Australian Private Equity &
Venture Capital Association Limited

01 June 2018

Corporate and International Tax Division
The Treasury
Langton Crescent
Sydney NSW 2000

Dear Sir/Madam,

RE: Exposure Draft - Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018

AVCAL welcomes the opportunity to provide comments to the Treasury on the exposure draft legislation titled *Treasury Laws Amendment (Stapled Structures and Other Measures) Bill 2018* (the Exposure Draft).

AVCAL represents the private equity (PE) and venture capital (VC) industry in Australia, which has a combined total of around $30 billion in funds under management on behalf of domestic and overseas investors, including a significant portion from offshore superannuation and pension funds (FSFs) and sovereign wealth funds (SWFs). Over the three-year period from FY2015 to FY2017, 67% of funds raised by Australian PE funds came from offshore investors. In the same period, almost 30% of total funds raised by Australian PE funds came from FSFs and SWFs.

We understand that the key objectives of the proposed reforms are to improve the integrity of the income tax law for arrangements involving stapled structures and to limit access to tax concessions for certain foreign investors. However, the proposed drafting potentially creates excessive uncertainty and complexity for FSFs and SWFs that invest in Australian PE, and places additional administrative burdens on this vital source of capital for domestic PE fund managers.

Overall, our submission seeks further clarification on the application of these laws to provide certainty, clarity and guidance for FSFs, SWFs, and Australian PE fund managers. Our response as set out below focuses on Schedule 3 (measures that deal with *Superannuation funds for foreign residents withholding tax exemption*) and Schedule 4 (measures that deal with *Sovereign immunity*) of the Exposure Draft, and respective Chapters 3 and 4 of the explanatory material.

1. Superannuation funds for foreign residents withholding tax exemption – section 123B(3CA)

This section of our submission addresses the proposed drafting of section 128B(3CA) of the *Income Tax Assessment Act 1936* (ITAA 1936). The stated policy objective of this provision seeks to improve the integrity of the income tax law to limit the circumstances in which the withholding tax exemption in section 123B(3)(jb) of the ITAA 1936 is available to FSFs.

The current drafting of subsection 128B(3CA) would deny an exemption from Australian dividend and interest withholding tax where the 'total participation interest' (TPI), within the meaning of section 960-180 of *Income Tax Assessment Act 1997* (ITAA 1997), of an FSF in an entity from which the FSF derived income (the 'paying entity') is 10% or more.

Section 960-180 of the ITAA 1997 provides that:

> *An entity's total participation interest at a particular time in another entity is the sum of:*
>
> *a) The entity's direct participation interest in the other entity at that time; and*
> *b) The entity's indirect participation interest in the other entity at that time.*

For these purposes, section 960-185 of the ITAA 1997 provides that in determining an entity's indirect participation interest, the interest must be traced through intermediate entities.

The reference in the current drafting of section 128B(3CA) to "the entity from which the superannuation fund derived the income" is ambiguous and should be clarified to confirm that in the context of a managed fund / trust, it is the direct participation interest in that managed fund / trust that is the relevant interest and not the indirect participation interest in the underlying investee entities.

AVCAL believes that an additional example is warranted for inclusion in the explanatory material which would clarify the application or non-application of section 128B(3CA) in the following scenario:

> <u>Scenario – combination of direct and indirect interest in a paying company</u>
>
> An FSF has a direct interest (debt or equity) in an Australian company (AusCo) that makes dividend and/or interest payments.
>
> The FSF also invests into a collective investment vehicle[1] which makes distributions of dividend and interest income, including income derived from its investments in underlying Australia portfolio companies which include AusCo.
>
> In the circumstances where AusCo is paying a dividend or interest on membership interests/debt interests it has issued, the relevant paying entity, for the purposes of the proposed section 128B(3CA), will be AusCo. The FSF's direct participation interest in the Australian company will be the relevant interest for the purposes of calculating TPI in the context of the proposed section 128B(3CA).

[1] The reference to collective investment vehicles is intended to cover all trusts and partnerships used for investment purposes, including managed investment trusts, corporate and limited partner collective investment vehicles, venture capital limited partnerships, and early stage venture capital limited partnerships.

