Alternative Investment Management Association

Manager
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By email to: investmentmanager@treasury.gov.au

26 April 2013

Dear Sirs,

Submission on the Exposure Draft – Tax Laws Amendment (2013 Measures No. 2) Bill 2013: Investment Manager Regime ("IMR 3")

The Alternative Investment Management Association ("AIMA")[1] and Managed Funds Association ("MFA")[2] and, together with MFA, the "Associations") appreciate the opportunity to provide feedback to the Australian Treasury (the "Treasury") in connection with the Exposure Draft of the IMR 3 and also with respect to the Draft Explanatory Memorandum. Members of the Associations have been closely following the development of the IMR Regime and the Associations and would like to refer to their submission to Treasury on 5 December 2012 in respect of the previous elements of the Regime ("IMR 1 and 2").

Many of our members manage investment funds which engage Australian based intermediaries and invest in both Australian and non-Australian securities and they are keenly interested in the further steps being taken by the Australian Government to address concerns as to the tax treatment of non-Australian investment funds investing in Australian securities and engaging Australian intermediaries.

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

[2] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and all other regions where MFA members are market participants.

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We have appreciated Treasury's willingness to consider concerns that we and others have raised to date, including with regard to the "widely-held test." We strongly support the objectives of the IMR 3 proposals set out in the Explanatory Memorandum, especially those to:

- provide certainty in relation to Australian income tax treatment of income from certain financial arrangements of qualifying widely held foreign funds;
- limit taxation in Australia of qualifying investment income of certain foreign managed funds and to expand the exemption available for such income; and
- reduce compliance costs by removing the need for investors to work through sophisticated provisions.

We recall that the Government, in its release of December 2011 announcing that it would implement the third and final element of the IMR, stated that it would provide "certainty of tax treatment for the funds management sector, ... further enhance Australia as a financial services centre in the Asia Pacific region..."and ensure "... that Australia's taxing arrangements with regards to passive portfolio investments are in line with international norms and ... make Australia a more attractive place to do business for foreign funds".

While we commend the Government for these goals, we remain concerned that, as drafted, the rules will present real difficulty for many of our members seeking to be compliant with the regime and to invest in the Australian market. Our members have indicated that, as it is currently drafted, they will find great difficulty in engaging (or continuing to engage) Australian-based fund managers or to invest in Australian securities.

Without further changes to the Exposure Draft that would bring the Regime in line with similar regimes operated in other countries, we believe that IMR 3 will not achieve the Government's stated objectives. Set out in the Annex here below are our proposed changes to the Exposure Draft, which we believe are necessary to fully achieve the Government's stated objectives of providing flexibility and certainty to the industry, in order to allow more funds to access the Australian market and to encourage fund managers to establish a presence in Australia. Where applicable, we have indicated how our proposed changes are aligned with international norms.

In summary and as the Annex sets out, the proposed Regime presents issues in all of these respects:

- Manager remuneration should be excluded for the purposes of bringing a fund within the Regime
- Increases are required in the limits for the "closely held test"
- Foreign widely held fund status should accommodate for sovereign wealth, funds of funds, endowments and foundations, and omnibus accounts
- The opening year rules require substantial amendment
- There should be a concession available for a fund's subsequent breach
- Managed accounts should be included
- The closing year rules require amendment
- The limit in participation interest should be increased from 10% to 20%

While we believe that the proposed legislative changes we have set out are necessary to achieve the Government's stated objectives, we are mindful of the tight deadlines the Government is working under in drafting IMR 3. As such, to the extent Treasury is appreciative of issues and suggestions which we make here but is not able to make changes to the legislation as drafted, we would urge that it reserves to itself sufficient authority to issue rules, guidance, or other appropriate relief, as appropriate to achieve the stated objectives underlying IMR 3. We believe this reservation of authority will help limit the potential for unintended consequences in applying the IMR 3 to a global and diverse industry.

We would be very happy to discuss with the Treasury our comments with respect to the widely held test or any of the other issues regarding the tax treatment of foreign investment funds under the IMR. If the Treasury has any comments or questions, please do not hesitate to contact Benjamin Allensworth (ballensworth@managedfunds.org) or Stuart Kaswell (skaswell@managedfunds.org) at +1 (202) 730-2600 or Mary Richardson (mrichardson@aima.org) at +44 (0) 207 822 8380.

