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1 June, 2011

Ms A. Zanardo
General Manager
International Tax & Treaties Division
The Treasury
Langton Crescent
Parkes, ACT 2600

**By email: a**manda.zanardo@treasury.gov.au

Dear Ms Zanardo

**Proposals Paper on the 'Options to Codify the Tax Treatment of Sovereign Investments'**

CPA Australia represents the diverse interests of more than 132,000 members in 111 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission concerning the abovementioned Proposals Paper released by the Assistant Treasurer on 20 April 2011. This submission is made not only on behalf of our members but also for the accounting profession and in the broader public interest.

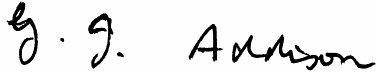
We have limited our comments to the identification of specific issues rather than making a submission on all aspects of the proposed codification of the sovereign immunity principles.

CPA Australia supports the Government initiative to codify the tax treatment of sovereign investments. In the context of CPA Australia's members and the client base that our members provide services to, the initiative is likely to have particular relevance to direct sovereign investment in small to medium sized businesses and indirect sovereign investment in such businesses, for example, via private equity funds.

The Paper sets out two possible options for the taxation of sovereign investments. CPA Australia supports the second option which consists of rules 1 to 11. Consistent with the current practice, the proposed rules will codify the income tax and withholding tax exemption in respect of foreign government's non-commercial investments.

The submission points we would like Treasury to consider are contained in the attachment to this letter. Should you have questions on any aspects of this submission, please do not hesitate to contact me.

Yours sincerely,



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# Attachment

## Rule 1: Non-assessable, non-exempt (NANE) and not subject to withholding

The Proposals Paper states at page 5 in relation to rule 1 the following:

"The rule provides that relief from Australian tax will be granted through non-assessable, non-exempt income status and the removal of any obligations to withhold. In relation to withholding obligations, there will be no liability to withholding tax on interest income, dividend income or distributions from managed investment trusts (including capital distributions)."

In terms of withholding tax obligations, the question is whether an Australian payer will be able to rely on the assertion made by the non-resident (either a foreign government agency or a sovereign fund) that it qualifies as an 'eligible entity' under rule 5 and thus benefits from the 'removal of any obligations to withhold' as stated above.

We understand that the two options described in the Paper for the taxation of sovereign investments are drafted in a way to be more conducive to self-assessment. As stated at page 2, "this will have the effect of increasing certainty, reducing compliance and administrative costs and better aligning the regime with optimal policy setting for the taxation of inbound investment".

In this context, the rules should provide *clarification* on whether a foreign government agency or sovereign fund (SF) can self-assess for the purposes of rule 5:

- If the rules confirm self-assessment for the purposes of rule 5, the question is how this self-assessment will be implemented. Should an Australian payer rely exclusively on the information provided by the foreign government agency or the SF in terms of their eligibility under rule 5? Should there be a specific form created under the rules that would be filled in by the sovereign investors for this purpose?

- In the opposite case, should the foreign government agency or SF seeking to claim the 'eligible entity' status apply to the Tax Office to be endorsed as an 'eligible entity'? Should a process similar to the process for registering and recognising an organisation that is a deductible gift recipient be put in place for registering and recognising a foreign government agency or SF as an 'eligible entity'? This could consist in establishing a registry similar to the Australian Business Register which could be publicly available, there could be an endorsement by the ATO to ensure that the organisation is eligible and the onus would be on the foreign government agency or SF to register and apply for the endorsement.

**We submit that the rules should provide *clarification* in relation to the self-assessment process for the purposes of rule 5. It is critical to identify the potential compliance burden for small to medium sized businesses (SMES) in terms of their withholding tax obligations**

## Rule 6: Income or gains arising in relation to debt interests will be NANE

Income and gains made in respect of a CGT asset that is a debt interest will not be NANE income if the debt interest contains a right (whether existing or contingent) to:

i) vote at a meeting of the Board of Directors (or other governing body) of the issuer of the debt interest; or
ii) participate in making financial, operating and policy decisions in respect of the issuer of the debt interest; or
iii) deal with assets of the issuer of the debt interest.

