Australian Government

The Board of Taxation

REVIEW OF TAX ARRANGEMENTS APPLYING TO COLLECTIVE INVESTMENT VEHICLES

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 tax arrangements applying to Collective Investment Vehicles.

The Board has made a number of recommendations that 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.

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 in relation to its review. 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, Martin Parkinson PSM, the Commissioner of Taxation, Mr Michael D'Ascenzo AO, and the First Parliamentary Counsel, Mr 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

The Board has reviewed the tax arrangements applying to Collective Investment Vehicles (CIVs) and has made a number of recommendations that seek to enhance Australia's status as a leading regional financial centre and support growth and employment in the Australian managed funds industry. Under its terms of reference, the Board was requested to form recommendations that maintain the integrity of the tax system and lead to revenue neutral or near revenue neutral outcomes.

The Board recommends the provision of a wider range of Australian CIVs which provide broadly tax neutral outcomes for foreign investors using legal structures that are similar to those with which foreign investors are familiar. In this context, tax neutral outcomes for investors in a CIV are outcomes that, other than flow through of losses, are broadly consistent with the tax outcomes of direct investments.

The Board recommends that:

- overseas experience in offshore jurisdictions inform the design of Australia's suite of CIVs;
- a range of CIVs be introduced with different tax treatments under Australia's international tax treaties to cater for the needs of different foreign investors seeking to invest through Australian CIVs; and
- the relevant regulatory frameworks be considered and amended to cater for the introduction of a larger suite of Australian CIVs.

The terms of reference required the Board to consider whether there were critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes, including by rationalisation of the regimes where possible.

The Board has recommended that harmonisation across the various CIV regimes be achieved through the identification of a set of qualifying characteristics and rules that would be common to all CIVs that provide broadly tax neutral outcomes for investors (Chapter 4).

Regarding the set of qualifying characteristics, the Board has recommended that CIVs should:

- be widely held, with the test capturing not only direct investors but also looking through direct ownership interests to assess whether the CIV is widely held, and with the test not imposing undue compliance burdens on CIVs;
- be limited in their activities to primarily passive investments;
- as a general rule, be subject to a requirement of residency in Australia; and
- for those CIVs that have access to the concessional withholding tax rate on fund payments, be subject to an additional requirement of having a significant connection with Australia, as is currently required under the MIT withholding tax rules.

Regarding the requirement for CIVs to be limited in their activities to primarily passive investments, the Board has recommended that:

- the control test contained as part of Division 6C of the *ITAA 1936* apply to CIVs, but only in respect of trading businesses conducted in Australia; and
- further legislative guidance be provided on the definition of control for the application of Division 6C to CIVs.

The Board has made a number of specific recommendations on the tax treatment that should apply for the introduction of a Corporate CIV (Chapter 5). Similarly, the Board has made a number of recommendations regarding the flow-through tax treatment that should apply under a Limited Partnership CIV (Chapter 6) and a Common Contractual Fund CIV (Chapter 7). In each of these cases, the aim is to provide tax outcomes for investors that are broadly consistent with the tax outcomes arising from direct investment.

The Board considers that the CIV related recommendations it has made in this report should assist in attracting increased foreign investment into Australian domiciled funds.

Regarding the potential extension of an IMR beyond foreign managed funds, the Board has recommended that gains made by a foreign individual or foreign closely held vehicle from the disposal of investments in non-Australian assets (conduit income) should not be subject to Australian tax if the only reason it may be subject to Australian tax is because of the use of an Australian intermediary.

The Board has also recommended that gains made on the disposal of portfolio investments in Australian assets by a foreign individual or foreign closely held vehicle should be exempt as long as the investment is of the type covered by Recommendation 7 of the Board's report on the review of an IMR for foreign managed funds.

The Board has recommended that to access either of the IMR exemptions above, the foreign individual or foreign closely held vehicle must:

- engage an Australian fund manager or IDPS operator; and
- the Australian fund manager or IDPS operator must lodge an annual notification with the ATO confirming that the foreign individual is not a resident of Australia for tax purposes or that the foreign closely held vehicle accessing the IMR is not ultimately owned by any Australian resident investors.

The Board is aware that under its recommendations for a Corporate CIV there is scope for a limited one-off deferral of tax and that providing the recommended suite of vehicles with an election for deemed capital gains treatment may have a cost to the revenue. The Board also acknowledges that under its recommendations for a Limited Partnership CIV and a Common Contractual Fund CIV there may be flow-through of losses that, although subject to limits, go beyond what is available currently through MITs and result in a cost to the revenue. Equally, the Board is aware that its recommendation for the extension of the exemption approach provided under the IMR for foreign managed funds to foreign individuals or foreign closely held vehicles may result in a potential cost to the revenue.

The Board acknowledges that there are currently a number of factors that may run counter to implementing all of the Board's CIV and IMR recommendations, and which may prompt consideration for staged implementation.

If the Government were to consider it desirable to stagger the implementation of the recommendations, priority should be given to the recommendations that relate to the tax treatment of conduit income. This will comprise:

- conduit income under the Corporate CIV regime, the Limited Partnership CIV and the Common Contractual Fund CIV; and
- extending the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle, but only in respect of gains made on the disposal of investments in non-Australian assets.

Also under a staged implementation approach, the Board recommends:

- second ranking priority be given to the implementation of the full suite of CIVs as recommended, as that would allow choices for foreign investors with different preferences for the type of CIVs; and
- third ranking priority be given to the extension of the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle in respect of gains made on the disposal of investments in Australian assets.

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 that it would ask the Board to review the tax treatment of Collective Investment Vehicles, having regard to the new Managed Investment Trust tax framework and including whether a broader range of tax flow-through vehicles should be permitted.

1.2 On 12 July 2010, the then Assistant Treasurer and the then Minister for Financial Services, Superannuation and Corporate Law announced the terms of reference for the review of the tax arrangements applying to Collective Investment Vehicles (CIVs)[2]. The Government noted that the review forms part of its commitment to position Australia as a leading financial services centre. It also noted that having design features of CIVs that are, wherever possible, simple, clear and harmonised, will help Australian investors, make the sector more efficient and also mean international investors will find investing in Australia an easier proposition.

TERMS OF REFERENCE

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

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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 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=

1.4 The review was asked to have regard to the following broad principles:

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

1.5 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.

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

- the nature and extent of, and the reasons for, any impediments to investment into Australia by foreign investors through CIVs;
- the benefits of extending tax flow-through treatment for CIVs, including the degree to which a non-trust CIV would enhance industry's ability to attract foreign funds under management in Australia;
- whether there are critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes, including by rationalisation of the regimes where possible.

1.7 The Board was also asked to examine and report on the design of an Investment Manager Regime (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.

1.8 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.

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

Scope of this report and interim reports completed

1.10 The Board has already delivered to Government reports on two components of this review ('the CIV review'). On 27 June 2011 it delivered its report on its review of the taxation arrangements under the Venture Capital Limited Partnership regime and, on 31 August 2011, it delivered its report on its review of an Investment Manager Regime as it relates to foreign managed funds.

1.11 This report is focussed on those aspects of the CIV review not examined under the previous two components, comprising in particular the examination of whether a broader range of tax flow-through vehicles (such as corporate CIVs) should be permitted, whether there are critical design features that would improve certainty and simplicity and enable better harmonisation, consistency and coherence across the various CIV regimes and the potential extension of the scope of an IMR beyond foreign managed funds.

Review processes

1.12 The Board's consultation process has involved:

- preliminary consultations with a range of stakeholders;
- the release of a discussion paper on the broader CIV review issues in December 2010 to invite and facilitate submissions;
- holding two public consultation meetings to provide information on the discussion paper and to seek feedback from participants; and
- holding targeted consultation meetings with a number of key stakeholders.

Submissions

1.13 The Board received 35 written submissions in response to the discussion paper.

Board's report

1.14 The Board has considered the issues raised by stakeholders in their submissions and at the consultation meetings, and the views of the members of the Expert Panel. However, the Board's recommendations reflect its independent judgment.

CHAPTER 2: IMPEDIMENTS TO FOREIGN INVESTMENT IN AUSTRALIAN CIVS

FINDINGS OF THE JOHNSON REPORT

2.1 As raised in the Board's discussion paper to this review, the 2009 Johnson Report made several findings in respect of Australia's funds management sector which included:

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

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

CURRENT LEVELS OF INVESTMENT

2.3 As at 30 June 2011 the managed funds industry had approximately $1.8 trillion of funds under management[3], comprising approximately $1.2 trillion of funds placed with resident investment managers and approximately $0.6 trillion of funds placed with non-resident investment managers or directly invested into the markets.

3 Managed funds, Australian Bureau of Statistics (ABS), June quarter 2011 (cat. no. 5655.0).

2.4 The $1,186 billion of funds placed with resident investment managers comprises:

- $800 billion of funds (67 per cent) sourced from managed funds (including $117 billion from public offer retail unit trusts and $16 billion from cash management trusts);
- $325 billion of funds (27 per cent) sourced from other Australian entities (including $142 billion sourced from wholesale financial trusts[4]); and
- $61 billion of funds (5 per cent) sourced from overseas investors.

2.5 Public offer retail unit trusts and cash management trusts are generally structured as MITs. A number of wholesale financial trusts are also structured as MITs.

2.6 In addition to the funds invested through resident investment managers, public offer retail unit trusts and cash management trusts invest directly into the markets. As at 30 June 2011, the total of unconsolidated assets (which includes cross-investments that take place between the various types of funds) was $283 billion for public offer retail unit trusts and $24 billion for cash management trusts.

2.7 The Johnson Report noted that '[f]*or the funds management sector as a whole, somewhere between 3.5 per cent and 11 per cent of total funds under management are sourced from offshore*.' It said that this was a surprisingly low amount of funds sourced from foreign investors given the strong capabilities of Australia's funds management sector.

2.8 The Board notes that Australia's collective investment sector is mainly made up of Australian resident investors using Australian funds for investment in Australian assets. However, the Board notes that there is potential for significant growth if Australian funds were to more actively target the management of funds sourced from foreign investors, particularly for investment in foreign assets (that is, conduit investments).

2.9 Certain foreign jurisdictions specialise in targeting this conduit investment activity. The two main jurisdictions are Ireland and Luxembourg. These countries have pursued the policy of setting up a range of CIV types tailored to the needs of different kinds of foreign investors. The two main types of funds in these countries are a contractual fund (called a Common Contractual Fund — or CCF — in Ireland) and a corporate fund (called a Société d'Investissement à Capital Variable — or SICAV — in Luxembourg).

4 ABS, ibid. Wholesale financial trusts are defined as funds which '*invest in financial assets and are only open to institutional investors (for example, life insurance corporations, superannuation funds) and high net worth individuals due to high entry levels*.'

2.10 Part of the growth of CIVs in Ireland and Luxembourg has been facilitated by the European Union Directives on Undertakings for Collective Investment in Transferable Securities (UCITS) which set out prudential and regulatory standards that have to be met for funds to be marketed throughout the European Union without further significant regulation by the country where the investors are resident.

2.11 The UCITS 'brand' has been very successful to the extent that a number of non-European countries, notably in Asia, have allowed UCITS compliant funds to be marketed there on a similar basis (without significant local regulation).

2.12 The Board understands that in the five main Asian jurisdictions that have authorised the sale of European funds — Hong Kong, Singapore, Taiwan, Japan and Korea — approximately 75 per cent are Luxembourg based UCITS compliant funds, of which 90 per cent are SICAVs. The next biggest European funds sold into Asia are Irish based UCITS compliant funds (approximately 15 per cent) and the majority of these are also corporate structures. The funds under management gathered by these UCITS compliant funds from Asian investors is somewhere in the region of Euro 350-500 billion (A$467-667 billion).[5]

Impediments to investment into Australian CIVs by foreign investors

2.13 The discussion paper noted a number of potential tax and non-tax impediments to investment into Australian managed funds from foreign investors, including those that had been identified in the Johnson Report, and sought comments from stakeholders on the specific reasons (from a tax and non-tax perspective) for the apparent unattractiveness of Australian current CIVs to foreign investors.

5 Information compiled by advice from PricewaterhouseCoopers to the Board of Taxation, dated 2 November 2011.

Views in submissions

2.14 Stakeholders identified a number of specific examples in the tax treatment of trusts that create complexity and difficulty for foreign investors. These examples include:

> ... different tax rates applicable to different types of income (e.g. taxable/non-taxable capital gains, rent and other trading income, foreign source income) and the treatment of differences between book and taxable income.
>
> Deloitte Touche Tohmatsu

> ... the liability to taxation is based on present entitlement rather than cash distribution. Non-residents may be unfamiliar with the concept of present entitlement.
>
> The Tax Institute

> ... many foreign investors are uncomfortable with the concept that they do not have legal title over the assets, and that legal ownership is held by a trustee, an entity that they do not own or collectively control.
>
> Law Council of Australia

2.15 A number of stakeholders commented that Australia's tax regime was not competitive compared to that of other jurisdictions in its overall approach to encouraging foreign investment. They agreed with comments made in the Johnson Report that a broader range of tax flow-through CIVs was necessary to attract increased foreign investment.

> Australia's tax treatment of internationally well-recognised vehicles for collective investment has been confusing through a failure to accept international norms, particularly in relation to limited partnerships and corporate CIVs.
>
> Greenwood & Freehills

> Australia has no true flow through collective investment entities, such as foreign jurisdictions' limited liability companies and limited liability partnerships and mutual funds, all of which have various flow-through tax treatments.
>
> Ernst & Young

2.16 Stakeholders commented that, in addition to the necessary tax reforms, changes to Australia's regulatory and prudential frameworks would also be required in order for greater levels of foreign investment to be drawn into Australian CIVs.

> Another message from the success of Ireland, Luxembourg and Singapore is that there must be a coordinated whole-of-law approach to attracting foreign funds. The areas of law concerned in addition to taxation are investor regulation and prudential controls.
>
> Greenwood & Freehills

Board's consideration

2.17 The Board refers to the statistics that European UCTIS compliant funds have made substantial entry into Asian markets, with funds under management from Asian investors at around Euro 350-500 billion (A$467-667 billion). As noted at paragraph 2.12, approximately 75 per cent of the European funds used in the main Asian jurisdictions are Luxembourg based UCITS compliant funds, of which 90 per cent are corporate SICAVs.

2.18 These statistics seem to support findings made by the Johnson report that Asian investors are more familiar with investments in corporate CIVs than through trust structures.

2.19 The Board is of the view that the provision of a wider range of Australian CIVs which provide broadly tax neutral outcomes for foreign investors, should assist in attracting greater foreign investment into Australian domiciled funds. It is desirable that foreign investors be familiar with the legal structures which allow for this flow-through tax treatment.

2.20 The Board notes stakeholders' comments that a number of foreign investors are reluctant to use trusts as a CIV for a variety of reasons.

2.21 The Board considers that tax complexity and lack of familiarity with Australian MITs is a contributing factor to the low levels of foreign investment into Australian domiciled funds. The Board also notes that the global financial crisis and economic conditions in European Union and United States markets have also affected the levels of foreign investment into Australian domiciled funds.

2.22 As the Johnson report noted, Australia has arguably the most sophisticated and advanced financial sector in the region but our exports and imports of financial services are low by international standards. The Johnson report considered that it is important for Australia to develop a wider range of CIVs which are attractive to foreign investors and which are internationally competitive.

2.23 As noted above, UCITS compliant funds are already well established in Asia and the SICAV (corporate) form of CIV is predominant. Absent other considerations, this suggests a strategy of modelling any Australian corporate CIV on the Luxembourg SICAV due to its familiarity to Asian investors. More generally it also indicates that Australia, in developing its strategy for attracting conduit investment activity into Australian CIVs, can learn from the Irish and Luxembourg experience, particularly in establishing the tax and regulatory frameworks for different types of funds suited to different types of investors.

2.24 The Board notes that one of the principles in the terms of reference is for CIVs to achieve broad tax neutrality, in the sense that the tax outcomes for investors, other than flow through of losses, in a CIV should be broadly consistent with the tax outcomes of direct investments. The Board also noted in the discussion paper that transparent tax treatment or flow-through taxation is one model to achieve broad tax neutrality and that other options, such as an exemption model, could also be used.

2.25 The provision of a greater range of Australian CIVs which provide broadly tax neutral outcomes should not only encourage increased foreign investment, but should also result in increased job opportunities in the Australian funds management sector and increased flow-on activity to associated financial service providers such as registries, brokers, custodians, and accounting, tax and legal advisors. Because of the significant penetration of UCITS compliant funds in Asia and the evidence of the types of funds that are attractive to Asian investors, the Board considers that Australia should look to international experience in designing its suite of CIVs.

2.26 The Board also agrees with stakeholder comments that any amendments to the tax law to introduce a larger suite of Australian CIVs which provide tax neutral outcomes must be done in tandem with a consideration of, and necessary amendments to, Australia's regulatory frameworks which govern such CIVs. This is necessary to ensure appropriate levels of investor protection and provide a strong regulatory environment to facilitate investment into these vehicles.

Recommendation 1:

The Board recommends that:

- a larger suite of Australian CIVs be introduced into the tax law which provide tax neutral outcomes for investors;
- overseas experience in offshore jurisdictions, such as Ireland and Luxembourg, inform the design of Australia's suite of CIVs; and
- the relevant regulatory frameworks be considered and amended to cater for the introduction of a larger suite of Australian CIVs.

CHAPTER 3: DESIGN OF A HARMONISED AUSTRALIAN CIV REGIME

A HARMONISED AUSTRALIAN CIV REGIME

3.1 As part of its terms of reference, the Board has been asked to consider 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.

3.2 The Board considered the option of recommending a single CIV regime in the tax law which would encompass unit trusts currently covered by the MIT regime as well as other types of CIV. The Board also considered the option of separate CIV regimes which would apply to each type of CIV structure.

Views in submissions

3.3 While some stakeholders suggested that as far as possible there should be a single CIV regime, others noted the particular challenges that would be faced under that option.

