The Institute of Chartered Accountants in Australia

28 February 2011

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

By email: taxboard@treasury.gov.au

Dear Sirs

Review of tax arrangements applying to collective investment vehicles

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to provide a submission on the Discussion Paper entitled "Review of the tax arrangements applying to collective investment vehicles".

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 67,000 of today's and tomorrow's business leaders, representing more than 55,000 Chartered Accountants and 12,000 of Australia's best accounting graduates currently enrolled in our world-class Chartered Accountants postgraduate program.

Our high level comments on selected issues and questions posed in the Discussion Paper are set out in the attached submission.

In our view, one of the main challenges to developing a successful collective investment tax regime is ensuring that an over-emphasis on perceived integrity concerns does not come at the cost of a regime that is attractive to investors, particularly non-resident investors. It will also require a willingness on the part of Government to deal with any non-tax roadblocks efficiently and effectively.

If you would like us to expand on any of the comments made in our submission please contact me on (02) 9290 5623 or Susan Cantamessa on (02) 9290 5625.

Yours sincerely,

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Introduction

The Institute supports the concept of a collective investment vehicle (**CIV**) regime and an investment manager regime (**IMR**). We also welcome the review of the effectiveness of the venture capital limited partnership (**VCLP**) regime which is long overdue.

Our response to selected questions posed in the Discussion Paper are high level because, in our view, it is important to get the policy settings right before addressing detailed tax issues associated with the design (or redesign) of these regimes .

Importantly we note that, to the extent that policy issues arise which are not income tax related, failure to deal with those issues will limit the effectiveness of any income tax solution.

In our view, any CIV regime should be based on the following principles:

- CIV status should depend on the nature of the investment activity and not the vehicle through which funds are pooled.
- The nature of a entity's investment activity should be primarily passive in nature.
- Ideally, a set of common rules for all CIVs with additional special rules as necessary to deal with the peculiarities of each sector within the funds management industry. This recognises that although there are differences in investment focus, location of investments etc, the rationale underlying those investments is similar.
- Integrity concerns must be valid and appropriately balanced against functionality and simplicity. For example, we question whether the correct balance has been struck in relation to the existing MIT regime.
- A flexible governance and regulatory framework is required. Such framework should appropriately distinguish between the level of protection required for retail as opposed to sophisticated investors.
- The tax rules must be clear, modern and well defined. For example, our view is that Division 6C is outdated and requires amendment, at least insofar as it relates to property.
- Taxes, other than income tax, must be appropriately dealt with. For example, for property funds, not only is stamp duty itself a significant cost, but this is exacerbated by differences in approach by the various states. Moreover, in the event that existing CIVs need to restructure to take advantage of any new CIV regime, stamp duty will be an important consideration.

We set out in 4.2 the characteristics we consider a CIV should have and how a CIV should be taxed.

We acknowledge that for the purposes of the review to qualify as a CIV a vehicle must not only undertake primarily passive investment activities but also be widely held. In this regard we note that there are investments set up under mandates for single investors which are either CIVs themselves or other investors like high net worth individuals, charities,

universities, churches and others. It is not immediately apparent to us why the regime cannot be extended to some or all of these products and other non-widely held products.

Collective investment vehicles for the purposes of this review

2.1

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

The tax and non-tax reasons why Australia's current CIVs are unattractive for non-resident investors were identified in the Johnson Report[1] and summarised in the Discussion Paper as including:

- For MITs – the lack of familiarity by non-resident investors and their advisers in civil law countries with the trust structure; complexity and uncertainty with respect to the extent to which funds structured as unit trusts can benefit under some of Australia's double tax treaties; competition from countries such as Luxembourg and Ireland where income and capital gains of funds domiciled there are exempt from income tax and there is no withholding tax on distributions to non-residents; and the lack of investor protection regulations applicable in foreign jurisdictions which may be a deterrent for non-resident retail investors.
- For listed investment companies (**LICs**) – the fact that their tax treatment is designed to create a more even playing field with MITs but only for Australian, and not non-resident, investors.

We have no reason to doubt that these reasons reflect the experience of the industry.

