

# Australia

## Taxation

HEDGE FUNDS 2009

The Australian experience is that the trust structure is the most common type of entity utilized for an Australian (Onshore) hedge fund, and that fund managers are usually corporate entities. Accordingly, unless otherwise indicated, the following analysis is based on the assumption that the fund is set up as a trust and any fund manager is incorporated.

### Hedge fund managers/advisors

#### Taxation

##### Tax rates applying to hedge fund managers/advisors

Any income received in the hands of the fund manager (that is, management and performance fees) is taxed at the corporate income tax rate of 30 percent.

##### The effective tax rate usually suffered by hedge fund managers/advisors

As stated above the effective tax rate should be 30 percent.

##### Tax concessions, allowances, or exemptions specifically available to hedge fund managers/advisors

There are no concessions, allowances, or exemptions that are specifically available to hedge fund managers.

##### Details of anti-avoidance tax rules that could bring the profits of an offshore hedge fund into tax

Broadly, where the fund manager of an offshore fund operates from Australia, the profits of the fund will be subject to Australian income tax liability where:

- Australian source – The income derived by the offshore fund has an Australian source; or

- Double taxation agreement (DTA) – The offshore fund is a resident of a country with which Australia has entered into a DTA and the taxing rights are restricted to Australia in accordance with that agreement.

Both matters are discussed in more detail below.

### Requirements to charge VAT (or equivalent sales tax) and the rate

Under the Australian GST legislation, services will be subject to Australian GST if they are connected with Australia (either the services are performed here or they are made through a business carried on in Australia) and are not GST-free (zero-rated) under the exported services provisions or input taxed (exempt) under the financial supply regime.

Generally, if an Australian fund manager provides services to an Australian resident fund, the services will be subject to GST at the rate of 10 percent. Because the fund manager's services are not input taxed (exempt) then it is likely that the fund manager can reclaim all of the input tax incurred.

If an Australian fund manager provides services to an offshore fund, and the offshore fund has no presence in Australia, then the fund manager's services will be GST-free. It is likely that the fund manager can reclaim all of the input tax incurred.

While the European model of VAT has an exemption that applies for negotiation or arranging of certain financial supplies, such activities in Australia are subject to GST at the standard rate of 10 percent, if they are not GST-free.

## Hedge fund structure

### Taxation

As mentioned above the trust structure (typically a unit trust) is the most common type of entity utilized for an onshore hedge fund. Accordingly, unless otherwise stated, the analysis set out below is based on the assumption that the fund is set up as a trust.

### Tax rates applying to the fund

Generally, trusts are flow-through or transparent vehicles which are not viewed as a separate legal entity for Australian income tax purposes. On this basis, except in certain circumstances, the fund should not be subject to taxation in Australia.

It should be noted that where the fund incurs losses of a revenue nature, these losses remain in the fund and cannot be distributed to investors. Broadly, the

trust may take them into account in determining its own net (taxable) income in a subsequent year, provided the Australian trust loss provisions are satisfied.

It should also be noted that under certain anti-avoidance rules, some trusts may be treated as corporate unit trusts or public trading trusts. If classified as such, a fund would be subject to tax at the corporate tax rate of 30 percent.

#### *Income of an Australian trust*

The net (taxable) income of a trust is calculated in a similar manner to companies (that is, assessable income less allowable deductions). However, the net (taxable) income of trust estates is taxed in the hands of the beneficiaries who are presently entitled to the net income, assuming those beneficiaries are not under a legal disability (see the Investors - Taxation section below for detail).

Generally, the Responsible Entity (RE) acting as trustee of the fund will be taxable in its own right in respect of net (taxable) income of the fund to which no beneficiary is presently entitled at the highest personal tax rate of 46.5 percent (including Medicare Levy) (for the year ended 30 June 2009).

When beneficiaries are presently entitled, broadly, the RE of the fund will bear the beneficiaries' Australian income tax liability attributable to the net income of the fund in the following circumstances:

- where a beneficiary is under a legal disability; or
- where income of the fund has an Australian source and the beneficiary is a non-resident for Australian income tax purposes.