> We do not support the creation of a single CIV entity to cover all investors and investor classes ... The fundamental legal, regulatory and commercial differences between the advantages to be sought from each CIV type dictate the need for the continuation of multiple CIV options. Even if one single form of CIV would suffice for all tax purposes, which we doubt, the non-tax regulatory issues would represent a major task. We note also that multiple choices of structures for CIVs are a feature of other jurisdictions...
>
> Ernst & Young

3.4 Submissions generally considered it important that any new corporate CIV regime and limited partnership CIV regime should be broadly aligned with the existing MIT regime. However, it was also noted that modifications would be needed to the MIT regime to ensure it operates appropriately for the various other vehicles.

> In general, we believe that a proposed CIV regime could be founded upon the current (or proposed) MIT regime, with modifications to ensure that it can operate appropriately for the various alternative vehicles.
>
> Pitcher Partners

3.5 While most submissions proposed a common set of defining characteristics for CIVs across the different regimes, submissions varied as to the extent to which the tax treatments for a new corporate CIV and limited partnership CIV could be aligned with the tax treatments applicable under the MIT regime.

Board's consideration

Harmonisation and the complexity of implementation

3.6 The Board considered the option of a single CIV regime extending the MIT tax treatment to CIVs structured as other types of legal entities or arrangements, such as a corporate CIV, limited partnership CIV or a common contractual arrangement CIV.

3.7 The option of extending the MIT tax treatment to a company or a limited partnership would require a consideration of each of the MIT tax rules and whether these rules should also apply to a corporate CIV, a limited partnership CIV or a common contractual arrangement CIV.

3.8 The Board further noted that the MIT regime is not a comprehensive and exclusive regime that covers all tax treatments for MITs. The tax treatments for MITs are also determined under tax rules applicable to trusts generally. For example, capital gains made by MITs are covered by the trust capital gains tax provisions, and losses made by MITs are covered by trust tax loss provisions. These tax provisions apply specifically to trusts, and are distinct from tax provisions that apply to other legal entities such as companies and partnerships.

3.9 Consequently, the option of a single CIV regime extending the tax treatment of MITs to other CIVs would require a process of identifying all the MIT specific and general trust tax provisions applicable to MITs, and a consideration as to whether these provisions should cover other CIVs. The Board considers that there would be a significant degree of complexity involved in this process likely to give rise to difficult compliance obligations for taxpayers and administrative complexities for the ATO.

3.10 A CIV not structured as a unit trust may also need to be deemed to be a unit trust for the purposes of applying a number of parts of the tax law to give it a similar tax treatment as an MIT, adding further complexity.

3.11 Similar approaches of deeming a CIV entity to be treated as a different entity for tax purposes have already been implemented in other parts of the tax law.

3.12 For example, the rules in Division 5A of the ITAA 1936 seek to treat a limited partnership as a company for tax purposes. To achieve this, Division 5A contains a number of modifications to the tax law to broadly 'activate' the company tax rules and 'deactivate' the partnership tax rules for a limited partnership. This includes rules such as treating references to a company or body corporate to also include a reference to a limited partnership, and deeming drawings by partners of a limited partnership to be dividends. These modifications under Division 5A are set out in more detail in the discussion paper at paragraphs 3.41 to 3.43.

3.13 The Board received feedback from its Expert Panel and certain stakeholders that the operation of Division 5A, with its objective of taxing limited partnerships *as* companies, has been problematic in determining the tax treatment of limited partnerships in a number of circumstances.

3.14 An important example is the absence of a rule in Division 5A to deem a limited partnership to be a beneficial owner of its assets. The Board understands that this lack of deeming in the provisions has given rise to a number of difficulties. For example, in Taxation Determination TD 2008/24, the ATO has taken the view that limited partnerships taxed as companies are not able to benefit from the exemption for non-portfolio dividends received by companies from foreign subsidiaries. Another example can be seen in ATO Interpretative Decision 2010/210 where the ATO takes the view that there is no disposal of assets when a partnership converts between the normal tax rules for partnerships and the rules in Division 5A.

3.15 In each of the above cases, the intended treatment of limited partnerships as companies under Division 5A has proved to be incomplete. A number of other tax rules also depend on beneficial ownership and it is not clear how those rules apply to limited partnerships.

3.16 Another approach would be to leave the normal rules that apply to the CIV entity intact, but identifying the specific rules that would need to be changed to produce an MIT like outcome. A comparable approach is followed in Division 6C of Part III of the ITAA 1936 (Division 6C) which seeks to tax a trust *like* a company, but leaves other trust tax rules, such as the trust tax loss rules, applying. Implementation of this approach still required a consideration of each of the tax rules applicable to companies to ascertain which specific rules would need to apply to a Division 6C trust.

3.17 Even though the MIT attribution rules are still under development, extending the MIT tax treatment to other types of vehicles would require these vehicles to be taxed as trusts, which carries a degree of complexity. It may also not be sufficiently attractive to foreign investors seeking to invest in Australian CIVs whose legal forms and tax treatments they can easily recognise and understand.

3.18 The Board concluded that MIT tax treatment should not be extended under a single regime to CIVs structured as entities or arrangements other than unit trusts.

Foreign investors and access to treaty benefits

3.19 In designing a broader range of CIVs, different types of foreign investors would seek different attributes from an Australian CIV. To achieve broadly tax neutral outcomes, some foreign investors, such as pension funds that are tax exempt in their jurisdictions, would prefer an Australian CIV to be treated as tax transparent, with character and source flow-through as is the case in part under the MIT regime. This way the investors can more readily access treaty benefits in their own right and claim credits for foreign tax paid by the CIV at source. In contrast, foreign retail investors may prefer that an Australian CIV be treated as non-tax transparent so that the CIV itself can more readily claim treaty benefits in its own right.

3.20 For example, a tax exempt investor based in the United States investing into an Australian CIV with a portfolio investment in a New Zealand company would be disadvantaged if the Australian CIV was recognised for tax treaty purposes. This tax exempt investor would generally prefer that the Australian CIV not be recognised for tax treaty purposes, so that it can claim treaty benefits in its own right under the United States/New Zealand tax treaty. This outcome would more closely align with the tax exempt investor investing directly into the New Zealand company.

3.21 By contrast, a retail investor based in China investing into an Australian CIV with a portfolio investment in a New Zealand company may be disadvantaged if the Australian CIV was not recognised for tax treaty purposes. In this case, the Chinese retail investor would need to claim treaty benefits in its own right, which may not be practical given the investor may not have the time, capacity or expertise to claim treaty benefits (which would have to be done separately by the investor for each investment made by the CIV) and the compliance costs of the investor engaging a tax practitioner may be prohibitive, indeed exceeding the income received by the investor from each separate investment made by the CIV. Instead, such a retail investor would likely prefer that the Australian CIV be able to claim treaty benefits in its own right and to pass those benefits on through distributions.

3.22 The Board understands that the treatment of an Australian CIV as transparent or non-transparent for Australian tax purposes will not necessarily determine whether that CIV is recognised or not recognised as entitled to benefits under a tax treaty by another country. This will depend on the terms of each tax treaty and the approach that the other country takes to the characterisation of the CIV. However, the Board understands that, generally, a non-tax transparent CIV is more likely to receive treaty recognition in its own right than a tax transparent CIV.

3.23 The Board recommended in its MIT report that the Government should participate in OECD discussions and seek to re-negotiate its treaties to enable MITs to be recognised under Australia’s international tax treaties, a recommendation which was accepted by Government. However, it is acknowledged that this process may take a number of years to achieve, and may not result in MITs being recognised in all of Australia’s international tax treaties.

3.24 The Board is of the view, therefore, that it is preferable for a new suite of Australian CIVs to contain types of CIV likely to be recognised as a non-tax transparent entity under Australia's international tax treaties. Other forms of a more transparent CIV (that is, more transparent than an MIT), such as a limited partnership or common contractual arrangement, may also be appropriate to ensure foreign investors can claim treaty benefits in their own right against the source country in which the CIV has its investments.

Other elements sought by foreign investors

3.25 The Board also considered the following as key elements to be incorporated into the introduction of a broader range of CIVs:

- for foreign investors more generally, being able to invest in a vehicle whose characteristics they are familiar with and that provides clarity and certainty of tax outcome; and

- for foreign retail investors in particular, having assurances that the CIVs in which they invest are subject an appropriate level of corporate governance and investor protection regulation.

Conclusions

3.26 In view of the above, the Board recommends that MIT tax treatment should not be extended to other forms of CIVs. Rather, broadly tax neutral outcomes should be provided through a range of CIVs, encompassing vehicles which are treated as both transparent and non-transparent for the purpose of different levels of access to international tax treaties, whose tax treatment is familiar to a wide range of foreign investors and through tax rules which are practicable to implement and provide more certain outcomes.

3.27 While full harmonisation of tax treatments would not be achieved through the introduction of a single CIV regime extending the MIT tax treatment to CIVs structured as legal entities or arrangements other than unit trusts, the Board still considers that a degree of harmonisation across the various CIV regimes is a desirable outcome. This could be achieved through the identification of a set of qualifying characteristics that would apply to the range of CIVs that provide broadly tax neutral outcomes for investors. It would have the benefit of providing a level of consistency and coherence across the various CIV regimes. These common characteristics and rules are discussed further in the next chapter.

Recommendation 2:

The Board recommends that:

- MIT tax treatment not be extended to other forms of CIV;
- a range of CIVs be introduced with different tax treatments under Australia's international tax treaties so as to cater for the needs of different foreign investors seeking to invest into Australia;
- broadly tax neutral outcomes be provided through a range of CIVs whose tax treatment is familiar to a wide range of foreign investors and through tax rules which are practicable to implement and provide certainty of outcomes; and
- harmonisation across the various CIV regimes be achieved through the identification of a set of qualifying characteristics and rules that would be common to all CIVs that provide broadly tax neutral outcomes for investors.

CHAPTER 4: DEFINITION OF A CIV

4.1 The terms of reference asked the Board to examine and report on the tax treatment of CIVs having regard to the Managed Investment Trust (MIT) tax framework and including whether a broader range of tax flow-through CIVs (such as corporate CIVs) should be permitted.

4.2 CIVs are described in the terms of reference as 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.

4.3 The Board sought stakeholder views on the appropriateness of the widely held definition in the MIT legislation as a characteristic for a wider range of CIVs, and whether there are any compelling reasons to have non-widely held vehicles included as CIVs.

4.4 The Board also sought views on the appropriateness of the current definition of eligible investment business (EIB) in Division 6C of the ITAA 1936 for a wider range of CIVs, and whether there are any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included in a broader range of tax flow-through CIVs.

4.5 In respect of the EIB rules, the Board also asked whether there was a need to further define 'control' in Division 6C of the ITAA 1936 to provide greater certainty for investors in MITs and other CIVs and, if so, how this could be achieved.

4.6 This chapter discusses the above issues in connection with a potentially wider range of CIVs (apart from MITs). Other characteristics such as whether CIVs should be subject to a connection with Australia requirement and to a new regulatory regime are also examined.

WIDELY HELD

4.7 As noted in the Board's discussion paper, Australia's MIT regime explicitly defines what constitutes a 'widely held MIT' and includes registered and unregistered wholesale funds that have at least 25 members or are held by certain widely held collective investment entities, such as superannuation funds. Widely held trusts with concentrated ownership or 'closely held trusts' are excluded.

Views in submissions

4.8 A number of stakeholders acknowledge that CIVs should be required to be widely held but state that the widely held definition contained in the MIT regime is not appropriate as a criterion for the new CIV regime. Stakeholders have noted that indirect interests held by qualifying widely held vehicles (listed in section 12-402(3) of the *Tax Administration Act 1953*) may only be counted towards the widely held testing if the interest is held through trusts or a chain of trusts (section 12-402(4)).

4.9 Stakeholders have submitted that any concept of 'widely held' for CIV purposes must contain adequate and simple to use tracing rules beyond the trust based rules in the MIT provisions, as non-resident investors include global CIVs which could be corporate entities or limited partnerships and other entities where tracing is not permitted under the MIT regime.

> Whilst the current widely held test in the MIT definition provides tracing rules for trusts holding interests in MITs, this is inadequate as many CIVs in other jurisdictions operate as corporate or limited partnerships and cannot benefit from the tracing concession. There is no policy basis for excluding these entities from the tracing concession.
>
> The Tax Institute

4.10 While some stakeholders have queried the need for CIVs to be restricted to widely held entities, noting that the key requirement should be that the CIV only undertake passive investments, others have stated that there are no compelling reasons to have non-widely held vehicles included as CIVs.

Board's consideration

4.11 As noted above, the terms of reference describe CIVs as being widely held. The Board considers that a widely held requirement is appropriate for any new vehicles included into Australia's suite of CIVs.

4.12 Consistent with the views conveyed in its report on its review of an IMR as it relates to foreign managed funds, the Board recommends that the widely held test should capture not only direct investors in the CIVs but also be able to look through these investors to assess whether the CIV is widely held.

4.13 In designing tracing rules, an appropriate starting point should 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 CIV. In addition, the test should be clear in its effect and not impose undue compliance burdens on CIVs.

4.14 The Board has made a similar recommendation regarding the widely held test in its report on an IMR as it relates to foreign managed funds (Recommendation 4).

Recommendation 3:

The Board recommends that:

- CIVs be required to be widely held;
- the widely held test capture not only direct investors in the CIVs but also be able to look through these investors to assess whether the CIV is widely held; and
- the widely held test be clear in its effect and not impose undue compliance burdens on CIVs.

PRIMARILY PASSIVE INVESTMENT ACTIVITIES

4.15 The Board's report on its *Review of the Tax Arrangements applying to Managed Investment Trusts* (the Board's 'MIT report') contained detailed discussion on the meaning of 'primarily passive investment' activities undertaken by MITs, including recommendations for changes to the eligible investment business (EIB) rules contained in Division 6C.

4.16 The Board recommended that MITs be considered to be undertaking primarily passive investments if they carry on an EIB as defined and made specific recommendations for amendments to the EIB rules, including an allowance for the trust to derive up to 10 per cent of income from non-eligible activities without losing trust taxation and an expanded definition of investments in real property. In its response, the Government deferred any immediate action in relation to the Board's recommendations to alter the EIB rules.

4.17 As noted above, the terms of reference for this review also require CIVs to undertake primarily passive investment activities, consistent with the eligible investment rules in Division 6C.

Views in submissions

4.18 Stakeholders broadly concur that the activities of a CIV that is subject to flow-through taxation should be subject to an EIB rules test.

> As noted elsewhere in this submission, AVCAL considers that to be successful, a CIV regime must be 'flow-through' for tax purposes. For the reasons expressed above, not all entities ought to benefit from 'flow-through'. An 'eligible investment business' test could be retained as a feature to exclude a CIV from entity tax.
>
> AVCAL

4.19 While there is broad support for an EIB rules test, there are different views about what it should contain. A number of stakeholders submit that an EIB rules test needs to be flexible and allow new and emerging investment activity of a primarily passive investment nature. As examples of these emerging new investment activities, these stakeholders have suggested that investments in water entitlements, carbon rights and renewable energy certificates should be included within the definition of 'eligible investment business'.

4.20 Some stakeholders have argued that instead of an EIB rules test there should be a list of 'ineligible' activities, but that if EIB rules are retained, they should be expanded to include modern business developments such as retirement villages and certain passive leasing arrangements. Some stakeholders have also stated that the EIB rules need to be revisited for MITs and other CIV entities to include other forms of non-rental income derived from the exploitation of infrastructure facilities, avoiding the need for stapled structures in an infrastructure context.

Board's consideration

4.21 As required by the terms of reference, CIVs that would be subject to flow-through taxation or that provide a similar broadly tax neutral outcome for investors should be limited in their activities to primarily passive investments.

4.22 The Board also notes that in its report on the MIT review, it made recommendations regarding amendments to the EIB rules (Recommendation 8 of the MIT report). In its response to the Board's MIT Report, the Government deferred consideration of this recommendation for further examination of its benefits relative to its cost to revenue.

4.23 If on a later examination the Government were to accept the recommendation that the EIB rules be amended for MITs, the Board considers that the Government should extend this amendment for the purposes of the application of the EIB rules to the other CIVs recommended in this report.

Recommendation 4:

The Board recommends that CIVs that would be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors, be limited in their activities to primarily passive investments.

THE CONTROL TEST

4.24 As noted by the Board in its report on the MIT review, under Division 6C, to maintain trust taxation, a managed fund that is a public unit trust is not able to carry on a trading business (which is defined to mean a business that does not consist wholly of EIB activities) or control, or be able to control, directly or indirectly, the affairs or operations of another person or entity that carries on a trading business. This includes owning a controlling interest in a domestic or foreign trading company.

4.25 The control test was introduced to avoid the circumvention of the tax law by preventing active trading businesses operating through a controlled entity and so undermining the integrity of the corporate tax base. It was introduced as a safeguard provision to support the primary test of whether a public unit trust carries on a trading business and therefore requiring it to be subject to corporate taxation. The corresponding 1985 Explanatory Memorandum made the following comments on the purpose of the control test:

> *Paragraph (b) of section 102N [the control test] is a safeguarding provision against arrangements to circumvent the operation of Division 6C by having activities that would constitute a trading business of a public unit trust carried on by an associated entity. By taking income from the associate in the form of eligible investment income, the trustee could otherwise ensure that the relevant trust did not qualify as a trading business and so avoid the operation of Division 6C.*
>
> *By paragraph (b), a unit trust will be a trading trust in a year of income if, at any time during the year, the trustee of the unit trust was in a position to control the affairs or operations of another person (i.e., the associated entity) in respect of the carrying on by that person of a trading business.)*

Views in submissions

4.26 Some stakeholders have submitted that there is no policy or practical reason to retain the control tests as it applies to subsidiaries or controlled companies in Australia that are subject to the corporate tax. Some have submitted that the only significant taxation policy requirement is to preserve the corporate tax levied on active businesses.

