Deloitte.

28 July 2015

2015/24

Tax insights

Investment Manager Regime (IMR) now in operation

Snapshot

On 25 June 2015, the legislation containing the third and final element of the Investment Manager Regime (IMR 3) received Royal Assent and is now enacted law. The law generally applies as from the 2015-16 income year (the year ended 30 June 2016), although taxpayers may elect to apply certain provisions in prior years.

The object 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 such as hedge funds with an Australian income tax exemption for returns or gains in respect of the disposal of their investments that otherwise might be subject to Australian tax.

Non-Australian residents 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).

While the concessions are aimed at foreign funds, the indirect IMR concession also provides significant opportunities for Australian fund managers.

So, what do funds and fund managers need to be aware of under the new law?

What are the consequences if the IMR concessions apply?

If a fund is entitled to the IMR concessions, returns or gains it makes from the disposal of shares, or returns or gains from loans or derivatives, will be exempt from Australian income tax.

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.

Example

A United States limited partnership (LP) invests in listed Australian shares. It receives unfranked dividends of AUD100,000 on those shares and, for the year ended 30 June 2016, makes a gain of AUD500,000 on the disposal of some of those shares. Assuming it satisfies the requirements for either or both of the direct and indirect IMR concessions, the gain of AUD500,000 should be exempt from Australian income tax. However, the dividends could still be subject to Australian dividend withholding tax. The domestic rate of withholding tax on unfranked dividends is typically 30% but this could be reduced under Australia's tax treaties (if applicable).

What are the requirements for the concessions?

The exemption is only available to non-Australian residents

To access the IMR concessions, a fund must be a non-Australian resident for Australian tax purposes. This means the concessions are primarily of relevance to foreign funds investing in Australia (where the direct IMR concession may apply) or investing in Australia through an Australian fund manager (where the indirect IMR concession may apply).

…non-resident funds may qualify for the exemption from Australian tax...

Given the introduction of the indirect IMR concession, the rules are also of significance to the Australian funds management industry as foreign funds may wish to consider engaging an Australian resident fund manager going forward (if they do not already) as this may allow access to the indirect IMR concession.

It should be noted that if a fund is a flow-through vehicle such as a partnership or a trust, any Australian resident investors in the fund would not be entitled to the benefit of the concessions.

Only returns or gains from certain investments qualify

The concessions are only available for returns and gains made from "IMR financial arrangements", for example, shares, loans or derivatives, unless they relate to Australian real property or a 10%-or-more associate-inclusive interest in an entity that is an Australian land-rich entity.

Furthermore, the direct and indirect IMR concessions have further conditions that must be met for either to apply. These are outlined below.

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 held by a fund that is a non-Australian resident:

- During the entire year in which the return or gain from the IMR financial arrangement was made, the fund qualifies as an "IMR widely held entity";
- During the entire year in which the return or gain from the IMR financial arrangement was made, the associate-inclusive interest of the fund 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 (PE) in Australia; and
- The fund 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 fund would be required to carry on only activities of investing or trading in shares, loans, derivatives or similar financial instruments.

Due to the second requirement above, the concession would typically be available to funds trading less-than-10% interests in Australian shares, or investing in loans or derivatives where a less-than-10% interest is held in the issuer or counterparty. However, it is important to note that the interests of any associates of a fund must be taken into account in determining whether or not the 10% threshold is exceeded.

Example

A limited partnership set up in the Cayman Islands invests in less-than-10% interests in listed Australian shares. The partnership carries on no other activities other than investing in shares. The partnership is managed from outside Australia and has no presence or fund manager in Australia. Provided the partnership is an IMR widely held entity (discussed below), the partnership would be eligible for an exemption from returns or gains made from the disposal of those shares.

IMR widely held entities

There are two ways that a fund 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:
    - Life insurance companies;
    - Superannuation (pension) funds with at least 50 members;
    - Certain government-related non-Australian pension funds; and
    - Certain non-Australian sovereign wealth funds.
2. Either of the following widely held ownership tests is met:
    - No member of the entity has a total participation interest of 20% or more in the entity (single member test); or
    - There are not five or fewer members the sum of whose total participation interests in the entity is 50% or more (closely held test).

A participation interest in a company, for example, is, broadly, the greatest of the following percentages:

- Total paid-up capital of the company
- Total rights to distributions of capital or profits of the company to its shareholders on winding up
- Total rights to distributions of capital or profits of the company to its shareholders otherwise on winding-up.

A look-through approach is applied 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, foundations 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 widely held ownership tests.

In applying the widely held ownership tests, interests of fund managers that relate to entitlements to remuneration may be disregarded (subject to certain conditions).

There are also certain concessional rules in applying the widely held ownership tests where a fund is starting up or winding down, or where there is a temporary failure of the tests due to circumstances beyond a fund's control.