The RE will be taxed as if it were an individual and were not subject to any deduction (even where the RE is a corporate entity). The exception being where the non-resident beneficiary is a company not acting in the capacity of a trustee. In this instance the RE should be liable to tax at the corporate rate of 30 percent.

Despite the RE being taxed in the above circumstances, the beneficiary is not relieved of its tax obligation. Income is taxed first to the trustee and then on the beneficiary, however, the beneficiary is entitled to a credit for the tax remitted by the trustee.

It should be noted that a non-resident beneficiary should not be liable to Australian income tax on foreign sourced income. However note that, in the view of the Australian Taxation Office, in the case of certain notional income amounts attributable to a resident fund under the foreign investment fund rules (which is otherwise foreign sourced taxable income) the notional income will be an amount to which no beneficiary is presently entitled, exposing the trustee to taxation.

### Access to double tax treaties

An Offshore hedge fund resident in a country with which Australia has concluded a DTA will generally be entitled to the benefits of the agreement, except to the extent that it maintains a permanent establishment in Australia. If the investment fund maintains a permanent establishment in Australia, the fund's income attributable to that establishment will generally be subject to tax in the same manner as that of an Australian resident hedge fund. The foreign unitholders of such a fund will generally also be denied the benefit of the relevant agreement as such foreign unitholders will be deemed also to be operating through a permanent establishment in Australia, subject to the comment below regarding deemed source rules.

In relation to onshore hedge funds deriving income from a country with which Australia has concluded a DTA, corresponding rules will apply to those described above.

Subject to satisfying certain conditions, where a non-resident unitholder is presently entitled to foreign source income (determined in accordance with Australian domestic tax law) derived from a widely held unit trust from funds management activities carried on through a permanent establishment in Australia, Australian domestic source rules (see below) will apply instead of the deemed source rules included in Australia's DTAs. Broadly, investments made offshore by the fund can be structured such that the income has a foreign source for Australian income tax purposes. This means that non-resident unitholders would not be subject to Australian income tax in respect of foreign source income attributable to a permanent establishment in Australia.

Currently, there are over 40 double tax agreements that have been entered into by Australia.

### *Australian source*

A non-resident trust will only be subject to Australian income tax on Australian sourced income. The Australian common law provides commentary on the source of income. The income resulting from carrying on the fund should be characterized as business income.

Set out below is a summary of the general criteria used within Australian case law to identify the source of business income:

- where the contract is concluded;
- the place of incorporation of the relevant parties;
- the place where the relevant parties carried on business;
- the place where the central management of the taxpayer was located;

- where the asset was located;
- the source of the funds of profits used to pay dividends; and
- where the decisions or instructions were given in relation to the purchase and sale of a transaction

Where it can be established that any of the business income of the offshore fund satisfies the above criteria within Australia then there is the possibility that the income may be subject to Australian income tax.

### Withholding tax on dividends, interest, and other payments

To the extent to which an onshore hedge fund's income is sourced in Australia, corresponding distributions to non-resident unitholders will generally be subject to tax. The rate of tax and method of payment will depend upon whether the income represents:

- Interest – the fund is generally required to withhold tax at 10 percent. This is a final tax. There are exemptions in limited circumstances.
- Dividends – in relation to dividends which are paid out of profits that have not previously been subject to company tax, the fund is generally required to withhold tax at 30 percent although DTAs to which Australia is a party generally reduce this to 15 percent. This is a final tax. Where the dividends have company tax credits attached, withholding tax is not required to be deducted from the franked portion of the dividend.
- Certain unfranked dividends that are paid to non-residents may be exempt from dividend withholding tax under conduit foreign income rules.
- Foreign superannuation (pension) funds, which are exempt from income tax in their own country, are not subject to Australian interest or dividend withholding tax.
- Other – the fund is generally required to withhold tax on other income (except non-taxable capital gains and foreign sourced income). Generally, tax is withheld at various rates depending on the type of investor, unless the fund constitutes a managed investment trust (MIT) (see discussion below). This is not a final tax, that is, the unitholder is required to pay tax at year end by way of assessment with a credit for any tax previously withheld/paid by the fund.
- For MIT rules to apply a fund must be a managed investment scheme under the Corporations Act 2001 and be either listed or widely-held (as defined). The tax rate which applies will depend on whether or not distributions are made to residents of 'information exchange countries' per

the Australian tax regulations. For distributions of other income made by MITs to residents of information exchange countries:

- For the 30 June 2009 year, a non-final rate of 22.5 percent applies.
- For the 30 June 2010 year, a final rate of 15 percent applies.
- For the 30 June 2011 year and onwards, a final rate of 7.5 percent applies.
- For distributions of other income made by MITs to residents of non-information exchange countries, a final rate of 30 percent applies for the 30 June 2009 year and onwards.

