Deloitte.

# International Tax for Asset Managers Update

## A global focus on the investment management industry

**In this issue**



# United States: Proposed regulations address the PFIC status of foreign insurance companies

On April 23, 2015, treasury and the Internal Revenue Service (IRS) issued proposed regulations (REG-108214-15) clarifying the scope of Internal Revenue Code Section 1297(b)(2)(B) and inviting comments.

## Background

Treasury and the IRS are aware that US investors have structured capital investments in hedge funds through foreign insurance companies[1]. The proposed regulations clarify the circumstances under which certain investment income of a foreign insurance company is excluded from the definition of passive income under Section 1297(b)(2)(B). As a result, the proposed regulations indirectly address the passive foreign investment company (PFIC) status of such foreign insurance companies and the US federal income tax consequences to US investors in such arrangements.

Section 1297(b)(2)(B) provides that, except as provided in regulations, the term "passive income" does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L as an insurance company if the corporation were a domestic corporation. The terms "active conduct" and "insurance business" are not defined in Section 1297. In the absence of guidance, commentators have argued, and some taxpayers have taken the position, that the insurance company exception in Section 1297(b)(2)(B) does not require the insurer to internally conduct all operational aspects of the insurance business. Because the PFIC exception does not appear to require conformity with the definitional requirements of "active conduct of a trade or business" contained in Section 367(a) and Treas. Reg. § 1.367(a)-2T(b)(3), there appears to be flexibility in how the operation of such a venture may be structured.[2] It has become fairly common for foreign insurance companies to outsource substantial management and operational functions to independent service providers.

[1] *See, e.g., Notice 2003-34, 2003-1 C.B. 990 (May 9, 2003).*

[2] See, e.g., Richard J. Safranek and Diana B. Chapman, Restrictive Regs May Threaten Insurance Company Exception to PFIC Rules, 13 INS. TAX REV. 1147 (July 1997).

### Definition of "Active Conduct"

The proposed regulations provide that the term "active conduct" has the same meaning as in Treas. Reg. § 1.367(a)-2T(b)(3) (the Active Conduct Requirement), except that officers and employees are not considered to include the officers and employees of related entities. The Active Conduct Requirement provides, among other things, that a corporation actively conducts a trade or business *only* if the officers and employees of the corporation carry out substantial managerial and operational activities.

### Definition of "Insurance Business"

The proposed regulations define the term "insurance business" to mean the business activity of issuing insurance or annuity contracts and the reinsurance of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support, or are substantially related to, insurance contracts issued or reinsured by the foreign insurance company. The regulations generally define investment activity as any activity that produces income defined in Section 954(c) (pertaining to foreign personal holding company income) and further provide that investment activities must support, or be substantially related to, insurance contracts issued or reinsured by the foreign corporation to the extent that income from the investment activities is earned from assets held by the foreign corporation to meet obligations under such contracts.

### Comments requested

Treasury and the IRS have requested comments on all aspects of the proposed rules and have specifically requested comments regarding how to determine the portion of a foreign insurance company's assets that are held to meet obligations under insurance contracts issued or reinsured by the company.

### Proposed effective/applicability date

The regulations are proposed to apply on the date of publication of the treasury decision adopting these rules as final regulations.

### Observations

The use of foreign insurance companies as hedge fund vehicles has also attracted attention in Congress. Both then-chairman of the House Ways and Means Committee Dave Camp and then-senator Max Baucus introduced proposals in 2013–2014 that would narrow the insurance company exception to the PFIC rules by defining more precisely the relationship between a foreign insurance company's assets and insurance liabilities. Under both proposals, more than 50% of the foreign insurance company's gross receipts for a taxable year must consist of insurance premiums, and applicable insurance liabilities must constitute more than 35% of total assets.

# OECD releases revised discussion draft on BEPS Action 7—Preventing artificial avoidance of PE status

On May 15, 2015, the Committee on Fiscal Affairs (CFA) of the Organization for Economic Cooperation and Development (OECD) released a new discussion draft of Action 7, Preventing the Artificial Avoidance of PE Status (the 2015 Draft). The 2015 Draft chooses among the multiple-choice options of the original discussion draft of Action 7 (the 2014 Draft) and supersedes the 2014 Draft, but still "does not, at this stage, represent the consensus views of the CFA or its subsidiary bodies." Comment is requested on the 2015 Draft, although no further public consultation meeting on it will be held.

The provisions affected and the options chosen are:

| Paragraph of Article 5 of OECD Model | Topic | Option chosen | Description |
|---|---|---|---|
| 5, 6 | Agency permanent establishments (PEs) in general | B | An agency PE requires conclusion of contracts or negotiation of material contract elements, where the contract is in the name of the principal or is for property or services of the principal. |
| 5, 6 | Agency PEs for insurance | N | No treaty provision. |
| 4 | Specific activity exemptions in general | E | No change to the enumerated exceptions, but all are contingent on preparatory or auxiliary character of the overall activity of the fixed place of business. |
| 4 | Antifragmentation rule for specific activity exemptions | J | To constitute a PE in a state, a fixed place in a state need not constitute a PE by itself if the "cohesive business operation" carried on by "complementary functions" of connected parties in the state is not of a preparatory or auxiliary character functions" of connected parties in the state is not of a preparatory or auxiliary character. |
| 3 | Splitting up of contracts for PE exceptions based on fixed-time periods | L | No treaty provision. |

In each case, the option is expanded upon via proposed commentary language, and in some cases, is slightly modified. Nothing is provided on the way in which profits should be attributed to agency PEs, or other PEs, that are newly deemed to exist by virtue of the proposed new provisions. The purpose of this alert is to provide a brief summary of the options chosen in the 2015 Draft.

## I. Agency PEs

To the brief explanation of option B in the 2014 Draft, the 2015 Draft adds detail in the form of proposed commentary on Article 5(5) and (6). The 2015 Draft also modifies proposed Article 5(6).

### A. Proposed changes to Article 5(5) and (6)

Today, paragraphs 5 and 6 of Article 5 (the "agency PE" rules) of the OECD Model Tax Convention (the "OECD Model") provide as follows:

- Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a PE in that state in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a PE under the provisions of that paragraph.
- An enterprise shall not be deemed to have a PE in a Contracting State merely because it carries on business in that state through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

#### 1. Article 5(5)

The 2015 Draft would replace the words "exercises, in a Contracting State an authority to conclude contracts" in paragraph 5 with the words "concludes contracts, or negotiates the material elements of contracts."

The choice of option B means that "engaging with specific persons in a way that results in the conclusion of contracts" (the language used in options A and C) was rejected as an activity that gives rise to agency-PE status.

