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The Manager
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The Treasury
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By email: investmentmanager@treasury.gov.au

Response to Second Exposure Draft Legislation Investor Manager Regime Elements 1 and 2

Dear Sir/Madam

Ernst & Young is pleased to provide this submission to Treasury in response to the second Exposure Draft elements of an upcoming Bill "Exemption for certain income attributable to a permanent establishment" and "FIN 48" (collectively, the second ED) of 7 March 2012.

We applaud the Government's approach to engage in further consultation on these elements of an Australian investor manager regime (IMR) responding to feedback made on the first ED released for consultation in August 2011. We acknowledge that improvements have been made in the second ED in response to feedback from Ernst & Young and others.

We hope that this further consultation will help ensure that appropriate and workable law is introduced to allow the policy objective of these IMR elements to be achieved. We thank you for discussing our initial concerns in the Treasury consultation session of 23 March 2012.

We are pleased to provide further detailed responses on the second ED in this letter. We outline a number of further adjustments which are required in order to ensure more comprehensive coverage of the proposed rules and we highlight certain other issues where clarification or further provisions are needed.

In particular, it will be important for those elements of the second ED which will subsequently form part of the yet-to-be-developed third element of the IMR, in respect of Australian source income, to be appropriately framed so that the potential benefits of a complete IMR to encourage the use of Australian financial intermediaries may be realised.

In this submission we refer to the "FIN 48" measure as the foreign fund tax amnesty or "FF tax amnesty" reflecting its wider application and Australian income tax impact, to the "Exemption for certain income attributable to a permanent establishment" as the foreign fund conduit income PE measure or "FF conduit PE exemption", and to the eventual full Investment Manager Regime as IMR3.

In summary, as set out further in Appendix A:

Application

1. Treasury should consider the potential application of the measures to entities other than corporate tax entities (as defined), beneficiaries of trusts subject to Division 6 of the Income Tax Assessment Act 1936 (ITAA36), and partners in partnerships subject to Division 5 of ITAA36
2. the rules should clarify how they apply to foreign limited partnerships which are treated as companies under Australian tax law yet are subject to flow through tax treatment in their country of residence, and other companies that elect flow though treatment for example under US check-the-box rules

Widely held or foreign widely held entity requirements

1. a number of adjustments are required to the widely held and closely held rules to ensure that certain foreign master funds within the policy design of the provisions are not inappropriately excluded
2. in particular the wholly owned entity widely held test should be reduced to a 80% threshold ownership test to ensure foreign funds with a small ownership stake owned by the foreign fund manager or general partner do not fail the test. Alternatively such foreign fund manager ownership should be disregarded for the purpose of the rules
3. an 18 month start-up period rule should be included, similar to that in the managed investment trust (MIT) definition
4. the explanatory material should clearly state that an entity will qualify as a widely held entity where it is wholly owned by another IMR foreign fund
5. wholly owned subsidiaries of a foreign widely held entity should also be listed as a foreign widely held entity
6. foreign sovereign wealth funds (SWFs) should be treated as a foreign widely held entity, at least for the purposes of the widely held 25% ownership test for non-SWFs
7. foreign endowment funds should be treated as a foreign widely held entity, with fund types potentially to be added by regulation

Concentration test

1. where voting rights of an entity are greater than its distribution and/or capital rights, that higher voting interest should not be taken into account in calculating the total participation interests of an entity for the purpose of the concentration test

IMR income for purposes of the permanent establishment measure

1. the drafting of the provisions in respect of entities resident in a country that has not entered into a double tax treaty with Australia should be improved – this is needed to provide greater certainty

Financial arrangements covered

1. the exclusion from covered financial arrangements where the IMR foreign fund has a 10% or greater total participation interest in that entity should be adjusted, in line with the government's 16 December 2011 announcement to exclude foreign investments

2. the exclusion for a financial arrangement where its terms allow the fund to vote at a meeting of the Board of Directors or other governing body of an investee entity should only apply where there is control of that entity

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Should you have any questions or would like to discuss our submission further, please do not hesitate to contact in the first instance either Peter Janetzki on (03) 8650 7525 or Daryl Choo on (02) 9248 4472 or Tony Stolarek on (03) 8650 7654.

