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

Attention: Chris Jordan, Acting Chairman of the Board of Taxation
John Emerson AM, Chairman of the Working Group
By e-mail: taxboard@treasury.gov.au

28 February 2011

Dear Sirs

Re: Review of Tax Arrangements Applying to Collective Investment Vehicles

We are pleased to provide our submission in response to the Discussion Paper issued by the Board of Taxation in December 2010 in relation to the Review of Tax Arrangements Applying to Collective Investment Vehicles. Our submission comments are included in Appendix A to this letter.

From a national policy perspective, we support the design of a new Australian tax regime for collective investment vehicles (CIVs) for the enhancement of Australia's status as a leading regional financial centre. We acknowledge that a well designed and robust tax regime will play a key part in influencing funds investment decisions in the national and global market.

In designing a new tax regime for CIVs, we submit that key features of the CIV regime should reflect the following policy considerations:

- The CIV regime should replicate the same outcomes as if the investors had directly acquired the underlying investments, subject to specific required exceptions to make this workable (e.g. retaining "outside" cost base of CIV interests/ investments)
- The CIV regime should provide certainty of tax treatment (e.g. guaranteed "fixed trust" status) and remove various current incongruous outcomes
- Transitional relief into the CIV regime should be available, so that there will be no disadvantage from electing into the proposed MIT regime in the meantime if a superior CIV regime is developed.

Our submission comments in Appendix A are directed towards assisting with the design of a new CIV regime for the Australian funds management industry that is attractive to offshore investors, comparable to international jurisdictions, and achieves the aim of making Australia a financial services hub.

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Once you have considered our submission, we would welcome the opportunity to discuss these issues with you in further detail.

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In the meantime, should you have any questions in relation to our submission, please contact Ryan English of our office on (03) 9671 6774 or me on (03) 9671 7436 in the first instance.

Yours sincerely

Mark Ekkel
Director
Deloitte Touche Tohmatsu Ltd

APPENDIX A – DELOITTE COMMENTS IN RELATION TO THE DISCUSSION PAPER

We provide the following comments in relation to the discussion points raised in the Board of Taxation's Discussion Paper and also raise additional discussion points that were not specifically mentioned as a focus of the Discussion Paper but that we believe are important considerations in designing an effective CIV regime.

#	Topic	Deloitte Comments
Collective investment vehicles for the purposes of this review and principles for tax treatment		
1.	**Unattractiveness of Australia's current system to non-resident investors**	The following factors, amongst others, contribute to the unattractiveness of Australia's current tax treatment of CIVs to non-resident investors: • Complexity, including 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. • Lack of certainty regarding MIT status and flow through status in some cases (for example Division 6C or the proposed under/over rules – see #7 and #10 below). The definition of MIT has been clarified substantially, but should be monitored to ensure that it appropriately addresses the scenarios encountered for types of non-residents. • Until recently, the impact of the FIF rules. Care needs to be taken that the replacement anti-deferral rules are as clear as possible. The above complexities may obscure the fact that Australia's conduit regime allows flow through of foreign source income to foreign investors free of Australian tax (subject to the concerns outlined in Chapter 5 of the Board's discussion paper). Part of the complexity is due to matching features of the Australian tax system with non-resident investors (e.g. franking and various CGT concessions). A non-tax factor is a lack of understanding and familiarity with trust structures or the inability of trusts to provide multi-currency classes of units and hedging (see #15 below). This is the case not only in the Asia-Pacific region but also in continental Europe. Unfamiliarity with the legal structure in turn leads to entity classification difficulties when applying the tax laws of the investor's country.
2.	**'Widely held' restriction**	• A CIV regime should not necessarily only be restricted to widely held entities (as currently defined in the MIT legislation). The key requirement should be that the CIV only undertakes primarily passive investment activities, as suggested in #3 below. Any concerns in relation to maintaining the integrity of the CIV tax regime for non-residents could be addressed by the relevant rate of tax (including any withholding tax) that is applied. For example, consistent with the current MIT regime, non-resident Exchange of Information (EOI) investors in widely held CIVs could be subjected to a final 7.5% tax rate whilst investors in non-widely held CIVs have "standard" tax rates applying (potentially on a "flow through" basis).