In the circumstances where that dividend and interest income is also received by the collective investment vehicle and is included in its net income, and then distributed by that collective investment vehicle, the relevant paying entity for that income and dividend income shall be the collective investment vehicle and not AusCo. The FSF's interest in the collective investment vehicle is the relevant interest for the purposes of determining its TPI in the paying entity.

Under the proposed drafting of section 128B(3CA), two different methods are used for calculating the FSF's TPI:

- in respect of interest and dividend income distributed by the collective investment vehicle, the FSF's TPI is only its interest in the managed fund (being the paying entity); and

- in respect of interest and dividend income paid by AusCo to the FSF (due to its direct interest in AusCo), the FSF's direct and indirect participation interests are required to be aggregated for the purposes of calculating its TPI.

It is our view that the aggregation of the direct and indirect participation interests in an underlying Australian portfolio company would be inappropriate in these circumstances. Relevantly, where FSF's indirect participation interest is held through a collective investment vehicle and that interest has already been tested as a direct participation interest in that collective investment vehicle, this interest should not be considered again in determining the FSF's TPI in the underlying Australian portfolio company.

Under the proposed drafting, it may be interpreted that an FSF's direct participation interest in a collective investment vehicle will be 'double counted' (i.e. at the collective investment vehicle level and at the Australian portfolio company level) for the purposes of calculating TPI in two separate entities. This section of the Exposure Draft needs to be clarified, especially with regard to the meaning of "the entity from which the superannuation fund derived the income", which could be interpreted to mean either the collective investment vehicle or the portfolio company.

Further, if such an interpretation of the current drafting is made, it would be very impractical in the context of a collective investment vehicle as an investor cannot control the investments of such a fund and cannot at all times be in a position to compute its indirect interest in an underlying Australian portfolio company.

The two investments by an FSF in this scenario are inherently distinct investments and carry different risks, risk-return profiles, and exposures:

- the investment in the collective investment vehicle is a passive investment; and

- the investment in the underlying Australian portfolio company is an investment into the underlying assets and business of the company.

In these circumstances, distributions on a direct interest and an indirect interest represent two separate payments derived from two distinct 'paying entities'. Aggregating such interests to determine whether an exemption to withholding tax applies may unintentionally disadvantage an FSF that holds both investments and has significant implications to the PE and funds management sectors.

The original intention of the proposed amendments is to limit the withholding tax exemption for an FSF to portfolio investments only. This objective can be achieved without causing unnecessary administrative and compliance burdens for FSFs, fund managers, and Australian companies imposed by the proposed section 128B(3CA). By excluding an FSF's indirect participation interests for the purposes of calculating TPI in the underlying Australian

portfolio company in limited circumstances (such as in the co-investment scenario described above and illustrated further in Example 1 below), administrative costs and compliance burdens can be alleviated in the following ways:

- the collective investment vehicle should not be required to continuously monitor an investor's indirect interest in an investment where that investor also has a direct investment into that portfolio company;

- the portfolio company should not be required to continuously monitor the investments of an FSF investor to determine whether it holds any indirect investments in the portfolio company through collective investment vehicles; and

- the FSF will not be required to monitor all of the portfolio investments of a collective investment vehicle to ensure that the fund manager is not making additional investments into companies in which the FSF already has a direct investment in.

Proposed amendment to section 123B(3CA)

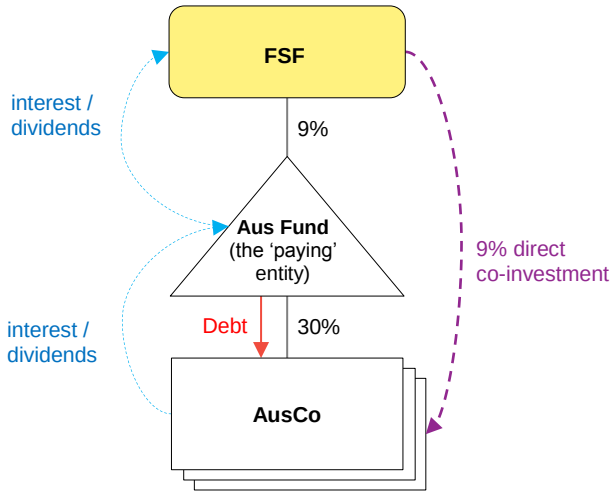
For the reasons noted above, we believe that the proposed section 128B(3CA) be amended so that an FSF's indirect participation interests held through a collective investment vehicle should be excluded for the calculation of TPI in an Australian paying entity in the context of this particular section of the legislation:

> *Paragraph (3)(jb) applies to income only if the total participation interest (within the meaning of the Income Tax Assessment Act 1997) of the superannuation fund mentioned in subparagraph (3)(jb)(i) in the entity from which the superannuation fund derived the income:*
>
> *a) is less than 10% at the time the payment mentioned in subparagraph (3)(jb)(ii) is made; and*
>
> *b) is less than 10% throughout any 12 month period that began no earlier than 24 months before that time and ended no later than that time,*
>
> *for the purposes of paragraph (a) and (b) above, disregard a superannuation fund's indirect participation interest in the entity to the extent that:*
>
> *a) the intermediate entity is a collective investment vehicle;*
>
> *b) the superannuation fund derives dividend and/or interest income from that intermediate entity; and*
>
> *c) that participation interest has already been used in determining the superannuation fund's total participation interest in that intermediate entity for the purpose of applying these provisions to that intermediate entity.*

** For the purposes of paragraph (b) above, where an interest is held for a period of less than 12 months, the interest held is deemed to be 0% for the remainder of the 12 month period.*

Amending section 128(3CA) as outlined above will provide the greatest clarity in relation to the implementation of the proposed legislation and its original policy objectives. In the absence of adopting the above amendment, we recommend that Treasury considers the inclusion of the following example in the explanatory material to further clarify the circumstances and application of the proposed section of legislation.

Example [3.X]: Co-investment in an Australian Company



- FSF is a superannuation fund for foreign residents. FSF holds 9% of the issued units of Aus Fund, which is a collective investment vehicle.
- Aus Fund holds a 30% interest in AusCo, an Australian resident company – it derives dividend and interest income on this investment.
- FSF also holds a 9% direct interest in AusCo on which dividend and interest is paid directly to FSF. There are no other factors present which indicate FSF can influence Aus Fund in any way.
- FSF's TPI in the relevant paying entities is as follows:
    - Aus Fund – 9%; and
    - AusCo – 9% (on the basis that the indirect participation interest of 2.7% (9% multiplied by 30%) is disregarded as Aus Fund is a collective investment vehicle for the purpose of section 275-20 of the ITAA 1997 and was already used to determine FSF's TPI in Aus Fund).
- Accordingly, any dividends or interest paid by Aus Fund to FSF and AusCo to FSF will be exempt from dividend and interest withholding tax under paragraph 128B(3)(jb).

2. Superannuation Funds for foreign residents withholding tax exemption – Section 128B(3CB)

AVCAL believes that the proposed deeming provisions in section 128B(3CB) as currently drafted could unintentionally capture a wide range of commercial relationships and arrangements, including participation by FSFs on investment advisory boards and committees.

> *128B(3CB) - for the purposes of paragraph (1)(d), treat one entity (the first entity) as holding a total participation interest in another entity (the second entity) of 10% at a time if, at that time:*
>
> *a) The first entity holds any of the following kind of interest in the second entity:*
>
> *i. A membership interest*
>
> *ii. A debt interest*
>
> *iii. A non-share equity interest; and*
>
> *b) That interest confers or those interests confer a right on the first entity:*
>
> *i. To vote at a meeting of the Board of Directors (or other governing body) of the second entity; or*
>
> *ii. To participate in making financial, operating and policy decisions in respect of the second entity; or*
>
> *iii. To deal with assets of the company.*

Firstly, further clarification is required in respect of section 128B(3CB) to determine which entity is the 'first entity' (i.e. whether the 'first entity' is the FSF).