2.2

- **The appropriateness of the widely held definition contained in the MIT legislation as a characteristic for a wider range of CIVs, and whether there any compelling reasons to have non-widely held vehicles included as CIVs;**

- **The appropriateness of the current definition of eligible investment business in Division 6C of the ITAA 1936 as a prerequisite for a wider range of CIVs, and whether there are any compelling reasons why vehicles undertaking investment activities involving control of active businesses should be included as CIVs; and**

- **Whether there is a need to further define 'control' in Division 6C of the ITAA 1936 to provide greater certainty for investors in MITs and other CIVs, and if so, how this could be achieved.**

[1] Report of the The Australian Financial Centre Forum *Australia as a financial centre: Building on our strengths*.

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Appropriateness of MIT "widely held" definition for CIVs

We see merit in having consistent definitions in the income tax law. So, to the extent that an entity must satisfy a widely held test to qualify as a MIT, that test should be the same for all CIVs.

However, the "widely held" definition contained in the MIT legislation still requires some refinement. We understand that Treasury is currently considering the shortcomings of this definition in the context of those rules.

In our view, 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 in recognition of the fact that investors include global CIVs which are corporate entities or limited partnerships (**LPs**) and other entities where tracing is problematic. It must also recognize that managers will have limited ability to trace through CIVs, custodians, trustees etc in multiple jurisdictions.

That said, the inclusion of a widely held requirement means that the CIV regime is only available to widely held structures and does not promote private investment by non-residents. Consequently, a segment of the non-resident investor market is unable to access this regime.

Appropriateness of EIB definition for CIVs

In order to provide consistency across the tax regime, we also consider that the test for determining whether a CIV's activities are primarily passive in nature should be based on the Division 6C definition of EIB.

In saying this we note that the Board, in its report to the Assistant Treasurer following its review of the tax arrangements applying to MITs, recommended a number of changes which the Government has not accepted at this time.

Mindful of the terms of reference for the review, there would not appear to be any scope to treat as a CIV a vehicle whose activities include the carrying on of an active business.

Definition of control

The Institute sees no policy or practical reason to retain the control test as it applies to subsidiary or controlled companies in Australia. Given these entities are taxed in their own right, any trading income will automatically be subject to Australian income tax. Any type of control test which is required (e.g. it may be required to retain a control test in relation to trusts) should have a "water edge" limit. That is, control of foreign entities that may carry on activities considered to be trading should not cause an Australian trust to become a trading trust.

If it remains appropriate to have a provision relating to control then the Institute has previously indicated that, in our view, the meaning of that term should be clarified in a manner consistent with the policy intent of the control test.

While this remains our preferred position we would be concerned if any attempt to define the term resulted in an unnecessary broadening of the concept beyond what was intended.

Australia's current range of CIVs

3.1	
	• **The nature and extent of, and the reasons for, any impediments to investments into Australia by foreign investors through MITs; and** • **Suggestions on how the complexity of character and source retention under flow-through taxation could be alleviated through alternative CIV vehicles that are more attractive or user-friendly to non-resident investors.**

Some of the reasons why MITs are unattractive to foreign investors are set out in the Discussion paper. However, the Johnson Report also highlighted the importance of ensuring that Australia be an attractive location for foreign fund managers to establish funds in Australia.

Set out below are a number of issues with the MIT rules which should be borne in mind in the design of a CIV regime which is attractive to both non-resident investors and foreign fund managers:

- The rules are complex. In a real estate context, the MIT regime has not been particularly attractive outside of existing funds which can more easily satisfy the "connected with Australia" tests. The use of undefined general terms like "investment management" creates uncertainty which deters global managers setting up operations in Australia.

- There is an overemphasis on integrity based rules. Any CIV regime should appropriately balance integrity concerns against the desire to have a CIV regime capable of competing for the fund creation activity currently occurring in places such as Luxembourg and Ireland.

- The widely held tests in the MIT regime are biased towards highly regulated retail funds. Any CIV regime should reflect the fact that significant funds are invested by other CIVs or sophisticated investors who do not participate in retail offerings and often enter into mandates directly with a manager.

- To the extent that an entity needs to qualify as widely held to access any CIV regime, as indicated in 2.2 above, the rules must contain adequate and simple to use tracing rules beyond the trust based rules in the MIT provisions.

- In a MIT context, a trust has to be Australian resident, have an appropriately qualified responsible entity or manager and satisfy the investment management test. This may not be appropriate for the proposed CIV regime as the integrity sought by these requirements might make the regime unattractive to foreign investors as compared to existing conduit countries.

  That said, it is important to ensure that the regime does not provide offshore managers with an advantage over local managers.

