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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (INVESTMENT MANAGER REGIME) BILL 2012

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
AFTS	<i>Australia's Future Tax System</i>
ASC	Accounting Standards Code
Board	Board of Taxation
CGT	Capital gains tax
FIN 48	Accounting Standards Code 740-10 (ASC 740-10)
FSC	Financial Services Council
IMR	Investment manager regime
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
ITTPA 1997	<i>Income Tax (Transitional Provisions) Act 1997</i>
Johnson Review	<i>Australia as a Financial Centre</i>
MIT	Managed investment trust
NANE	Non-assessable non-exempt
RIS	Regulation impact statement
US	United States
USGAA/ASC 740-10	US generally accepted accounting principles

General outline and financial impact

Investment manager regime

Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* to prescribe the treatment of returns, gains, losses and deductions, on certain investments of widely held foreign funds. The amendments will apply where the returns or gains would otherwise be assessable income of the fund only because they are attributable to a permanent establishment in Australia which arises solely from the use of an Australian based agent, manager or service provider. This measure is often referred to as the 'conduit income' measure or 'Element 2' of the investment manager regime (IMR).

Schedule 2 to this Bill amends the *Income Tax (Transitional Provisions) Act 1997* to prescribe the taxation treatment of certain returns, gains, losses and deductions for the 2010-11 and earlier income years of widely held foreign funds which have not lodged a tax return and have not had an assessment made of their income tax liability. This measure is often referred to as the 'FIN 48' measure or 'Element 1' of the IMR.

Date of effect: Schedule 1 of the Bill applies to assessments for the 2010-11 income year and later income years. Schedule 2 of the Bill applies for the 2010-11 income year and previous income years

The amendments may have a retrospective impact but are of a beneficial nature to affected entities.

Proposal announced: The measures were announced by the then Assistant Treasurer and Minister for Financial Services and Superannuation in Media Release No. 027 of 17 December 2010 (Schedule 2) and in Media Release No. 010 of 19 January 2011 (Schedule 1).

Financial impact: These measures represent part of the IMR package of reforms which were included in the 2010-11, 2011-12 and 2012-13 Budgets. 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 estimate period. The portion of this revenue impact which is attributable to the measures in this Bill is unquantifiable but small.

Human rights implications: This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — Chapter 3, paragraphs 3.1 to 3.5.

Compliance cost impact: These measures will reduce compliance costs and transaction costs for foreign managed funds and foreign investors, as well as reduce administrative costs for the Australian Taxation Office.

Summary of regulation impact statement

Regulation impact on business

Impact: Clarifying the Australian tax treatment of prior year investments by foreign managed funds so as to mitigate the impact of *United States Financial Accounting Standards Board Interpretation Number 48 Accounting for Uncertainty in Income Taxes* (FIN 48) and removing the tax impediment to foreign funds engaging Australian managers that occurs because a fund is taken to have a permanent establishment in Australia will affect:

- foreign managed funds (and investors in those funds) that are currently investing, or considering investing, via Australia; and
- the domestic funds management industry — that is, Australian based intermediaries, such as Australian investment advisers, fund managers, brokers and other financial service providers, that provide services to managed funds.

Overall, these changes will provide clarity and tax certainty regarding the tax treatment of certain portfolio investment income of foreign managed funds. The changes will maintain Australia's attractiveness as an investment destination and will benefit financial services businesses (such as funds managers and brokers).

Main points:

- The Regulation Impact Statement considers taxing arrangements for foreign managed funds investing in or via Australia. It deals with two issues which have arisen in relation to the existing arrangements, namely:
 - consequences foreign managed funds face, complying with US accounting rules; and
 - impediments to foreign funds using Australian-based financial intermediaries to manage (primarily offshore) assets.

- These two issues, if left unchecked, have the potential to impede Australia's development as a regional financial centre.
- By introducing rules to provide clarity regarding the treatment of certain portfolio investment income of foreign managed funds for the 2010-11 and prior income years, the changes will enable funds subject to FIN 48 to determine whether to make or vary tax provisions.
- These changes will also provide timely guidance to the Commissioner of Taxation regarding the administration of the law in respect of prior year investment income.

Chapter 1

Investment manager regime — conduit income of 2010-11 and later income years

Outline of chapter

1.1 Schedule 1 to this Bill inserts new Subdivision 842-I into the *Income Tax Assessment Act 1997* (ITAA 97). The Subdivision prescribes the treatment of returns, gains, losses and deductions on certain investments of widely held foreign funds. The amendments will apply where the returns or gains would otherwise be assessable income of the fund only because they are attributable to a permanent establishment in Australia which arises solely from the use of an Australian based agent, manager or service provider. Where the Subdivision applies, the relevant returns or gains will be treated as non-assessable non-exempt (NANE) income or will be disregarded and the deductions, losses, capital gains and capital losses will be disregarded.

1.2 The Subdivision together with new Subdivision 840-I of the *Income Tax (Transitional Provisions) Act 1997* (see Chapter 2) will form the first two elements of an investment manager regime (IMR).

1.3 As the amendments made to the ITAA 1997 and explained in this Chapter relate to foreign income derived indirectly by a foreign resident via an Australian permanent establishment, these amendments are often referred to as the ‘conduit income measures’ or ‘Element 2’ of the IMR.

1.4 All legislative references are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.5 Following the Board of Taxation’s 2003 *International Taxation* report, ‘conduit foreign income rules’ (Division 802-A) were introduced into the income tax law. Under these rules, certain foreign income of a company paid directly, or through one or more other Australian entities, to foreign owners do not attract any additional Australian tax. The rules were designed to provide foreign investors who structure their foreign investments through Australian companies with a more neutral Australian

tax outcome on foreign investments when compared to foreign investors who hold their foreign investments directly.

1.6 While the conduit foreign income rules provided relief from additional Australian taxation on conduit income received through an Australian company, the treatment of conduit income received through a managed fund remained uncertain.

1.7 The uncertain treatment of the conduit income of foreign funds was identified in *Australia's Future Tax System Review* ('the Henry Review') which recommended that the 'taxation arrangements applying to Australian managed funds and related services should be improved to provide greater certainty that conduit income will not be subject to Australian tax' (Recommendation 35).

1.8 Also the Australian Financial Centre Forum (the Forum) — established by the Government in September 2008, as part of its commitment to position Australia as a leading financial services centre — made a number of recommendations in relation to the taxation of foreign funds in Australia, including recommending the implementation of an IMR.

1.9 The Government responded to the Forum's report on 11 May 2010 and announced in-principle support for the introduction of an IMR.

1.10 The Government announced on 19 January 2011 changes to the tax law to ensure that relevant investment income of a foreign fund that is taken to have a permanent establishment in Australia solely because of its use of an Australian adviser, would be exempt from income tax. This announcement addressed the uncertain tax treatment of conduit income of managed funds as recommended by the Henry review.

1.11 Schedule 1 to this Bill introduces amendments to the tax law to give effect to the announcement made in January 2011 — the 'conduit income' measure. Schedule 2 to this Bill gives effect to the December 2010 announcement — the 'FIN 48' measure. Details of this measure are in Chapter 2.

Summary of new law

1.12 The amendments introduced by Schedule 1 to the Bill prescribe the tax treatment of income of widely held foreign funds, and are designed to ensure that the complex tax issues that previously arose do not discourage foreign funds from engaging the services of an Australian

intermediary. The amendments ensure that foreign funds that use Australian intermediaries are not subject to Australian tax on certain income that, in the absence of an Australian intermediary, would otherwise be foreign source income. This tax treatment will extend to foreign resident beneficiaries or foreign resident partners of foreign funds that receive or are attributed amounts through one or more interposed trusts or partnerships. Australian resident investors will not obtain any concession from this measure and the tax treatment of any income received from a fund by an Australian resident will remain unchanged.

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

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

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<p>For 2010-11 and later income years, certain amounts that would otherwise be included in the assessable income of a foreign fund will be treated as non-assessable non-exempt income, or disregarded if:</p> <ul style="list-style-type: none"> • the amount is assessable solely because it is attributable to an Australian permanent establishment; and • the only reason that fund has an Australian permanent establishment is because it has engaged the services of an Australian adviser who habitually exercises a general authority to negotiate and conclude contracts on its behalf. <p>In addition, certain deductions and capital losses will be disregarded.</p> <p>An Australian resident who invests in the foreign fund (whether directly or indirectly through one or more interposed entities) will not benefit from the tax concession.</p>	<p>Where a foreign fund engages the services of an Australian intermediary to exercise a general authority to negotiate and conclude contracts on its behalf, it may have a permanent establishment in Australia. Income of the foreign fund that is attributable to that permanent establishment will have an Australian source and may be taxable in Australia. This may result in income that would otherwise be foreign source income being subject to tax in Australia. It can also result in capital gains that would otherwise be exempt, being subject to Australian tax.</p> <p>Australian residents are subject to tax on their world-wide income.</p>

Detailed explanation of new law

Objects of Subdivision 842-I of ITAA 1997

- 1.15 The objects of the Subdivision are to:
- ensure that certain income of widely held foreign funds which are not owned by a small group of investors, are not subject to Australian tax solely because the fund engages the services of an Australian based agent, manager or service provider to exercise a general authority to negotiate and conclude contracts on its behalf; and
 - ensure that Australian resident taxpayers continue to pay tax on their world-wide income.

[Schedule 1, item 1, subsection 842-205(1)]

- 1.16 These objectives are achieved by:
- disregarding, or treating as NANE, certain income;
 - disregarding certain deductions and losses (including capital losses);
 - disregarding certain capital gains;
 - requiring a fund to pass a widely held test; and
 - excluding funds that are controlled by a small number of investors from being eligible for the exemption.

[Schedule 1, item 1, subsection 842-205(2)]

IMR foreign fund

1.17 The Subdivision applies to disregard certain amounts of an ‘IMR foreign fund’ that is a corporate tax entity, a trust or a partnership.