#	Topic	Deloitte Comments
3.	**Primarily passive investment activities requirement**	• The current test of an eligible investment business contained in section 102M provides a list of acceptable activities. This creates uncertainty in determining whether an activity falls within those parameters and also requires constant refinement where activities are inappropriately excluded from the definition. • In the interest of providing certainty and a robust but flexible regime for the future, we believe that it is preferable that an entity should qualify for CIV treatment provided it does not carry on any activities which are listed specifically as 'ineligible'. This would provide flexibility for CIVs to undertake investment in new types of products or assets which may emerge in the future, unimpaired by a fixed list of permitted activities based on currently available investments. • In the absence of an "ineligible' list of activities (which is preferred), there is a need to expand what constitutes eligible investment business to take into account modern business developments (for example, the inclusion of retirement villages, certain passive licensing arrangements etc.)
4.	**The 'Control' test**	• The uncertainty regarding the potential application of Division 6C is a significant issue for potential non-resident investors in specialist Australian funds (e.g. infrastructure, retirement, insurance, agriculture, etc.). • We query whether the control test needs to be retained. From a policy perspective, we are unsure about the tax preferences that could be obtained if a CIV were able to have a controlling interest in a company. In line with the recommendation regarding the listing of ineligible activities, the management of the day to day operations of an active trading company could be prescribed as ineligible without the need for a control test. • If a control test is to be retained, we submit that the test should be amended so that the parameters of its application are more clearly defined by reference to legal rights (e.g. majority voting rights and right to distributions of income and capital) rather than, for example, by reference to accounting standards which are increasingly moving towards economic control concepts which introduce unnecessary uncertainty in the context of a fundamental aspect of a CIV regime. • We note that the recommendations for MITs also included changes similar to this and suggest the implementation of a CIV regime would be the right time to address the concept.

#	Topic	Deloitte Comments
Australia's current range of CIVs		
5.	**Changes to the LP regime**	• A limited partnership type model that is treated as a general partnership/flow through for tax purposes is preferred, provided certain tests are met. Australia has various mechanisms within the current partnership tax rules to allow for character and source retention (including Division 830 in relation to restrictions on tax losses). Flow-through LPs are also well understood by most offshore investors. • LP CIVs could be taxed in the same way as MITs. • Another alternative would be to carve out LP CIVs from Division 5A and allow the normal partnership rules to apply (with the addition of loss limitation rules, perhaps modelled on those in the foreign hybrid rules). • However, the latter approach would create different tax regimes (MIT and LP CIV) for the same activity, which is arguably inconsistent with the guiding policy principles. Moreover, partnership treatment is likely to be impractical from a CGT perspective (especially for open-ended funds), due to the application of CGT at the investor level based on fractional interests in underlying assets (this is discussed further in #8 below). • LPs are most efficiently used for closed ended structures, which can deal with limited (if any) incoming/outgoing unit holders, and issues relating to the cost base of underlying investments if used in a widely held context.
6.	**Flow-through taxation for LPs with primarily passive investments**	Flow-through taxation for widely held LPs with primarily passive investments is desirable for the following reasons: • LPs are an internationally recognised form of CIV, familiar to investors in many countries. • An LP CIV may assist foreign investors to obtain credit for foreign withholding taxes imposed on income flowing through the CIV, as many countries view LPs as fiscally transparent. In some cases an LP CIV might also facilitate relief from source country withholding taxes under the tax treaty between the investor's country of residence and the source country. This may be of greater relevance for wholesale CIVs with a relatively small number of investors. • Allowing flow through taxation for LP CIVs would be consistent with the guiding principle of treating investment activities in the same way regardless of the type of entity that conducts them.