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Our comments on how investors in a CIV should be taxed on a flow-through basis, which deals broadly with character and source retention, is set out in 4.2 below.

3.2

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

We do not have any specific comments to make on the issues raised in relation to LICs other than to reinforce that we see no reason in principle why LICs, in their existing form, should not be able to elect capital account treatment in the same way as MITs.

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

International practice is that LPs are popular vehicles for collective investment purposes and it is imperative that the Australian funds management industry has the option of utilising similar vehicles in order to attract foreign investment.

In our view there should be a single CIV regime that can be accessed by different types of CIV entities. Australian LPs should be able to qualify as a CIV if key criteria are met (see discussion at 4.2 for the Institute's views on the common characteristics necessary for an entity or arrangement to qualify as a CIV).

The Institute's view is that LPs that are widely held and involved in passive investment activity (and meet certain other key criteria as discussed at 4.2) should be able to access the CIV regime and flow-through taxation.

In this regard, the following issues are relevant for LPs:

- As highlighted at 2.2 and 3.1, if LPs have to be widely held to qualify as a CIV, the rules must contain adequate and practical tracing provisions that address the nature of typical foreign investors in LPs (including other LPs, foreign government and pension plan investors and foreign corporate bodies)
- as LPs are currently regulated by the respective State or Territory legislation in which the LP is established, regulatory and governance issues may need to be addressed to ensure that there is a simple and consistent framework that achieves integrity and investor protection requirements but does not impede the use of LPs for collective investment purposes;
- consideration will also need to be given to how the "connection with Australia" requirement is to be satisfied by LPs in a manner that strikes the appropriate balance between integrity/governance requirements and the goal of increasing the levels of investment management activity in Australia (some of the existing difficulties with this concept in the MIT regime context are outlined at 3.1 and 4.2).

International practice demonstrates that LPs marketed to highly sophisticated/wholesale investors account for a significant portion of collective investment activity. Where such LPs undertake primarily passive investment 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 related income) and not the entity itself.

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

Design of a new corporate CIV regime

4.1

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

Our comments on what should qualify as a CIV and how a CIV should be taxed are set out under 4.2 below.

4.2

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

In our view, there is no need for a standalone corporate CIV regime. Rather, we consider that as far as possible there should be a single CIV regime.

We have set out below the characteristics we consider an entity or arrangement should have to qualify as a CIV and how it should be taxed. With those comments in mind, our responses to the specific questions posed in 4.2 are as follows:

- The appropriate way to achieve an outcome similar to tax flow through for a corporate CIV is to focus on the income arising from an entity's investment activity rather than the nature of the entity itself.
- The appropriate way of determining the tax liabilities of investors is an attribution regime with withholding applying in relation to non-residents.
- In our view qualifying CIVs should not be subject to tax.
- By adopting a flow through approach and focusing on the taxation of the investor the need for special rules should be limited. Much of the complexity arising from franking and the associated dividend/capital provisions is removed.
- The MIT regime should provide a starting point for considering a CIV regime but should be modified to address the shortcomings of that regime identified in 3.1 above.

Vehicles which should qualify as CIVs

In our view a CIV should be any entity or arrangement as defined. The definition should be inclusive and encompass not only trusts but also internationally recognised and accepted CIV entities such as companies and LPs.

A CIV should have the following characteristics:

- Be widely held

  On the basis that CIV treatment is to be limited to entities which are widely held, the test of whether a CIV is widely held should be the same for all CIVs. The rules must contain simple to use tracing rules beyond the trust based rules in the MIT provisions in recognition of the fact that many investors will be global CIVs which may be corporate entities or limited partnerships, sovereign funds, government pension plans etc.

  The widely held rules need to be flexible, simple and certain so that a proper assessment of the status of a CIV can be made at any time without conducting a costly and time consuming tracing exercise.

- Satisfy a regulatory and governance requirement

  One of the key attributes of the successful conduit regimes is a simple and effective system of regulation and governance. An outcome which does not allow for the recognition of CIVs which are LPs and/or companies would not be internationally competitive.

- Satisfy a connection with Australia test

  As indicated in 3.1, in a MIT context, a trust has to be Australian resident, have an appropriately qualified responsible entity or manager and satisfy the investment management test.

  This requires a significant connection with Australia which may be more justified in the context of investment in real property and highlights the fact that the policy emphasis is on attracting people to use Australian managers rather than foreign ownership of Australian assets.

