Alternative Investment Management Association

International Tax Base Unit
Corporate and International Tax Division
The Treasury
Langton Crescent,
PARKES ACT 2600

investmentmanager@treasury.gov.au

Treasury: Attention William Potts

Phil Lindsay
Office of the Assistant Treasurer

28 April 2014

Dear Sirs,

AIMA-MFA comments – Elements of an Investment Manager Regime
(Exposure Draft – Tax and Superannuation Laws Amendment (2014 Measures No. 2) Bill 2014 - "IMR 3")

The Alternative Investment Management Association (AIMA)[1] and the Managed Funds Association (MFA)[2] appreciate the opportunity to discuss further with Treasury the draft legislation for the implementation of the investment manager regime (IMR), as published on 31 January 2014.

We refer to our previous submissions, including AIMA's of 17 February 2014 and MFA's of 14 February 2014.[3] In particular, we refer to our previous comments on similar investment manager regimes in other jurisdictions, which are structured to protect fiscal interests without impeding policy objectives. Typically, such regimes are available where the arrangements between the local investment manager and the non-resident investor are such as would exist between persons who are independent and at arm's length.

We have attached a note on the essential elements of an IMR and suggested amendments that could be made to the implementing legislative provisions.

We are very concerned that, if the legislation were to be enacted in accordance with the January 2014 draft, funds, including hedge funds managed by our members, will face tax uncertainties which will deter them from appointing an Australian investment manager or making investments in Australia. In particular, the various parts of the IMR widely held test as proposed are for many hedge funds inconsistent with their investor profiles and their manager incentive remuneration structures and will be impractical to monitor for compliance.

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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 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 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.

3 MFA's letter is available at: https://www.managedfunds.org/wp-content/uploads/2014/02/MFA-Letter-on-Draft-IMR-3.pdf

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA
Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: http://www.aima.org

600 14th Street, NW, Suite 900 | Washington, DC 20005 | 202.730.2600 | Fax 202.730.2601 | www.managedfunds.org

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It is vitally important to funds that are offshore limited partnerships and use Australian managers that the funds are not automatically considered Australian resident for tax purposes. To that end, the IMR legislation does require amendment.

To ensure that the IMR is competitive with other regimes and to encourage investment in Australia's asset management industry, including the hedge fund sector, while also meeting policy objectives and not placing at risk tax revenues, we believe the adjustments we have put forward should be made.

We look forward to discussing our comments with you and, of course, if any questions arise from our comments, please do not hesitate to contact the undersigned.

Yours faithfully,

/s/ Stuart J. Kaswell

Paul Hale
Director, Head of Tax Affairs

Stuart J. Kaswell
Executive Vice President & Managing Director, General Counsel

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Elements of an investment manager regime

1. An IMR should contain these elements:

   - Exempt non-residents from taxation by direct assessment on income and capital gains from particular financial assets that would constitute a source in the jurisdiction
   - Exempt non-residents additionally from taxation (in their own name or the name of a permanent establishment or taxable representative) in respect of income and capital gains realised through an investment manager in the jurisdiction that is an independent agent
   - Apply to a wide range of non-residents
   - Apply to a wide range of financial assets.

2. The IMR should be straightforward in its application. It should not require frequent due diligence or knowledge of information not in the ordinary possession of the investment manager to ensure compliance.

3. The UK for example exempts from taxation by direct assessment almost all non-residents other than certain trusts in respect of income and capital gains from financial assets (subject to limited exceptions for securities relating to UK oil and gas fields or certain interests in UK real estate).

4. The UK's exemption from taxation in respect of income and capital gains arising to an investment manager acting as agent of the non-resident looks to the nature of the relationship between the parties:

   - The investment manager must receive not less than the customary rate of remuneration for its services, i.e. an arm's length fee (the customary rate of remuneration requirement).
   - The investment manager and its connected persons must not have an interest of more than 20% in the profits arising to the non-resident (fees payable to the investment manager being excluded from the calculation, irrespective of the form they may take – for example, a performance fee or profit allocation). This test may be measured over a number of taxable periods not exceeding five years and is deemed to be met if circumstances outside the investment manager's control intervene (the 20% test). If this test is not met, the exemption applies only to the part of the non-resident's profits in which the investment manager has no interest.
   - The relationship between the investment manager and the non-resident, having regard to its legal, financial and commercial characteristics, is a relationship between persons carrying on independent businesses dealing with each other at arm's length (the independent capacity requirement).

5. HM Revenue & Customs in the UK has published guidance on these factors, providing some 'bright-line' tests, any one of which may be met to satisfy the independent capacity test, but making clear that, even if all the tests are failed, one can look at the facts in the round.

   In particular, the independent capacity requirement can be met:

   - If the non-resident is a widely-held collective fund (i.e. no majority interest is held by five or fewer persons and their connected persons or no interest of more than 20% is held by one person and its connected persons), with a relaxation for the first 18 months of the fund's activities;
   - If the non-resident is not a widely-held collective fund but is being actively marketed with the intention of becoming one or is being wound up or dissolved;
   - If the services provided to the non-resident and persons connected with it are not a substantial part of the investment management business (i.e. more than 70% of the business by reference to fees or other appropriate measure – there is a relaxation for the first 18 months of the investment management business or if circumstances outside the investment manager's control intervene; or
   - If the overall circumstances of the relationship justify it.

