for use in an IMR. This includes the removal of the reference to investing in land.
>
> Taxation Institute of Australia

5.6 In defining the specific types of investments which should be exempted, some submissions referred to the investments exempted under tax rules in other jurisdictions comparable to an IMR and sought a wide list of eligible investments similar to the United Kingdom (UK) and Singapore regimes.

> Australia should consider establishing a similar wide ranging IMR to those of Singapore and the United Kingdom (UK), which include the full range of investment products. Otherwise the Australian initiative will not be competitive in attracting foreign investment management activities.
>
> Ernst & Young

5.7 Furthermore, some submissions stated the list of eligible investments should be adaptable to the development of financial services and investments over time.

> ... it is hoped that the range of eligible investments will be as broad as possible and or cover both direct investments in Australian collective investment vehicles (...) Trying to restrict the IMR regime to a closely defined group of assets (e.g. marketable securities only) may hinder innovation in this industry and leave Australia at a competitive disadvantage ...
>
> Henry Davis York

5.8 Submissions suggested the ring fencing of ineligible activities carried out in Australia by eligible non-residents. Measures to deal with ring fencing exempt income so that it is not tainted by non-qualifying investments would include:

- *de minimis* thresholds which if not satisfied would result in the application of the ordinary Australian taxation rules to the investments not covered by the IMR, if not to all of the non-resident's investments in Australia; or
- allowing the benefits of the IMR to be applied on a proportional basis (as in the UK).

> To have an effective IMR, other activities of non-residents coupled with the complexity of fund groups, should not influence their access to an IMR.
>
> Deloitte Touche Tohmatsu

Board's consideration

Portfolio investment requirement

5.9 The Board considers that IMR exemptions should only be granted for the disposal of portfolio investments made by foreign managed funds.

5.10 The Board notes that portfolio investments are typically more liquid in nature compared with non-portfolio investments, and therefore are more likely to be mobile and responsive to source taxation. For this reason countries such as the United Kingdom, Singapore and Hong Kong do not tax, or only lightly tax, portfolio investments. To the extent that Australia imposes taxation on mobile capital it will likely discourage investment in Australian financial assets.

5.11 The exemption of portfolio investments also flows on from findings made in the Asprey Report of 1975 which found that difficulties in collecting tax from stock-exchange transactions 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.

5.12 The Board notes that the exemption of portfolio investments is also consistent with elements of the non-resident capital gains tax exemption rules[18] introduced in December 2006. Under these rules, non-residents are generally exempted from capital gains tax on the sale of assets apart from Australian real property. However, non-residents remain taxable on capital gains from investments in an entity whose predominant value is in Australian real property (that is, a land-rich entity), but would generally be exempt if their investment in such an entity is only of a portfolio nature. These portfolio investments were exempted partly due to the mobility of such investments and the difficulty for foreign investors in obtaining information on whether their investments were land-rich.

5.13 The Board considers that in assessing whether a foreign managed fund has a portfolio investment, the foreign managed fund must have a less than 10 per cent interest in that investment.

5.14 The Board also considered whether a portfolio investment should take into account not only the interests held in an investment directly by a foreign managed fund, but also interests held in that investment by 'associates' of the foreign fund. This would stop related foreign managed funds making portfolio investments in the same entity such that their aggregate holding was of a non-portfolio nature.

5.15 However, if this requirement is imposed, and considering beneficiaries are associates of trustees and partners are associates of partnerships, a foreign managed fund established as a trust or partnership would need to ask its investors to disclose all of their investments in any of the entities that the fund invested in. The Board considers this would be practically unworkable for foreign managed funds given investors could refuse to disclose such information.

5.16 In view of the above, the Board recommends that, in implementing the portfolio investment requirement, further consideration be given to any integrity issues that would need to be addressed. In particular, it may be desirable to ensure that foreign managed funds do not act in concert with other entities to acquire interests of greater than 10 per cent while still accessing the exemption.

Prescribed list of eligible investments

5.17 The Board recommends that the IMR exemptions should only extend to a prescribed list of eligible investments made by a foreign managed fund. The Board notes that the prescribed list of eligible investments will comprise investments which must be portfolio in nature (including investments in shares of a company or units of a trust), and certain other financial investments (including investments in bonds and securities). Foreign managed funds would be permitted to make investments apart

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18 Division 855 of the ITAA 1997.

from those contained in the prescribed list, but these investments would not qualify for exemption.

5.18 The Board agrees with comments made by stakeholders that, in developing a prescribed list of eligible investments, the list of investments covered by the eligible investment business rules in Division 6C of Part III of the ITAA 1936 is an appropriate starting point. The Board also notes that other jurisdictions generally exclude investments in land and land-rich entities from qualifying for exemption.

5.19 For example, under the United Kingdom's Investment Manager Exemption rules, transactions relating to land, including transactions of any nature which result in either the acquisition of land or cash flows from such assets (that is, contracts in land or contracts relating to land), are not within the definition of investment transactions which are given exemption.

5.20 Futures and option contracts relating to land are specifically excluded from the definition of investment transactions subject to the exemption in the United Kingdom Investment Manager Exemption rules. However, certain futures and options contracts involving indices of land can qualify for exemption depending on the characteristics of the particular index used.

5.21 The Board recommends that, similar to other jurisdictions, transactions in land, including transactions of any nature which result in the acquisition of land, should be excluded from the prescribed list of eligible investments which qualify for IMR exemption. At the same time, the Board also recommends that the Government consider allowing certain land related futures and options contracts to be part of the prescribed list of eligible investments where they relate to a publicly quoted index.

5.22 The Board also considered whether IMR exemptions should apply to investments in Australian land-rich entities.

5.23 The Board noted in Chapter 2 that one of the generally accepted principles for the design of international taxation is that taxation arrangements should reflect the responsiveness of capital to taxation (*Principle 1*). In this context, land-rich entities can derive location-specific economic rents, and therefore there is scope to impose Australian tax without deterring investment in these entities.

5.24 However, as noted in paragraph 5.12, the Board acknowledges that Australia's non-resident CGT rules provide an exemption from capital gains tax to non-residents who dispose of investments in Australian land-rich entities, as long as those investments are portfolio in nature. One reason for this exemption from capital gains tax on portfolio investment in land-rich entities was the practical difficulty for foreign residents in determining whether the entities in which they invest are land-rich.

5.25 The same difficulty would arise if foreign managed funds are required to investigate whether their portfolio investments in Australian entities are land-rich

before they can access the IMR exemption for those investments. This difficulty may be particularly relevant where a foreign managed fund makes portfolio investments in Australian entities listed on an Australian stock exchange, which the Board understands would comprise the majority of Australian equity investments made by foreign managed funds.

5.26 The Board considers that investments in entities listed on an Australian stock exchange are typically more liquid than investments in unlisted entities. Investors wanting to invest in a listed entity can obtain information on the share price from the stock exchange, and normally can readily execute a purchase or sale using the stock exchange. In contrast, investors wanting to invest in an unlisted entity could typically be expected to undertake some level of investigation before committing to an investment, including obtaining pricing information and potentially a greater level of information on the nature of the investee's assets and activities. This is particular so since there are likely to be greater transaction costs in disposing of the investment.

5.27 The Board therefore considers that it would be overly cumbersome to require a foreign managed fund to ascertain whether an investment in an Australian listed entity was not land-rich before the investment could qualify for IMR exemption. Including such a requirement could create substantial compliance costs and may serve to undermine the objectives of the IMR for foreign managed funds. However, the Board considers it would not be unreasonable to require a foreign managed fund to ascertain as part of its purchase investigations whether an investment in an Australian unlisted entities was not land-rich.

5.28 The Board considers that this outcome would provide a practical approach which balances the desirability of maintaining taxation over Australian land interests and minimises compliance costs for foreign managed funds. The Board also notes that this approach would be broadly consistent with tax rules in the United States and Canada which also require land-rich testing for portfolio investments in unlisted entities, but no such testing for portfolio investments in listed entities.[19]

5.29 Therefore, the Board recommends that portfolio investments in Australian entities which are listed on an Australian stock exchange should be included in the prescribed list of eligible investments which qualify for IMR exemption, regardless of whether or not those entities are land-rich. However, the Board recommends that portfolio investments in Australian entities which are not listed on an Australian stock exchange should only be included in the prescribed list of eligible investments where those entities are not land-rich.

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19 Under the United States Foreign Investment in Real Property Tax Act (FIRPTA) rules, and the "taxable Canadian property" rules under subsection 248(1) of the Income Tax Act, RSC 1985, c 1 (5th Supp).

5.30 The Board notes that, under the non-resident CGT rules (in the case of non-portfolio investments)[20], an entity is land-rich if over 50 per cent of its market value is attributable to interests in Australian real property. This test requires a consideration of not only Australian real property interests directly held by that entity, but any Australian real property that may be held by the entity's subsidiaries. The Board considers that in the context of testing whether a portfolio investment in an Australian unlisted entity is land-rich under an IMR for foreign managed funds, the same test should broadly apply.

5.31 However, the Board suggests that the Government consider whether a modification should be made in testing whether a portfolio investment in an Australian unlisted entity is land-rich or not. Under this modification, Australian unlisted vehicles (such as Australian equity funds) whose value is predominantly attributable to investments in Australian listed entities would be taken not to be land-rich. This is consistent with the above recommendation that foreign managed funds be exempt on portfolio investments in Australian listed entities irrespective of whether they are land-rich or not.

