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4 April 2012

Deloitte Submission
Exposure Draft legislation released on 7 March 2012
Investment Manager Regime

Deloitte welcomes the opportunity to comment on the Exposure Draft legislation released by the Assistant Treasurer on 7 March 2012 in relation to the Investment Manager Regime – FIN 48 (**FIN48 rules**) and the Investment Manager Regime – conduit income (**IMR rules**) (**Exposure Draft**).

Deloitte supports the Australian Government's commitment to position Australia as a leading financial services centre.

Deloitte is generally supportive of the approach announced in the various press releases (No 27 of 17 December 2010, No 10 of 19 January 2011 and No 75 on 10 May 2011) and adopted in the Exposure Draft legislation. However, we submit that there are a number of matters that need to be refined to achieve the Government's objectives. In particular, the widely held tests and the concentration tests need modification to ensure that the very funds that are intended to be covered by the FIN48 rules will qualify as IMR foreign funds.

We would be happy to discuss our submission points further with you. If you have any questions, please call Mr Peter Madden on 02 9322 7449 or Ms Rosalind Myint on 02 9322 7144.

Yours sincerely,

Peter Madden
Director, Deloitte Tax Services Pty Ltd

Submission

1 Residency of IMR foreign fund that is a corporate limited partnership

In order to be an IMR foreign fund, it is necessary that the entity is not a resident of Australia at any time during the income year (refer section 842-220(a)(i)). The definition of an IMR foreign fund applies for both FIN48 rules and the IMR rules.

It is common for a fund vehicle to be set up as a "corporate limited partnership" within the meaning of Division 5A of the the *Income Tax Assessment Act 1936* (**the 1936 Act**). A limited partnership that is formed outside of Australia may nonetheless be a resident for Australian tax purposes if, inter alia:

- the partnership carries on business in Australia; or
- the partnership's central management and control is in Australia (refer section 94T of the 1936 Act).

Based on the existing tax laws and practices, there is a risk that the investment activities of the entity that is "connected with" Australia could cause the limited partnership to be regarded as carrying on business in Australia.

In relation to the FIN48 rules, we submit that mere investment activities in respect of Australian related assets undertaken by a foreign fund, and which may be seen to generate income with an Australian source, should not result in the foreign fund being regarded as carrying on business in Australia. We submit that this should be clarified by way of example or commentary in the explanatory memorandum (**EM**)..

However, in relation to the IMR rules, we submit that an amendment is required to the definition of residency of a limited partnership contained in section 94T of the 1936 Act. This is because if the limited partnership has some level of presence in or connection with Australia – albeit that those activities may be the carrying on of an eligible investment business and so not a disqualifying activity under section 842-220(b), that carrying on of an eligible investment business, could be sufficient to cause the limited partnership to be seen as carrying on business in Australia – with the result that the limited partnership is to be treated as an Australian resident.

We submit that the current definition of residence of a limited partnership is inappropriate, and should be aligned to that applicable to companies. This issue was noted by the Board of Taxation (**the Board**) in its report[1] and a legislative amendment recommended (refer paragraphs 4.38 to 4.40):

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

[1] Review of an Investment Manager Regime As It Relates to Foreign Managed Funds (August 2011) (**IMR Report**)

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

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

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

We concur with that recommendation and submit that the definition of residence of a limited partnership should be amended, not only for the purposes of the IMR rules but for all Australian tax purposes.

2 Permanent Establishment

The FIN48 rules propose that the potential IMR foreign fund "does not carry on a business in Australia other than carrying on an eligible investment business". Thus, it is clear that the 'mere' carrying on of an eligible investment business is not a disqualifying event. By contrast, in relation to the IMR rules, proposed section 842-235 imposes a requirement that:

- the fund does not have a place of business in Australia; but
- has a permanent establishment solely as a result of engaging an entity that is a resident of Australia to habitually exercise a general authority to negotiate and conclude contracts on behalf of the fund.

However, it is submitted that if a potential IMR foreign fund:

- has a permanent establishment in Australia; and
- is carrying on business in Australia through that permanent establishment; and
- that business is limited solely to carrying on an eligible investment business,

that fund should still qualify as an IMR foreign fund.

If the rules are not applied in this manner, then there is a disincentive for a foreign fund which invests in Australia from establishing an Australian presence which may amount to a permanent establishment. The policy objective should be to encourage foreign investment into Australian assets but also to establish a presence in Australia, in various ways (e.g. employ Australian persons, engage with Australian advisers etc.). To the extent that there is a permanent establishment in Australia, the appropriate result should be that Australia will tax any income/gains connected with that permanent establishment except IMR income.

3 Widely held and concentration tests

3.1 Introduction

The original Government announcements in relation to the FIN48 measures indicated that there would be a requirement that the fund be widely held and not closely held.