6. In effect, the benefit of the UK exemption is denied completely where the investment manager is acting wholly or mainly for the non-resident client and its connected persons, unless the client is a widely held fund, and is restricted where the investment manager has a substantial interest in the non-resident client.

7. While the proposed Australian IMR is similar to the UK regime, there are some significant differences:

- The Australian exemption from direct assessment or taxation in respect of an agent would be limited to non-residents that are widely-held funds or bodies that are deemed to be widely-held under the legislation or regulations. This will require due diligence (quite possibly requiring Australian legal advice to be obtained) on the part of an Australian investment manager and/or a non-resident investor in Australian financial assets to ensure that this requirement is met at all times. Given a preference on the part of institutional investors to hold assets in managed accounts rather than co-mingled in a fund, an Australian exemption in the proposed form would require managers to identify correctly the status of such investors as deemed widely-held bodies before acquiring Australian financial assets on their behalf.
- The Australian legislation would have a much narrower definition of a widely-held fund: there must be at least 25 members (or deemed members); no ten members may hold 50% or more of the fund; and no member may hold a 10% interest in the fund. Unless a fund comfortably meets these requirements, the fund will be reluctant to acquire Australian financial assets or to appoint an investment manager in Australia
- The exceptions for unpreventable circumstances of short duration and start up/wind down years would be less flexible than under the UK regime, so offer little comfort that they would be of assistance
- The requirement that no member may hold a 10% interest in the fund seems to take no account of carried interest structures where typically the investment manager (through the general partner of the fund) would be entitled to 20% of the net profits of the fund
- Further, regulatory regimes and market practice increasingly require the investment manager and its principals or other connected persons to hold interests in the fund which, in aggregate, could exceed 10%
- The requirement to look through to certain ultimate investors in the fund would require the investment manager to obtain information that is not in its possession and which an intermediate investor in the fund may not be able to disclose. A change in the status of such ultimate investors may affect the entitlement of the fund to the Australian exemption without being apparent to the fund or its investment manager.

8. A narrow IMR will give rise to uncertainty and potential tax liability, which will deter potential investors.

   Managers who currently have offices in Australia will consider closing those, while managers that are starting up and considering the location of their offices will not choose Australia as they cannot be certain of meeting the test in the short term (at least) and even if they do later meet the tests, they would be unlikely to relocate.

   A narrow IMR would also cause managers with a number of funds/managed accounts, not all of which qualify, to tend to withdraw from investing in Australian financial assets because of the difficulties in tracking performance across the different portfolios and possible compliance concerns if the manager excludes certain clients from participation in Australian financial assets.

9. The requirement that the fund or equivalent body must be a resident of an information exchange country presents two difficulties:

- It would exclude funds established in significant jurisdictions such as Luxembourg and equivalent bodies established in Middle East jurisdictions in particular that have no tax information exchange agreement or suitable tax treaty with Australia
- Where there is an agreement, such funds and equivalent bodies may not be "resident" in the jurisdiction in which they are established because of the nature of their legal form (e.g. as a partnership without legal personality), their exemption from tax there or because their business is carried on through an investment manager resident in another jurisdiction.

10. The requirement to provide an annual statement as a condition of the exemption, rather than as a separate compliance matter, is excessive, particularly as it seems that a non-resident investor in

Australian financial assets without an Australian investment manager or other representative in Australia would be required to provide this (and may not be aware that it should do so). It seems likely that the Australian Tax Office would receive statements, process these and simply file them as showing no grounds to query the exemption. The UK regime places the onus on the investment manager to ensure that a non-resident for whom it acts meets the exemption and, if not, to file a tax return as the non-resident's representative.

11. If the Australian IMR is to be effective, it should be amended in these respects:
    - The range of non-residents who may benefit from the regime should be extended and not be dependent on satisfying statutory definitions that are difficult to implement
    - There should be a presumption that a non-resident investor in Australian financial assets should not be subject to tax (unless the holding is not a portfolio investment)
    - Any limitation on benefit where profits are realised through an Australian investment manager should be because the relationship between the investment manager and its non-resident client is not independent in nature
    - Criteria to establish independence should be straightforward and flexible, and not require the investment manager to obtain information from investors that is additional to usual procedures or on a frequent basis
    - The requirement to file an annual statement as a condition of the exemption should be removed
    - The requirement for residence in an information exchange country should be reconsidered.

12. Additionally, the relationship between the legislation as set out in the exposure draft and the measures already implemented needs to be made clear. Non-residents that have relied upon IMR 1 and IMR 2 should be able to continue to do so, so that their position is not changed to their detriment. There is an issue in that it may be harder to pass the tests in the IMR 1 and 2 than the equivalent tests in the currently proposed IMR 3. We believe that a number of managers will have taken the IMR 1 to be a 'blanket' exemption, either having not considered the conditions or having assumed that they would be able to satisfy the conditions as they would be amended in final rules.