Respectfully submitted,

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ANNEX

OVERVIEW OF THE HEDGE FUND INDUSTRY

Many of the features of the industry that are discussed in this section are relevant to issues identified below with certain provisions in the Exposure Draft. As such, it is important to understand some of the fundamental aspects of the hedge fund industry, to understand why the proposed changes discussed below are necessary to achieve the underlying objective of providing certainty for foreign funds investing in Australian securities.

Hedge funds are pooled investment funds sold to sophisticated investors, including institutional investors (including pension plans and endowments) and high net worth individuals. Institutional investors include funds of hedge funds, which are themselves pooled investment funds that invest in a number of underlying hedge funds. Hedge fund interests typically are not traded on exchanges, but instead are sold in direct offerings to sophisticated investors. Hedge fund interests may be sold directly to investors by the fund or through distribution arrangements with financial institutions, such as banks or brokerage firms. Distribution arrangements vary across jurisdictions as well as across different financial institutions.

Hedge fund corporate structures also vary across jurisdictions and funds may be set up as corporations, limited partnerships, or other corporate structures. Many funds are also structured in so-called master-feeder arrangements. In a master-feeder arrangement, feeder funds are sold to investors and substantially all of the assets of the feeder funds are invested into a master fund. The master fund engages in the investing and trading activity and profits and losses at the master fund are allocated *pro rata* among the feeder funds. The master-feeder structure allows hedge fund managers to put similarly situated investors into various feeder funds (for example, one feeder fund may have U.S. taxable persons and another feeder fund may have tax-exempt or non-U.S. persons), while allowing all investors to participate in the same investment strategy, which is executed at the master fund level.

Some hedge fund managers also utilise managed accounts, often at the request of investors that want greater control over their investments, and these managed accounts invest in substantially similar assets and pursue substantially similar investment strategies as the manager's hedge funds. These types of managed accounts are sometimes referred to as "parallel accounts" because the managed account's assets are invested in parallel with the assets of the hedge fund.

Regardless of the structure of the fund, hedge funds are managed by an investment manager or investment adviser, which is compensated for managing the investment decisions of the fund. Hedge fund managers typically receive a management fee of a certain percentage of assets under management (2% is a common management fee) and also receive a performance fee or performance allocation (20% is a common performance fee or allocation). Hedge fund managers also frequently invest their own capital in the funds they manage, to align their interests with the interests of investors. Hedge fund managers that receive a performance allocation frequently leave that allocation in the fund, such that, over time, the manager owns a substantial equity interest in the fund. This ownership by the manager is expected by hedge fund investors and is viewed as promoting alignment of interest and providing an incentive for strong risk management.

A. SUMMARY OF RELEVANT PROVISIONS OF IMR 3

Widely held and closely held requirements

For ease of reference, we summarise here the proposed requirements for a foreign resident fund to qualify as an "IMR foreign fund", and in particular to satisfy both the "widely held" and "closely held" tests, which must be met at all times during a year. To qualify as an IMR foreign fund:

A fund must, among other things:

- not be Australian resident at any time during the income year;
- not carry on or control a trading business in Australia;
- be resident in an information exchange country; and
- be "widely held" and not "closely held".

Under the widely held test (by Section 842-240(1)), a fund:

- must have its units or shares listed on an approved stock exchange; or
- must have at least 25 members; or
- be of a kind specified in the regulations.

To comply with the closely held test (by Section 842-240(2)), a fund must not:

- have any investor holding greater than 10% "total participation interest"; or
- have 10 or fewer investors whose total participation interests amount to 50% or more.

For the purposes of these tests:

- modified ownership rules identify individuals with an economic interest in the fund as relevant members for the 25 member test;
- there is proposed "look-through" to interposed entities and individuals, and certain "foreign widely held entities" (*e.g.*, pension funds, life companies) are treated as a prescribed number of notional individuals; and
- the tests are not satisfied if an individual (together with relatives) has a 10% or more economic interest in the fund or the sum of total participation interests of 10 or fewer members is 50% or more

B. KEY ISSUES IN IMR 3 PROPOSALS - DRAFT AMENDMENTS

1. Treatment of carried interest/performance allocation or other payments to the manager/general partner for purposes of the "closely held test"

   As noted above, Section 842-240(2) of the IMR provides that an entity will fail the closely-held test if:

   (a) a member of the entity has a total participation interest in the entity of 10% or more; or

   (b) the sum of the total participation interests in the entity of 10 or fewer members of the entity is 50% or more.

