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International Tax

# Australia Tax Alert

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## New draft legislation released on investment manager regime


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On 30 January 2014, the Australian government released a third version of exposure draft (ED) legislation for the third and final element of the investment manager regime (IMR), which also amends already-enacted elements of the IMR. Two previous versions of this draft legislation were released in April and July 2013. (For details on the April 2013 legislation, see the alert dated 9 April 2013.)

Comments have been requested by 14 February 2014. We understand that there is a proposal to introduce the final legislation into parliament in March 2014 and to enact the law by mid-2014.

To briefly recap, the stated objective of the IMR is to remove tax impediments to particular kinds of investment made into or through Australia by certain foreign-managed funds that have wide membership. This is achieved by providing foreign residents with an Australian income tax exemption for their investments through such funds. In the absence of the IMR, many foreign funds could be subject to Australian tax on Australia-source income and gains.

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; 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 entity that exercises a general authority to negotiate and conclude contracts on behalf of a foreign fund, thus creating an Australian permanent establishment for the fund.

IMR 3 is intended to provide the prospective, long-term IMR exemption. The interaction of the latest ED with the already-enacted elements of the IMR is unclear, and will need to be clarified with the government through the consultation process.

### Overview of requirements for the exemption

The IMR applies to a fund that is an “IMR foreign fund.” This requires that the fund:

- Not be an Australian resident at any time during the income year;
- Be widely held; and
- Not carry on a trading business in Australia at any time during the income year (a trading business, broadly, is any business other than one consisting of investing or trading in loans, shares, derivatives or similar financial instruments).

At least in respect of IMR 3, the fund also would be required to meet the following requirements:

- Be a "resident of an information exchange country" at all times during the income year; and
- File an annual information return. This statement would require, *inter alia*, details of the country of residence, the fund's status as an IMR foreign fund and the application of the various requirements of the IMR. However, unlike under the previous EDs, the fund no longer would be required to provide an annual written notice to the beneficiaries or partners as to its status as an IMR foreign fund for that year.

As noted, it remains to be clarified whether these last two tests apply in respect of IMR 1 and 2.

Broadly, under IMR 3, the following amounts would be exempt for an IMR foreign fund:

- Income or gains from a disposal of most "financial arrangements," excluding:
  - Australian real property and
  - Generally speaking, share/equity interests of 10% or more; and
- Income or gains from a "derivative financial arrangement."

Note that amounts that are subject to withholding tax should not be impacted by the IMR.

## Improvements from the last ED

**Widely held test**

A number of key changes have been made in the new ED in relation to the requirement that an IMR foreign fund be widely held. In the previous ED, a fund was required:

- To satisfy the widely held test; and
- Not to breach a closely held test.

The closely held test would have been breached in any of the following cases:

- **The "10% significant member test":** A member of the fund had a total participation interest (on a look-through basis) of 10% or more;
- **The "tightly held test":** The sum of the total participation interests (on a look-through basis) in the entity of 10 or fewer members of the entity was 50% or more; or
- **The "20% manager test":** The sum of the total participation interests in the entity of a manager (and any associates of the manager) of the entity was 20% or more (with no look-through applied).

The new ED combines the widely held test and the closely held test into a single widely held test ("new widely held test"). In summary, the new widely held test would be met if:

- The fund has at least 25 members (directly or indirectly, on a look-through basis);
- The 10% significant member test (see above) is not breached; and
- The tightly held test (see above) is not breached.

That is, under the new widely held test, the 20% manager test would be removed. While this would be a positive change, the retention of the 10% significant member test would continue to mean that some funds are likely to be excluded from the IMR rules.

**Entities that would not need to satisfy the new widely held test**

Another positive change in the new ED is that a lengthy list of "IMR widely held entities" would be adopted. Such entities would be deemed to pass the new widely held test and thus could qualify as IMR foreign funds. In addition, the presence of an "IMR widely held entity" as an investor in a foreign fund potentially would help a fund meet the new widely held test. IMR widely held entities would include:

- Entities listed for quotation in the official list of an approved stock exchange;
- Australian and foreign superannuation (pension) funds with at least 50 members;
- Certain government-related foreign pension funds; and
- Foreign sovereign wealth funds.

## Issues that have not been addressed

A number of issues have been raised with the current rules and previous EDs, which still have not been addressed in the latest ED, including the following.

**Limited partnerships**

To qualify as an IMR foreign fund, a fund cannot be a tax resident of Australia under Australian tax law. Under Australian tax law, a limited partnership established outside of Australia will be an Australian resident if it carries on business in Australia. The concern is that actions, such as engaging an Australian-based fund manager or investment advisor that has a discretionary power to buy and sell shares on behalf of the fund, may satisfy this test and cause the limited partnership to become an Australian tax resident. IMR 3 does not address the wide definition of resident as it applies to limited partnerships.

**Residence in an information exchange country**

To be eligible to be an IMR foreign fund under IMR 3, the fund would be required to be resident at all times during a year in an information exchange country. The relevant test would require, broadly, that a fund be treated as resident in an information exchange country under the tax laws of that country or that it satisfy certain other conditions, including carrying on business in that other country. This requirement may prove problematic, depending upon the tax laws of the relevant country and where the fund carries on business.

Australia currently has information exchange arrangements with 56 countries, including the British Virgin Islands, Cayman Islands, Guernsey, Isle of Man and Jersey, among others. Luxembourg is not currently an information exchange country.

## Conclusion

The IMR reforms have significant implications for any fund with Australian investments, including shares in Australian entities, or any fund that uses the services of an Australian-based fund manager or investment advisor.

The latest ED contains some improvements over the previous versions, in particular, the extension of the list of IMR widely held entities. However, a number of previously highlighted issues remain unaddressed. Furthermore, the interaction of the latest ED with the already-enacted elements of the IMR is unclear.

Funds should undertake an IMR review to determine whether they qualify as an IMR foreign fund. This will allow a fund to confirm its Australian tax exposures, and enable it to complete any required annual information statement on a timely basis.

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