- Be involved in passive investment activity

This test should apply to all CIVs and should be based on the EIB test in Division 6C. As noted above, in our view Division 6C requires amendment/modernization. Recent amendments appear to be focused on revenue protection (e.g. the arm's length rule and retention of the control test) rather than creating a workable framework for industry as evidenced by the lack of a general review and the failure to allow real estate investment trust (**REIT**) subsidiaries.

How CIVs should be taxed

In our view Australian tax rules should apply to CIVs subject to the following modifications:

- Deemed CGT account treatment for assets on a similar basis to the existing MIT rules.
- Consolidation of all Australian resident wholly owned entities provided those wholly owned entities are also involved in passive activities.
- Taxable income of the CIV group attributed to investors. This approach is designed to overcome integrity concerns about the accumulation of income whilst giving the CIV flexibility in relation to capital management.

  Adopting this approach, income is attributed to Australian residents who include it in their assessable income. However, its application to non-residents is more challenging as the trustee (or a custodian) is required to withhold tax in respect of monies attributed (but not paid) to non-residents. Further thought is required here.
- Income retains its character and source when attributed.
- Losses are retained at the CIV level on a consolidated basis.
- Distributions are not subject to tax but a distribution in excess of a previously attributed amount reduces an investor's cost base in the CIV.

In the event that the control test was removed, the CIV itself would qualify for flow through treatment (rather than be subject to corporate tax) but controlled entities subject to Australian corporate tax would not be consolidated. Instead, dividends from these entities would flow through the CIV to investors.

Investment Manager Regime

5.1	• **The appropriateness of an exemption-based approach for an IMR applicable to foreign managed funds;** • **Whether an alternative approach would be more appropriate?**

In order to provide sufficient incentive for foreign funds to increase their level of activity in Australia, an exemption approach is considered preferable to the introduction of a range of measures intended to mitigate the impact of different aspects of Australia's regime for the taxation of the income of non-residents.

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

As a minimum, such an exemption should extend to gains relating to portfolio investments of foreign managed funds (whether held on capital or revenue account) which would be considered to have an Australian source.

Furthermore, as outlined by the Assistant Treasurer in his announcement of 19 January 2011, the measures should ensure than an Australian income tax liability does not arise only because the use of a local investment manager or agent by a foreign managed fund gives rise to a permanent establishment in Australia.

5.2

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

The option should be extended to a broad range of Australian intermediaries providing investment related services to foreign managed funds beyond just investment management activities e.g. brokers and counterparties to derivative transactions.

It is agreed that "ring fencing" measures would be required in conjunction with such an approach in order to maintain the integrity of the tax system.

These should include a measure which confines the concession to those transactions of the Australian intermediary which relate to the investment activities of the foreign managed fund. In this regard, it is noted that the Investment Manager Exemption (IME) in place in the UK applies the exemption on a proportionate basis where the intermediary engages in any "non-qualifying" activities.

Another integrity measure could set guidelines for the determination of an arm's length fee in respect of those transactions considered to be eligible for the exemption. In the case of the UK IME, the tax authorities are guided by the OECD Transfer Pricing Guidelines for Multinational Enterprises (which has also been fundamental to the practical application of Australia's transfer pricing rules).

5.3

- **Do the above features of a foreign managed fund encompass all funds that should be covered by an IMR;**
- **Should there be a 'managed in Australia' requirement or a minimum spend requirement as per Singapore's regime? Can the economic benefits and growth in the Australian financial services industry be maximised without such a requirement; and**
- **What are reasonable reporting and approval processes that are necessary to ensure that the IMR exemption is being appropriately claimed by qualifying foreign managed funds?**

Broadly, the Discussion Paper indicates that the IMR may be restricted to widely held foreign managed funds which typically undertake passive portfolio investments. Consideration should be given to whether the IMR should cover a broader range of investment vehicles. The Johnson Report indicated at page 59:

> *"Forum is of the view that IMR should be wide enough to cover in house financial intermediaries and should apply as widely as possible to encompass wholesale funds, including hedge funds and private equity funds, as well as retail funds."*

For example, the IMR operating in the UK is not restricted to widely held funds.