The 2015 Draft further would replace the words "contracts in the name of the enterprise" with—

- contracts that are a) in the name of the enterprise, or b) for the transfer of the ownership of; or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or c) for the provision of services by that enterprise."

The choice of option B means that the conclusion or negotiation of "contracts which, by virtue of the legal relationship between the agent and the principal, are on the account and risk of" the principal (the language used in options C and D) was rejected as a way to define the scope of contracts the conclusion or negotiation of which could give rise to agency—PE status.

#### 2. Article 5(6)

Like all the 2014 options, the 2015 Draft would revise Article 5(5) so that a PE could arise based on the activities of an "independent" agent (as well as a "dependent" agent), *unless* the independent agent is described in the first sentence of revised Article 5(6). All of the 2014 options would deny the current-law benefits of independent agency if the agent (1) is not "acting on behalf of various persons" or (2) "acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises."

The 2015 Draft, by contrast, excludes an otherwise independent agent from favorable treatment under Article 5(6) only if it "acts exclusively or almost exclusively on behalf of one or more enterprises to which it is *connected*" (emphasis added). The 2015 Draft defines "connected person" based on 50% or greater common ownership (by vote and value) or "if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises."

## B. Proposed changes to the Commentary on Article 5(5) and (6)

### 1. Proposed Commentary on Article 5(5)

Unlike the 2014 Draft, the 2015 Draft contains proposed new commentary language on agency PEs. It would add 12 new paragraphs to the Commentary on Article 5 (new ¶¶ 32.1 to 32.12). The proposed revised commentary would provide, among other things, that:

- A contract may be considered "concluded" in a particular state (e.g., an offer may be accepted in a state) even if it is not "signed" in that state (¶32.4);
- It is sufficient for a contract to be considered as concluded in a particular state if the key provisions of a contractual relationship have been determined in such state, even if the contract is subject to further approval or review outside the state (¶32.5);
- The "material elements" of a contract may vary, but typically include "the determination of the parties" and "the price, nature and quantity of the goods or services to which the contract applies" (¶32.5);
- The object and purpose of paragraph 5 is "to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise" (¶32.6);
- The phrase "concludes contracts or negotiates the material elements of contracts" applies to a person that "acts as a sales force of the enterprise and, in doing so, makes or accepts contractual offers even if standard contracts are used for that purpose" (¶32.6).

Proposed ¶32.6 of the commentary provides the following example to illustrate the application of Article 5(5):

- RCO , a company resident of State R, distributes various products and services worldwide through its websites. SCO , a company resident of State S, is a wholly owned subsidiary of RCO. SCO's employees promote RCO's products and services and are responsible for large accounts in State S; these employees' remuneration is partially based on the revenues derived by RCO from the holders of these accounts. When one of these account holders agrees to purchase a given quantity of goods or services promoted by an employee of SCO, the employee indicates the price that will be payable, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO's contracts, including the fixed price structure used by RCO, which the employee is not authorized to modify. When concluding that contract online, the account holder is offered a choice of payment options. In this example, SCO's employees are negotiating the material elements of the contracts that are concluded with RCO. The fact that SCO's employees cannot vary the terms of the contracts does not mean that there is no negotiation but rather means that the negotiation of the material elements of the contracts is limited to convincing the account holder to accept these standard terms.

### 2. Proposed Commentary on Article 5(6)

The 2015 Draft proposes to remove existing ¶37 from the commentary on Article 5(6). Paragraph 37 provides that a person will come within the scope of Article 5(6) only if "he is independent of the enterprise both legally and economically."

The proposed commentary also provides:

- It is not the case that Art 5(6) "will apply automatically where a person acts for one or more enterprises to which that person is not connected. Independent status is *less likely* if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are connected to each other) over the lifetime of that person's business or over a long period of time. Where, however, a person is acting exclusively for one enterprise, to which it is not connected, for a short period of time (e.g., at the beginning of that person's business operations), it is possible that paragraph 6 could apply. All the facts and circumstances would need to be taken into account to determine whether the person's activities constitute the carrying on of a business as an independent agent" (¶38.6, emphasis added).
- "Where, for example, t he sales that an agent concludes for enterprises to which it is not connected represent less than 10 per cent of all the *sal*es that it concludes as an agent acting for other enterprises, that agent should be viewed as acting 'exclusively or almost exclusively' on behalf of connected enterprises" (¶38.7).

- The concept of a "person connected to an enterprise" is distinct from the concept of "associated enterprises" which is used for the purposes of Article 9; "although the two concepts overlap to a certain extent, they are not intended to be equivalent" (¶38.8).

## II. Specific activity exemptions

The 2015 Draft would impose a "preparatory or auxiliary" condition on any use of Article 5(4), and would adopt the broader of the two "anti-fragmentation" proposals from the 2014 Draft.

### A. Proposed "preparatory or auxiliary" condition for application of Article 5(4)

Paragraph 4 of Article 5 provides as follows:

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

*a. The* use of facilities solely for the purpose of storage, display *or*

b. Delivery of goods or merchandise belonging to the enterp*rise*;

c. The mainten*ance* of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, *or* delivery;

*d. The* maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose *of processing by another enterprise*;

e. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

f. The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity *of a preparatory or auxiliary character*;

g. The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that *the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

The 2015 Draft eliminates the italicized passages set forth above and makes a proviso like the one found in subparagraph *f)* a condition of any application of paragraph 4. The proviso reads as follows: "provided that such activity or, in the case of subparagraph *f)*, the overall activity of the fixed place of business*, is* of a preparatory or auxiliary character."

### B. Proposed change to Commentary on Article 5(4)

The 2015 Draft proposes adding an example to ¶22 of *the Commentary in which an enterprise resident in one country, and which sells* online to customers in the other country, maintains "a very large warehouse" in the second country in which a "significant" number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in the second country. The proposed Commentary states that Article 5(4) should not prevent these activities from being a PE in the country where the warehouse is located because "being an essential part of the enterprise's sale/distribution business, [they] do not have a preparatory or auxiliary character."

Another example in the *proposed commentary indicates* that after adding the "preparatory or auxiliary" proviso to Article 5 (4), the place-of-purchase exception of Article 5(4) (d) "typically will not apply in the case of a fixed place of business used for the purchase of goods or merchandise" to prevent it from being a PE "*where the overall activity of the enterprise consists in selling these goods*" (¶22.5).

