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Asset Management Tax Update

# *Investment Manager Regime*

***Exposure Draft Legislation***
***Heading towards the finish line***

***11 April 2013***

The IMR measures aim to reduce tax uncertainty that has been a disincentive for foreign funds seeking to invest in Australia and use Australian intermediaries.

Following consultation with industry, on 4 April 2013, Treasury released Exposure Draft legislation for the final element of the IMR.

Consultation with industry will continue and submissions can be made until 26 April 2013.

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## Background

Global competition to attract "mobile capital" has driven tax concessions to lower taxes for foreign investors. These concessions, known as investment manager exemptions or regimes, are already offered by countries such as the USA, UK, Hong Kong and Singapore.

In reviewing Australia's position as a regional financial centre, the "Johnson Report" recommended that an IMR be introduced. The driver for the IMR was not so much about offering tax concessions but more to reduce tax uncertainty that was proving to be a key disincentive for foreign investors.

The IMR has been slowly cooking, having being introduced in 3 tranches through a series of announcements, consultations, draft legislation and enacted law. IMR 1 and IMR 2 were announced in December 2010 and January 2011 respectively and enacted last year.

- IMR 1: addressed the concern raised in applying US reporting requirements for uncertain tax liabilities for foreign funds on profits made on Australian equities for income years prior to 1 July 2011. This is known as the "FIN 48 exemption".
- IMR 2: confirmed that foreign funds having a permanent establishment in Australia solely by reason of using an Australian intermediary won't be taxed on profits on foreign assets. This is a conduit foreign income measure and called the "IMR – conduit income", and applied from 1 July 2011.
- IMR 3: as foreshadowed in a Government statement in December 2012, IMR 3 was released as exposure draft legislation on 4 April 2013. These new rules will operate retrospectively from 1 July 2011.

## IMR Foreign Funds

Broadly, an entity will be an IMR Foreign Fund provided <u>at all times</u> during an income year it:

- ❑ is not an Australian resident;
- ❑ is not a resident trust estate;
- ❑ is a resident of an information exchange country;
- ❑ does not carry on and does not control a trading business in Australia;
- ❑ satisfies the widely held test;
- ❑ does not breach the closely held test (previously the "concentration test"); and
- ❑ files an annual information statement within 3 months after year end.

*<u>What has changed?</u>*

The key changes focus on the qualification criteria for "*IMR Foreign Fund*" status:

1. Industry concerns about tracing to establish that a fund is widely held have been addressed. The closely held test may require further consideration.
2. The widely held and closely held tests can now be more easily met where a fund starts up, in addition to when a fund winds down. These rules need to be carefully considered to identify the year(s) of income to which the concession applies.
3. A fund must be resident in a country having an exchange of information (EOI) agreement with Australia.
4. A fund must file an annual information statement with the ATO. It is unclear whether these requirements apply retrospectively.

## Widely held requirements

The key change is the method by which 25 individual members can be traced to satisfy the widely held test:

1. Trace through interposed entities to underlying individual investors and treat the individual as a member but do not count the interposed entities.
2. Count an individual and his/her relati**v**es as a single member.
3. For foreign entities being life companies, superannuation funds (with at least 50 members) and exempt government pension funds, notional members are calculated as multiplying their participation interest by 50.
4. Disregard a nominee but include the other entity which it holds the investment on behalf of.

## Basis of Taxation

Broadly, in determining the taxable income of an IMR Foreign Fund, the rules exempt or disregard IMR income, IMR deductions, IMR Capital Gains and IMR Capital Losses in respect of qualifying financial arrangements. This also applies where such income or gains are derived by a foreign resident through a trust or partnership. An IMR Foreign Fund may also have activities outside the scope of the IMR subject to Australian tax.



## Financial Arrangements for IMR purposes - exclusions

The following are not financial arrangements for IMR purposes:

- investments in "taxable Australian real property" (i.e. Australian real property or certain mining rights over Australian land) or "indirect Australian real property interests" (broadly, an interest of 10% or more in a land rich entity); or
- those that give the foreign fund the right to vote at a meeting of the Board of Directors or participate in making financial, operating or policy decisions in respect of the operation of the issuer of the financial arrangement (unless due to a breach of the financial arrangement).

## IMR Income to which the IMR will apply

IMR income will be assessable income attributable to a gain or return in respect of:

- a portfolio interest in a financial arrangement for IMR purposes; or
- a non-portfolio interest in a foreign financial arrangement for IMR purposes, where use of an Australian intermediary results in a permanent establishment in Australia, and the amount would not have otherwise been Australian sourced.

*<u>What has changed?</u>*

- Subject to the exclusion below, exemption for gains in relation to portfolio interests in Australian investments (IMR3)
- Foreign funds may still be subject to Australian tax in relation to gains on Australian real property. However, it is notable that, contrary to an earlier announcement, it is proposed that portfolio interests in unlisted land rich entities will be exempt
- The expansion of the IMR2 exemption to non-portfolio interests in foreign investments
- In determining whether the foreign fund has a portfolio or non-portfolio interest in another entity, the direct participation interests of the foreign fund and its associates are now considered.

## Information reporting

An IMR Foreign Fund is required to lodge an annual information statement with the ATO within three months after year end to maintain IMR status. (IMR Foreign Funds that are trusts or partnerships must provide foreign investors with information in writing relating to their IMR status to avoid a penalty. Publication on a website should suffice for this purpose).

*<u>What has changed?</u>*

This is a new requirement. The annual filing means that reliance on the IMR is not a back up plan should Australian sourced income or a permanent establishment arise. The statement could include: details of the fund, how it achieved IMR status and profits on Australian investments.

## What should funds do now?

Foreign funds should reconfirm that they qualify as an IMR Foreign Fund and which investments are protected. Not all funds will qualify. For some that do not, there may be scope to discuss the reasons and seek changes to the tests during the consultation period.

We consider potential areas of lobbying may be as follows:

- Is the EOI requirement globally competitive when no other IMR/IME imposes it? Will the exclusion of funds domiciled in Luxembourg and Hong Kong be costly?
- Does the interaction between the domestic withholding tax provisions and the IMR result in unexpected outcomes?
- How can the issues concerning limited partnerships be resolved?
- Should the EOI requirement apply to earlier years of income?
- Should regulations deem charities and endowments to satisfy the widely held / closely held tests?
- Do the rules deal with carried interest arrangements appropriately?

## Focus on detail and diligence

As the IMR has evolved through announcements, there has been a tendency to quickly conclude that funds qualify. However, now that the rules are clearer, considerable care and diligence is needed to confirm this. The consequences of a surprise outcome make this critical. That said, we expect there will be funds that proceed on the basis of assumptions. The question to ask is:

***How comfortable will you (and investors) be when the ATO reviews your IMR compliance?***