5.32 The Board considers that withholding tax should continue to apply to payments of interest, dividends, royalties and MIT fund payments paid to foreign managed funds on their Australian investments. One of the policy drivers behind the IMR is to ensure that foreign funds receive the same after tax outcome whether or not they use an Australian intermediary. In addition, if withholding tax that currently applies to payments made to foreign managed funds was to be eliminated by the IMR, a tax bias toward qualifying IMR foreign funds would be created over other Australian assets that would otherwise have been subject to withholding taxes.

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20 Division 855 of the ITAA 1997.

Recommendation 7:

The Board recommends that:

- the tax exemption provided under an IMR should be restricted to the disposal of investments that are of a portfolio nature;
- a foreign managed fund will have a portfolio investment if it has a less than 10 per cent interest in that investment;
  - in implementing the portfolio investment requirement, further consideration be given to any integrity issues that would need to be addressed;
- the IMR exemptions should only extend to a prescribed list of eligible investments made by the foreign managed fund;
- transactions in land, including transactions of any nature which result in the acquisition of land, should be excluded from the prescribed list of eligible investments which qualify for IMR exemption;
  - however, the Government should consider allowing certain land related futures and options contracts to be part of the prescribed list of eligible investments where they relate to a publicly quoted index;
- portfolio investments in Australian entities which are listed on an Australian stock exchange should be included in the prescribed list of eligible investments, regardless of whether or not those entities are land-rich;
- portfolio investments in Australian entities which are not listed on an Australian stock exchange should only be included in the prescribed list of eligible investments where those entities are not land-rich; and
- withholding taxes should continue to apply to payments of interest, dividends, royalties and MIT fund payments paid to foreign managed funds on their Australian investments.

Non-portfolio investments in non-Australian assets

5.33 The Board's discussion paper also sought specific comments from stakeholders as to the appropriateness of providing IMR exemptions for the disposal of non-portfolio investments made by foreign managed funds in non-Australian assets.

Views in submissions

5.34 Some submissions commented on whether an IMR should exempt foreign managed funds on non-portfolio investments made in non-Australian assets. These submissions stated that such investments should be treated as exempt.

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

Board's consideration

5.35 The Board agrees with the views raised in submissions that foreign managed funds should be exempt on gains made on non-portfolio investments in non-Australian assets. The Board considers that the purpose of this would be to ensure that conduit income is not subject to Australian tax.

5.36 Foreign managed funds accessing the proposed IMR would generally have a diversified suite of investments, which may include both portfolio investments and non-portfolio investments in Australia or offshore. Whilst Recommendation 7 would treat gains made on the fund's Australian and offshore portfolio investments as exempt, gains made on any offshore non-portfolio investments (conduit income) could still be subject to Australian tax.

5.37 For example, under current tax rules, a foreign managed fund making a non-portfolio investment in a United States company listed on the New York Stock Exchange would generally not be subject to Australian tax. However, the foreign managed fund could be made subject to Australian tax if it used an Australian investment advisor to make this investment. Specifically, if the Australian investment advisor makes the buying and selling decisions with respect to the investment, any gains on disposal of the investment could be taken to be sourced in Australia and thus be potentially subject to Australian tax.

5.38 The Board considers that there will be a disincentive for a foreign managed fund to engage an Australian intermediary to manage its suite of investments if this creates the risk that non-portfolio offshore investments could be made taxable in Australia on the basis of being Australian-sourced. This could act to undermine the IMR for foreign managed funds. On this basis, the Board recommends that a gain made by a foreign managed fund from the disposal of non-portfolio investments in non-Australian assets (that is, conduit income) should not be subject to Australian tax if the only reason it is subject to Australian tax is because it uses an Australian intermediary.

Recommendation 8:

The Board recommends that a gain made by a foreign managed fund from the disposal of non-portfolio investments in non-Australian assets (that is, conduit income) should not be subject to Australian tax if the only reason it is subject to Australian tax is because it uses an Australian intermediary.

CHAPTER 6: PROTECTING THE AUSTRALIAN TAX BASE

6.1 While an IMR may provide exemptions for certain income and gains of foreign managed funds, these amounts should remain taxable in the hands of Australian investors in line with *Principle 3*. Thus, a well designed IMR should ensure that Australian residents, who would be taxable if particular investments were made directly, remain taxable on those investments where they are made through a foreign managed fund.

6.2 An IMR should also prevent opportunities for Australian residents to gain tax advantages through investing into foreign managed funds which qualify for IMR exemptions. Two main opportunities arise for such tax advantages to arise: (1) deferral of Australian tax; and (2) opportunities for tax evasion.

6.3 In designing measures to ensure the Australian tax base is protected, the design of an IMR should take into account existing integrity rules in the tax law. Additional integrity measures should only be imposed where the existing rules are insufficient to protect the Australian tax base.

6.4 Any IMR integrity measures should not place overly cumbersome eligibility or reporting requirements on foreign managed funds, or unduly increase the regulatory duties of the ATO.

VIEWS IN SUBMISSIONS

6.5 While submissions highlighted integrity measures as a key area of concern, they noted that an appropriate level of integrity should be achieved without constraining the IMR's intended outcomes with high compliance costs. The primary concern for stakeholders regarding round tripping was the accumulation by resident taxpayers of income and deferral of Australian tax, rather than opportunities for tax evasion that could arise from exemptions provided under an IMR.

> Whilst measures to deal with round tripping would be required, they should not impose such onerous compliance requirements on the foreign managed fund that they become counterproductive.
>
> The Institute of Chartered Accountants in Australia

6.6 Submissions underlined the scope for application of the Controlled Foreign Company and proposed Foreign Accumulation Fund provisions to safeguard resident taxation. Some submissions recommended that any integrity measures be directed at the underlying Australian investors rather than the foreign funds themselves.

6.7 Some submissions suggested that an appropriate widely held test be included into the IMR. Where such a test is satisfied, the spread of investors and the broad range of tax characteristics would make it difficult for any one particular investor to influence the fund's affairs, dictate its structure or influence its income distribution policy in order to obtain an inappropriate tax benefit. However, stakeholders also explained that Australian investors could achieve income deferral by investing in a widely held fund which has an explicit accumulation investment policy.

6.8 Submissions generally warned against imposing too onerous ownership tracing requirements.

> Ownership tracing is often not practical in widely held funds — for example, because investors are often themselves funds with a wide range of investors. Therefore, there is doubt as to whether the underlying ownership of the fund can be determined with any degree of certainty. In addition, proper tracing, even if practically possible, is often an expensive exercise and therefore an impediment to using the regime.
>
> Law Council of Australia

6.9 Some submissions suggested limiting the level of Australian investment in a foreign managed fund and applying ownership tracing tests to determine that the threshold level of Australian investment is not exceeded (a *de minimis* test). These submissions also advised against complicated ownership tracing and reporting requirements to prove the composition of Australian investment in the foreign fund.

> Any integrity rules relating to foreign funds which might have Australian resident investors should contain a significant Australian resident ownership de minimis test.
>
> Ernst & Young

6.10 A de minimis test allowing a degree of ultimate Australian ownership was generally considered appropriate and consistent with the approach in other jurisdictions (namely, Hong Kong and Singapore). Such a test could be applied in the determination of the aggregate level of Australian resident ownership or the level of ownership of single Australian residents and their associates (which may be easier to determine), or a combination of both. Submissions indicated specific threshold percentages ranging between 10 per cent and 50 per cent, with some indicating that it should not exceed those of competing jurisdictions.

> In Hong Kong, the exemption is denied where a single resident person (alone or with its associates) has an interest in 30 per cent or more of the equity in the offshore fund that is seeking access to the IMR. Of importance, it is noted that these tests are based on an associate inclusive investor test, and are not based on whether non-associated residents (on aggregate) meet such thresholds (which is different to that contained at a high level in the Board's report). These tests do not require a strict tracing of all unit holders and a

> grouping of all underlying resident unit holders to determine whether a de minimis threshold is satisfied.
>
> Pitcher Partners Advisors

6.11 Some stakeholders also suggested a maximum Australian exposure test with regard to the investments held by the foreign managed fund.

Taxation of Australian residents

Board's consideration

6.12 Although an IMR will grant exemptions to a foreign managed fund on income and gains from certain portfolio investments, the design of the IMR should ensure that the exemption does not pass on to Australian residents who may invest into the foreign managed fund.

6.13 Inappropriate outcomes may arise where the foreign managed fund is treated as a flow-through vehicle under Australian tax law. Examples may include the case where the foreign managed fund is a trust, a partnership or a mere contractual arrangement. In these instances, any exemption on gains provided to the foreign managed fund may flow-through to the investors in that fund.

6.14 The Board recommends that, at a minimum, the IMR rules ensure that Australian investors will remain taxable on distributions received from foreign funds (both directly and indirectly) where that distribution includes income that was exempt from income tax under the IMR for foreign managed funds. That is, such investors will not obtain a tax exemption merely by virtue of the IMR.

6.15 One way this could be achieved would be that ordinary or statutory income derived by Australian investors from a foreign managed fund (both directly and indirectly) is not made exempt merely by virtue of the income being treated as exempt for the foreign managed fund under the IMR.

Recommendation 9:

The Board recommends that income derived by Australian investors from a foreign managed fund (both directly and indirectly) is not made exempt merely by virtue of the income being treated as exempt for the foreign managed fund under the IMR.