   A performance allocation to an investment manager appears to be counted towards an investor's limit of a 10% holding (whereas an equivalent performance fee would not). Managers to private investment funds typically earn a performance fee or performance allocation to the extent that the investment fund has profits over the relevant period, typically one year. Because most U.S. domiciled hedge funds are structured as limited partnerships or other similar structures, the vast majority of managers to U.S. domiciled funds receive a performance allocation, rather than a performance fee.

   While the performance fee or allocation varies from fund to fund, it is not uncommon for managers to receive 20% or more of the fund's profits as performance-based compensation. In order to align their interests with investors, many fund managers leave their performance fees or allocations invested in the fund. As a consequence, many fund managers would appear to breach the "closely held" test as a result of the standard compensation structure for private investment funds.

   To the extent that a private investment fund meets the "widely-held" test in Section 842-240(1) and otherwise meets the "closely held" test in Section 842-240(2), we encourage Treasury to

amend IMR 3 to exclude from the test any interest held in an investment fund as a result of a performance fee or allocation paid by the fund. We note that this approach is consistent with the approach taken by the UK in its Investment Manager Exemption ("IME") regulations.

2. Application of the closely-held test to intermediary investors in hedge funds

Section 842-242 sets out the rules for determining the ownership thresholds in the closely-held test set out in Section 842-240. Among other things, Section 842-242 seemingly requires an IMR fund to look through entity and nominee investors to the underlying owners for purposes of determining ownership of the IMR fund. This unqualified look-through requirement would be problematic for private investment funds that have third party fund-of-fund investors, sovereign wealth funds, or financial institutions (such as banks or broker-dealers) as intermediary investors. Funds-of-funds, sovereign wealth funds, and financial institution investors do not provide the identities of their underlying investors or clients to the fund in which they invest. As such, an investment fund would not be able to look-through to the underlying investors to determine whether the fund meets the closely-held test. Accordingly, we encourage the Treasury to amend the deemed ownership provisions with respect to these types of investors.

Sovereign Wealth Funds and Endowment and Foundation Funds – similar to the types of entities included in Section 842-240(4), sovereign wealth funds and endowment and foundation funds generally are managed for the benefit of a large number of underlying owners. As such, we believe that sovereign wealth funds and endowment and foundation funds should be treated as foreign widely held funds ("FWHF") for the purposes of Section 842-242(3).

Funds-of-funds – many funds-of-funds would meet the legislation's widely held test because the fund-of-funds has a large number of underlying investors. To the extent a fund-of-funds represents to the entity seeking status as an IMR foreign fund that the fund-of-funds meets the widely held test, we believe that such a fund-of-funds should be treated as an FWHF for the purposes of Section 842-242(3).

Financial Institutions as nominee investors – as discussed above, financial institutions often distribute hedge fund interests. One way in which they engage in such distributions is by investing as a nominee or intermediary or by omnibus accounts on behalf of the financial institution's clients. Investors use such accounts because minimum investment thresholds apply and / or because banks offer discretionary management services, whereby they decide on investment decisions for clients and pool their money; they do not use them to conceal their identity.

There are a variety of arrangements by which a financial institution acts as a nominee investor; however, regardless of the arrangement, the financial institution typically does not share the identity of its underlying clients for business reasons. (For competitive reasons, a bank that engages in discretionary money management for its clients would not want to provide its client lists to another investment management firm.) The financial institution does provide various representations regarding the nature of their clients so that the hedge fund can meet regulatory obligations, such as "know-your-customer" rules. We believe that, to the extent the nominee investor represents that none of its underlying clients is an Australian resident and none of its underlying clients has a participation interest in the fund through the nominee arrangement greater than the amount specified in Section 842-240(2), that should serve to satisfy the test.

In addition, we encourage Treasury to amend Section 842-242 to provide that an IMR foreign fund does not have to look-through any third party (*i.e.*, not under common control with the manager of the IMR fund) intermediary investor that owns less than 10% of the IMR foreign fund. To the extent the intermediary investor (*e.g.*, fund-of-funds, nominee investors) owns less than 10% of the IMR foreign fund and / or no Australian resident beneficial owners are included, we believe it is unlikely that such arrangements present the potential for abuse of this provision.

3. Limitations on investor interest participation

Many foreign funds are likely to breach the closely held test because they have 10 (or fewer) investors who own more than a 50% interest in the fund. In most funds, investment manager participation is common and is likely to be greater than 10%. Having a proprietary investment in a fund is very much expected and desired by investors. EU regulators are, in fact, requiring managers to have deferral mechanisms which operate to retain a large proportion of the managers' remuneration in the fund for a period, serving to align the interests of the management firm with the investors. This is a feature which is only likely to become more significant for funds and managers.

