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Corporate Tax Residency

FSC submission to Board of Tax

October 2019

FSC FINANCIAL SERVICES COUNCIL

Contents

1 About the Financial Services Council 3

2 Introduction 3

3 Answers to questions 3

4 Tax residency of non-corporate entities 6

4.1.1 Impact on corporate structures under development 7

4.2 Preferred approach – legal incorporation 7

4.3 Alternatives 8

5 Australia's Investment Manager Regime 8

6 Problems caused by a managed fund becoming an Australian tax resident 9

6.1 Corporate managed funds: loss of flowthrough tax status 10

6.2 Managed funds that are trusts 11

6.2.1 Treaty issues 11

6.3 Foreign exchange hedging 12

6.4 Gains on bond sales 12

6.5 Narrow eligibility for functional currency election 13

6.6 Australian taxation of foreign capital gains 13

6.7 Costs to avoid reclassification as Australian tax resident 13

7 General reasons for reform 14

FSC FINANCIAL SERVICES COUNCIL

1 About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2 Introduction

The FSC welcomes the opportunity to make a submission to the Board of Tax (**the Board**) on the Australian corporate tax residency rules, which are of importance to a number of fund managers. The main focus of this submission is on residency issues relating to funds management, with some general comments on the issues relating to residency in Section 6.7 below.

3 Answers to questions

The FSC's response to the Board's questions are summarised below. The details of the response are in the remainder of this submission.

Consultation question 1: The Board seeks stakeholder comment on the difficulties associated with the central management and control test that have been discussed in Chapter 5 so far, and whether there are additional difficulties with the test that the Board's attention should be drawn to (particularly if such difficulties are attributable to matters other than board practices and if they arise in the context of an inward investing corporate structure).

FSC response: The Central Management and Control (**CM&C**) test has caused considerable problems for the managed funds industry, particularly for managed funds that are legally established overseas and have an Australian manager. For these funds, the ATO's interpretation of the CM&C test is considerably reducing if not negating the benefits of the Investment Manager Regime (**IMR**), which is meant to ensure that a foreign managed fund will not be subject to Australian tax solely because it appoints an independent Australian fund manager.

See Section 5 of this submission.

Consultation question 2 The Board seeks stakeholder comment on the primary theme that has informed the discussion under Part 4 of Chapter 5, being whether certain subsequent

additions to the income tax legislation have imported at least some degree of redundancy into the central management and control test.

FSC response: The FSC supports this position. We understand this issue is addressed in more detail in other submissions to this review.

The Board also seeks stakeholder assistance in identifying instances in which any other part of the income tax legislation produces different tax outcomes that are dependent on whether a foreign incorporated subsidiary company is, or is not, an Australian resident under the central management and control test.

FSC response: A foreign managed fund that is unexpectedly reclassified as an Australian resident for tax purposes could be faced with many detrimental tax outcomes, including:

- Australian corporate tax being imposed on income of the fund where this would not otherwise apply under tax rules including the Investment Manager Regime. The Australian rate of corporate tax is particularly high by global standards.
- Imposition of inappropriate tax relating to: loss of flowthrough tax status (ie loss of tax transparency); foreign exchange hedging; gains on bond sales.
- Uncertain and potentially inappropriate taxation of non-Australian capital gains.
- Penalties from a failure to lodge historical Australian tax returns – for a large fund, or a fund that is part of a large group, these penalties could be extremely large due to the application of the Significant Global Entity (SGE) provisions.
- Tax specifically arising from change in residency, potentially including capital gains tax on deemed disposal of assets.

While the question is specifically about corporates, there are also significant problems for trust entities – a foreign trust that is reclassified as an Australian tax resident faces other detrimental tax outcomes, including:

- complex eligibility tests for MIT/AMIT status, and extra tax if the fund is unable to meet these tests.
- lack of access to treaty benefits.
- new complex rules about withholding tax which generally apply a high tax rate (30%) to income relating to residential property (except affordable residential property) and agricultural property.
- potentially the loss of the capital gains discount for trusts that are MITs/AMITs.
- Inability to use a non-Australian currency as the functional currency for tax purposes (or high compliance costs of electing into this option).
- The imposition of inappropriate tax relating to foreign exchange hedging and gains on bond sales
- Penalties from a failure to lodge historical Australian tax returns and tax specifically arising from change in residency (as detailed above at the start of this answer).