The following should also be considered in relation to the proposed requirements for a foreign managed fund as set out in the Discussion Paper:

- before the "widely held" definition is borrowed from the MIT rules, various anomalies appearing in those rules should be addressed; and
- as discussed further below, changes would be required to address the fact that a foreign fund may be an Australian resident under the existing residency rules (because central management and control sits in Australia), however, may still be considered eligible for the benefits of the IMR (refer further below).

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

Consideration could be given as to whether a minimum advisory service spend amount would be beneficial for the Australian funds management industry, yet not significantly reduce the attractiveness of the IMR concession. This consideration should include an assessment as to the benefit that this approach has provided in Singapore.

It will be important that any reporting and approval processes for ensuring that the IMR exemption is being claimed by qualifying foreign managed funds are not too complex and onerous. Care needs to be taken to ensure that unreasonable information requirements and compliance costs are not imposed on foreign funds.

In terms of reporting to the Australian Taxation Office, questions relevant to the administration of the IMR could be added to the existing tax returns used for Australian income tax purposes, with lodgement becoming one of the requirements for entitlement to the benefits of the concession. In addition, foreign managed funds would be responsible for preparing and maintaining records required to determine the extent to which they are entitled to benefit from the IMR concession, and those transactions in respect of which they should pay income tax in Australia (e.g. determination of transfer pricing methodologies and calculations relating to the arm's length fee for services provided by Australian intermediaries).

5.4

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

In the Assistant Treasurer's announcement of 19 January 2011 in relation to aspects of the introduction of an IMR, the following investments were listed as giving rise to "relevant investment income" for the purposes of the proposals:

- Portfolio interests in companies (including companies listed on the Australian Securities Exchange), portfolio interests in other entities (including units in a unit trust) and bonds, except to the extent the amount gives rise to a withholding tax liability

- Financial arrangements (for example, derivatives) and foreign exchange transactions, except to the extent they are in respect of an underlying interest that is otherwise taxable (such as taxable Australian property).

This list of investments is broadly consistent with paragraphs (b) and (c) of the definition of EIB in section 102M of Division 6C of the ITAA 1936.

An alternative approach would be to adopt the UK model, under which investment transactions which may qualify under the IME are listed in regulations which complement the relevant provisions. These regulations provide significant detail in relation to certain transactions with a view to providing greater certainty for taxpayers. Further, updates to the regulations can be made more quickly and easily than if they were included within the legislative provisions.

As noted in 5.2, the fact that a foreign managed fund may carry out “non-qualifying” activities as well as those eligible for exemption under an IMR should not mean that the benefit of the exemption would be lost. Provisions which allow the benefits of an IMR to be applied on a proportional basis in such circumstances are a feature of the UK provisions.

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

As recommended in the Johnson Report, entities covered by an IMR should not be considered an Australian tax resident merely as a result of having central management and control in Australia.

To maintain the integrity of the tax system, this concession should be included as a feature of the IMR rules, rather than amending the residence rules that apply generally. This would mean only those non-residents meeting the other requirements for the IMR to apply would be eligible for this concession (one of the proposed requirements being that the foreign managed fund is not an Australian tax resident).

Comments regarding the application of the residency rules to corporate limited partnerships were discussed in an earlier submission to Treasury by the Institute on the subject of Conduit Income.

5.6

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

Where Australian residents exert control over a foreign managed fund, the CFC measures should apply, with attribution of income on an annual basis as appropriate.

In relation to a non-CFC investment, the latest exposure draft of the Foreign Accumulation Fund (FAF) rules seem to indicate that the Government is prepared to tolerate deferral of Australian tax by an Australian investor in a foreign fund unless it derives significant “low risk, interest like returns”. However, it may not be acceptable for an Australian resident to accumulate amounts through an investment in such a foreign fund which has claimed exemption from Australian tax through accessing the benefits of an IMR.

Whilst measures to deal with round tripping would be required, they should not impose such onerous compliance requirements on the foreign managed fund that they become counter productive.

A de-minimis level of ultimate Australian ownership should be an appropriate measure to police such abuses of an IMR. To remain competitive, the threshold percentage for the de-minimis test should not be any lower than that elected by other jurisdictions in the region.

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

The extent to which there would be issues remaining after the implementation of an exemption style IMR would depend on how broadly the exemption is applied. The broader the exemption, and the more practical the integrity measures adopted, the less likely that there would be residual Australian tax issues causing concern, or creating disincentives, for foreign managed funds.