This rule does not apply where a right of the kind specified under (i) to (iii) arises solely as a result of a breach of the terms of the debt interest by the issuer.

### (a) Clarification of the tests set out under rule 6 (i) to (ii)

In our view, the tests set out at paragraphs (i) to (iii) of Rule 6 need to be clarified. We believe that if a debt interest contains one of these rights, this should not automatically exclude from sovereign immunity any income or gains made in respect of this debt interest:

- Rule 6(i) excludes from sovereign immunity income or gains made in respect of a debt interest if this debt interest contains 'a right to vote at a meeting of a Board of Directors (or other governing body) of the issuer of the debt interest'.

We believe that depending on the circumstances, holding just one vote at a meeting of a Board of Directors may not be sufficient to convey any participation rights to the sovereign investor that would weigh in favour of participating in a commercial activity.

In our view, income or gains made in respect of a debt interest should be immune from taxation where the level of voting rights in the issuer's entity is such that the sovereign investor cannot be considered to be conducting or influencing the commercial activities undertaken by the issuer.

- Rule 6 (ii) excludes from sovereign immunity income or gains made in respect of a debt interest if this debt interest contains 'a right to participate in making financial, operating and policy decisions in respect of the issuer of the debt interest'.

We believe that depending on the circumstances, the ability to participate in making financial, operating and policy decisions in respect of the issuer may not be sufficient to convey any participation rights to the sovereign investor that would weigh in favour of participating in a commercial activity. Therefore, this ability should not of itself automatically prevent the debt interest from qualifying for sovereign immunity.

We understand that the policy intent is to limit sovereign immunity to non-commercial investments made by foreign government agencies and SFs. In this context, we believe that this ability to participate in making financial, operating and policy decisions should not, of itself, be determinative to exclude any income or gains from Australian taxation, it should only weigh in favour or not of participating in a commercial activity.

In our view, income or gains made in respect of a debt interest should be immune from taxation where the level of participation in the issuer's entity is such that the sovereign investor cannot be considered to be conducting or influencing the commercial activities undertaken by the issuer.

- Rule 6 (iii) excludes from sovereign immunity income or gains made in respect of a debt interest if this debt interest contains 'a right to deal with assets of the issuer of the debt interest'.

This concept of 'dealing' with assets of the issuer needs to be clearly defined under rule 6. Again, we believe that this ability to deal with assets of the issuer should not, of itself, be determinative to exclude any income or gains from Australian taxation, it should only weigh in favour or not of participating in a commercial activity.

In our view, income or gains made in respect of a debt interest should be immune from taxation where the level of dealing with assets of the issuer's entity is such that the sovereign investor cannot be considered to be conducting or influencing the commercial activities undertaken by the issuer.

**We submit that if a debt interest contains any of the rights set out under rule 6(i) to (iii), the income or gains made in respect of such debt interest should not automatically be excluded from sovereign immunity. These debt interests should still be eligible for sovereign immunity provided these rights do not confer rights for the sovereign investor to conduct or influence the commercial activities undertaken by the issuer.**

**We also submit that 'a commercial activity test' similar to the test under rule 9 could be introduced under rule 6 to test whether the nature of the debt interest held by the foreign**

**government agency or SF confers rights for the sovereign investor to conduct or influence the commercial activities undertaken by the issuer.**

### (b) Debt interests that are 'akin to a non-portfolio equity interest'

The Paper states at page 14 in relation to rule 6 the following:

"Income and gains arising from a debt interest will generally be exempt with the exception of those that convey participation rights akin to those typically held by a non-portfolio equity holder".