Whilst we appreciate that the 10% test is included to ensure a general alignment with Division 855, such a test is not compatible with the financial services industry where a significant "seed investment" by the investment manager is common and, in some cases, absolutely necessary to secure a client's investment in the fund.

As you may be aware, a 10% test is significantly less than the *de minimis* beneficial ownerships tests in Singapore and Hong Kong of 20% and 30% respectively. Based on the current drafting, this burdensome test would drive many foreign funds to invest in other countries in the region, and fail to achieve the stated objective of boosting Australia's financial services industry.

We request that to accord better with comparable provisions in the UK's IME and, in the interests of commercial reality, that the test be amended to the following:

- No one investor may have a total participation interest of greater than 20%; and
- No five or fewer investors may have a total participation interest of 50% or more.

The IME enables non-residents to appoint UK-based investment managers without the risk of UK taxation. Through a series of tests, the IME ensures that non-UK investors are not charged to UK tax in relation to investment transactions conducted on their behalf but that any fees received by a UK resident investment manager for services performed on behalf of the non-resident are fully chargeable to UK tax.

For the purposes of the IME, a fund will be regarded as widely held if either no majority interest in the fund is ultimately held by five or fewer persons and persons connected with them or no interest of more than 20% is held by a single person and persons connected with that person. This is designed as a test as to "independent capacity" - by allowing a participation interest by one person of maximum 20% and providing that no five or fewer persons might have a total participation interest greater than 50%.

If the IMR provisions were amended to accord better with the IME in this respect, that would be consistent with the objective that the exemption shall not apply to a small group of investors and would be better aligned with the commercial reality of income allocations to the investment manager.

We would, however, point out that the IME will, in this respect, remain more accommodating and less onerous as it requires satisfaction of only one of the tests (or others), whereas the proposed IMR would require both of its tests to be satisfied.

C. FURTHER ISSUES

1. Inadvertent breaches of the tests

An IMR foreign fund must comply with the tests "at all times during the income year". No provision has been made for discretionary treatment of a breach, so that, as drafted, if a fund breaches the tests for one day in a year, that will result in all Australian sourced income for the complete year

becoming subject to Australian tax. We would ask that specific provision be made so that inadvertent breaches be discounted (i.e., removing a "cliff edge" test).

We also ask that there be an express concession provided, allowing for a fund to be deemed compliant where subsequent breaches occur but it can demonstrate that it is being actively marketed and seeking to meet the conditions within a reasonable timeframe.

A requirement for daily compliance is very onerous and could impact investors negatively. We believe that, for most funds, compliance monthly might be acceptable and would conform with the ability of investors to subscribe or redeem interests in the funds. We would, therefore, ask that monthly compliance be considered the norm. Additionally, we would note that, in the UK IME regime, only the breached portion of income is taxed (instead of the entire fund becoming disqualified from the regime) and that there is a "safe harbour" provision in the Managed Investment Trust rules.

2. Fund start-up and wind-down rules

As drafted, a 'grace period' – or "start-up phase rule" – is provided to a fund for the income year in which a fund is created and, if it is created in the second half of the year, for the next income year also, for the purposes of satisfying the tests. However, that concession is only available if the fund eventually qualifies as, and continues for at least one year following as, an IMR foreign fund – leading to obvious uncertainty for investors during that opening period.

A hedge fund will usually take a longer period than other investment funds in start-up stage and, therefore, in meeting the tests – for example, the requirement for a 'track record'; it will also require a longer period of due diligence.

A hedge fund will also not wish to have a restriction applied to a period of wind-down as that could well be to the detriment of investors – for example, if the fund were then to be faced with a 'fire sale' of its assets.

We request that the start-up rule and the 'grace period' be amended to apply:

- from the date when a fund commences investment activities (not the date on which the fund is created);
- for the first two years; and
- so that, even if the qualifying tests are not all met at the end of that period, they are deemed met if the fund is able to demonstrate (if asked) that it is being actively marketed in an attempt to meet the conditions or that it is being wound down.

We request that the wind-down rules be amended to provide that:

- no time limit for the rules to apply, provided that the fund is able to demonstrate that it is actively taking steps to wind down.

3. Managed accounts

As discussed above, a managed account is an investment structure that is set up and governed by the managed account provider/client or similar entity to manage the assets pari-passu with the reference hedge fund. Typically, the managed account will be set up as a separate vehicle, enabling the ring-fencing of the assets. Managed accounts are becoming increasingly popular as investors want to see their investment managed carefully and in a fully controlled environment. If managed accounts are not accommodated in the IMR, that would certainly discourage managers from locating in Australia since they would be restricted from a large part of their potential client/asset base. As such, Australia's financial services industry would "miss out" on a significant pool of foreign investment if managed accounts are not permitted in terms of the IMR.