4.27 Stakeholders have also submitted that the 'control' test in Division 6C should be irrelevant in the context of a widely held CIV in a regime which aims to provide neutral/direct treatment.

> If the investors of a CIV invested directly in a corporate entity which carries on a trading business rather than through the CIV, the CIV investor would not control the corporate entity and therefore the aggregation of the investments through a CIV should not trigger the operation of Division 6C (even if the CIV controls a greater than 50 per cent interest in the corporate entity).
>
> Law Council of Australia

4.28 The view has also been put that a majority shareholding in a company or control of a company should not have the same tax outcomes as carrying on an active business. These stakeholders submit that merely holding a controlling interest or exercising those rights periodically is not the hallmark of an active business.

> Diversity of the shareholdings of a CIV, rather than the size of its shareholdings in each of its portfolio companies, is what should determine whether a vehicle should be treated as a CIV. Where it can be established that a CIV is using any majority shareholding to engage in more than just passive investment and it is in fact carrying on a trading business as per section 102N(1)(a), only then should it be treated as a trading trust.
>
> Clayton Utz

4.29 Other stakeholders have queried the rationale for the Board's assertion in the discussion paper that 'control is the factor that indicates active involvement in the trading business and so funds such as private equity funds would not typically be considered to be undertaking passive investment activity.' These stakeholders submit that the manager's activities should not be attributed to the CIV.

> In making this comment the Board appears to have disregarded the nature and intention of the ultimate investors in such funds, and the role of the CIV. The investors in private equity funds are typically passive investors. Such investors are for the large part pension/superannuation funds, fund of fund vehicles and sovereign wealth funds all of which have a passive investment intention. While the manager might be undertaking an active business, the manager's activities should not be attributed to the CIV.
>
> AVCAL

4.30 If a control test is to be retained, some suggest that it should be defined in legislation (pointing to potential references such as Div 165 of the ITAA 1997 or the accounting standard AASB 127/AASB 10) while others argue that it should not include 'negative control' through veto power.

4.31 Several stakeholders have suggested that the limitation on control should not apply when the CIV has control of foreign entities, as no Australian corporate tax is at risk.

4.32 Others argue that instead of the control test all that is needed is a rule to ensure that pricing between the CIV and an entity being taxed as a company is on a market value basis so that profits are not stripped out of the company.

4.33 Other stakeholders have stated that there is no need to remove the limitation on vehicles undertaking investment activities involving control of active businesses or to further define control in Division 6C.

> We do not see any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs. We also don't see a need to further define 'control' in Division 6C (ITAA 1936) to provide greater certainty for investors.
>
> CPA Australia

Board's consideration

Developments since the introduction of Division 6C

4.34 In the discussion paper on the MIT review, the Board noted that the introduction of dividend imputation, which was announced on the same day as Division 6C on 19 September 1985, reduced the incentive to use trusts over companies that existed under the classical system of taxation. However, there still remained an advantage in using a trust structure for tax-exempt institutional investors because it was not proposed at the time that imputation credits would be refundable. The statement 'Reform of the Australian Taxation System', September 1985, noted:

> Although the decision to introduce a full imputation system for companies will reduce the incentive to use trusts, there would still be advantage for tax-exempt institutional investors in the trust form because it is not proposed that imputation credits be refundable.
>
> To ameliorate that bias, it has been decided to extend company tax arrangements to those public trusts which operate a trade or business. Private trusts, and public unit trusts of the more traditional kind which invest in property, equities or securities will not be affected.[6]

4.35 The Board notes that similar advantages in the use of trusts (as against companies) are available for investments by foreign investors, as these investors are not entitled to a refund of imputation credits. Thus, the imputation system does not eliminate the bias towards the use of trusts over companies. In addition, there can be advantages in using public unit trusts over companies in relation to the treatment of certain distributions (for example, tax deferred, tax preferred or tax exempt amounts). Division 6C therefore, and as part of it the control test, continues to have a function in preventing an erosion of the company tax base by the use of trusts that carry on, or control an entity that carries on, a trading business.

4.36 As the Board noted in its MIT report, even though a controlled entity carrying on trading activities might be subject to company taxation, there is a potential for the controlling trust to extract value from the controlled entity and distribute it to beneficiaries, including as tax deferred distributions (for example through borrowings

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6 'Reform of the Australian Taxation System', September 1985, p 65.

against the increased asset value of the controlled entity) which would be a tax advantage compared to the equivalent distribution of non-franked dividends made by a holding company.

4.37 To counter the above risk the Board recommended, in the context of the MIT review, the introduction of arm's length rules to transactions between common interests or related interests of an MIT, including but not limited to subsidiaries and stapled entities. The Board considers that these arm's length rules (or alternative market value rules) should be sufficient to address the potential for extracting/shifting value from a controlled entity while it is held and distributing to beneficiaries with tax advantages.

4.38 The Board understands that the Government is currently developing these rules for the MIT regime. As part of this development, consideration should be given to whether an alternative rule to ensure that pricing between the MIT and an entity being taxed as a company is on a market value basis would produce the same outcome with lower compliance costs.

4.39 The Board recommends that once the arm's length rules (or alternative market value rules) are introduced as part of the MIT regime, these rules should be extended to the other CIVs recommended in this report.

Exception for a single wholly-owned taxable subsidiary

4.40 The Board also notes that in its report on the MIT review, it supported the retention of the control test with an exception allowing for a single wholly-owned taxable subsidiary (Recommendation 9 of the MIT Report). In its response to the Board's MIT Report, the Government deferred consideration of the single taxable subsidiary recommendation for further examination of its benefits relative to its cost to revenue.

4.41 If on a later examination the Government were to accept the recommendation that an MIT be allowed to have a single wholly-owned taxable subsidiary, the Board is of the view that the Government should consider extending this allowance to the other CIVs recommended in this report.

4.42 The Board also notes that if the single wholly-owned taxable subsidiary recommendation is introduced, the Government should consider whether additional integrity rules should be developed to ensure the appropriate treatment of any disposal of the wholly-owned subsidiary. In particular, consideration would need to be given to whether the disposal of a wholly-owned subsidiary should not be subject to deemed capital account treatment and whether any gains that are taken to be on revenue account should be subject to a 30 per cent withholding tax rate instead of the concessional 7.5 per cent MIT withholding tax rate for fund payments.

Replacing the control test with an 'active business test'

4.43 Against the background of the additional recommended safeguards to protect the corporate tax base, the Board considered the option of recommending the replacement of the control test with an 'active business test,' which would apply to CIVs.

4.44 Active business operations under this alternative 'active business test' would encompass not only business activities directly undertaken by the CIV itself, such as the manufacture and sale of trading stock, but also activities undertaken by the CIV as a profit making undertaking to build up the business of a subsidiary with a view to disposing of the subsidiary for a profit.

4.45 Even though the business activities of the subsidiary itself may be subject to corporate tax, to the extent the activity of the investing entity of building up the subsidiary for sale at a profit is 'active' in nature it should also result in the investing entity being subject to corporate taxation.

4.46 In this way, the active business test would be a more targeted proxy than the current control test.

4.47 Other activities of an active nature could also be specifically listed under this alternative 'active business test'. So, although a CIV would prima facie be able to control another entity and retain flow-through taxation, the carrying on of any active business operations by the CIV would result in the CIV being subject to corporate taxation and losing flow-through treatment.

4.48 This option could address cases where the current control test is too broad in its operation. For example, a CIV could be allowed 'passive control' over an active business entity, as long as the activities of the CIV do not amount to active business operations.

4.49 The Board concluded, however, that the introduction of an active business test to replace the current control test would likely require scrutiny of the actual activities undertaken by a CIV against a set of criteria to ascertain whether it in fact carries on an active business operation. An active business test could therefore, in many situations, result in greater uncertainty for CIVs than the current control test under Division 6C.

Clarifying the control test

4.50 An alternative option considered by the Board was to retain the control test in Division 6C, but introduce further legislative guidance on the definition of 'control' for the application of Division 6C to all CIVs that would be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors. Such guidance would have reference to the purpose of the control test, and would identify what types of control would be covered by the test and what other types of control would still be allowable under the rules.

4.51 Where helpful, principles could be drawn from other control tests in the tax law or from the current accounting standards. An example of a refined definition of control may capture cases where a CIV is engaged in the management of an entity, or directly or indirectly causes an entity to increase its level of indebtedness.

4.52 Consideration should also be given to the extent to which a veto power determines whether control exists as a matter of substance. Depending on the nature and degree of such a power, control could exist. However, the mere existence of a veto power of any nature should not of itself be taken to involve control.

4.53 This option would provide further clarity compared to the current control test in Division 6C and would reduce the reliance on assessments of specific facts and circumstances that would be required if the control test were to be replaced with an 'active business test'.

Introducing safe harbour tests for control

4.54 The Board considers that it is important that investors have greater certainty of the tax treatment applicable to their investments in CIVs. This is particularly desirable for foreign investors. Currently, public unit trusts that fail to meet the Division 6C rules, including the control test, lose flow-through tax treatment and are subject to corporate taxation in the corresponding income year.

4.55 The Board considers that providing legislative guidance on the definition of control should help provide clarity to investors. However, the Board also considers that, as part of providing clarity on the operation of the control test, the Government should consider whether to introduce safe harbour tests that would stipulate the circumstances where control would be deemed not to exist.

4.56 For example, a safe harbour test could state that where a CIV has a percentage ownership in an entity below a certain threshold, it would be deemed not to have control of that entity if the only reason for control is that holding. The legislative guidance should also stipulate what rights are to be taken into account in determining the ownership percentage a CIV holds in another entity for the purposes of determining the safe harbour.

4.57 An associate inclusive test is recommended as an integrity provision to ensure that related parties cannot structure arrangements that would allow individual CIVs to nominally meet the test but fail it in substance. The Board recommends that both safe harbour tests and any required integrity provisions that would apply as part of these tests be determined in further consultations with stakeholders.

4.58 The Board also recommends, consistent with the recommendation it made on the review of an IMR as it relates to foreign managed funds, that the control test should apply in respect of trading businesses in Australia. To the extent that there are no risks to the corporate tax base, the control test should not extend to situations where the CIV controls a foreign subsidiary.

Recommendation 5

The Board recommends that:

- the control test be included as a requirement for CIVs that would be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors;
- once the arm's length rules (or alternative market value rules) are introduced for the MIT regime, these rules be extended to the other CIVs recommended in this report;
- further legislative guidance be introduced on the definition of 'control' for the application of Division 6C to all CIVs that would otherwise be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors;
  - the Government consider whether to introduce:
    - : safe harbour tests test that would stipulate the circumstances where control would be deemed not to exist; and
    - : an associate inclusive test to ensure that related parties cannot structure arrangements that would allow individual CIVs to nominally meet the test but fail it in substance; and
- the control test apply in respect of trading businesses in Australia and, to the extent that there are no risks to the corporate tax base, the control test not extend to situations where the CIV controls a foreign subsidiary.

CONNECTION WITH AUSTRALIA REQUIREMENTS

4.59 To qualify as an MIT for withholding tax purposes, a trust must be an Australian resident and a substantial proportion of the investment management activities relating to the assets of the trust with a relevant connection with Australia must be carried out in Australia. Assets that have a relevant connection with Australia for this purpose are assets of the trust that are situated in Australia, taxable Australian property or shares, and units or interests traded on an Australian stock exchange[7].

7 Refer to paragraph 5.65 of the Revised Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No. 3) Act 2010*, and subparagraphs12-400(1)(c)(i) to (iii) of Schedule 1 of the *Taxation Administration Act 1953*.

Views in submissions

4.60 Some stakeholders have noted that MITs are required to have a significant connection with Australia which, they suggest, is more justified in the context of investments in real property (with access to the concessional withholding tax rate on fund payments). Stakeholders have noted that, for MITs, uncertainty around interpreting the investment management test is a significant barrier to global managers setting up operations within Australia and submit that the test should be simple and clear.

> To the extent that these requirements reflect integrity concerns, it is important that an investment management or connection test is clear, simple and is appropriately balanced against the policy aim of making Australia a leading financial centre.
>
> Financial Services Council

4.61 Other stakeholders have also pointed to the need to balance integrity concerns against the policy objective of making Australia a leading financial centre, but noted that the regime should not provide an advantage to offshore managers over local managers.

> We are concerned that integrity measures are appropriately balanced against the primary aim of making Australia a more attractive investment destination. It is also important however to ensure that the regime does not provide offshore managers with an advantage over local managers.
>
> Property Council of Australia

Board's consideration

4.62 The Board considers that, as the IMR for foreign managed funds is directed to non-residents only, there should be a clear distinction between on the one hand foreign managed funds that could access the recommended IMR for foreign managed funds and, on the other, MITs and other types of CIV that would be subject to flow-through taxation or that would provide a similar tax neutral outcome for investors.

4.63 The Board recommends that, as a general rule, a CIV that provides flow-through taxation or that would provide a similar tax neutral outcome for investors should be subject to a requirement to be a resident of Australia.

4.64 This would be particularly important in the case of a corporate CIV, which the Board recommends in Chapter 5 of this report, to more readily enable it to obtain treaty benefits under Australia's international tax treaties. These treaties require that an entity be resident in Australia as a prerequisite for obtaining treaty benefits.

4.65 In the case of the Australian common contractual fund CIV which the Board recommends in Chapter 7, the Board notes that an alternative connection to Australia test may be required. This modification is discussed further in Chapter 7.

4.66 The Board concurs with the view by stakeholders that an additional requirement of a significant connection with Australia, as applicable currently under the MIT withholding tax rules, should only be applicable to MITs and other types of CIV that have access to the concessional withholding tax rate on fund payments. The Board notes that the Government does not extend this requirement as a condition for MITs that are able to elect CGT treatment on their disposal of eligible assets.

Recommendation 6:

The Board recommends that:

- as a general rule, MITs and other types of CIV that provide flow-through taxation or that would provide a similar tax neutral outcome for investors be subject to a requirement to be residents of Australia; and

- MITs and other types of CIV that have access to the concessional withholding tax rate on fund payments be subject to an additional requirement of having a significant connection with Australia, as applicable under the MIT withholding tax rules.

APPROPRIATE REGULATION REQUIREMENT

4.67 The MIT withholding tax rules only apply to trusts that are subject to an appropriate level of regulation in Australia. To qualify as an MIT, the trust should be a Managed Investment Scheme (MIS) as defined in section 9 of the *Corporations Act 2001* and be registered under that Act. Unregistered wholesale trusts that are either operated or managed by the holder, or an authorised representative of the holder, of an Australian Financial Services Licence, are also able to qualify as an MIT.

Views in submissions

4.68 Stakeholders generally agree that CIVs should be subject to an appropriate regulatory and corporate governance requirement. However, a number have submitted that new forms of CIVs will require a custom built regulatory regime as appropriate, not simply adopting the current Corporations law regime as applies to MITs, and would need to maintain separation of regulatory rules for retail investors and rules for sophisticated investors.

> New forms of CIVs will require a custom built regulatory regime as appropriate, not simply adopting the current Corporations law regime. This will need to be considered

> separately; in particular it needs to maintain separation of regulatory rules for retail investors and rules for sophisticated investors.
>
> Ernst & Young

4.69 Other stakeholders have submitted that CIVs established as companies will need flexibility to allow investors to withdraw their investments and that this would require amendments to the Corporations Act restrictions on redeeming and buying back shares and reducing share capital. Stakeholders have also submitted that amendments would be required to allow a corporate CIV to have protected cells (or sub-funds) under which the assets of one cell are protected against the liabilities of another cell of the company.

4.70 Some stakeholders have noted that as limited partnerships are regulated by the States and Territories, regulatory and governance issues need to be addressed consistently to ensure a simple framework. A suggestion has been made that a federal limited partnership might be required for simplicity and certainty reasons.

Board's consideration

4.71 The Board acknowledges that under the terms of reference it has been asked to examine and report on the tax treatment of CIVs and not on the other regulatory or supervisory requirements that could also apply to CIVs.

4.72 Notwithstanding the above, the Board concurs with the views from stakeholders that introducing a wider suite of CIVs as recommended would require a specific regulatory regime for each type of vehicle. It may also be appropriate for there to be separate regulatory rules for retail investors and sophisticated investors.

Recommendation 7:

The Board recommends that, together with the introduction of a wider suite of CIVs, a specific regulatory regime for each type of vehicle be introduced. It may also be appropriate for there to be separate regulatory rules for retail investors and sophisticated investors.

CHAPTER 5: TAXATION TREATMENT FOR A CORPORATE CIV

5.1 The terms of reference asked the Board to examine whether a broader range of tax flow-through CIVs, such as corporate CIVs, should be permitted. This chapter reports on the Board's examination of whether a Corporate CIV regime should be introduced with flow-through taxation, or that provides a similar broadly tax neutral outcome for investors, as required by the terms of reference.

5.2 The Board sought stakeholder comments on whether companies are suitable vehicles for undertaking widely held, primarily passive, collective investments and whether it is desirable to introduce changes to the company tax law so that flow-through taxation is allowed for widely held companies that restrict their investment activities to primarily passive investments.

MECHANISMS TO ACHIEVE TAX NEUTRALITY

5.3 The Board's discussion paper outlined a number of taxation models through which tax neutrality could be achieved for a Corporate CIV — that is, the outcome from investing in the Corporate CIV would replicate, as far as possible, the outcomes that would arise if the investor had directly acquired the underlying investment, other than the flow through of losses.

5.4 The Board sought stakeholder comments on the most appropriate taxation model.

Views in submissions

5.5 Most stakeholders submitted that a 'flow-through model', similar to that in the MIT regime, would be appropriate for a Corporate CIV.

