Tax Laws Amendment (Investment Manager Regime) Bill 2012
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Economics Section

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## Glossary

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<td>AFTS</td>
<td><em>Australia’s Future Tax System</em></td>
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<td>ASC</td>
<td>Accounting Standards Code</td>
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<td>Board</td>
<td>Board of Taxation</td>
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<td>CGT</td>
<td>Capital gains tax</td>
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<td>FIN 48</td>
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<td>ITAA 1936</td>
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<td>Johnson Report</td>
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<td>MIT</td>
<td>Managed investment trust</td>
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<td>NANE</td>
<td>Non-assessable non-exempt</td>
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<td>Regulation impact statement</td>
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<td>US</td>
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<td>USGAA/ASC 740-10</td>
<td>US generally accepted accounting principles</td>
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Tax Laws Amendment (Investment Manager Regime) Bill 2012

Date introduced: 21 June 2012
House: House of Representatives
Portfolio: Treasury

Commencement: Most provisions of the Act commence on the day it receives the Royal Assent. The commencement dates of the various items in Schedule 1 are set out at items 2 to 7 of the table in clause 2 of the Bill. The measures in Schedule 2 commence on the day the Act receives the Royal Assent.

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill’s home page, or through http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation. When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website at http://www.comlaw.gov.au/.

Purpose

Schedule 1 inserts proposed subdivision 842-I to the Income Tax Assessment Act 1997 (ITAA 1997) with measures to ensure that a foreign managed fund with foreign sourced investment income including capital gains is not subject to tax in Australia merely because it engages an Australian based agent, manager or service provider.

Schedule 2 inserts proposed subdivision 840-I to the Income Tax (Transitional Provisions) Act 1997 (ITTPA 1997) to treat the income or gains of certain widely held foreign managed funds as non-assessable non-exempt income or disregard such income or gains and relevant deductions, losses, capital gains and capital losses for the year 2010–11 and earlier income years.

Background

Recent reviews that recommended changes to Australia’s taxation arrangements for foreign managed funds

Recently, two reviews have recommended changes to Australia’s taxing arrangements for foreign managed funds to enhance Australia’s position as a regional base for managing offshore assets.

The Henry Tax Review, in its report titled Australia’s Future Tax System (AFTS), in Recommendation 35 recommended that taxation arrangements applying to Australian managed

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funds and related services should be improved to provide greater certainty that conduit income will not be subject to Australian tax.\(^1\) Conduit income is income that comes from a foreign source and is passed to a foreign entity by an Australian fund manager.

The Johnson Review, in its report titled *Australia as a Financial Centre—Building on our Strengths* (Johnson Report), recommended the introduction of an investment manager regime (IMR) to provide clear statutory rules for the taxation of cross-border investment to substantially boost trade in financial services and further improve the sector’s competitiveness and efficiency. The Johnson Report also noted that the IMR would attract overseas investors into funds run out of Australia and make it easier for both local and international companies to use Australia as a regional base from which to manage offshore assets.\(^2\)

**What is an investment manager regime (IMR)?**

An IMR is designed to provide clarity and certainty regarding the tax treatment of the funds management sector with respect to assets sourced off shore. The Johnson Report noted that a number of overseas financial centres, including Hong Kong, Singapore, New York, Tokyo and London have legislated IMRs.

In Recommendation 3.1, the Johnson Report recommended the introduction of an IMR with a wide application to both retail and wholesale funds, but confined to entities operating within the financial sector.

It further recommended the IMR should provide that non-resident investors using an independent resident investment adviser, fund manager, broker, exchange or agent, should be exempt from all tax liabilities in Australia on income from all foreign assets. However, it recommended that any investments made in Australian assets should, for tax purposes, be treated as if the investments were made directly by the non-resident without the use of any Australian intermediary.

**Main issues**

The regulation impact statement (RIS) to the Bill states the measures in the Bill, which introduce an interim IMR, address two problems with existing tax law which have adverse impacts on foreign managed funds investing in Australia.

