Investment Manager Regime: Element 3

Regulatory Impact Statement

ASSESSING THE PROBLEM

INTRODUCTION

Following the report by the Australian Financial Centre Forum (AFCF) headed by Mark Johnson ("The Johnson report")[1] the Government agreed in principle to an Investment Manager Regime (IMR) which would provide a set of clear and comprehensive rules on the taxation of certain non-resident investments into Australian and offshore assets. The AFCF proposed that the IMR would apply broadly, extending beyond funds management to cover a range of other activities in the financial sector.

Subsequently, the Government announced two amendments to the income tax law:

1. On 17 December 2010, the Government announced that it would provide certainty of tax treatment for funds that have invested in Australia. Where a foreign managed fund has not lodged a tax return for the 2009-10 or prior income years in respect of certain investment income of the fund, the Australian Taxation Office will not be permitted to raise an assessment in respect of that income, except where the fund lodges a tax return disclosing such income.

2. On 19 January 2011, the Government announced that income from relevant investments of a foreign fund, that is taken to have a 'permanent establishment' in Australia solely due to the use of an Australian financial intermediary, will be exempt from income tax.

This Regulation Impact Statement (RIS) relates to the third, and final, element of the IMR which will address providing certainty in the prospective tax treatment of foreign managed funds investing in portfolio, passive, Australian securities. While this RIS is intended to be a stand-alone document, further background and context of the measures is contained in the RIS on the first two elements of the IMR published on 16 September 2011.[2] That RIS contains details of the AFCF recommendations for an IMR and details of consultation which had occurred. Exposure drafts of legislation relating to these announcements was released on 16 August 2011 for public comment.[3]

THE JOHNSON REPORT

Australia's taxing arrangements for non-resident investment in domestic and offshore assets was most recently examined as part of the Johnson Report into developing Australia as a Financial Centre.

The Johnson Report, released in January 2010, found that Australia has arguably the most efficient and competitive 'full service' financial sector in the Asia-Pacific region. However, it also found the percentage of funds under management sourced from offshore investors was low.

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[1] http://cache.treasury.gov.au/treasury/afcf/content/final_report/downloads/AFCF_Building_on_Our_Strengths_Report.pdf

[2] http://ris.finance.gov.au/2011/09/16/interim-investment-manager-regime-%E2%80%93-regulation-impact-statement-%E2%80%93-treasury/

[3] http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2121

While the Johnson Report acknowledged that there were a number of reasons for the low level of offshore funds under management, it found that a critical reason was uncertainty regarding the tax treatment of funds managed out of Australia but sourced from offshore.

The Johnson Report found that this uncertainty stemmed from the fact that many of the taxation concepts central to the taxation of non-resident investment — such as “source”, “permanent establishment”, “central management and control” and the revenue/capital distinction — were generally not codified in statute but rather relied on the application of common law principles, developed through cases that were not always easily adapted to the operation of modern financial markets, with taxation outcomes depending on a consideration of the facts and circumstances of each company and/or transaction.

The Report also noted that, in contrast, a number of overseas financial centres, including Hong Kong, Singapore, New York, Tokyo and London have statutory rules designed to provide clarity and certainty regarding the taxation treatment of the income of non-resident investors, including where they used domestic fund managers.

According to the Johnson Report, some of the consequences of the current taxation arrangements are that:

- potential foreign investors being unwilling to invest via Australian-based vehicles or use Australian-based investment advisers;
- financial transactions or decisions that could have occurred through an Australian-based broker, exchange or other intermediary being undertaken offshore, or not at all; and
- some Australian fund managers resisting opportunities to expand their funds under management from offshore clients or, alternatively, setting up offshore vehicles that were managed offshore.

In summary, the Johnson Report found that the combined effects of the current taxing arrangements were that Australia was unable to take advantage of some potential financial transactions, investment flows and new business opportunities.

Johnson Report Recommendation 3.1 — an Investment Manager Regime

To resolve this uncertainty on a prospective basis, the Johnson Report recommended introducing an Investment Manager Regime (IMR) to provide clear and comprehensive statutory rules for taxing non-residents investing in Australian and offshore assets.

