Interim Investment Manager Regime

Regulatory Impact Statement

ASSESSING THE PROBLEM

INTRODUCTION

This Regulation Impact Statement (RIS) considers taxing arrangements for foreign managed funds investing in or via Australia. It identifies two problem areas 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.

These two issues, if left unchecked, have the potential to impede Australia's development as a regional financial centre.

The RIS outlines three options to address these problems. After analysing the costs and benefits of each option, it identifies a recommended option which is most likely to achieve the desired objectives. Finally, the RIS also details the consultation process undertaken, and discusses possible implementation and review of the preferred option.

BACKGROUND

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') reviews.

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 Report focused on the taxation of internationally mobile capital in the context of developing Australia as a regional financial centre.

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 Report recommended that the IMR be extended beyond funds management to other financial sector activities.

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 is due to report to Government by 31 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.

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.

While a broad range of issues were canvassed during consultation, this RIS considers two issues that were identified as having adverse impacts on foreign managed funds investing in Australia:

- the recent application of a 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

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.

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.

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 MFA have indicated there are very few countries that give rise to ASC 740-10 difficulties — the main countries being Australia, Spain and China.

With respect to their Australian investments, industry has 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

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..

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 interests[1] in land-rich entities, or assets used in carrying on business through a permanent establishment in Australia).

This means that a non-resident investor that makes a capital gain from selling shares in a company listed on the Australian Securities Exchange will not be liable to capital gains tax (so long as the investment is a portfolio interest). In contrast, were 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.

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.

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

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?

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.

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

– 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 were 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.

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.

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.

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, currently 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-GFC environment).

While industry has responded to the ASC 740-10 standard in different ways (the majority are understood to have already raised tax provisions, while others are yet to do so), for most funds **December 2010** will be a critical time to re-evaluate or raise these provisions, review unit redemption prices and investment strategies. Industry has indicated that a Government decision

regarding the tax treatment of these investments is required in order to enable funds to meet their obligations under ASC 740-10.

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

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.

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.

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.

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-reident. 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.

Both the Johnson and AFTSreviews 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.

WHY IS GOVERMENT ACTION REQUIRED TO CORRECT THE PROBLEM?

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.

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.

Government action alone can address these deficiencies through amending the current taxing rules.

WHAT ARE THE OBJECTIVES OF GOVERNMENT ACTION?

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.

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

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 a no or low cost to revenue over the forward estimates would be consistent with this fiscal strategy.

OPTIONS FOR CONSIDERATION

OPTION 1: NO CHANGE TO THE LAW

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 Australian Taxation Office) 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

Under Option 2, the problems identified would 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 is scheduled to report to Government by 31 December 2011.

OPTION 3: ADDRESS THE ISSUES IDENTIFIED AS PART OF AN 'INTERIM' IMR

Under Option 3, the Government could progress an interim IMR to address the problems identified in this RIS in advance of the Board of Taxation's report. 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.

Under Option 3, the Government could 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.

The interim IMR would be developed in consultation with the Board of Taxation. Once the Board provides 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

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.

The definition of Foreign Managed Fund could 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.

While the specific definition of foreign managed fund will be 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.

To ensure the rules are appropriately targeted, the amendment should cover the types of investments typically undertaken by foreign managed funds. Consultation with industry stakeholders has 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).

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 should not apply. The industry has 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.

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 need to be proportionate to the revenue at risk, and will be developed in consultation with industry stakeholders and the Australian Taxation Office.

Where the Australian Taxation Office 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

Option 3 could 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.

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 could apply with effect from the 2010-11 income year.

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 CGT 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.

IMPACT ANALYSIS

IMPACT GROUPS

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 Australian Taxation Office.

OPTION 1: NO CHANGE TO CURRENT LAW

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).

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 has 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).

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.

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.

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 is scheduled to report to the Government by 31 December 2011.

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 is that it would allow these issues to be considered holistically. This approach would increase the likelihood of a set of clear, internally consistent policy outcomes.

On the other hand, deferring action to the Board of Taxation process would not deal with the impacts of ASC 740-10 in a timely way. Industry has indicated that many funds with US GAAP reporting obligations need to re-assess their accounts and investment strategies by the reporting deadline of 31 December 2010. Representations from the managed funds sector, their auditors, and legal advisers indicate that failure to address the ASC 740-10 issues would result 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).

The second problem does not have a critical deadline (as is the case with ASC 740-10). Hence, this issue could be deferred to the Board of Taxation review, which would report on the issue by 31 December 2011. 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 Australian Taxation Office. 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. Therefore, deferring action until the Board reports will impact on the Government's objective to be a regional financial centre.

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

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.

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 has indicated that for most funds **December 2010** will be a critical time to: re-evaluate or raise existing or new tax provisions; review unit redemption prices; and review or change investment strategies. Industry has indicated that a Government decision regarding the tax treatment of these investments is required by this date in order to enable funds to meet their obligations under ASC 740-10.

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.

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.

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 is 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.

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 would be developed in consultation with the Board of Taxation and industry stakeholders. The Board of Taxation will retain the ability to review the changes introduced by the interim IMR as part of its report on the design of the broader IMR.

CONSULTATION

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

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'.

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.

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

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.

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.

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.

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.

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

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

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. The next stage of the IMR will be developed by the Board of Taxation when it reports on the design of an IMR in December 2011.

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

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

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.

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 Australian Taxation Office

Treasury has also had ongoing consultation with the Australian Taxation Office 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 — RECOMMENDED OPTION

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

- mitigate the impacts of ASC 740-10 on an urgent basis;
- 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
- set the foundations for an IMR framework as it applies to funds management, thereby complementing the work being undertaken by the Board of Taxation.

As Option 3 has an unquantifiable but small cost to revenue, it can be progressed outside of the Budget context, permitting these issues to be addressed in a timely manner. Accordingly, Option 3 is the recommended option.

Consistent with this recommendation, on 17 December 2010, the Government announced it would introduce amendments to the income tax laws to provide certainty regarding the treatment of relevant investment income of foreign managed funds for the 2009-10 and prior income years to address ASC 740-10. On 19 January 2011, the Government announced it would introduce amendments to the income tax laws to remove a tax impediment to foreign managed funds engaging Australian financial services intermediaries.

IMPLEMENTATION AND REVIEW

The interim IMR proposals set out under Option 3 are anticipated to reduce their compliance costs and transaction costs for foreign managed funds and foreign investors, as well as reduce administrative costs for the Australian Taxation Office. Legislation to implement these announcements will be developed in consultation with industry.

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

Treasury and the Australian Taxation Office 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.