## Value-added tax registration and charging requirements

### *Registration*

Under the Australian GST system, trusts (including investment funds) are recognized as entities and therefore the fund may be required to separately register for GST purposes. The fund will be required to register if it exceeds the registration threshold of AUD 75,000 of taxable or GST-free supplies (but not including input taxed supplies). However, it may choose to register for GST to claim input tax suffered, generally by way of reduced input tax credits (see below).

### *GST Liability*

Supplies made by an investment fund will normally be input taxed financial supplies. Financial supplies, which are input taxed (exempt), are made where a registered entity supplies or acquires an interest in certain defined interests including shares, units in a trust fund, interests under superannuation funds, life insurance and other forms of securities (for example, debentures).

### *Recovery of GST*

Therefore, the Australian GST charged on acquisitions made by an investment fund to make its investments will generally not be recoverable as an input tax credit. In addition, a reverse charge rule of 10 percent of the price of the services will generally apply where the fund acquires services from outside Australia, to impose an unrecoverable GST cost.

### *Reduced input tax credits*

However, reduced input tax credits equal to 75 percent of the GST imposed, are available for acquisitions that are specifically nominated in the GST

legislation as a reduced credit acquisition, which include (as relevant to investment funds):

- brokerage and trade execution services for securities, including arranging fees;
- securities and unit registry services to securities and unit issuers;
- origination and broking services in relation to loans;
- loan application, management, and processing services;
- responsible entity, trustee, and custodial services;
- portfolio management services;
- facilitation or arranging for the supply of an interest in a security;
- certain debt collection services; and
- certain administrative functions in relation to investment funds, such as, document handling, processing services, report production and distribution, record maintenance and distribution, mailing services, member inquiry services, and some compliance services.

As an overriding consideration, certain financial supplies may qualify for GST-free classification, where they involve:

- a non-resident counterparty that is not in Australia; or
- an interest which can only be exercised outside of Australia.

In this case, the fund is entitled to recover input tax related to making those GST-free supplies.

### *Summary*

To summarize the GST position, the supply or acquisition of interests in an investment fund will generally be input taxed. Acquisitions of Australian services made by an investment fund will generally be subject to GST. Whether an investment fund can recover an input tax credit or reduced input tax credit will be subject to the exact circumstances in which each acquisition is made.

## Tax return requirements

Irrespective of the amount of income derived, a trust tax return must be lodged on behalf of the fund by the RE resident in Australia or by any RE if required by the Commissioner of Taxation.

If there is no RE resident in Australia, the trust tax return is lodged by the public officer of the fund or, if a public officer does not need to be appointed, by an agent in Australia for the RE.

It should be noted that the non-resident beneficiary should lodge an Australian income tax return in order to receive the credit for the tax already paid by the RE.

If an investment fund or fund manager is registered for GST it will be required to lodge a VAT/GST return with the Commissioner of Taxation called a Business Activity Statement (BAS). Generally, the BAS is due monthly or quarterly depending on turnover. Most investment funds register for quarterly BAS returns.

## Investors

### Taxation

As noted above, hedge funds established in Australia will usually be structured as unit trusts. Generally, the tax liability for the fund's net (taxable) income will fall upon the unitholders. The income arises to the unitholder when the unitholder is presently entitled, that is, has a vested and indefeasible interest in the income of the trust. Under the trust deed, unitholders are usually deemed to be presently entitled on a monthly, quarterly, semi-annual or annual basis. The physical distribution of income usually follows within a few months of the date of present entitlement.

The trust deed generally requires that the income and/or gains of the trust are distributed. If the unitholder is not presently entitled to all income and gains of the trust, then the trustee will be subject to tax in respect of some or all of the taxable income of the trust.