The Report argued that an IMR should:

- ensure non-resident investors investing in Australia or overseas through an Australian intermediary did not attract additional Australian tax on investments merely by use of that intermediary;
- remove impediments to Australian investment managers (or fund managers) managing offshore sourced funds, and also encourage financial services companies to establish or maintain their regional headquarters in Australia; and
- remove disincentives to attracting financial services business to Australia.

While the focus of much of the discussion in the Johnson Report identifies problems in the tax law that affect the managed funds industry, the report recommended an IMR with wide application, extending beyond funds management to other financial services activities (such as banking and insurance). This RIS addresses funds management aspect of the IMR only.

WHY IS GOVERNMENT ACTION REQUIRED TO CORRECT THE PROBLEM?

Uncertainty regarding their potential tax liability for investment in Australia is likely to have an adverse impact on the investment decisions of foreign managed funds, and act as an impediment to the development of Australia as a regional financial centre. There is also anecdotal evidence that some foreign funds managers are not investing in Australia as a result. That said, the overall level of investment in Australia is currently at historically high levels, and projected to grow further in coming years.

WHAT ARE THE OBJECTIVES OF GOVERNMENT ACTION?

The objective of Government action is to remove impediments to Australia's continued development as a regional financial centre from uncertain taxation treatment of foreign managed funds, consistent with maintaining the integrity of the income tax base and achieving the Government's medium term fiscal strategy.

In order to achieve this it is important that Australia's taxing arrangements in this area be amended so that they:

- are clear and certain;
- maintain the integrity of the taxation system (by safeguarding the taxation of the corporate tax base and the taxation of resident investors);
- do not discourage the use of Australian-based financial intermediaries; and
- have only a limited impact of government revenue, consistent with the Government's commitment to return the budget to surplus in the 2012-13 financial year.

BOARD OF TAXATION REVIEW OF IMR IN RELATION TO FOREIGN MANAGED FUNDS

The Board of Taxation was asked to examine and report on the design of an IMR for foreign managed funds as part of its review of the taxation treatment of collective investment vehicles. In response to a request by the Assistant Treasurer on 10 May 2011, the Board of Taxation brought forward its consideration of an IMR as it applies for foreign managed funds to 30 August 2011.

The Board of Taxation made 12 recommendations in relation to the implementation of the IMR. The Board recommended that:

- An IMR for foreign managed funds should be implemented using an exemption style approach (Recommendation 1).
- Foreign managed funds covered by the IMR should:
  - comprise a broad set of collective investment vehicle (CIV) structures and arrangements, and should not be limited to particular types of legal entity (Recommendation 2);

  - not be an Australian resident (Recommendation 3) — (in this context, the Board also recommended that certain modifications be made to Australia's residence and permanent establishment tests for foreign managed funds accessing the IMR);

  - be widely held (Recommendation 4);

  - not carry on or control a trading business in Australia (Recommendation 5); and

  not be subject to a 'managed in Australia' requirement (Recommendation 6).

- For foreign managed funds covered by the IMR, gains from the disposal of portfolio investments (those in which the foreign managed fund has a less than 10 per cent interest) in a prescribed list of eligible investments should be exempt from tax (Recommendation 7).

- A gain made by a foreign managed fund from the disposal of a non-portfolio investment in non-Australian assets (that is, conduit income) should not be subject to Australian tax if the only reason it is subject to Australian tax is because it uses an Australian intermediary (Recommendation 8).

- In order to protect the Australian tax base:

  - income derived by Australian investors from a foreign managed fund is not made exempt merely by virtue of the income being treated as exempt for the foreign managed fund under the IMR (Recommendation 9);

  - integrity rules should not be introduced into the IMR for foreign managed funds to address deferral of taxation that would operate in addition to Australia's foreign source income attribution rules, and that a review be undertaken of these rules after enactment to ensure that inappropriate outcomes are not arising through the IMR rules (Recommendation 10); and

  - foreign managed funds should be required to be resident of an information exchange country and to lodge annual information returns with the Australian Taxation Office (ATO) (Recommendation 11).

