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Investment manager regime bill introduced into parliament

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On 27 May 2015, a bill for the third and final element of the investment manager regime (IMR 3) was introduced into the Australian parliament. The introduction of the bill is the culmination of a lengthy process that spanned over four years and included the release of multiple versions of exposure draft legislation, the most recent of which was issued in March 2015 (for coverage of the draft legislation, see the alert dated 13 March 2015).

The stated objective of the IMR is to encourage particular kinds of investment made into or through Australia by certain non-Australian residents that have wide membership, or that use Australian fund managers. This is to be achieved by providing non-Australian residents with an Australian income tax exemption for income or gains in respect of the disposal of their investments that otherwise might be sourced in Australia and subject to Australian tax.

The first two elements of the IMR, as enacted in 2012, broadly deal with the following:

- IMR 1 provides a statutory exemption for an IMR foreign fund in respect of IMR income for periods up to 30 June 2011. However, as enacted, IMR 1 generally is of limited assistance; and
- IMR 2 provides a statutory exemption for an IMR foreign fund in respect of certain IMR income, with effect from 1 July 2010. IMR 2 is intended to apply, broadly, where the relevant income is attributable to an Australian entity that exercises a general authority to negotiate and conclude contracts on behalf of a non-Australian fund, thus creating an Australian permanent establishment (PE) for the IMR foreign fund.

IMR 3 is intended to provide a prospective, long-term IMR exemption. It would apply as from the 2015-16 income year (the year ended 30 June 2016), although a fund would be able to choose to apply the amendments from as early as the 2011-12 income year. The version of IMR 3 contained in the bill reflects a number of features similar to those of the UK investment manager exemption.

Overview of proposed requirements for IMR exemption

Non-Australian entities would be able to qualify for the IMR exemption for an income year either by investing directly in Australia (direct IMR concession) or

investing in Australia via an Australian fund manager (indirect IMR concession). In both cases, the non-Australian entity would have to be an “IMR entity.”

IMR entity: The term “entity” would be broadly defined and would include individuals, companies, partnerships and trusts.

An IMR entity would have to be a non-Australian resident at all times during the income year.

Under Australian tax law, a limited partnership established outside of Australia may be considered an Australian resident if it merely carries on business in Australia. This may cause concern that certain actions, such as trading in Australian assets or engaging an Australian-based fund manager, could result in the limited partnership being considered to carry on business in Australia and, therefore, could cause the limited partnership to become an Australian tax resident. The bill proposes to address this issue by clarifying that, in determining whether a partnership is carrying on business in Australia, any business that relates solely to IMR financial arrangements would be disregarded.

Under previous versions of the exposure draft legislation, to be eligible for the IMR concession, a fund would have been required to be resident at all times during a year in an “information exchange” country. This could have resulted in certain funds (e.g. Luxembourg-based funds) being excluded from the exemption. However, this requirement is not included in the bill. Further, although previous versions of the exposure draft legislation would have required an IMR entity to file an annual information return, this requirement is not included in the bill.

IMR concession: Provided an IMR entity meets the requirements for the direct or indirect IMR concession, returns or gains from an “IMR financial arrangement” would be exempt from Australian tax, and losses from such arrangements would not be deductible. However, amounts that are subject to withholding tax, such as dividends or interest, would not be entitled to the IMR concessions. Those amounts would continue to be subject to the regular Australian withholding tax law.

In broad terms, an IMR financial arrangement would be defined as any financial arrangement (e.g. shares, loans or derivatives), except for an arrangement that relates to Australian real property or a “10%-or-more associate-inclusive” interest in an entity that is an Australian land-rich entity.

Although the definition of an IMR financial arrangement would be broad, the IMR exemption would not be available where:

- In the case of the direct IMR concession, the IMR entity has an interest of 10% or more in the issuer, or the counterparty, of the financial arrangement; and
- In the case of the indirect IMR concession and where the issuer or the counterparty is an Australian resident, the IMR entity has an interest of 10% or more in the issuer, or the counterparty, of the financial arrangement (this requirement would not apply to non-Australian issuers or counterparties).