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Problem 1: Consequences of the application of US accounting standard FIN 48 to foreign managed funds, as discussed below, and

Problem 2: Current rules act as an impediment to engaging Australian fund managers.

The RIS outlines three options for resolving the issues arising from these two problems and concludes that Option 3, which the measures in the Bill seek to implement, will mitigate the impact of the US accounting standard on foreign managed funds and address concerns about Australian fund managers being deemed to be permanent establishments.3

The background to each of these is briefly considered below.

Problem 1: issues arising from the application of the US Accounting Standards Code 740-10 or ‘FIN 48’

The application of the United States (US) financial accounting standard (Accounting Standards Code 740-10(ASC 740-10)), generally referred to as ‘FIN 48’, requires US managed funds that have invested in Australia, when reporting under ASC 740-10, to examine their tax positions for current and prior years. If such managed funds conclude that the tax positions taken hitherto may not be consistent with the standards of the tax administrator, they are required to make provision in their financial accounts to meet any future adverse tax assessments.

Under the self-assessment regime the question may arise whether a US managed fund had correctly assessed its tax liabilities for the current and prior years because there are different rules under Australian tax law for taxing the income of non-residents and the capital gains of non-residents. As a result, there is scope for disputes as to whether any profits made on the disposal of assets are required to be treated as income or capital gains. The income of non-resident entities from Australian sources is taxed on the basis of source. The capital gains of non-residents are taxed on the disposal of assets which are ‘taxable Australian property’. If the assets disposed of are not ‘taxable Australian property’ foreign funds would generally not be subject to capital gains tax on profits arising on the disposal of those assets.

‘Taxable Australian property’ comprises generally Australian land, non-portfolio interests in land rich entities or assets used in carrying on business through a permanent establishment in Australia. A non-portfolio interest is one where the interest is 10 per cent or greater in another entity.

The question whether the disposal of investment assets such as shares, bonds, units and certain derivatives, which are not ‘taxable Australian property’ gives rise to taxable income or a capital gains is generally decided on the facts relating to a particular disposal and the application of case law. The Explanatory Memorandum states that ‘foreign fund managers have generally taken the view that


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gains on the disposal of investment assets give rise to capital gains (not income)’. If, for the purpose of reporting under ASC 740-10, these foreign fund managers were to review their previously held tax positions (that is, that the disposal of investment assets gave rise to capital gains on which no tax was payable) some foreign funds may come to the conclusion that they may have to make provision for any tax liabilities that may arise, if the Australian Taxation Office takes a contrary view that the profits on the disposal of those assets are in fact taxable income.

The fact the potential for foreign managed funds to become liable to tax in respect of prior years is contributing to a negative investor perception of Australia as an investment destination.

The RIS states that the objective of the measures in Schedule 2 of the Bill are to clarify the Australian tax treatment of prior year investments by foreign managed funds so as to mitigate the impact of ASC 740-10 on US managed funds investing in Australia and the ‘contagion effect’ on other foreign investors.

**Problem 2: issues arising from current rules that act as an impediment to engaging Australian managers of foreign funds**

If a foreign fund engages an independent Australian fund manager based in Australia to manage its investments listed in overseas stock exchanges, the foreign fund would be receiving income from a foreign source, which would be subsequently passed to the foreign fund. This foreign sourced income would not normally be liable to tax in Australia. The income received by the foreign fund through its Australian fund manager is generally described as ‘conduit income’ as the income generated overseas merely passes through the Australian manager to the foreign fund.

However, if the Australian fund manager is treated in Australia as a ‘permanent establishment’ for tax purposes, as defined in section 6 of the ITAA 1936 or under tax treaties, the conduit income may become liable to tax as being derived from a permanent establishment in Australia. Thus when a foreign managed fund engages the services of investment advisers, fund managers and brokers, the fund may be taken to have a permanent establishment in Australia.

This issue also arises in relation to capital gains made by a foreign fund where Division 855 of the ITAA 1997 provides that a foreign resident can disregard a capital gain or loss unless the relevant capital gains tax (CGT) asset is a direct or indirect interest in Australian real property, or relates to a business carried on by the foreign resident through a permanent establishment in Australia.

