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New draft legislation released on investment manager regime (IMR)

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On 12 March 2015, the Australian government released a fourth version of exposure draft (ED) legislation for the third and final element of the investment manager regime (IMR 3), which also would amend already-enacted elements of the IMR. Three previous versions of this draft legislation were released in April and July 2013 and in January 2014. The most recent ED contains a number of improvements over the earlier versions and also would make beneficial improvements to IMR 1 and IMR 2. Comments on the ED have been requested by 9 April 2015; it is possible that final legislation will be enacted by mid-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 achieved by providing non-Australian residents with an Australian income tax exemption for their investments that otherwise might give rise to taxable Australian-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. However, as enacted, IMR 1 generally is of limited assistance to non-Australian funds; 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 to the 2015-16 income year (year ended 30 June 2016) and later income years, although a fund would be able to choose to apply the amendments from as early as the 2011-12 income year.

Overview of proposed requirements for the IMR exemption

Non-Australian entities would be able to qualify for the IMR exemption 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," which broadly would require that the entity:

- Be a non-Australian resident at all times during the income year;
- Not carry on a trading business in Australia at any time during the income year (a trading business generally is any business other than one consisting of investing or trading in loans, shares, derivatives or similar financial instruments). In other words, investing or trading in shares or similar financial instruments would be an acceptable activity; and
- Not control, or be able to control, directly or indirectly, the affairs or operations of such a trading business.

The term "entity" is widely defined and would include individuals, companies, partnerships and trusts.

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 would not be affected by the IMR). In broad terms, an IMR financial arrangement would be 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 would not be 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, the issuer or the counterparty is an Australian resident and the IMR entity has an interest in the issuer, or the counterparty, of the financial arrangement of 10% or more.

As with prior EDs, the March 2015 ED states that the IMR concession is intended to be available, broadly, to non-Australian funds trading less-than-10% equity interests in Australian entities.

***Direct IMR concession*:** The following requirements would have to be met for the direct IMR concession to apply in relation to a particular year:

- 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%; and
- None of the returns, gains or losses for the year from the arrangement are attributable to a PE in Australia.

An example of a transaction that could be considered for an exemption under the direct IMR concession would be a non-Australian fund (Cayman LP or US LP fund) that is managed from outside Australia and has no presence or fund manager in Australia.

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 that automatically qualifies. Such entities would 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 tests is met:

   - No member of the entity has a total participation interest in the entity of 20% or more; or
   - There are no five or fewer members the sum of whose total participation interests in the entity is 50% or more.

As with previous EDs, the March 2015 ED would use a look-through approach in determining whether either of these tests is satisfied. This would require tracing through any interposed entities to the ultimate individual investors. Where entities that automatically qualify as IMR widely held entities themselves hold interests in the IMR entity, it would be unnecessary to trace through those entities (they would be considered to have a participation interest of nil).

It appears, however, that in working out the participation interest, manager profit allocations or carried interests would not be excluded. This may mean that some non-Australian funds, where there is a key principal who, together with certain related entities, is entitled to a significant profit allocation or carried interest, may not qualify for the concession (see comments below).

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 actively marketed within 18 months after accepting its first member with the intention of satisfying either of the widely held tests. However, if the IMR entity did not satisfy either of the widely held tests by the end of the 18-month period, the IMR entity would be deemed never to have been widely held. This could result in prior year income tax returns having to be filed or amended.

If an IMR widely held entity notifies its members of a decision to wind down the entity's activities and investments, the entity would continue to be deemed widely held during the winding down period.

Temporary failures 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. For example, a significant or cornerstone investor may exit the fund. Provided such circumstances are temporary, and having regard to actions of the IMR entity to address the circumstances (e.g. to attract new investors), 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: Although the direct IMR concession would not apply where gains or losses are attributable to an Australian PE, the indirect IMR concession could apply if the Australian PE arises because of the activities of an independent Australian fund manager.

The requirements for the indirect IMR concession are:

- 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
- 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%.

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:

- The managing entity is an Australian resident;
- The managing entity carries out investment management activities for the IMR entity in the ordinary course of its business;
- The managing entity's remuneration for carrying out those activities is what the remuneration would be between parties dealing at arm's length;
- One or more of the following applies:
  - The IMR entity is an IMR widely held entity;
  - 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 genuinely independent of the IMR entity.

As noted above, to access the direct IMR concession, an IMR entity would have to be an IMR widely held entity. In the context of the indirect IMR concession, the concept of an IMR widely held entity may be relevant to establishing whether a managing entity is an independent Australian fund manager. However, if an IMR entity is not an IMR widely held entity, the indirect IMR concession still may be available, for example, if the 70% or less limitation on the managing entity's income is satisfied.

Reduction in concession

The March 2015 ED proposes that the concession 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"). For example, if an independent Australian fund manager (together with connected entities) was entitled to 25% of the IMR entity's profits for the year, the concession (exemption) would be reduced by 25%. It appears that any manager profit allocation or carried interest would be taken into account in determining whether the 20% threshold is exceeded.

An IMR entity would be able to apply to the Commissioner of Taxation to disregard any breach of the 20% threshold. The Commissioner would need to be satisfied that the IMR entity intends that the independent Australian fund manager not have a right to over 20% of the profits within five years and that the investment in the IMR entity is being actively marketed.

Proposed amendments to IMR 1 and IMR 2

Although IMR 1 and IMR 2 were enacted in 2012, there are a number of technical issues with IMR 1 and IMR 2, in particular, with the definition of "IMR foreign fund," which means that many non-Australian funds do not qualify. IMR entities would be able to choose to apply the new widely held tests when determining if they qualify for exemption under IMR 1 and IMR 2.

Improvements from the 2014 ED

Widely held test: As noted above, the widely held test under the direct IMR concession would require that either no member of the IMR entity has a total participation interest in the entity of 20% or more, or that there are no five or fewer members, the sum of whose total participation interests in the entity is 50% or more.

This is a significant improvement from the January 2014 ED, which required that *all* of the following tests be satisfied:

- The fund has at least 25 members (directly or indirectly, on a look-through basis);
- No member of the fund has a total participation interest (on a look-through basis) of 10% or more; and
- 10 or fewer members do not have a total participation interest (on a look-through basis) of 50% or more.

While this relaxation of the widely held test is a positive change, it appears that manager profit allocations and carried interests would be taken into account in applying the new widely held test, so some funds still would be excluded from the IMR rules.

Limited partnerships: To qualify as an IMR entity, an entity 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 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 ED has addressed this issue by clarifying that, in determining whether a partnership is carrying on business in Australia, any business that relates to IMR financial arrangements would be disregarded.

Residence in an information exchange country: Under the January 2014 ED, 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. This requirement is not included in the March 2015 ED.

Annual information statement: The January 2014 ED would have required the non-Australian fund to file an annual information return that included 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. This requirement is not included in the March 2015 ED.

Conclusion

The latest ED contains a number of improvements over the previous versions, in particular, the new 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.

A key issue, however, will be whether manager profit allocations or carried interests are taken into account when applying the widely held tests under the direct IMR concession, or when determining whether there may be a reduction in the indirect IMR concession under the 20% profits test. This issue hopefully will be addressed during the consultation process.

Funds should undertake an IMR review to determine whether they qualify for the direct or indirect IMR concession.