Yours sincerely

Ernst & Young

cc. Mr Daniel Mulino, Office of Minister Mr Bill Shorten

Appendix A

In this submission we refer to the "FIN 48" measure as the foreign fund tax amnesty or "FF tax amnesty" reflecting its wider application and Australian income tax impact, to the "Exemption for certain income attributable to a permanent establishment" as the foreign fund conduit income PE measure or "FF conduit PE exemption", and to the eventual full Investment Manager Regime as IMR3.

1. Application of the measures

1.1 Application to other entities and managed fund arrangements

The proposed FF tax amnesty and FF conduit PE exemption are currently proposed to apply in respect of:

- an IMR foreign fund which is a corporate tax entity
- a non-resident beneficiary of a trust (other than a trust or a partnership)
- a non-resident partner in a partnership (other than a trust or a partnership)

We are concerned how the measures are intended to apply in respect of entities or arrangements or in other circumstances that may not fit within any of these categories, for example managed funds established as jointly held property or contractual arrangements.

This includes 'contractual common funds' (CCFs) used in Ireland and other arrangements that meet requirements to qualify as 'Undertakings for Collective Investments in Transferable Securities' (UCITS) in countries in the European Union, which may apply despite the legal form of the investment fund.

Such arrangements are described in further detail in the Board of Taxation's December 2010 discussion paper "Review of Tax Arrangements Applying to Collective Investment Vehicles".

The drafting of the provisions in terms of Australian tax law definitions may be problematic when trying to apply the measures more broadly to income and gains in respect of such arrangements and entities other than readily identifiable 'corporate tax entities' and beneficiaries of trusts considered under Division 6 of the Income Tax Assessment Act 1936 (ITAA36), and partners in partnerships subject to Division 5 of the ITAA36.

An approach which is not based upon and therefore potentially restricted by Australian tax law definitions may be better.

At a minimum the potential application of the measures to income and gains in respect of other entities and arrangements should be made clear in the explanatory material to the Bills.

1.2 Application to foreign limited partnerships and companies

Clarification is needed for how the rules apply in respect of a foreign limited partnership which is treated as a company for Australian tax purposes but is subject to flow trough taxation treatment in its country of residence. Such fund structures are very common as part of US and Cayman Island investment funds, as set out in our submission on the August 2011 ED law.

For the purposes of the application provisions for the FF tax amnesty and FF conduit PE exemption a corporate tax entity is defined in section 960-115 of the Income Tax Assessment Act 1997 (ITAA 1997) and includes a corporate limited partnership. However a corporate limited partnership will not be the taxpayer for US tax purposes: rather its investors will be subject to tax on their share of the income as if they are partners in a partnership. Such investors may not be partners in a partnership for the purpose of Division 5 of the ITAA36 therefore the application of the proposed measures to them is unclear.

In addition, under US check-the-box regulations, taxpayers may elect corporate or non-corporate 'partnership' (where more than one member) flow through status for their federal income tax purposes for any domestic or foreign entity, as long as the entity is not specifically treated as a corporate under US tax law (a "per se corporation"). So a US company may also be treated as a flow through entity causing a mismatch with the Australian taxation approach.

We would be pleased to separately discuss these structures and the potential problems in a conference call if that would assist.

2. Widely held or foreign widely held requirements

A number of additional circumstances should be covered by the widely held/foreign widely held rules to ensure the measures will be available to appropriate foreign funds and their investors.

2.1 Coverage of typical foreign fund structures

As set out in our submission on the August 2011 ED it is vital that the proposed measures apply appropriately in respect of the common structures used by foreign funds that are intended to benefit in accordance with the policy intent.

Examples of common foreign fund structures include:

- Cayman Island Master Funds
- Hedge funds

We highlight below a number of adjustments required to the widely held and closely held rules to ensure that such funds are not inappropriately excluded.

The "base case" factual scenario which is applicable to a significant number of affected funds typically involves a foreign collective investment "Master Fund" which is legally structured as a company established in (for example) the Cayman Islands or an equivalent taxing jurisdiction.

The Cayman Master Fund is typically owned by a series of "Feeder Funds", although the Master Fund may (for reasons driven by legal protection and investor choice selection) itself establish one or more sub-funds into which its portfolio is structurally divided. The Feeder Funds are themselves collective investment vehicles and may also be structured as entities such as Cayman Island corporations and partnerships, or US resident partnerships and limited liability companies. Investing into the various feeder funds are typically a wide range of foreign individuals, institutions, pension and retirement funds. In some cases, there are multiple tiers of feeder funds.