In other words, the IMR concession is intended to be broadly available to non-Australian residents trading less-than-10% equity interests in Australian entities, as well as nonequity investments.

Direct IMR concession: The following requirements would have to be met for the direct IMR concession to apply in relation to an IMR financial arrangement:

- During the entire year, the IMR entity is an "IMR widely held entity";
- During the entire year, the interest of the IMR entity in the issuer of, or counterparty to, the IMR financial arrangement is less than 10%;
- None of the returns, gains or losses for the year from the arrangement are attributable to a PE in Australia; and
- The IMR entity does not carry on noneligible investment business that relates to the arrangement at any time during the income year. This broadly means that the IMR entity would be required to carry on only activities of investing or trading in shares, loans, derivatives or similar financial instruments.

An example of an arrangement that could be considered for an exemption under the direct IMR concession would be a non-Australian fund (e.g. a Cayman Islands LP or US LP fund) that is managed from outside Australia and has no presence or fund manager in Australia, and that invests or trades in shares listed on an Australian stock exchange.

IMR widely held entities

There are two ways that an IMR entity would be able to qualify as an IMR widely held entity:

1) It is a type of entity deemed to be widely held. Such entities include:
    a) Australian and non-Australian life insurance companies;
    b) Australian and non-Australian superannuation (pension) funds with at least 50 members;
    c) Certain government-related non-Australian pension funds; and
    d) Certain non-Australian sovereign wealth funds
2) Either of the following widely held ownership tests is met:
    a) No member of the entity has a total participation interest of 20% or more in the entity (single-member test); or
    b) There are not five or fewer members, the sum of whose total participation interests in the entity is 50% or more (closely held test).

As with previous exposure draft legislation, the bill would adopt a look-through approach in determining whether either the single-member or the closely held test is satisfied. This typically would require tracing through any interposed entities to the ultimate investors to determine an entity's indirect participation interest in the IMR entity. Where entities that are deemed to be widely held themselves hold direct or indirect interests in the IMR entity, it would be unnecessary to trace through those deemed widely held entities (such deemed widely held entities would be considered to have a participation interest of nil).

It generally would not be possible to trace through charities and endowment funds to identify direct or indirect participation interests. Accordingly, the presence of such investors could make it more difficult to satisfy either of the ownership tests.

Furthermore, direct or indirect entitlements (including contingent entitlements) to remuneration from the IMR entity that are subject to Australian income tax or foreign tax in the year in which they are received would be disregarded for purposes of the ownership tests. This is a welcome acknowledgement of the common practice of rewarding the performance of managers in a typical fund; however, the exclusion would be limited to cases where the fund manager is an

Australian resident. It often will be the case that the fund manager of an IMR entity will not be an Australian resident.

Starting up and winding down

In recognition of the fact that an IMR entity may take some time to attract investors after it starts up, an IMR entity would be considered an IMR widely held entity if it is being actively marketed with the intention of satisfying either of the widely held ownership tests. The explanatory materials accompanying the bill state that, although there is no express time limit on how long an IMR entity could be actively marketed with such an intention before it is considered to fail this test, an IMR entity that has not satisfied the ownership tests within a reasonable period of time (such as 18 months) of receiving its first investor could need to provide compelling evidence of its genuine attempts to obtain third-party investment to rebut any presumption that it is not being actively marketed with such an intention.

If an IMR entity that satisfies the widely held ownership tests is winding down its activities and investments, it would be considered to continue to be widely held.

Temporary failure of the widely held tests

An IMR entity would be able to temporarily cease to be an IMR widely held entity due to circumstances beyond its control. Provided such circumstances are temporary, and considering the actions of the IMR entity to address the circumstances, the IMR entity could continue to be treated as an IMR widely held entity if this treatment is fair and reasonable.

Indirect IMR concession: The indirect IMR concession would apply if the IMR entity uses an independent Australian fund manager. The role of the independent Australian fund manager might or might not give rise to an Australian PE of the IMR entity, but, in either case, the indirect IMR concession would be available.

