General outline

Investment Manager Regime – FIN 48

Schedule # to this Bill amends the *Income Tax (Transitional Provisions) Act 1997* by inserting new Division 842. That Division will clarify the taxation treatment of certain income of foreign funds for 2010-11 and prior income years.

Date of effect: The amendment will apply to the 2010-11 income year and prior income years.

Proposal announced: The amendment was announced by the Assistant Treasurer and Minister for Financial Services and Superannuation on 17 December 2010 (Media Release no 27) and 10 May 2011 (Media Release no 75).

Investment Manager Regime – conduit income

Schedule # to this Bill amends the *Income Tax Assessment Act 1997* by inserting new Subdivision 842-I. That Division will clarify the treatment of returns and gains, as well as losses and deductions on certain investments of foreign funds where the returns or gains are treated as being attributable to a permanent establishment in Australia. Where the Subdivision applies, the returns and gains will be treated as non-assessable non-exempt income and the deductions, losses, capital gains and capital losses will be disregarded.

Date of effect: The amendments will apply from the 2010-11 income year.

Proposal announced: The amendment was announced by the Assistant Treasurer and Minister for Financial Services and Superannuation on 19 December 2010 (Media Release no 10).

Chapter 1 IMR - 'FIN 48'

Outline of amendments

1.1 This measure gives effect to the Assistant Treasurer's and Minister for Financial Services and Superannuation Press Release of 17 Dec 2010 and is designed to clarify the treatment of gains and losses from certain past investments by foreign managed funds in Australia.

1.2 The proposed amendment will provide certainty of tax treatment for funds that have invested in Australia. Where a foreign managed fund has not lodged a tax return for the 2010-11 or prior income years in respect of certain investment income of the fund, the Australian Taxation Office will not be permitted to raise an assessment in respect of that income, except where the fund lodges a tax return disclosing such income.

1.3 The amendments deal with 'taxable entities' and 'transparent or flow-through entities'. These have been dealt with separately to reflect the way the Australian tax law applies.

1.4 These amendments will be included in the *Income Tax (Transitional Provisions) Act 1997*.

Commissioner to disregard certain amounts in respect of IMR foreign funds and IMR trustees

1.5

1.6 Section 842-5 applies to IMR foreign funds and IMR trustees only. These entities are 'taxable entities' and are the relevant taxpayers in question. Section 842-10 applies to beneficiaries and partners of an IMR foreign fund, which will be the relevant taxpayers where the fund is a 'transparent' or 'flow-through' entity.

1.7 Section 842-5 provides an exemption for IMR foreign funds from an assessment by the Commissioner in relation to 'IMR income' or 'IMR loss'. These terms are defined in the conduit income amendments (see paragraphs 2.10-2.18).

1.8 This exemption only applies where:

(a) the income year is the 2010-11 income year or an earlier income year; and

(b) the IMR foreign fund has IMR income or an IMR loss in relation to the income year; and

(c) the IMR foreign fund has not lodged an income tax return in relation to the income year or any previous income year; and

(d) the Commissioner has not made an assessment of the income of the IMR foreign fund (or trustee of the fund) prior to the announcement of the measure (18 December 2010).

1.9 The exemption for IMR funds from an assessment by the Commissioner in relation to IMR income or an IMR loss, will *not* apply where:

(a) the Commissioner is of the opinion that there has been fraud by the IMR foreign fund or;

(b) the Commissioner, before 18 December 2010, has notified the IMR foreign fund that an audit or compliance review would be undertaken.

1.10 Fraud is not defined. Refer to Appendix 3 of PS LA 2008/6 for the Commissioner's consideration as to what constitutes 'fraud '.

Commissioner to disregard certain amounts in respect of a beneficiary or partner of an IMR foreign fund

1.11 Section 842-10 provides an exemption for beneficiaries and partners of IMR funds, who are not Australian residents, from an assessment by the Commissioner in relation to IMR income or an IMR loss. This exemption also applies in respect of IMR income or an IMR loss to non-resident trustees (that are assessed and liable to pay tax – if any), where that entity is a trustee of a trust that is a beneficiary or partner of an IMR fund.

