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What Hedge Funds Need to Know About Tax Relief Under the New Australian Investment Manager Regime

Jun. 11, 2015

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A new Australian investment manager regime (IMR) is set to take effect on July 1, with possible retroactive effect to 2011. Following the U.K. Investment Manager Exemption (IME) model, the IMR is intended to provide eligible foreign investors with relief from Australian tax with respect to most investments in Australia. This article discusses the history and current status of the IMR provisions; elements and scope of Australian tax exemptions under the IMR; certain considerations when establishing a hedge fund in Australia under the IMR; the potential impact of the IMR on the hedge fund industry in Australia; and a comparison of the Australian IMR to other similar regimes. For more on the Australian IMR, see "Key Hedge Fund Tax Developments in the U.K., the European Union, Ireland, Germany, Spain, Australia, India and Puerto Rico," Hedge Fund Law Report, Vol. 6, No. 26 (Jun. 27, 2013).

History and Current Status of the Changes

The new provisions of the IMR are intended to take effect from 1 July 2015, with the option to elect retrospective application from 1 July 2011. The IMR will provide eligible foreign investors with certainty in relation to the Australian tax treatment of their investments. Broadly, the IMR provides an Australian tax exemption to foreign investors for all investments other than direct Australian real property holdings and non-portfolio investments in Australian entities. Amounts subject to Australian withholding tax (e.g., interest, dividend and royalty payments) will continue to be subject to the withholding provisions. The inclusion of an independent Australian fund manager limb to the concession will provide significant benefits to the Australian funds industry and encourage foreign funds to engage Australian managers.

Background

The objective of the IMR provisions is to remove the tax impediments to investing in Australia – attracting foreign investors in Australia by exempting specific classes of income of qualifying foreign funds from Australian tax. The IMR provisions also promote the use of Australian managers by ensuring foreign investors are in the same position as if they had invested in the underlying investments directly.

The industry has been waiting a long time for the introduction of an IMR in Australia. An Australian IMR was initially recommended in a report entitled *Australia as a Financial Centre: Building on our Strengths* (Johnson Report), dated November 2009 and released in January 2010 by the Australian Financial Centre Forum. The Johnson Report identified some key impediments to foreign funds investing in Australia. Whilst not specific as to what the IMR would encompass, the recommendations in the Johnson Report set out the broad principles on which the IMR should be based.

Through subsequent government announcements and reviews by the Board of Taxation, the IMR has been implemented in stages, and, as such, the scope of the exemptions has remained limited. However, the latest bill enacting the IMR (Bill) includes the remaining concessions, and once the Bill is effective, the new legislation will implement the complete IMR.

Prior to releasing the Bill, the Australian government had released four Exposure Drafts containing the complete IMR. Industry associations such as the Alternative Investment Management Association (AIMA) were very vocal in expressing concern that earlier Exposure Drafts were too limited and restrictive and that few hedge funds would qualify for the exemption. In response to such concerns, a number of positive concessions have been made to the Bill, including broadening of the "widely held" test described below and concessions for start-up funds.

Summary of the Bill

The IMR as contemplated in the Bill contains concessions with respect to both direct investments by foreign funds and indirect investments where a local intermediary is engaged.

The complete IMR provides concessions with respect to both:

1. Direct investment, which involves a foreign investor investing directly without the use of an Australian intermediary. The investors to whom the concession will be available is limited to funds that meet the widely held tests and other deemed widely held entities; and
2. Indirect investment, which involves the engagement of an independent Australian investment manager or broker.

The Bill has been largely commended, as it addresses concerns raised over the course of the consultation process. In particular, the Bill includes improvements to the onerous "gateway" tests to the IMR regime that were contained in prior Exposure Drafts, including the redrafted widely held tests; the removal of the requirement for foreign funds to provide an annual statement to the Commissioner of Taxation; and the expansion of the application of the rules to all foreign funds rather than only those that are resident in an information exchange country.

Scope of the IMR Exemption

Once the full IMR has been implemented, it is intended that a foreign fund which qualifies under the IMR regime will be excluded from Australian tax on gains and losses from the disposal of non-Australian entities and portfolio equity interests (i.e., interests of <10%) in Australian entities. Gains and losses from specific financial products are also excluded.

The exemption applies to specified income classes and does not extend to Australian real property. Income in the form of dividends, interest and royalties will remain subject to

withholding tax. Private equity-style investments would not be subject to the exemption, and exposure to Australian tax would remain for investors in those products.

It is not intended that the exemptions will be available to all foreign investors, and foreign funds that do not satisfy the IMR requirements will continue to be taxed under general Australian income tax rules.

