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Domestic tax changes point Australian managers to Cayman


By Thomas Granger and Andy Randall

Amid renewed pipeline activity in the Australian hedge fund industry, the impending overhaul of the domestic tax regime applied to foreign investment funds has brought the question of the most appropriate domicile to centre stage.

The spin out of MST Capital from UBS this year, led by star trader Gerard Satur, has excited the sector, with the rumoured soft launch of the group's first fund said to be around US$200 million – the largest launch in Australia for seven years. Speculation in the market points to several other Volcker Rule-inspired spin outs from banks in Australia preparing to launch by the end of this calendar year.

With the recent repeal of the Foreign Investment Fund rules in Australia, which to some extent dictated how domestic investors and foreign investors participate, Australian managers are now examining how that would play out under the new tax regime. For many reasons, Australian managers are now taking a closer look at the Cayman Islands as their domicile of choice for fund structure.

Traditionally, global managers have been attracted to Cayman by the flexible corporate environment, English Common Law, tax neutrality and the presence of world class service providers. With over 10,000 funds currently domiciled in Cayman, momentum has surged over the past decade. Significantly, the recent confirmation that Cayman Islands funds could still be marketed into Europe under the Alternative Investment Fund Managers Directive was further welcome news.

Australian managers have historically formed Cayman domiciled parallel or master funds to attract foreign investors and for reasons of tax and familiarity use Australian domestic unit trusts for domestic investors. With the changes now expected to the Australian tax regime, the Cayman Islands may suit both Australian and non-Australian investors from the outset. There are significant cost efficiencies and benefits from the formation of a single Cayman fund for both Australian and non-Australian investors that will ultimately benefit all investors.

Australian domestic tax considerations still remain important for any Australian manager looking to domicile their fund offshore. Funds that are not conducting business in Australia – or managed or controlled from Australia – would not be Australian resident for tax purposes and would therefore not be subject to Australian income tax on worldwide sourced income. As a non-resident of Australia, income tax would only apply on a capital gains tax event on taxable Australian property, as well as Australian source income, or dividends and interest that would attract Australian withholding tax.

Provided certain conditions are satisfied, a Cayman fund would be a Controlled Foreign Company (CFC) where rules provide for annual tax on Australian investors, even if the Cayman fund has not distributed gains. These CFC conditions apply where five or less Australian entities together hold over half the Cayman fund's assets, one Australian entity holds at least 40 percent of the assets and no other entity controls the Cayman fund, or control of the Cayman fund is with five or less Australian entities. As the Cayman fund grows its investor base over time, Australian investors will likely be in the minority and the latest amendments to the CFC rules would not apply to the interests of Australian investors. Instead Australian investors would only be liable for any gains on the sale of their interest in the Cayman fund.

The Foreign Investment Fund rules are also being replaced with tighter anti-deferral provisions, also not currently expected to apply to the interests of Australian investors, but instead to any gains on the sale of their interest in the foreign fund. The efficiencies and benefits of Cayman funds have therefore become significantly more pronounced for Australian fund managers in accommodating investors both at home and abroad.

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