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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2013 MEASURES NO. 2) BILL 2013: INVESTMENT
MANAGER REGIME

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>
ATO	Australian Taxation Office
CGT	Capital Gains Tax
IMR	Investment Manager Regime
IT(TP) Act 1997	<i>Income Tax (Transitional Provisions) Act 1997</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
MIT	Managed investment trust
TAA 1953	<i>Taxation Administration Act 1953</i>
TAP	Taxable Australian property
TARP	Taxable Australian real property
The Johnson Report	Australia as a Financial Centre Report – November 2009.

General outline and financial impact

Element 3 of the Investment Manager Regime

Schedule # to this Bill amends the *Income Tax Assessment Act 1997* to introduce the third and final element of the Investment Manager Regime (IMR). These reforms expand the exemption available for qualifying investment income of certain foreign widely held foreign managed funds.

Schedule # also amends aspects of the first two elements of the IMR that were enacted in the *Tax Laws Amendment (Investment Manager Regime) Act 2012*. These changes apply to the previous income years to which the first two elements of the IMR applied and include modifications to the widely held and concentration tests, as well as other technical amendments.

Date of effect: Broadly, this measure applies from the 2011-12 income year. However, some parts of the measure that amend the first two elements of the IMR will apply to prior income years.

Proposal announced: The measure was announced by the Minister for Financial Services and Superannuation in Media Release No. 168 of 16 December 2011.

Financial impact: This measure represents the final part of the IMR reforms which were included in the 2010-11, 2011-12 and 2012-13 Budgets. The measure is estimated to have a small but unquantifiable cost to revenue over the forward estimates period.

Human rights implications: This Bill does not raise any human rights issue.

Compliance cost impact: This measure will reduce compliance costs by removing the need for investors to work through a series of sophisticated provisions in the law. This measure is also expected to reduce administrative costs for the ATO.

Summary of regulation impact statement

Regulation impact on business

Impact: These changes clarify the tax treatment of qualifying investment income of certain foreign widely held foreign managed funds. In so doing they will impact:

- foreign residents who invest through foreign managed funds; 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 foreign managed funds.

Main points:

- The Regulation Impact Statement for this measure examined three options for addressing the uncertainty generated by the general rules relating to source, permanent establishments and the distinction between revenue and capital for certain financial arrangements.
- These options were to:
 - Rely on administrative practice to create certainty over time;
 - Amend the law so the investment income of foreign managed funds is more clearly captured by Australia's income tax regime; or
 - Amend the law to limit the taxation of qualifying investment income of certain foreign managed funds.
- The third option, being the option to limit the taxation of qualifying investment income of certain foreign managed funds, is the subject of this measure.

Chapter 1

Element 3 of the Investment Manager Regime

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to introduce the third element of the Investment Manager Regime (IMR). These reforms expand the existing exemption available for qualifying investment income of certain foreign widely held managed funds. These entities must be residents of information exchange countries and meet information reporting requirements.

1.2 Schedule # also amends aspects of the first two elements of the IMR that were enacted in the *Tax Law Amendment (Investment Manager Regime) Act 2012*. These changes apply to previous income years to which the first two elements of the IMR applied and include modifications to the widely held and closely held tests, as well as other technical amendments.

1.3 All legislative references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.4 The proposal to introduce an IMR arose from a recommendation of the *Australia as a Financial Centre: Building on our Strength - Report by the Australian Financial Centre Forum* (the Johnson Report). In that report it was noted that the uncertainties and scope of Australia's tax system acted as an impediment to cross-border activities. The introduction of an IMR, providing clear and comprehensive statutory rules for the taxation of foreign resident's investment income, was proposed as a means of addressing these impediments and as a means of encouraging the use of Australian financial service intermediaries.

1.5 In addition, recommendation 35 of the *Australia's Future Tax System: Report to the Treasurer* was to improve the conduit income arrangements for managed funds. Under the rules applying at the time, some conduit income was potentially taxable in Australia due to it being considered Australian sourced or attributable to an Australian permanent establishment.