1.12 This exemption only applies to entities that have not lodged an income tax return for the current or previous income tax years and the Commissioner has not made an assessment of the income of the IMR fund (or trustee of the fund) prior to the announcement of the measure (18 December 2010).

1.13 Furthermore, the exemption applies to IMR foreign fund partners and beneficiaries, both directly or indirectly through one or more interposed entities. Thus, entities that are 'ultimately entitled' to a share of, or an individual interest in, IMR income will be exempt from an assessment by the Commissioner in relation to that IMR income or IMR loss (provided all other eligibility criteria are satisfied).

1.14 The exemption for beneficiaries or partners of IMR foreign funds from an assessment by the Commissioner in relation to IMR income or IMR loss, will not apply where the Commissioner, before 18 December 2010, has notified the IMR fund that an audit or compliance review would be undertaken.

1.15

Chapter 2 IMR - 'Conduit income'

Outline of amendments

2.1 This measure gives effect to the Assistant Treasurer's and Minister for Financial Services and Superannuation Press Release of 19 Jan 2011 regarding the treatment of certain types of conduit income of foreign funds.

2.1 The proposed amendments are designed to ensure that a foreign fund is not discouraged from engaging the services of an Australian based intermediary and to ensure that non-residents are not subject to Australian tax on what would otherwise be foreign source income. This may occur where some or all of the investment income of a foreign fund is attributed to a 'permanent establishment' in Australia, and is therefore subject to Australian tax. Australian resident investors should not gain any tax benefit from this measure.

2.2 Where the conditions of the Subdivision are met, certain types of investment income and gains will be exempt from Australian tax. In addition, losses or outgoings in respect of certain investments will be disregarded.

2.3 These amendments will apply to the 2010-11 income year and later income years.

Certain amounts in respect of IMR foreign funds and trustees of IMR foreign funds to be disregarded

2.4 It is intended that the amendments apply to entities that are taxable in their own right (such as companies) as well as transparent or 'flow-through' entities (such as trusts), provided all the relevant eligibility criteria are satisfied. Whether the entity is a taxable entity or a transparent entity will determine at what level the exemption applies.

2.5 In order to be eligible for the exemption, an entity must satisfy the following criteria:

(a) the entity must be an IMR foreign fund (as defined) or a trustee of an IMR foreign fund. This is discussed in more detail below. However, it is intended that the term 'IMR foreign fund' will include a variety of legal structures, including (but not

limited to) companies, partnerships (general and limited), trusts and certain contractual arrangements.

(b) the entity must not have a place of business in Australia but is treated as having a permanent establishment ('PE') solely because it engages the services of an Australian based investment manager that habitually concludes contracts on behalf of the fund. Where the fund has a permanent establishment for other reasons, it will continue to be subject to the normal taxation rules that apply in respect of PEs. These provisions are only intended to apply where a fund is treated as having a PE only because it uses an Australian intermediary. It is not intended to provide an exemption where the fund has a 'bricks and mortar' PE or is genuinely carrying on business in Australia and is deriving Australian sourced income.

2.6 Provided that the criteria in subsection 842-210(1) are satisfied, certain amounts will be excluded from the calculation of an entity's taxable income, either at the fund level or at the beneficiary/partner/member level (where the fund is a transparent entity). Importantly, the exemption does not apply to Australian resident taxpayers so that, if a transparent entity has an Australian resident beneficiary/partner/member, that beneficiary/partner/member remains taxable on their share of the net income of the fund (which is calculated on the assumption that the exemption did not apply).

2.7 When working out its taxable income (or share of taxable/net income), the entity will be able to treat certain amounts of income as non assessable non-exempt (NANE). Further, certain deductions and losses, as well as certain capital gains and capital losses, will be disregarded.

2.8 As discussed above, where the fund is a transparent entity, the treatment of income as NANE or the disregarding of deductions/losses, capital gains or capital losses will occur at the member/beneficiary/partner level not at the fund level. This ensures that Australian resident investors remain taxable on their world-wide income. Further rules may be needed, particularly in relation to partnerships and trusts, to ensure that this outcome is achieved and the exemption applies at the appropriate level.