The size of these likely costs means fund managers will probably take strong preventative measures to reduce or eliminate the risks of reclassification as an Australian tax resident

FSC FINANCIAL SERVICES COUNCIL

which will discourage foreign funds using Australian fund managers, at a cost to the Australian economy.

For more detail see Section 6 of this submission.

Consultation question 3 The Board seeks stakeholder comment on whether the central management and control test should be replaced with an alternative test that features place of effective management. The Board is particularly interested in how place of effective management would increase commercial certainty and align with modern corporate practices, whilst maintaining integrity of the rules as they apply to multinational corporations.

FSC response: The FSC does not consider a change in the test to an 'effective management' test is warranted on its own, because the tiebreaker rules for effective management take too long to resolve, and the CM&C test has significant Australian legal precedent while 'effective management' does not.

See Section 4.3 of this submission.

Consultation question 4 The Board seeks stakeholder comment on whether there are criteria other than central management and control or place of effective management that could be used to establish corporate residency. The Board is particularly interested in how alternatives would increase commercial certainty and align with modern corporate practices, whilst maintaining integrity of the rules as they apply to multinational corporations.

Consultation question 5 The Board seeks stakeholder comment on whether an incorporation only test should be used as the sole basis for establishing corporate residency.

FSC response: The FSC's preferred approach is an incorporation test alone, which would provide greatly increased certainty for the funds management industry. Additional rules should be unnecessary – the ATO's wide-ranging suite of measures as well as global BEPS measures should be sufficient to address the risks to revenue relating to residency.

If there is a need for an additional anti avoidance rule relating to residency, we consider this should be highly targeted at clearly contrived arrangements to avoid residency rules only.

If the CM&C test is retained, then the FSC recommends:

- A renewed focus on the 'carrying on business in Australia' limb of the test through a clarifying legislative change or interpretive guidance.
- any changes to the test ensure that the appointment of an Australian manager to a foreign managed fund does not result in a foreign fund being reclassified as an Australian resident for the purposes of the Investment Manager Regime (IMR).
- the CM&C test be clarified to indicate CM&C can only occur in one place.
- Provisions that result in unpredictable and frequent changes in CM&C should be avoided.

See Sections 4.2 and 4.3 of this submission.

FINANCIAL SERVICES COUNCIL

Any proposal should take into account the OECD work program on the taxation of the digitalizing economy.

Consultation question 6 The Board also seeks stakeholder comment on whether there is a compelling basis for retaining the second limb of the test for corporate residence (under which a company is a resident if it carries on business in Australia and has its voting power controlled by shareholders who are residents of Australia) in the event that the central management and control test is replaced with an alternative test.

FSC response: The FSC can see no compelling reason to retain the voting power test as it is not relied on to any significant extent.

4 Tax residency of non-corporate entities

The focus of the Board's review is on Australia's tax residency rules relating to corporates. However, fund managers make use of a range of other legal structures for which tax residency is an important issue.

The following table shows the different way the residency test applies to other structures, including the different ways the CM&C test is used for these structures.

Table 1 – Australian tax treatment of various entities

Vehicle	How generally taxed in Australia	Residency test currently applied
Trust	Generally as a trust – ie flowthrough tax status (Div 6 of Part III of the ITAA 1936 or AMIT provisions as relevant)	Where at any time in the income year: • Trustee was a resident of Australia; or • CM&C of the trust was in Australia
Corporate Limited Partnership	As a company	Partnership was formed in Australia; or Partnership either carries on business or has its CM&C in Australia
Foreign Hybrid Limited Partnership	As a partnership	See Corporate Limited Partnership above
Foreign Hybrid Company	As a partnership	Corporate residency requirements

For consistency, the FSC considers any change proposed by the Board relating to 'standard' corporate entities should also apply across all other relevant legal structures – otherwise this could:

FSC FINANCIAL SERVICES COUNCIL

- increase complexity and costs for taxpayers using these structures, and for investors in those structures;
- mean any benefits from the change are not available to these structures; and
- increase risks of tax arbitrage based on the different tax treatments of the structures.