#	Topic	Deloitte Comments
7.	**Public Trading Trusts**	In order for Australia to be competitive in this regime, clarity is required on the policy towards public trading trusts: • Specifically, a CIV regime needs to recognise that Australian expertise is also used to invest in projects (e.g. infrastructure) where inevitably a greater than 50% stake may be taken. Arguably, it is just as important that Australia be competitive internationally in attracting and managing funds in this area. • In the current environment, a non-resident investing in a “trading trust” (e.g. due to controlling a downstream infrastructure investment) as part of a portfolio of investments would be subject to withholding at 30% from fund payments (compared to a possible 7.5%). • The underlying corporate entity would already be subject to Australian tax so, in principle, should not impact on the appropriate level of Australian tax revenue. • Rather than include restrictions on “controlling” investments which is inherently unclear, the rules should state ineligible investment activities or the level of voting rights and right to distributions of income and capital, etc. that cause policy concern (if considered necessary at all). • Any uncertainty in this area makes Australian vehicles unattractive for foreign investors. In this context, Division 6C review should be given priority.
Design of a new corporate CIV regime		
8.	**Inside/outside cost base of investments**	• 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). • This is particularly relevant given the “open” nature of many investment vehicles in Australia, allowing for regular incoming and outgoing unit holders. Many overseas vehicles work well for closed ended funds with fixed investors for a finite duration, e.g. 5/7/10 years, so the issue of rebasing the cost base of a portfolio’s investment is far more manageable than with an open retail fund. • Although alignment of inside/outside cost base could be considered (or possibly elected) for closed and closely held vehicles (typically at the wholesale end), similar to limited partnerships used by some overseas jurisdictions, this would result in more than one type of CIV with different tax consequences.

#	Topic	Deloitte Comments
9.	**CIV framework**	The framework of a CIV should allow for the following (absent a clear policy reason that outweighs any uncertainty or disadvantage created in an internationally competitive framework): • Australia could allow CIVs in both corporate and non-corporate (MIT and LP) form, in line with other leading investment management jurisdictions. This should provide more flexibility for managers to establish CIVs to suit different investor and asset profiles. To promote clarity and neutrality, the new regime could potentially be drafted to apply to all qualifying CIVs (regardless of legal form), rather than deeming qualifying companies and LPs to be MITs for tax purposes (and clearly noting any express differences by exception). • The CIV framework should be developed so that a CIV replicates, as far as possible, the outcomes that would arise if the investors had directly acquired the underlying investments. Any exceptions should reflect specific and conscious policies that enhance the attractiveness of the vehicle (and do not detract, and as far as possible, do not result in unfavourable consequences). An example of an exception may be the inside/outside cost base difference mentioned above (see #8). This would be comparable to many international jurisdictions, where a typical CIV often reflects an open ended fund that has the flexibility of a corporate structure.
10.	**Interaction with the MIT regime**	• Many of the design features have already been reflected in the proposed MIT changes for eligible trusts. If the "clean sheet of paper" design for a new CIV results in superior features, then similar changes would be required to the MIT rules to meet the stated design parameter of *"the tax treatment of collective investment vehicles should be determined by the nature of their investment activities, rather than the structure of the entity through which the funds are pooled*". Given this, it is necessary to consider the MIT rules (and their relative positive and detracting features). Our comments made in this submission focus on rules for a new CIV regime and assume that corresponding changes would be made to the MIT rules to address this design principle (without necessarily covering the MIT issues in making these changes under existing trust law). That being said, the design construct of the MIT rules should not unduly restrain the design of an internationally competitive CIV regime. • As the proposed MIT regime is elective, the CIV framework should ensure that an MIT that has elected into the MIT regime is not precluded from accessing the CIV regime. That is, an MIT should not be disadvantaged in any way, from having elected into an MIT regime where a subsequent CIV regime is developed. • To the extent the new MIT rules, that are to be effective from 1 July 2011, are to be embraced by a new CIV regime, it needs to be borne in mind that the proposed new MIT rules are still being drafted and are subject to significant consultation and differing views, which may not necessarily be the ideal backdrop for a new internationally competitive CIV regime. For example, if the relatively inflexible MIT 5% under/over rule introduces a real risk of taxation for the CIV in practice, and examples of this being enforced become common place, this may not provide non-residents investing in a new CIV with sufficient comfort or certainty if the CIV regime adopts a similar concept. This is particularly true for "fund of funds" that are anticipated to find the under/over rules difficult to comply with due to their reliance on downstream investments. The setting of a sufficiently manageable de-minimus test for MITs and CIVs may be important for non-resident investor certainty in this respect.