1.6 Representations from the managed funds industry also highlighted issues with complying with the US Accounting Standard ASC 740-10 (widely known as 'FIN 48'), which requires funds reporting under the US Generally Accepted Accounting Principles to raise tax provisions for potential tax exposures from 'uncertain' tax positions. Such a tax provision affects a fund's net asset value and unit redemption price (where the fund is not exchange traded). Industry advised the Government that as a result of FIN 48, funds were reviewing their investments in Australia.

1.7 As part of the 2010-11 Budget the Government provided in-principle support for the introduction of an IMR and released a discussion paper entitled *'Developing an investment manager regime: improving conduit income arrangements for managed funds'* at the same time.

1.8 The Government subsequently announced the implementation of the first two elements of the IMR in the following terms:

- Element 1 would address the 'FIN48' issue reported by industry, by amending the law to restrict the Commissioner of Taxation's ability to raise assessments in respect of certain investment income of a foreign managed fund for the 2010-11 and prior income years;
- Element 2 would address the tax uncertainty where a widely held foreign managed fund engaged an Australian-based financial services intermediary with respect to certain investments. In particular, it would ensure that income from such investments would be exempt from Australian tax if the only reason it was taxable was because the fund engaged the financial services intermediary. This element would apply from the 2010-11 income year and is also known as the 'conduit income exemption'.

1.9 These first two elements were enacted in the *Tax Laws Amendment (Investment Manager Regime) Act 2012*. This Act received Royal Assent in September 2012.

1.10 As part of the reforms, the Government requested that the Board of Taxation prepare a report on the design of an IMR as part of its review of the taxation of collective investment vehicles.

1.11 On 16 December 2011, the Minister for Financial Services and Superannuation responded to the Board's Report, announcing that the Government would introduce the third and final element of the IMR.

- Element 3 extends the IMR so that a broader range of investments are exempt from Australian tax. In effect, element 3 is intended to address the tax uncertainty faced by a widely held fund investing into Australia, whether using an Australian based intermediary or not.

1.12 On 21 December 2012, the Minister for Financial Services and Superannuation further announced that the existing ‘widely held’ and ‘concentration’ tests, which applied to the already enacted elements 1 and 2 and would also apply to element 3, would be amended.

Operation of the current law

1.13 Consistent with international tax principles, Australia generally taxes its residents on their worldwide income and taxes foreign residents on their Australian sourced income.

1.14 Notwithstanding the existing IMR rules, a foreign managed fund that invests in Australia would generally be taxed on all income from Australian sources and on capital gains that arise in relation to CGT assets that are ‘taxable Australian property’ (for the tax treatment of capital gains of foreign residents, see Division 855).

1.15 As identified in the Johnson Report, particular questions must be answered in order to determine whether a foreign resident is liable to pay tax in Australia. Such question can include whether the foreign resident has a permanent establishment in Australia, whether the foreign resident’s income is Australian sourced, and whether that income is on capital or revenue account.

1.16 Subdivision 842-I (which introduced element 2 of the IMR) sought to address some of the uncertainties that arise as a result of these concepts and distinctions. It did this by modifying the general tax treatment of investments made through an ‘IMR foreign fund’.

1.17 Not all foreign resident entities can access the current IMR. To be considered an ‘IMR foreign fund’ a fund must pass a widely held and concentration test, and cannot:

- be an Australian resident at any time during the income year; or
- undertake a trading business in Australia at any time during the year (note, the omission of the requirement that such trading business be carried on in Australia is rectified by these amendments) .

1.18 The widely held and concentration tests are key aspects of the IMR (note that under element 3, the concentration test is renamed the 'closely held test'). The widely held test ensures that the fund is a genuine collective investment vehicle in which a number of investors pool their resources. The concentration test supports the widely held test by ensuring that a small number of the investors do not hold a significant proportion of the interests in the fund. It also acts as an important integrity measure, reducing the risk that the IMR is used by Australian residents for tax deferral purposes.