> The FSC's view is that the flow-through model should be adopted... Flow-through is a model which is similar in practice to the current Division 6 taxation model underpinning MITs. It is also the taxation model underpinning Irish CCFs. This would formally make the CIV a non-taxpaying entity. All income and realised gains (net of losses) of the CIV would be fully attributed to investors in the CIV, along with tax credits/offsets received by the CIV.
>
> Financial Services Council

5.6 Stakeholders noted that the flow-through model with an attribution method of taxation, as is the case for MITs, would enable the Corporate CIVs to accumulate and reinvest profits. Some stakeholders also proposed modifications which could be made to the flow-through model to apply a single rate of withholding tax to simplify tax treatments for non-residents.

5.7 Some stakeholders identified that, under the flow-through model, consideration would need to be given to the withholding tax implications where amounts are attributed to non-resident investors but no amount is distributed. Similarly, stakeholders noted that differences in amounts attributed to investors and amounts distributed to investors may need to be taken into account in adjusting the investors' cost bases in the Corporate CIV.

5.8 Other stakeholders submitted that a flow-through model similar to the MIT style attribution model would be complex to implement into the company tax law framework, and that applying a taxation model which mirrors the taxation of unit trusts would be unattractive to non-resident investors.

5.9 Despite the general support for a flow-through model for the Corporate CIV regime, stakeholders commented that achieving flow-through by deeming the Corporate CIV to be a trust for income tax purposes would be difficult.

> It is submitted that deeming a corporate entity to be a trust would introduce undue complexity into the tax law (and possibly entity law).
>
> Law Council of Australia

5.10 A few stakeholders submitted that an 'exemption model' would be appropriate for a Corporate CIV, where the Corporate CIV would be required to pay an annual dividend equal to a substantial proportion (given as a fixed percentage) of what would be its taxable income.

5.11 These stakeholders also proposed some modifications to the 'exemption model' to provide a flow-through of certain character and source attributes to investors who received dividends from the Corporate CIV. To achieve this, dividends received by investors could be re-characterised in certain circumstances in order for particular character and source attributes to flow-through to investors:

- for resident investors, dividends paid by the Corporate CIV would be treated as franked and unfranked dividends and capital gain amounts; and
- for non-resident investors, dividends paid by the Corporate CIV would be treated as amounts not subject to withholding tax (foreign income, non-taxable Australian property capital gains and franked dividends), with all other amounts being subject to dividend withholding tax.

5.12 Stakeholders commented that these modifications under an 'exemption model' Corporate CIV regime would provide a more simplified distribution statement for non-residents as compared to current distribution statements used in the MIT regime.

> The distribution statement would thus have a number of components similar to MIT distribution statements so far as resident shareholders are concerned... The distribution statement would, however, be much simpler for non-residents as showing only two components effectively — a part exempt from dividend withholding tax (foreign income, capital gains on non-taxable Australian assets and the franked part of dividends redistributed) with the rest subject to dividend withholding tax at the normal rate.
>
> Greenwood & Freehills

5.13 Other stakeholders affirmed the importance of simplifying distribution statements and withholding tax obligations under a Corporate CIV regime.

> Information on the components of a distribution is not generally available at the time withholding tax is payable and therefore it is not possible to determine the correct amount of withholding tax payable. The rules do not cater for later adjustments to pay extra or obtain refunds for incorrect withholdings.
>
> Australian Custodial Services Association

5.14 Apart from the 'flow-through model' and 'exemption model', only a few submissions provided brief comments for alternative taxation models for the Corporate CIV regime, such as the 'deduction model' and the 'integration model'/'imputation model'.

5.15 In considering the appropriate taxation model to apply to the Corporate CIV regime, some stakeholders commented that loss flow-through would be a beneficial feature.

5.16 A number of submissions also stated that the Corporate CIV must be recognisable as an entity under Australia's international tax treaties in order for non-resident investors to be able to claim credits for withholding tax paid in Australia. Submissions note that treaty recognition may be difficult to secure in the case of the flow-through model. To address this concern, these stakeholders suggest that one option would be for the CIV to be deemed to be an Australian resident taxpayer just for the purposes of determining entitlement to treaty withholding tax concessions.

> The main disadvantage of the flow-through taxation model is that it would make it difficult (if not impossible) for the CIV to qualify for concessional WHT treatment under most treaties. It is a serious issue for CIVs to not qualify for treaty (concessional) rates of WHT given it will not be clear whether the WHT will be creditable to non-residents. This may make the CIV especially unattractive to large non-resident institutional investors

(who have large amounts of capital to invest) if the investor is tax exempt or 'lightly taxed' in the investor's home jurisdiction.

Financial Services Council

5.17 As set out in its discussion paper, the Board recognises there are a number of models that could be adopted for the design of a Corporate CIV regime with flow-through taxation or that provides a similar tax neutral outcome for investors. These include the MIT attribution model, exemption model, deduction model and integration model.

Board's consideration

Considering the MIT attribution model

5.18 The Board recommended in Chapter 3 that extending the MIT tax treatment to other forms of CIVs should not be progressed given the complexity required in considering which MIT specific rules and which general trust tax provisions would need to be extended (Recommendation 2). Further complexity would arise if the Corporate CIV were deemed to be a trust for tax purposes.

5.19 The Board also recognised in Chapter 3 that there is value in including into a new suite of Australian CIVs, types of vehicles different to MITs, one of which would be non-tax transparent so as to increase the likelihood of their recognition under Australia's international tax treaties. This would cater to foreign investors, in particular foreign retail investors, who would not seek to claim treaty benefits in their own right but would want the Australian CIV to claim them.

5.20 The Board acknowledges that there are certain advantages which corporate vehicles have over other legal entities for the purposes of achieving recognition under Australia's current international tax treaties.

5.21 Specifically, corporate vehicles are more likely to be recognised under Australia's current international tax treaties by virtue of the fact that 'companies', which are subject to corporate tax, are covered by specific articles of international tax treaties. This is distinct from the case of an MIT which must generally demonstrate it is a 'person' and a 'resident' before qualifying for treaty recognition. Accordingly, extending the MIT attribution model to a Corporate CIV may cause problems in the Corporate CIV being recognised as a 'company' and its distributions as dividends for the purpose of Australia's international tax treaties.

5.22 The Board is of the view that it would be appropriate for a model different to the MIT attribution model to be designed for a Corporate CIV that seeks to ensure that the CIV would be recognised under Australia's international tax treaties, while still providing flow-through taxation or similar tax neutral outcomes for investors.

An exemption model for the Corporate CIV

5.23 The Board considers that an exemption model would be the most appropriate mechanism for giving a Corporate CIV flow-through taxation or tax neutral outcomes.

Determining tax liabilities

5.24 The basic principle of an exemption model for a Corporate CIV would be to provide a tax exemption at the entity level and to require tax to be paid at the investor level.

5.25 In order for sufficient tax to be paid, the taxable income of the Corporate CIV would need to be taxed in the hands of investors on a timely basis such that there would not be inappropriate tax deferral.

5.26 The Board considered whether the taxable income of the Corporate CIV should be attributed to investors each year. As is the case for MITs, under an attribution model of taxation, taxable income would be attributed to investors on a fair and reasonable basis, consistent with their rights under the constituent documents of the Corporate CIV.

5.27 The Board considered that an attribution method of taxation would provide commercial flexibility, as the Corporate CIV would not be required to pay distributions. Under attribution, the taxable income of the Corporate CIV for an income year would be allocated to its shareholders, whether the Corporate CIV makes cash distributions to shareholders or chooses to retain the income. The possibility for the taxable income attributed to shareholders to exceed the cash distributed to them would need to be identified in the disclosure documents of the Corporate CIV.

5.28 However, the Board considers an attribution model would add complexity into the Corporate CIV regime. Unlike investors in other corporate vehicles, investors in a Corporate CIV would be assessed on income without necessarily receiving cash distributions (or having decided to reinvest their dividends), and would need to reconcile attributed amounts to amounts actually received. The Corporate CIV may also need to pay withholding tax at the time of attribution even though no payments are made to its foreign investors.

5.29 The Board considered an alternative model where the Corporate CIV is required to pay dividends equal to a substantial proportion (given as a fixed percentage) of what would be its taxable income. Investors in the Corporate CIV would then be taxable at the time they receive dividends from the Corporate CIV. This option has significant benefits in terms of simplicity, since dividend income is assessed to investors on a receipts basis, and the Corporate CIV would not need to go through a separate process of attribution. Corporate CIVs that wish to retain cash would need to offer dividend reinvestment plans to their shareholders.

5.30 Any dividend withholding tax would apply at the time dividends are paid to non-residents.

5.31 Tax deferral could arise in the case of resident investors, since their final tax liabilities are only determined after lodging their tax returns in relation to the income year in which they received the dividends. So, for example, a Corporate CIV may have taxable income for the 30 June 2013 income year, pay this out via a dividend on 30 September 2013, resident individual investors would include this dividend in their 30 June 2014 tax return and may not pay tax until November 2014 or later if on a lodgement program of a tax agent. To the extent that resident investors pay tax on an instalment basis for their investment income or are not taxable because they fall under current or future arrangements which exclude low income earners from tax up to amounts of approximately $20,000 taxable income, deferral will not be such an issue.

5.32 To the extent that deferral will involve a revenue cost (and/or may be regarded as creating a tax bias for investors as between investing in MITs or a Corporate CIV), there are other possible avenues to deal with the issue. One would be to require that the Corporate CIV pay its dividends in respect of a particular financial year by 30 June. This would ensure that the dividend is assessed to resident investors in the same income year as for MITs subject to taxation on an attribution basis.

5.33 The difficulty with this approach is that directors of the Corporate CIV are unlikely to be willing to pay final dividends before the required percentage of taxable income to be distributed is known which will not be until after 30 June if the Corporate CIV has an income year ending on that date. This could be overcome by requiring such Corporate CIVs to have a substituted accounting period of sufficient length to enable it to pay final dividends in respect of that period by 30 June, but not too early so as to facilitate deferral (with a suggested limit being 31 March). The Board understands that, in the past, it was not uncommon for MITs to have substituted accounting periods for somewhat similar reasons.

5.34 To reduce the incidence of tax deferral, the Board recommends that consideration be given to a requirement for the Corporate CIV to have a substituted accounting period of sufficient length to enable it to pay final dividends in respect of that period by 30 June (with a suggested limit being 31 March). This has the advantage of typically making the majority of the taxable income derived by the Corporate CIV for an income year taxable to resident investors in the same income year.

5.35 The Board also recommends that consideration be given to integrity measures where additional tax deferral results from multiple layers of Australian Corporate CIVs.

5.36 For example, assume a Corporate CIV has derived taxable income for the 31 March 2012 income year and pays a dividend on 30 June 2012 to a second Corporate CIV which also has a 31 March year end. The receiving Corporate CIV would include the dividend income in its taxable income for the 31 March 2013 year. So, taxable income for the 31 March 2012 year would be deferred into the 31 March 2013 year through the interposition of one additional Corporate CIV. This deferral would multiply where additional Corporate CIVs exist.

5.37 One option the Government could consider to prevent this tax deferral is to require all Corporate CIVs to have a common 31 March year end, and to deem dividends paid by the Corporate CIV after year end to another Corporate CIV to have been received in the prior income year. In practice, the recipient Corporate CIV would need to estimate the dividend income it expects to receive in order for it to pay out the required percentage of taxable income to its investors.

Character retention and flow-through

5.38 To achieve broad tax neutrality for investors other than flow through of losses, the Board considered the need for character retention and flow-through for dividend payments made by a Corporate CIV under an exemption model.

5.39 In consultations with stakeholders, the Board was advised that the retention of tax characteristics which flow-through to investors was more a priority for a resident investor than a general foreign retail investor.

5.40 Foreign retail investors generally do not require the flow-through of character of income, but do seek certainty as to the amount of withholding tax that will apply on distributions made to them. In the case of a Corporate CIV distributing dividends, foreign retail investors would only need to know what amount of the dividend is subject to dividend withholding tax, and what amount would be free from withholding tax. Most stakeholders considered that this would be a beneficial approach as it would simplify the multiple withholding tax arrangements that currently apply for MITs.

5.41 To achieve tax neutrality for foreign investors, dividends paid by the Corporate CIV would be treated as amounts not subject to dividend withholding tax where the dividend comprises foreign income, non-taxable Australian property capital gains or franked dividends. All other amounts paid out as dividends would be subject to dividend withholding tax.

5.42 In the case of resident investors, the Board was of the view that character retention was more important. Although there are multiple tax characteristics which could flow-through to resident investors, the Board considered that the key tax characteristics which should flow through are franking credits and discount capital gains.

5.43 While provisions are already in place to facilitate the passing of franking credits via dividends paid to resident investors, the Board considered that additional rules should be incorporated into a Corporate CIV regime to enable the flow-through of discount capital gains to resident investors. These rules could be modelled on those in the Listed Investment Company (LIC) regime which provide investors with a deduction where dividends paid to them include a 'LIC capital gain' component to achieve a similar effect to the CGT discount.

5.44 The Board also considered that it may be appropriate to enable entitlement to the 'foreign income tax offset' to flow-through a Corporate CIV to resident investors. Specifically, where a Corporate CIV pays a dividend to a resident investor comprising amounts attributable to foreign income which has been subject to foreign income tax, a 'foreign income tax offset' entitlement could flow-through to investors.

5.45 The Board considers it would be inappropriate for a Corporate CIV to be able to stream franking credits or other tax attributes to particular investors in a manner that is contrary to the economic positions of those investors. Accordingly, the Board considers the anti-streaming rules that currently apply to companies generally under the tax law should continue to apply to the Corporate CIV.

The treatment of tax deferred distributions

5.46 In the context of the MIT regime as recommended by the Board, tax deferred distributions would generally not be treated as ordinary income in the hands of investors, but rather result in cost base adjustments of the investors' units (with a potential exclusion in the case of revenue account holders).

5.47 However, contrary to the case under the MIT regime, it would be necessary for a Corporate CIV to distinguish between tax deferred distributions and distributions of share capital. In the case of dividends paid by a Corporate CIV comprising tax deferred income, the Board considers that such a dividend would likely be unfranked when received by resident investors, and would be subject to dividend withholding tax if paid to a foreign investor. This would have positive revenue implications when compared to the tax treatment of tax deferred distributions in the MIT regime.

5.48 The Board considers that distributions of share capital by a Corporate CIV should not be treated as ordinary income but should result in cost base adjustments to the shares held by investors.

5.49 The Board also notes that, in the case where a Corporate CIV is required to distribute taxable income in excess of accounting income, the entire distribution should be treated as a dividend for tax purposes. This would ensure that income tax is paid by investors on the taxable income of the Corporate CIV each year.

5.50 The Board considers that the mechanics of achieving the above outcomes should be determined as part of detailed implementation consultations with stakeholders, including considering the appropriate treatment that should apply when initial positions reverse in later years.

5.51 The Board also notes that Australia has a range of rules to prevent streaming of capital or conferring capital benefits on shareholders which would be available to prevent abuse. Consideration should also be given as to whether these rules require modification for a Corporate CIV.

Special withholding tax rate for dividends paid by the Corporate CIV

5.52 The Board considers that a special dividend withholding tax rate would be appropriate for dividend payments made by a Corporate CIV to foreign investors resident in an information exchange country.

5.53 This is particularly in light of comments raised in targeted consultations that Australia's dividend withholding tax rates (which are generally 15 per cent under Australia's international tax treaties for portfolio investments) are typically higher than Australia's interest withholding rate (which is generally 10 per cent) as well as the 7.5 per cent concessional withholding tax rate for MIT fund payments. Foreign investors may prefer investing in MITs which can access these lower withholding tax rates over a Corporate CIV which would be subject to only one dividend withholding tax rate.

5.54 The Board also notes that foreign investors in MITs have an effective nil withholding tax rate on tax deferred distributions, whereas such distributions would be subject to dividend withholding tax for foreign investors in a Corporate CIV.

5.55 In considering what dividend withholding tax rate would be appropriate for the Corporate CIV, the Board considered that a balance would need to be struck between the need to ensure that the rate would not be a disincentive to investors who could invest through MITs and foreign managed funds and the need not to cause an undue cost to the revenue.

5.56 The Board recommends that a special dividend withholding tax rate should apply for dividend payments made by a Corporate CIV to foreign investors resident in an information exchange country, which produces a tax outcome equivalent to the application of Australia's different treaty withholding tax rates for different types of payments to foreign investors.

5.57 For dividend payments made by the Corporate CIV to foreign investors not resident in an information exchange country, the Board recommends the same dividend withholding tax rate that applies for dividends paid to non-treaty countries.

5.58 As some of Australia's international tax treaties contain maximum rates of dividend withholding tax of 5 per cent or zero for non-portfolio interests, it will be necessary to limit a foreign resident corporate shareholder to holding a less than 10 per cent voting interest in a Corporate CIV to ensure that tax is collected at the appropriate rate from such corporate shareholders. Australia already has a similar rule in the LIC regime as do Germany and the UK for their Corporate REITs.

5.59 Similarly, it will be necessary to determine if some domestic law exemptions from dividend withholding tax are appropriate. An example is the case of foreign superannuation funds where the Corporate CIV is primarily invested in real estate.

Dealing with 'unders and overs'

5.60 As noted above, the proposed Corporate CIV regime exemption would require a Corporate CIV to pay dividends to investors equal to a substantial proportion (given as a fixed percentage) of what would be its taxable income in a particular year.

5.61 The issue of 'unders and overs' could arise under the proposed exemption model Corporate CIV regime if the Corporate CIV pays a dividend and later ascertains that the dividend amount was less than the required percentage of its taxable income. The same issue arises under the MIT regime.

5.62 The Board considered whether this issue could be resolved for the Corporate CIV regime by enabling it to make a top up dividend payment to investors if it had not distributed a sufficient percentage of its taxable income. However, such an option has numerous difficulties, including the onus that would be placed on the Corporate CIV to pay additional dividends that may be nominal in value, and the added complexity that would be imposed on the regime. The Board also received comments from stakeholders that requiring 'unders and overs' adjustments would be a complex process.