### Taxation of resident unitholders/investors in an onshore hedge fund

An Australian resident unitholder in an onshore hedge fund will be subject to tax in Australia as follows.

Distributions of income and/or net capital gains by the fund will be taxed as ordinary income (subject to the capital gains tax concessions discussed below) of the individual unitholder at their marginal rate of tax as follows (applicable for

year ending 30 June 2009):

Taxable Income	Income Tax Payable
AUD	AUD
0 – 6,000	0
6,001 – 34,000	15 percent on excess over 6,000
34,001 – 80,000	4,200 plus 30 percent on excess over 34,000
80,001 – 180,000	18,000 plus 40 percent on excess over 80,000
> 180,000	58,000 plus 45 percent on excess over 180,000

In addition, a Medicare levy of 1.5 percent is currently payable by most residents thus bringing the highest marginal rate (in most circumstances) up to 46.5 percent.

Capital gains on the disposal of units in a fund are generally subject to income tax at the above marginal rates (subject to capital gains tax (CGT) concessions). For capital gains derived on assets acquired prior to 21 September 1999, individuals, trusts, and complying superannuation funds may elect to be assessed either on the old basis (except that indexation is frozen at 21 September 1999) or they may elect to obtain a 50 percent discount on the gain (33 1/3 percent discount for complying superannuation funds), where the relevant asset has been held for at least 12 months. For assets acquired after 21 September 1999 and have been held for at least 12 months, the abovementioned entities can benefit from the CGT discount to gains derived from the disposal of the assets.

The CGT discount or the election in respect of assets (that were acquired prior to 21 September 1999) will also be available at the fund level in calculating the fund's net (taxable) income, although to the extent that activities of a hedge fund gives rise to gains that are on revenue account, such gains do not attract the CGT concessions.

Complying superannuation entity unitholders in an onshore hedge fund are taxed at the concessional rate of 15 percent on income distributions. As noted above a one-third discount applies to capital gains for assets held for more than 12 months.

Corporate unitholders are taxed at 30 percent and the CGT concession is not available.

#### *Specific anti-avoidance tax legislation applying to an investor in an onshore hedge fund*

Australia provides a general anti-avoidance rule (Part IVA) that allows the Commissioner of Taxation to cancel the effect of any tax benefit that a taxpayer derived from an arrangement where it can be concluded that a person (not

necessarily the taxpayer) entered into or carried out the arrangement for the sole or dominant purpose of enabling the taxpayer, or the taxpayer and other persons, to obtain a tax benefit.

An arrangement will be considered to give rise to a tax benefit if it causes an amount to be excluded from the taxpayer's assessable income, an amount to be allowed as a deduction, an amount of a capital loss to be incurred, a Foreign Tax Credit to be allowable or an amount of withholding tax not to be payable.

See also CFC, FIF, and deemed entitlement provisions discussed below.

### Taxation of resident unitholders/investors in an offshore hedge fund

Where an Australian resident invests in an offshore hedge fund and the non-resident fund distributes income (including capital gains) to the resident investor, such income (including capital gains) will generally be included in the investor's assessable income. The foreign sourced income will be grossed up for any foreign tax credit.

A unitholder in a non-resident unit trust will generally be entitled to a foreign tax credit for foreign taxes suffered by the trust either on its income and/or gains or on the distribution of net income to the beneficiary.

In the case of an offshore hedge fund organized as a company, a foreign tax credit is generally available for foreign tax paid on the dividend payment to an Australian non-company investor (that is, withholding tax). Similarly, a foreign tax credit will generally be available for foreign taxes paid by a foreign fund organized as a company on the dividend payment to an Australian company investor where the Australian company investor has a portfolio interest (less than 10 percent voting interest in the foreign paying company) (that is, withholding tax). Where the Australian company investor has a non-portfolio interest (a 10 percent or more voting interest in the foreign paying company), the dividend will be tax exempt in Australia.

Most of the DTAs which Australia has negotiated provide that relief from double taxation shall be available on the above basis also.

