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Draft legislation released on investment manager regime

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On 4 April 2013, the Australian government released draft legislation for consultation that will implement the third and final element of the investment manager regime (IMR); the first two elements were enacted in 2012.

The draft legislation improves the widely held and closely held tests – key elements of qualifying as an IMR foreign fund – and addresses a number of other issues that have arisen with the existing elements of the IMR.

The stated objective of the draft legislation is to remove uncertainty from Australia's tax laws that may impede certain international investment into Australia and the use of Australian agents, managers and service providers.

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, with effect from 1 July 2010, for an IMR foreign fund in respect of certain IMR income. IMR 2 is intended to apply, broadly, where the relevant income is deemed to be Australian sourced solely due to the use of an Australian entity that exercises a general authority to negotiate and conclude contracts on behalf of a foreign fund creating an Australian permanent establishment of the fund.

IMR 3 is intended to be the prospective, long-term IMR exemption.

Executive summary

In the absence of the IMR, many foreign funds could be subject to Australian tax if the fund has an income gain sourced in Australia, including gains on non-Australian investments if those investments are managed by an Australian-based fund manager or investment advisor.

The third installment of the IMR legislation completes the IMR framework for how non-Australian tax resident funds are to be subject to, or exempt from, Australian tax.

Broadly, under IMR 2 and IMR 3, in respect of a non-Australian resident fund that qualifies as an IMR foreign fund, returns or gains of the fund are (subject to some exceptions) treated as follows:

- *Non-taxable amounts*: Returns or gains generally should not be taxable if they are attributable to eligible "financial arrangements" (defined broadly), which will include portfolio investments (i.e. less than 10% interests) in Australian entities, other non-equity Australian investments and non-Australian investments; and
- *Taxable amounts*: Returns or gains from the following generally should be taxable:
    - Non-portfolio interests (i.e. interests of 10% or more) in Australian entities;
    - Non-portfolio interests in entities that are Australian land rich (i.e. their assets are predominantly related to Australian land or mining rights). Such entities can include entities formed in countries other than Australia;
    - Interests in entities that allow the fund to be involved in certain prescribed decision-making for the entity; and
    - Real property (including mining rights) located in Australia.

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

To qualify as an IMR foreign fund, the 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. Disappointingly, IMR 3 does not address the wide definition of resident as it applies to limited partnerships.

Other IMR eligibility requirements include:

1. A fund must be listed on an approved stock exchange or have at least 25 members. IMR 3 introduces significantly modified ownership rules that identify individuals with an economic interest in the fund as the relevant members for the 25-member test. Broadly, the proposed rules look through interposed entities to individuals and also treat certain foreign widely held entities, such as superannuation/pension funds, as a prescribed number of notional individuals. A fund generally will not qualify if an individual (together with relatives) has a 10% or more economic interest in the fund.
2. A fund must be sufficiently resident in a country that has an information exchange arrangement with Australia.
3. A fund must file an annual information statement with the Australian Taxation Office (ATO) within three months after the end of the income year. Failure to file the statement will cause the fund not to be entitled to the IMR. Funds that are partnerships or trusts will be required to provide their investors with certain information within the three-month period.

A new feature that is welcomed is a concession to deal with the start-up phase of a fund.

The draft legislation generally applies as from 1 July 2011. However, the parts that amend the IMR 1 and IMR 2 will apply to prior income years.

Comment

IMR 3 has significant implications for any fund with Australian investments, including shares in Australian entities, or which uses the services of an Australian-based fund manager or investment advisor.

The draft legislation proceeds on the basis that – in the absence of qualifying under IMR 3 – a foreign fund could be subject to Australian tax on returns or gains derived from Australian investments, including portfolio interests in companies listed on the Australian stock exchange even if the investment activity is undertaken outside Australia. Funds with Australian investments need to ensure that all IMR conditions are satisfied, including filing the information statement.

Given the IMR 3 commencement date of 1 July 2011, some funds may be deriving income that is not covered by IMR 3 and so is subject to Australian tax; such funds should be taking action to manage their potential Australian tax obligations.

We recommend that funds undertake an IMR Fund Review to determine whether they qualify as an IMR foreign fund. This will allow the fund to confirm its Australian tax exposures, and enable the fund to complete the information statement on a timely basis. Under IMR 3, almost every fund that invests in Australian assets has Australian tax filing obligations, even if by way of filing the annual information statement.

Overall, the draft legislation is an improvement over the existing elements of the IMR. Consultation closes on 26 April 2013, which may be the last opportunity to have input in the drafting of the rules before the law is enacted.

Features of IMR 3

The key features of the draft legislation are as follows.

Tax residence: To qualify as an IMR foreign fund, a fund cannot be a tax resident of Australia under Australian tax law.

A limited partnership established outside Australia will be an Australian resident if it carries on business in Australia. Various 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. This tax residence test may result in many funds that invest into Australia not being entitled to the IMR, and those funds being subject to Australian tax.