What is an 'IMR foreign fund'?

2.9 The aim of section 842-210 is to determine what entities will be 'IMR foreign funds' for the purposes of this measure. A number of criteria must be met in order for an entity to be an 'IMR foreign fund'. These are:

(a) the entity must be not be an Australian resident at any time during the income year. Regardless of whether the fund is a taxable entity or a transparent entity, it is the *fund* that is relevant entity for the purposes of paragraph 842-215(a). In the case of a transparent entity, the residence of the member/beneficiary/partner will be relevant when determining what amounts are excluded/disregarded when calculating the taxable income of the member/beneficiary/partner (or their share of the taxable/net income of the fund).

(b) the entity is recognised under a foreign law as a collective investment vehicle. The fund may take a variety of forms, for example, a company, trust, limited partnership or Common Contractual Fund. Broadly, provided the entity is designed to pool the funds of a number of investors and has a common purpose of investing, it should be eligible for the exemption (subject to the other eligibility requirements).

(c) the members of the entity should not control the day-to-day operations of the fund. The exemption is targeted to widely held funds where investors collectively pool their funds to make portfolio investments in foreign sourced assets. Where members control the day-to-day activities of the fund, this would indicate that the fund is not widely held and will therefore not be eligible for the exemption.

(d) the entity does not carry on a trading business in Australia for the purpose of section 102M of the ITAA 1936. This means that the entity must exclusively undertake the 'passive' activities included in the definition of 'eligible investment business' in section 102M. This does not mean that an entity is prevented from actively trading in the types of financial arrangements listed in section 102M. This provision is intended to prevent entities from carrying on an 'active' trading business in Australia (other than trading in financial arrangements).

An entity will not be excluded from claiming the exemption if it carries on a trading business outside Australia.

(e) and (f) require that the entity be widely held. These tests are discussed further below and are based on the tests in the Managed Investment Trust (MIT) withholding regime.

'IMR income' and 'IMR loss'

2.10 This section details what is included in an IMR foreign fund's 'IMR income' and 'IMR loss' for the purposes of section 842-210.

2.11 For the purposes of determining a fund's IMR income and IMR loss, assume that the IMR exemption did not apply (subsection 842-220(3)).

2.12 An amount will be included in an IMR foreign fund's IMR income if the following criteria are satisfied:

(a) the assessable income is attributable to a return or gain from a *financial asset* covered by section 842-225; and

(b) the income or gain must have been taxable in Australia only because of rules that deem an item to have an Australian source because of the presence of a PE in Australia.

Had it not been for the PE in Australia, the amounts would not otherwise have had an Australian source and would not have been taxable in Australia. Where the amount is taxable for another reason (for example it has an Australian source for other reasons), it remains taxable. The exemption only applies where the taxation right has arisen because the income is attributable to a PE.

Accordingly, the amounts must have been included in the entity's assessable income *only* because of one of the following provisions:

(i) the 'source' provisions in the *International Tax Agreements Act 1953;* or

(ii) section 136AE of the *ITAA 1936*; or

(iii) item 3 or 4 of the table in section 855-15. This provision is designed to deal with revenue gains on CGT assets (or options or rights over such assets) that are used in carrying on a business through a PE.

2.13 Importantly, amounts that are subject to the withholding tax regime (or would be but for an exemption), are not eligible for the IMR exemption and will continue to be treated in the same manner as is currently the case. In other words, the IMR exemption is not designed to alter *any* tax outcomes in respect of amounts that are dealt with by the withholding tax regime. This includes amounts that are not subject to

withholding tax (because of an exemption within the withholding tax provisions) and are included in the assessable income of a PE (for example interest paid by an Australian payer to an Australian PE of a non-resident). In this case, the amount would continue to be included in the assessable income of the PE and would not form part of the IMR foreign fund's IMR income.

2.14 A fund's IMR income is intended to deal with 'revenue' type items, as capital gains are dealt with separately in section 842-222.