These master funds and/ or feeder funds will have a management contract in place with a foreign "Investment Manager" (often based in financial centres such as New York, Chicago, London and Hong Kong). It is common for the performance return of the investment manager to be structured as an equity interest in the fund, owned by the investment manger or a related vehicle.

An illustrative diagram of the base case scenario is provided in Appendix B.

We are concerned that the exposure draft legislation does not extend an exemption to gains arising for foreign managed funds in these base case scenarios.

If entities are excluded from the definition of IMR foreign fund because their investment manager holds a portion of underlying capital, a large number of funds that are intended to benefit from the FF tax amnesty and FF conduit PE exemption could be excluded. This could undermine the policy intent and fail to resolve the "FIN 48" issue for many of the affected foreign managed funds.

We recommend that an entity which otherwise meets the IMR foreign fund definition should not be excluded from qualifying simply because the investment manager for that entity holds a portion of the membership interests. We highlight that the UK investment manager exemption provisions allow for the investment manager to hold up to 20% of the equity in the fund (or to take an equivalent proportion performance return) without the fund being excluded from concessional fund status.

We recommend that the wholly owned entity widely held test should be reduced to a 80% threshold ownership test to ensure foreign funds with a small ownership stake owned by the foreign fund manager or general partner do not fail the test. Alternatively such foreign fund manager ownership should be disregarded for the purpose of the rules.

2.2 Start-up period rules

The rules should include a start-up period rule that deems the widely held requirement to be met and the concentration test not to be breached in that period, in addition to the proposed wind-up rule.

Such a rule is necessary so that foreign funds and their investors are not denied access to the measures during the initial establishment phase of the fund.

It is a common commercial practice for funds to be established with 'seed capital' from one or more 'cornerstone investors' as a necessary step in starting a new fund before it is offered more widely to other feeder funds and investors.

Without a start-up rule the fund and its investors may not be entitled to the foreign fund amnesty or conduit foreign income PE exemption relief until the first full year in which the fund is widely held (and not closely held). This would be a particularly harsh outcome where the commercial start-up phase does not finish until shortly after the commencement of the next income year.

The absence of a start-up rule will also be important for the definition of an IMR foreign fund for the IMR 3 law. Foreign funds may see this potential initial exposure as an unacceptable risk for using the services of Australian resident financial intermediaries and they may therefore continue to avoid Australia or defer expanding into Australia until the fund is mature (which might not be until a second round of investment in the fund is made). We recommend that the start-up rule is introduced as part of the current ED law to avoid such issues.

The start-up rule might be modelled on the managed investment trust (MIT) definition in subsection 12-400(4) of the Taxation Administration Act 1953.

Treasury expressed a concern in the consultation meeting that a start-up rule might be exploited and foreign funds afforded deemed widely held, not closely held treatment might be wound up before it ever became genuinely widely held. We are not aware of any cases of abuse of this rule in the MIT context (certainly such abuse has never to our knowledge been raised publically by the ATO) and we would not expect the foreign funds likely to rely on the current measures to do this for an avoidance purpose, in particular given the limited nature of the FF conduit PE exemption. However a possible solution may be to only allow the start-up rule to apply where the fund subsequently becomes widely held within 18 months.

2.3 Entity owned by another IMR foreign fund

We understand that proposed paragraph 842-230(1)(d) of ITAA1997 would result in an entity which is wholly owned directly or indirectly by another IMR foreign fund satisfying the widely held tests as that IMR foreign fund entity would need to satisfy either paragraphs 842-230(1)(a), (b) or (c) for it to qualify as an IMR foreign fund. It should also follow that the subsidiary entity would not breach the concentration test on the basis that the IMR foreign fund must not have breached that test in order to have this status.

However to assist understanding of the proposals and ease of compliance of the rules we recommend that the explanatory material to the Bill include the circumstances of a foreign fund wholly owned directly or indirectly by a IMR foreign fund as an example in which the widely held tests would met and the concentration test not breached.

2.4 Foreign widely held entity subsidiaries

Proposed subsection 842-230(2) should also include a subsidiary of any of the entities listed in that subsection as a 'foreign widely held entity' for completeness (as new paragraph 842-230(2)(d)).

The concentration test should be amended to include the new paragraph reference in the counting rule in proposed paragraph 842-230(4)(b).

2.5 Ownership by foreign sovereign wealth funds

Foreign sovereign wealth funds (SWFs) should also be included in the list of 'foreign widely held entities'. This is appropriate as such funds are of a widely held nature being either government or government agency owned and they can be significant investors in global funds.