MEASURES TO DEAL WITH DEFERRAL OF INCOME TAX

6.16 Where Australian residents invest into foreign managed funds which qualify for IMR exemptions, this may give rise to deferral of income tax since profits made on investments could be accumulated in the foreign managed fund and would only be taxable when paid to the Australian investor.

Australia's existing anti-tax-deferral rules

6.17 The operation of Australia's foreign source income attribution rules was reviewed by the Board in its September 2008 report on its *Review of the foreign source income anti-tax-deferral regimes*. The Board recommended that Australia's controlled foreign company (CFC) rules be retained as the primary set of rules designed to counter tax deferral arrangements. It also made a number of recommendations to modernise the CFC rules.

6.18 The CFC rules apply to holdings in foreign companies that are controlled by Australian residents. Given these foreign companies are controlled by Australian residents, those residents may use these companies to accumulate profits and defer Australian taxation. The CFC rules generally apply to prevent resident taxpayers from obtaining a tax deferral benefit on CFC's passive income and gains by treating those income and gains as assessable income to resident taxpayers on an accruals basis. The CFC rules are currently in the process of being updated and rewritten into the *ITAA 1997*.

6.19 Prior to 1 July 2010, investments by Australian investors in non-resident funds could have been subject to the foreign investment fund (FIF) rules.

6.20 The FIF rules were repealed as from 1 July 2010 in response to recommendations made by the Board in its *Review of the foreign source income anti-tax-deferral regimes*. In its report on this review, the Board found that in cases where Australian residents did not control a foreign accumulation fund, only a small risk existed for the deferral of tax, which was to be addressed by a narrowly targeted foreign source income attribution rule. In this respect, exposure draft legislation for a foreign accumulation fund (FAF) rule was released in February 2011.[21] This attribution rule, as currently drafted, would seek to target Australian residents holding certain interests in non-resident accumulation funds.

Board's consideration

6.21 Although the proposed IMR will treat Australian source income made by a foreign managed fund on the disposal of certain portfolio investments as exempt, the

21 Assistant Treasurer's Media Release No 032 of 17 February 2011 – http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/032.htm&pageID=003&min=brs&Year=&DocType=0.

Board considers that the risk of tax deferral for an Australian resident investing into the foreign fund in such instances would appear to be similar to the deferral risk which presently exists for Australian residents investing in other offshore vehicles which derive Australian source income.

6.22 The Board considers that the risk of deferral of tax through investments via foreign funds following the introduction of the IMR should be considered and addressed through the application of Australia's foreign source income attribution rules, in addition to the requirement of foreign managed funds to be widely held.

6.23 If an Australian resident sets up artificial arrangements offshore to accumulate investment income which involved a foreign managed fund, these arrangements would likely only be effective where that resident had control (whether directly or together with associates) over the foreign accumulation vehicle. In this case the Board considers the CFC rules are sufficient to address any deferral of taxation arising from such an arrangement.

6.24 Where an Australian resident invests in a foreign entity but is unable to control decisions of that foreign entity to accumulate or distribute income, the Board understands that the proposed FAF rules are aimed to address the key areas where there is a heightened risk of tax deferral.

6.25 The Board therefore considers it desirable not to create a further set of integrity rules to address deferral of taxation under the proposed IMR for foreign managed funds. Any such additional integrity rules would only add further complexity to the tax law given the existence of the foreign source attribution rules and their further development.

6.26 As part of the further development of the foreign source income attribution rules, the Board recommends that the Government consider whether any unique tax deferral opportunities arise from the design of the IMR for foreign managed funds, and take this into account in the final design of the attribution rules to ensure that any potential for such deferral is adequately addressed prior to the finalisation of those rules.

6.27 In this context, the Board notes that unlike Australian investors in a MIT which are to be subject to an attribution method of taxation, Australian investors in a foreign managed fund under the IMR would only be taxable when they derive income from the foreign managed fund. Whether or not this would constitute a heightened risk of tax deferral, including through a possible shift in investments by Australian investors from MITs to IMR foreign managed funds, is an area that may warrant further consideration by the Government.

6.28 The Board also recommends that the Government should undertake a post-implementation review of the operation of the foreign source income attribution rules and the IMR for foreign managed funds following their introduction into law to

ensure that inappropriate deferrals of tax are not being carried out through the IMR rules.

Recommendation 10:

The Board recommends that:

- integrity rules should not be introduced into the IMR for foreign managed funds to address deferral of taxation that would operate in addition to Australia's foreign source income attribution rules;
- the Government consider whether any unique tax deferral opportunities arise from the design of the IMR for foreign managed funds, and take this into account in the final design of the foreign source income attribution rules to ensure that any potential for such deferral is adequately addressed prior to the finalisation of those rules; and
- the Government should undertake a post-implementation review of the operation of the foreign source income attribution rules and the IMR for foreign managed funds following their introduction into law to ensure that inappropriate deferrals of tax are not being carried out through the IMR rules.

MEASURES TO DEAL WITH EVASION OF TAX

6.29 Where Australian residents invest into offshore assets, the basic risk arises that those residents may not report the income made on those offshore assets (the evasion of tax). This same basic risk arises where Australian residents invest into a foreign managed fund.

6.30 To assist in addressing this risk of tax evasion, a number of initiatives are being developed internationally, especially in the area of round tripping. These initiatives seek to provide tax authorities and revenue collection agencies with information on offshore investments made by their residents. The initiatives also seek to provide information on whether offshore investors into their jurisdiction are beneficially owned by domestic investors (that is, cases of round tripping by domestic investors), to ensure that any potential tax evasion can be addressed.

6.31 Some tax jurisdictions impose requirements on foreign funds investing into their jurisdiction to disclose information on any residents who invest into their fund. There are varying levels of information disclosure which are imposed on such funds, including disclosure of the residence of direct investors only to the disclosure of the residence of ultimate beneficial owners.

Existing projects for the tracing and identification of resident investors

6.32 A variety of approaches are being developed to address informational asymmetries which exist between market participants and revenue collection agencies. The United States (US) is currently implementing the Foreign Account Tax Compliance Act (FATCA) to address various issues relating to round tripping. Under the new laws:

- Foreign banks and other financial institutions operating in the US must reach an agreement with the Internal Revenue Service (IRS) and identify US accounts or they could subject their owners to a 30 per cent withholding tax.
- The definition of affected foreign financial institutions is broad and wide-ranging, and includes entities that manage investments, including alternative investment entities and insurance companies.
- Non-financial foreign entities (NFFEs) will be required to disclose whether they have any 10 per cent US owners. NFFEs that fail to document the existence or non-existence of US owners may be subject to the 30 per cent withholding tax regime.

6.33 The OECD has created the new Treaty Relief and Compliance Enhancement (TRACE) Group to deal with a broad range of issues relating to cross border taxation of capital flows, including the issue of round tripping. The objectives of its work are two-fold: (i) to develop treaty relief systems that are as efficient as possible, in order to minimise administrative costs and allocate the costs to the appropriate parties; and (ii) to identify solutions that enhance countries' abilities to ensure proper compliance with tax obligations, from the perspective of both source and residence countries.

6.34 One of the issues being considered by TRACE is the identification of beneficial ownership in foreign entities which may be used by resident investors for round tripping. Resident investors may invest in multiple tiers of offshore vehicles before investment is directed back on-shore. In these instances, ownership needs to be traced through potentially a number of vehicles and a number of tax jurisdictions.

6.35 Another measure that could be used to assist tax authorities to obtain information on investments made by resident investors in their jurisdiction is to rely on the network of countries with which the jurisdiction has exchange of information arrangements in place (information exchange countries). An example is Australia's MIT regime which provides a concessional withholding tax rate on fund payments only if those payments are made to investors who are resident in an information exchange country.

Measures to deal with compliance in other jurisdictions

6.36 Apart from measures which aim to provide tax authorities with relevant information on the investments made by investors resident in their tax jurisdiction, a number of jurisdictions have incorporated alternative measures to reduce the risk of

tax evasion by residents through round tripping. These measures may incorporate a combination of elements including reporting obligations on foreign funds as well as restrictions on the degree of ownership by resident investors in foreign funds seeking to access exemptions.

6.37 As an example, the Singapore tax law will provide tax exemptions on certain investments made by foreign funds into Singapore, but only for qualifying investors in the foreign fund. Non-qualifying investors are required to pay tax broadly based on the profits of the fund multiplied by their percentage holding in the fund. Foreign funds are required to identify and disclose to the Singapore tax authority the identities of any non-qualifying investors in the fund each year.

6.38 The definition of qualifying and non-qualifying investors under the Singapore tax regime only requires the identification of the direct investors into the foreign fund. The Singapore tax rules incorporate a de minimis test where Singaporean companies are entitled to tax exemptions if they own not more than 30 per cent of the foreign fund (or not more than 50 per cent if the fund has over 10 or more investors).

6.39 The Hong Kong tax law provides for a similar de minimis test where Hong Kong residents are entitled to exemption only if they own a beneficial interest of not more than 30 per cent in the foreign fund.

Board's consideration

6.40 The Board recommends that foreign managed funds should be required to be resident in an information exchange country (as defined in the MIT withholding tax rules[22]) as a prerequisite for accessing the IMR. This requirement will assist the Commissioner of Taxation to seek relevant information on the residence of investors in foreign managed funds with a view to identifying tax evasion by Australian resident investors.

6.41 This requirement will also align the residence requirements of foreign managed funds in the IMR with the MIT regime, fits into the broader policy context of information exchange and would support Australia's effort to address cross border tax non-compliance.