- Australia's transfer pricing rules should continue to operate where appropriate to tax Australian intermediaries on their arm's length fees for services provided to foreign managed funds (Recommendation 12).

OPTIONS FOR CONSIDERATION

OPTION 1: NO CHANGE TO THE LAW

Option 1 would maintain the current legislative arrangements. Where there is uncertainty in the law, this would be resolved through the existing administrative processes, with interpretative guidance to be sought from the Australian Taxation Office or the judicial process (the courts).

OPTION 2: CHANGE THE INCOME TAX LAW TO ENSURE DEFINE AND FULLY TAX AUSTRALIAN INCOME OF FOREIGN MANAGED FUNDS

Option 2 would seek to resolve uncertainty in relation to current income taxation treatment of foreign managed funds by bringing these investments more clearly within the Australian income tax net. That is, the legislation would be amended to state that income, gains and losses from such investments would be on revenue account and fully subject to income tax in Australia.

OPTION 3: **CHANGE THE INCOME TAX LAW TO RESTRICT THE TAXATION OF AUSTRALIAN INCOME OF PORTFOLIO INVESTMENTS OF FOREIGN MANAGED FUNDS (IMR)**

Option 3 would seek to resolve uncertainty in relation to current income taxation treatment of foreign managed funds by restricting the application of Australian income tax law, subject to appropriate safeguards to protect the integrity of measures, consistent with the recommendations of the Board of Taxation report.

Foreign managed funds would generally be exempt from Australian tax on income, gains and losses on portfolio investments, with Australia's tax received on these investments limited to income on which withholding tax currently applies (dividends, interest, royalties and certain distributions from management investment trusts),[4] and gains and losses on the sale of interests in land.

A foreign managed funds would be defined as an entity with the following features:

- it is not an Australian resident;
- is widely held[5];
- it undertakes passive, typically portfolio investment (this refers to the kinds of investments typically undertaken by managed funds)[6];
- it does not carry on or control a trading business in Australia; and
- it is domiciled in a country which is recognised by Australia as engaging in effective exchange of information.

Apart from the final dot point (the domicile/exchange of information requirement), which was recommended by the Board of Taxation as an integrity measure, this definition is consistent with draft legislation which relates to Element 1 and 2 of the IMR released on 16 August 2011.[7]

In addition, to the extent a tax liability arises only because of the use of an Australian intermediary, the investment income would not be taxed. However, the Australian intermediary would be taxed on their arm's-length fees for services. This would be similar to the approach adopted in the United Kingdom Investment Manager Regime, which taxes income derived by a UK investment manager from providing management services and requires that the manager must receive remuneration at a rate not less than what is 'customary' for the services provided.

To ensure resident taxpayers remain taxable on income received by resident investors from investing via foreign managed funds, integrity rules to prevent such 'round-tripping' may be

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[4] Of course, where the investment is in an Australian company, that company would remain subject to income tax. Note that withholding tax is not imposed on franked dividends. In addition, some foreign funds, such as foreign pension funds, may be exempt from withholding tax.

[5] A fund will be deemed to be widely held if it has more than 25 members.

[6] See Appendix A for a description of the kinds of income which will be eligible for exemption under Option 3.

[7] http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2121

needed. In developing such rules, compliance design would need to be proportionate to revenue at risk. Option 3 would, consistent with the Board's Recommendations, would be implemented with the following integrity measures to ensure the integrity of the resident tax base:

- income derived by Australian investors from a foreign managed fund is not made exempt merely by virtue of the income being treated as exempt for the foreign managed fund under the IMR;
- foreign managed funds will be required to be resident of an information exchange country and to lodge annual information returns with the Australian Taxation Office (ATO) (Recommendation 11); and
- foreign managed funds will be required to be widely held.

IMPACT ANALYSIS

Impact groups

The main groups to be impacted by this proposal are:

- non-resident investors, including foreign managed funds, that are currently investing, or considering investing, in or 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;
- Australian managed funds; and
- the Australian Government, including the Australian Taxation Office.