4.1.1 Impact on corporate structures under development

The Government is currently developing a Corporate Collective Investment Vehicle (**CCIV**) and has made a commitment to develop a new Corporate Limited Partnership (**CLP**) vehicle. These two structures are likely to use the same residency test as a 'standard' corporate, and hence would be directly affected by any change proposed by the Board. However, the likely takeup of these two new structures is quite uncertain.[1]

Regardless, as stated earlier we consider the Board's proposed changes should apply to all structures used by managed funds, including trusts as well as corporate entities.

4.2 Preferred approach – legal incorporation

Australian fund management vehicles face significant issues from Australia's tax rules producing uncertain or inappropriate results, and cause high compliance costs. These rules will also have adverse effects on foreign funds that are reclassified as Australian tax residents. These issues are discussed in more detail in Sections 5 and 6 of this submission.

The FSC argues these numerous issues should be addressed directly.

However, as long as these issues remain unaddressed, it then becomes more important to resolve the problems relating to tax residency.

The FSC's preferred solution to the residency problems is to move to a legal incorporation test. This test would mean significant improvements in certainty for managed funds. As noted in the Board's discussion paper, the ATO currently has a wide-ranging suite of measures to address the risks to revenue relating to residency. If there is a need for an additional anti-avoidance measure, we consider this should be highly targeted at clearly contrived arrangements to avoid the application of the residency rules only.

We understand that moving to a legal incorporation test might mean there are some companies that need to change their place of incorporation from Australia to another jurisdiction. This is because these companies are incorporated in Australia, but are treated as non-Australian for tax purposes – these companies will need to move their incorporation overseas to comply with the new residency rule.

To address this situation, there could be a special rule applying to entities that are (a) legally established in Australia; but (b) not Australian tax residents under the current rules. For

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[1] The FSC has raised concerns with the proposed tax treatment of the CCIV which may limit the takeup of the structure, see: https://fsc.org.au/resources/1719-fsc-submission-cciv-draft-2019-01-tax/file

FINANCIAL SERVICES COUNCIL

these entities, their existing tax residency status could be retained for a reasonable transition period.

4.3 Alternatives

The Board's discussion paper raises an alternative 'effective management' test. On the one hand, this test would improve on the CM&C test because effective management can only be in one place, whereas CM&C can be in more than one place. However, the tiebreaker rules for effective management can take significant time to resolve between jurisdictions, and the CM&C test has significant Australian legal precedent while effective management does not. On this basis, the FSC does not consider a change in the test to an 'effective management' test, on its own, is warranted.

However, if the CM&C test is retained in some form, then the FSC recommends:

- any changes to the test ensure that the appointment of an Australian manager to a foreign managed fund does not on its own result in a foreign fund becoming an Australian resident for the purposes of the Investment Manager Regime (this issue is discussed in Section 5 below).
  - The FSC recommends a CM&C test that would either deal with this issue in all cases, or includes a specific exception designed for widely held managed funds.
- renewed emphasis on the 'carrying on business in Australia' limb of the test via either clarifying legislative change or interpretive guidance. The ATO's recently amended views on the CM&C (in TR 2018/5 and PCG 2018/9) result in this limb of the CM&C being largely redundant.
- the CM&C test be clarified to indicate CM&C can only occur in one place.
- provisions that result in unpredictable and frequent changes in CM&C should be avoided.

5 Australia's Investment Manager Regime

The Investment Manager Regime (**IMR**) was introduced to reduce the risks that non-resident investors, including foreign managed funds, would be inappropriately subject to Australian tax.

The IMR should broadly operate so that a foreign managed fund will not be subject to Australian tax solely because it appoints an independent Australian fund manager. Without the IMR, a foreign fund using an Australian fund manager could be considered to have a Permanent Establishment (**PE**) in Australia, which may result in all its income being subject to Australian tax.