The foreign tax credit allowed to investors in a unit trust or company is limited to the lower of the Australian tax otherwise payable on the foreign income or the foreign tax paid (no limitation where the foreign tax credit amount for a year is less than AUD 1,000). Any excess credits cannot be carried forward into subsequent income years.

If the unitholder makes a net capital gain from the disposal of his/her interest in the non-resident fund the gain will generally be included in the taxable income of the unitholder.

*Specific anti-avoidance tax legislation applying to an investor in an offshore hedge fund*

The Australian income tax regime has Controlled Foreign Companies (CFC) rules. These CFC rules broadly operate to tax Australian resident shareholders on profits or gains which are considered tainted income of the foreign company or trust in which they control, or are deemed to control. Tainted income may broadly be described as income from passive sources (for example, interest, dividends, or royalties) or from sales to related parties or from the provision of services to parties connected with Australia. These provisions annually attribute to Australian resident taxpayers their share of the tainted income generated by the CFC in that year. The statutory accounting period for a CFC is usually 1 July to 30 June each year.

Australia also has a residual anti-deferral regime, the Foreign Investment Funds (FIF) rules. Broadly, the FIF provisions may apply to interests held by Australian residents in foreign companies or trusts where the interest held is not a controlling interest (that is, usually an interest of less than 50 percent). Similar to the CFC rules, the FIF rules operate to annually attribute to an Australian resident taxpayer their share of the income generated by the FIF in that year. Generally, the FIF year also runs from 1 July to 30 June each year. Thus the FIF legislation may operate to include unrealized gains on the investment, such as, undistributed income (including capital gains) of the non-resident fund, in a unitholder's taxable income.

The income is calculated:

- on an increase in the market value of the fund;
- deemed rate of return; or
- re-calculation of income basis.

There are a number of exemptions available under the legislation. These include:

- where the fund holds active business interests;
- where the individual unitholder's (and their associates') interests in foreign companies and trusts and foreign life assurance policies at year end does not exceed AUD 50,000;
- where the resident unitholder's interest in the fund is trading stock;
- where the total value of the resident unitholder's interest in non-exempt foreign investment funds does not exceed 10 percent of the total value or cost (whichever is greater) of all of the taxpayer's interests in foreign investment funds (excluding certain specific exempt foreign investment funds); and

- where the fund invests in certain U.S. investment entities.

Complying superannuation entities, and fixed trusts wholly owned by such entities, are not subject to the foreign investment fund legislation.

If the unitholder makes a net capital gain from the disposal of his/her interest in the non-resident fund the gain will generally be included in the taxable income of the unitholder. However, to prevent double taxation the gain on the disposal of the interest in the non-resident fund may be reduced if such gain has already been assessed under the foreign investment fund legislation (see above).

To prevent double taxation, where the unitholder receives a distribution from the non-resident fund consisting of the assessable portion of the distribution will be reduced to the extent the income has previously been assessed under the foreign investment fund provisions.

Australia also has relatively complex Deemed Entitlement rules which may have application where an Australian resident holds an interest in a non-resident trust estate. Where these rules apply, the Australian beneficiary is deemed to be a beneficiary who is presently entitled to a share of the foreign trust's income, even if otherwise under a legal disability. The Australian beneficiaries' net income is calculated via statutory formula and included in their assessable income, even if they received no distribution from the non-resident trust. It should be noted that these provisions only apply where the CFC and FIF provisions do not.

See also the comments above on the general anti-avoidance provision (Part IVA).

#### *Foreign hybrid rules*

An Australian resident investor may invest in an offshore hedge fund which is a foreign hybrid. A foreign hybrid is an entity which, but for the foreign hybrid rules, would be treated as a company for tax purposes in Australia but which is treated as a partnership for tax purposes overseas (that is, the members of the entity are taxed rather than entity itself. Under the foreign hybrid rules, Australian investors in these entities are treated as having partnership interests for tax purposes. Entities to which the rules may apply include foreign limited partnerships (LP), foreign limited liability partnerships (LLP), U.S. limited liability companies (U.S. LLC) and other similar entities that are taxed as partnerships in their relevant jurisdiction (as specified by regulation, for example, U.K. LLP).