1.19 Subdivision 842-I only covers certain investments of qualifying funds. Significantly, it is only intended to cover passive investments. In translating this principle into law, Subdivision 842-I therefore generally applies to returns or gains from financial arrangements with entities in which a fund holds a total participation interest of less than 10 per cent, and over which the fund cannot exercise substantial influence.

1.20 Such returns or gains are exempt or disregarded under Subdivision 842-I where they are Australian sourced because the fund has a permanent establishment in Australia solely as the result of engaging an Australian intermediary (for example, an investment manager). This treatment ensures that Australia does not tax the overseas investment income of foreign residents simply because they engage Australian managers, agents or service providers.

1.21 Deductions or losses made in the course of deriving returns or gains to which Subdivision 842-I applies are also disregarded in calculating the foreign fund's Australian tax position.

1.22 Special rules also ensure that the IMR exemption only flows to foreign resident beneficiaries and partners where the IMR foreign fund is a trust or partnership.

Interaction with FIN48 (IMR element 1)

1.23 As well as introducing Subdivision 842-I (element 2 of the IMR), the *Tax Laws Amendment (Investment Manager Regime) Act 2012* also enacted element 1 through amendments to the *Income Tax (Transitional Provisions) Act 1997* (IT(TP) Act 1997). These amendments were introduced to overcome potentially adverse consequences of FIN 48 by removing any uncertainty over the tax positions of foreign funds that had invested in Australia in the 2010-11 and previous income years.

Summary of new law

1.24 The purpose of element 3 of the IMR is to provide certainty in relation to the Australian income tax treatment of income from certain financial arrangements of qualifying widely held foreign funds. In particular, it seeks to remove the need for such funds to determine whether income from these investments is on capital or revenue account.

1.25 To achieve this, whilst at the same time retaining the effect of element 2 of the IMR, these amendments to Subdivision 842-I remove the existing requirement that returns or gains from financial arrangements with entities in which an IMR foreign fund holds a portfolio interest would be included in the assessable income of the fund only because the returns or gains are Australian sourced because the fund has a permanent establishment in Australia as the result of engaging an Australian intermediary.

1.26 In addition, the amendments also extend element 2 of the IMR (the conduit income measure) to financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest. To ensure that this extension only applies in relation to conduit income (income from investments overseas), the permanent establishment tests under the current law (which no longer applies to portfolio interests) is retained in respect of financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest.

1.27 These amendments also introduce additional eligibility criteria that an entity must satisfy in order to be an IMR foreign fund. In addition to the existing requirements, a fund must be a resident of an information exchange country and must submit an information statement to the Commissioner of Taxation (Commissioner) in respect of each income year that it is an IMR foreign fund.

1.28 These amendments also change the existing widely held test and concentration test (which is renamed as the 'closely held test'). The revised closely held test applies to each member of the fund (rather than any entity that holds an interest), and introduces an additional requirement that a total participation interest of 10 per cent or more cannot be held by a single member. Special rules are also included for determining a fund's members. These rules count individuals as members where they hold their interest in the fund indirectly through one or more interposed entities. The rules also include provisions for counting members when interests in the fund are held by 'foreign widely held entities', and where interests are held by related individuals and other entities acting in the capacity of their nominees.

1.29 The amendments also include a ‘start-up’ rule to complement the existing ‘wind-down’ rule. Consistent with the existing ‘wind-down’ rule, the widely held and closely held tests will be deemed to be satisfied when a fund is in its start-up phase. Integrity rules are included to ensure that this start-up phase rule will only apply in respect of entities that ultimately become IMR foreign funds, and to ensure that the start-up and wind-down phase rules cannot be used consecutively.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Changes to the definition of IMR foreign fund	
To qualify as an IMR foreign fund for an income year, an entity must be a resident of an information exchange country at all times during the income year.	No equivalent
To qualify as an IMR foreign fund for an income year, an entity must lodge an information statement in respect of the income year with the Commissioner in the approved form.	No equivalent
An entity cannot qualify as an IMR foreign fund for an income year if it carries on or controls a trading business in Australia at any time during that income year.	An entity cannot qualify as an IMR foreign fund for an income year if it carried on a trading business at any time during that income year.
In determining whether a fund is widely held, entities that are interposed between a fund and individual interest holders or foreign widely held entities are disregarded. Individuals are treated as members of the fund, and foreign widely held entities are allocated 50 notional ‘individual’ members.	In applying the widely held test, the ordinary membership rules (which relate to direct interests in the fund) apply.
In determining whether a fund breaches the closely held test, the total participation interests of individuals (being members under the widely held test) are assessed. A fund will breach the closely held test if a member holds a total participation interest in the fund of 10 per cent or more or if 10 or fewer	In determining whether a fund breaches the concentration test, the total participation interest of any entity that holds an interest in the fund is assessed. A fund will breach the concentration test if 10 or fewer entities have a combined total participation interest

