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Tax insights

Investment Manager Regime (IMR) finally takes shape

Snapshot

On 27 May 2015, a Bill containing the third and final element of the Investment Manager Regime (IMR 3) was introduced into Parliament. The introduction of the Bill is the culmination of a lengthy process that has spanned over 4 years and included the release of multiple versions of exposure draft legislation, the latest of which was in March 2015. A copy of our alert on the March 2015 draft legislation can be viewed here.

The Bill should be welcomed by non-Australian residents such as hedge funds investing in Australia, and funds which engage independent Australian fund managers. Many issues raised during the consultation process have been addressed including the modified 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 qualify for the direct or indirect IMR concession for any year (including prior years) in which income or gains from investments might otherwise be subject to Australian tax.

Investment Manager Regime

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 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 is to apply to the 2015-16 income year (year ended 30 June 2016) and later income years, although a fund is able to choose to apply the amendments from as early as the 2011-12 income year. IMR 3 reflects a number of features of the UK Investment Manager Exemption.

Overview of proposed requirements for the IMR exemption

Non-Australian entities will be able to qualify for the IMR exemption for an income year either where 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

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

The term “entity” is widely defined and includes individuals, companies, partnerships and trusts.

Under Australian tax law, a limited partnership established outside of Australia will be an Australian resident merely if it carries on business in Australia. The concern is that actions, such as trading in Australian assets or engaging an Australian-based fund manager, may result in the limited partnership carrying on business in Australia, and so 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 solely relates to IMR financial arrangements is disregarded.

Under previous versions of exposure draft legislation, to be eligible for the IMR concession a fund was 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. This requirement is not included in the Bill. Further, previous versions of exposure draft legislation required an IMR entity to file an annual information return. This requirement is also 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” should be exempt from Australian tax, and losses from such arrangements should not be deductible. However, amounts that are subject to withholding tax such as dividends or interest are not entitled to the IMR concessions. Those amounts continue to be subject to the regular Australian withholding tax law.

In broad terms, an IMR financial arrangement is defined as any financial arrangement (e.g. shares, loans and derivatives) except 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 is broad, the IMR exemption is not available where:

- In the case of the direct IMR concession: the IMR entity has an interest in the issuer, or the counterparty, of the financial arrangement of 10% or more; and
- In the case of the indirect IMR concession and if the issuer or the counterparty is an Australian resident: the IMR entity has an interest in the issuer, or the counterparty, of the financial arrangement of 10% or more.

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

Direct IMR concession

The following requirements 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 permanent establishment in Australia; and
- The IMR entity does not carry on non-eligible investment business that relates to the arrangement at any time during the income year. This broadly means that the IMR entity is required to carry on only activities of investing or trading in shares, loans, derivatives or similar financial instruments.

An example of a transaction that could be considered for an exemption under the direct IMR concession would be a non-Australian fund (eg, Cayman LP or US LP fund) that is managed from outside Australia and has no presence or fund manager in Australia, and which 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:
   - Australian and non-Australian life insurance companies;
   - Australian and non-Australian superannuation (pension) funds with at least 50 members;
   - Certain government-related non-Australian pension funds; and
   - Certain non-Australian sovereign wealth funds.

2. Where either of the following widely held ownership tests is met:
   - No member of the entity has a total participation interest in the entity of 20% or more (single member test); or
   - There are no 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 adopts a look-through approach in determining whether either the single member or the closely held tests are satisfied. This typically requires 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 is unnecessary to trace through those deemed widely held entities (such deemed widely held entities are taken to have a participation interest of nil).

It will generally 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 they are received are disregarded. This is a welcome acknowledgement of the common basis

of rewarding the performance of managers in a typical IMR fund. However, the exclusion has been limited to the case where the fund manager is an Australian resident. It will often 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 is 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 can be actively marketed with such an intention before it is taken 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 may need to provide compelling evidence about 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 is to be taken to continue to be widely held.

Temporary failures of the widely held tests

An IMR entity is able to temporarily cease to be an IMR widely held entity due to circumstances beyond its control. Provided such circumstances are temporary, and having regard to actions of the IMR entity to address the circumstances, the IMR entity may continue to be treated as an IMR widely held entity if it is fair and reasonable to do so.

Indirect IMR concession

The indirect IMR concession applies if the IMR entity uses an independent Australian fund manager. The role of the independent Australian fund manager may rise to a PE of the IMR entity, but in either case, the indirect IMR concession is available.

The requirements for the indirect IMR concession are:

1. 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; and
2. If the issuer of, or counterparty to, the IMR financial arrangement is an Australian resident during the entire year, the interest of the IMR entity in the issuer or counterparty is less than 10%
3. The IMR entity does not carry on non-eligible investment business that relates to the arrangement at any time during the income year.

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 what the remuneration would be between parties dealing at arm's length;
4. One or more of the following applies:
   - The IMR entity is an IMR widely held entity; or
   - No more than 70% of the managing entity's income for the income year is income received from the IMR entity, or entities connected with the IMR entity; or
   - 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 stock broking function would be considered to be carrying out investment management activities, and therefore could be an independent Australian fund manager. For example, a non-Australian fund (eg, Cayman LP or US LP fund) that engages an Australian resident broker to trade Australian shares may 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 where the independent Australian fund manager, or another entity connected with that manager, has a direct or an indirect right to receive part of the profits of the IMR entity exceeding 20% of the profits for the year ("20% profits test"). In broad terms, the concession is 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 they are received are 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 need not reduce the amount of the IMR concession.

Application

IMR 3 is to apply to the 2015-16 and subsequent years of income (ie, from 1 July 2015). However, a choice would be available to taxpayers to apply the changes in the Bill to the 2011-12 to 2014-15 income years (ie, between 1 July 2011 to 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 means that many funds do not qualify. IMR entities are able to choose to apply the new widely held ownership tests when determining if they qualify for exemption under IMR 1.

Next steps

The Bill should be welcomed by non-Australian residents such as hedge funds investing in Australia, and funds which engage independent Australian fund managers. Many issues raised during the consultation process have been addressed including the modified 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.

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