6.42 The definition of whether an entity is resident in an information exchange country in the MIT withholding tax rules specifically takes into account the circumstance where that entity may not strictly be a resident of any country. In this case, the MIT withholding tax rules will deem an entity to be resident in an

22 'Resident in an information exchange country' is defined in subsection 4(3) of the Income Tax (Managed Investment Trust Withholding Tax) Act 2008.

information exchange country if 'the entity is incorporated or formed in that country and is carrying on a business in that country'.[23]

6.43 However, the Board notes there may be circumstances where a foreign managed fund may not be considered to be an "entity", such as the case of common contractual arrangements, and thus may not be taken to be resident of any country. The Board considers that these types of CIV arrangements should be able to qualify for the IMR, and thus a residence deeming provision may be required such that, provided information is available as if the CIV were an entity resident in an information exchange country, it is deemed to be a resident of such a country for the purpose of the IMR. This will need to be taken into account in implementing the Board's recommendation.

6.44 The Board also notes that most jurisdictions where foreign managed funds are currently based are listed as information exchange countries[24]. A list of Australia's 51 current information exchange countries is contained in Appendix C. The scope of the IMR will increase as Australia enters into exchange of information agreements with more jurisdictions.

6.45 The requirement that foreign managed funds be resident in an information exchange country will also provide greater information to the Commissioner of Taxation in order to administer the CFC and proposed FAF rules to safeguard Australian resident taxation.

6.46 The Board also considered imposing reporting requirements on foreign managed funds under an IMR. In considering different reporting options, the Board agreed with stakeholders that any options should not place overly burdensome or impractical reporting obligations on foreign managed funds as this could act to deter investment through the IMR.

6.47 The Board came to the view that while, in principle, reporting obligations that require the tracing of ultimate beneficial ownership of funds would assist in integrity, such a requirement was considered to be too onerous. It would also go beyond the level of compliance required by foreign managed funds investing in most other tax jurisdictions.

6.48 After considering different options, the Board came to the view that foreign managed funds should be required to lodge an annual information return to the Australian Taxation Office to indicate that it was claiming IMR exemptions. The Board considers this would be important to enable the ATO to identify which foreign managed funds were claiming exemptions under the IMR.

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23 Refer footnote 23.

24 'Information exchange country' is defined in section 12-385 in Schedule 1 to the Taxation Administration Act 1953.

6.49 The Board recommends that the information return should be lodged within six months of the end of the foreign managed fund's accounting year, and that failure to do so would make the fund ineligible for the IMR for that year. The Board also recommends that the Commissioner of Taxation be given a power to exercise discretion in extending the time in which the foreign managed fund can lodge its information return.

6.50 The Board recommends that information required to be disclosed on the annual information return should be further developed by the ATO and Treasury. The Board recommends that the required content of the information return be set out in regulations to the tax law, so that changes can be made expeditiously where required.

6.51 The Board also recommends that in developing the required content for the information returns, the ATO and Treasury should take into account the following principles:

- the information should assist the ATO in identifying whether the foreign managed fund complies with the IMR eligibility requirements;
- the information should be readily obtainable by the foreign managed fund; and
- the information should not place overly burdensome or impractical reporting obligations on foreign managed funds.

6.52 Examples of the type of information which could be required in the annual information return include:

- the name and address of the foreign managed fund;
- accounting year for the foreign managed fund;
- confirmation that, at both the start and end of the year, the foreign managed fund is widely held, does not carry on or control a trading business in Australia, and is resident in an information exchange country;
- the information exchange country in which the fund is resident;
- the amount of profits made by the fund on portfolio investments, non-portfolio investments and other investments (such as derivatives and bonds); and
- contact details of representatives of the fund.

6.53 The Board considers that its recommended information return requirement is reasonable for foreign managed funds to comply with, and would provide the ATO with the information necessary to monitor compliance with the IMR.

6.54 In addition, the Board notes that if FATCA or TRACE are eventually integrated into the business systems of foreign managed funds, then Australia could consider adopting additional reporting rules consistent with these programs.

Recommendation 11:

The Board recommends that:

- as an integrity measure, foreign managed funds should be required to be resident of an information exchange country as a prerequisite for accessing the IMR;
- foreign managed funds should lodge an annual information return with the ATO within six months of the end of the fund's accounting year, and that failure to do so would make the fund ineligible for the IMR for that income year;
- the Commissioner of Taxation should be given a power to exercise discretion in extending the time in which the foreign managed fund can lodge its information return;
- the information required to be disclosed on the annual information return should be further developed by the ATO and Treasury;
- the required content of the information return be set out in regulations to the tax law, so that changes can be made expeditiously where required; and
- in developing the required content for the information returns, the ATO and Treasury should take into account the following principles:
  - the information should assist the ATO in identifying whether the foreign managed fund complies with the IMR eligibility requirements;
  - the information should be readily obtainable by the foreign managed fund; and
  - the information should not place overly burdensome or impractical reporting obligations on foreign managed funds.

Chapter 7: Taxation of Australian based intermediaries

7.1 The Johnson Report noted difficulties were faced by foreign funds with Australia's 'permanent establishment' rules. Under these rules, a foreign fund could be taken to have a taxable presence in Australia if it used an Australian investment advisor or fund manager and could result in the fund paying Australian income tax or losing the benefit of the non-resident capital gains tax exemption.

7.2 The Government's announcement[25] on 19 January 2011 of the conduit income element of the IMR for foreign managed funds proposed income tax amendments to exempt income from relevant investments of a foreign managed fund where such income would be taxable only due to the fund being taken to have a permanent establishment in Australia. The exemption was designed to ensure that no tax is imposed on investment income of a fund by virtue of it engaging domestic investment advisers or other Australian based intermediaries when the fund has no real presence in Australia.

7.3 The announcement noted that the proposed changes would not affect the taxation in Australia of the arm's length fee for the management function performed by Australian based intermediaries used by foreign managed funds.

7.4 The Board's discussion paper sought comments on the option of ensuring Australian intermediaries were only taxed on their arm's length fees for providing services to foreign managed funds. Specifically, it asked what types of intermediaries such an option should apply to and whether ring-fencing issues should be considered.

Views in submissions

7.5 Submissions generally called for a broad notion of eligible intermediaries.

> We consider that the IMR should be potentially applicable to all investment intermediaries in Australia whether they execute contracts for non-residents as part of the investment advisory and management function or whether they simply provide advice in one of many possible forms. The basic conditions of the UK IMR in this regards should be sufficient.
>
> Greenwoods & Freehills

25 Assistant Treasurer's Media Release No 010 of 19 January 2011 - refer footnote 6.

7.6 Stakeholders broadly concurred that Australia's transfer pricing rules would be sufficient to determine the arm's length fee which is appropriate for the services rendered.

7.7 If the IMR were to include provisions dealing with the taxation of the payments for an intermediary's services, some submissions suggested that a special bright line test for independence would be appropriate. This test would deem an intermediary to be dealing with the foreign managed fund at arm's length for the purpose of dispensing with any further substantiation requirements to prove that they were indeed dealing at arm's length. If the relationship could, by virtue of the bright line test, be characterised as independent then there would be no need to include such explicit rules dealing with payment for services in the regime.

> The UK threshold of 80 per cent of the business of the adviser being constituted by work for the non-resident provides a sensible bright line test for independence (...) though the manager should be able to demonstrate independence as a factual matter if outside this test."
>
> Greenwoods & Freehills

7.8 However, those submissions were generally opposed to unnecessarily onerous requirements to substantiate that the intermediary is acting independently.

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

Board's consideration

7.9 The Board is of the view that the recommendations it has made above in relation to introducing an exemption style IMR for foreign managed funds are adequate to ensure that foreign managed funds are not inappropriately taxed by virtue of the use of an Australian intermediary.

7.10 The exemption proposed for the IMR would apply to portfolio investments made by qualifying foreign managed funds. Since the exemption would apply to such investments made by the foreign managed fund, the fund would be exempt whether it made the investments directly or whether it made the investments using an Australian intermediary which gave rise to it having an Australian permanent establishment.

7.11 The exemption would cover the case of a foreign managed fund using any type of Australian intermediary for its investments, including investment advisers, fund

managers, brokers, financial institutions, dependent agents and custodians. It would also cover the case of a foreign managed fund being taxable on its investment income only by virtue of it using the Australian stock exchange as an intermediary.

7.12 The Board also agrees with the majority of stakeholders that Australia's existing transfer pricing rules would be sufficient to ensure an Australian related party intermediary's arm's length management fee is appropriately taxed.

7.13 The Board notes that, during targeted consultations, concerns were raised that there may be a problem in the operation of the arm's length test where the test may apply to assess what would be appropriate remuneration based on the actual performance of an Australian fund manager rather than being based on what would be considered appropriate remuneration at the time the management contract was entered into. Accordingly, the Board recommends that the Government investigate whether there is a problem in the operation of the arm's length test within the transfer pricing rules in this context, and if so, that any appropriate amendments be made.

7.14 During targeted consultations, stakeholders also raised the point that fund managers seeking tax certainty and wanting to avoid possible problems in the operation of the arm's length test may require advanced confirmation of arm's length fees with the ATO. These stakeholders acknowledged that fund managers could enter advanced pricing arrangements (APAs) with the ATO to provide this certainty, but to achieve this outcome the process to obtain APAs would need to be timely.