OPTION 1: NO CHANGE TO CURRENT LAW

Option 1 maintains the current legislative arrangements and deals with tax uncertainty through guidance from the ATO and litigation. Under this option, certainty could be marginally improved through the use of private rulings and access to other interpretative guidance.

Complexity/Uncertainty

Under Option 1, it is conceivable that over time tax law *uncertainty* could be addressed through increased interpretative guidance through the Australian Taxation Office or judicial processes, this option would: (a) be time consuming and only resolve issues as they arise; and (b) increase administration and compliance costs for the ATO.

However relying on tax administrators and the judicial process to resolve *uncertainty* in the tax law would clearly be inferior to legislating to provide 'upfront' certainty (for example, through introducing clear statutory inclusions or exemptions or specific legislative schemes such as IMRs).

Revenue impact

While there would be no direct costs to revenue from Option 1 (as current tax settings would be left unchanged), there could be an indirect (negative) impact should it result in lower economic growth by impeding the development of Australia as a regional financial centre.

OPTION 2: CHANGE THE INCOME TAX LAW TO ENSURE DEFINE AND FULLY TAX AUSTRALIAN INCOME OF FOREIGN MANAGED FUNDS

Option 2 would seek to subject to Australian income tax the Australian income of foreign managed funds.

Compliance Costs/Enforcement

This option would pose very significant enforcement difficulties for the ATO. While it would improve certainty of treatment compared with the current law, there could also be significant compliance costs for non-resident taxpayers, particularly where international taxation treaty issues arise.

Revenue impact

While in theory this approach might be expected to raise additional revenue, in practice the significant practical difficulties involved in enforcing this legislation would mean that the revenue impact may not be very different to under the current law. In addition, as with Option 1, there could be an indirect (negative) impact should it result in lower economic growth by impeding the development of Australia as a regional financial centre.

OPTION 3: **CHANGE THE INCOME TAX LAW TO RESTRICT THE TAXATION OF AUSTRALIAN INCOME OF PORTFOLIO INVESTMENTS OF FOREIGN MANAGED FUNDS (IMR)**

Option 3 would seek to resolve uncertainty in relation to current income taxation treatment of foreign managed funds by restricting the application of Australian income tax law, subject to appropriate safeguards to protect the integrity of measures, consistent with the recommendations of the Board of Taxation report.

Improved certainty/reduced compliance costs

This option, by exempting a range of portfolio type investments, improves certainty with respect to tax treatment of investment management services within. In particular the exemption regime would address current revenue/capital, source and permanent establishment issues affecting foreign managed funds through providing **specific tax outcomes** over these issues. This approach should reduce compliance costs by removing the need for investors to work through a series of sophisticated provisions in the law.

Impact on resident savers and investors

The measures are not expected to have a significant impact on Australia resident savers and investors.

As an exemption style regime would provide a different tax treatment to foreign investors than is provided to resident savers and investors in the absence of other measures it would provide an incentive Australian residents to structure their affairs in such a way as to take advantage of the more favourable tax treatment. In order to reduce the risk to the resident tax base the IMR will include a number of integrity measures designed to minimise the potential such structuring. These measures include

A **widely held requirement** would mean that, in order to gain access to the IMR, foreign managed funds would need 25 or more members. This limits the opportunity for Australian investors to engage in 'clubbing' arrangements which involve a small number of people with similar tax profiles banding together to access the benefits of the regime by structuring through an off-shore entity.

Requiring a fund to be widely held will reduce the likelihood that a small number of people with similar tax profiles will be able control the investments of a foreign managed fund and hence benefit inappropriately from the IMR.

- the requirement that foreign managed funds be domiciled in countries which are recognised by Australia as engaging is **effective exchange of tax information**. This will enable the Commissioner of Taxation to request information on foreign managed funds operating in Australia, including details about their Australian investors (if any).

The integrity rules designed to protect the revenue base from the incentive for resident investors to restructure affairs to take advantage of the preferential treatment of foreign managed funds are disclosure based, and should not impose significant compliance costs on resident taxpayers or funds.

Australian funds management sector.