Example

A United States (US) LP (Master Fund) trades Australian futures and shares. The Master Fund is 50% owned by another US LP (Feeder 1) and 50% owned by a BVI company (Feeder 2). Feeder 1 has 10 unrelated natural person partners, all with equal interests in the LP (i.e. each partner indirectly holds 5% in the Master Fund). Feeder 2 is held 30% by an endowment fund (i.e. a 15% indirect interest in the Master Fund), 40% by a foreign life insurance company (i.e. a 20% indirect interest in the Master Fund) and 30% by a foreign company (i.e. a 15% indirect interest in the Master Fund) which is in turn owned equally by 3 natural person shareholders.

The single member test would be passed as there is no one investor that holds 20% or more of the participation interests:

- *Any of the natural person partners in Feeder 1 would have an indirect participation interest of 5% in the Master Fund*
- *The endowment fund would have an indirect participation interest of 15% in the Master Fund*
- *The foreign life insurance company would be taken to have a participation interest of nil in the Master Fund*
- *The 3 natural person shareholders in the foreign company would each be taken to hold an indirect participation interest of 5% in the Master Fund (worked out by multiplying their 33 1/3% interest in the foreign company by the foreign company's 30% interest in Feeder 2 by Feeder 2's 50% interest in the Master Fund).*

As the single member test would be passed, it would be unnecessary to consider the closely held test. For completeness, that test would also be passed as the endowment fund, together with any four natural person investors, would hold total participation interests of 35%.

Indirect IMR concession

The indirect IMR concession would apply if the fund 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 fund, but, in either case, the indirect IMR concession may be available.

The requirements for the indirect IMR concession are:

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

The requirement that the associate-inclusive interest of the fund 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).

Example

A limited partnership set up in the Cayman Islands invests in less-than-10% interests in listed Australian shares. It also holds a 20% interest in a non-Australian company. The partnership carries on no other activities other than investing in shares. The partnership is managed by an Australian resident fund manager. Provided the fund manager is an independent Australian fund manager (discussed below), the partnership would be eligible for an exemption from Australian tax on returns or gains made from the disposal of both the Australian shares and the shares in the non-Australian company.

Independent Australian fund manager

The following requirements would need to be satisfied for a fund manager to qualify as an independent Australian fund manager:

- The managing entity is an Australian resident;
- The managing entity carries out investment management activities for the fund in the ordinary course of its business;
- 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
- One or more of the following applies:
  - The fund is an IMR widely held entity;
  - No more than 70% of the managing entity's income for the income year is received from the fund, or entities connected with the fund; 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 fund.

The explanatory materials accompanying the legislation indicate 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. However, it is not clear whether all brokers (e.g. both executing and advisory brokers) would be taken to be carrying out investment management activities so reliance on the indirect IMR concession where an Australian broker is engaged should be approached with caution.

In some circumstances, the indirect IMR concession could be reduced. This is where the independent Australian fund manager (and certain related parties) are directly or indirectly entitled to receive more than 20% of the fund's profits for the year (ignoring entitlements to remuneration, subject to certain conditions).

Application

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

Further, there was previously enacted IMR legislation enacted in 2012 that was intended to provide an exemption for periods up to 30 June 2011 (IMR 1). However, there are a number of technical issues with IMR 1 that cause many funds to fail to qualify for the exemption. Accordingly, under IMR 3, funds are permitted to choose to apply the new widely held ownership tests when determining if they qualify for the exemption under IMR 1.

Importantly, while the statute of limitations in Australia for income tax purposes is typically 4 years, this would not apply to an entity in respect of any year of income for which it has not lodged an Australian tax return. Accordingly, funds may be required to determine the availability of the IMR concessions to all years of income in which they had a potential exposure to Australian income tax.

Next steps

The IMR concessions are clearly of relevance to foreign funds that have made (or are making) less-than-10% investments in Australia. Such funds should be undertaking an IMR review to assess historical exposures to Australian tax and to determine whether the various conditions associated with the concessions are met.

Funds should undertake an IMR Review to test their eligibility for the concession

Looking forward, there is also an opportunity for foreign funds to consider whether they should engage an Australian resident fund manager with a view to relying on the indirect IMR concession. This may present Australian fund managers with new business opportunities.

Contacts

For more information, please contact

Vik Khanna
Partner
+61 (3) 9671 6666
vkhanna@deloitte.com.au

David Watkins
Partner
+61 (2) 9322 7251
dwatkins@deloitte.com.au

Mark Hadassin
Partner
+61 (2) 9322 5807
mhadassin@deloitte.com.au

Julian Cheng
Partner
+61 (2) 9322 7749
jcheng@deloitte.com.au

For further information, visit our website at www.deloitte.com