7.15 It is expected that once an IMR is introduced, there would be considerable demand for APAs to be obtained from the ATO from Australian financial intermediaries which act for related foreign managed funds. If APAs could not be provided in a timely manner, it would deter the use of Australian financial intermediaries even after introduction of the IMR.

7.16 The Board therefore recommends that the ATO take into account a potential increase in APA applications following the introduction of an IMR, and that it accords appropriate priority to this area in its allocation of resources.

Recommendation 12:

The Board recommends that:

- no further measures should be incorporated into an IMR for foreign managed funds to ensure the appropriate taxation of Australian intermediaries; and
- Australia's transfer pricing rules should continue to operate where appropriate to tax Australian intermediaries on their arm's length fees for services provided to foreign managed funds;
- the Government investigate whether there is a problem in the operation of the arm's length test within the transfer pricing rules, and if so, that any appropriate amendments be made; and
- the ATO take into account a potential increase in APA applications following the introduction of an IMR, and that it accords appropriate priority to this area in its allocation of resources.

Appendix A: List of Board's recommendations

Recommendation 1

The Board recommends that an IMR for foreign managed funds should be implemented using an exemption style approach.

Recommendation 2

The Board recommends that the scope of the IMR for foreign managed funds should cover a broad set of CIV structures and arrangements, including common contractual arrangements, and should not be limited to particular types of legal entity.

Recommendation 3

The Board recommends that:

- in order to be eligible for the IMR, a managed fund must not be an Australian resident;
- the operation of Australia's residence test be modified, only for the purposes of it applying to a foreign managed fund under the IMR, such that a foreign managed fund will be deemed not to be an Australian resident if the only reason it would be an Australian resident is because it uses an Australian intermediary;
- the residence test for limited partnerships should be amended, only for the purposes of it applying to a foreign managed fund under the IMR, such that a limited partnership will be taken to be Australian resident if:
  - the partnership is formed in Australia; or
  - the partnership carries on business in Australia *and* has its central management and control in Australia;
- the Government investigate whether the amendment to the residence test for limited partnerships should apply for all limited partnerships in the general tax law, and not only to limited partnerships seeking to access the IMR;
- the general residence test for trusts (in subsection 95(2) of Division 6 of Part III of the ITAA 1936) should be applicable in testing whether a trust is not a resident of Australia for the purposes of accessing the IMR for foreign managed funds;

- a foreign managed fund eligible for the IMR under the modified residence test should be taken not to be an Australian resident for the purposes of applying all provisions in the tax law;
- a foreign managed fund should not be taken to have a permanent establishment in Australia if the only reason it would have a permanent establishment is because it uses an Australian intermediary; and
- the Government consider whether there should be consistent permanent establishment and residence tests for income tax and GST purposes, but only for the purpose of applying to foreign managed funds under the IMR.

Recommendation 4

The Board recommends that:

- a widely held requirement be included as part of the eligibility criteria for a foreign managed fund to access the IMR;
- the widely held test should be able to look through direct investors in the foreign managed fund to assess whether the fund is widely held; and
- the look through rules for the widely held test should be as simple as possible to create certainty and to not impose undue compliance burdens on foreign managed funds.

Recommendation 5

The Board recommends that to be eligible for the IMR, a foreign managed fund should not carry on or control a trading business in Australia (as defined in Division 6C of Part III of the ITAA 1936).

Recommendation 6

The Board recommends that a 'managed in Australia' requirement not be incorporated into the IMR for foreign managed funds.

Recommendation 7

The Board recommends that:

- the tax exemption provided under an IMR should be restricted to the disposal of investments that are of a portfolio nature;

- a foreign managed fund will have a portfolio investment if it has a less than 10 per cent interest in that investment;
  - in implementing the portfolio investment requirement, further consideration be given to any integrity issues that would need to be addressed;
- the IMR exemptions should only extend to a prescribed list of eligible investments made by the foreign managed fund;
- transactions in land, including transactions of any nature which result in the acquisition of land, should be excluded from the prescribed list of eligible investments which qualify for IMR exemption;
  - however, the Government should consider allowing certain land related futures and options contracts to be part of the prescribed list of eligible investments where they relate to a publicly quoted index;
- portfolio investments in Australian entities which are listed on an Australian stock exchange should be included in the prescribed list of eligible investments, regardless of whether or not those entities are land-rich;
- portfolio investments in Australian entities which are not listed on an Australian stock exchange should only be included in the prescribed list of eligible investments where those entities are not land-rich; and
- withholding taxes should continue to apply to payments of interest, dividends, royalties and MIT fund payments paid to foreign managed funds on their Australian investments.

Recommendation 8

The Board recommends that a gain made by a foreign managed fund from the disposal of non-portfolio investments in non-Australian assets (that is, conduit income) should not be subject to Australian tax if the only reason it is subject to Australian tax is because it uses an Australian intermediary.

Recommendation 9

The Board recommends that income derived by Australian investors from a foreign managed fund (both directly and indirectly) is not made exempt merely by virtue of the income being treated as exempt for the foreign managed fund under the IMR.

Recommendation 10

The Board recommends that:

- integrity rules should not be introduced into the IMR for foreign managed funds to address deferral of taxation that would operate in addition to Australia's foreign source income attribution rules;
- the Government consider whether any unique tax deferral opportunities arise from the design of the IMR for foreign managed funds, and take this into account in the final design of the foreign source income attribution rules to ensure that any potential for such deferral is adequately addressed prior to the finalisation of those rules; and
- the Government should undertake a post-implementation review of the operation of the foreign source income attribution rules and the IMR for foreign managed funds following their introduction into law to ensure that inappropriate deferrals of tax are not being carried out through the IMR rules.

Recommendation 11

The Board recommends that:

- as an integrity measure, foreign managed funds should be required to be resident of an information exchange country as a prerequisite for accessing the IMR;
- foreign managed funds should lodge an annual information return with the ATO within six months of the end of the fund's accounting year, and that failure to do so would make the fund ineligible for the IMR for that income year;
- the Commissioner of Taxation should be given a power to exercise discretion in extending the time in which the foreign managed fund can lodge its information return;
- the information required to be disclosed on the annual information return should be further developed by the ATO and Treasury;
- the required content of the information return be set out in regulations to the tax law, so that changes can be made expeditiously where required; and
- in developing the required content for the information returns, the ATO and Treasury should take into account the following principles:
  - the information should assist the ATO in identifying whether the foreign managed fund complies with the IMR eligibility requirements;

  - the information should be readily obtainable by the foreign managed fund; and
  - the information should not place overly burdensome or impractical reporting obligations on foreign managed funds.

RECOMMENDATION 12

The Board recommends that:

- no further measures should be incorporated into an IMR for foreign managed funds to ensure the appropriate taxation of Australian intermediaries; and
- Australia's transfer pricing rules should continue to operate where appropriate to tax Australian intermediaries on their arm's length fees for services provided to foreign managed funds;
- the Government investigate whether there is a problem in the operation of the arm's length test within the transfer pricing rules, and if so, that any appropriate amendments be made; and
- the ATO take into account a potential increase in APA applications following the introduction of an IMR, and that it accords appropriate priority to this area in its allocation of resources.

APPENDIX B: OVERVIEW OF OTHER JURISDICTIONS

1. A number of jurisdictions have introduced rules to allow investors (including foreign funds) to establish discretionary management advisory businesses in their jurisdictions without creating a taxable presence there. These rules are referred to generically in this Appendix as investment manager regimes (IMRs). This note reviews IMRs in the United Kingdom, Hong Kong, Singapore and the United States. Recent proposed IMR reforms in New Zealand are also summarised.

2. The introduction of IMRs in a number of jurisdictions has largely responded to competitive pressures between jurisdictions seeking to attract this highly mobile business by simplifying the taxation arrangements applying to offshore funds, and by restricting their source rules. The IMRs generally allow non-resident investors to appoint or establish investment managers within a jurisdiction without creating a taxable presence in that jurisdiction.

3. Most jurisdictions have also exempted the gains made by foreign residents from the disposal of a wide range of securities, as well as in some cases the income from holding these securities. The nature of the transactions which are provided with exemption is generally limited to traditional financial assets, and generally excludes contracts dealing with interests in real property.

4. A variety of approaches to eligibility rules have been established to deal with resident investors. The broad trend is that resident investors in an offshore fund should not affect the fund's eligibility under IMR arrangements, but other measures (such as attribution rules and general resident taxation provisions) are used to ensure the taxation policies for residents are maintained.

5. A more detailed overview of the approaches taken in other jurisdictions follows.

Scope of other IMRs — Key feature comparison

The following discussion of overseas regimes is organised along these lines:

1. Objectives and background;
2. Scope;
3. How is a foreign fund defined?
4. What investment activities are permitted?
5. How is the fund taxed?
6. How is the intermediary taxed?
7. 'Round tripping': What happens to resident investors?
8. Where in the law?
9. Comments.

UNITED KINGDOM

Objectives and background

6. The Investment Manager Exemption (IME) was introduced to encourage non-resident investors to conduct investment business through financial institutions based in the UK without the risk of being taxed as though they were carrying on a trade in the UK through an agent — the investment manager. That is, the regime operates to prevent a UK investment manager from being treated for tax purposes as the UK representative of a non-resident trading in the UK. The amounts of tax assessable on the income of the non-resident are limited to amounts deducted at source. Any fees earned by the UK investment manager for services performed for the non-resident remain fully subject to UK tax.