5.63 The Board therefore considered an alternative option of requiring the Corporate CIV to pay tax at the normal corporate tax rate if its dividend payment was less than the required percentage of its taxable income. Any tax paid would then be available as franking credits for the Corporate CIV for attachment to future dividends. Depending on the particular package of measures decided upon for the Corporate CIV regime, there may be little reason for the required percentage to be less than (or substantially less than) 100 per cent.

5.64 The Board was of the view that this alternative option would provide a substantial degree of simplification to dealing with the issue of 'unders and overs' when compared to the MIT regime.

5.65 However, the Board considers that this alternative option should only apply in cases where there is a not a substantial deficiency in the payments of dividends by the CIV with respect to the required percentage of its taxable income. Where there is a substantial deficiency, the Corporate CIV would lose access to the Corporate CIV regime treatment.

5.66 The Board recommends that the Government consider measures to promote compliance with the distribution requirement. For example, an additional integrity measure the Government could consider is to:

- require that the Corporate CIV make an irrevocable election to be subject to the recommended CIV regime treatment; and
- set a cap on the maximum deficiency that would be allowed for a Corporate CIV without losing access to the CIV regime treatment.

Treaty recognition

5.67 The Board reiterates that its recommended exemption model Corporate CIV regime would not require the deeming of the Corporate CIV to be a trust or any other entity for tax purposes. Instead, it would leave the Corporate CIV as a company for tax purposes, and would require modifications to be made to the company tax rules.

5.68 This should facilitate the recognition of the Corporate CIV in Australia's international tax treaties. The Corporate CIV should accordingly be in a position to claim treaty benefits in its own right in many cases, an attribute that would be important for foreign retail investors. The Board understands there are some countries, such as France, which do not permit the claiming of treaty benefits if the foreign entity is generally exempt from tax (such as pensions funds) but the Corporate CIV would generally be in the same position as other foreign Corporate CIVs investing into such countries.

5.69 Corporate vehicles with similar tax treatments in other jurisdictions, such as Luxembourg SICAVs, have established over time the extent of treaty recognition that can be obtained from other countries. The Board considers that Australia, in drafting the rules for a Corporate CIV regime, should try to replicate the SICAV rules as far as possible in order to seek a similar outcome in a short time frame. It has already been noted in Chapter 2 that Luxembourg SICAVs have been very successful in attracting money from Asia and so modelling an Australian Corporate CIV regime on this approach should increase its attractiveness to Asian investors.

Interactions with other areas of the tax law

5.70 The Board also notes that if its recommended Corporate CIV regime is implemented, care would be required to consider the interaction of the regime with other areas of the income tax law applicable to corporate vehicles. Examples include the rules which provide companies with an exemption for non-portfolio dividend income, whether a Corporate CIV should be allowed to become a member of a tax consolidated group, how the Corporate CIV rules would interact with the Taxation of Financial Arrangements rules, and whether a requirement should be included into the Corporate CIV rules that all shares held in the Corporate CIV must be equity interests under the debt / equity provisions.

Changes required to corporate regulation

5.71 The Board recommends that changes be made to the Corporations Act and other corporate regulations to facilitate the Board's recommended Corporate CIV regime.

5.72 It may be desirable for the Corporate CIV to have flexibility to allow investors to withdraw their investments, which would require amendments to the Corporations Act. The Government could also investigate whether to allow the Corporate CIV to have protected cells (or sub-funds) under which the assets of one cell are protected against the liabilities of another cell of the company.

5.73 The Board also notes that on 28 November 2011 the Government announced a review of reforms to the dividends payment test in the Corporations Law[8]. The outcomes of this review would also need to be taken into account in determining what changes would be required to corporate regulation to facilitate the Board's recommended Corporate CIV regime.

Recommendation 8:

The Board recommends that a Corporate CIV regime be introduced using an exemption model incorporating the following elements:

- the Corporate CIV be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4;
- the Corporate CIV be treated as exempt for tax purposes, with the intention of passing the tax burden to its investors;
- the Corporate CIV be required to pay dividends to investors periodically, with the dividends being equal to a substantial proportion (given as a fixed percentage) of what would be the taxable income of the Corporate CIV;
- the Corporate CIV be required to have a substituted accounting period of sufficient length to enable it to pay final dividends in respect of that period by 30 June (with a suggested outside limit being the prior 31 March);
  - consideration be given to integrity measures where additional tax deferral results from multiple layers of Australian Corporate CIVs;
- resident investors be taxable at the time they receive dividends from the Corporate CIV;
- where the dividend paid to resident investors comprises amounts attributable to

8 Parliamentary Secretary to the Treasurer's Media Release No 57 of 28 November 2011 - http://parlsec.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/057.htm&pageID=003&min=djb&Year=&DocType=

capital gains made by the Corporate CIV, rules be incorporated into the Corporate CIV regime to enable the flow-through of discount capital gains to resident investors;

- where the dividend paid to resident investors comprises amounts attributable to foreign income which has been subject to foreign income tax, a 'foreign income tax offset' entitlement flow-through to investors;

- for foreign investors in the Corporate CIV, dividends paid by the Corporate CIV be treated as amounts not subject to dividend withholding tax where the dividend comprises foreign income, non-taxable Australian property capital gains or franked dividends, with all other amounts being subject to dividend withholding tax;

- a special rate of dividend withholding tax apply for dividend payments made by a Corporate CIV to foreign investors resident in an information exchange country which produces a tax outcome equivalent to the application of Australia's different treaty withholding tax rates for different types of payments to foreign investors;

- for dividend payments made by the Corporate CIV to foreign investors not resident in an information exchange country, the dividend withholding tax rate that applies for dividends paid to non-treaty countries apply;

- investors in a Corporate CIV be limited to holdings of no more than 10 per cent in the Corporate CIV to prevent foreign investors from accessing reduced rates of withholding tax under Australia's international tax treaties for non-portfolio investments;

- if the Corporate CIV pays a dividend and later ascertains that the dividend amount was less than the required fixed percentage of its taxable income, the Corporate CIV be required to pay tax at the rate of 30 per cent for the undistributed amount (with that tax paid being available as franking credits for future distribution);

- that the Government consider measures to promote compliance with the distribution requirement. For example, an additional integrity measure the Government could consider is to:

  – require that the Corporate CIV make an irrevocable election to be subject to the recommended CIV regime treatment; and

  – set a cap on the maximum deficiency that would be allowed for a Corporate CIV without losing access to the CIV regime treatment; and

- changes be made to the Corporations Act and other corporate regulations to facilitate the Board's recommended Corporate CIV regime.

DEEMED CGT TREATMENT

5.74 The Board considered whether the Corporate CIV regime should include an option to elect deemed capital account treatment similar to that available in the MIT regime.

Views in submissions

5.75 Submissions were in broad agreement that Corporate CIVs should be given a deemed capital account treatment similar to that available in the MIT regime. This would better harmonise the Corporate CIV regime with the existing MIT regime.

> To avoid capital-revenue issues at the level of the CIV creating potential disputes with the ATO that may prejudice corporate CIV status and to align tax treatment with MITs the corporate CIV should be able to elect capital account treatment in the same way as an MIT...
>
> Greenwood & Freehills

5.76 Other submissions note that apart from the deemed capital account treatment, other options are available which will give certainty to non-resident investors such that they will not have to deal with the capital/revenue distinction in Australia's tax law.

> In the VCLP context, eligible non-resident investors are exempt from taxation on both capital and revenue gains, and so are indifferent to this characterisation question. A third option could be a bright line test, for example, related to the length of time that an investment is held (a long-term investment, however defined, could generate capital gain).
>
> Law Council of Australia

Board's consideration

5.77 The Board is of the view that, similar to the MIT regime, the Corporate CIV regime should include an option to elect deemed CGT treatment for its eligible investments. This would be equivalent to the deemed CGT treatment that applies to the disposal of eligible passive investments by MITs.

5.78 An election for deemed CGT treatment would result in:

- gains made by the Corporate CIV on all assets that are not taxable Australian property being able to be distributed to non-resident investors free of withholding tax; and

- gains made by the Corporate CIV that are distributed to Australian investors being treated as capital gains, and qualifying for discount capital gain treatment.

5.79 The Board acknowledges that providing a Corporate CIV with an election for deemed CGT treatment may have a cost to the revenue. It also acknowledges that investors may shift from the current LIC regime, which does not currently have a deemed CGT treatment, into the Corporate CIV regime.

5.80 However, the Board considers it important that Corporate CIVs not be placed at a competitive disadvantage to MITs in not being given a deemed CGT treatment. Providing an election for deemed CGT treatment would also not create a bias for non-resident investors to make their investments exclusively through foreign managed funds, for which the Government has recently announced the final element of an IMR broadly in line with the Board's recommendations.

Recommendation 9:

The Board recommends that an option to elect deemed CGT treatment be included into the Corporate CIV regime similar to that introduced into the MIT regime.

ALTERNATIVE CONDUIT CORPORATE CIV REGIME

5.81 The Board understands that some stakeholders desire a Corporate CIV regime should not only be aimed at targeting conduit investment activity, but should also be open to Australian resident investors and facilitate investments in Australian assets.

5.82 Enabling Corporate CIVs to have Australian investors and Australian assets would avoid the need for fund managers to incur additional costs to establish and operate 'mirror' funds.

5.83 Industry has also advised that the establishment of new Corporate CIVs aimed at Asian investors would likely need a minimum base of Australian investors in the fund prior to being marketed into Asia, in order to justify establishment and maintenance costs of the fund. This would require Australian residents to be able to invest into the Corporate CIV. Furthermore, Asian investors may only seek to invest into Corporate CIVs with a proven track-record of returns to existing investors.

5.84 Foreign investors into the Corporate CIV may also find it restrictive that the fund not be able to invest into Australian assets. This would prevent Australian investments being included in the diversified portfolio of investments held by the fund. Any competitive advantage which the Australian CIV fund manager may have in its expertise in investment in Australian assets would also be lost.

5.85 The Board also acknowledges that preventing access by Australian superannuation funds to a Corporate CIV regime may severely limit the source of funds available.

5.86 In view of the above, the Board is of the view that the Corporate CIV regime should be implemented as per its recommendations above (Recommendations 8 and 9) without restrictions to prevent access by Australian investors and investments in Australian assets.

Chapter 6: Taxation treatment for a Limited Partnership CIV

6.1 The terms of reference asked the Board to examine whether a broader range of tax flow-through CIVs should be permitted, including the degree to which a non-trust CIV would enhance industry's ability to attract foreign funds under management in Australia. This chapter reports on the Board's examination of whether flow-through tax treatment should be provided to a Limited Partnership CIV (LP CIV).

6.2 The Board sought stakeholder comments on whether limited partnership (LPs) are suitable vehicles for undertaking widely held, primarily passive, collective investments and whether it is desirable to introduce changes to the limited partnership regime, so that flow-through taxation is allowed for those widely held LPs that restrict their investment activities to primarily passive investments.

6.3 The Board also sought views on whether it would be appropriate not to require LPs to be 'widely held' (as defined in the MIT regime) where they restrict their investment activities to primarily passive investments and are marketed to wholesale investors or sophisticated investors.

6.4 Views from stakeholders were also sought on whether, apart from limiting the flow-through of losses, there would be a need, in light of integrity and investor protection considerations, to apply further restrictions under that modified LP regime and, if so, what would be the nature of those restrictions.

A Limited Partnership CIV

6.5 The Board sought comments from stakeholders on the desirability for the introduction of a LP CIV with tax flow-through treatment.

6.6 The current tax treatment of limited partnerships was described in the Board's discussion paper. *Taxation Laws Amendment Act (No 6) 1992* amended the law to treat limited partnerships as companies for tax purposes under Division 5A of the *ITAA 1936* (Division 5A).[9] The corresponding Explanatory Memorandum noted that if

9 However, Division 830 of the *ITAA 1997* provides for foreign hybrid limited partnerships to be treated as partnerships for the purposes of that Act. Similar treatment applies under the venture capital limited partnership (VCLP) regime as discussed in the Board's report on its review of the taxation arrangements under the venture capital limited partnership regime.

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

Views in submissions

6.7 A number of stakeholders supported the view that LPs that are widely held and involved in passive investments should be able to access the CIV regime and flow-through taxation.

> Limited partnerships are familiar vehicles for collective investment purposes. Expanding the type of flow through vehicles that could be used to by investors in the funds management industry would remove some of the impediment to attracting foreign capital into Australia. In particular, limited partnerships that are widely held and involved in passive investment activity should be able to access the flow through benefits of a new CIV regime.
>
> The Tax Institute

6.8 Some stakeholders submitted that LP CIVs that undertake primarily passive investments but do not meet the 'widely held' requirement should also be permitted to access flow-through taxation. This was viewed by these stakeholders as consistent with the principle 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.

> Where such LPs undertake primarily passive investments but do not meet 'widely held' requirements, the Institute's view is that these entities should also be permitted to access flow through taxation. This would be consistent with the overarching principle that the taxation focus is on the investment activities (and the related income) and not the entity itself.
>
> The Institute of Chartered Accountants in Australia

6.9 While most submissions supported the introduction of a LP CIV regime with flow-through taxation, some conveyed a reluctance to support the use of LPs for this purpose at this stage in the absence of appropriate investor protection and regulatory arrangements for such vehicles. However, these stakeholders submit that LPs may have a role in relation to CIVs that are marketed at a wholesale level for sophisticated investors, noting that in those cases there would not appear to be a need for these vehicles to be widely held.

6.10 Other stakeholders submit that LP CIVs should be restricted to institutional and sophisticated investors under an appropriate regulatory regime, with restrictions on the ability of a limited partner to claim a tax loss to the extent that it exceeds their capital contribution into the partnership, but not be restricted to any particular type of investments.

6.11 Some stakeholders have submitted that a general flow-through LP CIV structure should be introduced, which could be used for all forms of venture capital and private equity investment. Under this proposal, gains and losses would flow through to investors as in the Venture Capital Limited Partnership (VCLP) structure; the LP CIV would be able to elect capital account treatment; 'carry' from the manager, unlike in the VCLP structure, would not benefit from capital account treatment, but the LP CIV would be free from VCLP type restrictions on 'eligible partners' and 'eligible investments' and would be subject to a governing body overseeing registration and ongoing operation of the structure as an integrity measure.

Board's consideration

6.12 The Board recommends that an LP CIV regime be introduced into the suite of CIVs that provide tax flow-through treatment, as that would provide further choice for foreign investors with different preferences for the type of CIVs. The Board also recommends that these LP CIVs be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4, including the widely held requirement.

6.13 The Board notes that, internationally, LPs are commonly structured with a relatively limited number of investors. In many cases, these investors are institutional investors. While such LPs may be considered not to be widely held in the first instance, if the Board's recommendation in Chapter 4 to amend the widely held tracing tests are adopted (Recommendation 3), these LPs would likely meet the widely held test. This is because most institutional entities, such as pension funds, would be treated as widely held vehicles.

6.14 The Board notes that, in its Report on the design of an IMR as it relates to foreign managed funds, it recommended (at Recommendation 3) 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 it central management and control in Australia.

6.15 The Board also recommended that the Government investigate whether this amendment should apply for all limited partnerships in the general tax law.

6.16 The Board recommends that the modified limited partnership residence test set out in paragraph 6.14 should apply for the purposes of the LP CIV regime. This will align the residence tests for limited partnerships accessing the IMR for foreign managed funds and those accessing the LP CIV regime.

Recommendation 10:

The Board recommends that:

- an LP CIV regime be introduced into the suite of CIVs that provide tax flow-through treatment;
- LP CIVs be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4, including the widely held requirement; and
- an LP CIV be taken to be Australian resident if:
  - the partnership is formed in Australia; or
  - the partnership carries on business in Australia *and* has it central management and control in Australia.

TAXATION TREATMENT OF A LP CIV

Views in submissions

6.17 A number of stakeholders submitted that flow-through taxation in LP CIVs should be achieved by attributing the taxable income of the CIV to the limited partners with appropriate withholding tax rules applying with respect to taxable income attributed to non-resident limited partners.

6.18 Stakeholders suggest that the preferred approach would be to exclude a class of LPs that meet certain widely held and investment tests (LP CIVs) from the existing LP corporate tax treatment in Division 5A, such that they would receive general partnership tax treatment, with the addition of appropriate loss limitation rules.

> The preferred approach would be to exclude a class of LPs which we call Collective Investment Vehicles LPs (CIVLPs) from the existing LP corporate treatment. This might be achieved by carving out LPs, meeting certain widely held and investment tests, from the current company tax treatment for LPs ... Appropriate integrity around the use of losses might be introduced using rules such as the approaches in other jurisdictions. For example, losses in UK LPs and UK LLPs can be deducted but limited to the capital contributed ... The CIV LP might be restricted to institutional and sophisticated investors under an appropriate regulatory regime.
>
> Ernst & Young

6.19 Other stakeholders have submitted that, rather than introducing a carve-out from Division 5A, LP CIVs could be taxed in the same way as MITs, which would be consistent with the principle 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.

6.20 Stakeholders that submit that LPs should be taxed in the same way as MITs argue that partnership tax treatment would require each investor to have a separate cost base in each individual investment held by the LP which would be impractical from a CGT perspective (especially for open-ended funds with incoming and outgoing investors). Loss limitation rules applied at the investor level with a loss limitation amount calculated for each investor would also be needed.

> The CIV regime should enable CIVs to maintain a separate 'outside' cost base in the CIV interests (as currently is the case for units held in an MIT), rather than requiring a rebalancing of the 'inside' cost base of underlying investments each time there are incoming and outgoing investors (which would be extremely difficult administratively for widely held retail trusts) ... Many overseas vehicles work well for closed ended funds with fixed investors for a finite duration, for example, 5/7/10 years, so the issue of rebalancing the cost base of a portfolio's investment is far more manageable than with an open ended fund.
>
> Deloitte Touche Tohmatsu

6.21 Some stakeholders have suggested that a partnership tax treatment could still apply for LP CIVs subject to modifications, with capital gains being calculated at the partnership level rather than at the partner level, but cautioned that this would require fundamental changes to the CGT provisions, including new rules dealing with investors and their interests in the partnership.