Treasury expressed a concern in the consultation session that SWFs should not be included because they have their own exemption.

We note that in Australia an exemption may apply in accordance with the ATO's application of the "doctrine of sovereign immunity" derived from international law and proposals to codify the exemption in Australian tax law have not yet been finalised or introduced into law. We therefore recommend that the current measures should also be available to these SWF investors in the period until that measure commences.

We suggest that even if SWFs cannot be included on the list as a 'foreign widely held entity' for the purpose of proposed paragraph 842-220(c)(ii) (ie in their own right), then they should be included in any event as an entity that can be considered for the purposes of the 25% total participation interests test for an entity which is part owned by a SWF, for the purpose of proposed paragraph 842-220(c)(i).

2.6 Foreign endowment funds

Another notable exclusion from the list of entities which would allow a foreign fund to be widely held is foreign endowment funds, such as the funds maintained for great foreign charities, universities and medical institutions.

Such funds are also significant investors in global funds and are themselves of a widely held nature being owned by universities or having the status of charities, however they are not listed entities and cannot be traced through and may therefore not otherwise be considered widely held under the proposals.

These include foreign organisations established for medical, educational or other charitable purposes that are organised in foreign jurisdictions and are recognized as exempt from income tax in their home jurisdiction.

A further category of foreign widely held entity should be added to the definition of 'foreign widely held entities' for these foreign endowment funds.

We note that as an alternative these foreign endowment funds could be added by regulation. If Treasury prefers the regulation approach then the explanatory material should provide information on what types of entities could be included by regulation under such a heading to assist relevant funds to apply for their inclusion. Adding additional entities by fund type is our preferred approach as this will be more workable than adding entities by name.

3. Concentration test

We welcome the modifications of this test and the reduction in the 20 or fewer persons/75% requirements of the August 2011 ED.

However we are concerned that the calculation of the entities which are counted for the replacement 10 or fewer entities/50% test may still result in the inappropriate exclusion of some entities, including limited partnership master fund structures with an unrelated general partner or foreign fund manager, as described above.

The concentration test uses the concept of 'total participation interests' which are defined in section 960-180 of ITAA1997 which in turn refer to the Part X of the ITAA36 controlled foreign companies (CFC) rules. These rules result in the higher of the distribution rights, capital held or entitled to and voting rights for a company and the higher of entitlements to corpus or income of a trusts being counted when calculating the participation interests.

Where a fund structure as illustrated in Appendix B has an unrelated foreign fund manager or an unrelated general partner with an interest in the fund it is common for those entities to have a voting interest reflecting their relationship with the fund to control the day to day management of the entity but with lesser distribution or capital return rights in line with their remuneration structuring.

This voting interest may cause the foreign fund to fail the concentration test as that foreign fund manager or general partner will be counted for the purpose of the 10 or fewer entities/ 50% test.

The rule should be adjusted so that the only the higher of the distribution or capital return rights of the entity are counted.

4. IMR income for purposes of the permanent establishment measure

The IMR income rules for the FF conduit PE exemption propose that assessable income will only qualify in certain circumstances including where the amounts are:

- included in assessable income only because it is in relation to an Australian permanent establishment in respect of a treaty country resident or
- are CGT assets not covered by the exclusion in Division 855 of ITAA1997 because of their connection with a permanent establishment in Australia.

In respect of an entity that is resident of a non-treaty country it will only apply where "the Commissioner makes a determination under section 136AE" to include that amount as Australian source income.

In our view it is unclear how and when the proposed measure will apply to a non-resident entity as a consequence of this drafting.

We are also concerned that this uncertainty will discourage foreign funds in non-treaty countries or funds with non-treaty investors from engaging Australia financial intermediaries in order to avoid any risk that their income will not fall with the provisions.

Treasury outlined, in the consultation session, difficulties with drafting this provision. Notwithstanding this, the rules need to be improved to provide greater certainty.

At minimum a note to the section, supported by commentary in the explanatory material to the Bill, should advise that an affected entity is not required to seek a determination from the Commissioner in order to receive the protection of the measure where all the other elements would be present.

5. Financial arrangements covered

5.1 10% portfolio interests restriction

On 16 December 2011 the government announced as part of its response to the Board of Taxation's August 2011 report "Review of an investment manager regime as it relates to foreign managed funds" that it would extend the conduit foreign income PE measure to apply to foreign non-portfolio interests, effectively removing the proposed 10% portfolio interests restriction in subsection 842-245(2) for qualifying foreign investments.