The tax residence rule also may prevent a company fund vehicle from qualifying as an IMR foreign fund if an Australian-based fund manager has been granted discretionary power to buy and sell assets on behalf of the fund and the fund's voting power is controlled by shareholders who are residents of Australia.

Ownership tests – widely held and closely held tests: To qualify as an IMR foreign fund, the fund must meet the widely held and closely held tests at all times during a year (the term "concentration" test has been replaced by the term

"closely held" test). The IMR as enacted drafted these tests in such a way that many funds, which were intended to be eligible funds, could not meet the restrictive requirements. The government has acknowledged these issues—hence, the proposed changes.

The widely held requirement in the draft legislation is as follows:

- The units or shares in the fund must be listed on an "approved stock exchange"; or
- The fund must have at least 25 members (determined in accordance with a new look-through methodology); or
- The entity must be of a kind specified in regulations.

The key aspects of the look-through approach are as follows:

- An individual who holds interests in a fund "indirectly" through one or more interposed entities will be treated as a member of the fund, and the interposed entities are disregarded.
- Specific rules apply to "foreign widely held entities," i.e. foreign life insurance companies; foreign superannuation funds (e.g. US pension funds) with at least 50 members; and certain foreign government pension funds.

  Interests held by such foreign widely held entities are effectively deemed to be attributable to a number of "notional" individuals. For example, if a foreign widely held entity had a participation interest of 40% in the fund, this is deemed to be held by 20 individuals (40% interest in the fund x prescribed factor of 50 = 20 deemed individuals). In this example, each deemed individual is taken to have a participation interest of 2% in the fund (relevant to the closely held test). The interposed foreign widely held entity is disregarded.

Having identified the members (ultimate individuals or deemed individuals) of the fund under the look-through approach, the fund will fail the closely held test if:

- The sum of the total participation interests of 10 or fewer members in the test entity is 50% or more; or
- A member has a total participation interest in the test entity of 10% or more. This is a new restriction as compared to the IMR law as enacted.

In applying the widely held and closely held tests, an individual, together with relatives, is treated as one individual.

Both the widely held and closely held tests will require the determination of an entity's participation interest in the fund. In determining an entity's participation interest, the voting interests of that entity are disregarded. This reflects the fact that the widely held and closely held tests are designed to identify individuals who have an "economic interest" in a fund. This is an important concession and, as noted in the explanatory materials to the draft legislation, "in the case of a fund that is a corporate limited partnership, it would not be unusual for the majority of the voting rights in the fund to be retained by a general partner (who might exercise those rights directly, or delegate that function to an agent acting in their capacity as a fund manager)." Because such voting rights are disregarded, the general partner's voting based participation interest should not result in the closely held test being failed.

Funds should commence to gather and analyze the necessary information to determine whether the fund structure and membership satisfies the ownership tests. A fund may need to obtain information from upstream funds, which may be time consuming or difficult to obtain.

Fund resident in an information exchange country: To be eligible as an IMR foreign fund, the fund must be sufficiently resident at all times during a year in a country that has an information exchange arrangement with Australia. The relevant test requires, broadly, that a fund is treated as resident in an exchange of information country under the tax laws of that country, or otherwise satisfies 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 exchange of information arrangements with 56 countries, including the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, among others. There is no exchange of information arrangement between Australia and Luxembourg.

Annual information statement: To be eligible as an IMR foreign fund, the fund must provide an annual information statement to the ATO within three months after the end of the income year. This statement will 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.

It will be important that initially, and then subsequently on an annual basis, a fund determines its status as an IMR foreign fund and meets its compliance with the IMR requirements, so that the fund is able to make the necessary representations on a timely basis to the ATO.

Further, where the fund is a trust or partnership, the fund must provide an annual written notice to the beneficiaries or partners as to the status of the fund as an IMR foreign fund for that year. Failure to provide such notice on a timely basis will be subject to penalty.

Start-up and wind-down phases: The existing elements of the IMR had a limited concession to deal with the wind-down phase of a fund. This has been enhanced and expanded to address the start-up phase.

The widely held and closely held tests broadly will be deemed to be satisfied:

- In the income year in which the fund is created; or
- Where the fund is created in the second half of the year, in the income year in which the fund is created and the following year.

However, the concession will be retained only if the fund, in fact, qualifies as an IMR foreign fund in the first year after the start-up phase for a reason other than satisfying the wind-down phase requirements.

The wind-down phase rule broadly treats a fund that ceases to exist in an income year as having satisfied the widely held and closely held tests for that year.

Conclusion

It is more than two years since the IMR measures were first announced. The long development process is almost finalized.

We recommend that funds undertake an IMR Fund Review to assess their position to determine whether they can qualify as an IMR foreign fund and whether income that would otherwise be subject to Australian income tax is IMR income.