Proposed ¶22.4 of the commentary adds an example of a stock of goods belonging to an enterprise resident in one country that is maintained by a toll manufacturer in the other country for purposes of processing by that toll manufacturer. This will not constitute a PE of the nonresident enterprise under any paragraph of Article 5, unless the enterprise is allowed unlimited access to a separate part of the facilities of the toll manufacturer for the purpose of inspecting and maintaining the goods stored therein. If such unlimited access is allowed, then Article 5(4) (c) *will be relevant, and an analysis must be done* as to whether or not the maintenance of that stock of goods by the resident enterprise constitutes a preparatory of auxiliary activity of the nonresident enterprise. No conclusion is reached in the proposed commentary on this point).

A more unambiguously favorable example in the proposed commentary under Article 5(4)(d) provides that where an investment fund sets up an office in a state solely to collect information on possible investment opportunities in the state, "the collecting of information will be a preparatory activity" and the office will therefore be deemed not to be a PE (¶22.6).

### C. Antifragmentation rule

The 2015 Draft adds a new restriction (proposed Article 5(4.1)) on claiming the benefits of Article 5(4):

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a connected enterprise carries on business activities at the same place or at another place in the same Contracting State and

a. That place or other place constitutes a PE for the enterprise or the connected enterprise under the provisions of this article or

b. The overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or connected enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or connected enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

This is the less favorable of the two 2014 options, and is illustrated in proposed commentary language. One of the examples set forth in the proposed commentary (see ¶30.3, Example B) provides as facts:

RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse.

The example concludes that Article 5(4.1) "prevents the application of the exceptions of paragraph 4 to the warehouse." It will not be necessary, therefore, to determine whether Article 5(4)(a) applies to the warehouse. "The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions that are part of a cohesive business operation (i.e., storing goods in one place and selling these goods through another place)."

## III. Splitting up of contracts

Paragraph 3 of Article 5 provides as follows:

A building site or construction or installation project constitutes a PE only if it lasts more than 12 months.[3]

[3] Similarly (in terms of setting a fixed-time period that separates PEs from non-PEs), ¶42.23 of the commentary on Article 5 sets forth a service-PE provision that would create a PE where none is created under the OECD Model Convention provisions. This provision reads as follows: Notwithstanding the provisions of paragraphs 1, 2, and 3, where an enterprise of a Contracting State performs services in the other Contracting State:

a) Through an individual who is present in that other state for a period or periods exceeding in the aggregate 183 days in any 12-month period, and more than 50% of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other state through that individual or

b) For a period or periods exceeding in the aggregate 183 days in any 12-month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other state, the activities carried on in that other state in performing these services shall be deemed to be carried on through a PE of the enterprise situated in that other state, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual. See, e.g., Article V(9) of the U.S.-Canada Treaty as amended by the protocol signed in 2007.

The commentary on Article 5 discusses abuses that have arisen in order to avoid crossing the 12-month threshold. The abuse involves dividing "contracts up into several parts, each covering a period less than 12 months and attributed to a different company which was, however, owned by the same group."[4]

The 2015 Draft adopts the option of adding no language to Article 5, but relying instead on the general antiabuse rule (the Principal Purpose Test or PPT rule) proposed as part of Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), and adding an example to the commentary on that rule.

The proposed commentary describes a case in which multiple contracts are entered into by a customer in one treaty country with two separate associated enterprises resident in the other treaty country and, absent other facts and circumstances showing otherwise, it would be reasonable to conclude one of the principal purposes for the conclusion of the separate contracts is so that each of the associated enterprises can obtain the benefits of Article 5(3) contrary to the object and purpose of Article 5(3).

In addition, the 2015 Draft proposes that the commentary set forth a treaty provision to be used in treaties that do not include the PPT rule or as an alternative provision to be used by countries concerned with the splitting-up-of-contracts issue. The alternative provision is based on the option in the 2014 Draft to insert language on this point directly into the OECD Model, with the following modifications:

- Replace the concept of "associated enterprises" with the concept of "connected enterprises" (based on the definition of "person connected to an enterprise" proposed for the purpose of Article 5(6)).
- Add a minimum time threshold (30 days) under which the provision could not apply.
- Restrict the application of the rule to cases where the enterprises perform "connected activity."
- Factors to be considered in the determination of whether activities are connected would include especially:
- Whether the contracts covering the different activities were concluded with the same person or related persons
- Whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons
- Whether the activities would have been covered by a single contract absent tax planning considerations
- Whether the nature of the work involved under the different contracts is the same or similar
- Whether the same employees are performing the activities under the different contracts

## IV. Conclusion

Comments on the 2015 Draft were due by June 12, 2015, and will be made available to the public. The work on Action 7 is scheduled to be completed by September 2015. Only after that time will follow-up work on the attribution-of-profits issues related to Action 7 be carried out. The plan seems to be to provide the necessary attribution-of-profits guidance before the end of 2016 (the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7).

[4] Paragraph 42.45 of the Commentary sets forth an additional treaty provision which states may wish to adopt that would deal with this problem in the service-PE context: For the purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are present and performing such services in that State, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals. For the purpose of the preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States.

# OECD: Discussion draft on cost contribution arrangements released

The OECD, as part of its work on the action plan to address base erosion and profit shifting (BEPS), released a discussion draft on April 29, 2015, proposing revisions to Chapter VIII of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* on cost contribution arrangements (CCAs). The proposed changes would update and expand guidance for ensuring that the application of a CCA within a multinational group is consistent with the arm's-length principle.

As with other discussion drafts on BEPS actions, the proposals do not represent a consensus view from the G20/OECD governments involved, but are designed to provide preliminary but substantive proposals for public analysis and comment.

The discussion draft proposes a significant change to the transfer pricing of CCAs by stipulating that contributions made by participants would need to be assessed, in almost all cases, by reference to "value." This is a change from the current guidance, which leaves open the question of whether cost or value should be used. This change is proposed to ensure that the transfer pricing outcomes under CCAs are consistent with those relating to intangibles developed outside CCAs and with developments in relation to the control and management of risk, presumably relating to concerns about minimally functional entities that provide funding for the development of intangibles.

Most CCAs to date have been based on costs, in part because of the accessibility of similar arrangements between third parties that are based on costs (e.g., joint ventures in the oil and gas and pharmaceutical industries).

The discussion draft does not make any reference to transitional arrangements, so businesses may need to apply a value-based assessment of contribution in relation to existing multiyear arrangements.

### CCAs

The discussion draft sets out guidance for application of the arm's-length principle to CCAs undertaken by companies within multinational groups. A CCA would be defined for this purpose as a contractual arrangement to share the contributions and risks involved in projects to create direct benefits for the businesses of each of the participants. There would be two broad categories of CCAs:

- *Development CCAs* for the joint development, enhancement, maintenance, protection, or exploitation of intangible or tangible assets, where each participant will receive a share of the rights in the developed intangible or tangible asset and
- *Services CCAs* for obtaining services.