However, following the *Bywater Investments* decision, the ATO has argued that foreign funds engaging an Australian fund manager may now be treated as Australian tax residents. In effect, the ATO's interpretation of the CM&C rules is considerably reducing, if not negating, the benefits of the IMR. The FSC's concerns with the ATO compliance actions are explained in the letter to the Government at Attachment A.

FSC FINANCIAL SERVICES COUNCIL

In response to these concerns, on 19 July 2017 the then Minister for Revenue and Financial Services stated:

> "The Government is committed to implementing an effective IMR whilst maintaining the integrity of our residency rules. The Government will therefore consult on whether a legislative amendment is required to ensure that the engagement of an Australian independent fund manager will not cause a fund that is legitimately established and controlled offshore to be an Australian resident. Any legislative amendment would be retrospective to apply from the start of the IMR regime in 2015".[2]

The FSC considers a legislative change is required to reduce or remove the uncertainty for the funds management industry, and remove a barrier to opportunities for Australian fund managers to export their services. However, this issue remains unresolved.

In relation to the current review by the Board, we recommend any tax residency rule should ensure that a foreign managed fund does not become an Australian resident for tax purposes merely because it engages an Australian fund manager. The FSC's preferred approach to residency, a legal incorporation test, would achieve this outcome. If the Board adopts a different approach, we recommend a test that would either deal with this issue in all cases, or includes a specific exception designed for widely held managed funds.

A change to the tax residency rules along these lines should address the specific issues with the IMR outlined above.

6 Problems caused by a managed fund becoming an Australian tax resident

The Board has requested feedback on the situations where an entity becoming an Australian tax resident would result in inappropriate tax outcomes.

In most cases, non-Australian income earned by a managed fund that is passed to a non-Australian investor is exempt from withholding tax through the conduit foreign income rules. However, the withholding tax does apply to many types of Australian source income, which would form part of the portfolio of many global funds (particularly if they have an Australian manager). The rules are complex and contain many exemptions, meaning the actual effective tax rate is not that high, but the compliance costs are considerable.

A study by KPMG summarises the tax treatment of non-resident retail investors for funds domiciled in various jurisdictions (with Australia highlighted):[3]

[2] See: http://ministers.treasury.gov.au/ministers/kelly-odwyer-2016/media-releases/improving-australias-financial-services-taxation-regime

[3] See slide 18 of: https://treasury.gov.au/sites/default/files/2019-03/C2016-052_Financial-Services-Council-attachment.pdf

FSC FINANCIAL SERVICES COUNCIL

Table 2 – taxation of non-resident investors in managed funds

Domicile	Tax treatment
Luxembourg, Ireland, Hong Kong, Singapore	Tax neutral: • No tax at fund or investor level • No complex qualifying or calculation rules to achieve neutrality • Wide choice of funds
UK, Malaysia	Tax neutral but complex: • Complex calculation rules to achieve neutrality
China, **Australia**, Thailand, NZ, South Korea, Philippines	Not tax neutral and/or complex/uncertainty: • Tax at fund and/or investor level • Complex qualifying rules (eg Australian MIT rules) • Uncertainty in tax treatment

The above analysis means it is particularly risky for a fund from a neutral jurisdiction to be reclassified as an Australian taxpayer.

The issues are outlined in the remainder of this section.

6.1 Corporate managed funds: loss of flowthrough tax status

A foreign managed fund that is 'tax transparent' (ie a flowthrough tax vehicle) in the relevant foreign jurisdiction may not have that same status for Australian tax purposes if it becomes an Australian tax resident. In particular, companies and Corporate Limited Partnerships are not treated as tax transparent under Australian tax law (see Table 1 above). It is common for managed funds to operate through these types of entities in some jurisdictions.

In broad terms, flowthrough status is more important in jurisdictions that tax managed funds in some circumstances (such as Australia) and less important in jurisdictions that exempt managed funds from tax (such as Singapore – see Table 2).

For Australian managed funds, tax transparency is essential to ensure direct investment is taxed the same way as indirect investment through an Australian managed fund. For example, an investor receiving capital gains directly is similarly treated as if they received the same capital gain indirectly through a managed fund.