Managed account platforms will not be able to satisfy the widely held test and closely held test as one investor generally owns a 100% interest in a managed account; accordingly, we recommend that "managed account" platforms are excluded from having to satisfy the widely held test and the closely held test. Excluding managed account platforms from having to satisfy these tests will not jeopardize the integrity of the exemption because:

- Managed accounts platforms are not suitable for foreign funds with many investors; and
- The cost and administrative burden of establishing a managed account will prevent foreign funds (with only a few investors) that breach the widely held test and closely held test moving to a managed account platform.

If you are not minded to agree to exclude them from the tests, we would ask, instead, that where a managed account invests in substantially similar assets and follows a substantially similar investment strategy as a fund, that the managed account and the fund be consolidated for the purposes of satisfying the widely held and closely held tests.

For fund managers that operate managed accounts, there may be additional issues created where the fund itself is within the IMR. If the managed account is set up to follow the same investment strategy as the fund, it may be unable to achieve this if it is unable to get within the IMR. This may force the fund that is within the IMR to avoid investing directly into Australia, so that it does not create tracking errors with the managed account.

D. REQUESTS FOR CLARIFICATION

1. Retroactive application of certain IMR provisions

The draft legislation amends Section 842-230 to require, among other things, that an IMR fund be resident in an information exchange country at all times during the income year and provide the Commissioner of Taxation an information statement as specified in the statute. Imposing these requirements retroactively would create substantial uncertainty for investment funds as they may have been resident in prior years in a jurisdiction that was not, at that time, an information exchange country. Similarly, investment funds likely would not have submitted information statements for prior years. In order to prevent uncertainty regarding prior income years, a result inconsistent with the underlying intent of amending the IMR legislation, we encourage Treasury to clarify that these two requirements are not applicable to prior income years to which the earlier elements of the regime, IMR 1 and 2, apply.

We also encourage Treasury to clarify that the additional closely held test (a member of the entity cannot have a total participation interest of 10% or more) are not applicable to prior income years to which the earlier elements of the regime, IMR 1 and 2, apply.

2. Residency requirement

a. General residency rules

Section 842-230(aa) requires an IMR fund to be a resident of an information exchange country (as determined in accordance with subsection 12-390(7) in Schedule 1 to the Taxation Administration Act 1953). This definition creates potential ambiguity regarding the residency of investment funds located in certain jurisdictions common to offshore investment funds.

Given the tax regimes of typical locations and the fiscally transparent nature of investment funds in those locations, it will often be the case that the requirements of 12-390(7)(a) cannot be met.

Further, subsection 12-390(7)(b) provides that an entity is resident in a jurisdiction if the entity is incorporated or formed in that country ***and*** is carrying on a business in that country [emphasis added]. For investment funds organised and located in one jurisdiction but which have an

investment manager located in a different jurisdiction (e.g., a Cayman Islands fund with a US or UK investment manager), it is unclear whether that fund would be deemed to meet this test.

As such, we encourage Treasury to amend the residency test to provide that, for purposes of the IMR, an IMR fund is resident in a jurisdiction if it is incorporated or formed in that country ***or*** is carrying on a business in that country. Alternatively, we encourage Treasury to provide that an IMR fund is resident in the jurisdiction in which its investment manager resides. To the extent that the investment manager to a fund is located in an exchange of information jurisdiction, we believe this will provide Treasury with appropriate access to information about the IMR fund.

b. Limited partnerships

There is a further question regarding the residency of investment funds that are structured as limited partnerships. We understand that, under Australian tax law, a limited partnership established outside Australia will be treated as Australian tax resident if it carries on business in Australia and that activity such as engaging an Australian-based fund manager or investment adviser that has discretion to buy and sell shares on behalf of a fund may cause a limited partnership to become Australian tax resident.

We understand that Treasury intends to address the question of residency of partnerships as part of a wider review of tax legislation. However, to avoid uncertainty regarding the status of investment funds structured as limited partnerships, we encourage Treasury to provide public guidance that there will not be any significant change in its approach or actions under the IMR regarding auditing or enforcement with respect to investment funds structured as limited partnerships as a result of the limited partnership residency question, provided that the fund would otherwise meet the test to qualify as an IMR fund.