2.15 It is intended that IMR income would generally be a gross concept (with expenses dealt with as part of a fund's IMR loss), except in the case of a profit making undertaking, which would be a net profit calculation. Where a deduction is taken into account in calculating a net profit, it would not then be included in a fund's IMR loss.

2.16 A fund's IMR loss for an income year is the amount of deductions for the income year to the extent they are attributable to gaining the fund's IMR income.

2.17 Where the fund does not gain/produce any IMR income and only incurs deductions/makes losses, this section will still treat those amounts as being part of a fund's IMR loss provided the deductions/losses were incurred with the intention of gaining IMR income. For example, assume a fund enters into a futures contract and has no other financial arrangements. The fund also does not derive any income. If the fund makes a loss on the futures contract, the loss will still be treated as an IMR loss because it was incurred with the intention of gaining IMR income, even though no IMR income was actually 'gained' by the IMR foreign fund.

2.18 'IMR loss' does not include a capital loss, as these are dealt with separately in section 842-222. An IMR loss would include both general and specific deductions (including a net loss from a profit making undertaking or scheme). Where a net loss is incurred, the gross amount would not be included in both 'IMR income' and in calculating the net loss. Only one amount (the net amount) would be included as part of a fund's 'IMR loss'.

IMR capital gain and IMR capital loss

2.19 An IMR foreign fund's 'IMR capital gain' or IMR capital loss are those capital gains or losses of the fund that are attributable to financial arrangements covered by section 842-225. These amounts would be gross amounts as opposed to a single net capital gain or loss.

2.20 A capital gain or capital loss will only be an IMR capital gain or IMR capital loss if it is a financial arrangement covered by either item 3 or 4 of the table in section 855-15. As with IMR income, the capital gain or loss must have arisen solely because of the presence of a PE in Australia.

2.21 When determining the fund's IMR capital gains and losses, calculate those amounts as if the exemption did not apply (subsection 842 222(3)).

2.22 A fund's IMR capital gain(s) and capital loss(es) are disregarded in calculating the fund's net capital gain.

Meaning of 'financial arrangement'

2.23 In order to treat an amount as NANE or in order to disregard a deduction, loss, capital gain or capital loss, the amount must be in respect of a 'financial arrangement' covered by section 842-225.

2.24 'Financial arrangement' for these purposes is based on the definition in Division 230 of the *ITAA 1997*, with some modifications. Those modifications are as follows:

(a) where the financial arrangement is a debt or equity interest, or a derivative arrangement related to a debt or equity interest, it will not be eligible for exemption if the IMR foreign fund has a total participation interest of 10% or more in the entity (paragraphs 842-225(2)(a) and (b));

(b) derivative financial arrangements that relate to CGT assets that are either taxable Australian real property or an indirect interest in taxable Australian real property are not eligible for exemption (subsection 842-225(3)); and

(c) financial arrangements that give a right to vote on the Board of Directors or an ability to participate in the management decisions of the entity or an ability to deal with the assets of the entity are not eligible for exemption. However, if these rights only arise when the issuer breaches the terms of the financial arrangement, they may still be eligible financial arrangements (provided they meet the other criteria to be a financial arrangement) (subsections 842—225(4) and (5)).

Winding down phases

2.25 Section 842-230 is intended to ensure that a fund will be able to satisfy the widely held test in the year it is winding up. Provided the fund satisfied the tests for the previous income year, it will satisfy the test for the 'winding up year', despite the fact that it would ordinarily fail those tests in that income year.

Widely held requirements

2.26 For an entity to be an IMR foreign fund it must be widely held.

2.27 The widely held and closely held rules are based on the current Managed Investment Trust provisions in sections 12-402, 12-402A and 12-402B of the *Tax Administration Act 1953*. These rules have been modified so that the foreign fund is treated as a trust and all interests in the fund are deemed to be units in the trust (whether it is a trust or not). Once this assumption is made, the MIT rules apply to determine whether the entity satisfies the widely held and closely held tests.

2.28 Paragraph 842-235(4)(c) is designed to allow for tracing up a chain of entities so that, where a fund is not itself widely held, it will be able to satisfy the widely held test if it is held by an entity that is widely held.