> New CGT events would need to be introduced to cater for a disposal of such interests and to avoid double taxation issues. Such a change may need to be thought through appropriately before being implemented.
>
> Pitcher Partners

Board's consideration

Models for flow-through taxation for a LP CIV

6.22 The Board understands that, internationally, LPs are commonly structured as closed-ended funds with a relatively limited number of investors. New partnership interests are rarely issued once the LP is established, and these interests are not normally redeemable for cash or securities until the fund liquidates after a set period of time. This is also the general case for VCLPs used in Australia.

6.23 There are two broad options for the design of an LP CIV: using flow-through taxation under the general partnership tax rules as is the case under the VCLP and foreign hybrid limited partnership regimes; or using flow-through taxation under the MIT attribution model.

6.24 The Board is of the view that the general partnership tax rules should be applied to provide flow-through taxation for the LP CIV regime, with the addition of loss limitation rules.

6.25 The Board considers that applying the general partnership tax rules for the LP CIV would require fewer amendments to the tax law, and would therefore be easier to implement. This option would also prevent the need for investors to have a cost base in the LP CIV different from the cost base held by the LP CIV in its underlying assets. Capital gains of the LP CIV would be treated as being directly made by the partners in the partnership.

6.26 While under this approach there may be complexity in requiring each investor to have a separate cost base in each individual investment held by the LP CIV, the Board considers that this complexity should be manageable as long as these LP CIVs are used predominantly as closed-ended partnerships with a reasonably limited number of partners.

Loss limitation rules

6.27 The Board notes that in considering whether limitations should be placed on the flow-through of losses under the LP CIV regime, its terms of reference require that the tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment with the exception of the flow through of losses, which are to be subject to limited special rules for their utilisation.

6.28 The Board notes that both the foreign hybrid limited partnership regime and the VCLP regime have special loss limitation rules to ensure that investors cannot gain access to tax losses greater than their economic investment. The Board understands that the foreign hybrid limited partnership regime loss limitation rules, which apply to capital and revenue losses, are more robust than those in the VCLP regime.

6.29 The Board considers that, in accordance with international practice, losses under a LP CIV should be able to flow through to investors but that there should be a limit on the utilisation of losses to the amount which the limited partner has invested. Accordingly, the Board recommends that loss limitation rules, similar to those under the foreign hybrid limited partnership regime, should apply to the LP CIV regime.

6.30 The Board notes that similar loss limitation rules apply to limited partnership CIVs in other jurisdictions and considers that if a degree of loss flow-through is not incorporated into the LP CIV regime, it will not be competitive with foreign LP CIVs. Moreover, it would be necessary to construct rules for the carry-forward of losses in the LP CIV. The Board notes that there are no such rules in current law for partnerships and that the extensive loss rules for trusts and companies would need to be replicated in some form for LP CIVs.

6.31 The Board also acknowledges that, for the reasons discussed at paragraphs 6.25 to 6.26 above, capital gains and losses would be treated as being directly made by the partners in the LP CIV (subject to the proposed loss limitation rules).

6.32 The Board nevertheless notes that the provision of the limited flow through of losses would have a cost to the revenue when compared with the tax treatment applicable to MITs.

Deemed CGT treatment

6.33 Similarly to the Board's recommendation in the case of the Corporate CIV, the Board recommends that the LP CIV should include an option to elect deemed CGT treatment for its eligible investments. This would be equivalent to the deemed CGT treatment that applies to the disposal of eligible passive investments by MITs. Once the election is made it would operate at the level of the partners as capital gains would not arise at the LP CIV level as already explained.

Withholding tax considerations

6.34 The Board considered how the non-resident withholding tax rules would operate for the proposed LP CIV.

6.35 The Board noted that the current non-resident withholding tax rules would only apply on dividends, interest and royalties paid by the proposed LP CIV to foreign investors. No such withholding tax would apply if rent, revenue gains (such as gains on the sale of bonds) or gains made on the sale of taxable Australian real property were paid by the LP CIV to foreign investors. The payments of these types of income by an MIT would be classified as 'fund payments' and be subject to a 7.5 per cent MIT withholding tax.

6.36 To assist with simplicity and compliance in relation to the collection of income tax on income derived by foreign residents, the Board recommends that a final withholding tax be introduced on payments made by a LP CIV to foreign investors of types of income that are equivalent to those categorised as MIT fund payments.

6.37 To help maintain parity with MIT outcomes, the Board recommends that the Government consider aligning the final withholding tax on fund payments made by a LP CIV to that applying to MITs.

6.38 Consistent with Recommendation 6, the Board also recommends that LP CIVs with access to the recommended final withholding tax on fund payments should be subject to a requirement of having a significant connection with Australia, as applicable under the MIT withholding tax rules.

6.39 In the case where a fund payment is made by a LP CIV to a foreign investor who is not resident of an information exchange country, the Board recommends the final withholding tax should be the same as that applicable under the MIT regime.

Recommendation 11:

The Board recommends that:

- the general partnership tax rules be applied to provide flow-through taxation for the LP CIV regime;
- LP CIVs be subject to loss limitation rules similar to those in the foreign hybrid limited partnership regime;
- an option to elect deemed CGT treatment be included into the LP CIV regime similar to that introduced into the MIT regime;
- the Government consider aligning the final withholding tax on fund payments made by a LP CIV to that applying to MITs;
- fund payments made through a LP CIV to foreign investors who are not resident of an information exchange country be subject to the same final withholding tax as that applicable under the MIT regime; and
- LP CIVs with access to the recommended final withholding tax on fund payments be subject to a requirement of having a significant connection with Australia.

CHAPTER 7: TAXATION TREATMENT FOR A COMMON CONTRACTUAL FUND CIV

7.1 As noted in the previous chapters, the terms of reference asked the Board to examine whether a broader range of tax flow-through CIVs should be permitted.

7.2 This chapter reports on the Board's examination of whether flow-through tax treatment should be provided through a Common Contractual Fund (CCF).

7.3 The Board understands that the CCF in Ireland is a collective investment undertaking under which investors participate and share in the assets of the collective investment undertaking as co-owners by contractual arrangement.

7.4 The CCF is an unincorporated body, not a separate legal entity, and is transparent for Irish legal and tax purposes. As a result, investors in a CCF are treated as if they directly own a proportionate share of the underlying investments of the CCF, rather than shares or units in an entity which itself owns the underlying investments.

7.5 The Irish CCF is established by a management company which is vested with powers for the management of the property of the fund. A CCF will also generally have a custodian in which the property of the CCF is entrusted. Investors in a CCF have their liability limited to the amount of their investments.

7.6 The Board's discussion paper also notes that the Irish CCF is generally transparent for Irish tax and treaty purposes, and was designed primarily for use by institutional investors like pension funds. The profits (income and gains) arising or accruing to the CCF are treated as arising or accruing to the unit holders in proportion to the value of the units beneficially owned by them, as if such profits did not pass through the hands of the CCF.

7.7 Other key features of the Irish CCF include:

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

- income derived through the CCF is distributed on a mandatory basis annually, pro rata to each investor's units in the CCF;
- investors in the CCF are provided with an annual breakdown of income on investments by type and source;
- units in a CCF are not freely transferable but are redeemable. No redemption charge is levied on investors; and
- the CCF is obliged to report annually to the Irish revenue authority on profits made and benefits accruing to each investor.

Views in submissions

7.8 The Board did not specifically call for stakeholder comments in its discussion paper on the inclusion of a CCF into the suite of CIVs that provide tax flow-through treatment.

7.9 However, a number of submissions identified that CCFs used in Ireland were an effective tax flow-through structure.

> The flow-through model is the most appropriate to achieve tax neutrality... Examples of transparent CIVs that have attracted significant funds under management from offshore investors are the Common Contractual Fund (CCF) in Ireland and the Luxembourg Fonds Commun de Placement (FCP)
>
> Moore Stephens

> Many foreign investors (even though they may reside in a Double Tax Treaty country) do not come from a common law jurisdiction. Consequently, these investors are not familiar with trusts and often prefer to invest in a Collective Investment Vehicle (CIV) which has either a contractual basis (e.g. an Irish common contractual fund) or is a corporate entity (for example, a Luxembourg SICAV).
>
> Financial Services Council

Board's consideration

Consideration of a CCF CIV

7.10 Although the Board's discussion paper and submissions raised only limited comments on the CCF, the Board understands that Irish CCFs and the similar Fonds Commun de Placement (FCPs) in Luxembourg are commonly used for collective investment in Europe, particularly for institutional investors that wish to maximise their access to treaty benefits.

7.11 The Board understands that CCFs and FCPs are generally treated as transparent for tax treaty purposes by the vast majority of tax authorities, enabling investors in these arrangements to access treaty benefits in their own right and claim credits for foreign tax paid at source. This is particularly advantageous for institutional investors, such as pension funds, as well as tax exempt entities.

7.12 In a number of cases, the transparent nature of the CCF or FCP for treaty purposes is reinforced by tax rulings by local revenue authorities. In the case of Australia, ATO Interpretative Decision 2008/63 confirms that an Irish CCF is not a resident of Ireland for the purposes of the Ireland/Australia tax treaty.

7.13 The Board recommended (at Recommendation 2) that a range of CIVs should be introduced with different tax treatments under Australia's international tax treaties so as to cater for the needs of different foreign investors seeking to invest into Australia. The Board also noted at paragraph 3.24 that a common contractual arrangement is a form of CIV that would be more transparent when compared to an MIT.

7.14 In line with the considerations above, the Board recommends that a CCF CIV regime should be included into the suite of CIV regimes that provide tax flow-through treatment.

7.15 The Board recommends that the CCF CIV be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4, subject to a modification to the Australian residence requirement discussed below.

Alternative connection to Australia test

7.16 In the Board's report on an IMR as it relates to foreign managed funds, the Board noted that there may be circumstances where a foreign managed fund may not be considered to be an 'entity', such as the case of a common contractual fund, and thus may not be taken to be resident of any country. The Board considered that these types of CIV arrangements should be able to qualify for the IMR, and so a 'residence deeming provision' may be required to ensure that such CIVs could be taken to be resident in an information exchange country.

7.17 This same residence issue arises in the context of designing an Australian CCF CIV regime. Without any modifications to the general residence rules, a CCF CIV would be unlikely to be considered to be an entity and therefore could not be an Australian resident.

7.18 The Board considers that, as the criteria for the 'residence deeming provision' is developed for use in the IMR for foreign managed funds, the same criteria should be used to ascertain, conversely, whether a common contractual fund should qualify for the CCF CIV regime.

Legal nature and tax treatment of a CCF CIV

7.19 The Board considers that the legal nature and tax treatment of the CCF CIV should be implemented as closely as possible to that under the Irish regulatory and tax law for the Irish CCF.

7.20 The advantage of this approach in introducing a new CIV into Australia would be that it leverages off the legal and tax treatment of an existing model commonly used internationally. The introduction of a similar vehicle in Australia with the same name and characteristics should aid in the competitiveness of the Australian CCF CIV in international markets.

7.21 The Board sees particular advantages in replicating as closely as possible the characteristics of the Irish CCF given that it is understood that the Irish tax policy and regulatory authorities took a number of years to adapt the CCF to ensure its effective operation from a legal perspective and to maximise its recognition as being transparent for treaty purposes by most tax authorities.

7.22 The Board acknowledges, however, that modifications would need to be made to the tax treatment of the Irish CCF to take into account the fact that the Irish CCF is predominantly used to facilitate investments in non-Irish assets. In contrast, the Australian CCF CIV would be used to make investments both inside Australia and overseas. Tax rules would need to be included to ensure appropriate taxation of income derived from Australian assets, such as withholding tax on the different components of Australian source income.

7.23 In addition, while the Irish CCF is not exclusively used by non-Irish investors, the Board understands that the participation by domestic investors into Irish CCFs is relatively limited, whereas there would be a potential for a more significant presence of domestic investors into an Australian CCF CIV. Tax rules would need to be designed to ensure the appropriate taxation of Australian resident investors.

7.24 In considering the design of the tax treatments for an Australian CCF CIV that draws on the Irish CCF subject to necessary modifications, the Board recommends that investors in the CCF CIV should receive flow-through of character and source similar to investors in the Board’s recommended LP CIV, with no need for a cost base at the CIV level as is the case under the MIT regime.

7.25 The Board recommends that, similar to the Irish CCF, the profits (income and gains) arising or accruing to the CCF CIV should be treated as arising or accruing to the investor in proportion to the value of assets beneficially owned by them, as if such profits did not pass through the hands of the CCF CIV.

7.26 Further, the Board notes that the potential losses that investors would be exposed to by investing in a CCF CIV would be limited by the amount of their respective investments. Therefore, in the case of a CCF CIV, there may not be a need to impose additional loss limitation rules to achieve an equivalent outcome to that obtained by investors in the Board's recommended LP CIV.

7.27 Similar to the Board's recommendation in the case of the Corporate CIV and the LP CIV, the Board recommends that CCF CIVs should include the option to elect deemed CGT treatment for its eligible investments. In the case of the CCF CIV, the option to elect deemed CGT treatment should be made by the manager of the CCF CIV so as to provide certainty in this regard to its investors.

7.28 Finally, to help maintain parity with MIT outcomes, the Board recommends that:

- the Government consider aligning the final withholding tax on fund payments made by the CCF CIV to that applying to MITs;
- fund payments made through a CCF CIV to foreign investors who are not resident of an information exchange country should be subject to the same final withholding tax as that applicable under the MIT regime; and
- CCF CIVs with access to the recommended final withholding tax on fund payments should be subject to a requirement of having a significant connection with Australia.

Recommendation 12:

The Board recommends that:

- a CCF CIV be included into the suite of CIVs that provide tax flow-through treatment;
- the CCF CIV be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4;
- investors in the CCF CIV receive flow-through of character and source similar to investors in the Board's recommended LP CIV, with no need for a cost base at the CIV level as is the case under the MIT regime;
- the profits (income and gains) arising or accruing to the CCF CIV be treated as arising or accruing to the investor in proportion to the value of assets beneficially owned by them, as if such profits did not pass through the hands of the CCF CIV;
- in the case of the CCF CIV, there may not be a need to impose additional loss limitation rules to achieve an equivalent outcome to that obtained by investors in the Board's recommended LP CIV;
- CCF CIVs include the option to elect deemed CGT treatment for its eligible investments;

  - the option to elect deemed CGT treatment be made by the manager of the CCF CIV so as to provide certainty in this regard to its investors;

- the Government consider aligning the final withholding tax on fund payments made by the CCF CIV to that applying to MITs;

- fund payments made through a CCF CIV to foreign investors who are not resident of an information exchange country be subject to the same final withholding tax as that applicable under the MIT regime; and

- CCF CIVs with access to the recommended final withholding tax on fund payments be subject to a requirement of having a significant connection with Australia.

CHAPTER 8: SCOPE FOR HARMONISATION WITH AUSTRALIA'S OTHER CURRENT CIV REGIMES

8.1 As noted in Chapter 3, the Board has been asked to report on 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.

8.2 In Chapter 3, the Board reported on the scope for harmonisation between unit trusts currently covered by the MIT regime and potential new flow-through CIVs structured as companies or limited partnerships. In this Chapter, the Board reports on the scope for harmonising the MIT regime and the proposed Corporate CIV, LP CIV and CCF CIV regimes with other currently existing CIV regimes, namely the LIC regime and the VCLP regimes.

THE LIC REGIME

8.3 In the discussion paper, the Board sought stakeholders' views on whether it would be desirable to introduce changes to the LIC regime to better obtain parity of tax outcome with direct investments in the underlying assets of the LIC. This was in line with the principle in the terms of reference that the tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment, having regard to the MIT tax framework.

Views in submissions

8.4 Stakeholders generally were of the view that the existing LIC regime was beneficial for resident investors, and should continue to operate in tandem with any new corporate CIV regime.

> ... we do not agree that LICs should be forced to adopt the flow through tax arrangements for investors which apply to MITs. To move to a model that required LICs to distribute each year all income and capital gains would be to remove some of the fundamental investment characteristics and attractiveness of LICs. It would introduce significant variability into the distribution stream from year to year and directly remove the ability of LICs to accumulate reserves for difficult times. The distributions made to investors would be made up of differing components of income, franking credits and capital gain and the structures become more complex in their operation.

> Australian Foundation Investment Company Limited
>
> From the perspective of an Australian resident taxpayer, a LIC provides access to the discount capital gains and the flow through of imputation, whilst allowing the LIC an easy ability to retain funds for investment purposes... Given that up to $18 billion of funds are invested through LICs and LITs, we believe that this represents an important part of the domestic funds management practice that may not otherwise exist if there was a move to a pure flow-through tax structure...
>
> Pitcher Partners

8.5 A number of stakeholders proposed that a deemed capital account treatment be allowed to LICs in the same way that it has been provided to MITs, noting that the existing LIC regime was disadvantaged when compared to MITs due to the uncertainty of the capital or revenue characterisation of gains.

> It would, however, be very important to remove any uncertainty that currently surrounds the capital/revenue issue. This uncertainty leads some investors to regard LICs as being less advantageous from a personal taxation perspective than an MIT. This uncertainty defeats the purpose of the original LIC legislation which was designed to remove any such perceptions of disadvantage and promote consistency of treatment.
>
> Australian Listed Investment Companies Association

Board's consideration

8.6 In its report on the *Review of the tax arrangements applying to Managed Investment Trusts*, the Board noted that given the similarity in investment restrictions between LICs and eligible MITs and that arguably they compete for the same investor dollar, particularly from individuals, it would be reasonable for their tax treatment to be the same and recommended that consideration be given to extending any capital account treatment provided to eligible MITs to LICs. The Government decided to defer consideration of this recommendation.