7. Historically, the UK has tried to attract overseas investors to utilise local investment managers, thereby encouraging investment managers to establish themselves in the UK. However, there has always been the risk that the profits of the overseas clients carrying out trading activities in the UK might be subject to tax there, where conducted by local investment managers, because of the operation of income source and permanent establishment rules. In this context, the IME legislation was introduced to exempt those profits from UK tax in specified circumstances.

8. The trading safe harbour was introduced in 1995 and the UK was one of the first jurisdictions to have such an exemption. It was received as a positive measure by the industry as an incentive over other countries.

Scope

9. Five conditions must be met before the IME can apply:

- The investment manager must be carrying on the business of providing investment management services;
- The transaction must be carried out by the investment manager in the ordinary course of that business;
- The investment manager must act in relation to the transaction on behalf of the non-resident in an independent capacity (the 'independence test');
- The investment manager, together with any connected persons, must not be beneficially entitled to more than 20 per cent of the non-resident's taxable profits arising from transactions carried out through the investment manager (the '20 per cent rule').
- The remuneration that the investment manager receives in respect of the transaction is at least the 'customary' amount for that class of business (the 'customary remuneration test').

10. Transactions that do not meet the criteria will be subject to UK income tax or corporate tax, as the case may be, unless otherwise exempted.

How is a foreign fund defined?

11. The UK regime applies to non-residents generally, where they engage a UK investment manager which meets the five conditions.

What investment activities are permitted?

12. The IME applies to 'investment transactions' carried out by a UK investment manager for a non-resident. The definition of 'investment transactions' is now provided for under Statutory Instrument 2009/May (The Investment Manager (Specified Transactions) Regulations 2009). In summary, qualifying investment transactions would specifically include:

- any transaction in stocks or shares;
- any transaction in a 'relevant contract' which covers a wide range of derivatives such as options, futures and contract for differences;
- any transaction resulting in a non-resident person becoming party to a 'loan relationship' or a 'related transaction' in respect of such;

- any transaction in units in a 'collective investment scheme';
- any transaction in "securities" other than shares, debts and collective investment schemes as provided for above;
- any transaction consisting in buying or selling foreign currency; and
- any transaction in defined carbon emission trading products.

13. A major change in 2008 was to remove a 'cliff-edge' provision from the legislation. As originally framed, the protection of the IME could be lost entirely if there was just one non-qualifying transaction (for example, a commodity trade). Now, the result in that situation would be that the offending transaction would be fully exposed to tax, but the qualifying transactions would still be protected. This does not apply, however, if the qualifying transactions are integral to a non-qualifying trade carried on in the UK.

How is the intermediary taxed?

14. The income derived by the UK investment manager from the provision of services remains taxable. Further, to be eligible for the regime the UK investment manager must receive remuneration at a rate that is not less than customary for the services. 'Customary rate' is not defined in the legislation, but left to the discretion of the UK tax authority (Her Majesty's Revenue and Customs (HMRC)).

15. HMRC is guided by the OECD Transfer Pricing Guidelines in determining whether the level of remuneration received by the UK investment manager is customary. Managers that have adequate documentation in place and apply an acceptable methodology for achieving an arm's length reward will not jeopardise the exemption, even if transfer pricing adjustments to the managers' returns are subsequently found to be warranted.

'Round tripping': What happens to resident investors?

16. With the exception of rules which apply to the UK investment manager, the tax position of a foreign fund is not affected by the participation of UK investors.

17. The five qualifying conditions which must be met by UK investment managers (set out at paragraph 9) do impose certain restrictions which prevent UK residents from inappropriately benefiting from the IME.

18. The '20 per cent rule' must be met to ensure that the investment manager and persons connected with it do not have more than a 20 per cent interest in the offshore fund — that is, they must not be entitled to more than 20 per cent of the non-resident's chargeable profit arising from transactions carried out through the investment manager.

19. Where the only reason that the IME criteria are not met in relation to an investment transaction is that the 20 per cent rule is breached, the part of the income that the investment manager and connected persons are beneficially entitled to will remain subject to UK tax.

20. It is important to note that the 20 per cent test is one of intention, and can be deemed to be met throughout a reference period not exceeding five years, provided the UK manager's average entitlement (including that of any persons connected with the manager) to the fund's taxable income over the reference period arising from investment transactions carried out by the manager, meets the 20 per cent test.

21. The 20 per cent test is also treated as satisfied if the manager intended to meet the condition but failed to do so for reasons outside his control, as long as it can be proven that reasonable steps were taken in order to attempt to meet the condition. Therefore, the investment manager should make every effort to satisfy the 20 per cent test within a chosen reference period, but need not do this at all costs if there are valid commercial reasons why satisfying the test has not been possible.

22. . The 'independence test' also operates as an integrity measure by ensuring the investment manager is independent from the non-resident investor. It will be satisfied if the non-resident is a widely held vehicle or, if it is not, the provision of services by the investment manager to the non-resident is not a 'substantial part' (that is, no more than 70 per cent) of its overall business within 18 months of start up. Alternatively, the independence test will be met where HMRC is satisfied that the relationship between the investment manager and the non-resident is at arm's length, having regard to the overall circumstances of the relationship and HMRC are happy to advise on particular circumstances.

23. The UK legal system also includes anti-deferral rules in the form of an offshore funds regime by which profits or gains made in offshore investment funds are taxed on a realisation basis, but at income tax rates, rather than concessionary capital gains tax rates. The Offshore Funds (Tax) Regulations 2009 aims to prevent UK taxpayers from accumulating untaxed income offshore by investing in offshore roll-up funds and only paying tax on any chargeable gain realised on a later disposal of their investment. The attraction of such practice is in the disparity between the income tax and capital gains tax rates (top rate of 50 per cent and flat rate of 28 per cent respectively). Under the offshore funds regime, where a taxpayer invests in an offshore fund that rolls up income, the rules seek to tax the UK investor to income tax on any gain realised on a subsequent disposal of their investment unless the fund has reporting fund status.

Where in the law?

24. The UK IME is largely contained in Schedule 26 to the Finance Act 2003, parts of which are re-written in ITA 2007. The exemption interacts with a number of provisions in legislation, as well as statutory instruments, and is supplemented by an extensive statement of practice from HMRC (SP 1/01).

25. The UK tax law uses the permanent establishment concept as the jurisdictional connection for corporations. The law operates in relation to specified transactions, to set guidelines on the circumstances in which fund managers may be treated as a permanent establishment. Managers acting within the guidelines are independent agents (not permanent establishments) thus precluding a corporation tax charge and limiting UK taxation to fee income only. The relevant legislation works as follows:

- For corporation tax purposes, s 149(1) of the Finance Act 2003 limits UK taxation of non-resident companies to trade carried on through permanent establishments.
- Agents of independent status acting in the ordinary course of business are not permanent establishments of non-residents (s 148(3)).
- Schedule 26 to the Finance Act (which broadly describes the IME) sets out the circumstances of whether in relation to specified transactions the investment manager is regarded as an independent agent. Statement of Practice SP 1/01 amplifies the concept.

Comments

26. UK industry representatives have indicated that a key component of the UK IME is the accommodating approach taken by HMRC — that is, a focus on ensuring the objectives of the IME are achieved, rather than a black letter approach to the law. The importance of HMRC's approach is emphasised by reliance on joint development of the Statement of Practice and a highly responsive advance clearances regime to provide certainty as to the law's application, and substantial discretion to deal favourably with technical non-compliance with the rules.

Hong Kong

Objectives and background

27. In 2006, Hong Kong responded to existing measures in other financial centres to exempt offshore funds from taxation. It was thought to be vital for Hong Kong to provide a profits tax exemption to offshore funds to prevent asset management businesses being relocated to Singapore.

28. Prior to the IMR (contained in section 20AC of the Inland Revenue Ordinance), a person (including a non-resident) was liable to pay tax where the person derived profits from trading of securities listed in Hong Kong or other Hong Kong sourced income of revenue nature through a trade or business carried on directly by the person or indirectly by its agent. This apparently resulted in a significant movement of funds to Singapore.

Scope

29. Under Section 20AC of the Inland Revenue Ordinance, a non-resident entity is exempt from tax in respect of profits derived from 'specified transactions' carried out through 'specified persons' ('exempt transactions') and transactions incidental to the carrying out of those transactions. In order for the exemption to apply, the non-resident entity must not carry on any other trade, profession or business in Hong Kong that involves any transaction other than the exempt and incidental transactions.

How is foreign fund defined?

30. 'Offshore funds' include non-resident entities which can be individuals, partnerships, trustees of trust estates or corporations administrating a fund. Offshore funds include closely held funds.

What investments and activities are permitted?

31. The Hong Kong IMR exempts profits derived from 'specified transactions' carried out through 'specified persons' (exempt transactions), as well as transactions incidental to the carrying out of those exempt transactions provided that these do not exceed 5 per cent of the total trading receipts from both exempt and incidental transactions.

32. The Hong Kong regime does not distinguish between portfolio interests and non-portfolio interests. Instead, a non-resident is precluded from benefiting from the IMR if it carries on any other trade, profession or business in Hong Kong at all (that is, any activity or transaction other than the exempt and incidental transactions).

33. 'Specific transactions' in the Hong Kong IMR are listed in Schedule 16 to the Inland Revenue Ordinance and include six categories of transactions:

- Transactions in securities;
- Transactions in futures contracts;
- Transactions in foreign exchange contracts;
- Transactions consisting in the making of deposits other than by way of a money-lending business;
- Transactions in foreign currencies; and
- Transactions in exchange-traded commodities.