5.8

- **What financial services sector entities apart from foreign managed funds would it be appropriate to encompass within the scope of an IMR as described above? Are there any other types of financial services entities which should be taken into account in addition to those identified above;**
- **What justifications would there be to relax the requirements for foreign entities to be widely held before qualifying for IMR exemptions;**
- **What justifications would there be to relax the requirements for foreign entities to undertake primarily passive investments in order to qualify for the IMR exemptions;**
- **What integrity issues would be raised if portfolio investments through IDPS or foreign private vehicles were exempted through an extended IMR? Are there some risks that are higher than others? What can be done to mitigate these risks;**
- **Recognising the need to maintain the integrity of the tax system, how could Australia’s residence rules be amended so as to apply only to foreign financial sector entities under an IMR? Which foreign financial sector entities should be taken into account, and how could they be appropriately defined in such rules; and**
- **To what extent does the current law (for example, OBU provisions) already adequately provide IMR like concessions for financial sector entities apart from foreign managed funds?**

No comments.

Venture capital limited partnerships

The Board seeks stakeholder comment on the following questions/issues:

6.1	• **Whether the restrictions imposed on the VCLP and ESVCLP regimes are consistent with their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;** • **What are the restrictions that arguably require the use of some sort of companion structure to overcome shortcomings of the regime;** • **Suggested amendments to the tax treatments under the VCLP and ESVCLP regimes that would enhance their effectiveness in achieving their policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses;** • **Are the current levels of investment through VCLPs and ESVCLPs consistent with what would be expected normally for these types of programs compared to similar programs in other jurisdictions;** • **Would the introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP contribute or detract from its policy objectives? What other considerations would be relevant to introducing such a deemed capital account treatment;** • **Given the carried interests of general partners are already deemed to be on capital account, should general partners receiving gains made by a VCLP on the disposal of eligible venture capital investments also be deemed to be on capital account; and** • **The desirability of further changes to the tax treatments in the VCLP or ESVCLP regimes to enable them to better achieve their policy objectives?**

In response to each of the above questions/issues we make the following comments:

- In our view the restrictions imposed on the VCLP and early stage VCLP (**ESVCLP**) regimes are not consistent with their stated policy objectives of promoting early stage, high risk start-up companies and expanding Australian businesses.

  Requirements such as:

  - the need for there to be at least 4 investors;
  - an investment by an ESVCLP in any one entity cannot exceed 30% of the ESCVLP's committed capital limit; and
  - more than 75% of assets held by an ESVCLP's eligible venture capital investment company must be used in eligible activities,

  do not have regard to the commercial reality of many investment decisions. We would recommend that these be reconsidered.

  The lack of clarity around whether gains derived by a VCLP's limited partners are on capital account (and therefore uncertainty as to their after tax returns) often acts as a deterrent to potential investors.

  Furthermore, the use of VCLPs has become largely redundant for foreign investors since the introduction of Division 855 of the Income Tax Assessment Act 1997 (**ITAA**

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1997), as exits from direct investments in non taxable Australian real property assets can be achieved without the imposition of Australian capital gains tax.

In addition, restrictions attaching to the eligible venture capital investment company (subsection 118-425(4) of the ITAA 1997) mean that it is not possible to acquire compatible businesses from unrelated third parties during the early high risk stage. This therefore limits the ability of the eligible venture capital investment company to expand their activities through acquisition.

- In Australia the use of companion structures for ESVCLPs are critical because funds may be deployed in acquiring companies that do not qualify as early stage venture capital investment companies.

- An important change to the tax treatment would be to allow for the flow through of investment company losses to investors. Where an investment company makes losses investors should be able to have access to these, as this more accurately reflects the commercial reality of the investment decision.

  Clarity around the capital account treatment of gains derived by a VCLP's limited partner should also be considered including the introduction of a deemed capital account treatment for all limited partners (not just domestic limited partners).

- No, current levels of investment through VCLPs and ESVCLP's are very low.

- The introduction of a deemed capital account treatment for domestic limited partners investing into a VCLP would contribute to its policy objectives as it would provide greater certainty to investors as to their after tax returns. However, this deemed capital account treatment should apply to all limited partners, not just domestic limited partners.

- Yes, gains received by general partners on the disposal of eligible venture capital investments should be deemed to be on capital account.

- As noted above, we would recommend that the flow through treatment of losses incurred by investment companies be considered.