The discussion draft acknowledges several commercial reasons for companies within multinational groups to enter into CCAs, such as to spread risk, utilize different skill sets, achieve economies of scale, and avoid complex intragroup licensing arrangements for intangible assets. The draft also would establish the methods to be employed to share contributions among the participants in a manner consistent with what would have been agreed upon between independent parties in similar circumstances (i.e., under the arm's-length principle). For a CCA to satisfy the arm's-length principle, each participant's proportionate share of the overall contributions to the CCA would be required to be consistent with its proportionate share of the overall expected benefits.

The first step in evaluating an arrangement would be to determine the participants of the CCA. Since a CCA is premised on expected mutual benefit and on all participants sharing not only the contributions to, but also the risks of, the CCA activities, each participant would be required to have a reasonable expectation that it will benefit from the CCA activity itself (and not just from performing part or all of that activity). In addition, each participant would be required to have the capability and authority to control the risks associated with the CCA (in accordance with the principles set out in Chapters I-III of the OECD transfer pricing guidelines, including in relation to risk).

It would be necessary to estimate each participant's expected benefits from the CCA. This could be based on the anticipated additional income generated, costs saved, or other benefits received by each participant. In practice, a relevant allocation key, such as sales; units used, produced, or sold; or number of employees could be appropriate to reflect the participants' proportionate shares of expected benefits. To the extent that benefits of a CCA activity are expected to be realized in the future, and not only in the year the costs are incurred, the allocation of contributions should take account of projections about the participants' shares of those benefits. Particularly in the case of development CCAs, projections may be subjective and uncertain, and it could be appropriate for a CCA to provide for possible adjustments to proportionate shares of contributions over the term of the CCA on a prospective basis to reflect changes in circumstances that result in changes in shares of benefits.

Where the value of a participant's contributions is not consistent with its share of expected benefits, balancing payments could be required. However, making minor or marginal adjustments or general adjustments based on evidence from a single year could be inappropriate, as CCAs can be long-term projects where costs and benefits need to be measured over a period of years.

Changes in the participants of a CCA could trigger a reassessment of the proportionate shares of a participant's contributions and expected benefits. In the case of a new entrant contributing to a CCA, arm's-length compensation would be required in the form of a buy-in payment.

Conversely, a participant withdrawing from a CCA could be entitled to a buy-out payment to reflect a disposal of its interest. Such payments would be based on value rather than cost (as they are under the current transfer pricing guidelines).

Contributions by or for a participant of a CCA, including any balancing payments, buy-in payments, or buy-out payments, would continue to be treated for tax purposes in the same manner as they would be under the rules of the tax system applicable to each participant if the contributions were made outside of a CCA. The character of the contribution would depend on the nature of the activity being undertaken by the CCA (e.g., whether it is capital or revenue in nature) and will determine how it is treated for tax purposes.

The guidance remains broadly unchanged in terms of its recommendations for structuring and documenting CCAs (e.g., conditions for participants eligible to join a CCA, terms to be included and information that should be documented at the outset and throughout the duration of the CCA).

### Comments

The simplicity and ease of application that arises from using costs (which are readily identifiable to businesses and readily auditable by tax authorities) would be eliminated in favor of a more subjective approach based on value. This would have wide-reaching consequences and would introduce considerable complexity for businesses that are not engaging in BEPS (e.g., where the participants in the CCA do not involve low-tax jurisdictions or minimally functional entities). In essence, the proposals mean that CCAs would have the same difficulties as profit splits, including the complexities of applying and agreeing on the outcome with multiple tax authorities. The result would be an increase in the compliance burden for companies and additional costs for tax authorities that must understand and audit the arrangements, with a significant potential for disputes and double taxation where tax authorities do not share the same view.

Comments on the discussion draft are invited by May 29, 2015; a public consultation will be held on the draft and other transfer pricing topics at the OECD on July 6/7, 2015.

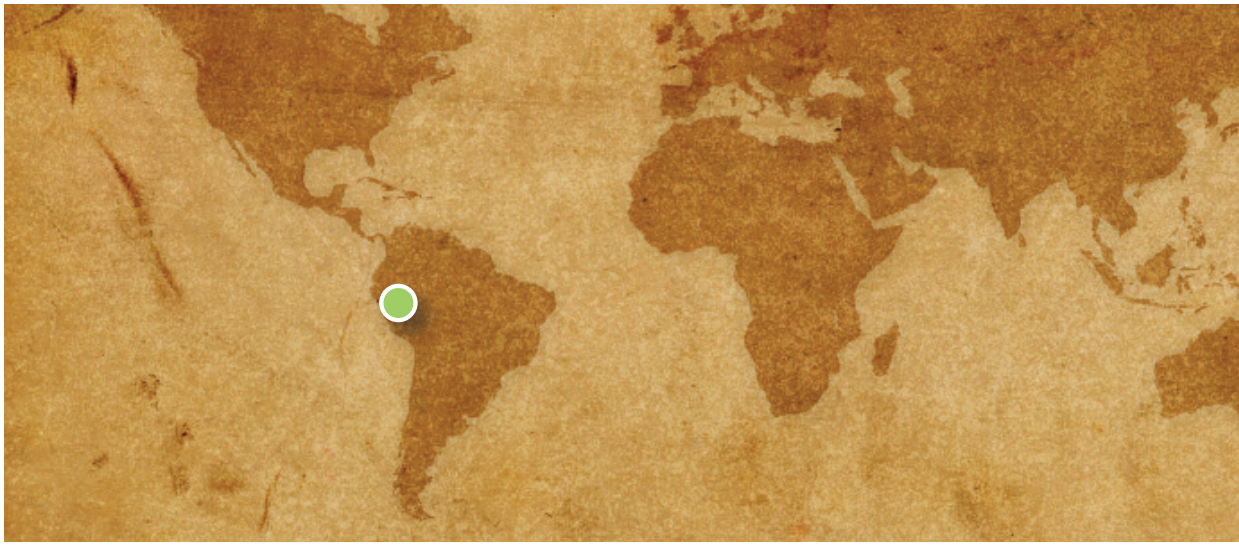
# Peru:
# Nonresidents must obtain certification of tax basis for indirect transfers of shares

Peru's Ministry of Economy and Finance published a decree on April 18, 2015, that repeals the provision in the capital gains tax (CGT) regulations that exempted nonresident taxpayers from the requirement to obtain a tax basis certification from the Peruvian tax authorities when determining the amount subject to tax on indirect transfers of shares of Peruvian legal entities.