members of the fund have a combined total participation interest in the fund of 50 per cent or more.	in the fund of 50 per cent or more.
In determining whether a fund satisfies the widely held test of breaches the closely held test, direct participation interests of one entity in another that are voting interests are disregarded.	In determining whether a fund satisfies the widely held test of breaches the closely held test, all direct participation interests are taken into account.
A start-up phase rule (with relevant integrity rules) deems an entity to have satisfied the widely held test, and to have not breached the closely held test, for the income year in which it was created, as well as for the next income year if it was created in the second half of the income year.	No equivalent.
Changes to covered financial arrangements	
A return or gain from a financial arrangement that is with an entity in which an IMR foreign fund holds a non-portfolio interest (determined in accordance with section 960-195) gives rise to a non-portfolio interest (10 per cent or more) can be IMR income or an IMR capital gain if it is attributable to an Australian permanent establishment that only existed because the fund engaged an Australian intermediary.	A return or gain from a financial arrangement with an entity in which an IMR foreign fund holds a total participation interest of 10 per cent or more will generally not be IMR income or an IMR capital gain.

Detailed explanation of new law

Objects of Subdivision 842-I of ITAA 1997

1.30 The objects of the Subdivision have been amended to reflect the fact that the IMR now includes element 3. There are two objectives of the provisions, each of which is broadly consistent with those of element 2 of the IMR.

1.31 The first objective is to address uncertainty that exists as a consequence of particular aspects of Australia's taxation laws and the impediments that such uncertainty may have on particular international investments into or through Australia. *[Schedule #, item 3, paragraph 842-205(1)(a)]*

1.32 This uncertainty relates to the Australian income tax consequences for widely held foreign managed funds in two key areas. The first area relates to the use by such funds of Australian-based agents, managers or service providers in circumstances where returns or gains of the fund might be taxable in Australia solely because of the use of such intermediaries. The second area relates to the investments of foreign widely held managed funds into Australian assets and whether or not the return or gains from those assets are on capital or revenue account.

1.33 The second key objective of the provisions is to ensure that Australia retains its taxing rights in respect of the worldwide income of its residents and continues to tax foreign resident taxpayers on their returns and gains from most taxable Australian property. *[Schedule #, item 3, paragraph 842-205(1)(b)]*

Changes to the definition of 'IMR foreign fund'

1.34 Access to the IMR is only available for an entity that qualifies as an 'IMR foreign fund' in respect of a particular income year. (For simplicity, references to a 'fund' hereinafter refer to an entity to which the criteria for being an IMR foreign fund apply).

1.35 Currently under Subdivision 842-I, a fund cannot be an IMR foreign fund in relation to an income year if at any time during the income year it is an Australian resident, a resident trust estate, or carries on a trading business. These criteria are intended to ensure that the IMR only applies to foreign funds that do not undertake active businesses in Australia.

1.36 In addition, a fund must satisfy the widely held test at all times during the income year, and must not breach the concentration test at any time during the income year. These tests ensure that eligible funds are genuine collective investment vehicles, and that a small group of investors do not hold a significant proportion of the interests in the fund.

1.37 The amendments to Subdivision 842-I introduce two additional criteria that must be satisfied in order for a fund to be an IMR foreign fund in respect of an income year. These criteria require that the fund:

- at all times during the income year, be a resident of an 'information exchange country'; and
- submit an information statement to the Commissioner in relation to the income year.

