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New examples have been provided in the EM to illustrate the change.

Conclusion

While the latest TOFA ED brings welcome refinements to the 2007 Bill, a number of aspects in that ED still require some further clarification. Those affected by the ED are encouraged to contribute to the consultation process, not forgetting that comments are due by 17 October 2008.

[1898] New Div 6C rules - Can managed funds invest in offshore "look-through" vehicles?

by Nicole Sammel, Senior Associate, Mallesons Stephen Jaques

The proposed amendments to Div 6C of the ITAA 1936 (contained in *Tax Laws Amendment (2008 Measures No 5) Bill 2008* - see 2008 WTB 41 [1817]) aim to clarify the categories of items in which a public unit trust (eg a managed fund) may trade or invest without jeopardising its status as a Division 6 trust ("Permitted Investments"). (If Div 6 status is lost, the fund will be taxed like a company, which is generally undesirable.)

This article considers whether investments in offshore "look-through" vehicles are Permitted Investments under proposed Div 6C. A vehicle is a "look-through" vehicle if, under the laws of the jurisdiction in which the vehicle is established, tax is imposed not on the vehicle, but instead, on its investors. Look-through vehicles can include, but are not limited to, vehicles called "limited liability company" (LLC), "limited liability partnership" (LLP) and "limited partnership" (LP).

In short, while interests in US LLCs and UK LLPs are Permitted Investments under proposed Div 6C, whether interests in other look-through vehicles are Permitted Investments is unclear.

Background - foreign hybrids

The foreign hybrid rules impact on whether an interest in a look-through vehicle is a Permitted Investment.

An offshore look-through vehicle will be a "foreign hybrid" under Div 830 of the ITAA 1997 if it satisfies the definition of "foreign hybrid company" ("FHC") (in s 830-15) or "foreign hybrid limited partnership" ("FHLP") (in s 830-10). By way of background:

- FHCs are limited to vehicles specifically named in s 830-15 or in regulations. Currently, only US LLCs and UK LLPs have been named.
- FHLPs include, but are not necessarily limited to, Delaware LPs, UK LPs, and German Kommanditgesellschafts (according to the ATO, at least).

(For more information on the tests for determining whether an offshore look-through vehicle is a foreign hybrid, see 2007 WTB 30 [1352].)

Where a look-through vehicle is a foreign hybrid (whether an FHC or an FHLP), an Australian investor will be taxed, broadly, as if the vehicle were a partnership, ie the investor will be taxed on their share of the vehicle's net income under Div 5 of the 1997 Act. If the vehicle is not a foreign hybrid, the investor will generally be taxed as if the vehicle were a company, meaning that the Australian investor might be liable to tax under the CFC or FIF regimes.

Potentially inconsistent treatment for FHCs and FHLPs under Div 6C

Given that investors in FHCs and FHLPs are taxed the same way, it might be expected that interests in FHCs and FHLPs would be treated consistently under the Div 6C rules, ie that each would be a Permitted Investment, or instead, that neither would be a Permitted Investment. In other words, it would be a strange if one kind of foreign hybrid interest were a Permitted Investment and the other were not.

Nevertheless, this may well be the position under proposed Div 6C as:

- shares in FHCs are explicitly listed as Permitted Investments (para (b)(iii) of

the definition of "eligible investment business" in s 102M as modified by item 3 of Sch 5 to the Bill);
- interests in FHLPs are not explicitly listed as Permitted Investments and may not qualify as Permitted Investments under the "catch all" provisions.

Are FHLPs "Permitted Investments"?

Under proposed Div 6C, Permitted Investments include, relevantly:

- (A) a share in a FHC (para (b)(iii) of the definition of "eligible investment business" in s 102M as modified by item 3 of Sch 5 to the Bill);
- (B) a financial instrument that arises under a financial arrangement other than … an interest in a partnership … if … the interest is an "equity interest" in the partnership (item 4 and proposed s 102MA (3) in item 8 of Sch 5 to the Bill); and
- (C) a financial instrument that is "similar" to a share in a FHC (para (b)(xiii) of the definition of "eligible investment business" in s 102M).

Tests (A), (B), and (C) are alternative tests. That is, an investment need satisfy only one of the tests to be a Permitted Investment. In particular, an investment which fails test (B) because it is an "equity interest in a partnership" could still be a Permitted Investment under test (C). (See the note to proposed s 102MA(1) in item 8 of Sch 5 to the Bill.)

So, can an interest in a FHLP qualify as a Permitted Investment under any of tests (A), (B) or (C)?

- ***Test (A)***: An interest in a FHLP cannot satisfy test (A) as it is not a share in a FHC.
- ***Test (B)***: An interest in a FHLP is an interest in a partnership for the purposes of the tax legislation (s 94D(5) of the ITAA 1936 and the note to Subdiv 830-B of the ITAA 1997). Whether an investor's interest is an "equity interest" in a partnership (rather than, eg a "debt interest") will depend on the investor's rights under the vehicle's constituent documents etc. However, commonly, the interest would be an "equity interest" in which case the interest would fail test (B).
- ***Test (C)***: It is unclear whether an interest in a FHLP is "similar" to a share in a FHC for the purposes of test (C). The "similar financial instrument" test has always been problematic - what does "similar" mean? Interests in FHLP and shares in FHCs are "similar" insofar as they are afforded the same tax treatment under Div 830. However, in other respects, eg legal form, the interests can be "different".

What was intended?

The explanatory memorandum to the Bill is silent as to whether interests in FHLPs are intended to be Permitted Investments.

Perhaps the drafters intended was that, where a fund invests in a FHLP, the "Permitted Investment" test is to be applied at the level of the underlying assets of the FHLP. In other words, perhaps it was intended that, to determine whether the fund has made a Permitted Investment, the FHLP is ignored, the fund is treated as having invested directly in each asset of the FHLP and the relevant inquiry is whether those underlying assets are Permitted Investments.

Practical implications

To provide certainty for the managed funds industry, the Bill should be amended to clarify whether interests in FHLPs are Permitted Investments and/or how the Permitted Investment test is to be applied where a fund invests in a FHLP.

One factor in support of interests in FHLPs being treated as Permitted Investments is that, under the Tax Act, interests in FHLPs are taxed the same way as shares in FHCs (see above). Further, the foreign tax treatment of investors in FHCs and FHLPs is also generally consistent - in each case, foreign tax is imposed on the investor, not on the vehicle. Given that the interests are essentially identical for other tax purposes, it is difficult to see why one kind of interest should be a Permitted Investment and the other, not.

Unless the Bill is amended, a managed fund should be wary about investing in offshore look-through vehicles other than US LLCs or UK LLPs. Investing in such vehicles might jeopardise the fund's status as a Division 6 trust.

TAX PRACTICE UPDATE

[1899] ATO to issue tax assessments re Liechtenstein bank clients

The ABC1 *Four Corners* program (8:30pm, 6 October 2008) reported that the Tax Office is about to issue notices of assessment in its offshore tax haven investigation. It is understood the assessments will seek up to $60m from people who have bank accounts in Liechtenstein. In response to suggestions that settlements in such tax cases should be made public, the Assistant Treasurer said the Commissioner had discontinued this practice around 1984. However, he said he could understand the "attraction of naming and shaming" and would be open to the idea if the Commissioner said he wanted to do it, although he stressed that it was a matter for the Commissioner. (*Source: Transcript of ABC1 Four Corners program "Tax Me If You Can", 6 October 2008 [http://www.abc.net.au/4corners/content/2008/s2381529.htm]*)

TIA not in favour of "naming and shaming"

The TIA has urged the Federal Government not to return to the "bad old days" when taxpayers penalised under the tax law were publicly labelled a tax cheat [see Thomson Reuters comment below]. The Institute said that currently, tax cheats were named and shamed when prosecuted through the courts and found guilty. To extend the process to an alleged disagreement with the Tax Office would be far too subjective, said TIA President, Sue Williamson.

Ms Williamson said there are crucial questions unresolved such as what constitutes a tax cheat and when they are deemed to be a cheat for the naming and shaming to occur. She said the question of when an individual or company could be named is therefore open to abuse. "It didn't work then and will not work now", Ms Williamson said. She warned that there is too great a risk that such legislation would capture and name the wrong people. (*Source: TIA media release, 7 October 2008*)

Thomson Reuters comment

The prospect of such assessments follows the recent hearings by the US Senate Committee on Homeland Security and Governmental Affairs, Permanent Subcommittee on Investigations, on the use of tax haven banks at which the Tax Office made a submission - see 2008 WTB 31 [1343], 2008 WTB 32 [1377]-[1379] and 2008 WTB 33 [1432]. At the time, Subcommittee Chairman Senator Carl Levin said the Subcommittee's 6-month long investigation examined LGT Bank in Liechtenstein and UBS in Switzerland "to expose how tax haven banks are assisting US taxpayers to evade taxes, in particular by urging US clients to open accounts in their offshore jurisdictions".

In its submission to the Committee, the Tax Office said that concealment was its main concern - in particular, those schemes and arrangements that use secrecy laws to conceal assets and income that are subject to tax in Australia. The Tax Office also said it was investigating the use of Liechtenstein entities and bank accounts in collaboration with other revenue agencies. The ATO said it had a particular focus on taxpayers who had used the services of the LGT Group and its trustee entity, LGT Treuhand Aktiengesellschaft in Vaduz, Liechtenstein (LGT).

The Commissioner's so-called "naming and shaming" practice was discontinued following his 1983-84 Annual Report. The Commissioner used to publish the names of taxpayers (individuals and companies) that