Secondly, the proposed drafting of section 128B(3CB)(b) is broad and creates ambiguity in determining whether a deemed TPI of 10% should be applied. For example, it may be deemed that an FSF has a TPI of 10% where it has a position on an investment advisory board (IAB) of a collective investment vehicle, despite that position not holding any influence over key decisions made by the fund or its managers.

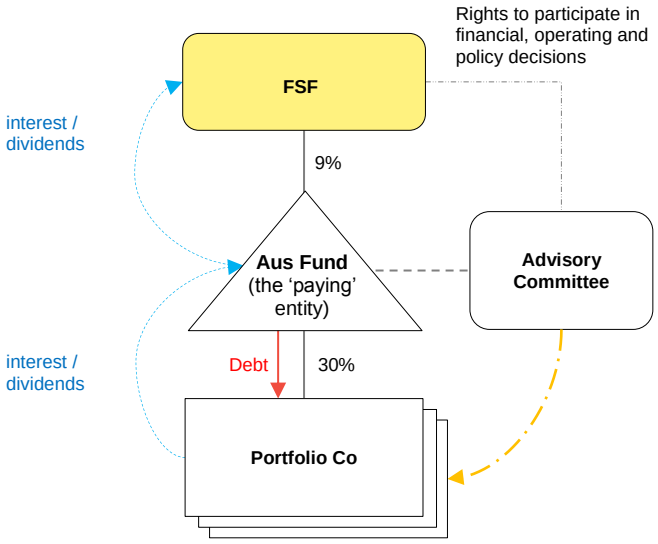
Most PE funds have an IAB which generally allows approvals to be obtained for certain actions of the GP or trustee that are outside their pre-agreed investment mandate and which could have the potential to affect the nature of the investor's investment in the fund. Broadly, the purpose of such an IAB is to allow the GP or trustee to seek approvals in a manner that is less burdensome from a timing and logistical perspective than a formal amendment to, or waiver of, the fund documents.

The IAB merely provides advice or makes recommendations to the GP or trustee. The GP or trustee is not bound to follow the advice or recommendations of the IAB, but rather it owes a separate fiduciary duty and obligation to the investors to make independent decisions in respect of the fund's financial, operating and policy matters. Accordingly, the rights conferred on the members of an IAB should not be captured under the proposed section 128B(3CB)(b)(ii). The example outlined below illustrates this case.

Similarly, we submit that Example 4.3 of the explanatory materials (while it relates to SWFs, it could equally apply to FSFs) does not reflect commercial practice. Typically the IAB of ABC Unit Trust would not have the rights as listed in proposed section 128B(3CB)(b). Instead, such decisions can only be made by AusCo's Board of Directors exercising their independent minds. Accordingly, SWF's total participation interest in ABC Unit Trust in this scenario should not be deemed to be 10%.

To further improve clarity on this particular issue, we believe that the following example should be included in the explanatory material:

Example [4.X]: Interest in an Investment Advisory Board



- FSF is a superannuation fund for foreign residents. FSF holds 9% of the issued units of Aus Fund, which is a collective investment vehicle in the form of a trust.
- Under Aus Fund's trust deed, any investor with an equity interest of 9% or more is entitled to appoint an individual to an Advisory Board of Aus Fund.
- Members of the Advisory Board can participate in making investment recommendations to Aus Fund including allowing the trustee to make certain investment decisions outside its agreed mandate. Such recommendations and approvals do not bind the trustee.
- The trustee of Aus Fund will consider the recommendations made by the Advisory Board but in line with its fiduciary obligations will make an independent assessment prior to making any investments.
- Accordingly, FSF's interest in Aus Fund does not confer the right to:
    - vote at a meeting of the Board of Directors (or other governing body) of the second entity; or
    - participate in making financial, operating and policy decisions in respect of the second entity; or
    - deal with assets of the company.

Based on the circumstances outlined above, section 128B(3CB) should not apply with the result that the FSF is taken to have a total participation interest of 10%.

3. Sovereign immunity

SWFs are becoming an increasingly important source of capital for numerous Australian businesses that attract investment through Australian PE fund managers. These sovereign entities contributed around 18% of all Australian PE funds raised over the FY2015-17 period. It is important to ensure that this institutional investor segment isn't disadvantaged when making investments into domestic PE, both through fund structures and directly into local businesses.