8.7 The Board concurs with stakeholders that LICs represent an important part of the domestic funds management practice that may not otherwise exist if there were a move to a pure flow-through tax structure and therefore recommends that no further changes are required to the LIC regime to better align them with the other CIV regimes in the Australian tax law.

8.8 The Board considers that it should be possible for existing LICs to convert to a Corporate CIV within a specified time frame after the introduction of any Corporate CIV regime. This will ensure that the creation of the Corporate CIV regime does not disrupt the operation of the LIC regime, for example, if there is a market perception that investors will withdraw funds from LICs for reinvestment in Corporate CIVs.

Recommendation 13:

The Board recommends that no further changes be made to the LIC regime to better align them with the other CIV regimes in the Australian tax law but that existing LICs be able to convert to a Corporate CIV within a specified time frame after the introduction of any Corporate CIV regime.

THE VCLP REGIMES

8.9 As noted at paragraph 1.10, on 27 June 2011 the Board delivered its report to the Government on the VCLP component of the CIV review — *the review of taxation arrangements under the Venture Capital Limited Partnership regime* and made a number of recommendations that seek to improve the operation of the Venture Capital Limited Partnership and Early Stage Venture Capital Limited Partnership (ESVCLP) regimes in accordance with their policy objectives of increasing investment in high-risk start-up and expanding businesses in the Australian venture capital sector.

8.10 In this Chapter, the Board considered whether any further changes are necessary to the VCLP and ESVCLP regimes to better align them with the other CIV regimes in the tax law to improve certainty and simplicity in the tax law.

Board's consideration

8.11 The Board considers that although VCLPs could be considered broadly to be CIVs as they pool funds for the purpose of investment, the characteristics of VCLPs materially differ to the characteristics of CIVs set out in the Board's terms of reference.

8.12 CIVs are described in the terms of reference as 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.

8.13 In contrast, VCLPs do not need to be widely held, can undertake investments which are not passive investments, are subject to certain value cap restrictions for 'eligible investments', and treat carried interests as being on capital account. These characteristics of a VCLP reflect the specific policy objectives of the VCLP regime to attract increased investment into high-risk, start-up and expanding businesses in the Australian venture capital sector that would otherwise have difficulty in attracting investment through normal commercial means.

8.14 Given the unique policy objectives of the VCLP regime, the Board recommends that no changes be made to the VCLP regime in order to align it with the other CIV regimes in the tax law.

8.15 The Board also recommends that no changes be made to the ESVCLP regime for the same reasons.

Recommendation 14:

The Board recommends that no changes be made to the VCLP and ESVCLP regimes to align them with the other CIV regimes in the Australian tax law.

CHAPTER 9: EXTENSION OF AN INVESTMENT MANAGER REGIME BEYOND FOREIGN MANAGED FUNDS

9.1 The Board has been asked to examine and report on the design of an investment manager regime (IMR) for investments by foreign residents managed in Australia. As noted at paragraph 1.10, on 31 August 2011 the Board delivered its report on its review of an IMR as it relates to foreign managed funds and the Government has recently issued its response to the Board's report, broadly accepting the Board's recommendations.

9.2 In its report on the review of an IMR as it relates to foreign managed funds, the Board made a number of recommendations that seek to reduce tax impediments to international investment into Australia by foreign managed funds and impediments to the use of Australian intermediaries by these funds.

9.3 This chapter reports on whether the recommendations that the Board has made regarding an IMR as it relates to foreign managed funds should be applicable for investments by foreign residents other than foreign managed funds, including its potential extension to private equity funds.

9.4 This chapter also reports on the potential extension of an IMR to separately managed accounts of non-residents and on the possibility of extending IMR treatment to other parts of the financial sector, in particular for treasury and similar operations within Australia by Australian and foreign multinational financial institutions.

9.5 The discussion paper had already noted that investments by sovereign wealth funds are the subject of a separate review by Government.

FOREIGN PRIVATE EQUITY FUNDS

9.1 This section considers whether the recommendations made by the Board in relation to an IMR as it relates to foreign managed funds should apply to investments made by foreign private equity funds.

9.2 An issue that this section discusses in particular is whether a typical foreign private equity fund should be accorded the same tax treatment as that recommended by the Board for eligible foreign managed funds under the IMR, namely exemption from income tax on the disposal gains of certain investments by such funds.

What is private equity?

9.3 Private equity refers to a form of pooled investment where the equity securities are not publicly listed.

9.4 Private equity covers a wide range of investment types. However, in relation to an Australian investment, it appears that it is often characteristic of a private equity fund that:

- directly or indirectly has a non-portfolio interest in an Australian entity (the 'target entity') sufficient to allow it to control the entity;
- seeks to increase the value of the target entity by directly or indirectly (through, for example, an arrangement to which the fund manager is a party) taking an active role in the strategic or operational management of the target entity, as part of a strategy to realise a gain through disposal of the target entity, often within 3 to 5 years of acquisition;
- causes a change in the financial structure of the target entity, typically by increasing the gearing levels;
- involves the manager being paid a fee for managing the fund's investment and obtaining a share of any gain made on disposal of the target entity.

9.5 For the purposes of this report, this scenario is referred to as 'typical private equity' and the target entity is assumed to be carrying on a trading business (as defined in Division 6C of the *Income Tax Assessment Act 1936*). Where the typical private equity fund is a foreign resident, it is referred to as a 'typical foreign private equity fund'.

Board's consideration

9.6 In the Board's review of an IMR as it relates to foreign managed funds, reference was made to a number of taxation principles (which to some extent overlap with the CIV terms of reference) in the design of the IMR. As these principles are commonly used to guide the design of taxation legislation more generally (particularly in the modern international context), it is appropriate to have regard to them in the design of the IMR irrespective of the nature of the fund (and irrespective of whether a fund is involved). These principles are:

(i) taxation arrangements should reflect the responsiveness of capital to taxation;

(ii) taxation arrangements should be broadly neutral for economically equivalent investments in order to minimise distortions to investment decisions;

(iii) the taxation of active business income and resident investors should be appropriately safeguarded;

(iv) taxation arrangements should be simple, administrable, enforceable and should conform to international norms and practices.

9.7 Having regard to these principles and the terms of reference in the design of an IMR as it relates to foreign managed funds, the Board has concluded 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 the *Income Tax Assessment Act 1936*); and
- the exemption provided under an IMR should be restricted to the disposal of investments that are of a portfolio nature or are in a prescribed list of eligible investments made by the foreign managed fund (the starting point for which should be the eligible investment business rules in Division 6C).

9.8 The nature of a typical foreign private equity fund is such that the application of these requirements would preclude it being eligible for the IMR tax exemption. That is, the existence of control of a target entity should of itself preclude access to the exemption. Instead, whether the gain or loss on disposal of the entity is on capital or revenue account — and the implications that flow from that — should depend on the application of general provisions of the income tax law to the particular facts.

9.9 Where there is an exercise of control to enhance the value of the target entity with a view to profit by disposal of the investment in the target entity, it may be desirable to clarify that that amounts to the carrying on of a trading business in Australia. This would be in accordance with the third (international) tax principle referred to above.

9.10 Control of the generation of profit by, or the increase in value of, a target entity can substantially affect the nature of the fund's activities. In particular, it would be very difficult to characterise a typical foreign private equity fund's activities in respect of a target entity as primarily passive or to conclude that the disposal of the entity is the disposal of an investment of a passive nature.

9.11 Rather, the involvement of the fund in the strategic or operational management of the target entity (which is facilitated by control) indicates an active role. Typically, the rationale for the fund manager (or an entity on its behalf) in doing this is to make the entity attractive to potential buyers. At the same time, at least in the initial period after acquisition, earnings of the target entity may show little or no growth or indeed may fall due to investment in the business and changes to operations. Also, increased borrowing will normally decrease current earnings. The typical strategy is, nevertheless, that the active role, which could involve considerable restructuring of the target entity, will enable expected future earnings to be capitalised into the entity's sale price. This suggests that a typical foreign private equity fund's activities are much more than a primarily passive one.

9.12 The fact that individual investors in a typical foreign private equity fund are themselves passive investors in, say, a limited partnership does not derogate from the nature of the fund's activities and should not alter the tax treatment of such activities.

9.13 Consistent with the terms of reference, 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. It is to be noted in this regard that whether or not an individual investor in a foreign private equity fund itself has control, it shares in the benefits of control held by the fund which can come from the ability of the fund to have an active role in the relevant business.

9.14 Moreover, this outcome is not inconsistent with the principle in the terms of reference that the tax outcomes for investors in a CIV should be broadly consistent with the tax outcomes of direct investment. If the passive individual investor had invested directly, it would not have had control of the target entity and access to the benefits of that control. From the perspective of an investor in a private equity fund that obtains control of a target entity, the nature of the investment is transformed so that the investor can share in the active undertaking facilitated by control and carried out on behalf of the investor by the fund manager.

9.15 The Board understands that the outcome that investors obtain through a CIV is to some degree different from the outcome that they would obtain if investing directly, benefiting in part from the economies of scale of the aggregation of investors' monies and professional management of the investments undertaken by the CIV. However, in a typical private equity fund, this change of character is markedly different as it involves not just professional management of passive investments on behalf of investors, but rather effectively participating in the active management of a business.

9.16 In summary, the Board is of the view that the conclusions it reached for eligibility for the IMR tax exemption for foreign managed funds should extend to the IMR as it applies more broadly and therefore the Board recommends that the IMR exemption from income tax on the gains from disposal of certain investments by foreign managed funds should not be extended to typical foreign private equity funds.

9.17 At the same time, the Board notes a gain made by a foreign private equity 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 (as per Recommendation 8 in the Board's report on an IMR as it relates to foreign managed funds).

Recommendation 15:

The Board recommends that the IMR exemption from income tax on the gains from disposal of certain investments by foreign managed funds not be extended to typical foreign private equity funds.

SEPARATELY MANAGED ACCOUNTS AND IDPSS

9.18 The discussion paper noted that 'separately managed accounts' are often used by foreign high net worth individuals and closely held vehicles who engage a fund manager to make investments while retaining their beneficial ownership of the underlying investments. Similarly, an Investor Directed Portfolio Service (IDPS) will often be used to administer a portfolio of investments.

9.19 Gains made by these foreign investors on the disposal of their portfolio investments may be taken to be sourced in Australia which could result in Australian tax applying and could create disincentives to utilise Australian fund managers or IDPS operators.

9.20 It also noted that families with significant private wealth ('family offices') which invest through a vehicle that is closely held could experience similar problems.

9.21 The discussion paper noted that such accounts and private vehicles, by their very nature, are not widely held and are frequently made through nominees.

9.22 The Board's recommendations for an IMR for foreign managed funds require those funds to be widely held, which should help limit the extent to which funds can be established as accumulation vehicles to defer taxation by deferring distribution of income (which can compromise the ability to tax resident investors). It noted that in the absence of this rule greater reliance would need to be placed on anti-deferral 'roll-up' and anti 'round tripping' rules.

Views in submissions

9.23 A number of stakeholders submit that an IMR should extend to all non-resident investors that invest in Australian securities (except where those securities constitute taxable Australian property) and that this extension should be sufficient to cover non-resident high net worth individuals investing via separately managed accounts and IDPSs as well as investments in Australian securities made by 'family offices'.

9.24 Stakeholders note that this extension would allow access to a significant pool of non-resident investment funds for management and would increase Australia's competitiveness in the Asia-Pacific region.

> As at 2009, the pool of funds held by HNWIs [high net worth individuals[10]] in the Asia-Pacific region amounted to US$9.7 trillion. If Australian HNWIs were excluded, this would have totalled approximately US$9.1 trillion ... HNWI wealth represents a significant pool of offshore funds that could otherwise be managed in Australia. As at 31 December 2010, this represents approximately 160 times the amount of total foreign funds under management in Australia and represents close to eight times the amount of total funds under management in Australia...
>
> In order to remain competitive with our Asia-Pacific trading partners, and to help increase our management of foreign investment funds, we believe it is critical that the Board consider an expanded IMR regime (rather than a narrow interim regime) which is at least on par with other countries in the Asia-Pacific region.
>
> Pitcher Partners

9.25 Regarding integrity considerations, stakeholders submitted that where the foreign investor is not a widely held fund, the local intermediary should confirm that the ultimate investor is not an Australian resident.

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

Board's consideration

9.26 The Board is supportive of the principle that foreign individuals and foreign closely held vehicles should be able to access the tax treatments as recommended by the Board under the IMR for foreign managed funds, subject to appropriate integrity rules and revenue considerations.

9.27 Given the significant size of the pool of offshore funds held by high net worth individuals, the extension of these recommendations to foreign individuals and foreign closely held vehicles should facilitate an increase in the amount of funds managed and administered in Australia.

Conduit income of foreign individuals and foreign closely held vehicles

9.28 The Board considers that gains made by foreign individuals or foreign closely held vehicles from the disposal of non-Australian assets should not, because only of the engagement of an Australian intermediary, be subject to Australian tax. The

10 High net worth individuals are defined as 'those persons having investable assets of US$1 million or more, excluding primary residence, collectables and consumer durables'.

engagement of an Australian intermediary to manage or administer these investments should not cause the gains to be taxable in Australia. This is consistent with recommendations made in the Board's report on the review of an IMR for foreign managed funds, which have been broadly accepted by Government.

9.29 The Board therefore recommends that a gain made by a foreign individual or foreign closely held vehicle from the disposal of investments in non-Australian assets should not be subject to Australian tax if the only reason it is subject to Australian tax is because of the use of an Australian intermediary.

Portfolio investments in Australian assets

9.30 The Board also considered whether gains made by foreign individuals or foreign closely held vehicles from the disposal of portfolio investments in Australian assets should not be subject to Australian tax.

9.31 The Board noted in its report on the review of an IMR for foreign managed funds that portfolio investment into Australia was typically mobile in nature and responsive to source taxation, and recommended they be treated as exempt under an IMR for foreign managed funds.

9.32 The Board considers that similar reasoning would apply to portfolio investments in Australian assets made by foreign individuals or foreign closely held vehicles. On this basis, the Board recommends that gains made on the disposal of portfolio investments in certain types of Australian asset should be exempt.

9.33 The Board recommends that the types of portfolio investments which should be covered by the exemption should be consistent with the types covered by Recommendation 7 made in the Board's report on the review of an IMR for foreign managed funds. This means:

- the IMR exemptions should only extend to a prescribed list of eligible investments;
- transactions in land, including transactions of any nature which result in acquisition of land, should be excluded from the prescribed list of eligible investments;
  - however, the Government should consider allowing land related futures and option 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 individuals or foreign closely held vehicles on their Australian investments.

9.34 The Board notes that, compared to an exemption for conduit income, the exemption of gains from the disposal of portfolio investments in Australian assets could potentially have more revenue implications.

Integrity considerations

9.35 The Board is supportive of the suggestion made by stakeholders that 'round-tripping' by Australian residents could be reduced by requiring an Australian fund manager or Australian nominee to confirm that the foreign individual is not a resident of Australian for tax purposes or that the foreign closely held vehicle accessing the IMR is not ultimately owned by any Australian resident investors.

9.36 Further, the Board considers that when the foreign closely held vehicle accessing the IMR has investors, consideration could be given to requiring the Australian fund manager or Australian nominee to disclose the names of the investors. An example of a foreign closely held vehicle not having investors would be a discretionary trust.

9.37 This could be reinforced by requiring the Australian fund manager or Australian IDPS operator to lodge an annual notification to the ATO on behalf of the foreign individual or foreign closely held vehicle accessing the IMR. The Australian fund manager or Australian IDPS operator could also be required to retain documentation which can substantiate the absence of any ultimate Australian resident investors.

Managed in Australia requirement

9.38 To reinforce the benefits to the Australian economy, the Board recommends that the proposed IMR exemptions for conduit income and portfolio investments in Australian assets should only be allowed where the foreign individual or foreign closely held vehicle engages an Australian fund manager or IDPS operator.

9.39 This requirement is similar to the 'connection with Australia' requirement in the MIT regime, and should facilitate increased fees for management activities undertaken by Australian investment managers. It should also reduce the possible cost to the revenue as the scope of the IMR exemption would be limited.

9.40 While the Board recommended against a 'managed in Australia' requirement in an IMR for foreign managed funds on the grounds that it would limit the flexibility for foreign managed funds to manage their assets, the Board considers that such flexibility would be of a lesser importance in the case of private investors and closely held vehicles. These investors would generally be less constrained by corporate investment policies as would apply in the case of foreign managed funds.

Recommendation 16:

The Board recommends that:

- gains made by a foreign individual or foreign closely held vehicle from the disposal of investments in non-Australian assets (conduit income) not be subject to Australian tax if the only reason it is subject to Australian tax is because of the use of an Australian intermediary;

- gains made on the disposal of portfolio investments in Australian assets by a foreign individual or foreign closely held vehicle be exempt as long as the investment is of the type covered by Recommendation 7 of the Board's report on the review of an IMR for foreign managed funds;

- to access either of the IMR exemptions above, the foreign individual or foreign closely held vehicle be required to engage an Australian fund manager or IDPS operator;

- the Australian fund manager or an Australian IDPS operator be required to lodge an annual notification with the ATO to confirm that the foreign individual is not a resident of Australia for tax purposes or that the foreign closely held vehicle accessing the IMR not be ultimately owned by any Australian resident investors; and

  – consideration could also be given, when the foreign closely held vehicle accessing the IMR has investors, to requiring the Australian fund manager or Australian nominee to disclose the names of the investors.

OTHER PARTS OF THE FINANCIAL SERVICES SECTOR

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

9.42 The discussion paper also noted that the extension of an IMR to the financial sector raises risks to the Australian tax base in departing from internationally accepted transfer pricing arrangements and queried if the current Offshore Banking Unit (OBU) provisions already adequately provide IMR like concessions for financial sector entities apart from foreign managed funds.