There are significant tax concessions available to qualifying funds under the IMR regime, and, as such, a hedge fund that is contemplating investing either directly or indirectly into Australia should consider what options are available to them and whether they would qualify under the rules.

Direct Investment

In order to access the IMR regime, a hedge fund that is investing directly would need to be an IMR entity that is also an "IMR widely held entity." In this case, the nature of the foreign investor is quite specific.

Broadly, an entity is an "IMR entity" for an income year if it is a foreign resident entity at all times during the income year and does not carry on or control a trading business at any time during the income year.

An IMR entity is "widely held" if no member of the entity has a "total participation interest" in the entity of 20% or more or there are not 5 or fewer members who have a combined participation interest in the entity of at least 50%. Certain entities, such as foreign life insurance companies and pension funds are deemed to be widely held. Where such entities hold a majority interest in a foreign fund, the fund would qualify as an IMR widely held entity.

In determining total participation interest, reference is made to both direct and indirect participation. As such, it is possible to trace through investors and entities to determine whether an IMR meets the tests.

A further requirement for an IMR widely held entity is that none of the returns, gains or losses from the financial arrangement must be attributable to a permanent establishment in Australia.

Indirect Investment

If a hedge fund is unable to qualify for concessions under the direct investment limb, then it may still be able to qualify under the indirect investment limb of the IMR if it appoints an independent Australian fund manager.

A foreign fund may qualify for tax concessions where it satisfies the tests for an IMR entity (excluding the widely held conditions) and engages an "independent Australian fund manager." An entity is an "independent Australian fund manager" where no more than 70% of the managing entity's income for the income year is received from the IMR entity (or associates). There is a concession available for new managing entities unable to meet the 70% test for the first 18 months. Further, the remuneration of the managing entity must be determined on an arm's length basis.

Where the managing entity does not satisfy the tests for independence, the foreign fund will need to then satisfy the test for an "IMR widely held entity" in order to access the concessions.

Where the Concession Is Not Accessible

The IMR concession is reduced where the independent Australian fund manager as well as its connected entities have a right to receive, either directly or indirectly, more than 20% of the IMR entity's profits for that year.

The concessions are not intended to apply to all foreign funds, and, to the extent that a foreign fund does not qualify, it will be subject to the general tax laws and may incur some tax exposure where the fund invests into Australia.

Previous practice for hedge funds, in the absence of the IMR, has been to gain access to the Australian market through derivatives that are sourced outside Australia. This may continue to be the case; however, investors should be aware of any associated risks with this type of investment.

Other Considerations of Establishing a Hedge Fund in Australia Under the IMR

There are specific rules that apply to an IMR entity that is starting up or winding down. If an IMR entity has never satisfied the total participation interests test, then it is still taken to be an IMR widely held entity, provided that it is being actively marketed with the intention of satisfying the total participation tests. It will be a question of fact as to whether an IMR is being actively marketed, and this requires evidence of ongoing genuine attempts to obtain third-party investment to meet the total participation interests test. Whilst no express time is given as to how long an IMR entity can be actively marketed with the intention of becoming widely held, the Explanatory Memorandum issued by the Australian government states that a reasonable period of time is 18 months.

The rules also cover an IMR entity whose activities and investments are being wound down. The IMR entity in this case will continue to be considered to be widely held, even if it no longer satisfies the total participation interests test.

Potential Impact on the Hedge Fund Industry

The IMR is regarded as a positive development for the hedge fund industry for a number of reasons. Currently, many foreign funds are using swaps to gain exposure to Australian investments. It is anticipated that going forward under the IMR, eligible foreign funds will be able to invest in Australian investments more directly.

In addition, hedge fund principals now have the opportunity to relocate to Australia. Currently, many Australians wanting to return have been deterred by the tax uncertainty for their foreign investors if they were to manage money from Australia.

Likewise, the IMR is likely to encourage more Australian fund managers to actively market their investment management services globally and for offshore funds to establish trading operations in Australia.

Comparison of Australian IMR to Other Regimes

The Bill contains measures that have been largely modelled on the U.K. IME. Similar investment manager regimes also operate in Hong Kong and Singapore. See "K&L Gates Partners Offer

Practical Guidance for Hedge Fund Managers on Raising Capital in Australia, the Middle East and Asia," Hedge Fund Law Report, Vol. 7, No. 41 (Oct. 30, 2014).

The IME has been largely recognised as a successful and effective regime. Mirroring the IME rules will give foreign funds and investors a better understanding of the Australian IMR laws and the scope of the concessions available.

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