- 1.18 An entity will be an **IMR foreign fund** if it:
- is not a resident of Australia at *any* time during the income year *[Schedule 1, item 1, subparagraph 842-230(a)(i)]*;
 - is not a resident trust estate under section 95(2) of the *Income Tax Assessment Act 1936* (ITAA 1936) at *any* time during the income year *[Schedule 1, item 1, subparagraph 842-230(a)(ii)]*;

- does not carry on a trading business in Australia, as set out in section 102M of the ITAA 1936 at *any* time during the income year [*Schedule 1, item 1, paragraph 842-230(b)*];
- is widely held at *all* times during the income year [*Schedule 1, item 1, subparagraph 842-230(c)(i)*]; and
- does not breach the ‘concentration test’ at *any* time during the income year [*Schedule 1, item 1, subparagraph 842-230(c)(ii)*].

[*Schedule 1, item 1, section 842-230, and item 7, subsection 995-1(1)*]

Residency

1.19 In order for a fund to be an IMR foreign fund it must not be an Australian resident at any time during the income year. The relevant residency test will depend on the legal structure of the fund. Whatever residency test would ordinarily apply to the fund (for Australian taxation purposes) will apply in determining its residency status for the purposes of these amendments. For many funds the relevant test will be that in section 6 of the ITAA 1936.

1.20 In other cases specific provisions apply. For example if the fund is a corporate limited partnership (which is taxed like a company) section 94T of the ITAA 1936 will be applicable.

Trading business

1.21 The fund must not be carrying on a business in Australia other than an eligible investment business as set out in section 102M of the ITAA 1936. This means the fund can only carry on ‘eligible investment business’. ***Eligible investment business*** is widely defined and includes:

- investing in land for the purpose of deriving rent;
- investing or trading in:
 - secured or unsecured loans;
 - bonds, debentures, stock or other securities;
 - shares in a company;
 - units in a unit trust;
 - futures contracts;
 - forward contracts;

- currency swap contracts;
- forward exchange rate contracts;
- forward interest rate contracts;
- life assurance policies; and
- a right or option in respect of such a loan, security, share, unit, contract or policy.

[Schedule 1, item 1, paragraph 842-230(b)]

1.22 ‘Eligible investment business’ specifically excludes a number of arrangements identified in section 102MA of the ITAA 1936 such as:

- arrangements that give a right to control the use of, or licence to use:
 - real property
 - goods or a personal chattel; or
 - intellectual property.

1.23 Although a foreign fund can qualify as an IMR foreign fund if is carrying on eligible investment business, the income from such business will not automatically qualify as IMR income or an IMR capital gain. That is, the IMR foreign fund must apply additional tests to determine what income will be excluded from taxable income (see paragraph 1.34 to 1.57). Broadly speaking, income which does not satisfy these tests will not be ‘non-IMR’ income and may be taxable in Australia depending on the circumstances. Further, the derivation of ‘non-IMR’ income does not of itself disqualify a fund from being considered an IMR foreign fund.

Widely held

1.24 In order for an entity to be an IMR foreign fund the entity must be widely held *[Schedule 1, item 1, subparagraph 842-230(c)(i) and section 842-240]*. Broadly, a fund will be considered to be widely held if its shares or units are listed on an approved stock exchange, it has a minimum number of members or a sufficient proportion of its membership interests are held, directly or indirectly, by specified types of entities.

1.25 An entity — a foreign fund — will be considered widely held for the purposes of this measure if:

- the fund's units or shares are listed on an approved stock exchange;
- all of the funds membership interests are held, directly or indirectly, by an entity whose units or shares are listed on an approved stock exchange;
 - an approved stock exchange is a stock exchange that is listed in Schedule 5 of the *Income Tax Assessment Regulations 1997*.
- the fund has at least 25 members;
- all of the fund's membership interests are held by an entities that has at least 25 members;
 - **member of an entity** is defined in section 960-130. Broadly, a member of:
 - : a company, is a shareholder of the company;
 - : a trust, is a beneficiary of the trust, unit holder or object of the trust. For the purposes of the widely held test an object of a trust is ignored;
 - : a partnership, is partner in the partnership; or
 - : a corporate unit trust or a public trading trust, is a unit holder in the trust.
- 25 per cent or more of the 'total participation interest' (as defined in section 960-180, includes direct and indirect participations interests in the fund) is held by;
 - life insurance companies that are not Australian residents;
 - foreign superannuation funds with at least 50 members; or
 - funds established by exempt foreign government agencies for the principal purposes of funding pensions of foreign citizens or contributors; or
- it is held by a type of entity specified in the regulations.

[Schedule 1, item 1, section 842-240]

Concentration test

1.26 In addition to satisfying the widely held test (see paragraph 1.25) an entity must not breach the concentration test at any time during the income year. This condition ensures that an entity which is widely held is not controlled by a small group of investors.

1.27 A foreign fund will breach the concentration test if 10 or fewer entities have a total participation interest in the fund of 50 per cent or more. [*Schedule 1, item 1, subsection 842-240(4)*]

1.28 Entities that satisfy the concentration test and foreign widely held entities that satisfy subsection 842-240(3) are not counted when applying the concentration test.

1.29 This recognises that these entities participation interests represent diversified investors rather than the interests of a concentrated group of investors. Consequently, if a foreign widely held entity held 100 per cent of the a foreign fund, that fund would not breach the concentration test as 10 or fewer entities (that are counted) do not have a 50 per cent or greater participation interest in the foreign fund.

Participation interest

1.30 In applying the widely held test it is necessary to identify the total participation interest of each member of a foreign fund. Total participation interest is defined in section 960-180 and includes both direct and indirect participation interests. Broadly, a direct participation interest in another entity is the proportion of ownership or control that one entity has directly in the other entity. An indirect participation interest in another entity is, broadly, the proportion of ownership or control an entity has in another entity through one or more interposed entities.

Wind-down phases

1.31 An entity which is winding down prior to ceasing to exist may not be able to satisfy the requirements of the widely held test or the concentration test solely or largely because of the process of winding down. To ensure that an entity does not fail either of these tests in the year it ceases to exist, the entity will be taken to have satisfied the requirement in subsection 842-230(c) — that is, the entity will be taken to be widely held and not to have breached the concentration test — if it was an IMR fund in the previous year. [*Schedule 1, item 1, section 842-235*]

1.32 This will ensure that where an entity, which was previously an IMR foreign fund, ceases to exist during an income year the treatment of

IMR income, IMR deductions, IMR capital gain and IMR capital losses available under the Subdivision will not be denied simply because of the process of winding down of the entity's activities prior to ceasing to exist.

IMR amounts

1.33 Amounts which are to be disregarded in determining an IMR foreign fund's taxable income, net income, partnership loss or net capital loss include:

- returns and gains from certain financial arrangements (which in the case of corporate tax entity are treated as NANE income);
- deductions relating to that income;
- capital gains and capital losses arising from certain financial instruments; and
- deductions relating to capital gains which are disregarded.

IMR Income

1.34 For an amount to be treated as IMR income, the amount:

- must be attributable to a return or gain from a financial arrangement covered by section 842-245; and
- would otherwise be assessable income only because the income is attributable to a permanent establishment which exists because of the engagement of an Australian resident agent, who habitually exercises a general authority to negotiate and conclude contracts on its behalf.

[Schedule 1, items 1 and 8, subsection 842-250(1) and 995-1(1)]

1.35 IMR income of a foreign fund which is a corporate tax entity is treated as NANE income. *[Schedule 1, item 1, paragraph 842-210(3)(a)]*

1.36 The IMR income of an IMR foreign fund which is a flow through vehicle is taken into account in determining the fund's non-IMR net income, non-IMR partnership net income, and non-IMR partnership loss. In effect, the IMR income of a flow through vehicle IMR foreign fund is disregarded in calculating:

- amounts which are included in the assessable income or deductions of a foreign resident beneficiary or foreign resident partner of the fund; or
- amounts on which a trustee of a fund may be subject to tax.

Financial arrangement

1.37 For an amount to be treated as IMR income, the amount must be attributable to a return or gain from a financial arrangement. However, financial arrangements which give rise to a non-portfolio interest in another entity or control of another entity are excluded and consequently returns or gains from such arrangements are not treated as IMR income. Such financial arrangements are excluded to ensure that the only returns and gains from passive investments are treated as IMR income.

1.38 Financial arrangements which do not give rise to IMR income are:

- debt interests, equity interests, and financing arrangements which are neither debt or equity, in an entity which the fund has a total participation interest of 10 per cent or more;
- derivative financial arrangements that relate to:
 - a debt interest, equity interest, or a financing arrangement which is neither debt or equity, in an entity which the fund has a total participation interest of 10 per cent or more; or
 - a capital gains tax (CGT) asset that is taxable Australian real property or an indirect Australian real property interest; or
- arrangements which allow the fund to:
 - vote at the board of directors;
 - participate in making financial, operating or policy decisions in respect of the operation of the issuer of the financial arrangement; or
 - deal with the assets of the issuer of the financial arrangement other than where the issuer breaches the terms of the financial arrangement.

[Schedule 1, item 1, section 842-245]

1.39 Debt interest is defined in Division 974, and includes bonds, loans, promissory notes, and bills of exchange. Equity interest is defined in section 995-1 and includes equity interests under Subdivision 974C (equity interests in a company) and also an equity interest in a trust or partnership.

1.40 Derivate financial arrangement is defined in subsection 230-350(1). For the purposes of section 842-245, a derivative financial arrangement relates to another financial arrangement or to a CGT asset if the derivative financial arrangements, is or would be a hedging financial arrangement for the purposes of Division 230, or is a deliverable derivative and the fund will either acquire or cease to have the financial arrangement or CGT asset which is the subject of the derivative.

Permanent establishment

1.41 In addition to being attributable to financial arrangements covered by section 842-245 (see paragraphs 1.38 to 1.40), for an amount to be treated as IMR income, the amount must otherwise be assessable income only because the fund has a permanent establishment in Australia and that permanent establishment has arisen because the fund utilises the services of an Australian entity that habitually negotiates and concludes contracts on behalf of the fund. This means that, where the fund has a permanent establishment for *other* reasons (for example because it has a manufacturing plant in Australia), it will continue to be subject to the normal taxation rules that apply in respect of permanent establishments and the IMR exemption will not apply. These provisions are not intended to provide an exemption where the fund has a ‘bricks and mortar’ permanent establishment in Australia (that is, where the fund has a presence and is carrying on business in Australia and deriving Australian sourced income). [*Schedule 1, item 1, paragraph 842-250(1)(b)*]

1.42 The intention of the Subdivision is to ensure that a fund does not pay Australian tax on income where, but solely for the use of an Australian entity that exercises a general authority to negotiate and conclude contracts on behalf of a foreign fund creating an Australian permanent establishment, that income would be foreign source income. In other words, the exemption is designed to restore the fund’s position as if it had made an investment directly (other than through a ‘bricks and mortar’ permanent establishment in Australia) and not had *any* Australian presence.

1.43 Here, the ‘entity’ includes (but is not limited to) such entities as agents (dependent and independent), brokers, managers, advisors, lawyers and accountants. The term should be read widely and is intended to cover any Australian resident *entity* that exercises a general authority to negotiate and conclude contracts on behalf of a foreign fund and therefore

may result in that fund having a permanent establishment in Australia.
[Schedule 1, item 1, subsection 842-250(1)]

IMR deduction

1.44 Expenses which relate to earning IMR income or an IMR capital gain are to be excluded from the calculation of an entity's taxable income, tax loss, net income or partnership loss.

1.45 As the IMR income of a IMR foreign fund that is a corporate tax entity is treated as NANE, expenses incurred in deriving that income are not deductible because of the operation of paragraph 8-1(2)(c) of the ITAA 1936.

1.46 However, IMR income of IMR foreign funds that are trusts or partnerships and IMR capital gains of any IMR foreign fund are not NANE income. Rather they are simply disregarded.

1.47 Therefore, amounts incurred in earning IMR income or an IMR capital gain are not included in the taxable income of an IMR foreign fund, IMR deductions are specifically disregarded.

1.48 The IMR deduction for an income year is the total amount of deductions for that income year to the extent that those amounts are attributable to the gaining of the fund's IMR income, IMR capital gain, pre-2012 IMR income and pre-2012 IMR capital gain. [Schedule 1, item 1, subsection 842-250(2)]

1.49 The inclusion of amounts attributable to pre-2012 IMR income and pre-2012 capital gains in IMR deduction prevents amounts incurred after the 2010-11 income year that are attributable to income or a gain which was disregarded under Subdivision 842-I of the *Income Tax (Transitional Provisions) Act 1997* — the FIN 48 measures — from being deductible.

1.50 IMR deductions include amounts deductible under the general deduction provision — section 8-1 — but also amounts which may otherwise be deductible under another provision of the income tax law, but which relate to IMR income.

IMR capital gain

1.51 The IMR capital gain of an IMR foreign fund is the sum of the capital gains in an income year referable to a permanent establishment in Australia that arises solely as the result of the IMR foreign fund engaging an entity that is a resident of Australia to habitually exercise a general

authority to negotiate and conclude contracts on its behalf and the capital gain is made in respect to a CGT asset which is:

- used in the carrying on of a business through a permanent establishment in Australia other than an asset which is taxable Australian real property or an indirect interest in Australian real property; or
- is an option or right to acquire to acquire such an asset.

[Schedule 1, items 1 and 4, subsections 842-255(1) and 995-1(1)]

IMR capital loss

1.52 An entity's IMR capital loss is the sum of the capital losses in an income year to the extent that the fund has a permanent establishment in Australia solely as the result of engaging an entity that is a resident of Australia to habitually exercise a general authority to negotiate and conclude contracts on its behalf and the capital gain is made in respect to a CGT asset which is:

- used in the carrying on of a business through a permanent establishment in Australia other than an asset which is taxable Australian real property or an indirect interest in Australian real property; or
- is an option or right to acquire such an asset.

[Schedule 1, items 1 and 5, subsections 842-255(2) and 995-1(1)]

Other IMR amounts

Non-IMR net income, non-IMR Division 6E net income non-IMR net capital gain of a trust

1.53 A trust's non-IMR net income is the amount of net income, disregarding IMR income (or an amount attributable to IMR income) and IMR deductions for the income year. *[Schedule 1, items 1 and 11, subsections 842-260(1) and 995-1(1)]*

1.54 A trust's non-IMR Division 6E net income is amount of net income calculated under Division 6E of the ITAA 1936, Division 6E net income, disregarding IMR income and IMR deductions and the things mentioned in subparagraphs 102UW(b)(i) to (iii) of the ITAA 1936 in relation to the income year. *[Schedule 1, items 1 and 9, subsections 842-260(2) and 995-1(1)]*

1.55 A trust's non-IMR net capital gain is the amount of net capital gain, disregarding any IMR capital gain (or an amount referable to an IMR capital gain) and IMR capital loss in relation to the income year. *[Schedule 1, items 1 and 10, subsections 842-260(3) and 995-1(1)]*

Non-IMR partnership net income and non-IMR partnership loss

1.56 Non-IMR partnership net income or non-IMR partnership loss is broadly the net income or partnership loss of the partnership, disregarding IMR income of the partnership (or an amount attributable to IMR income) and IMR deductions of the partnership for the income year. *[Schedule 1, items 1, 12 and 13, section 842-265 and subsection 995-1(1)]*

Application of the Subdivision to taxable entities and flow through entities

1.57 The Subdivision applies to foreign funds that are either 'taxable entities' (such as companies and corporate limited partnerships) and 'transparent' or 'flow-through entities' (such as partnerships and trusts). The structure of the foreign fund will dictate the level at which the measures apply to exclude IMR amounts. Where a fund is a taxable entity, the exclusion will occur at the fund level. Where a fund is a flow through entity, the exclusion will occur at the trustee level as well as the foreign resident beneficiary level or at the foreign resident partner level in the case of a partnership.

1.58 This approach is designed to ensure that an Australia member in a foreign fund which is a flow through entity, does not access the exclusion which may be available to foreign resident members of the fund.

IMR foreign funds that are taxable entities

1.59 Where the IMR foreign fund is a corporate tax entity under section 960-115, the IMR income of the fund is treated as NANE and any IMR deduction, IMR capital gain and IMR capital loss are disregarded in calculating the fund's taxable income, tax loss or net capital loss. *[Schedule 1, item 1, subsection 842-210(3)]*

1.60 Where in an income year, IMR deductions exceed IMR income or IMR capital losses exceed IMR capital gains, a loss cannot be carried forward to future income years and net capital losses are not available to the extent that the loss is attributed to IMR amounts. *[Schedule 1, item 1, subsection 842-210(4)]*

1.61 As the Subdivision does not apply to any distributions (including capital distributions) received from a company or a corporate

limited partnership, the tax treatment of such distributions remains unchanged by the amendments.

Example 1.1

FMF1, a foreign resident company, is an IMR foreign fund for the purposes of Subdivision 842-I. FMF1 engages an Australian manager to manage a portfolio of Japanese bonds on its behalf giving rise to a permanent establishment in Australia. FMF1 also conducts non-intermediated trades, that is, it purchases and sells financial assets directly in Australia. For the 2012-13 income year, FMF1 has the following income and expenses:

Table 1.1 Income and expenses for the 2012-13 income year

<i>Income</i>	\$	\$
Interest income from bonds issued by a Japanese company	200,000	
Gains on the sale of bonds issued by the Japanese company	150,000	
Unfranked dividends paid by a company listed on ASX	30,000	
Rental income from Australian commercial property	55,000	
Gain on sale of Australian shares (not land rich)	32,000	
Total Income		467,000
Expenses		
Rental property expenses	12,000	
Management and advisory fees (paid to Australian advisers and managers in relation to Japanese bonds)	38,000	
Loss on sale of Australian commercial property	25,000	
Total expenses		75,000
Net Profit		392,000

The gain on the sale of the Japanese bonds is considered to be on revenue account while the gain on the sale of the Australian shares and the loss on the Australian commercial property are considered to be on capital account.

The taxable income or tax loss and the net capital loss of FMF1 will be calculated under the existing provisions of the income tax law but taking account of the modifications introduced by new Subdivision 842-I. Broadly, this means that income, deductions, and

capital gains and capital losses that relate to certain financial arrangements are not included in the calculation of the funds taxable income or tax loss and net capital loss. More specifically, as FMF1 is a corporate tax entity it means that it will:

- treat IMR income as NANE; and
- disregard IMR deductions, IMR capital gains; and IMR capital losses.

Income tax treatment of FMF1's income and expenses

\$200,000 interest income and \$150,000 gain from the sale of the Japanese bonds

As both the interest, and the gain on sale:

- relate to financial arrangements which are subject to Subdivision 842-I; and
- would have otherwise been (that is without Subdivision 842-I) assessable income, but only because of the engagement of the Australian manager which has given rise to a permanent establishment in Australia;

both amounts are IMR income and are treated as NANE income. If the IMR fund was a trust, the amounts would be disregarded.

\$32,000 gain on sale of Australian shares

The \$32,000 gain on the Australian shares is disregarded under Division 855, therefore Subdivision 842-I has no application.

Unfranked dividends of \$30,000 and rental income of \$55,000

The rental income is Australian source income and would be assessable income irrespective of whether FMF1 had a permanent establishment. Therefore the amount does not constitute IMR income and is unaffected by Subdivision 842-I.

The unfranked dividends are subject to withholding tax and are not assessable income. Therefore the amount does not constitute IMR income and is unaffected by Subdivision 842-I.

Management and advisory fees of \$38,000

The management and advisory fees relate to the Japanese bonds, the income from which is IMR income and is NANE under Subdivision 842-I. As a result of subsection 8-1(2), the \$38,000 is not deductible as it is incurred in deriving NANE income.

If the IMR fund was not a corporate tax entity, the income from the Japanese bonds would be disregarded rather than be NANE income. Therefore the management fees of \$38,000 would not be denied under subsection 8-1(2) and would be considered an IMR deduction and therefore disregarded.

Rental property expenses of \$12,000

The rental property expenses relate to the rental property income of \$55,000 which is unaffected by the provisions of Subdivision 842-I and is neither IMR income nor IMR capital gain. Therefore the expenses are also unaffected by the Subdivision and will be deductible under section 8-1.

Loss on the sale of Australian commercial property of \$25,000

As the loss arises from the disposal of taxable Australian property, it is not affected by Subdivision 842-I.

Table 1.2 FMF1's taxable income and net capital loss are:

<i>Assessable Income</i>	<i>\$</i>
Rental income from Australian commercial property	55,000
Deductions	
Rental property expenses	12,000
Taxable income	43,000
Net capital loss (to be carried forward)	25,000

IMR foreign funds that are flow through entities

1.62 Where the IMR foreign fund is not a taxable entity but a 'flow through' entity, in particular a partnership or a trust, the IMR income and any IMR deduction, IMR capital gain and IMR capital loss are disregarded in calculating:

- a foreign resident beneficiary's or foreign resident partner's taxable income, tax loss or net capital loss [*Schedule 1, item 1, sections 842-215 and 842-220*]; or
- the amount on which a trustee may be assessable [*Schedule 1, item 1, section 842-225*].

Foreign resident beneficiary that is not a trust or partnership

1.63 Section 842-215 sets out rules for calculating taxable income of an entity that is the foreign resident beneficiary of an IMR fund, where the

fund is a trust and the foreign resident beneficiary is a taxable entity. The purpose of the section is to ensure the alignment of the IMR with rules pertaining to the calculation of amounts for trusts.

1.64 Where a foreign resident beneficiary of an IMR foreign fund is a taxable entity, for the purposes of calculating its taxable income or tax loss any income attributable to an IMR amount is to be disregarded and no Australian tax consequences in respect of these amounts. [*Schedule 1, item 1, section 842-215*]

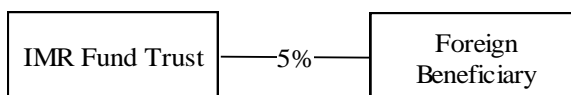
1.65 A foreign resident beneficiary of an IMR foreign fund that is a taxable entity will still be liable to pay tax its non-IMR related income and capital gains, in line with the ordinary tax treatment of those amounts. [*Schedule 1, item 1, subsections 842-215(3) and (4)*]

1.66 This measure is also intended to apply when there are interposed flow through entities, including both partnerships and trusts, between the IMR foreign fund and a beneficiary that is not a flow through entity — which would normally be a natural person or a corporate tax entity.

Example 1.2

Using the scenario in Example 1.1 assume FMF1 is a foreign resident trust, that is an IMR foreign fund for the purposes of Subdivision 842-I. Foreign beneficiary 1 (FB1) is a taxable entity and has a 5 per cent interest in FMF1.

Diagram 1.1



Section 842-215 applies to FB1 as it is a foreign resident and a beneficiary of a trust (FMF1) as stipulated in subsection 842-215(2). To calculate FB1's Australian tax liability, subsections 842-215(3) and (4) must be applied.

First, FB1 needs to calculate FMF1's non-IMR net income, non-IMR Division 6E net income and non-IMR net capital loss. As reflected in Example 1.1, FMF1 has a non-IMR net income of \$43,000 and a non-IMR net capital loss of \$25,000.

As FB1 is a foreign resident, the trustee of FMF1 will be liable to be assessed under section 98 of the ITAA 1936. Section 842-225 will make the trustee liable to pay tax only in relation to FB1's share of the non-IMR net income of the trust. As FB1 has a 5 per cent interest in FMF1, the trustee will be liable to pay tax on an amount of \$2,150.

FB1 will also include in its assessable income under subsection 98A(1) of the ITAA 1936 its share of FMF1's non-IMR related activities. FB1's assessable income will therefore include \$2,150 being its individual interest in the non-IMR net income of the trust. To prevent double tax, FB1 may deduct under subsection 98A(2) of the ITAA 1936 the tax paid by the trustee on the share of the non-IMR net income from the tax assessed against itself.

Foreign resident partner that is not a trust or partnership

1.67 Section 842-220 sets out rules for calculating taxable income of an entity that is the foreign resident partner of an IMR fund, where the foreign resident partner is a taxable entity. The purpose of the section is to ensure the alignment of the IMR with rules pertaining to the calculation of amounts for partnerships.

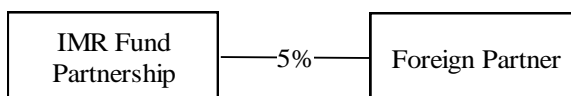
1.68 Where a foreign resident partner of an IMR foreign fund is a taxable entity, for the purposes of calculating its taxable income, net loss or net capital loss, any income attributable to an IMR amount is to be disregarded and no Australian tax consequences in respect of these amounts. *[Schedule 1, item 1, section 842-220]*

1.69 A foreign resident partner of an IMR foreign fund that is a partnership, will still be liable to pay tax on its non-IMR related income and capital gains, in line with the ordinary tax treatment of those amounts.

1.70 This provision is also intended to apply when there are interposed entities, between the IMR foreign fund and the partner.

Example 1.3

Using the scenario in Example 1.1 assume FMF1 is a foreign partnership that is an IMR foreign fund for the purposes of Subdivision 842-I. Foreign Partner 1 (FP1) has a 5 per cent interest in FMF1.



Section 842-220 applies to FP1 as it is a foreign resident and a partner of an IMR fund (FMF1) as stipulated subsection 842-220(2). To calculate FP1's Australian tax liability, the adjustments in subsection 842-220(3) must be applied.

In working out FP1's tax liability, FP1 needs to calculate FMF1's non-IMR partnership net income or non-IMR partnership loss. As reflected in Example 1.1, FMF1 has a non-IMR partnership net income of \$43,000.

In applying paragraph 842-220(3), the \$32,000 gain on sale of Australian shares will be disregarded in calculating FP1's capital gain or loss as it is an amount referable to an IMR capital gain.

As FP1 is liable for tax under Division 5 of Part III of the ITAA 1936, subsection 842-220(3) will make FB1 liable for tax on its share of FMF1's non-IMR related activities. As FP1 has a 5 per cent interest in FMF1, FP1's assessable income will include \$2,150 for the income year, and FB1 will have a capital loss \$1,250 which it can use against capital gains or carry forward (which is 5 per cent of the loss on the sale of Australian commercial property of \$25,000 — as the loss arises from the disposal of taxable Australian property, it is not affected by Subdivision 824-I).

Treatment of trustee of an IMR foreign fund

1.71 Section 842-225 sets out rules for calculating the taxable income of the trustee of an IMR fund. The purpose of the section is to ensure the alignment of the IMR with rules pertaining to the calculation of amounts for trustees.

1.72 For the purposes of calculating the taxable income of a trustee of an IMR foreign fund, any tax loss or net capital loss, any income attributable to an IMR amount is to be disregarded and no Australian tax payable. [*Schedule 1, item 1, section 842-225*]

1.73 A trustee of an IMR foreign fund will still be liable to pay tax on non-IMR related income and capital gains, in line with the ordinary tax treatment of those amounts.

Application and transitional provisions

1.74 The main provisions of Subdivision 842-I will apply to assessments for the 2010-11 income year and later income years.

1.75 Some of the provisions contained in this Subdivision will have effect where a business profits article contained Australia's agreements (within the meaning of the *International Tax Agreements Act 1953*) apply. Such agreements and the business profits articles themselves are defined in Subdivision 815-A, which was introduced into the Parliament under the Tax Law Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012. Given that that Bill has not yet received Royal Assent, this Subdivision includes stand-alone provisions which provide a definition for business profits article that may be used in the event that Subdivision 842-I is enacted before Subdivision 815-A.

1.76 In the event that Subdivision 815-A and Subdivision 842-I are both enacted, additional provisions are included in this Bill which will repeal the business profits article definition contained in this Subdivision, and will instead implement those contained in Subdivision 815-A. In addition, because Subdivision 815-A also includes a definition for ‘international tax agreement’, this Subdivision will also utilise that definition once it is enacted. The provisions giving effect to these specific amendments will only apply in the event that both this Bill and the Tax Law Amendment (Cross-Border Transfer Pricing) Bill (No. 1) 2012 are enacted, with the later of the day of Royal Assent for each Bill being the relevant day from which they will apply. *[Schedule 1, items 2 and 17]*

Consequential amendments

1.77 The definition of ‘business profits article’ is repealed from item 9 of Schedule 1 of the *Tax Laws Amendment (Cross Border Transfer Pricing) Act (No. 1) 2012* subsections 995-1(1) and replaced with a new definition. *[Schedule 1, items 3 and 16]*

Chapter 2

Investment manager regime — 2010-11 and earlier income years — FIN 48

Outline of chapter

2.1 Schedule 2 to this Bill inserts new Subdivision 840-I into the *Income Tax (Transitional Provisions) Act 1997* (ITTPA 1997).

The Subdivision prescribes the treatment of returns, gains, losses and deductions on certain investments of widely held foreign funds, for the 2010-11 and earlier income years. The amendments will apply where the returns or gains would otherwise be assessable income of the fund and where the fund or a foreign resident partner or beneficiary of the fund has not lodged an income tax return and the Commissioner of Taxation (Commissioner) has not made an assessment or notified the fund of an audit or review. Where the Subdivision applies, the relevant returns or gains will be treated as non-assessable non-exempt (NANE) income or will be disregarded and the deductions, losses, capital gains and capital losses will also be disregarded.

2.2 This Subdivision together with new Subdivision 842-I of the *Income Tax Assessment Act 1997* (ITAA 1997) (see Chapter 1) will form the first two elements of the investment manager regime (IMR).

2.3 As the amendments made by Schedule 2 and explained in this Chapter are designed to address the consequences of the *United States Financial Accounting Standards Board Interpretation Number 48 Accounting for Uncertainty in Income Taxes* — the amendments are often referred to as the ‘FIN 48’ measures.

2.4 All legislative references are to the ITAA 1997 unless otherwise stated.

Context of amendments

2.5 In 2006, the US Financial Accounting Standards Board issued *United States Financial Accounting Standards Board Interpretation Number 48 Accounting for Uncertainty in Income Taxes* (FIN 48) — subsequently codified into the United States accounting standard ASC 740-10, to increase the relevance and consistency of income tax reporting.

2.6 The standard initially applied only to public companies subject to US Generally Accepted Accounting Principles (US GAAP), however since 31 December 2009 the standard also applies to private entities that prepare US GAAP accounts (including managed funds).

2.7 The standard does not affect the income tax treatment of entities as it does not prescribe whether or not a particular amount is included in assessable income or allowed as a deduction. Rather, the standard sets out rules on how to report in financial statements, in particular reporting the income tax benefits received from taking uncertain tax positions in any tax return for any jurisdiction.

2.8 FIN 48 has had a particular impact on foreign funds with US reporting requirements which have a presence in Australia, or derive income that could be considered to have an Australian source, as the tax treatment of the income of these foreign funds is uncertain.

2.9 These issues were raised with the Australian Financial Centre Forum. The Forum's final report — *Australia as a Financial Centre: Building on our Strengths* — stated that tax uncertainties and the scope of the tax system acted as significant constraints on cross border activities. It also noted the impact of FIN 48 on the managed funds industry.

2.10 The Forum recommended the introduction of an IMR to improve the certainty and scope of the current taxation arrangements of managed funds.

2.11 The Government announced on 17 December 2010 that the tax law would be amended to deal with the uncertainty surrounding the impact of FIN 48. This measure was to apply to the 2009-10 and earlier income years but was later extended to also apply to the 2010-11 income year.

2.12 Schedule 2 to this Bill introduces amendments to the tax law to give effect to the 17 December 2010 announcement — the 'FIN 48' measure. Schedule 1 to this Bill gives effect to the announcement made in January 2011 — the 'conduit income' measure. Details of this measure are in Chapter 1.

Summary of new law

2.13 The proposed amendments are designed to clarify the taxation treatment of certain income for the 2010-11 and earlier income years of foreign funds which have not lodged a tax return or have had an assessment made of their income tax liability. Australian resident

investors will not gain any tax benefit from this measure and will remain taxable on any income received from foreign funds.

2.14 Where the conditions of the provisions 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.

2.15 These amendments will apply to the 2010-11 and earlier income years.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
For 2010-11 and earlier income years where a foreign fund or a foreign resident partner or beneficiary of a foreign fund has not lodged an income tax return and the Commissioner has not made an assessment or notified the fund of an audit or review, certain income will be disregarded or treated as NANE income. In addition, certain deductions and capital losses will be disregarded.	Where a foreign fund invests in Australian financial arrangements or in foreign financial arrangement and engages the services of an Australian intermediary, any income or gains from that financial arrangement may be taxable in Australia.

Detailed explanation of new law

IMR foreign fund

2.16 The Subdivision applies to an IMR foreign fund that is a corporate tax entity, a trust or a partnership. 'IMR foreign fund' is defined in section 842-230 which is introduced by Schedule 1 of the Bill and is discussed at paragraphs 1.17 to 1.18. [Schedule 1, item 1, subsections 842-210(2), 842-215(2) and 842-220(2), item 1, section 842-230 and item 7, subsection 995-1(1)]

Requirements for amounts to be disregarded

2.17 For income, deductions, gains or losses of a foreign fund to be disregarded under this Subdivision, relevant entities must satisfy the requirements of not having lodged a tax return, or having an assessment made or having received a notification of an audit or compliance review.

2.18 There is no requirement that for an amount to be treated as a pre-2012 IMR income it must otherwise be assessable income only because the fund has a permanent establishment in Australia that arises solely as a result of engaging an Australian resident entity to habitually exercise a general authority to negotiate and conclude contracts on its behalf. This requirement only applies to the conduit income measure in Division 842-I.

No lodgement of a tax return, issue of an assessment, or notification of an audit

2.19 In the case of a corporate tax entity which is an IMR foreign fund, for an amount to be disregarded the entity must:

- not have lodged an income tax return in relation to the 2010-11 or any earlier income year before the commencement of the Subdivision [*Schedule 2, item 1, paragraph 842-210(2)(c) to the ITTPA 1997*];
- not have had, before 18 December 2010, an assessment made of tax payable for any income year [*Schedule 2, item 1, paragraph 842-210(2)(d) to the ITTPA 1997*]; and
- not have been notified before 18 December 2010 of an audit or compliance review [*Schedule 2, item 1, subsection 842-210(5) to the ITTPA 1997*].

2.20 Where the IMR foreign fund is a flow through vehicle, for an amount to be disregarded in the calculation of the foreign beneficiary's or non-resident partner's share of the net income or partnership loss:

- the trust and beneficiary or the partnership and partner must not have lodged an income tax return in relation to the 2010-11 or any earlier income year before the commencement of the Subdivision [*Schedule 2, item 1, paragraphs 842-215(2)(c) and 842-220(2)(c) to the ITTPA 1997*];
- the beneficiary or partner must not have had, before 18 December 2010, an assessment made of tax payable for any income year [*Schedule 2, item 1, paragraphs 842-215(2)(d) and 842-220(2)(d) to the ITTPA 1997*]; and
- the trust or partnership must not have been notified before 18 December 2010 of an audit or compliance review [*Schedule 2, item 1, subsections 842-215(6) and 842-220(5) to the ITTPA 1997*].

2.21 Broadly, the above requirements apply to the entity which would otherwise be subject to tax on the IMR income:

- in the case of a fund which is a corporate tax entity, the requirements apply to the IMR fund, and
- in the case of a flow through IMR fund, the requirements apply to the beneficiary or partner.

2.22 However, 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.

Fraud

2.23 In addition to the above requirements, if the Commissioner is of the opinion that there has been fraud by the corporate tax entity, trust or partnership of a foreign fund, any amounts which may have been otherwise disregarded will not be disregarded in the calculation of the entity's taxable income, net income or partnership loss. [*Schedule 2, item 1, subsections 842-210(4), 842-215(5) and 842-220(4) to the ITTPA 1997*]

Amounts to be disregarded

Pre-2012 IMR amounts

2.24 Amounts to be disregarded include income from certain financial arrangements (which in the case of a corporate tax entity will be NANE income), deductions relating to that income, capital gains and capital losses arising from certain financial arrangements.

2.25 While the disregarded amounts are similar to amounts disregarded for the purposes of the conduit income provisions — Division 842-I (see Chapter 1) — the requirements of the two Subdivisions are not the same. Amounts disregarded for the purposes of the conduit income measures are referred to as IMR income, IMR deductions, IMR capital gains and IMR capital losses, while amounts disregarded under this Subdivision — the FIN 48 measures — are referred to as:

- pre-2012 IMR income;
- pre-2012 IMR deductions;
- pre-2012 IMR capital gains; and
- pre-2012 capital losses.

Pre-2012 IMR income

2.26 The pre-2012 IMR income of a foreign fund which is a corporate tax entity is treated as NANE income. [*Schedule 2, item 1, paragraph 842-210(3)(a) to the ITTPA 1997*]

2.27 The pre-2012 IMR income of a foreign fund which is a flow through vehicle is taken into account in determining the fund's pre-2012 non-IMR net income, pre-2012 non-IMR partnership net income or pre-2012 non-IMR partnership loss. In effect the pre-2012 IMR income of a flow through vehicle is disregarded in calculating the distribution to a non-resident beneficiary or partner of the fund.

2.28 For an amount to be treated as pre-2012 IMR income, the amount must be attributable to a return or gain from a financial arrangement covered by section 842-245 [*Schedule 1, item 1, paragraph 842-270 and item 15, subsection 995 1(1)*]. Financial arrangements covered by section 842-245 are discussed in Chapter 1 (see paragraphs 1.37 to 1.40).

Pre-2012 IMR deductions

2.29 Pre-2012 IMR deductions are amounts that (ignoring subsection 842-210(3) and paragraphs 842-240(1)(b) and 842-245(a)) would be deductible, but only to the extent that they are attributable to pre-2012 IMR income. [*Schedule 2, item 1, section 842-230 to the ITTPA 1997*]

2.30 Pre-2012 IMR deductions are disregarded in working out:

- the taxable income or tax loss of a IMR fund which is a corporate tax entity [*Schedule 2, item 1, paragraph 842-210(3)(b) to the ITTPA 1997*]; and
- the pre-2012 non-IMR net income, or the pre-2012 non-IMR partnership net income or the pre-2012 non-IMR partnership loss of a IMR fund which is a flow through vehicle [*Schedule 2, item 1, paragraphs 842-230(2)(b), and 842-230(2)(c) to the ITTPA 1997*].

2.31 In effect pre-2012 non-IMR deductions are not taken into account in determining a foreign resident beneficiary's or foreign resident partner's share of the net income or partnership loss or an IMR fund which is a flow through entity.

Pre-2012 IMR capital gains

2.32 The ***pre-2012 IMR capital gain*** is the sum of the fund's capital gains made in the relevant income year in respect of capital gains tax (CGT) assets that are financial arrangements covered by section 842-245. [*Schedule 1, item 1, subsection 842-270(3) and item 14, subsection 995-1(1)*]

Pre-2012 capital losses

2.33 The ***pre-2012 IMR capital loss*** is the sum of the fund's capital losses made in the relevant income year that are attributable to a CGT asset that is a financial arrangement covered by section 842-245. [*Schedule 2, item 1, section 842-235 to the ITTPA 1997*]

Taxable entities and flow through entities

2.34 As is the case for the conduit income measures — that is new Subdivision 842-I (see Chapter 1) — Subdivision 842-I of the ITTPA 1997 applies to foreign funds that are either 'taxable entities' (such as companies and corporate limited partnerships) or 'transparent' or 'flow-through entities' (such as partnerships and trusts). The structure of the foreign fund will dictate the level at which the exemption applies.

2.35 Where a fund is a taxable entity, the exemption of certain amounts will apply at the fund level.

2.36 Where a fund is a transparent entity, the exemption of certain amounts will apply either at the trustee level or at the foreign resident beneficiary level, and in the case of a partnership, at the foreign resident partner level. This approach is designed to ensure that an Australia member of a flow through entity, cannot access the exemption which may be available to foreign resident members of the entity.

IMR foreign funds that are taxable entities

2.37 Where the IMR foreign fund is a corporate tax entity, certain amounts (pre-2012 IMR amounts) are disregarded in calculating the entity's taxable income, tax loss or net capital loss. [*Schedule 2, item 1, subsection 842-210(3) to the ITTPA 1997*]

2.38 The calculation of the corporate entity's taxable income, tax loss or net capital loss for the for the 2010-11 and earlier income years, is the same as that described in paragraphs 1.59 to 1.61, except the amounts to be disregarded are pre-2012 IMR amounts.

2.39 As the Subdivision does not apply to any distributions (including capital distributions) received from a company or a corporate

limited partnership, the tax treatment of such distributions remains unchanged.

IMR foreign funds that are flow through entities

2.40 Where the IMR foreign fund is a flow through entity, for example a partnership or a trust, certain amounts (pre-2012 IMR amounts) are in effect disregarded in calculating a foreign resident partner's or foreign resident beneficiary's taxable income, tax loss or net capital loss. *[Schedule 2, item 1, subsections 842-215(3), 842-215 (4) and 842-220(3)]*

2.41 The *Income Tax Assessment Act 1936*, in particular Divisions 6 and 115, apply to the trustee of an IMR foreign fund, subject to the modifications of this Subdivision. The effect of the modifications is that where a trustee is assessed and liable to pay tax that liability will only be in respect of non-IMR net income rather than in respect of all the net income of the IMR foreign fund.

2.42 The calculation of the flow-through entity's net income, partnership loss, tax loss or net capital loss for the 2010-11 or earlier income years is the same as described in paragraphs 1.62 to 1.73, except the amounts to be disregarded are pre-2012 IMR amounts.

Application and transitional provisions

2.43 The Subdivision will commence on the date that the Bill receives Royal Assent and applies to the 2010—11 and prior income years. *[Section 2 of the Tax Laws Amendment (Investment Manager Regime) Bill 2012, item 8 of the table].*

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Tax Laws Amendment (Investment Manager Regime) Bill 2012

2.44 This Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

2.45 This Bill clarifies the treatment of returns and gains, as well as losses and deductions, on certain investments of foreign funds.

2.46 The Bill also clarifies the taxation treatment of certain income for the 2010-11 and earlier income years of foreign funds which have not lodged a tax return or have had an assessment made of their income tax liability.

Human rights implications

2.47 This Bill does not engage any of the applicable rights or freedoms.

Conclusion

2.48 This Bill is compatible with human rights as it does not raise any human rights issues.

**Minister for Financial Services and Superannuation,
the Hon Bill Shorten**

Chapter 3

Regulation impact statement

Introduction

3.1 Australia's taxing arrangements for foreign managed funds were examined in the *Australia's Future Tax System* (AFTS) and the *Australia as a Financial Centre* (Johnson Review) reviews.

3.2 Both reviews recommended that the Government modify current taxing arrangements for foreign managed funds. The AFTS review focused on the treatment of conduit income (foreign sourced income earned by non-residents investing via Australia). While the Johnson Review focused on the taxation of internationally mobile capital in the context of developing Australia as a regional financial centre.

3.3 The Johnson Review recommended overhauling the taxation of non-resident investment in domestic and offshore assets through an Investment Manager Regime (IMR), designed to provide clear, statutory rules for the taxation of cross-border investment and ensure that using an Australian intermediary would not attract additional tax. The Johnson Review recommended that the IMR be extended beyond funds management to other financial sector activities.

3.4 In the 2010-11 Budget, the Government responded to both the Johnson and AFTS recommendations by:

- providing in-principle support for an IMR and indicating that design issues relating to an IMR would be considered under the umbrella of a Board of Taxation review of collective investment vehicles. The Board delivered that report to Government in December 2011; and
- releasing a consultation paper on Budget night on the tax treatment of the conduit income of managed funds as a first stage in developing an IMR.

3.5 On 12 July 2010, the Government announced that based on initial feedback from the conduit income consultation process (refer to 'Consultation'), Treasury would provide advice to the Assistant Treasurer by 31 October 2010 on the scope for early delivery of an IMR. This advice was provided in November 2010.

3.6 While a broad range of issues were canvassed during consultation, the Regulatory Impact Statement considers two issues that were identified as having adverse impacts on foreign managed funds investing in Australia:

- the application of a United States (US) financial accounting standard (Accounting Standards Code 740 10 (ASC 740-10), widely referred to as ‘FIN 48’) was causing difficulties for foreign managed funds that currently or previously invested in Australia, and was contributing to negative investor perceptions of Australia as an investment destination; and
- certain Australian taxation rules regarding ‘permanent establishments’ that created tax impediments to foreign managed funds engaging Australian financial intermediaries to manage primarily offshore assets.

Problem 1: Application of US accounting standard to Foreign Managed Funds

3.7 ASC 740-10 applies to entities preparing financial accounts under US Generally Accepted Accounting Principles (US GAAP). Since December 2009, the standard has applied to private entities, including managed funds and hedge funds. US based managed funds that have invested or are investing in Australia are understood to face reporting obligations which arise due to ASC 740-10.

3.8 Under ASC 740-10, US reporting entities are required to examine all of their tax positions, including for current and prior income years, and assess whether, on the balance of probabilities, their claimed tax position is sustainable having regard to its technical merits, and standing in the shoes of the tax administrator. Where, it is concluded that on the balance of probabilities, the tax position will not be sustained entities are required to raise tax provisions in their financial accounts to reflect any possible adverse future tax assessments.

3.9 The international gravitas of the issue is underscored by the creation of the first sub-committee by the Managed Funds Association (the US peak industry body for hedge funds) on tax related matters. This sub-committee deals exclusively with the impact of ASC 740-10 upon its members. Discussions with the Managed Funds Association have indicated there are very few countries that give rise to ASC 740-10 difficulties — the main countries being Australia, Spain and China.

3.10 With respect to their Australian investments, industry indicated that US managed funds mainly experience difficulties in relation to

ASC 740-10 where the fund is (or was) trading in shares, bonds and other financial assets that give (gave) rise to income or gains considered to have an Australian source.

Foreign fund trading in financial assets that give rise to Australian sourced income and gains

3.11 ASC 740-10 issues have arisen in relation to trading in certain financial instruments (such as shares, bonds, units and certain derivatives) because of the uncertainty which surrounds the tax treatment of the associated income.

3.12 The issue arises because the basis upon which Australia taxes the income of non-residents is different to the basis upon which capital gains are taxed. Non-residents are generally taxed on income from Australian sources. In contrast, Australia does not tax capital gains of non-residents on the basis of source but on the basis of whether the asset disposed of is 'taxable Australian property' (broadly, Australian land, non-portfolio interests¹ in land rich entities, or assets used in carrying on business through a permanent establishment in Australia).

3.13 Where the investor is a share trader, the gain would generally be considered to be income. As gains from shares listed on the Australian Securities Exchange are generally considered to have an Australian source, the gain made by a non-resident share trader would be subject to tax.

3.14 There are relatively few statutory rules that determine the character of a gain (or loss) on investment assets. This is determined pursuant to case law, which generally looks to the particular facts and circumstances of a gain (or loss). Foreign fund managers have generally taken the view that gains on the disposal of investment assets give rise to capital gains (not income). Accordingly, to the extent the assets disposed of do not constitute taxable Australian property (which is typically the case), foreign funds would not be subject to Australian tax on any gains from the disposal.

3.15 However, upon reviewing past positions for ASC 740-10, many foreign funds have determined that their previously established tax positions (that they are realising capital gains) may be contestable. This is particularly in light of the fact the Australian Taxation Office (ATO) has not necessarily taken the view that funds always trade on capital account. In the past the ATO has found some funds to be trading on revenue

¹ A non-portfolio interest is where the investor has 10 per cent or greater equity interest in the underlying entity.

account, resulting in Australian tax being payable where gains have an Australian source.

3.16 Accordingly, some funds have determined that a tax provision for potential Australian tax exposures may be required under ASC 740-10. Where a provision is raised it will have the effect of reducing the fund's net asset value and, where the fund is not exchange traded, the investor's unit redemption price.

What have been the implications of ASC 740-10?

3.17 To some extent the immediate impact of ASC 740-10 is relatively confined as the percentage of funds under management sourced from offshore investors is low (as noted by the Johnson Report). Nevertheless, in terms of the fundamental objective of expanding activity in this sector, the effects of ASC 740-10 are of concern:

- Some foreign investors are ceasing to invest in or via Australia. Discussions with industry associations, including the Financial Services Council and the US-based Managed Funds Association, have indicated that the reporting and provisioning obligations under ASC 740 10 as well as the tax risk that has arisen from investing in Australia is perceived as commercially unacceptable by some foreign investors.
 - This is significant because once an investor makes a decision to cease investing in Australia, the likelihood of them investing in Australia in the future may fall. In other cases, foreign investors have maintained Australian asset exposure through the use of synthetic arrangements (for example, derivatives), which have increased their transaction costs.
- During the consultation process Treasury was informed of at least one case where funds have been frozen, with transactions in the fund halted and investors being unable to enter or exit the fund. In addition, where a fund has a potential outstanding tax liability, there are constraints on winding up the fund.
- Discussions with overseas fund managers and auditors in the United States, United Kingdom and Hong Kong have indicated that investor perceptions of Australia as a place to invest are being negatively impacted. Industry representatives argue that the development of Australia as a leading regional financial centre may be undermined.

- Australian fund managers may suffer by comparison to regional and global competitors, as ASC 740-10 issues do not arise in most other jurisdictions in regards to this type of investment as such jurisdictions generally exempt this type of income.

3.18 The effects of ASC 740-10 may not be limited to foreign managed funds that have US reporting obligations as offshore investors are now concerned about the underlying exposure to Australian tax rather than simply the requirement to report in financial accounts. This underlying issue with Australia's taxing arrangements affects all foreign managed funds, irrespective of whether they report under US GAAP. In one case, an investment potentially worth around \$200 million did not proceed because the Australian investment adviser was unable to provide an 'all clear' that engaging the Australian investment adviser and trading in Australia would not give rise to Australian tax. Accordingly, ASC 740-10 can be said to have both a direct impact — affecting funds that report under US GAAP — and a 'contagion effect' — affecting funds that do not report under US GAAP but that are now concerned about Australia's taxing rules.

3.19 An additional complication is that while ASC 740-10 has generally applied to funds from December 2009, ASC 740-10 requires funds to account for any potential prior year tax liabilities, possibly as far back as the inception of the fund.

3.20 While the potential Australian tax liability in a particular year may not be material relative to the fund's assets, aggregation of a number of years of Australian tax exposures makes the tax provision under ASC 740-10 material for many funds. In extreme cases, it may represent a significant portion of the fund's current net asset value and the fund may be frozen (with investors unable to enter or exit the fund). This was the case of one fund, worth between \$80 to 100 million. The potential Australian tax exposure on this fund was \$10 million, with an additional potential exposure of \$15 million for interest and penalties. (The relatively large tax exposure reflects, in part, potential tax on gains made in the pre-global financial crisis environment.)

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

3.21 Foreign managed funds may engage or deal with a number of entities (or intermediaries) based in Australia. For example, a foreign managed fund may engage the services of Australian based financial services providers (for example, investment advisers, fund managers and brokers) or establish a related party advisory business in Australia. These

situations may result in the foreign fund being taken to have a taxable presence — a ‘permanent establishment’ — in Australia.

3.22 Where a foreign fund is taken to be carrying on business through a permanent establishment in Australia, the fund is subject to Australian tax on any profits attributable to that permanent establishment. When profits are attributed to the fund’s permanent establishment, an amount greater than the arm’s length fee for the management services — that is all or a part of the investment income of the foreign fund — may become taxable in Australia. To the extent this investment income is taxable solely due to there being an Australian permanent establishment it can act as a disincentive to engaging Australian financial services intermediaries or basing operations in Australia.

3.23 For example, take the case of a foreign fund that engages an Australian fund manager to manage a portfolio of shares listed on various overseas stock exchanges. If engaging the fund manager does not create a permanent establishment in Australia, the income from the offshore shares would generally be considered foreign sourced and accordingly an Australian tax liability would not arise. However, if engaging the Australian fund manager does result in a permanent establishment income from the offshore shares is attributed to that permanent establishment. The Australian tax liability on what is effectively ‘conduit income’ (foreign source income earned by a non- resident via Australia) can create a disincentive to use the Australian intermediary.

3.24 A similar outcome could also arise under the capital gains tax rules in Division 855 of the *Income Tax Assessment Act 1997*, which assesses non- residents on capital gains (and losses) from assets. Under this Division, an asset used in carrying on business through a permanent establishment is included in the definition of ‘taxable Australian property’ and is taxable to a non-resident. This can mean that a foreign managed fund could be subject to Australian tax on an asset that would not ordinarily give rise to a capital gains tax liability to a non-resident. For example, a foreign fund, which does not have a permanent establishment in Australia, making a capital gain on the disposal of a portfolio interest in a company would not be subject to capital gains tax as that asset would not constitute taxable Australian property. However, if the fund had a permanent establishment in Australia, gains on the disposal of overseas listed shares would become taxable in Australia, potentially creating a disincentive to use an Australian financial services provider.

3.25 Both the Johnson and AFTS reviews identified this as a problem for the domestic financial services industry. The Johnson Report found this aspect of the current taxation arrangements contributed to a loss of new business and job opportunities. The AFTS review found that the ease with which savings can be reallocated between managed funds in different

jurisdictions means that any Australian tax on such ‘conduit’ income — or even the risk of tax — could have an impact on investment choices.

Investment Manager Regime

3.26 This measure deals with the taxation of foreign managed funds investing in or via Australia. It deals with two issues which have arisen in relation to the existing arrangements, namely:

- difficulties that foreign managed funds have with complying with US accounting rules; and
- impediments to foreign funds using Australian-based financial intermediaries to manage (primarily offshore) assets.

3.27 This RIS outlines the three options which were identified to address these issues. After analysing the costs and benefits of each option, it identifies the option chosen by the Government to achieve the desired objectives. Finally, the RIS details the consultation process undertaken.

Problems with Existing Law

3.28 In relation to the first problem identified — issues arising from the US accounting standard ASC 740-10 — there is evidence that continued uncertainty regarding potential tax exposures for prior years is affecting foreign managed funds’ investment decisions. As discussed previously, some funds are ceasing to invest in Australia, while others are maintaining exposure to Australia through using synthetic arrangements — such as derivatives. Overall, industry has indicated that Australia’s status as a place to invest is being negatively impacted as a result of ASC 740-10.

3.29 In the case of the second problem — taxation arrangements that apply to foreign managed funds engaging Australian financial intermediaries — there is a risk that the additional tax impost on highly mobile income that arises under the current rules, acts to create a disincentive to engage Australian fund managers and investment advisers.

The desired objectives

3.30 The objectives 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; and
- remove the tax impediment to foreign funds engaging Australian managers that occurs because a fund is taken to have a permanent establishment in Australia.

3.31 These objectives complement the Government's overarching objective to further Australia's development as a regional financial centre.

3.32 The Government's deficit exit strategy limits increases in real expenditure to two per cent once the economy is growing above trend until the budget returns to surplus, and allows tax receipts to recover naturally as the economy strengthens. In order to deliver on the fiscal strategy, the Government will need to fully offset new spending pressures and pursue structural reform to address long-term spending pressures. Options that have no or low cost to revenue over the forward estimates are consistent with this fiscal strategy.

Options for consideration

Option 1: No change to the law

3.33 Under Option 1, there would be no changes to the existing tax arrangements for foreign managed funds. To the extent there is uncertainty regarding the current law, it would be addressed through the existing administrative processes (such as interpretative guidance from the ATO) or the judicial process (the courts).

Option 2: Defer action on the development of an IMR until The Board of Taxation reports in December 2011

3.34 Under Option 2, the problems identified were to be examined by the Board of Taxation in the course of its report on the design of an Investment Manager Regime (IMR). The Board of Taxation reported to Government in December 2011.

Option3: Address the issues identified as part of an ‘interim’ IMR

3.35 Under Option 3, the Government would progress an interim IMR to address the problems identified in this RIS using the Board of Taxation’s report and the Johnson Report [for guidance]. On 12 July 2010, the Government announced that Treasury would provide advice on the scope of an ‘interim IMR’ — that is, advice on what aspects of an IMR could be progressed in advance of the Board’s report. That advice was provided in November 2010.

3.36 Under Option 3, the Government would introduce an interim IMR to:

- mitigate the impacts of US accounting standard ASC 740-10, as it applies to prior income years; and
- remove some of the tax impediments to foreign funds establishing operations in Australia or engaging financial intermediaries that currently arise due to the creation of a permanent establishment.

3.37 The interim IMR would be developed in consultation with the Board of Taxation. Once the Board provided its recommendations on the overall design of an IMR, this interim IMR could be extended to accommodate its recommendations.

Mitigating the impacts of ASC 740-10 for prior years

3.38 To mitigate the impacts of ASC 740-10, the Government would amend the tax law to clarify the tax treatment of prior year investment income of foreign managed funds by ensuring that no further Australian tax liabilities could be raised in respect of this income. This would be achieved through amending the law to prevent the ATO from raising an assessment in respect of certain prior year investment income where a fund has never lodged an Australian tax return.

3.39 The definition of ‘foreign managed fund’ would be along the following lines:

- the fund is not an Australian tax resident;
- the fund is widely held and not closely held;
- the fund undertakes ‘passive’ investment; and
- the fund does not carry on or control a trading business in Australia.

3.40 While the specific definition of foreign managed fund was developed in consultation with industry stakeholders, aspects of the proposed definition are already features of the law. For example, the definition of a ‘managed investment trust’ (MIT) that applies for the purposes of the MIT withholding tax rules already contain widely held requirements and exclude entities that carry on or control a trading business from qualifying as a MIT. Likewise, ‘eligible investment business’ rules in Division 6C of the *Income Tax Assessment Act 1936* set out the meaning of ‘passive’ investment.

3.41 To ensure the rules are appropriately targeted, the amendment would cover the types of investments typically undertaken by foreign managed funds. Consultation with industry stakeholders indicated these are:

- portfolio interests (in companies and other entities, such as unit trusts) and certain debt interests such as bonds; and
- financial arrangements (for example, derivatives and foreign exchange transactions).

3.42 Again, to ensure the rules are appropriately targeted, where the investment gives rise to income that is subject to withholding tax (for example, dividends earned on shares), these amendments would not apply. The industry indicated that where the withholding tax rules apply, appropriate tax has been collected and accordingly a need to disclose under ASC 740-10 does not arise. Likewise, to the extent a financial arrangement is in respect of taxable Australian property, the amendments should not apply. Again, taxable Australian property is clearly defined in Australian taxation law, and accordingly, the need to disclose under ASC 740-10 does not arise in respect of such transactions.

3.43 Consistent with the internationally-accepted principle that residents are taxable on world-wide income, the amendments should provide that resident investors investing through a foreign managed fund will remain taxable on the relevant investment income. Integrity rules to prevent such ‘round-tripping’ may be needed. The design of these rules needs to be proportionate to the revenue at risk, and would be developed in consultation with industry stakeholders and the ATO.

3.44 Where the ATO has notified foreign fund of its intention to commence an audit or compliance review prior to the commencement of these amendments (which will apply from the date of announcement), the amendments will not apply.

Removing tax impediments to foreign funds engaging Australian-based financial intermediaries

3.45 Option 3 would also remove some of the current tax impediment to foreign funds engaging Australian financial intermediaries for the management of primarily offshore assets or to establishing operations in Australia.

3.46 This would be achieved through providing that to the extent certain investment income is taxed only because a foreign managed fund is taken to have a 'permanent establishment' in Australia, that income would be exempt from income tax, except for amounts representing the arm's length fee for services of the permanent establishment. The definition of both foreign managed fund and relevant investment income would be the same as proposed for the amendments relating to ASC 740-10. These changes would apply with effect from the 2010-11 income year.

3.47 These changes are not intended to provide a general exemption for Australian assets. Income and gains that are sourced in Australia would continue to be subject to Australian tax. However, the amendments would affect the treatment of Australian investments in the specific case of capital gains. This is because capital gains are taxed to non-residents not on the basis of Australian source but on the basis of whether the Capital Gains Tax asset is taxable Australian property. Accordingly, where an asset is treated as taxable Australian property solely due to the presence of a permanent establishment in Australia, the amendments will provide that a capital gains tax liability will not arise. For integrity reasons, resident investors should remain taxable on income received by resident investors from investing via foreign managed funds.