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4. Ibid., p. 41.
5. Explanatory Memorandum, RIS, paragraphs 3.7 to 3.10, pp. 40 and 41.
Consultation prior to implementation of the IMR in stages

The RIS sets out the consultation process with stakeholders, undertaken by government prior to the introduction of the Bill.\(^8\) Some of the highlights are set out below.

- the Government gave its in-principle support for a two stage implementation of an IMR (as set out at recommendation 3.1 of the Johnson Report) in a joint media release of 11 May 2010 by the Minister for Human Services, Financial Services, Superannuation and Corporate Law and the Assistant Treasurer\(^9\)
- at the same time, the Government released a consultation paper titled *Developing an investment manager regime: improving conduit income arrangements for managed funds*\(^10\)
- the consultation paper suggested that there were three elements to the IMR proposal for meeting the requirements of non-resident investors. These elements were that there should be no Australian tax on income earned on offshore assets (that is, conduit income); neutral tax treatment for direct investments and investments made through an *independent* intermediary; and neutral tax treatment for direct investments that have only a small proportion of Australian assets and other direct investments via a *dependent* intermediary acting at arm’s length (such as a branch\(^11\)) and
- the Treasury received ten submissions in response to its consultation paper. The RIS states that key messages from these submissions were that while the Johnson Report recommendation for an IMR was that it should apply more broadly than funds management, most of the current issues arose in relation to the funds management sector, particularly foreign managed funds and that Australia’s taxing arrangements for managed fund investments were out of step with a number of overseas jurisdictions.\(^12\)

On 17 December 2010, the Government announced that it would introduce amendments to the income tax laws to provide certainty of tax treatment for funds that have invested in Australia. The Government announced that where a foreign managed fund had not lodged a tax return for the 2009–10 or prior income years in respect of certain investment income of the fund, the Australian Taxation Office would not be permitted to raise an assessment in respect of that income, except where the fund lodges a tax return disclosing such income.\(^13\) Schedule 2 of this Bill gives effect to this

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8. Ibid., paragraphs 3-64 to 3.78, pp. 52 to 55.
11. Ibid., p. 4.

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announced and is generally referred to as ‘Element 1’ of the IMR and is a response to Problem 1 arising out of the application of the US accounting standard ‘FIN 48’. However, the Bill provides that the measures will apply to a foreign managed fund that has not lodged an income tax return in relation to the 2010–11 income year or any earlier income year, as discussed below.

On 19 January 2011, the Government announced that it would amend the income tax law to exempt from income tax the investment income, including capital gains, of a foreign managed fund from non-Australian sourced investments. The amendments will apply in circumstances where such income (known as conduit income) would be taxed in Australia only because the foreign managed fund is taken to have a permanent establishment to which such income may be attributed solely because it employs an Australian intermediary. The amendments would apply from the 2010–11 and later income years.14 These proposed measures, which Schedule 1 of the Bill gives effect to, are often referred to as the ‘conduit income measures’ or ‘Element 2’ of the IMR.

Financial implications

The Explanatory Memorandum states that prior to the introduction of the IMR, income tax payable by foreign managed funds was estimated to be $50 million per annum over the forward estimates period. Further, it states that the portion of this revenue impact which is attributable to the measures in the Bill is unquantifiable, but small.15

Human rights implications

The Statement of Compatibility with Human Rights concludes that this Bill is compatible with human rights as it does not raise any human rights issues.16

Key provisions

Amendments proposed in Schedule 1—Investment manager regime

Item 1 of Schedule 1 amends the ITAA 1997 to add proposed subdivision 842-I at the end of Division 842.

15. Explanatory Memorandum, p. 3.
16. Explanatory Memorandum, paragraphs 2.44 to 2.48, pp. 36 and 37.
Objects of proposed Subdivision 842-I

Proposed section 842-200 states that proposed subdivision 842-I includes rules about the taxation of certain foreign funds with investment income or losses which are treated as being attributable to a permanent establishment in Australia solely because the fund retains the services of an Australian based agent, manager or service provider.