34. The specified transactions must be carried out through 'specified persons', being any persons licensed by the Hong Kong Securities and Futures Commission (SFC) and authorised institutions registered with the SFC (other persons are specified in Section 20AC in relation to prior transactions), a corporation licensed under Part V of the Securities and Futures Ordinance (Cap 571) or an authorised financial institution

regulated under that Part for carrying on a business in any regulated activity within the meaning of Part 1 of Schedule 5 to that Ordinance.

How is the fund taxed?

35. Non-resident funds are exempt from tax on qualifying transactions. No application for exemption is required. As mentioned above, the offshore fund is restricted from carrying on any other business in Hong Kong other than the specified transactions (or transaction incidental to those specified transactions).

How is the fund manager taxed?

36. There is no tax incentive or concessions to fund managers in Hong Kong.

'Round tripping': What happens to resident investors?

37. Hong Kong has enacted specific provisions to maintain taxation on certain residents who invest in offshore funds which access IMR exemptions.

38. Under the HK IME, a Hong Kong resident investor who (i) alone or jointly with its / his associates holds 30 per cent or more of the beneficial interests in a Section 20AC Exempted Offshore Fund, or (ii) holds any percentage of the beneficial interest in a Section 20AC Exempted Offshore Fund which is an associate of the Hong Kong resident investor, would be deemed to have derived otherwise taxable profits of the exempt offshore fund but for the exemption. The deeming provision would not apply where the Fund is bona fide widely held.

39. The disclosure requirements in the Hong Kong tax returns for incorporated and unincorporated entities and individuals specifically require the disclosure of any deemed assessable profits. However, the "deeming provisions" will not be invoked if the offshore fund is a 'bona fide widely held' fund (that is, a fund that has at least 50 investors holding all of the units or shares in the entity and at least 21 investors retaining beneficial ownership of 75 per cent of the income and assets of the entity). The Hong Kong system requires the relevant resident beneficial owner who is caught by the "deeming provisions" to report the deemed assessable profits to the Inland Revenue Department.

Where in the law?

40. The Hong Kong IMR rules are set out in Section 20 AC Inland Revenue Ordinance.

Comments

41. Hong Kong has a territorial based tax system. Generally, a person is only subject to a profits tax in Hong Kong on profits arising in or deriving from a trade, profession or business in Hong Kong, regardless of the residence of the person. Importantly, mutual funds authorised under Section 104 of the Securities and Futures Ordinance, unit trusts and similar widely held investment schemes set up in jurisdictions with

Recognised Supervisory Regime have always been exempt from profits tax. In addition, Hong Kong has a number of exemptions, for example no tax is levied on capital gains, interest or dividends.

SINGAPORE

Objectives and background

42. The Singapore IMR (Singapore Fund Tax Incentives) was introduced to implement a series of policy objectives including:

- the encouragement of world-class fund management services in Singapore;
- the encouragement of further development of the equity capital market in Singapore; and
- simpler administrative procedures and more flexible qualifying criteria for tax exemption.

Scope

43. The Singapore IMR exempts a qualifying fund (individuals, companies and trusts) from tax on 'specified income' from 'designated investments' (as defined in the tax regulations).

How is the foreign fund defined?

44. The exemption applies to non-resident individuals, companies and trusts. For companies and trusts, there are rules to exclude those with business activities in Singapore and to require at least some level of foreign beneficial ownership, that is, that the foreign investor is not 100 per cent owned by Singaporean persons.

45. A non-qualifying investor in the qualifying fund will have to pay a financial penalty. A qualifying investor is defined as:

- An individual investor;
- A bona fide non-individual investor that:
  - Does not have a permanent establishment in Singapore (other than a fund manager) and does not carry on a business in Singapore, or
  - Has a permanent establishment in Singapore but does not use funds from its operations in Singapore to invest in the qualifying fund;
- Certain specified Singapore government entities; or
- Any other investor that owns not more than 30per cent (or 50 per cent if the fund has 10 or more investors) of the qualifying fund.

What investment activities are permitted?

46. Tax exemption is only provided to certain income from designated investments.

47. Designated investments cover a range of transactions, including foreign exchange financial arrangements, shares (including unlisted shares), securities, certain derivatives, foreign real property, certain loans, physical commodities incidental to trading in commodity derivatives and certificates of deposits.

48. However, where the qualifying fund carries on business in Singapore (including through a permanent establishment other than the Singapore fund manager), the fund will be liable to tax in Singapore on profits attributable to the permanent establishment.

How is the fund taxed?

49. Subject to meeting eligibility requirements, income of the fund and the investor is exempt from Singapore taxation.

'Round tripping': What happens to resident investors?

50. Singaporean qualifying investors (for example, resident individual investors and non-individuals owning not more than 30 per cent / 50per cent) are not subject to the financial penalty where they invest into a qualifying fund eligible for the Singapore IMR.

51. However, as mentioned above, the Singapore IMR imposes a penalty on 'non-qualifying investors' who invest into the qualifying fund. The penalty has to be declared in the income tax return of the 'non-qualifying investors' for the relevant year of assessment.

52. A Singapore resident non-individual (other than the specified Singapore government entities) investor becomes a 'non-qualifying investor' when its interest in the non-resident fund exceeds more than a 'prescribed percentage' being:

- where the fund has less than 10 owners or beneficiaries: 30 per cent; and
- where the fund has 10 or more owners or beneficiaries: 50 per cent.

53. Fund managers are required to make an annual declaration of information on non-qualifying investors to the Inland Revenue Authority of Singapore (IRAS). This allows the IRAS to assess residents on their earnings from the funds in question and ensure the integrity of the exemption. This information is used to assess any liability for penalties which has been incurred by owners or beneficiaries as a result of exceeding the prescribed percentage.

Enhanced Tier Fund Tax Incentive Scheme

54. The Enhanced Tier Fund Tax Incentive Scheme (ET Scheme) is available for application from 1 April 2009 to 31 March 2014. It was introduced to provide certain

concessions (as discussed below) for funds with a minimum size of S$50 million at the point of application (among other conditions). The purpose of the scheme is to open up the existing exemption to local investors if certain conditions are met.

55. Under the ET Scheme, there are no restrictions imposed on the residence status of the funds or the investors. In addition, the 30 per cent (or 50 per cent) investment limit imposed on resident non-individual investors has been lifted for funds within the ET Scheme. There is no limit on the amount of investments that Singapore investors can place in an ET fund.

56. A fund that is approved under this scheme enjoys a tax exemption on specified income derived from designated investments for the entire life of the ET fund.

57. In order to be approved for the ET Scheme, the fund must meet a number of conditions evidencing a greater connection with the Singaporean jurisdiction, for instance display a minimum size, being managed or advised directly by a an eligible fund management company in Singapore, incur a minimum local business spending and not change its investment strategy after being approved for the ET Scheme.

Where in the law?

58. The Singapore Fund Tax Incentives are contained in the Income Tax Act under sections 13C, 13CA, 13Q, 13R, 13X and 13Y. This legislation is supplemented by the Arrangement of Regulations S640/03, S 6/2010, S 7/2010, S 8/2010 and S 414/2010. The Monetary Authority of Singapore has also issued these Circulars FDD Cir 04/2007, 03/2009 and 05/2010 on the matter.

59. The offshore fund rules in Singapore are complex. Singapore has many wealth management and asset management related tax rules. Many have evolved over time to what they are today and in some cases the old provisions remain (leaving behind several schemes for almost the same ultimate goal). The above discussion has focused on sections 13CA and 13X which are two of the more recent rules.

Comments

60. Singapore operates a quasi-territorial basis of taxation — that is, generally income sourced in Singapore is liable to tax, and income having a source outside Singapore is liable to tax where it is received in Singapore. Certain types of foreign-sourced income are exempt from tax where conditions are satisfied. No tax is levied on capital gains.

61. For non-resident persons without a permanent establishment in Singapore, tax is only levied on income sourced in Singapore.

United States

Objectives and background

62. Since 1936 the US has introduced a number of trading 'safe harbours' which provide certainty that foreign persons who merely trade stocks and securities would not be subject to the net income tax regime. These measures were intended over time to encourage foreign investors to trade in US capital markets.

63. The US law relating to trading on behalf of non-residents has had a number of iterations over time, and there is no 'IMR' as such. Further, these developments are often contextual to the broader US tax framework that existed at the time, and as such the policy objectives of the current rules are not as easily discernable as those in the UK or other jurisdictions.

64. The US law provides a 'safe harbour' that exempts non-resident investors from federal income tax on non-real estate related capital gains and other investment income, unless that non-resident is engaged in the conduct of a trade or business within the US. A foreign entity may be engaged in a US trade or business when an agent conducts activities on its behalf in the US. Where the foreign entity has a high degree of control over the agent, the (dependent) agent's activities will be imputed to be those of the foreign entity. In such cases, the fund will be subject to tax on a net income basis on the income that is 'effectively connected' with the conduct of the trade or business, at the corporate tax rate.

Scope

How is foreign fund defined?

65. The concept of residence as used by the US is based on the place of incorporation. Corporations are considered to be domestic corporations if they are organized under the laws of one of the US states or the District of Columbia, and are considered foreign corporations if they are organized under the laws of a foreign jurisdiction.