We had assumed that this adjustment would apply from the commencement of the conduit foreign income PE measures and that this adjustment would therefore be made as part of the finalisation of the proposed Bill. However we understand from the discussions in the Treasury consultation meeting that this adjusted position will not be included in the current Bill but will rather be deferred to be developed as part of the IMR3 measures.

This deferred consideration and adjustment (which we expect would have retrospective application) is in our view not appropriate and will cause uncertainty in relation to the proposed conduit foreign income PE measure.

5.2 Exclusion where entitlement to vote at Board of Directors meeting

The exclusion from being a covered financial arrangement in proposed subsection 842-245(4) where the terms of the financial arrangement allow the fund to vote at a meeting of the Board of Directors or other governing body of an investee entity may result in the inappropriate exclusion of many arm's length commercial passive investment arrangements from the measures.

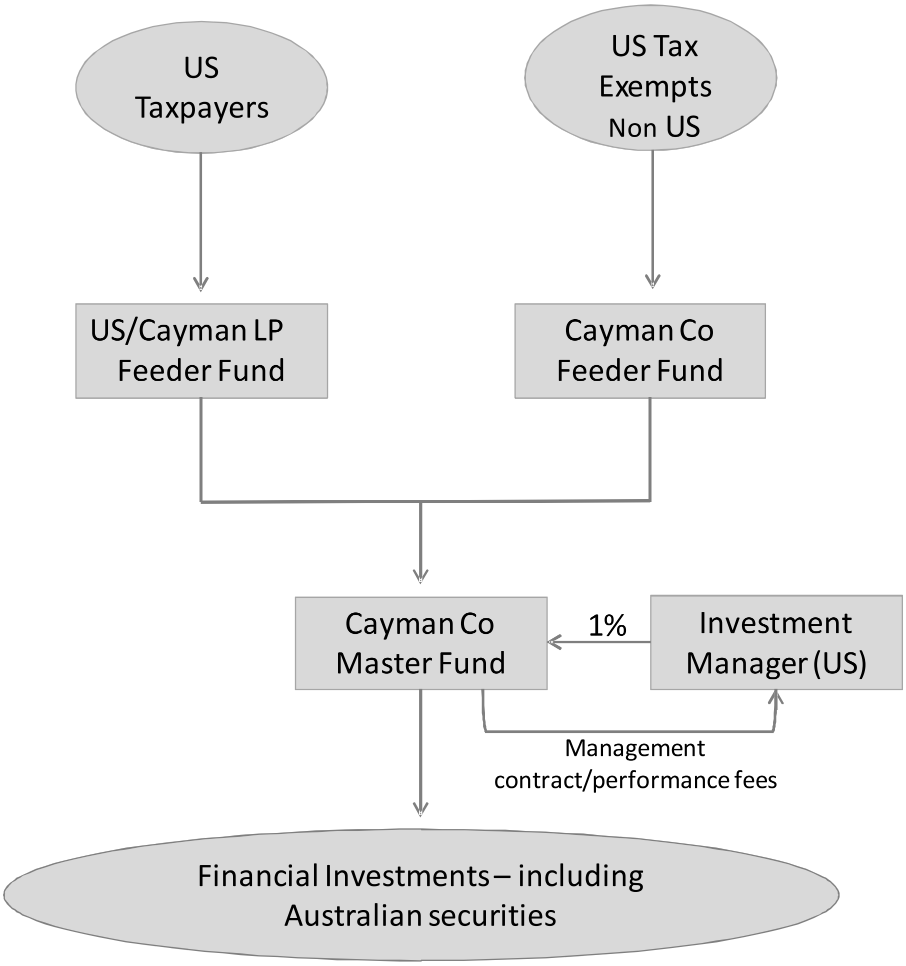
It is common for foreign funds to hold a level of investment which entitles them to Board of Directors representation. However such representation will usually be restricted and will allow them only to protect their interests in respect of their investment in that entity.

We understand that this rule (along with the other restrictions in that subsection) is intended to exclude non-passive investments including those of private equity investors. However as currently drafted it may have much wider application to exclude genuine passive investments.

The rule should only apply where there is control of that entity which results from the rights to vote at the Board of Directors/governing bodies meeting.

Appendix B

Master fund example


US
Taxpayers
US Tax
Exempts
Non US
US/Cayman LP
Feeder Fund
Cayman Co
Feeder Fund
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