1.38 In respect of the existing criteria, the amendments modify:

- the requirement related to an entity carrying on a trading business;
- the widely held test; and
- the concentration test (which is now called the ‘closely held’ test).

1.39 The amendments also introduce new rules which apply to the widely held and closely held tests. These changes:

- introduce rules to calculate the members of the fund and their total participation interests in the fund; and
- provide a rule in respect of the ‘start-up phase’ of the fund, consistent with the existing rule in respect of ‘wind-down phases’.

Additional criteria for being an IMR foreign fund

The fund must be a resident of an information exchange country

1.40 The amendments to the criteria for IMR foreign funds include an additional requirement that a fund must at all times during the relevant income year be a resident of an information exchange country. [*Schedule #, item 6, paragraph 842-230(aa)*]

1.41 The term, ‘information exchange country’ is defined by subsection 12-385(4) of Schedule 1 to the TAA 1953. The relevant test for when an entity is a resident of an information exchange country is contained in subsection 12-390(7) of Schedule 1 to the TAA 1953. However in contrast to the way that rule generally applies (that is, discretely at particular points in time), the IMR criteria require that a fund satisfy the information exchange country residency test at all times throughout the income year.

1.42 This requirement is appropriate given the concessional nature of the IMR, and the potential for limited access to information to undermine the Commissioner’s ability to effectively administer regimes that include tests that involve offshore arrangements. The information exchange country residency requirement therefore provides the Commissioner with better access to information in respect of eligible funds and their members, and is consistent with Australia’s broader efforts to promote effective information exchange globally as a means of combatting tax avoidance.

1.43 Given that this requirement has been introduced to ensure the Commissioner has access to appropriate information, the test can still be

satisfied where a fund changes its residence from one information exchange country to another during an income year (the requirement is in relation to ‘an’ information exchange country, rather than ‘a single’ information exchange country).

Application of the information exchange country residency requirement to income years in which a fund is created or ceases to exist

1.44 A fund that is created or ceases to exist during an income year will only be a resident of a country for the time that it actually exists. Such funds will be unable to satisfy the general requirement that they be a resident of an information exchange requirement *at all times* during an income year.

1.45 In order to ensure that the information exchange country residency requirement applies appropriately in respect of income years in which a fund is created or ceases to exist, the part of such a year that the fund actually existed is deemed to have been the entire income year for the purpose of applying the information exchange country residency test to the fund. *[Schedule #, item 11, subsection 842-235(1) and paragraph 842-235(2)(a)]*

1.46 As the result of this rule, a fund is not required to satisfy the information exchange country residency requirement in respect of the part of income year in which it did not exist.

The entity must provide an information statement to the Commissioner

1.47 A new criteria is also included that requires that a fund provide an information statement to the Commissioner in respect of an income year in order to qualify as an IMR foreign fund for that income year. *[Schedule #, item 10, paragraph 842-230(d)]*

1.48 The purpose of this rule is to require IMR foreign funds to notify the Commissioner that they have accessed the IMR in respect of an income year. Although funds must also be residents of information exchange countries in order to qualify as IMR foreign funds, the self-assessment nature of the IMR means that eligible entities are relieved from the need to lodge a tax return in respect of income or gains to which the IMR applies.

1.49 In the absence of the information statement rule, the lack of formal reporting requirements can make it difficult for the Commissioner to identify which entities obtain the benefit of the IMR, or distinguish between compliant and non-compliant funds.

Division 395 of Schedule 1 to the TAA 1953

Annual information statement

1.50 Although the link between a fund's status as an IMR foreign fund and the provision of the information statement to the Commissioner is contained in Subdivision 842-I, the obligation to provide the information statement is imposed separately under Division 395 of Schedule 1 to the TAA 1953 (which is inserted by these amendments).