Proposed section 842-205 states that the objects of proposed Subdivision 842-I are to ensure that:

- foreign funds are not subject to Australian income tax in respect of certain financial arrangements solely because they engage the services of an Australian based agent, manager or service provider (proposed paragraph 842-205(1)(a))
- Australian resident taxpayers continue to be subject to tax on their worldwide income (proposed paragraph 842-205(1)(b)) and
- the benefits of the tax concessions in this Subdivision are only available where funds are widely held and are not owned by a small group of investors (proposed paragraph 842-205(1)(c)).

These objects will be achieved by:

- treating certain ordinary income and statutory income as non-assessable non-exempt income (NANE income) (proposed paragraph 842-205(2)(a))
- disregarding certain deductions (proposed paragraph 842-205(2)(b))
- disregarding certain capital gains and capital losses (proposed paragraph 842-205(2)(c)) and
- requiring foreign funds that seek to benefit from the tax in this Subdivision to pass:
  - a widely held test and
  - a concentration test

  to show that they are not controlled by a small group of investors (proposed paragraph 842-205(2)(d)).

The new Subdivision 842-I will apply to a foreign fund that is a corporate tax entity (proposed section 842-210), a foreign resident beneficiary that is not a trust or partnership (proposed section 842-215), a foreign resident partner that is not a trust or partnership (proposed section 842-220) and a trustee of a foreign trust (proposed section 842-225).

Tax treatment of an IMR foreign fund that is a corporate tax entity

Proposed section 842-210 sets out the tax treatment that applies to an IMR foreign fund (as defined in proposed section 842-230) that is a corporate tax entity, in relation to its IMR income and its IMR deduction (terms which are defined in proposed section 842-250), and its IMR capital gain and its IMR capital loss (terms which are defined in proposed section 842-255).
Proposed paragraph 842-210(3)(a) requires that the IMR income is treated as non-assessable non-exempt (NANE) income.

IMR deductions, IMR capital gains and IMR capital losses are to be disregarded under proposed paragraphs 842-210(3)(b), (c) and (d) respectively.

A corporate tax entity is a company, or a corporate limited partnership, a corporate unit trust or a public trading trust as defined in section 960-115 of the ITAA 1997.

Definitions of IMR amounts

The income and deductions in relation to an IMR foreign fund to which Schedule 1 applies are defined in proposed section 842-250 as IMR income and IMR deduction. Likewise the capital gain and capital loss to which Schedule 1 applies are defined in proposed section 842-255 as IMR capital gain and IMR capital loss. These definitions of IMR income, IMR deduction, IMR capital gain and IMR capital loss have been included in the Dictionary to the ITAA 1997 by item 8, item 6, item 4 and item 5 respectively of Schedule 1.

The reader is invited to refer to the Explanatory Memorandum to the Bill in paragraphs 1.33 to 1.52, where these terms are explained in simple language. These paragraphs include clarification of the meaning of ‘financial arrangement’ and ‘permanent establishment’ which occur in Schedule 1 and are referred to in this Bills Digest.17

What are the conditions to be met to pass the widely held test?

The conditions that are required for an entity to pass the widely held test are set out in proposed subsections 842-240(1), (2) and (3). They include the conditions that the units or shares in the entity are listed in an approved stock exchange or that the entity has at least 25 members. Proposed subsection 842-240(3) provides that an entity will be covered by the subsection if: it is a life insurance company that is not resident in Australia at any time during an income year; a foreign superannuation fund that has at least 50 members; or is an entity that is established by an exempt foreign government agency for the principal purpose of funding pensions (including disability and similar benefits) for the citizens or contributors of a foreign company. Under proposed paragraph 842-240(1)(c), an entity will satisfy the ‘widely held’ test if one or more of the entities covered by proposed subsection 842-240(3) have a total interest of more than 25 per cent in the first-mentioned entity.

In addition, an entity that is specified in regulations made for the purposes of proposed paragraph 842-240(1)(e) will satisfy the widely held test.