#	Topic	Deloitte Comments
11.	**Transition to the new CIV regime – rollover**	• At a minimum, if a new CIV regime does offer alternative vehicles with preferred features to the new MIT regime that applies to trusts, or to allow for existing trusts to be able to convert into a new vehicle to which the CIV regime applies (e.g. a flow through corporate or limited partnership), then a clear form of rollover should be available. • The rollover should ideally cover all tax characteristics e.g. CGT and revenue, unrealised foreign exchange etc. • Although more complex, stamp duty relief should also be available to not prevent converting property or infrastructure intensive trusts into new CIVs if commercially preferred. • Although rollover relief should be afforded to give existing vehicles a commercial choice, it should be acknowledged that given trusts are an entrenched feature of the Australian tax landscape, many existing trusts and retail investors at a domestic level may resist changing to a new vehicle.
12.	**Flow-through design features and meshing the corporate CIV with the rest of the Australian tax system**	The CIV regime should allow for the following features in relation to flow-through of tax treatment to investors: • Flow-through of tax losses – under the current law losses are trapped within the trust and investors do not directly get the benefit of trust losses. However, the design principles for the review appear to exclude losses. The foreign hybrid rules provide a mechanism to allow this to occur (which may be workable at least in the closely held fund structures). • Flow-through of foreign tax credits – under the current law for trusts, foreign tax credits do not necessarily flow through to investors and where a trust cannot distribute foreign tax credits, these are lost and not able to be carried forward by the trust. Investors are penalised for investing through a trust. • The ability to flow through allocations of capital gains in the same manner as unit trusts, including CGT discount and "tax preferred" distributions where capital gains offset against capital losses carried forward in trusts can be distributed without requiring a cost base adjustment (so effectively the benefit of the capital loss utilised flows through) • The CIV regime should address current incongruous outcomes as between the tax treatment of trusts and the Australian tax system for corporate. For example, where a trust has not derived overall net assessable income, investors are not able to access franking credits, notwithstanding that investors may have dividend income from other sources or the trust has utilised losses to validly offset the dividend income. This policy should be revisited for CIVs and MITs as it penalises investment through a CIV, and adds further "insult to injury" in years where distributions have already been eliminated due to unfavourable investment returns.

#	Topic	Deloitte Comments
13.	**Certainty of 'fixed trust' status**	In order to give meaning to the above flow-through design features, the CIV regime should allow for the following: • "Fixed trust" certainty – uncertainty over "fixed trust" status raises concerns over managed funds' ability to access concessions in relation to recoupment of tax losses and providing flow-through of franking credits to investors. This is also an issue that discourages offshore investors from investing in Australian managed funds. All CIVs should have the certainty of being a "fixed trust" to avoid the ambiguity of whether concessional tax treatment is available, particularly in light of the Colonial decision. The decision in Bamford v Commissioner of Taxation gives rise to further uncertainty in respect of the application of the proportionate view i.e. the strict interpretation is that each beneficiary is assessed on an unallocated and un-dissected amount and therefore streaming is not possible. There is some uncertainty as to whether the proposed Regime MIT amendments and the rewrite of Division 6 will alleviate all these uncertainties. • We query whether a CIV with an appropriate associate corporate governance regime (under the Corporations Law or otherwise) should be subject to this criteria, which is likely to include a requirement to act in the best interests of members. If an equivalent test remains for a new form of CIV, then it should have unequivocal carve outs for registered / regulated funds or alternatively, only include implications if any non-fixed elements that give rise to policy concerns (if any) actually eventuate.
14.	**Flexibility of distribution / redemption**	The framework of a CIV should allow for the following features in relation to distribution to / redemption by investors: • Flexible distribution policy – all taxable income of the CIV should not need to be distributed (i.e. can be accumulated) to prevent the trustee being taxed at the top marginal rate. For example, currently taxable capital gains must be distributed to investors (at least the discounted component), whereas it may benefit CIVs in certain circumstances not to distribute all net income (for example, where its investment strategy includes reinvesting gains, or where commercial circumstances require the cash to be retained for financing or other balance sheet reasons etc). This is already reflected in the proposed MIT attribution rules. A workable solution for non-resident allocations would need to be agreed with industry. • The ability to expressly include or allocate income and gains on redemption of an interest in the CIV i.e. to mitigate the extent to which the same income is reflected in the capital gains calculation of the redeeming investor and ongoing investors (in their taxable income allocation). If a full flow through model is adopted, this scenario is less likely to arise as the redeeming investor should receive a flow through year to date allocation up until redemption that can be made on a reasonable basis. The uncertainty created by the recent Federal Court decision in Colonial First State Investments Limited v Commissioner of Taxation (Colonial) should be addressed by adopting this approach – for example, it should be possible to allocate capital gains realised for the redemption (as this is reasonable), rather than having to adopt a strict proportionate outcome.