The Johnson Report the Australian funds management industry currently manages only a small volume of funds from offshore.[8] This option would reduce compliance costs of the industry by providing certain treatment in relation to the management of foreign funds by Australian domiciled fund managers. In the longer term, as this option removes an impediment to the development of the Australian funds management industry it could be expected to assist in the development of Australia as a regional financial centre.

CONSULTATION

Extensive consultation was undertaken with industry, stakeholders, the ATO and the Board of Taxation throughout this process. See RIS published on 16 September 2011[9].

Consultation with the Financial Centre Task Force (FCTF) (formerly AFCF)

Treasury has met with the FCTF in order to review the benchmarks which had proposed when designing a framework for the IMR suggested in the Johnson Report.

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

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[8] *Australia as a Financial Centre* Report by the Australian Financial Centre Forum, November 2009, suggests up to 11% of funds under management are sourced offshore (p27). It notes ABS data suggesting the proportion is only 3.5%.

[9] (ibid)

Treasury has consulted closely with the Board of Taxation and its Panel of practitioner advisers on the development of the IMR.

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 early version IMR, specifically in relation to the design principles underpinning the early version IMR.

Later the Assistant Treasurer requested that the Board of Taxation bring forward its consideration of an IMR as it applies for foreign managed funds to 1 September 2011. As noted above, the Board of Taxation has since delivered that report and the recommendation option is consistent with that report.

Consultation with the Australian Taxation Office (ATO)

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.

Revenue impact

Option 3 of the IMR has been assessed as having an unquantifiable but small cost to revenue over the forward estimates.

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 that is attributable to a prospective exemption (option 3) is unquantifiable but small.

CONCLUSION

RECOMMENDED OPTION

The recommended option is Option 3 would seek to resolve uncertainty in relation to current income taxation treatment of foreign managed funds by restricting the application of Australian income tax law, subject to appropriate safeguards to protect the integrity of measures, consistent with the recommendations of the Board of Taxation report.

IMPLEMENTATION AND REVIEW

The IMR would be implemented by amending the Income Tax Assessment Act 1997.

As discussed, implementing Option 3, an IMR which addresses funds management issues for foreign managed funds, is anticipated to reduce their compliance costs and transaction costs. This initiative is also expected to reduce administrative costs for the ATO. As the purpose of Option 3 is to address deficiencies in the tax treatment of foreign managed funds and reduce the complexity of those arrangements, transitional arrangements would not be required.

Treasury and the ATO will monitor this taxation arrangement, as part of the whole taxation system, on an ongoing basis in order to identify and manage any unanticipated issues arising from implementing the IMR. It is intended that there will be a review of the IMR 2 years after its implementation.

APPENDIX A

Proposed treatment of investments of foreign managed funds

Table 1: Investments of foreign managed funds

Income	***Tax treatment if covered by Interim IMR***
Gains or losses from disposal of portfolio equity interests in companies (including shares in ASX-listed companies)	Disregarded[10]
Gains or losses from disposing of portfolio interests in other entities (including units in a unit trust)	Disregarded[11]
Gains or losses from disposal of bonds	Disregarded, other than when gain is considered to be 'in the nature of interest' and subject to interest withholding tax.
Gains or losses from derivatives	In general, disregarded unless gain or loss from the derivative is in respect of an underlying interest that is otherwise taxable.
Foreign exchange gains or losses	In general, disregarded unless foreign exchange gain or loss is in respect of an interest that is otherwise taxable.
Rental income from offshore land	No change — no Australian tax
Gains or losses from disposals of offshore land	No change — no Australian tax
Interest, dividends or royalties paid by an Australian payer	No change — withholding tax (where it applies)
Interest, dividends or royalties paid by a foreign payer	No change — no withholding tax
'Fund payment' from an Australian managed investment trust (MIT)	No change —MIT withholding tax
Rental income from land in Australia	No change — maintain Australian taxation
Gains or losses from disposals of land in Australia	No change — maintain Australian taxation

[10] That is, gains are not subject to Australian tax, losses are not deductible.

[11] Except to the extent that privately held companies are land rich, as defined in Division 855 of the income Tax Assessment Act 1997, in which case they would not be eligible for the exemption under the IMR.