As of April 19, 2015, the same general process that applies to direct transfers of shares by a nonresident also applies to indirect transfers that fall within the scope of the Peruvian tax net: the nonresident transferor of shares of another nonresident entity that owns a Peruvian legal entity must submit an application to the Peruvian tax authorities requesting a "Certificate of Invested Capital" to support the tax cost basis (amount paid) for the shares that are intended to be transferred. This certification must be issued before the agreed-upon consideration is paid by the transferee; otherwise, the nonresident transferor will not be allowed to offset its tax basis against the gain on the shares that are transferred, and, thus, the applicable CGT will be imposed on the gross amount of the sales proceeds.

**Background**

According to rules introduced in 2011, capital gains derived from certain indirect transfers of the shares of a Peruvian legal entity are subject to Peruvian tax, generally at a rate of 30% (or 5% if the shares of the nonresident entity are recorded in the Peruvian Public Securities Registry and traded through the Lima stock exchange (LSE)). These rules subsequently were revised to facilitate compliance by taxpayers and to enable the Peruvian tax authorities to monitor transactions and collect tax due. However, the revised CGT rules continued to give rise to practical implementation issues, and additional guidance was necessary to provide more legal certainty to investors and ensure compliance. (For prior coverage, see *World Tax Advisor,* November 22, 2013.)
URL: http://newsletters.usdbriefs.com/2013/Tax/WTA/131122_6.html



**Scope of indirect transfers:** Capital gains derived from an indirect transfer of the shares of a Peruvian legal entity are subject to Peruvian tax if the conditions in 1) or 2) below are satisfied:

1. The shares of a nonresident entity that owns, directly or indirectly, shares of a Peruvian company are transferred and either:
   a. The market value of the shares of the Peruvian company owned directly or indirectly by the nonresident entity is equal to 50% or more of the market value of all of the shares representing the equity capital of the nonresident entity ("50% market value rule") for the 12-month period before the transfer, and there has been a transfer (or transfers) of shares representing 10% or more of the equity capital of the nonresident entity within the relevant 12-month period (in the event of an audit, the tax authorities have the burden of demonstrating that these conditions are satisfied) or
   b. The nonresident entity is resident in a tax haven or low-tax jurisdiction, unless it can be demonstrated that the conditions in a) above are not satisfied (in the event of an audit, the taxpayer has the burden of demonstrating that these conditions are not satisfied).
2. The nonresident entity issues new shares as a result of a capital increase (generated by a new capital contribution, the capitalization of credits, or a reorganization) and allocates the shares a value below their market value. This provision will apply only if at least one of the circumstances described in 1) above is present. Under this CGT antiavoidance measure, the nonresident entity will be deemed to have transferred the shares issued as a result of the capital increase.

**Payment of tax and reporting obligations:** If a transaction falls within the scope of an indirect transfer taxable in Peru, CAVALI (the Peruvian clearing and settlement institution) will act as a withholding agent for transfers carried out through the LSE. As of January 1, 2014, an information reporting requirement applies to nonresident investors participating in indirect transfers on the exchange. In all other cases, unless there is a Peruvian transferee who acts as a withholding agent, the nonresident transferor must self-assess the tax. Where the transfer is not carried out through the LSE and a Peruvian transferee acts as a withholding agent, that transferee is jointly and severally liable with the nonresident transferor for the payment of any CGT that may arise from the indirect transfer, and the tax authorities can audit and seek collection directly from the transferee.

A distinctive feature of the CGT regime is that, under specific circumstances (i.e., if, in the 12-month period before the transfer, the Peruvian company whose shares are transferred and the nonresident transferor are economically related), the Peruvian issuer company is jointly and severally liable with the nonresident transferor for the payment of CGT, even if the transaction is carried out through the LSE, and the Peruvian tax authorities can seek collection of the tax due directly from the Peruvian issuer company. Additionally, the current provisions require resident legal entities to notify the Peruvian tax authorities when their shares or participating interests are transferred indirectly, in accordance with the reporting rules issued to facilitate compliance and collection of the applicable CGT.

### Determination of potential CGT liability

Under the current rules, the taxable base for purposes of the CGT on indirect transfers is determined by taking into account the market value of the shares in the nonresident legal entity that are transferred (identified following the procedure specified by the regulations), multiplied by the percentage identified when applying the 50% market value rule. The tax basis of the shares in the nonresident legal entity transferred is the value obtained by applying the percentage determined when applying the 50% market value rule to the total tax basis available under Peruvian provisions.

It should be noted that the tax basis considered in the calculation must be supported by documents issued abroad according to the tax rules of the relevant jurisdiction, or by any other documents that accurately support the amount claimed as the tax basis.

Rules prior to the decree: Before the April 18 decree, the CGT regulations provided that there was no obligation to obtain a Certificate of Invested Capital for an indirect transfer of shares. Consequently, it was only necessary for the nonresident taxpayer (or any local party considered jointly and severally liable with the nonresident, either as the Peruvian transferee or the Peruvian company whose shares were transferred) to retain evidence of the amount invested in the shares that supports a valid tax basis for purposes of the calculation.

In practice, the absence of further guidelines regarding the requirements and the type of documentation necessary to support the tax basis in the foreign shares created certain uncertainty for investors that need to know the amount that the Peruvian authorities will recognize as the tax basis for purposes of determining the tax liability.

Effect of the decree: As a consequence of the decree, once a potential transaction has been identified as an indirect transfer, the nonresident transferor generally will need to submit a formal application to the Peruvian tax authorities for a Certificate of Invested Capital for the basis of the foreign shares to be transferred, before the transaction is carried out. This application will trigger a preliminary audit by the authorities, and until the certification is issued, it is not possible to offset the transferor's basis against the gain from the transfer.

If a certificate is obtained, the nonresident transferor will be taxed only on the difference between the market value of the shares and their certified cost (i.e., on the net capital gain). In the absence of this certification, the 30% tax rate would apply to the total sales proceeds.

Thus, in practice, the Certificate of Invested Capital must be requested before implementing the transaction, taking into account that the certification process takes approximately two months. The certificate is valid for only 45 days from its issuance, and only as long as the tax basis in the shares remains the same (if it changes, a new certificate must be obtained).

Based on other provisions in Peruvian law, a Certificate of Invested Capital will not be required if the indirect transfer is made through the LSE.

**Comments**

The new requirement to obtain a Certificate of Invested Capital for indirect transfers before the date of the transaction should eliminate some of the uncertainty for nonresident investors seeking to accurately manage their tax compliance obligations. However, this measure also will increase the administrative burden and costs associated with tax compliance for indirect transfers of shares, since nonresident transferors now will have to wait until the Peruvian tax authorities issue the certificate to complete the transaction and must incur the costs associated with the request (e.g., costs of translation of relevant documents into Spanish, validation of documents by the Peruvian consulate, appointment of a Peruvian representative, and preparation of an application letter for the certificate).

Before this new requirement, any assessment issued by the tax authorities would have calculated the CGT on indirect transfers on a net basis, as long as proper supporting documentation was submitted upon request, even if the transaction and the CGT were not timely reported and paid, respectively. Now the Peruvian tax authorities will apply the 30% tax rate to the entire consideration (with no reduction for the taxpayer's basis) if the Certificate of Invested Capital is not timely obtained, regardless of whether there is other sufficient supporting documentation on record. Thus, it appears that the new rule is designed to encourage the voluntary reporting of transactions involving the indirect acquisition of Peruvian shares and, therefore, to facilitate the Peruvian tax authorities' collection of the applicable income tax.

Nonresident taxpayers wishing to dispose of investments in companies holding Peruvian shares, or evaluating a corporate reorganization or any other foreign transaction that would require the indirect transfer of Peruvian shares, should take this new requirement into consideration to accurately assess the associated tax costs, and the tax risks involved if the transaction falls within the scope of an indirect transfer.

# Switzerland: Swiss Supreme Court rules on treaty beneficial ownership in connection with derivative transactions

Switzerland's Federal Supreme Court issued two important decisions on May 5, 2015, regarding the concept of beneficial ownership of income under tax treaties, as it applies to total return swaps and futures contracts.

A total return swap is a financial contract in which the parties agree to exchange the return (dividends and price changes) of an underlying asset or a basket of underlying assets for a set rate. In such an arrangement, the party receiving the total return will receive income generated by the asset, as well as the benefit if the price of the asset increases over the life of the swap. In return, the recipient must pay to the counterparty the set rate over the life of the swap. If the price of the asset drops over the life of the swap, the total return recipient will be required to pay the counterparty the amount by which the asset has dropped in price.

A futures contract is a financial contract between two parties to buy an underlying asset or a basket of underlying assets at a predetermined price, with settlement occurring in the future. For Swiss market index (SMI) futures, the underlying assets are the shares representing the SMI. SMI futures are traded on the EUREX stock exchange.

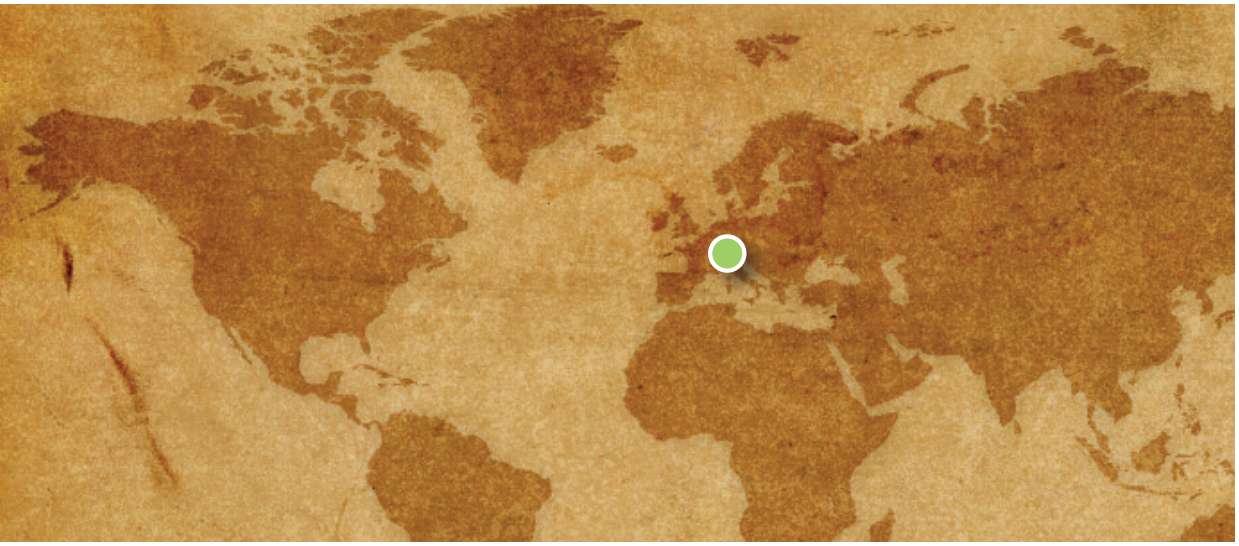
The cases involved two Danish banks that had fully hedged Swiss equities positions and claimed refunds of Swiss withholding tax on dividends received. The Federal Tax Administration (FTA) denied the refunds on the grounds that the conclusion of these derivative transactions resulted in the loss of beneficial ownership of dividends received from Swiss shares acquired for hedging purposes. The banks appealed to the Federal Administrative Court, which ruled against the FTA. The FTA appealed and the Federal Supreme Court reversed the decisions of the Federal Administrative Court and upheld the position of the FTA.

### Total return swap case

In 2007, a Danish bank entered into total return swap agreements with several counterparties; the underlying assets for the agreements were shares in Swiss companies. On the basis of the swap agreements, the bank was required to pay the counterparties an amount equal to the returns generated during the life of the swaps (i.e., dividends) and the bank received fixed interest based on London InterBank Offered Rate, as well as an additional margin.

To hedge the swap positions, the bank purchased the corresponding number of the underlying Swiss shares of the total return swap. Dividends were paid on the shares and a 35% Swiss withholding tax was levied. The Danish bank claimed a full refund of the withholding tax, based on the Switzerland-Denmark tax treaty in effect at the time. The treaty did not contain a beneficial ownership clause in the dividends article or an antiabuse provision.

The FTA denied the refund on the grounds that the bank was not the beneficial owner of the dividends because it had entered into the total return swap agreements and was de facto obliged to forward the Swiss dividends received to the swap counterparties. The bank appealed



to the Federal Administrative Court, which concluded in 2012 that, even though the bank entered into the swap transactions, it retained beneficial ownership of the dividends; therefore, the court granted a full refund of the withholding tax.

In its decision, the Federal Supreme Court confirmed that the beneficial owner concept is implicit in all tax treaties, i.e., a recipient of dividend income must be the beneficial owner to claim treaty benefits, even if the relevant treaty does not contain a specific reference to beneficial ownership.

Beneficial ownership requires that a dividend recipient have certain rights and authority with respect to the use and disposition of the dividends received; these rights are limited if the recipient is legally or de facto obliged to pass on the dividends to a third party. A further indication of beneficial ownership is the assumption of the dividend risk, i.e., the beneficial owner should be the party that bears the risk that no dividend will be distributed.
The Federal Supreme Court concluded that the Danish bank was obligated to forward the dividends to the counterparties that this obligation was inextricably linked to the dividend distributions on the underlying shares and that the bank did not assume any risk in the transaction and, consequently, could not be considered the beneficial owner of the dividends.

### SMI futures case

A Danish bank sold SMI futures and purchased the underlying Swiss shares to hedge the position. To exit its position when the futures contracts were about to expire, the bank repurchased the contracts and sold the shares that served as a hedge. The futures and shares were traded via different brokers. Over the life of the SMI futures, the bank collected dividends on the acquired Swiss shares and then claimed a refund of the 35% Swiss withholding tax, based on the Switzerland-Denmark treaty.

The FTA again took the position that the bank was not the beneficial owner of the dividends and, therefore, was not entitled to treaty benefits—because of the sale of SMI futures, the bank was factually obliged to pass on the Swiss dividends received to third parties. The FTA also suspected that the buyers of the SMI futures and the sellers of the Swiss shares were identical, and that the entire transaction was prearranged with the sole purpose of benefitting from the favorable withholding tax rate under the treaty. Furthermore, the acquisition of the shares was fully debt financed by the bank's parent company and no evidence was presented that the interest paid was not dependent on the dividend payments received on the Swiss shares. The bank was criticized for not disclosing the financing agreement with the parent company. However, the bank appealed the FTA's decision and the Federal Administrative Court ruled against the FTA.

The Federal Supreme Court's opinion referred to its definition of beneficial ownership in the other Danish bank case, although the facts of the SMI futures case were more complex and not entirely clear. Nevertheless, the court held that the facts that the shares were traded in block trades and not anonymously over the stock exchange, and that the counterparties behind the brokers were not disclosed, indicated that the transactions were prearranged.
Further, the bank fully hedged the position and did not bear any risk. As such, the economic (i.e., nontax) reason for the brokers and the bank to conclude the transactions was not apparent. Finally, the nondisclosure of the financing arrangement was considered indicative of a potential harmful interdependence between the dividends received and the interest paid by the bank. The court held that the FTA was correct in denying the withholding tax refund.

### Impact of the decisions on the financial market

During the time these cases have been proceeding through the judicial system, the FTA has denied or suspended numerous similar refunds of Swiss withholding tax in cases involving derivatives. It is important to note that the Federal Supreme Court decisions are not directly applicable to other cases—each case must be analyzed on its own merits, so different outcomes are possible.

# India:
# In a major relief to FIIs, MAT proceedings put on hold by the government

### Synopsis

The Central Board of Direct Taxes (CBDT) has issued an internal instruction to tax officers asking them to keep on hold all proceedings concerning levy of Minimum Alternate Tax (MAT) on foreign companies especially Foreign Institutional Investors (FIIs).

### MAT demands by tax officers

- While completing scrutiny assessments (tax audits) for the financial year 2011–12, tax officers concluded that FIIs set up as companies were liable to MAT on capital gains and other income earned in India.
- Consequent to various representations made to the government, it has been proposed in the Budget 2015 that foreign companies will not be liable to MAT in respect of capital gains, interest, royalties, and fee for technical services from April 1, 2015.
- Since the budget amendment is applicable prospectively from April 1, 2015, tax officers have raised demands for the financial year 2011–12 and have also reopened audits for prior years with a view to apply MAT.

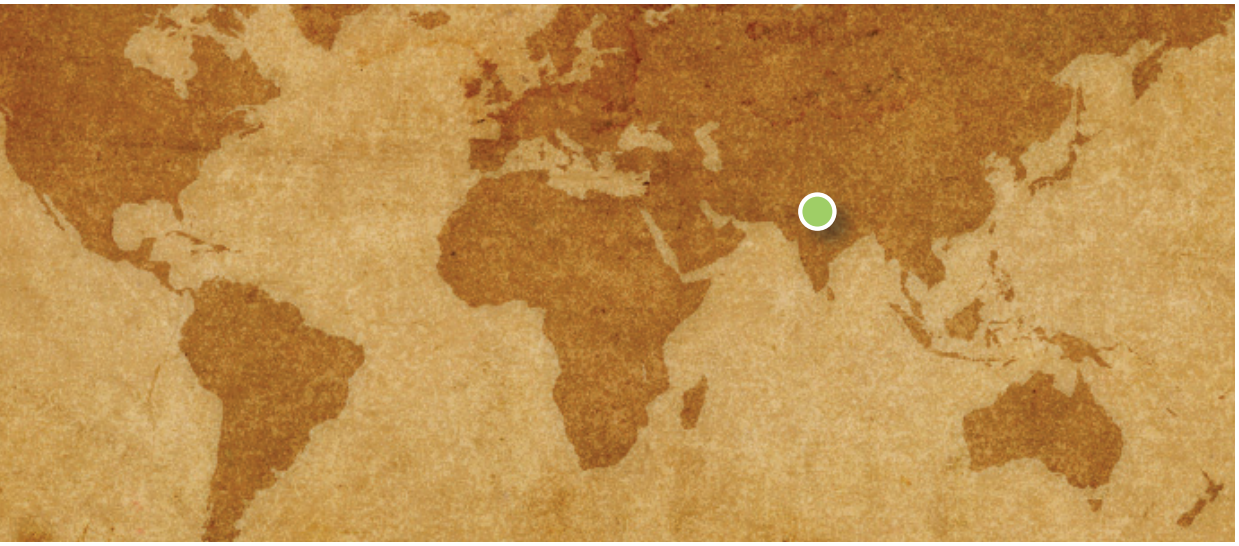
### MAT proceedings put on hold

- On May 7, 2015, the finance minister announced the constitution of a committee to look into the applicability of MAT provisions for the period prior to April 1, 2015, and submit a report expeditiously. The specific terms of reference of the committee are expected to be announced soon.
- In a welcome development, the government has today issued an internal instruction to tax officers to keep on hold all audit proceedings relating to MAT against all foreign companies, especially FIIs. This includes restrictions on issue of fresh notices as well as completion of audits. The government has also asked tax authorities not to recover any tax demands from foreign companies relating to MAT.

### Comments

The government's direction to the tax officers to put on hold all MAT-related proceedings is certainly a huge relief for FIIs. We will now have to wait and watch for the committee's views on applicability of MAT, as well as the judgement of the Supreme Court in the case of Castleton Investments that is expected to be heard in August of this year.

*Source: CBDT notification dated May 11, 2015, FTS No. 96370/2015.*



# Australia: Investment manager regime bill introduced into parliament

On May 27, 2015, a bill for the third and final element of the investment manager regime (IMR 3) was introduced into the Australian parliament. The introduction of the bill is the culmination of a lengthy process that spanned over four years and included the release of multiple versions of exposure draft legislation, the most recent of which was issued in March 2015 (for coverage of the draft legislation, see the alert dated March 13, 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 to be 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 June 30, 2011. However, as enacted, IMR 1 generally is of limited assistance.
- IMR 2 provides a statutory exemption for an IMR foreign fund in respect of certain IMR income, with effect from July 1, 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 PE for the IMR foreign fund.

IMR 3 is intended to provide a prospective, long-term IMR exemption. It would apply as from the 2015–2016 income year (the year ended June 30, 2016), although a fund would be able to choose to apply the amendments from as early as the 2011–2012 income year. The version of IMR 3 contained in the bill reflects a number of features similar to those of the UK investment manager exemption.

### Overview of proposed requirements for IMR exemption

Non-Australian entities 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). In both cases, the non-Australian entity would have to be an "IMR entity."

**IMR entity:** The term "entity" would be broadly defined and would include individuals, companies, partnerships, and trusts.

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

Under Australian tax law, a limited partnership established outside of Australia may be considered an Australian resident if it merely carries on business in Australia. This may cause concern that certain actions, such as trading in Australian assets or engaging an Australian-based fund manager, could result in the limited partnership being considered to carry on business in Australia and,

therefore, could 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 relates solely to IMR financial arrangements would be disregarded.

Under previous versions of the exposure draft legislation, 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. However, this requirement is not included in the bill. Further, although previous versions of the exposure draft legislation would have required an IMR entity to file an annual information return, this requirement is 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" would be exempt from Australian tax, and losses from such arrangements would not be deductible. However, 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.

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

- In the case of the direct IMR concession, the IMR entity has an interest of 10% or more in the issuer, or the counterparty, of the financial arrangement and
- In the case of the indirect IMR concession and where the issuer or the counterparty is an Australian resident, the IMR entity has an interest of 10% or more in the issuer, or the counterparty, of the financial arrangement (this requirement would not apply to non-Australian issuers or counterparties).

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

**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:

- 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 PE in Australia.
- The IMR entity does not carry on noneligible investment business that relates to the arrangement at any time during the income year. This broadly means that the IMR entity would be required to carry on only activities of investing or trading in shares, loans, derivatives, or similar financial instruments.

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

2. Either of the following widely held ownership tests is met:
   a. No member of the entity has a total participation interest of 20% or more in the entity (single-member test).

b. There are not 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 would adopt a look-through approach 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 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 in which they are received would be disregarded for purposes of the ownership tests. This is a welcome acknowledgement of the common practice of rewarding the performance of managers in a typical fund; however, the exclusion would be limited to cases where the fund manager is an Australian resident. It often will 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 would be 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 could be actively marketed with such an intention before it is considered 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 could need to provide compelling evidence of 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 would be considered to continue to be widely held.

### Temporary failure 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. Provided such circumstances are temporary, and considering the actions of the IMR entity to address the circumstances, the IMR entity could continue to be treated as an IMR widely held entity if this treatment is fair and reasonable.

**Indirect IMR concession:** The indirect IMR concession would apply if the IMR entity 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 IMR entity, but, in either case, the indirect IMR concession would be available.

The requirements for the indirect IMR concession would be:

- 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;
- The IMR entity does not carry on noneligible investment business that relates to the arrangement at any time during the income year; and
- If the issuer of, or counterparty to, the IMR financial arrangement is an Australian resident during the entire year, the IMR entity's interest 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:

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 equivalent to what the remuneration would be between parties dealing at arm's length.
4. One or more of the following applies:
   a. The IMR entity is an IMR widely held entity.
   b. No more than 70% of the managing entity's income for the income year is received from the IMR entity, or entities connected with the IMR entity.
   c. 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 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.

### Reduction in concession

The bill proposes that the concession for the IMR entity be reduced for an income year in which the independent Australian fund manager, or another entity connected with that manager, has a direct or indirect right to receive a portion of the profits of the IMR entity exceeding 20% of the profits for the year ("20% profits test"). In broad terms, the concession would be 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 in which they are received would be 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 would not need to reduce the amount of the IMR concession.

### Application

IMR 3 would apply to the 2015–2016 and subsequent years of income (i.e., from July 1, 2015). However, an option would be available to taxpayers to apply the changes in the bill to the 2011–2012 to 2014–2015 income years (i.e., between July 1, 2011, and June 30, 2015).

Further, although IMR 1 was enacted in 2012 and was intended to provide an exemption for periods up to June 30, 2011, there are a number of technical issues with IMR 1, in particular, with the definition of "IMR foreign fund," which cause many funds to fail to qualify under the regime. The bill would permit IMR entities to choose to apply the new widely held ownership tests when determining if they qualify for exemption under IMR 1.

### Comments

The bill should be welcomed by non-Australian residents, such as hedge funds investing in Australia and funds that engage independent Australian fund managers. Many issues raised during the consultation process have been addressed, including the introduction of significantly relaxed 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 would qualify for the direct or indirect IMR concession for any year (including prior years up to 2011–2012) in which income or gains from investments, otherwise, might be subject to Australian tax.

# Contacts

For additional information or questions regarding international tax developments, please visit http://www.deloitte.com/us/internationaltax or contact one of the following tax leaders:

**Julia Cloud**
**National Managing Partner, Investment Management Tax Practice**
Deloitte Tax LLP
+1 312 486 9815
jucloud@deloitte.com

**Ted Dougherty**
**National Managing Partner, Investment Management Tax Practice**
Deloitte Tax LLP
+1 212 436 2165
edwdougherty@deloitte.com

**Thomas Butera**
**ITAMS Group Co-Leader**
Principal
Deloitte Tax LLP
+1 212 436 3231
tbutera@deloitte.com

**Jimmy Man**
**ITAMS Group Co-Leader**
Partner
Deloitte Tax LLP
+1 213 553 1476
jman@deloitte.com


RUSSIA
ASIA
KAZAKHSTAN
MONGOLIA
INDONESIA
ARCTIC OCEAN
CANADA
UNITED STATES
ARGENTINA
URUGUAY


Greenland
ICELAND
SPAIN
BAHAMAS
Mexico