

MARCH 2015

# AUSTRALIAN TAX ALERT

## INVESTMENT MANAGER REGIME (IMR) – DRAFT LEGISLATION TO IMPLEMENT ELEMENT 3 FINALLY RELEASED

### INTRODUCTION

The exposure draft (**ED**) legislation removes tax impediments for foreign investors investing into Australia in order to attract foreign investment and promote the use of Australian fund managers.

### OVERVIEW

The introduction of the Australian investment manager regime (**IMR**) was initially proposed by the Australian Financial Centre Forum in the Johnson Report in 2009 and the Board of Taxation in 2011.

The ED legislation and the relevant explanatory memorandum were released by the Australian government on 12 March 2015 for public consultation to implement the final/third element of the IMR reforms as well as amend some parts of the existing regime. The IMR reforms are designed to attract greater foreign investment to Australia and allow Australian fund managers to actively market their financial services globally, thereby promoting Australia as a regional financial services centre. The closing date for submissions is 9 April 2015.

### RECAP ON CURRENT AUSTRALIAN IMR REGIME

Element 1 was enacted in 2012 and was designed to mitigate the consequences of the US accounting standard Financial Interpretation Number 48 by clarifying the tax treatment of past transactions of foreign funds. Generally, these amendments prevent the Australian Tax Office (**ATO**) from raising an assessment in respect of gains from portfolio investments and certain derivative and other financial arrangements. These changes applied to the 2010/11 and prior income years.

Element 2 was also enacted in 2012 and exempted income derived by widely held foreign funds from foreign investments and Australian assets that were only subject to capital gains tax. However, this exemption only applies where the income would be taxable in Australia solely as a result of the widely held foreign fund having an Australian permanent establishment as a result of engaging an Australian based financial services intermediary. Australian sourced income gains were not exempted. These changes also applied from the 2010-11 income year.

### ELEMENT 3 OF IMR IN DETAIL

Generally, Element 3 of the IMR exempts Australian sourced capital and revenue gains realised by a widely held foreign fund in respect of portfolio Australian investments (that is, less than 10%) from Australian tax. Further, a foreign investor that engages an independent Australian fund manager to invest in portfolio Australian investments will also disregard Australian sourced capital and income gains realised in respect of those investments.

In particular, these proposed amendments allow an IMR entity to qualify for the IMR concession either by investing:

- directly in Australia (referred to as the **direct IMR concession**);
- indirectly in Australia via an Australian fund manager (referred to as the **indirect IMR concession**).

### IMR CONCESSION

Generally, the IMR concession disregards certain Australian income tax consequences (such as income or capital gains) arising to an IMR entity in respect of derivative and non-derivative financial arrangements. However, the IMR concession does not apply to income in respect of the following: a direct interest in Australian real estate; or an interest of 10% or more in an entity that principally holds Australian real estate (**direct and indirect real estate interests**).

### IMR ENTITY

An entity will only be an IMR entity if it:

- is a foreign resident and not a resident trust; and
- does not carry on a trading business in Australia or control/able to control the affairs or operations of such a business.

An IMR entity may include individuals, companies, beneficiaries of non-resident trusts and partners in partnerships.

### IMR FINANCIAL ARRANGEMENT

IMR financial arrangement is defined to generally include arrangements to raise finance and excludes: derivatives used solely for managing financial risk

and direct and indirect real estate interests (refer above). On this basis, the portfolio (or 10%) requirement in respect of IMR financial arrangements (discussed below) only applies to equity type investments (and not derivatives).

### DIRECT IMR CONCESSION

An IMR entity may qualify for the direct IMR concession if:

- it is widely held entity;
- 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 from the arrangement are attributable to an Australian permanent establishment.

An IMR entity may qualify as being widely held where either: it is specifically listed; or meets certain membership requirements.

The entities specifically listed as being widely held include foreign or Australian life insurance companies; managed investment trusts (MITs), complying superannuation funds etc. The listed entities are identical to the entities that are taken to be widely held under the MIT rules in sub-section 12-403(3) of Schedule 1 of the Tax Administration Act 1953 except for the exclusion of foreign collective investment vehicles.

Alternatively, an IMR entity may also qualify as an IMR widely held entity if:

- no member of the entity has a total participation interest in the entity of 20% or more; or
- there are not five/fewer members who have combined participation interest of at least 50%.

These rules are based on the requirements contained in the United Kingdom's (UK) Investment Manager Exemption (IME). These rules allow tracing through certain interposed entities to individuals to determine if the total participation interest thresholds are satisfied. However, these rules do not necessarily allow the tracing through all types of interposed entities.

In addition, there are specific rules which apply when the IMR entity is starting up, winding down or there are temporary circumstances outside an IMR entity's control. However, if the IMR entity does not satisfy the requirements of the IMR concession during the start-up period (18 months), the concession is taken never to have applied to the entity (that is, concession is removed retrospectively).

### **INDIRECT IMR CONCESSION**

An IMR entity may qualify for the indirect IMR concession if:

- the IMR financial arrangement is made on the IMR entity's behalf by an independent Australian fund manager; and
- if the issuer, or counterparty to, the IMR financial arrangement is an Australian resident – then the interest of the entity less than 10%.

However, if the independent Australian fund manager has a right to receive (either directly or indirectly), more than 20% of the IMR entity's profits for that year, then the IMR concession is reduced by an equivalent percentage.

### **INDEPENDENT AUSTRALIAN FUND MANAGER**

A fund manager will qualify as an independent Australian fund manager where the following are satisfied:

- 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 is an arm's length amount; and
- either of the following are satisfied:
  - the IMR entity is an widely held entity (refer to comments above); or
  - 70% or less of the managing entity's income for the income year is received from the IMR entity or its connected entities; 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 income received from the IMR entity or its

connected entities will be reduced to 70% or less.

### **RELATED AMENDMENTS**

One of the related amendments included in this ED is to exclude business carried on by a partnership that solely relates to IMR financial arrangements from being used to determine if the partnership carries on business in Australia for the purposes of section 94T of the *Income Tax Assessment Act 1936*. This section deems a partnership to be an Australian resident where it carries on business in Australia and therefore, results in the partnership being subject to Australian tax in respect of its worldwide income. However, these amendments do not ignore the business carried on by the partnership (or its fund manager) for the purposes of the central management and control test contained in section 94T.

### **DATE OF EFFECT**

These proposed changes are to apply to assessments for the 2015-16 income year and later income years. Further, the taxpayers may choose to apply the new rules (except the direct IMR concession) to assessments for the 2011-12 to 2014-15 (inclusive) income years.

## MORE INFORMATION

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