66. Unincorporated entities such as partnerships and limited liability companies (LLCs) may make a voluntary election under the Treasury Department's 'check-the-box' regulations to be taxed as corporations or as pass-through (transparent) entities.

What investments/activities are included?

67. A foreign fund without a permanent establishment in the US is exempt from tax on profits or gains from listed shares, bonds and money market or other financial instruments and derivatives.

68. Furthermore, foreign funds will not be subject to tax on profits or gains resulting from trading in stocks, securities, or commodities in the US for the taxpayer's own account, even if the transactions are consummated directly by the taxpayer or by an

agent with full discretionary authority to make decisions. This protection applies (except for dealers) whether or not the trading is carried out through an office of the taxpayer in the US.

How is the fund taxed?

69. A foreign fund without a permanent establishment in the United States will not be liable to US tax on profits or gains from listed shares, bonds and money market or other financial instruments and derivatives. Dealing in these instruments is not regarded as constituting an active business for US tax purposes and is treated as a 'passive investment activity'. Interest and dividend withholding taxes are still payable.

How is the fund manager taxed?

70. US fund managers are taxed on their arm's length income.

'Round tripping': What happens to resident investors?

71. The US has specific rules to tax the offshore investment income of their residents on an accruals basis.

Where in the law?

72. Section 864 if the Internal Revenue Code provides that the phrase 'trade or business within the United States' generally includes the performance of personal services within the US at any time during the taxable year but, under certain circumstances, does not include trading in stocks, securities, or commodities through an independent agent, or for the taxpayer's own account (the 'trading safe harbours').

73. Regulations 1.864-2 defines several contingent terms regarding trade or business within the United States, and exempt transactions.

Comments

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

75. A non-resident's income that is subject to US income tax is generally divided into two categories:

- Income that is 'effectively connected' with a trade or business in the US; and
- US source income that is Fixed, Determinable, Annual, or Periodical (FDAP).

76. Effectively Connected Income, after allowable deductions, is taxed at the same rates that apply to US citizens and residents. FDAP income generally consists of passive investment income and is taxed at a flat 30 per cent (or lower treaty rate) and no deductions are allowed against such income.

NEW ZEALAND

77. The New Zealand Government has recently considered recommendations on how to enhance New Zealand as an international financial services centre. These recommendations were contained in a report by the International Funds Services Development Group (IFSDG)26 which, in New Zealand, fulfils a similar function to the Australian Financial Centre Forum.

78. The IFSDG recommended that establishing New Zealand as a financial services centre would require clarification of existing tax policy as it relates to Portfolio Investment Entities (PIEs).

Objective

79. The objective of the proposed reforms is to make New Zealand a 'funds domicile' or the legal 'home' of a managed fund. The IFSDG report notes that New Zealand should focus its efforts in attracting funds administrators / servicers rather than fund managers and distributors. The IFSDG report sees New Zealand as complementing rather than competing with Australia, Hong Kong and Singapore, jurisdictions that they see as focussing primarily on attracting fund managers.

80. The report from the IFSDG suggests that New Zealand could develop into a viable funds domicile in the medium to longer term and that the full realisation of the domicile opportunity would generate revenue in New Zealand of approximately NZ$0.5 billion to NZ$1.3 billion per year, tax revenue of between NZ$150 million and NZ$360 million per year, and 2,000 and 5,000 high-quality jobs by 2020/2030.

Strategy

81. The IFSDG proposes a two-staged approach as the most appropriate strategy for establishing New Zealand as a funds domicile. In stage one, to be completed by the end of 2012, the focus will be on establishing the conditions for a funds domicile. Stage two would capitalise on the implementation of the changes in stage one and will be focussed on attracting domicile activities to New Zealand.

82. As part of stage one, three key activities are proposed: (a) tax reform; (b) regulatory reform and (c) high-level government support in leading the required reforms and complementary initiatives, such as jurisdiction relationship building and developing New Zealand's labour market capability.

Regulatory reform

83. Regarding regulatory reform, the aim is to replicate or improve upon existing investor protection global standards, with rules equivalent or better than the European

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26 Exporting Financial Services: A Report from the International Funds Services Development Group, February 2011

Union's UCITS regime. A two-tiered opt-in system is proposed with the export industry being required to conform to the higher standard of regulation and the domestic industry being subject to a less rigorous system. Individual players in the domestic market would be able to opt-in to the more stringent export regulatory standard.

Tax reform

84. Tax reform comprises changes to the tax treatment of non-residents investing in foreign assets through a New Zealand portfolio investment entity (PIE). The New Zealand Government has noted that these changes are intended to remove a barrier to non-residents investing into New Zealand and are a clarification of existing tax policy.

85. On 5 April 2011, the New Zealand Minister for Revenue, the Hon Peter Dunne, announced the new tax rules which will allow foreign investors to pay a zero percent tax rate on their foreign-sourced PIE income. Mr Dunne said that the rules were designed to be as simple as possible for PIEs to administer, while still providing that non-residents pay the right amount of tax on their investments.

86. The new rules introduce two new categories of PIEs:

- The first new category of PIE, which entities could elect into, will have both resident and non-resident investors and only foreign-sourced income, subject to a 5 per cent minimum threshold for New Zealand-sourced interest income and a 1 per cent minimum threshold for New Zealand-sourced income from equities. Non-residents in these PIEs will be taxed at zero percent.

- The second category of PIE, which entities could elect into, will have both resident and non-resident investors, and both foreign-sourced income and New Zealand-sourced income, with variable rates applying to non-resident investors reflecting the rates that would apply if the investment was direct:

  - (i) 0 per cent on foreign-sourced income;

  - (ii) 0 per cent on dividends derived from New Zealand companies that are fully-imputed;

  - (iii) 15 per cent on dividends derived from New Zealand companies that are unimputed where the investor is from a country with which New Zealand has a double tax agreement (DTA);

  - (iv) 30 per cent on dividends derived from New Zealand companies that are unimputed when the investor is from a country with which New Zealand does not have a DTA;

  - (v) 1.44 per cent on New Zealand-sourced financial arrangement income (being the deductible approved issuer levy (AIL) rate); and
  - (vi) 28 per cent on other New Zealand-sourced income.

- The application date for the first category is the date the Taxation (Tax Administration and Remedial Matters) Bill 2010 receives Royal assent. The application date for the second category is 1 April 2012.

87. The above two new categories of PIEs were canvassed initially as options in a discussion paper issued jointly by the New Zealand Inland Revenue and The Treasury[27]. Commenting on these options, the IFSDG noted that it would like to subsequently expand upon the recommended changes to ensure that the tax environment was clearly understood by non-residents and does not depend on the structure of the investment entity.

88. The IFSDG also noted in its February 2011 report that a zero percent tax rate for foreign sourced income benefitting non-residents was a prerequisite to funds incorporating in New Zealand. It also noted that in order to allow the establishment of a funds domicile in New Zealand the PIE tax changes need to:

- be managed by the Government, providing confidence that the changes are enduring;
- ensure that multi-layer 'fund of funds' or 'master feeder' structures that are common globally are eligible to participate in the zero per cent PIE regime;
- apply to all sources of foreign income with absolute certainty in statute as to the definition of what constitutes foreign-sourced income for all security types (including shares, money market placements, interest-bearing securities, derivatives and private equity style investments);
- extend to the full range of investment vehicles commonly used by fund managers internationally, including unit trusts, limited liability partnerships (LLPs), companies (including open ended investment companies) and other vehicles such as SICAVs[28], SICAFs[29] and FCPs[30] commonly used in Luxembourg;
- not unduly disadvantage New Zealand financial solutions providers where they provide services to domicile participants, which is classified as New Zealand income (the need for a minimum threshold);

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27 *Allowing a zero percent tax rate for non-residents investing in a PIE – An officials' issues paper*, Policy Advice Division of Inland Revenue and The Treasury, April 2010.

28 'Société d'investissement à capital variable'.

29 'Société d'investissement à capital fixe'.

30 'Fond commun de placement'.

- be readily understood and recognised by international fund managers; and
- for LLPs, not treating foreign income as New Zealand source income if an LLP obtains New Zealand-based management or administration services.

APPENDIX C: LIST OF INFORMATION EXCHANGE COUNTRIES

The tax jurisdictions which are currently listed as information exchange countries in Regulation 44E of the *Taxation Administration Regulations 1976* are set out in the table below.

No	Tax jurisdiction	No	Tax jurisdiction
1	Argentina	27	Russia
2	Bermuda	28	Slovakia
3	Canada	29	South Africa
4	China	30	Spain
5	Czech Republic	31	Sri Lanka
6	Denmark	32	Sweden
7	Fiji	33	Taipei
8	Finland	34	Thailand
9	France	35	United Kingdom
10	Germany	36	United States of America
11	Hungary	37	Vietnam
12	India	38	Antigua and Barbuda
13	Indonesia	39	British Virgin Islands
14	Ireland	40	Isle of Man
15	Italy	41	Jersey
16	Japan	42	Gibraltar
17	Kiribati	43	Guernsey
18	Malta	44	Belize
19	Mexico	45	Cayman Islands
20	Netherlands	46	The Commonwealth of the Bahamas
21	Netherlands Antilles	47	Principality of Monaco
22	New Zealand	48	The Republic of San Merino
23	Norway	49	The Republic of Singapore
24	Papua New Guinea	50	Saint Kitts and Nevis
25	Poland	51	Saint Vincent and the Grenadines
26	Romania		