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17. Explanatory Memorandum, paragraphs 1.33 to 1.52, pp. 15 to 19.

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What are the conditions to be met to pass the concentration test?

The conditions that are required to pass the concentration test are set out in proposed subsections 842-240(4) and (5). An entity breaches the concentration test if 10 or fewer entities have a total participation interest in the entity of 50 per cent or more (proposed subsection 842-240(4)).

Proposed subsection 842-240(5) provides details of the entities that are excluded for the purpose of deciding whether there are 10 or fewer entities having a total participation interest in the entity of 50 per cent or more under proposed subsection 842-240(4). The excluded entities include an IMR foreign fund and an entity that satisfies the requirement in proposed subsection 842-240(3) for the widely held test (described above).

Application

Item 17 of Schedule 1 provides that the amendments made by the Schedule apply to assessments for the 2010–11 income year and later income years.

Amendments proposed in Schedule 2—FIN 48

Item 1 of Schedule 2 inserts proposed Division 842 into the ITTPA 1997 which includes proposed Subdivision 842-I, which is titled ‘Investment manager regime’.

Proposed subsection 842-210(1) deals with the treatment of an IMR foreign fund that is a corporate tax entity. It states that the object of the section is to disregard, for the purpose of calculating the assessable income of a corporate entity that is an IMR foreign fund, certain gains and losses that arise in the 2010–11 income year, or an earlier income year, in respect of certain kinds of financial arrangements.

Definition of pre-2012 IMR amounts

Pre-2012 IMR income, pre-2012 IMR deductions, pre-2012 capital gains, pre-2012 capital loss and connected definitions in relation to an IMR foreign fund to which Schedule 2 applies are clarified in paragraphs 2.24 to 2.33 of the Explanatory Memorandum. The reader is invited to refer to these paragraphs for the meaning of these terms.\(^\text{18}\)

Application

Proposed subsection 842-210(2) states that the section applies to a corporate tax entity that is an IMR foreign fund in relation to an income year if the income year is the 2010–11 year or an earlier

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\(^{18}\) Explanatory Memorandum, paragraphs 2.24 to 2.33, pp. 33 to 35.

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year; and the corporate entity has pre-2012 IMR income, a pre-2012 IMR deduction, a pre-2012 IMR capital gain or a pre-2012 IMR capital loss in relation to an income year; and the corporate entity did not lodge an income tax return in relation to the 2010–11 income year or an earlier income year before the day that this Act receives the Royal Assent (proposed paragraphs 842-210(2)(a),(b), and (c) respectively).

Proposed paragraph 842-210(2)(d) also states that for the section to apply it is necessary that the Commissioner did not, before 18 December 2010, make an assessment of the taxable income of the corporate entity for any income year.

In addition, proposed section 842-10 does not apply if the Commissioner has reason to believe that there has been a fraud by the corporate tax entity in relation to any income year (proposed subsection 842-210(4)).

If proposed section 842-210 applies to a corporate tax entity, the relevant pre-2012 IMR income will be treated as non-assessable non-exempt income and the pre-2012 IMR deduction, the pre-2012 IMR capital gain or the pre-2012 IMR capital loss will be disregarded.

Similar provisions apply to an IMR fund which is a flow through investment vehicle such as a trust or partnership where the benefits flow through to a foreign beneficiary or a non-resident partner respectively. However, pre-2012 IMR income of IMR foreign funds that are trusts or partnerships are not NANE income, but are simply disregarded in calculating the distribution to a non-resident beneficiary or a partner of a fund. Further, in the case of a flow through entity, the requirement that there has been no tax return lodged applies both to the foreign fund and the relevant beneficiary or partner (proposed sections 842-215 to 842-245).

Concluding comments

The RIS states that the IMR proposals which this Bill implements will reduce compliance costs and transactions costs for foreign managed funds and foreign investors.

The RIS also requires Treasury and the ATO to monitor the IMR rules, as part of the whole taxation system, on an ongoing basis in order to identify and manage any unanticipated issues arising from their implementation.19


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