The stated policy objective of Schedule 4 of the Exposure Draft and Chapter 4 of the explanatory material (both relating to sovereign immunity) is to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by codifying and limiting the scope of the sovereign immunity tax exemption.

We believe that, as outlined above with respect to certain withholding tax exemptions for FSFs, our views and proposals with respect to the proposed section 128B(3CA) should apply equally to the proposed drafting in section 880-105(1)(d) of the ITAA 1997, and that our views and proposals with respect to the proposed section 128B(3CB) apply equally to the proposed drafting in section 880-105(2) of the ITAA 1997.

Based on our interpretation, the current drafting of section 880-105(1)(d) of the ITAA 1997 looks to aggregate the interests of all sovereign entities of a country such that the 10% requirement cannot be breached on a 'whole of country' basis.

However, there are often instances where PE funds raise capital from a number of sovereign entities (for example, entities that operate either at a state or federal level) from the same country. These entities may be owned by different arms of a government, or by different levels of government, and will often have different objectives set out in their charters or mandates. There are many other examples from around the world, including in Asia, the Middle East, and North America of different SWFs established for distinct purposes and overseen by separate governance frameworks, although they may be controlled by the same foreign government. To pool these separate investors together for tax purposes may cause undue uncertainty and dissuade this key investor segment from committing more capital to Australian PE funds, or preclude them from direct investing in Australian businesses altogether.

In light of this, we believe that the current drafting in relation to sovereign immunity requires further consideration and clarification.

4. Interaction of sovereign immunity with VCLPs

Venture capital limited partnerships (VCLP) are an important type of fund vehicle for the PE and VC industry here in Australia. As currently drafted, it is unclear whether income derived by a sovereign entity from a portfolio company through a VCLP is eligible for sovereign immunity based on current drafting of the proposed paragraph 880-105(1)(a). To clarify this uncertainty, and consistent with the policy intention of the law to limit sovereign immunity to circumstances of passive portfolio investments, we propose that the following language be added to paragraph 880-105(1)(a):

> *(a) that amount is derived, received or made from a trust or company (the paying entity), including through an interposed partnership;*

Additionally, it is standard industry practice that VCLPs are part of structures that use companion trusts, which are typically managed investment trusts (MITs). Based on the current Exposure Draft, income derived, received or made from an MIT would be eligible for sovereign immunity (subject to satisfying the other relevant requirements) whilst sovereign immunity may not be available for exactly the same profile of investment if it were to be made by a sovereign entity through a VCLP.

This appears to be an anomalous result, given the VCLP regime is designed to incentivise investment, particularly from foreign tax exempt investors such as SWFs (see paragraph 118-420(1)(a) of the ITAA 1997).

The above clarification in the law is also relevant to income received from Early Stage Venture Capital Limited Partnerships (to the extent it is not otherwise non-assessable non-exempt income) and Australian venture capital funds-of-funds.

5. About AVCAL and Australia's private equity and venture capital industry

AVCAL represents PE and VC industry in Australia, which has a combined total of around $30 billion in funds under management on behalf of domestic and overseas investors including Australian and offshore superannuation and pension funds, sovereign wealth funds, and family offices. VC and PE firms invest billions of dollars in early stage and established businesses spanning across almost every sector of our national economy. In the financial year ending 30 June 2017 alone, PE and VC invested around $3.6 billion into Australian businesses.

An April 2018 study by Deloitte Access Economics provides some deeper insights into the economic contribution of PE including:

- In FY2016, private-equity backed businesses contributed $43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);
- In FY2016, private equity-backed businesses added almost 20,000 FTE jobs, accounting for 11% of total Australian employment growth in FY2016;
- PE-backed businesses typically delivered annual revenue growth of 20%, while boosting the size of their workforce by 24%;
- More than 85% of private-equity businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

6. Next steps

We would like to thank you for the opportunity to provide a submission in relation to the Exposure Draft and explanatory material. If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Kosta Sinelnikov (AVCAL's Policy & Research Manager) on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL