SQUIRE PATTON BOGGS

Australian Investment Funds Update

December 2016

In our final Australian Investment Funds Update for 2016, we look at three current regulatory developments affecting the investment funds space. In this edition we look at:

- Tax Commissioner provides guidance on fixed trust status
- FIRB releases guidance on tax conditions
- ASIC extends the transition period for revised fee and cost disclosure requirements to 30 September 2017

IMPORTANT NOTE: Our Australian offices will be closed from 5 p.m. Friday 23 December 2016, reopening Tuesday 3 January 2017.

Commissioner Provides Guidance on Fixed Trust Status

What Has Happened?

The Australian Taxation Office (ATO) has recently released a draft Practical Compliance Guideline (PCG 2016/D16) of the factors the Commissioner will consider whether to treat a trust as a fixed trust.

Why is Fixed Trust Status Important?

The concept of being a "Fixed Trust" or having a "fixed entitlement" to trust income is relevant to a number of important tax provisions including trust loss, CGT, consolidation, franking, beneficiary reporting, superannuation and value shifting.

One of the most important aspects is that fixed trust status is important to enable franking credits to flow through a trust to the beneficiaries. If a structure includes a unit trust which holds shares in a company which may pay franked dividends, fixed trust status can be critically important.

Fixed trust status is also important for trusts which have (or may incur) tax losses as it allows the 50% stake test to be used to determine whether the trust is able to carry forward the tax losses. If a trust does not qualify as a fixed trust it must satisfy the pattern of distributions and control tests which can be more difficult to satisfy.

Another area where the concept of "fixed entitlement" is relevant is for superannuation funds which must hold a "fixed entitlement" to trust income, otherwise the income will be taxed at the top tax rate. The PCG specifies that it does not apply to the "non-arm's length income" test, which is instead covered by the existing ruling TR 2006/7.

Impact on Managed Investment Trusts (MIT)

Unit trusts which are classified as MITs for tax status and which satisfy the tests of unitholders having clearly defined rights can elect to be an Attribution MIT (AMIT). By making this election, the MIT will automatically have fixed trust status and this PCG will not be relevant.

However, MITs which choose not to elect to be an AMIT may find the PCG helpful in determining whether they will nevertheless be able to be treated as a fixed trust. However, if the MIT is not able to elect for AMIT status because it does not have "clearly defined rights" it may be difficult to meet the requirements of the PCG to be a fixed trust.

Impact on Other Trusts

The PCG may be of most assistance to trusts which do not qualify as a MIT. Such trusts will be able to weigh up the factors outlined in the PCG in order to get an indication as to whether the Commissioner would exercise his discretion to nevertheless treat the trust as a fixed trust. The PCG gives some examples of situations where there would be a favourable impact on the exercise of the discretion such as an unregistered MIS managed by an AFSL holder with a single class of units with redemptions of units at NTA value and where the trustee has never amended the constitution to defeat a beneficiary's interest in the income or capital of the trust. However, if the trustee had a discretion to redeem units at a price between 90% and 150% of the market value of the units this would have an unfavourable impact on the exercise of the discretion.

What Happens Now?

The draft PCG is currently under consultation and it is understood that a number of the professional bodies are seeking further clarification and examples. A final PCG may be issued sometime in 2017. In the meantime, the draft PCG is not able to be relied on, but may give some comfort to trustees where their circumstances fit the examples in the guidelines that the Commissioner may exercise his discretion to treat the trust as a fixed trust.

FIRB Issues Guidance on Tax Conditions

The Foreign Investment Review Board (FIRB) has recently issued Guidance Note 47 (GN47), which outlines the circumstances in which the Federal Treasurer will impose tax conditions on a "no objection notification" (Approval). The tax conditions apply to all Commonwealth taxes, including capital gains tax, withholding tax, thin capitalisation and transfer pricing.

The tax conditions, which were discussed in our September update, were issued by FIRB in May 2016 and have been imposed on Approvals since that date. However, prior to the issue of GN47, FIRB applicants had limited guidance on how to interpret the tax conditions, creating uncertainty as to scope and compliance.

GN47 set out the rationale for the tax conditions, and provides clarity on when the tax conditions will be imposed and how the tax conditions should be interpreted. In summary, GN47 states:

- The national interest will be the basis for imposing the tax conditions (i.e. if the potential foreign investment will have an adverse impact on Australia's tax revenues, the tax conditions are likely to be imposed).
- Relevant factors to be taken into account by the Treasurer will include the applicant's previous interactions with Australia's tax system, the size of the action and complexity of the action.
- The imposition of the tax conditions will be on a case-by-case basis.
- Where the proposed action has a significant or particular tax risk, the Treasurer may impose one or more of the "additional tax conditions".
- The Treasurer will not impose the tax conditions where the tax risks can be managed without them (e.g. where the proposed action poses a minimal risk to Australia's tax system, which would likely capture investors who are exempt from payment of Australian income tax, including foreign government investors).
- Breach of a tax condition may result in criminal prosecution or FIRB seeking a civil penalty order. In extreme cases, the Treasurer may order that the action the subject of the Approval be disposed of.

Importantly, applicants will be given the opportunity to make submissions on the tax conditions. While this is a positive for applicants, it is our view that amendments by FIRB to the tax conditions will only be made on rare occasions, as the tax conditions are drafted to be standard across all Approvals on which they are implemented.

There are some inconsistencies in GN47 which will require further clarity. For example, the additional information on tax conditions 3 and 4 refers to an applicant to provide information that is requested by the ATO, whereas the tax conditions contained in GN47 are drafted on the basis that the requested information is "required to be provided" to the ATO. There may be ambiguity as to what is strictly required.

GN47 also contains FIRB's interpretation of the phrases "control group" and "best endeavours", which are the basis of a number of the tax conditions.

- "Control group" – an entity will be within the applicant's control group where there is practical influence, rather than strictly being determined by what rights can actually be enforced. The application of "control group" will only apply to entities in a control group in relation to the action and any associated transactions, operations or assets in connection with the assets or operations acquired as a result of the action.
- "Best endeavours" – what constitutes "best endeavours" will depend on the applicant's position within its control group. For example, if the applicant is a subsidiary, then best endeavours may include making representations to the head company regarding the tax conditions, even if the head company decides not to act on those representations.

GN47 will assist in providing certainty on the tax conditions, but should a dispute arise in relation to the tax conditions, there is no guarantee that a court will take the same view of the tax conditions as that expressed by FIRB.

ASIC Extends Transition Period for Revised Fee and Cost Disclosure Requirements (RG 97) to 30 September 2017

It is not surprising that this transition period has been extended to 30 September 2017, due to the difficulties that industry is having in interpreting how the updated requirements in RG 97 should apply. By way of background, ASIC amended the rules for disclosing fees and costs when it amended the enhanced fee disclosure regulations (by issuing ASIC Instrument 2015/876 and amended ASIC Class Order [CO 14/1252]) and released updated Regulatory Guide 97 – Disclosing fees and costs in product disclosure statements (PDSs) and periodic statements (RG 97) in November 2015. The new requirements apply to trustees of superannuation funds and responsible entities of managed funds and other managed investment schemes (Issuers) in respect of the way in which they disclose fees and costs. The revised RG 97 followed ASIC'S review of fee and cost disclosure practices in Report 398 Fee and cost disclosure: *Superannuation and managed investment products* (refer: 14-158MR), in which ASIC identified inconsistencies in industry practice and under-disclosure of fees and costs.

The extension to the transition period will give industry a little longer to grapple with the changes and work out the best practice to address them. The way in which ASIC is managing the extension will also mean that ASIC will receive advanced notice of the different views from industry participants as to how they consider the changes are to apply.

Strict Procedures to Apply for the Extension to 30 September 2017

If you wish to take advantage of the extension, please note there are strict procedures for ensuring that you can take advantage of the extension as follows:

Issuers that wish to take advantage of the extension to 30 September 2017 must:

a. By 31 January 2017, notify ASIC in writing that they intend to take advantage of the extension in relation to a PDS to the fee and cost disclosure team.

b. By 1 March 2017, provide ASIC with information about the fees and costs that would be required to be included in the PDS had they complied with the updated fees and costs disclosure requirements. ASIC has confirmed that although such information may be published by it, it would not be published in a manner that would identify the issuer of a relevant product.

Issuers that do not want to take advantage of this extension will have to comply with the updated requirements by 1 February 2017. Any Issuer that has already adopted the updated requirements will not be required to provide ASIC this information.

ASIC's Approach to the Extension – What Issuers Need to Know

ASIC has reiterated that it will be taking a facilitative approach for those Issuers who opt in to comply before 1 October 2017 (as published previously in "*Questions and answers – fees and costs disclosure – superannuation and managed investment products*") until that date.

ASIC has also made it expressly clear that this is a final extension and no further extensions will be provided.

To affect the extension, ASIC will be:

- Amending ASIC Class Order 14/1252 *Technical modifications to Schedule 10 of the Corporations Regulations* [CO 14/1252].
- Providing instructions and the forms which Issuers must provide ASIC with and the fees and costs information which is required if the Issuer is seeking to take advantage of the extension.

ASIC Will Assess the Information Provided in the Transition Period by Issuers

ASIC has disclosed that it intends to use this information to assess whether Issuers are taking reasonable steps towards compliance and to identify whether the disclosures indicate any likely non-compliance. Furthermore, ASIC has confirmed that it will not take enforcement action based on errors in the information provided unless it is identified that the Issuer is intentionally providing information that is not complying or has failed to take reasonable care or is not taking reasonable steps.

ASIC has also stated that it will continue with an extensive engagement with industry during the extended transition period to assist industry in the implementation of the new requirements.

Extension Does Not Apply to Certain Requirements

The extension of transition does not apply to all aspects of the updated fees and costs requirements under RG 97. Issuers should note that the extension of transition does **not** provide an exemption from:

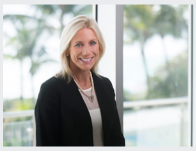
1. The requirements that apply under the Corporations Regulations, unamended by CO 14/1252.
2. The requirement for Issuers not to make misleading or deceptive statements about their products.
3. The requirement for Issuers to comply in respect of periodic statements.

Background Information

Some of the key changes of the revised fees and costs disclosure relate to the description of "indirect costs" (including as to how defined for management costs paid to an investment manager as distinct to an RE and, separately, as to how the costs of derivative products are now indirect costs) and the amended definition of "investment fee" (which carves out certain indirect costs having regards to the definition of "interposed vehicle") and the resulting challenge of integrating indirect costs (as now defined) and indirect cost ratios into the existing fee and cost frameworks.

If you have any questions about the revised fee and cost disclosure requirements in RG 97 and how the extended transition period will apply to you, please contact Michelle Segaert.

Contacts



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