By treating foreign hybrids as partnerships, flow through taxation treatment will apply under the normal tax provisions for partnerships (that is, the resident investor will be subject to tax on its share of the entity's taxable income). The main modification is that the amount of foreign hybrid losses available to be used by the investor to offset other income is limited based on the investors contribution to the entity (although excess losses may be carried forward).

Where an investor's interest in the foreign hybrid would otherwise be a FIF interest, the default treatment is that the interest is treated as a FIF interest (see above). However, the investor may make an irrevocable election for the FIF rules not to apply but rather the flow through partnership treatment.

### Taxation of non-resident unitholders/investors in an onshore hedge fund

To the extent to which an onshore hedge fund's income is sourced in Australia, corresponding distributions to non-resident unitholders will generally be subject to some form of withholding tax. The rate of tax and method of payment will depend upon whether the nature of the income involved (refer to the *Withholding tax on dividends, interest, and other payments* section).

#### *Capital Gains Tax (CGT) concession*

The Australian income tax legislation provides a CGT concession for non-residents. The categories of assets to which non-residents are liable to capital gains tax is restricted to Australian real property held directly or indirectly through an interposed entity and the disposal of business assets used in an Australian branch/permanent establishment. Broadly, non-resident investors will only be subject to Australian capital gains tax on disposal of interests in an Australian investment fund if they (and their associates) own 10 percent or more of the fund and the underlying assets of the fund which are attributable to Australian real property comprise more than 50 percent of the total assets of the fund (by market value). However, if the activities of a hedge fund give rise to gains on revenue account this concession for non-residents may not be available.

Similarly, only capital gains relating to Australian real property (whether held directly or indirectly through an interposed entity) realized by an Australian resident unit trust are taxable on distribution to non-resident unitholders.

Where a fund is set up as a fixed trust and otherwise satisfies the above criteria, the Manager's liability to withhold and pay tax is disregarded.

### Tax information needs of investors

The investor will require a distribution statement from the hedge fund setting out the composition of any distributions, including:

- currency the distribution is paid in;
- date of the distribution;
- payment before withholding tax;
- amount of withholding tax; and

- the amount of any capital gain and certain attributes relating to the gain.

If the investment in the hedge fund constitutes a CFC detailed information pertaining to the funds income may be needed to calculate the attributable CFC income. If the investment in the fund is a FIF interest, information necessary for determining FIF attributable income under the method elected would be necessary. Similarly, if the Foreign Hybrid rules apply, it may be necessary to have access to the fund's income calculations to determine the investor's share of partnership income. In practice, these matters may create significant compliance barriers.

## Recent developments

### Review of tax arrangements applying to managed funds

The Australian Labor Party (ALP) was elected into Government in December 2007. The ALP issued various statements prior to the election undertaking to review the taxation of managed investments. The review of the tax arrangements governing managed investment funds is currently in progress and the Government has tasked the Board of Taxation (BoT) with recommending options for providing a specific taxation regime for managed investment trusts as well as examining other changes to improve the competitiveness and attractiveness of Australian REITs and other managed investment trusts. This may have implications for the tax treatment of hedge funds. The BoT is expected to provide a final report to the Government by the middle of 2009.

### Taxation of Financial Arrangements (TOFA)

Australia has progressively introduced a regime which deals with the taxation of financial arrangements (collectively known as TOFA). This regime may impact the taxation of hedge funds and their investors. Tranches already in place deal with foreign currency gains/losses and debt/equity characterization.

The Government has introduced draft legislation of the final tranche which is intended to simplify the tax treatment of financial arrangements, predominantly by allowing for a greater linkage between accounting principles/treatment in determining the applicable tax treatment. The proposed TOFA rules will apply from 1 July 2010 onwards (unless a taxpayer elects to early adopt from 1 July 2009).

Generally, a hedge fund will be subject to the proposed TOFA rules where it holds assets of AUD 100 million or more. Whilst the proposed TOFA rules are unlikely to have a significant impact on most Australian managed funds, funds that have significant investments in financial securities such as derivatives and hedging instruments (such as hedge funds) will need to consider the impact of the application of the proposed TOFA rules to their investments. Investors in

hedge funds will need to consider the application of the new rules to their investment in the hedge fund, as well as the how impacts on the hedge fund itself may have flow-on implications for their investment.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.