Example 5 also refers to this concept and states that the ability for the SF to participate in the operations of the Australian entity is limited to standard investor protection measures and thus the right to participate in the operations of the Australian entity is not 'akin to a non-portfolio equity holder.

These statements referring to "participation rights akin to those typically held by a non-portfolio equity holder" seem to be inconsistent with the tests set out under rule 6 (i) to (iii).

**We submit that if the policy intent is to exempt income and gains arising from a debt interest that do not convey participation rights 'akin to those typically held by a non-portfolio equity holder', this should be clearly stated under rule 6.**

**If so, the rules should clarify how this concept should be reconciled with the tests under rule 6(i) to 6(iii). We submit that a 'safe harbour test' similar to the test under rule 7 could be introduced under rule 6 to achieve such a reconciliation process.**

**Importantly, the concept of 'akin to those typically held by a non-portfolio equity holder' should be clearly defined under rule 6.**

Conclusion:

Rule 6 could be structured as follows:

- Step 1: debt interest subject to a safe harbour test

The safe harbour test would exclude from sovereign immunity any income or gains arising in relation to a debt interest that conveys 'participation rights akin to those typically held by a non-portfolio equity holder'.

- Step 2: fall back option - the 'commercial activity test

  A debt interest that fails the safe harbour test could still be eligible for the tax treatment under rules 1 to 4 where such debt interest, under the 'commercial activity test', would not confer rights for the sovereign investor to conduct or influence the commercial activities undertaken by the issuer.

**Rule 7: Income or gains arising in relation to certain equity interests will be NANE (the 'safe harbour test')**

Rule 7 states that the 'safe harbour test' is satisfied if:

i) the foreign government agency has a direct or indirect investment in the CGT asset;
ii) the CGT asset is an equity interest in a corporate tax entity, fixed trust or partnership; and
iii) the foreign government agency has a total participation interest (or voting interest), in that entity of less than 10 per cent.

We support the application of a safe harbour test which provides an exemption for equity interests held by foreign government agencies or SFs that constitute less than 10% of the participation interest in the corporate tax entity, fixed trust or partnership.

Rule 7(i) states that the safe harbour test is satisfied if the foreign government agency has a 'direct or indirect' investment in the CGT asset. We assume that the reference to a 'direct or indirect investment' covers situations where a sovereign investor holds its investments through fiscally transparent entities, including limited partnerships (LPs), trusts or limited liability companies. However, this assumption should be clearly stated under rule 7 to provide greater certainty for sovereign investors. We believe sovereign immunity relief should flow through to the sovereign investors.

In the context of CPA Australia's members and the client base that our members provide services to, we note that many sovereign investments in SMEs are held indirectly, for example, via private equity funds. We believe that the sovereign exemption should apply whether a sovereign investor holds a total participation interest of less than 10% in an Australian entity either directly or indirectly through a fiscally transparent entity.

**We submit that where a sovereign investor holds its investments through fiscally transparent entities, sovereign immunity relief should flow through to the sovereign investors. This flow through principle should be clearly stated under rule 7 to provide greater certainty in respect of Australian tax consequences for sovereign investors.**

Rule 7 (iii) states that the safe harbour test is satisfied if the foreign government agency has a 'total participation interest', or 'voting interest', whichever is higher, in a corporate tax entity, a fixed trust or a partnership of less than 10%.

In relation to the 'total participation interest' test, rule 7 is drafted with a view to adopting the meaning given to the term 'direct participation interest' in the proposed amendments contained in the draft *Tax Laws Amendment (Foreign Source Income Deferral) Bill 2011*. The proposed section 960-190 contained in the draft *Tax Laws Amendment (Foreign Source Income Deferral) Bill 2011,* defines the term 'direct participation interest' as follows:

*'An entity holds a **direct participation interest** at a particular time in another entity equal to the percentage that the entity holds at that time of the total rights of members of the other entity to returns on equity interests in the other entity (otherwise than on winding-up) that are distributions of profits".*

In our view, relying on this 'direct participation interest' test will not satisfy the Government's aim 'to provide greater certainty for sovereign investors in determining whether a potential investment will be eligible for an exemption from Australian tax' as in most cases, the sovereign investor will not be informed of the terms of all the interests issued by the entity.