The loss of tax transparency would remove this equivalency and often result in different tax treatments. If a foreign jurisdiction provides a lower tax rate on capital gains, then this discount would be available to investors from that jurisdiction if they invest directly, or if they invest indirectly through non-resident tax transparent entities, but not through a corporate or limited partnership that has been deemed to be an Australian tax resident.

We also note that a foreign corporate entity that is reclassified as an Australian tax resident and becomes subject to corporate tax on its global income will (for larger funds) be taxed at one of the highest corporate tax rates in the world, well above the OECD average, regional

averages, and world averages; and the third highest effective marginal tax rate of the 74 countries included in a recent OECD report on corporate taxes.[4]

6.2 Managed funds that are trusts

Because most trusts are taxed on a flowthrough basis in Australia, a foreign managed fund that is a trust will likely be treated as flowthrough if it is reclassified as an Australian resident. This is a less adverse result than a corporate managed fund that would not be able to access that treatment.

There are nevertheless a variety of tax treatments applying to trusts in Australia:

- A Managed Investment Trust (MIT) is a flowthrough vehicle that can obtain lower rates of withholding tax, unavailable to other trusts.
- An Attribution Managed Investment Trust (AMIT) has the features of a MIT and in addition is afforded other concessions that are beneficial for the operation of managed funds.[5]
- All types of trust can make use of the capital gains tax discount, although the Government has announced it will remove the discount for MITs and AMITs.[6]
    - The FSC has made several submissions strongly opposing this proposal.[7] If this proposal proceeds, it will mean Australian resident investors into MITs and AMITs will likely be overtaxed on gains made collectively through MITs and AMITs in comparison to deriving those gains directly.

A foreign trust that is reclassified as an Australian tax resident would need to meet fairly complex eligibility rules to be classified as a MIT or AMIT. If the trust cannot meet these tests, it will be subject to higher rates of withholding tax on a broader range of income; and if the trust cannot meet the AMIT eligibility tests it will be ineligible to use the other specific AMIT concessions.

6.2.1 Treaty issues

Some Australian tax treaties do not provide full treaty benefits for trusts, which are the overwhelming structure used for managed funds in Australia. A foreign managed fund that is a trust would face this issue if it is reclassified as an Australian resident for tax purposes (foreign managed funds that use other types of legal structures face the issues outlined in Section 6.1 above).

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[4] See Figures 4, 7 and 10 of OECD Corporate Tax Statistics, available from: https://www.oecd.org/tax/tax-policy/corporate-tax-statistics-database-first-edition.pdf
[5] See: https://www.ato.gov.au/General/Trusts/In-detail/Managed-investment-trusts/Managed-investment-trusts---overview/?page=7
[6] See 2018-19 Budget, page 44 of Budget Paper 2.
[7] See for example Section 5 of: https://fsc.org.au/resources/1719-fsc-submission-cciv-draft-2019-01-tax/file

The FSC's concerns with tax treaties are explained in more detail in the FSC 2018–19 Pre-Budget submission.[8]

6.3 Foreign exchange hedging

Australia currently imposes inappropriate tax on Australian managed funds relating to foreign exchange hedging.

Under Australia's current Taxation of Financial Arrangement (**TOFA**) rules, hedging gains/profits are normally treated as being on revenue account and therefore potentially bear withholding tax. This hedging is normally related to the holding of foreign assets which generate income and gains that are exempt from withholding tax. A key principle is that hedging contracts should be taxed the same as the asset they hedge – if the underlying asset is exempt from tax, then so should the hedge. However, this is not what the current rules deliver.

One of Korea's largest investment managers has specifically raised the issue of Australia's taxation treatment of foreign exchange hedging being a barrier to offering their Australian asset funds in Korean won.

Acknowledging these concerns, the 2016–17 Budget made a commitment to simplified TOFA rules including: "A new tax hedging regime which is easier to access, encompasses more types of risk management arrangements (including risk management of a portfolio of assets) and removes the direct link to financial accounting."

However, this issue remains unaddressed, and is another reason why a foreign fund becoming an Australian taxpayer would result in additional inappropriate taxation.