Assessment of impacts

Impact groups

- 3.48 The main groups to be impacted by this proposal are:
- foreign managed funds (and investors in those funds) that are currently investing, or considering investing, via Australia;
 - the domestic funds management industry — that is, Australian based intermediaries, such as Australian investment advisers, fund managers, brokers and other financial service providers, that provide services to managed funds; and

- the Australian Government, including the ATO.

Option 1: No change to current law

3.49 Option 1 would maintain the current legislative arrangements. Uncertainty in the tax law will be dealt with through funds seeking guidance from the ATO (for example, through public and private rulings) and litigation (via the courts).

3.50 This option will not address issues that have arisen as a consequence of ASC 740-10. To the extent there is uncertainty about the need to raise tax provisions for prior year liabilities, industry indicated it will have deleterious effects on managed fund investments in Australia and potentially on Australia's reputation as an investment destination. As discussed above, the impact of ASC 740-10 appears increasingly to impact foreign funds generally, not just funds reporting under US GAAP (via the 'contagion' effect).

3.51 Additionally, maintaining the status quo would also not address the existing tax impediments to foreign funds engaging Australian financial intermediaries or establishing operations in Australia, which currently arise where a fund is taken to have a permanent establishment in Australia.

3.52 Option 1 would not give rise to a cost to revenue as current tax settings would be left unchanged. However, to the extent it would lead to a loss of business opportunities for the Australian financial intermediaries, it could be expected to result in second round revenue effects with lower tax revenues in the medium term, as noted in the Johnson Report.

Option 2: Defer action on the development of an IMR until the Board of Taxation reports in December 2011

3.53 Option 2 would allow the problems identified in this RIS to be considered by the Board of Taxation as part of its report on the design of an IMR. The Board reported to the Government in December 2011.

3.54 The IMR, as conceived by the Johnson Committee, was intended to apply broadly, extending beyond funds management to other financial sector activities (such as banking). An advantage of allowing the Board of Taxation to consider the identified problems in the context of its broader consideration of an IMR was that it allowed these issues to be considered holistically. This approach increased the likelihood of a set of clear, internally consistent policy outcomes.

3.55 On the other hand, deferring action to the Board of Taxation process did not deal with the impacts of ASC 740-10 in a timely way. Representations from the managed funds sector, their auditors, and legal advisers indicate that failure to address the ASC 740-10 issues resulted in a flight to certainty, whereby funds adversely affected by ASC 740-10 would cease investing in Australia, or restructure transactions through synthetic transactions (for example, derivatives).

3.56 The second problem did not have a critical deadline (as is the case with ASC 740-10). Hence, this issue was deferred to the Board of Taxation review. However, this issue was identified in the Johnson and AFTS reviews as a key factor inhibiting foreign funds from engaging Australian financial services intermediaries. The AFTS review noted the current arrangements give rise to complexity, which negatively impacts on foreign managed funds, their investors and the ATO. Additionally, to the extent the current arrangements result in highly tax sensitive income being taxed, they affect the ability of Australian financial services intermediaries to attract offshore capital and expand their business.

3.57 This option would not have a cost to revenue. A cost to revenue would be determined at the time the Board of Taxation provided its report to Government. However, to the extent deferring action on the identified problems would lead to a loss of business opportunities for the Australian financial intermediaries, it could be expected to result in second round revenue effects with lower tax revenues in the medium term, as noted in the Johnson Report.

Option 3: Progress an interim Investment Manager Regime

3.58 Under Option 3, the Government would progress an interim investment manager regime by introducing amendments to:

- clarify the treatment of prior year investment income of foreign managed funds to address the impacts of ASC 740-10; and
- remove the tax impediments to foreign fund managers engaging Australian financial services intermediaries (such as fund managers, investment advisers) to manage primarily offshore assets.

3.59 By introducing rules to provide clarity regarding the treatment of certain portfolio investment income of foreign managed funds for the 2009-10 and prior income years, Option 3 will enable funds subject to ASC 740-10 to determine whether to make or vary tax provisions. As discussed previously, industry indicated that for most funds December

2010 was a critical time to: re-evaluate or raise existing or new tax provisions; review unit redemption prices; and review or change investment strategies. Furthermore, industry indicated that a Government decision regarding the tax treatment of these investments was required by that date in order to enable funds to meet their obligations under ASC 740-10. This deadline was achieved.

3.60 Option 3 will also provide timely guidance to the Commissioner of Taxation regarding the administration of the law in respect of prior year investment income.

3.61 As the increased tax certainty provided under Option 3 is not limited to funds reporting under ASC 740-10 but extends to foreign managed funds (and foreign investors in those funds) more broadly, Option 3 will maintain Australia's attractiveness as an investment destination. This will benefit financial services businesses (such as funds managers and brokers) that are seeking to attract offshore capital.

3.62 Option 3 will also address a key finding of the Johnson Report — that the tax law discouraged the use of Australian based investment advisors while improving the tax treatment of conduit investment and investment management services within Australia, consistent with the recommendation of the Johnson and AFTS reviews. While this was not as time critical as ASC 740-10, addressing it now has the benefit of taking early action on an issue that has been identified by the Johnson and AFTS report as affecting the competitiveness of Australia's financial services intermediaries.

3.63 The changes proposed under Option 3 have been identified as having an unquantifiable but small cost to revenue over the forward estimates. The detailed design of Option 3 was developed in consultation with industry stakeholders

Consultation

3.64 Extensive consultation was undertaken with industry stakeholders and the Board of Taxation throughout this process.

Development of Government consultation paper on the taxation of conduit income of managed funds

3.65 Consultation with managed funds industry (primarily through meetings with the Financial Services Council (FSC), formerly the Investment and Financial Services Association) was undertaken in the development of the Government consultation paper 'Developing an

investment manager regime: improving conduit income arrangements for managed funds’.

3.66 Treasury received a number of submissions in response to the consultation paper, which were generally wide-ranging and comprehensive. Key messages from 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/problems arose in relation to the funds management sector, particularly foreign managed funds;
- Australia’s taxing arrangements for managed fund investments were out of step with a number of overseas jurisdictions; and
- a clear and specific legislative regime was a superior means of improving the tax treatment of cross border investment to ‘piece-meal’ changes (such as clarifying or providing source rules), which may result in additional complexity.

3.67 Subsequent to this feedback, Treasury commenced development of an early version IMR in order to provide a more systemic and effective means of providing conduit relief and addressing other issues affecting managed funds.

Consultation on issues arising from ASC 740-10

3.68 Treasury has had a number of discussions with industry, including a workshop on 28 July 2010 to gather information on the impacts of ASC 740-10 for the managed funds industry. Industry indicated that early action is required to minimise the potential for damage to Australia’s reputation as a favourable place to invest, which may hinder the Government’s objective of developing Australia as a financial services centre.

3.69 Some industry representatives indicated that a Government announcement regarding the tax treatment of past investments was required by December 2010 in order to alleviate the impact of ASC 740-10. Otherwise, funds would need to make or review tax provisions in their end of year reports.

3.70 This feedback has been incorporated in the development of the early version IMR (Option 3). The Option 3 IMR will include special rules to provide clarity regarding the treatment of prior year investments by foreign managed funds. These rules will provide certainty for those

funds considering whether to raise tax provisions for ASC 740-10, and will likely go a significant way to reducing the potentially detrimental impacts of ASC 740-10. The rules will also provide guidance to the Commissioner of Taxation with respect to administering the law in respect of past investments.

3.71 Treasury has also held discussions with a number of fund managers operating in the United Kingdom and Hong Kong to discuss the implications of ASC 740-10. These discussions have proved useful in forming Treasury's views as to the merits of an interim IMR.

3.72 Treasury has also had informal contact with the United States' Financial Accounting Standards Board.

3.73 As part of the development of the interim IMR, Treasury engaged a consultant — Deloitte — consistent with the recommendations of the Tax Design Review Panel's report *Better Tax Design and Implementation* to advise on tax law aspects of the project, particularly the operation of the profit attribution (transfer pricing) rules.

Consultation with the Financial Centre Task Force

3.74 Additionally, a staged approach to developing and implementing an IMR was discussed with general support from the Financial Centre Task Force (formerly the Australian Financial Centre Forum). This approach is reflected in the current interim IMR proposal, which is the first stage of an IMR designed to largely address funds management issues.

Consultation with the Board of Taxation on the early version IMR to address funds management issues

3.75 Treasury has consulted closely with the Board of Taxation and its 'Panel of Experts' (practitioner advisers) in developing the Option 3 interim IMR proposals.

3.76 In the period August to October 2010, Treasury attending several meetings of the Board of Tax Working Group on the Collective Investment Vehicle review, during which the Working Group was provided with opportunities to comment on a draft interim IMR. Feedback from consultation was incorporated into the design of the interim IMR, specifically with regard to the design principles underpinning the interim IMR.

3.77 The Board of Taxation has advised Treasury of its support for the two interim IMR proposals as the best available policy response at this stage consistent with established budgetary processes.

Consultation with the ATO

3.78 Treasury has also had ongoing consultation with the ATO in developing these proposals, including formal processes through the Board of Taxation and the Working Group established to oversee the review of the taxation of collective investment vehicles.

Conclusion and recommended option

3.79 The recommended option was Option 3, which is the only option that:

- mitigates the impacts of ASC 740-10;
- address the concerns articulated in the Johnson and AFTS reviews regarding certain tax impediments (the permanent establishment rules) that discourage foreign funds from engaging Australian financial services intermediaries; and

3.80 This was the option accepted by the Government.

Implementation and review

3.81 The interim IMR proposals set out under Option 3 will reduce compliance costs and transaction costs for foreign managed funds and foreign investors, as well as reduce administrative costs for the ATO. Legislation to implement these announcements was developed in consultation with industry.

3.82 As Option 3 will provide benefits to the industry and investors, there is no need for transitional arrangements.

3.83 Treasury and the ATO will continue to monitor the interim 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

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General: Commencement

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<i>Bill reference</i>	<i>Paragraph number</i>
Item 1, subsection 842-205(1)	1.15
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Schedule 1: Investment manager regime — conduit income of 2010-11 and later income years (continued)

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