9.43 The OBU regime is a concessional tax regime that allows entities registered as OBUs to undertake certain financial transactions for non-residents at a reduced rate of taxation (10 per cent). Permissible investment activities include managing a portfolio of investments on behalf of a non-resident. No more than 10 per cent of the total assets under management (by value) can be Australian assets, although the reduced tax rate of 10 per cent will not apply to the income earned by the OBU attributable to its management of the Australian assets.

Views in submissions

9.44 The view has been put by a stakeholder that an Australian IMR should apply to portfolio investments of foreign financial institutions that are managed by their Australian subsidiaries.

> We submit that such a proposal would not create revenue costs or integrity risks. The reason is that, currently, foreign banks limit the activities of their Australian subsidiaries to purely domestic business and tend not to conduct international fund management activities, including in respect of their own funds, from Australia. Foreign banks have significant investment pools available to them and we submit it would be in Australia's interest to have Sydney, Melbourne and other cities being able to operate as bases for the management of the longer term investment of such foreign banks.
>
> Ernst & Young

9.45 Other stakeholders have submitted that the existing OBU provisions are adequate for other financial sector entities apart from foreign managed funds.

Board's consideration

9.46 The Board acknowledged that it is in principle a reasonable proposition that the IMR should apply to foreign financial institutions which have non-Australian assets that are managed by their Australian subsidiaries. The Board has the view that a foreign financial institution should not be subject to Australian tax on the disposal of its non-Australian assets if the only reason it is subject to Australian tax is because of the use of an Australian subsidiary to manage those assets.

9.47 However, in considering such an extension of the IMR, the Board noted that the operation of Australia's transfer pricing rules would need to be taken into account where foreign financial institutions were currently managing their investments through an Australian subsidiary. This would be necessary to ensure that any extension of the IMR would not override any policy principles underpinning the taxation of international related party transactions under the transfer pricing regime.

9.48 Furthermore, the Board understands that, currently, a number of foreign financial institutions manage their foreign investments through branch operations rather than through subsidiaries in other jurisdictions. The allocation of profits for tax purposes between foreign financial institutions and their overseas branch operations is covered by Australia's transfer pricing rules, and would also need to be taken into account.

9.49 The Board acknowledges that the operation of the transfer pricing rules to transactions with foreign subsidiaries and foreign branches is a complex area in the tax law. Furthermore, the Board notes that on 1 November 2011 the Government announced a review of Australia's transfer pricing regime.

9.50 Given the interrelationship of the transfer pricing rules, the Board recommends that, in principle, the IMR be extended to foreign financial institutions which engage Australian subsidiaries to manage their investments, but that this should be considered in the context of the Government's transfer pricing review.

Recommendation 17:

The Board recommends that, in principle, the IMR be extended to foreign financial institutions which engage Australian subsidiaries to manage their investments, but that this should be considered in the context of the Government's transfer pricing review.

CHAPTER 10: STRATEGIES FOR IMPLEMENTATION

CONCURRENT IMPLEMENTATION

10.1 The Board is of the view that, ideally, all of the recommendations in this report should be developed and implemented concurrently. The Johnson report specifically noted, as part of their key recommendations, the following:

> The Investment Manager Regime, funds management vehicles and Asian passport package of proposals, which will help Australian fund managers to attract overseas investors into funds run out of Australia.

10.2 The recent announcement by the Government of the final element of an IMR for foreign managed funds and the current development of an Asia Region Funds passport are important to facilitate the broader use of the new suite of Australian CIVs across the Asia-Pacific region. The Asian Region Funds passport would facilitate CIVs from one country being marketed in other countries, thereby encouraging direct investment into Australian CIVs from Asian investors.

10.3 The Board's IMR and CIV related recommendations, together with the Asia Region Funds passport, will provide foreign investors with a package of commercial options for using Australia as a financial services hub, whilst also providing more tax certainty.

10.4 A larger suite of Australian CIVs should encourage not only the use of Australian fund managers but also the use of vehicles domiciled in Australia, thereby increasing business for the funds management sector as well as for ancillary services such as custodians, share registries, and accounting, auditing, legal and tax services.

10.5 The Board understands from stakeholders that there is a window of opportunity for the new package of IMR, CIV and Asian Region Funds passport measures to break into the global funds management market. The Board understands that the current economic climate in Europe has impacted on the attractiveness of UCITS compliant funds to Asian investors. If the package of Australian measures can be implemented expeditiously, it can leverage off Australia's strong regulatory framework and provide an opportunity for Australian CIVs to take market share away from UCITS compliant funds.

STAGED IMPLEMENTATION

10.6 The Board acknowledges that there are currently a number of factors that may run counter to implementing all of the Board's CIV and IMR recommendations, and which may prompt consideration for staged implementation. These factors include:

- considerations of the potential cost to the revenue;
- the complexity of design;
- macroeconomic considerations; and
- resource constraints and alternative Government priorities.

10.7 Furthermore, while the Board understands that from a legislative drafting perspective there are advantages in designing the suite of recommended CIVs as a package, dealing appropriately with certain aspects of the recommendations, particularly to ensure appropriate tax outcomes where Australian investors and Australian assets are involved, could prove to be more complex than other aspects.

10.8 The Board understands that, following delivery of this report, Treasury will be completing an assessment of the potential cost to the revenue of implementing the Board's recommendations. The Board considers that it would be important for the Government to also receive an assessment of the likely benefits of implementing the Board's recommendations.

10.9 If, following an assessment of the benefits and costs, the Government considers it desirable to prioritise the implementation of the recommendations, the Board recommends that priority be given to the implementation of the recommendations that relate to the tax treatment of conduit income. This will comprise:

- conduit income under the Corporate CIV regime, the Limited Partnership CIV and the Common Contractual Fund CIV; and
- extending the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle, but only in respect of gains made on the disposal of investments in non-Australian assets.

10.10 Implementing in the first instance only the recommendations that relate to the tax treatment of conduit income should have a negligible cost to the revenue, would attract potentially a substantive amount of fee and associated income subject to Australian tax, and be less complex to design than implementation of the whole package concurrently. This should still allow Australian fund managers to be more attractive to overseas investors.

10.11 Also under a staged implementation approach, the Board recommends:

- second ranking priority be given to the implementation of the full suite of CIVs as recommended, as that would allow choices for foreign investors with different preferences for the type of CIVs; and
- third ranking priority be given to the extension of the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle in respect of gains made on the disposal of investments in Australian assets.

Recommendation 18:

The Board recommends that:

- if the Government considers it desirable to stagger the implementation of the recommendations, priority be given to the recommendations that relate to the tax treatment of conduit income. This will comprise:
  - conduit income under the Corporate CIV regime, the Limited Partnership CIV and the Common Contractual Fund CIV; and
  - extending the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle, but only in respect of gains made on the disposal of investments in non-Australian assets;
- second ranking priority be given to the implementation of the full suite of CIVs as recommended in this report; and
- third ranking priority be given to the extension of the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle in respect of gains made on the disposal of investments in Australian assets.

APPENDIX A: SUMMARY OF RECOMMENDATIONS

Recommendation 1:

The Board recommends that:

- a larger suite of Australian CIVs be introduced into the tax law which provide tax neutral outcomes for investors;
- overseas experience in offshore jurisdictions, such as Ireland and Luxembourg, inform the design of Australia's suite of CIVs; and
- the relevant regulatory frameworks be considered and amended to cater for the introduction of a larger suite of Australian CIVs.

Recommendation 2:

The Board recommends that:

- MIT tax treatment not be extended to other forms of CIVs;
- a range of CIVs be introduced with different tax treatments under Australia's international tax treaties so as to cater for the needs of different foreign investors seeking to invest into Australia;
- broadly tax neutral outcomes be provided through a range of CIVs whose tax treatment is familiar to a wide range of foreign investors and through tax rules which are practicable to implement and provide certainty of outcomes; and
- harmonisation across the various CIV regimes be achieved through the identification of a set of qualifying characteristics and rules that would be common to all CIVs that provide broad tax neutral outcomes for investors.

Recommendation 3:

The Board recommends that:

- CIVs be required to be widely held;
- the widely held test capture not only direct investors in the CIVs but also be able to look through these investors to assess whether the CIV is widely held; and
- the widely held test be clear in its effect and not impose undue compliance burdens on CIVs.

Recommendation 4:

The Board recommends that CIVs that would be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors, be limited in their activities to primarily passive investments.

Recommendation 5

The Board recommends that:

- the control test be included as a requirement for CIVs that would be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors;
- once the arm's length rules (or alternative market value rules) are introduced for the MIT regime, these rules be extended to the other CIVs recommended in this report;
- further legislative guidance be introduced on the definition of 'control' for the application of Division 6C to all CIVs that would otherwise be subject to flow-through taxation, or that provide a similar tax neutral outcome for investors;
  - the Government consider whether to introduce:
    - safe harbour tests test that would stipulate the circumstances where control would be deemed not to exist; and
    - an associate inclusive test to ensure that related parties cannot structure arrangements that would allow individual CIVs to nominally meet the test but fail it in substance; and
- the control test apply in respect of trading businesses in Australia and, to the extent that there are no risks to the corporate tax base, the control test not extend to situations where the CIV controls a foreign subsidiary.

Recommendation 6:

The Board recommends that:

- as a general rule, MITs and other types of CIV that provide flow-through taxation or that would provide a similar tax neutral outcome for investors be subject to a requirement to be residents of Australia; and
- MITs and other types of CIV that have access to the concessional withholding tax rate on fund payments be subject to an additional requirement of having a significant connection with Australia, as applicable under the MIT withholding tax rules.

Recommendation 7:

The Board recommends that, together with the introduction of a wider suite of CIVs, a specific regulatory regime for each type of vehicle be introduced. It may also be appropriate for there to be separate regulatory rules for retail investors and sophisticated investors.

Recommendation 8:

The Board recommends that a Corporate CIV regime be introduced using an exemption model incorporating the following elements:

- the Corporate CIV be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4;
- the Corporate CIV be treated as exempt for tax purposes, with the intention of passing the tax burden to its investors;
- the Corporate CIV be required to pay dividends to investors periodically, with the dividends being equal to a substantial proportion (given as a fixed percentage) of what would be the taxable income of the Corporate CIV;
- the Corporate CIV be required to have a substituted accounting period of sufficient length to enable it to pay final dividends in respect of that period by 30 June (with a suggested outside limit being the prior 31 March);
  - consideration be given to integrity measures where additional tax deferral results from multiple layers of Australian Corporate CIVs;
- resident investors be taxable at the time they receive dividends from the Corporate CIV;
- where the dividend paid to resident investors comprises amounts attributable to capital gains made by the Corporate CIV, rules be incorporated into the Corporate CIV regime to enable the flow-through of discount capital gains to resident investors;
- where the dividend paid to resident investors comprises amounts attributable to foreign income which has been subject to foreign income tax, a 'foreign income tax offset' entitlement flow-through to investors;
- for foreign investors in the Corporate CIV, dividends paid by the Corporate CIV be treated as amounts not subject to dividend withholding tax where the dividend comprises foreign income, non-taxable Australian property capital gains or franked dividends, with all other amounts being subject to dividend withholding tax;
- a special rate of dividend withholding tax apply for dividend payments made by a Corporate CIV to foreign investors resident in an information exchange country which produces a tax outcome equivalent to the application of Australia's different treaty withholding tax rates for different types of payments to foreign investors;

- for dividend payments made by the Corporate CIV to foreign investors not resident in an information exchange country, the dividend withholding tax rate that applies for dividends paid to non-treaty countries apply;
- investors in a Corporate CIV be limited to holdings of no more than 10 per cent in the Corporate CIV to prevent foreign investors from accessing reduced rates of withholding tax under Australia's international tax treaties for non-portfolio investments;
- if the Corporate CIV pays a dividend and later ascertains that the dividend amount was less than the required fixed percentage of its taxable income, the Corporate CIV be required to pay tax at the rate of 30 per cent for the undistributed amount (with that tax paid being available as franking credits for future distribution);
- that the Government consider measures to promote compliance with the distribution requirement. For example, an additional integrity measure the Government could consider is to:
  - require that the Corporate CIV make an irrevocable election to be subject to the recommended CIV regime treatment; and
  - set a cap on the maximum deficiency that would be allowed for a Corporate CIV without losing access to the CIV regime treatment; and
- changes be made to the Corporations Act and other corporate regulations to facilitate the Board's recommended Corporate CIV regime.

Recommendation 9:

The Board recommends that an option to elect deemed CGT treatment be included into the Corporate CIV regime similar to that introduced into the MIT regime.

Recommendation 10:

The Board recommends that:

- an LP CIV regime be introduced into the suite of CIVs that provide tax flow-through treatment;
- LP CIVs be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4, including the widely held requirement; and
- an LP CIV be taken to be Australian resident if:
  - the partnership is formed in Australia; or
  - the partnership carries on business in Australia and has it central management and control in Australia.

Recommendation 11:

The Board recommends that:

- the general partnership tax rules be applied to provide flow-through taxation for the LP CIV regime;
- LP CIVs be subject to loss limitation rules similar to those in the foreign hybrid limited partnership regime;
- an option to elect deemed CGT treatment be included into the LP CIV regime similar to that introduced into the MIT regime;
- the Government consider aligning the final withholding tax on fund payments made by a LP CIV to that applying to MITs;
- fund payments made through a LP CIV to foreign investors who are not resident of an information exchange country be subject to the same final withholding tax as that applicable under the MIT regime; and
- LP CIVs with access to the recommended final withholding tax on fund payments be subject to a requirement of having a significant connection with Australia.

Recommendation 12:

The Board recommends that:

- a CCF CIV be included into the suite of CIVs that provide tax flow-through treatment;
- the CCF CIV be required to meet all the characteristics of a CIV as set out in the Board's recommendations in Chapter 4;
- investors in the CCF CIV receive flow-through of character and source similarly to investors in the Board's recommended LP CIV, with no need for a cost base at the CIV level as is the case under the MIT regime;
- the profits (income and gains) arising or accruing to the CCF CIV be treated as arising or accruing to the investor in proportion to the value of assets beneficially owned by them, as if such profits did not pass through the hands of the CCF CIV;
- in the case of the CCF CIV, there may not be a need to impose additional loss limitation rules to achieve an equivalent outcome to that obtained by investors in the Board's recommended LP CIV;
- CCF CIVs include the option to elect deemed CGT treatment for its eligible investments;
  - the option to elect deemed CGT treatment be made by the manager of the CCF CIV so as to provide certainty in this regard to its investors;

- the Government consider aligning the final withholding tax on fund payments made by the CCF CIV to that applying to MITs;
- fund payments made through a CCF CIV to foreign investors who are not resident of an information exchange country be subject to the same final withholding tax as that applicable under the MIT regime; and
- CCF CIVs with access to the recommended final withholding tax on fund payments be subject to a requirement of having a significant connection with Australia.

Recommendation 13:

The Board recommends that no further changes be made to the LIC regime to better align them with the other CIV regimes in the Australian tax law but that existing LICs be able to convert to a Corporate CIV within a specified time frame after the introduction of any Corporate CIV regime.

Recommendation 14:

The Board recommends that no changes be made to the VCLP and ESVCLP regimes to align them with the other CIV regimes in the Australian tax law.

Recommendation 15:

The Board recommends that the IMR exemption from income tax on the gains from disposal of certain investments by foreign managed funds not be extended to typical foreign private equity funds.

Recommendation 16:

The Board recommends that:

- gains made by a foreign individual or foreign closely held vehicle from the disposal of investments in non-Australian assets (conduit income) not be subject to Australian tax if the only reason it is subject to Australian tax is because of the use of an Australian intermediary;
- gains made on the disposal of portfolio investments in Australian assets by a foreign individual or foreign closely held vehicle be exempt as long as the investment is of the type covered by Recommendation 7 of the Board's report on the review of an IMR for foreign managed funds;
- to access either of the IMR exemptions above, the foreign individual or foreign closely held vehicle be required to engage an Australian fund manager or IDPS operator;
- the Australian fund manager or an Australian IDPS operator be required to lodge an annual notification with the ATO to confirm that the foreign individual is not a resident of Australia for tax purposes or that the foreign closely held vehicle

accessing the IMR not be ultimately owned by any Australian resident investors; and

   – consideration could also be given, when the foreign closely held vehicle accessing the IMR has investors, to requiring the Australian fund manager or Australian nominee to disclose the names of the investors.

Recommendation 17:

The Board recommends that, in principle, the IMR be extended to foreign financial institutions which engage Australian subsidiaries to manage their investments, but that this should be considered in the context of the Government's transfer pricing review.

Recommendation 18:

The Board recommends that:

- if the Government considers it desirable to stagger the implementation of the recommendations, priority be given to the recommendations that relate to the tax treatment of conduit income. This will comprise:
  – conduit income under the Corporate CIV regime, the Limited Partnership CIV and the Common Contractual Fund CIV; and
  – extending the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle, but only in respect of gains made on the disposal of investments in non-Australian assets;
- second-ranking priority be given to the implementation of the full suite of CIVs as recommended in this report; and
- third ranking priority be given to the extension of the IMR related recommendations to investments made by a foreign individual or foreign closely held vehicle in respect of gains made on the disposal of investments in Australian assets

APPENDIX B: LIST OF SUBMISSIONS

Alternative Investment Management Association

Australian Custodial Services Association

Australian Foundation Investment Company Limited

Australian Listed Investment Companies Association

Australian Private Equity & Venture Capital Association

Brandon Capital Partners

Brookvine Pty Limited

Clayton Utz

CPA Australia

Deloitte

Equity Trustees

Ernst & Young

Financial Services Council (two submissions)

Greenwoods & Freehills

Harbert Fund Advisors (Australia) Pty Ltd

Henry Davis York

Infrastructure Partnerships Australia

Innovation Australia

Innovation Capital

Institute of Chartered Accountants in Australia

Law Council of Australia

Mallesons Stephen Jaques

Moore Stephens

OneVentures

Pitcher Partners

Porter, Andrew J B

PricewaterhouseCoopers

Property Council of Australia

Starfish Ventures

Taxation Institute of Australia