6.4 Gains on bond sales

Another area where Australian managed funds can be subject to inappropriate taxation is the tax on gains (or profits) on the sale of bonds. These gains normally reflect an interest rate movement, meaning the gains are economically equivalent to interest.

However, for Australian funds the gains can be treated as ordinary income for withholding tax purposes and can therefore be subject to withholding tax. This means in particular:

- The withholding tax on interest is 10%, however the bond profit would likely be subject to withholding tax at 15%, which is the rate applying to ordinary income.
- Many bonds are exempt from withholding tax under section 128F, but it is unclear if bond profits on these securities are also exempt.

This inappropriate taxation result would apply to a foreign fund that is reclassified as an Australian taxpayer.

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[8] See https://fsc.org.au/resources/726-2017-12-22-fsc-2019-pre-budget-submission-final-combined/file

6.5 Narrow eligibility for functional currency election

The current tax rules about using a foreign currency to calculate net income are very restrictive, resulting in high costs of compliance.

This is a particular issue for foreign managed funds, if the fund is reclassified as an Australian taxpayer, because the fund will most likely calculate income in a currency other than the Australian dollar.

Recognising this issue, the 2011–12 Budget announced the then Government would allow "certain trusts and partnerships that keep their accounts solely or predominantly in a particular foreign currency to calculate their net income by reference to that currency." The current Government announced in 2013 it would proceed with this measure[9] and recommitted to this in the 2016–17 Budget. The measure remains unenacted.

6.6 Australian taxation of foreign capital gains

A recent court case, *Burton v Commissioner* decision of the Full Federal Court,[10] has created considerably uncertainty about the tax treatment of foreign capital gains, and if applied broadly could result in Australian taxpayers (including managed funds) paying excessive rate of tax on non-Australian capital gains.

The *Burton v Commissioner* decision reduced the taxpayer's Foreign Income Tax Offset (**FITO**) to the extent the taxpayer was able to access the CGT discount. This decision runs contrary to a tax policy principle that the Australian tax on foreign income should be no greater than either the foreign tax on the income, or the Australian tax that would apply if the income was subject to Australian tax only.

If the decision is applied to all Australian taxpayers with foreign capital gains, this could substantially increase compliance burdens for Australian-based global funds. The issue would be even more problematic if it is applied to all foreign income, including income that is not from capital gains.

This is another case where reclassifying a foreign managed fund as an Australian resident could result in the imposition of incorrect levels of tax.

6.7 Costs to avoid reclassification as Australian tax resident

A foreign fund that is reclassified as an Australian tax resident is likely to face many tax and compliance costs as outlined above. The significance of these costs means fund managers are likely to take strong preventative measures to ensure the risks of reclassification as an Australian tax resident are reduced or eliminated. These will come at substantial costs to either the Australian economy or to the fund:

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[9] http://ministers.treasury.gov.au/ministers/arthur-sinodinos-2013/media-releases/integrity-restored-australias-taxation-system

[10] See https://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/full/2019/2019fcafc0141

- The risk is largely eliminated if a foreign fund does not appoint an Australian manager – but this option comes at a large cost to the Australian economy.
- If a foreign fund *does* have an Australian manager, then the preventative measures, such as flying directors out of Australia for meetings, are unnecessary and burdensome costs on the fund.

7 General reasons for reform

In addition to the issues specific to funds management, we note a number of other arguments for reform of the tax residency rules have been raised by the Board and other participants, including the following:

- For some larger Australian businesses, reclassifying a related entity as an Australian taxpayer could result in the imposition of extremely large, and clearly unwarranted, penalties for the failure to submit historical tax returns.
- Multiple changes in residency are likely to mean the cancellation of carry forward losses in at least one jurisdiction and potentially multiple deemed realisation events for CGT.
- The interpretation of the residency test since *Bywater* focusses on the CM&C element more than the carrying on a business element. This however means foreign wholly owned subsidiaries of an Australian business could fail the CM&C test (as good corporate governance would likely mean the CM&C of these businesses is in Australia). Reclassifying most or all foreign subsidiaries as Australian residents is clearly the wrong policy outcome.

Attachment A

Mr. Andrew Mills
Second Commissioner
Law Design and Practice
Australian Taxation Office

11 May 2017

Sent via email to: Andrew.Mills@ato.gov.au

Dear Andrew

RE: ATO Audit Activity and the Investment Manager Regime

I am writing to you to inform you of recent ATO audit activity which is of significant concern to the FSC members and which we believe is contrary to the policy of the Investment Manager Regime (IMR) contained in Subdivision 842-I of the ITAA 1997.

Background

In 2016 the ATO commenced auditing the tax affairs of a Cayman Limited Partnership (with only non- resident investors (and primarily US based)) which had appointed an Australian investment manager. The ATO has focused on the issue of whether the appointment of the Australian manager and its funds management activities in Australia has resulted in the Cayman LP becoming a resident of Australia for tax purposes thus subjecting its entire taxable income to 30% Australian corporate income tax.

The ATO issued a Position Paper in April 2017 arguing that the Cayman LP was a tax resident of Australia under s 94T of the ITAA 1936 and therefore it was subject to Australian income tax on its worldwide taxable income in relation to the 2010 -2012 years of income. The audit has reached the stage that negotiations have commenced as to how the ATO can take a security interest over the Cayman LP's assets.

It should be noted that but for this "residence issue" the Cayman LP and its investors (whom as noted above are all non-resident investors) would not be subject to any Australian income tax in relation to 2010-12 years by virtue of the fund's income consisting solely of gains on NTAP assets. Had the investors in the Cayman LP directly invested in the same assets, they also would not have been subject to any Australian income taxation. Furthermore, but for the issue of residence of the fund, it would satisfy the requirements of the IMR concessions in s 842-215 of the ITAA 1997.

The ATO's audit activity also appears to be contrary to the policy behind ATO TD 2011/24 in relation to the private equity industry. This Tax Determination provides guidelines under which offshore private equity funds would not be subject to Australian tax provided certain tests were satisfied. This Cayman LP does carry on private equity type investment activities and should but for the "residence issue" satisfy the tests to qualify for the protection from tax offered by ATO TD 2011/24.

The fact pattern of this Cayman LP is very similar to that of many of the offshore funds established by our members and we expect that the issue of income tax assessments to the fund will have the following adverse consequences:

- Negating the benefits achieved to date under the IMR, with adverse international publicity as to the sovereign risk associated with making Australian investments, particularly for foreign funds that appoint Australian investment managers.
- Encourage Australian investment managers of foreign funds to move offshore, with the consequent loss of Australian jobs and associated tax revenue.
- Create uncertainty for auditors of such foreign funds as to whether provisions for Australian tax should be raised under ASC 740-10 and other similar accounting standards.
- Cause foreign funds to reassess whether they should continue with their existing, or indeed undertake any future investments in Australia.

IMR Consultations

The Board of Taxation's August 2011 Report recommended that the IMR address 3 separate issues being (i) the permanent establishment issue, (ii) the residence issue and (iii) the source of income issue.

The IMR as enacted dealt with issues (i) and (iii) but did not address the residence issue, despite numerous submissions that it do so, including those in the FSC's IMR submissions to Treasury dated 1 July 2010, 29 April 2013 and 14 February 2014. The industry took a pragmatic approach at the time of consultations to avoid delaying the implementation of the IMR and did not insist that the residence issue should be dealt with in IMR stages 1-3. However there was a clear policy intent behind IMR that the appointment and use of Australian managers should not create a residence issue.

This gap in the IMR coverage is now creating significant uncertainty for the industry which we wish to resolve as soon as possible. Further the audit of foreign funds, such as the case in point has the potential to significantly raise an alarm to the broader industry. Already we are aware of foreign funds making enquiries as to the ATO approach and whether the Government has now changed its approach.

We would welcome the opportunity to discuss this matter with you at your earliest convenience and will contact you shortly in this regard.

Yours sincerely

SPYRIDON PREMETIS
Senior Policy Manager
Tax and Economics
Financial Services Council