#	Topic	Deloitte Comments
15.	**Multi-class units per currency and hedging**	• CIVs should have the ability to issue multiple classes of units with different currency overlays, with the ability to make appropriate hedging elections (to retain character), and calculate the taxable income of a particular class on an isolated basis (based on the currency and asset portfolio for that class) such that income of the classes that can vary due to foreign exchange positions (amongst other things) does not unduly impact the tax allocation of other classes. • Tax treatment should reflect the investment activity of funds – for example, hedging activity is on revenue account and the underlying asset may be on capital account, which gives rise to distorted tax outcomes. Whilst the Taxation of Financial Arrangements (TOFA) regime does provide for alignment of hedging activity with the underlying hedged item, the requirements to achieve these are very onerous and not practical for many funds to meet (e.g. most funds do not adopt hedge accounting which is one requirement for the TOFA hedging election). A hedging solution (particularly for foreign exchange) that provides logical tax outcomes is an imperative for a multi-class CIV to be offered globally.
16.	**Impact of tax treaties and foreign tax**	In the context of international taxation and CIVs, we make the following comments: • To provide additional flexibility, CIVs in corporate form could have the alternative of being taxed as a resident company, but with a deduction for dividends paid (i.e. a distribution model). This may allow the CIV itself to obtain relief from source country withholding taxes under Australia's tax treaty with the source country. • This alternative may be important because many investor countries would not regard a corporate CIV as fiscally transparent, regardless of how it is treated in Australia. This may result in: (i) inability to obtain relief under the tax treaty between the investor's country of residence and the source country; and (ii) inability for the investor to obtain credit for taxes imposed on income received by the CIV. • A corporate CIV taxed under a distribution model may reduce these concerns. This could be particularly relevant for very widely held CIVs, where it is impractical for investors to claim treaty relief from source country taxes. • Distributions made by a corporate CIV taxed under a distribution model could be subjected to Australian tax in the same way as distributions from a flow through CIV (i.e. character and source could be deemed to flow through). • Subject to the potential revenue impacts, consideration could be given to treating interest and unfranked dividend distributions by CIVs to foreign investors in the same way as fund payments under the current MIT rules. This would reduce the number of categories of income and result in the simpler outcome that CIV distributions are either subject to 7.5% withholding tax or are tax free. While it would conflict with the policy of aligning investment via CIVs with direct investment, this may (with appropriate safeguards) be justified by the benefits of simplification.
17.	**Year end matters**	• The flexibility to adopt different year ends for a CIV should be explored (particularly for a CIV which established with the intention of marketing into foreign jurisdictions). Non-resident investors may have a preference, for example, a 31 December year end. The possible spread achieved in the year end of Funds may arguably also assist the industry in managing the heavy compliance and administration burden that currently exists around 30 June.

#	Topic	Deloitte Comments
18.	**Flexibility for elections at CIV level**	• In certain circumstances, the ability of a CIV to elect to make a collective tax decision on behalf of unit holders may be preferred on the grounds of administrative simplicity. For example, TOFA elections, capital elections, CFC attribution accounts (generally not currently permitted but recommended), reasonable allocation of expenses etc all assist with administration and consistency, rather than investors undertaking separate calculations.
Investment manager regime		
19.	**Key considerations**	We support an IMR and consider that in developing an effective IMR, the following policy considerations should be taken into account: *Exemption model* • An exemption based approach as has been successfully adopted in other countries in Asia, such as Singapore, seems appropriate for further exploration. *Application and access to IMR* • Intermediaries to which the IMR applies should recognise the valuable role many intermediaries play in funds management, such as banks, brokers, custodians, trustees. Consideration should also be given to an IMR covering private equity and hedge funds and other specialist asset management vehicles • Consider applying an IMR to both portfolio and non portfolio investments (including interests in MITs), which for example with regards to non-portfolio investments would encourage further investment in, for example, Australian infrastructure projects • To have an effective IMR, other activities of non-residents coupled with the complexity of fund groups, should not influence their access to an IMR *Integrity measures/compliance* • Integrity measures should have a relatively high de minimis threshold and should not be unduly impractical (e.g. there should not be a requirement to trace or identify ultimate ownership) • Although limited reporting may be required, pre-approval or a clearance approach should be resisted in order for the IMR to be workable. • Caution should be adopted in relation to introducing a ‘managed in Australia’ requirement, as this has proven restrictive and created uncertainty in relation to the MIT fund payment rules.