Also we note that the direct participation interest needs to be held '*at a particular time'.* It is unclear what is meant by the reference to hold a direct participation interest '*at a particular time*'. If the safe harbour test relies on this 'direct participation interest' test, this reference should be clearly defined under rule 7 or in the Explanatory Memorandum for rule 7.

In relation to the 'voting interest' test, sub-rule 7-2 states that voting interest means the foreign government agency's or SF's total right to vote at a general meeting (or participate in a similar decision making process) of the members of the corporate tax entity, fixed trust or partnership. The voting interest is measured as a percentage of the total of all rights to vote of all members of the entity.

We believe that in most cases, this percentage information in relation to voting interests should be more easily accessible to sovereign investors compared to the percentage information in relation to direct participation interests. Thus, relying on the voting interest test should satisfy the Government's aim 'to provide greater certainty for sovereign investors in determining whether a potential investment will be eligible for an exemption from Australian tax'.

**We submit that the safe harbour test should rely exclusively on the voting interest test test. This would be consistent with the statement made in the Paper on page 22 that in most cases there will be a direct correlation between the size of the foreign government agency's or SF's interest in the right to vote on financial, operating and policy decisions of an entity and the level of commerciality, with small interests generally considered to be non-commercial in nature.**

**Also, we submit that the timing rules associated with this test should be clearly defined under rule 7 or in the Explanatory Memorandum for rule 7.**

- **Income or gains made in respect of a CGT asset not covered by rule 6 or rule 7**

We understand that rule 5 prescribes the types of entities that may be eligible for relief from Australian taxation while the other rules limit this eligibility on the basis of the nature of the eligible entity's holding. Broadly, income or gains made in respect of a CGT asset will be NANE income and not subject to any Australian withholding tax if such income or gains are derived in relation to 'non-commercial investments' made by foreign government agencies or SFs.

We note that We note that 'rules 6 to 8 set out the circumstances in which income and gains arising from certain interests will attract the tax treatment set out in rules 1 to 4. The initial determination a sovereign investor needs to make is whether the interest in question is a debt interest or an equity interest. The reference to a debt or an equity interest in the Paper refers to whether such interest is characterised as debt or equity under Division 974 of the Income Tax Assessment Act 1997 (ITAA 1997).

We assume that 'non-commercial investments' in relation to a CGT asset that is neither a debt interest nor an equity interest will also be covered by the sovereign immunity exemption.

For instance, financial instruments, such as interest rate swap contracts or currency swap contracts that are entered into to hedge investments will not be categorised as either a debt interest or an equity interest. If these financial instruments are sourced in Australia and they relate to non-commercial investments, we would assume income or gains derived by an eligible entity in relation to these financial instruments would be eligible for relief from Australian taxation under the sovereign immunity rules.

Another example would be a 15-year term legal form loan that does not satisfy the debt interest test under sections 974-20 of the ITAA 1997 and at the same time may not satisfy the equity interest test under section 974-75 of the ITAA 1997. Again, we assume income or gains derived by an eligible entity in relation to this type of financial arrangement would be eligible for relief from Australian taxation under the sovereign immunity rules provided this type of arrangement relates to a non-commercial investment.

**We submit that income or gains made from any type of property or legal and equitable interests that are held by an eligible entity should be eligible for relief from Australian taxation even if these interests cannot be classified as a debt interest or an equity interest as long as these interests relate to non-commercial investments.**

**We also submit that the 'commercial activity test' set out under rule 9 which currently seems to only apply to equity interests that fail rule 7, could also apply to these types of interests to determine their eligibility for sovereign immunity.**