Following consultation, the Board also recommended that the widely held requirement should allow tracing through direct investors in a foreign managed fund. The Board comments in the IMR Report that (refer paragraphs 4.71 to 4.72):

> "In implementing a **widely held** requirement, the Board agrees with stakeholders that the **test should capture not only direct investors in a foreign managed fund but should also be able to look through those investors to assess whether the fund is widely held**. The Board also considers that the **look through or tracing rules** should be as simple as possible to create certainty and to not impose undue compliance burdens on foreign managed funds
>
> In designing these tracing rules, an **appropriate starting point may be the widely held requirements in the definition of an Australian MIT**. However, the **MIT tracing rules would need to be modified to ensure that the widely held test can trace through entities with different legal structures** which may invest into the foreign managed fund. The Board understands that the current MIT tracing rules may not allow tracing through entities apart from trusts" [Our emphasis added]

However, we consider that the current widely held and concentration tests in proposed section 842-230 do not adequately implement the stated policy of the Government. This is most evident in cases involving feeder funds which are used to invest in potential IMR foreign funds. The use of feeder funds is an integral part of facilitating the investment by a range of different global investors into a master fund. The rationale for the use of feeder funds is driven by reasons that are not related to Australian tax.

We submit that the Exposure Draft does not adequately "look through" or "trace through" feeder funds, and furthermore, does not fully draw on some of the mechanisms that currently exist in the MIT rules that could be drawn on to address these deficiencies. Examples to illustrate the deficiencies with the proposed section 842-230 are outlined below.

Furthermore, the application of the proposed section 842-230 to a series of fact patterns illustrates that certain fund structures that are economically and commercially equivalent may produce different outcomes, depending on the use of feeder vehicles. In our submission, if a particular case (referred to as the base case) results in a fund being treated as an IMR foreign fund, consistent with the stated policy as proposed section 842-230, then a structure that is economically and commercially equivalent to the base case should also result in a fund being treated as an IMR foreign fund.

With reference to the specific examples, we explain below the issues with proposed section 842-230 (refer **Appendix**).

We agree that the MIT rules serve as a base model to develop appropriate tracing rules. In this regard, all of the existing related concepts should be drawn from the MIT rules and as indicated by the Board, appropriate extensions should be drafted to give effect to the stated policy of the Government.

3.2 Issue 1 – Widely held test: indirect members

3.2.1 Notional member from membership holdings by a specified widely-held entity

The first issue is in respect of the 25 member test in section 842-230(1)(b). This test only looks to the "members" in an entity (i.e. the direct members) and does not allow "indirect members" to be taken into account.

By contrast, the MIT rules have two mechanisms to identify "indirect members".

In determining the number of members in a trust, the MIT rules contain a notional or deemed member concept, where a member of the trust is a listed widely-held entity, as set out in section 12-402(3) of Schedule 1 to the *Taxation Administration Act 1953* (**TAA**). The list of entities in section 842-230(2) consists of some of the same entities that are included in section 12-402(3) of the TAA.

In respect of the notional member concept in the MIT rules, the Revised Explanatory Memorandum to *Tax Laws Amendment (2010 Measures No. 3) Bill 2010* states:

> "5.75 In determining the number of members of the trust for the first criterion [at least 25 wholesale members], **there is a special rule for counting the members of the trust that are specifically listed widely-held entities holding an interest, either directly or indirectly** in the value of, over the control of, or rights to, distributions of, income from the trust.
>
> 5.84 The percentage holding by one of these specifically listed entities is multiplied by 50 (generally the minimum number of members that such an entity must have to qualify as a specifically listed widely-held entity) to provide a **'notional member' number of members**.
>
> 5.87 The effect of this 'notional member' calculation is that a registered trust can qualify as widely held if it has only one member (for tax purposes) and that member is a specifically listed widely-held entity" (*emphasis added*)

It is submitted that the same concept of a notional member should be incorporated into the IMR rules where a foreign widely-held entity is either a direct member or an indirect member.

3.2.2 Appropriate "look through" mechanism

In respect of the MIT rules, the Revised Explanatory Memorandum to the *Tax Laws Amendment (2010 Measures No. 3) Bill 2010* states at paragraph 5.90:

> "To ensure the **appropriate operation of the widely-held test**, two rules apply as follows:
>
> - …
> - The second rule is that if an entity that is not a trust indirectly holds an interest in a trust (the purported MIT) through a chain of trusts, **only the interests of the non-trust entity are taken into account for the purposes of the widely-held test**. That is, the interests of interposed trusts are disregarded *[Schedule 5, item 4, paragraph 12-402A(2)(b)]*" (*emphasis added*)

Further, the concept that the MIT rules has in respect of looking through a "chain of trusts" should be applied to the IMR rules. However, the "look through" mechanism should not apply only to a "chain of trusts" but should apply to other intermediate vehicles. So much is evident in the recommendations made by the Board in the IMR Report (cited above at section 3.1).

Thus, if a feeder fund is a member of a potential IMR foreign fund, and there are, say, 15 direct members in the feeder vehicle, we submit that the interests of the feeder vehicle should be disregarded, and instead the members of the feeder should be treated as members of the potential IMR foreign fund.

3.3 Issue 2 – Widely held test: wholly owned and the interaction of the GP

Section 842-230(1)(d) treats an entity as widely held if it is:

> "wholly owned, directly or indirectly, by one or more entities that satisfy the requirements in paragraph (a), (b) or (c)"

A fund vehicle will often be a limited partnership which has (usually) one general partner and a number of limited partners. The limited partnership interest is typically associated with the external investors, and the general partnership interest is typically associated with the fund manager.

If all the limited partnership interests in a fund were owned by one or more entities with 25 members, it is considered that this should be sufficient to deem the fund to be widely held.

Assume that all of the limited partnership interests are held by one or more entities with at least 25 members. If so, the fund's limited partnership interests are wholly owned (directly or indirectly) by an entity / entities with at least 25 members. If it is also necessary to have regard to the status of the General Partner (**GP**), then different results can apply depending on whether the GP is a wholly owned subsidiary of a listed company.

- The GP may itself be widely held where it is wholly owned (directly or indirectly) by an entity listed for quotation in the official list of an approved stock exchange (e.g., where the GP was a wholly owned subsidiary of a listed financial institution) – refer section 842-230(1)(a) and 842-230(1)(d). In this case, together with all of the limited partnership interests (held by one or more entities with 25 members), it can be concluded that the fund is "wholly owned, directly or indirectly, by one or more entities that satisfy the requirements in paragraph (a), (b) or (c)".

- By contrast, if the GP is not a wholly owned subsidiary of a listed company, it cannot be concluded that the fund is "wholly owned, directly or indirectly, by one or more entities that satisfy the requirements in paragraph (a), (b) or (c)".

It is submitted that the widely held test should focus on the mix and makeup of the limited partners / external investors, and any interest owned by the GP should be disregarded.

3.4 Issue 3 – Widely held test: foreign widely held entities

It is submitted that the list of deemed "foreign widely held entities" should include sovereign wealth funds, similar to Section 12-402(3)(g) of the TAA and other entities as specified by regulations (similar to section 12-402(3)(i) of the TAA).

3.5 Issue 4 – Concentration test

In applying the concentration test under the proposed section 842-230, entities such as IMR foreign funds, or an entity that holds an indirect participation interest in a fund through, say an IMR foreign fund, are disregarded.

Based on this, and the concept of total participation interest, it is evident that in applying the concentration test, we are required to test direct and indirect interests. On the positive side, if for example, a direct interest is held by an IMR foreign fund, then we are not required to look through the IMR foreign fund and test at the level of any indirect interest which may be held via the IMR foreign fund.

However, this requirement to test both direct and indirect interests produces an anomalous outcome where a group of investors (which themselves would pass the concentration test) invest via an entity.

For example, assume that 21 equal investors invested into a fund. Each investor had a 4.76% interest in the fund, such that 10 or fewer entities cannot have an interest of 50% or more. In that case, the concentration test would be passed.

However, if those same 21 equal investors invested into a fund via a feeder:

- an indirect application of the concentration test (i.e., at the level of the 21 investors) would result in the concentration test being passed; but
- the direct application of the concentration test (i.e., at the level of the feeder) would result in the concentration test being failed, as the feeder has 100% of the limited partnership interests.

It is submitted that the appropriate result is that the concentration test should be passed where a feeder is used, and to achieve this result, the direct interest of the feeder should be looked through and ignored. Instead, the indirect interest of the 21 equal investors in the feeder should be the basis for the application of the concentration test.

This same result has been achieved in the MIT rules in respect of a chain of trusts – refer section 12-402B(2) of the TAA.

3.6 Examples 1A to 1E

Set out at the Appendix are a series of examples that demonstrate the inadequacies of the proposed widely held and concentration tests.

Example 1A sets out the base case of 46 limited partner investors investing equally and directly into a fund. In this case, the fund would pass both the widely held test and the concentration test, and so would be an IMR foreign fund.

Examples 1B to 1E are economically and commercially equivalent to the base case.

Example 1B involves all 46 equal limited partner investors investing via two separate feeders (23 investors per feeder), and the two feeders then own 100% of the limited partner interests in Master fund. In this case, it is submitted that the Master fund:

- fails the widely held test – at a direct member level, the fund has only two limited partner members and a general partner member (this is an example of issue 1).
- fails the concentration test – 100% of the partnership interests are held by 3 entities, being the two feeders and the general partner (this is an example of issue 4).

Example 1C involves 40 equal limited partner investors investing via Feeder 1, and the remaining 6 investors investing via Feeder 2. Feeder 1 should:

- qualify as an entity with at least 25 members (refer section 842-230(1)(b));
- pass the concentration test; and
- be an IMR foreign fund.

In this case, it is submitted that the Master fund:

- fails the widely held test – at a direct member level, the fund has only two limited partner members and a general partner member (this is an example of issue 1), and it is not wholly owned by an entity / entities that has at least 25 members.
- fails the concentration test – 100% of the partnership interests are held by 3 entities, being the two feeders and the general partner (this is an example of issue 4).

Example 1D involves 40 equal limited partner investors investing via Feeder 1, and the remaining 6 investors investing directly in the Master fund. The analysis of Feeder 1 is as per Example 1C. In this case, it is submitted that the Master fund:

- fails the widely held test – at a direct member level, the fund has only seven limited partner members and a general partner member (this is an example of issue 1), and it is not wholly owned by an entity / entities that has at least 25 members.
- fails the concentration test – 100% of the partnership interests are held by 8 entities, being the six direct investors, the Feeder and the general partner (this is an example of issue 4).

Example 1E involves all 46 equal limited partner investors investing via a single feeder. The analysis of Feeder 1 is as per Example 1C. In this case, it is submitted that the Master fund:

- fails the widely held test if it is necessary to take into account the GP interest and the GP is not an IMR foreign fund.
    - If GP is a wholly owned subsidiary of a listed entity, then GP should be taken to pass the widely held test (refer sections 842-230(1)(d) and (a)). Further, Feeder 1 passes the widely held test (refer sections 842-230(1)(d) and (a)). As GP and Feeder 1 own all of the partnership interests, the fund should be wholly owned by two entities which are themselves “widely held”.

- If GP is not a wholly owned subsidiary of a listed entity, but it is necessary to take into account the GP interest, then it cannot be said that all of the partnership interests of the fund are wholly owned by entities which are themselves widely held

- passes the concentration test – As Feeder 1 should qualify as an IMR foreign fund, it should not be counted for the purposes of the concentration test.

In respect of Example 1E, it is submitted that the conclusion should not differ depending on whether or not the GP is a wholly owned subsidiary of a listed entity. The widely held test should focus on the makeup and mix of the limited partners.

It is submitted that economically and commercially, all of the scenarios above are equivalent to the base case. The base case passes the widely held and concentration tests such that the fund is an IMR foreign fund. It is submitted that the Master fund in Examples 1B to 1E should qualify as an IMR foreign fund.

3.7 Examples 2A and 2B

Example 2A involves a "foreign widely held entity" being a foreign superannuation fund holding 26% of the limited partner interests in the Master fund. The remaining 74% is held by 21 limited partner investors investing equally and directly into a fund.

In this case, it is submitted that the Master fund:

- passes the widely held test – due to the greater than 25% interest held by the foreign superannuation fund. In this regard, it is noted that whilst the foreign superannuation fund(s) holds 26% of the limited partner interests in the Master fund, it is strictly necessary to compute the "total participation interest" of the foreign superannuation fund and the rights held by the GP will need to be analysed in detail to ensure that the foreign superannuation fund maintains the requisite percentage.

- passes the concentration test – ignoring the interest held by the foreign superannuation fund, it should not be the case that 10 or fewer of the remaining members have an interest of 50% or more.

Example 2B shows a small dilution of the foreign superannuation fund holding to 24% of the limited partner interests in the Master fund. The remaining 76% is held by 21 limited partner investors investing equally and directly into the fund.

When testing under section 842-230(1)(b), the fund has only 22 limited partner members and a GP member.

In regards to the concentration test, the Master fund in Example 2B should pass that, similar to Example 2A.

It is an anomalous outcome that a small dilution in the interest of a deemed "widely held foreign entity" (as compared to Example 2A) has the result that not only is it no longer the case that the foreign superannuation fund has an interest of more than 25%, but for the purpose of a "headcount test", under Section 842-230(1)(b), the foreign superannuation fund counts as only 1 member.

It is submitted that a deemed "widely held foreign entity" should itself be treated as certain number of deemed or notional members in the fund, similar to the MIT rules. We refer to our comments above at 3.2.1. If the MIT concepts are imported into the IMR rules, a foreign superannuation fund with say a 24% interest

in a fund should count as 12 members. In that case, the Master fund in Example 2B should qualify as widely held fund.

* * *

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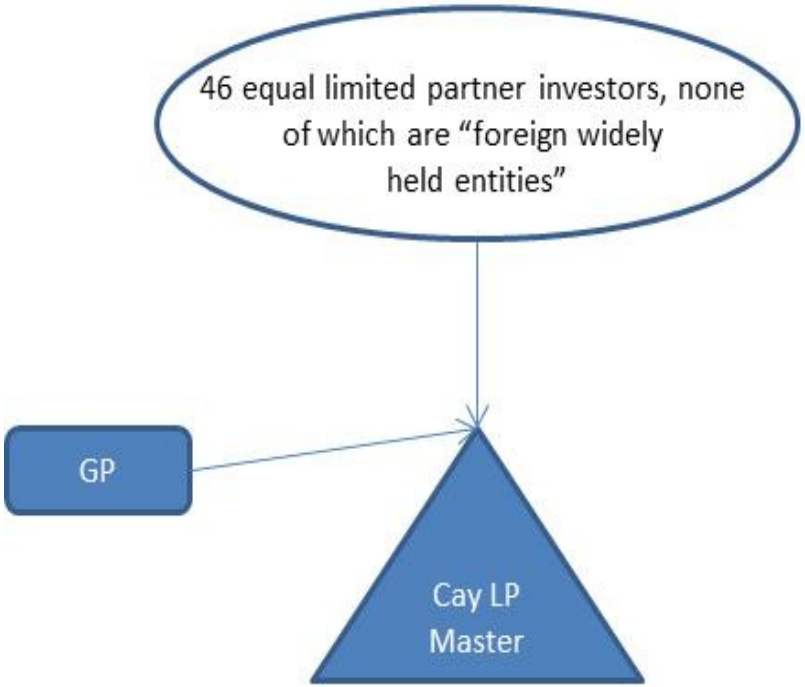
Appendix

Example 1A



Assumptions:

- **Commercially, examples 1A – 1E are the same**
- All investors have equal stakes, unless otherwise noted
- GP vehicles are not 100% owned, directly or indirectly by a listed vehicle and is not otherwise an "IMR foreign fund"
- Master is not >25% owned, directly or indirectly by "foreign widely held entities"

Conclusion:

Cay LP Master

- Passes the widely held test
- Passes the concentration test

* = percentage of the LP interest

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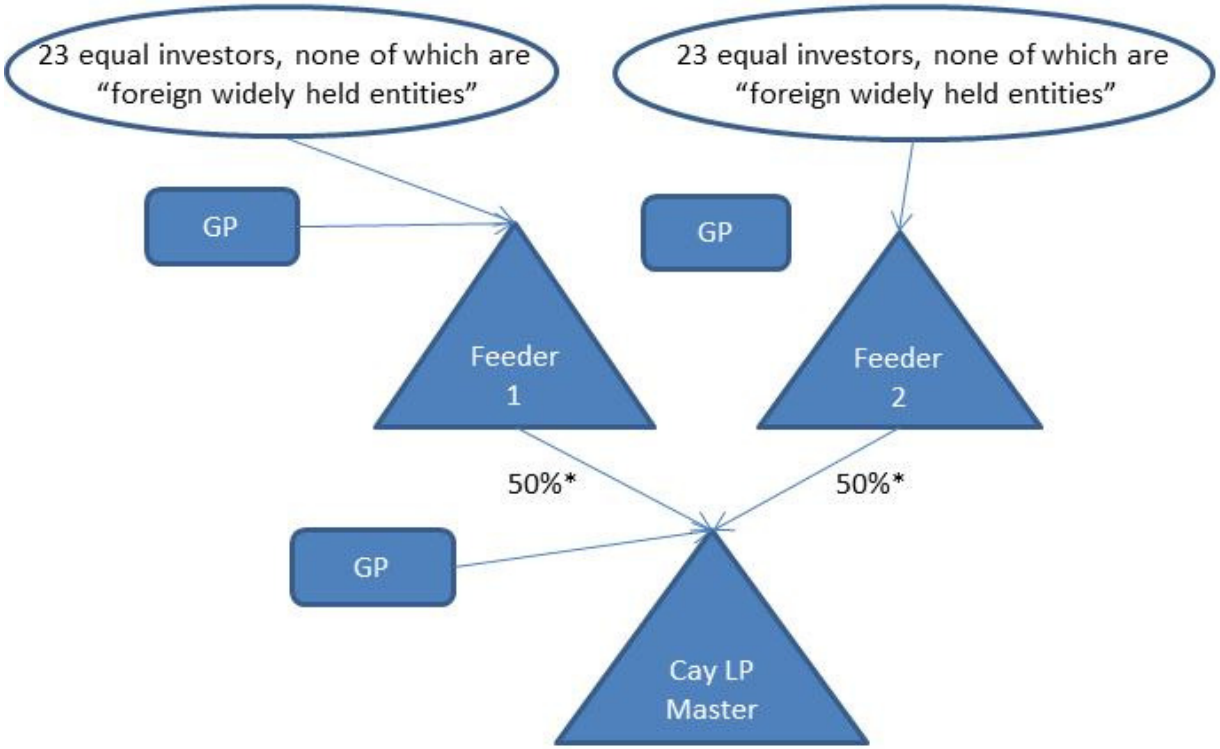
Example 1B



Assumptions:

- **Commercially, examples 1A – 1E are the same**
- All investors have equal stakes, unless otherwise noted
- GP vehicles are not 100% owned, directly or indirectly by a listed vehicle and is not otherwise an "IMR foreign fund"
- Master is not >25% owned, directly or indirectly by "foreign widely held entities"

Conclusion:

Feeders

- **Fail** the widely held test
- Pass the concentration test

Cay LP Master

- **Fails** the widely held test
  - Feeder LPs are not IMR funds
- **Fails** the concentration test
  - 2 LP members + GP member own all interests

* = percentage of the LP interest

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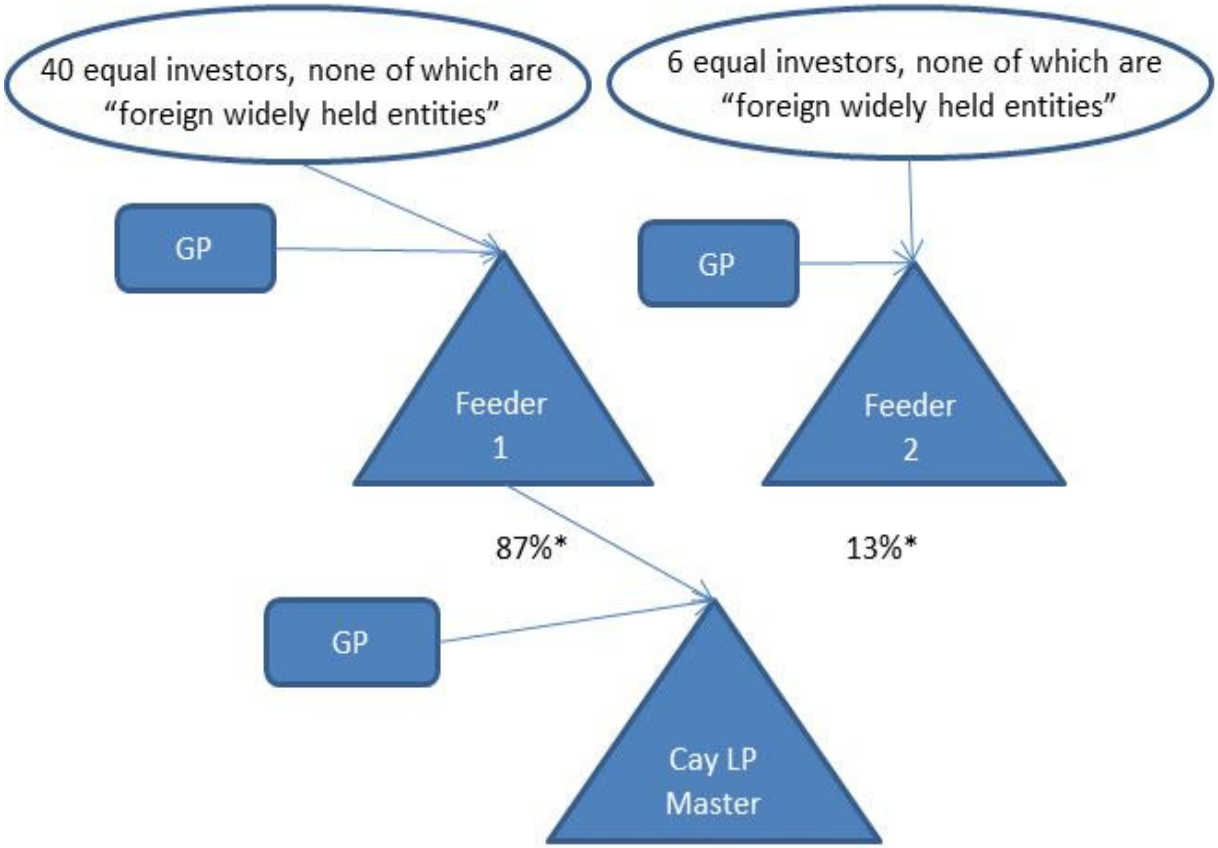
Example 1C



Assumptions:

- **Commercially, examples 1A – 1E are the same**
- All investors have equal stakes, unless otherwise noted
- GP vehicles are not 100% owned, directly or indirectly by a listed vehicle and is not otherwise an "IMR foreign fund"
- Master is not >25% owned, directly or indirectly by "foreign widely held entities"

Conclusion:

Feeder 2

- Fails the widely held test
- Fails the concentration test

Cay LP Master

- Fails the widely held test
- Passes the concentration test
    - do not count Feeder 1

* = percentage of the LP interest

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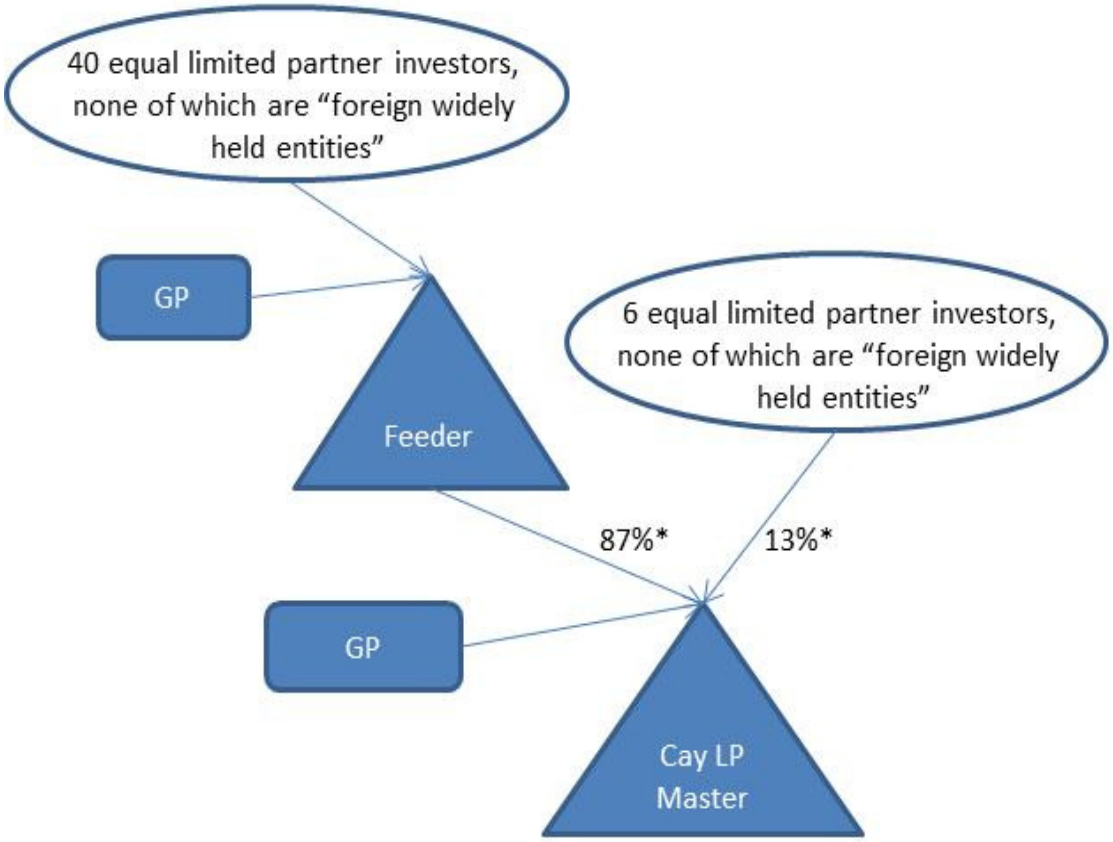
Example 1D



Assumptions:

- **Commercially, examples 1A – 1E are the same**
- All investors have equal stakes, unless otherwise noted
- GP vehicles are not 100% owned, directly or indirectly by a listed vehicle and is not otherwise an "IMR foreign fund"
- Master is not >25% owned, directly or indirectly by "foreign widely held entities"

Conclusion:

Feeder

- Fails the widely held test
- Passes the concentration test

Cay LP Master

- **Fails** the widely held test
- **Fails** the concentration test

* = percentage of the LP interest

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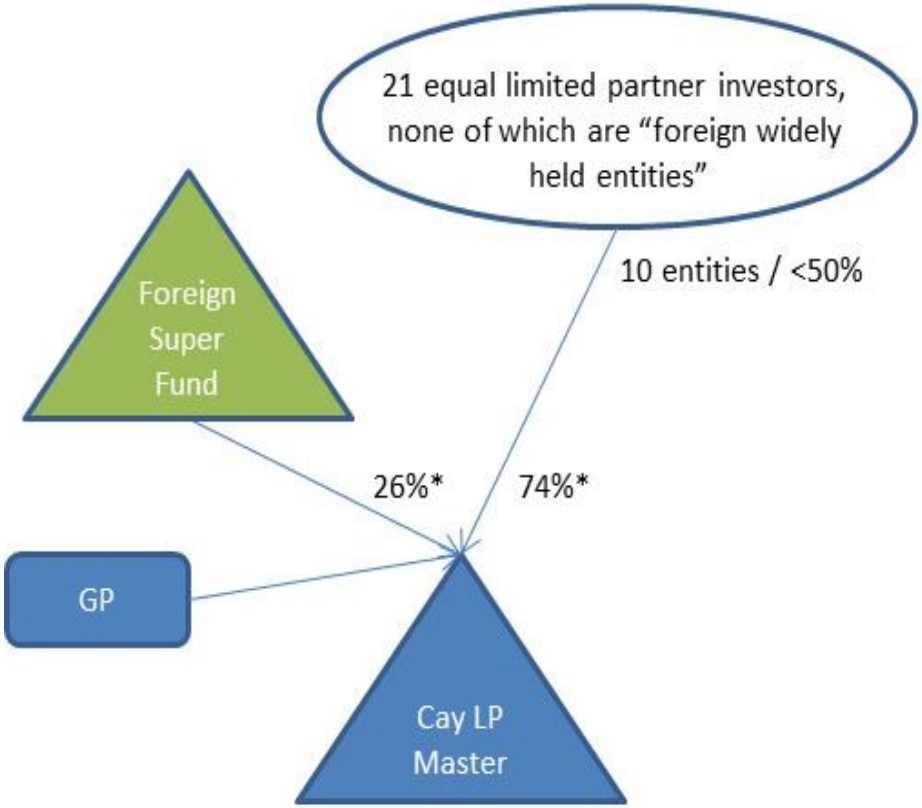
Example 2A



Assumptions:

- All investors have equal stakes, unless otherwise noted
- GP vehicles are not 100% owned, directly or indirectly by a listed vehicle and is not otherwise an "IMR foreign fund"
- Master is >25% owned, directly or indirectly by "foreign widely held entities"

Conclusion:

Cay LP Master

- Passes the widely held test
- Passes the concentration test

* = percentage of the LP interest

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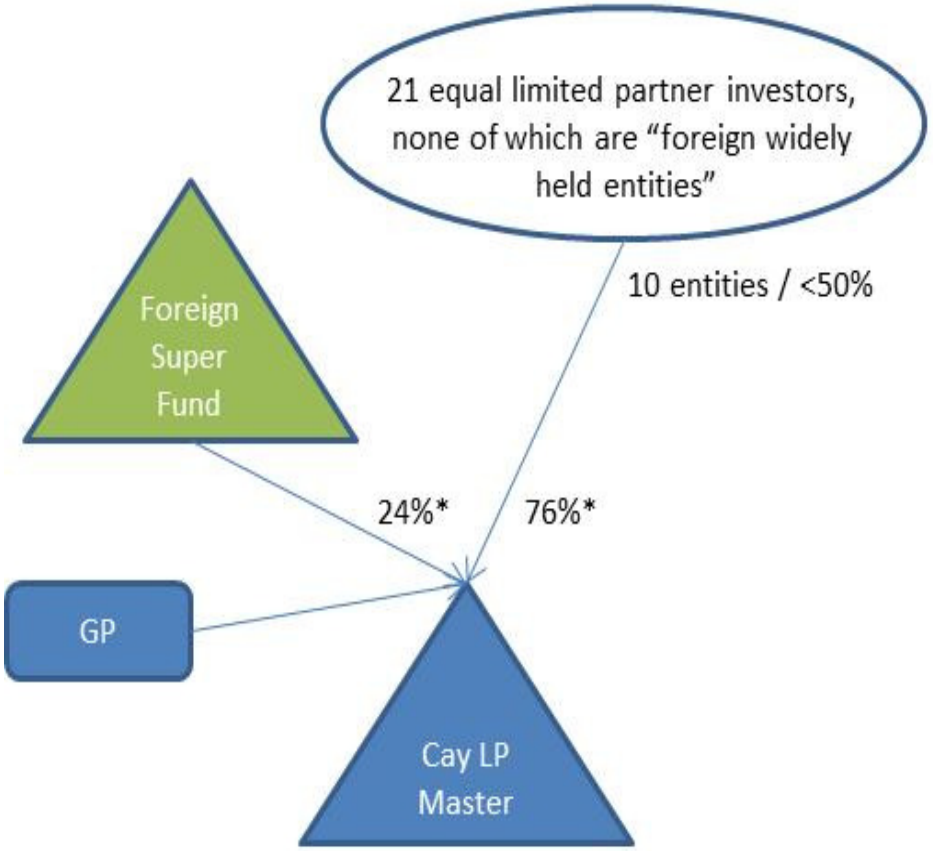
Example 2B



Assumptions:

- All investors have equal stakes, unless otherwise noted
- GP vehicles are not 100% owned, directly or indirectly by a listed vehicle and is not otherwise an "IMR foreign fund"
- Master is >25% owned, directly or indirectly by "foreign widely held entities"

Conclusion:

Cay LP Master

- Fails the widely held test
- Passes the concentration test

* = percentage of the LP interest