The requirements for the indirect IMR concession would be:

- The IMR financial arrangement was made, on the IMR entity's behalf, by an entity that is an "independent Australian fund manager" for the IMR entity for the income year;
- The IMR entity does not carry on noneligible investment business that relates to the arrangement at any time during the income year; and
- If the issuer of, or counterparty to, the IMR financial arrangement is an Australian resident during the entire year, the IMR entity's interest in the issuer or counterparty is less than 10%.

The requirement that the interest of the IMR entity in the issuer or counterparty be less than 10% would apply only where the issuer or counterparty is an Australian resident, i.e. the concession could apply to interests of 10% or more in non-Australian issuers or counterparties.

Independent Australian fund manager

To qualify as an independent Australian fund manager, an entity (the managing entity) would have to meet all of the following requirements:

1) The managing entity is an Australian resident;
2) The managing entity carries out investment management activities for the

IMR entity in the ordinary course of its business;
3) The managing entity's remuneration for carrying out those activities is equivalent to what the remuneration would be between parties dealing at arm's length; and
4) One or more of the following applies:
   a) The IMR entity is an IMR widely held entity;
   b) No more than 70% of the managing entity's income for the income year is received from the IMR entity, or entities connected with the IMR entity; or
   c) If the managing entity has been carrying out investment management activities for 18 months or less, it is taking all reasonable steps to ensure that the 70%-or-less threshold will be met.

The rationale for the 70%-or-less limitation on the managing entity's income is to ensure that the managing entity is independent of the IMR entity.

The explanatory materials accompanying the bill confirm that Australian brokers that buy and sell securities on the Australian Securities Exchange for foreign investors as part of their ordinary stockbroking function would be considered to be carrying out investment management activities and, therefore, could be considered independent Australian fund managers. For example, a non-Australian fund (e.g. a Cayman Islands LP or US LP fund) that engages an Australian resident broker to trade Australian shares could be eligible for the indirect IMR concession.

Reduction in concession

The bill proposes that the concession for the IMR entity be reduced for an income year in which the independent Australian fund manager, or another entity connected with that manager, has a direct or indirect right to receive a portion of the profits of the IMR entity exceeding 20% of the profits for the year ("20% profits test"). In broad terms, the concession would be reduced by that profit entitlement; however:

- Direct or indirect entitlements (including contingent entitlements) to remuneration from the IMR entity that are subject to Australian income tax or foreign tax in the year in which they are received would be disregarded for the purposes of the 20% test; and
- If the fund manager's entitlement does not, on average, fail the 20% test over a qualifying period (of up to five years), or the circumstances for the breach are outside the control of the IMR entity or the fund manager and the fund manager is taking steps to address these circumstances, then the IMR entity would not need to reduce the amount of the IMR concession.

Application

IMR 3 would apply to the 2015-16 and subsequent years of income (i.e. from 1 July 2015). However, an option would be available to taxpayers to apply the changes in the bill to the 2011-12 to 2014-15 income years (i.e. between 1 July 2011 and 30 June 2015).

Further, although IMR 1 was enacted in 2012 and was intended to provide an exemption for periods up to 30 June 2011, there are a number of technical issues with IMR 1, in particular, with the definition of "IMR foreign fund," which cause many funds to fail to qualify under the regime. The bill would permit IMR entities

to choose to apply the new widely held ownership tests when determining if they qualify for exemption under IMR 1.

Comments

The bill should be welcomed by non-Australian residents, such as hedge funds investing in Australia and funds that engage independent Australian fund managers. Many issues raised during the consultation process have been addressed, including the introduction of significantly relaxed widely held tests under the direct IMR concession and the removal of the requirements for a foreign fund to be a resident of an information exchange country and to file an annual information statement.

Funds should undertake an IMR review to determine whether they would qualify for the direct or indirect IMR concession for any year (including prior years up to 2011-12) in which income or gains from investments otherwise might be subject to Australian tax.

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