1.51 Division 395 of Schedule 1 to the TAA 1953 (Division 395) requires an entity that is an IMR foreign fund in relation to an income year to provide the Commissioner with a statement in respect of that income year. *[Schedule #, item 33, subsection 395-5(1) of Schedule 1 to the TAA 1953]*

1.52 The statement must be in the approved form, and must be provided to the Commissioner within three months of the end of the relevant income year (being the income year in relation to which the entity was an IMR foreign fund). *[Schedule #, item 33, subsections 395-5(2) and (3) of Schedule 1 to the TAA 1953]*

1.53 Given that a failure to submit an information statement prevents a fund from being an IMR foreign fund in relation to the relevant income year, any IMR income or IMR gains that would have otherwise been exempt or disregarded under Subdivision 842-I will become taxable (and will therefore require the lodgement of an Australian income tax return). The three month time period is therefore intended to strike a balance between providing entities with adequate time to prepare and submit the information statement to the Commissioner, while ensuring that sufficient time remains for entities, including beneficiaries or partners of an IMR foreign fund, to finalise their Australian tax positions in the event that they are required to lodge an Australian tax return for that income year.

1.54 The statement is intended to provide the Commissioner with information in respect of the name and address of the fund, the country or countries of which the fund was resident during the income year, the fund's status as an IMR foreign fund, and the application of Subdivision 842-I to the fund for the income year. *[Schedule #, item 33, subsection 395-5(4) of Schedule 1 to the TAA 1953]*

1.55 Although these amendments describe the types of information required in the information statement, the references to such information do not limit the information that may be required in the approved form. *[Schedule #, item 33, subsection 395-5(5) of Schedule 1 to the TAA 1953]*

1.56 As such, in addition to the specified types of information, the information statement could be used to collect information relevant to the

underlying policy intent of the regime and to inform any future analysis of the regime.

1.57 In determining whether an entity is an IMR foreign fund for the purpose of Division 395, the requirement in the eligibility criteria for being an IMR foreign fund in respect of the provision of an information statement to the Commissioner is disregarded. *[Schedule #, item 33, section 395-15 of Schedule 1 to the TAA 1953]*

1.58 This rule addresses a circularity issue that arises from Division 395 applying to IMR foreign funds, and an entity's status as an IMR foreign fund being contingent on it providing the Commissioner with a statement required under Division 395. As a result of this rule, the other criteria for an entity being an IMR foreign fund are relevant in determining whether an entity is required to provide a statement to the Commissioner in respect of an income year. The provision of the completed information statement to Commissioner will then satisfy the information statement requirement for the entity under paragraph 842-230(1)(d) for that income year.

Notification of other entities

1.59 In addition to providing an information statement to the Commissioner in respect of an income year, a trust or partnership that is an IMR foreign fund under Division 395 must provide a written notice containing information in respect of its status as an IMR foreign fund for the income year to each of its foreign resident beneficiaries or foreign resident partners. *[Schedule #, item 33, subsections 395-10(1), (2), (4) and (6) of Schedule 1 to the TAA 1953]*

1.60 The provision of this information is required because a trust or partnership's status as an IMR foreign fund will have direct consequences for the Australian tax position of its foreign resident beneficiaries or foreign resident partners. As such, whether or not the trust or partnership has satisfied the criteria for being an IMR foreign fund will be relevant for each beneficiary or partner of the fund.

1.61 Where an IMR foreign fund publishes the relevant information on a website in a way that is readily accessible to its foreign resident beneficiaries or foreign resident partners, the IMR foreign fund will be treated as having provided written notification to each of its foreign resident beneficiaries and foreign resident partners. *[Schedule #, item 33, subsection 395-10(3) of Schedule 1 to the TAA 1953]*

1.62 Consistent with the information statement to the Commissioner, entities that are IMR foreign funds under Division 395 must provide the notification no later than the same time that the information statement to the Commissioner is due (that is, within three months of the end of the

relevant income year, being the income year in relation to which the entity was an IMR foreign fund). *[Schedule #, item 33, subsection 395-10(4) of Schedule 1 to the TAA 1953]*

1.63 Although in practice it is expected that an IMR foreign fund will be required to provide the information statement to the Commissioner prior to providing the notification (given that fund's status as an IMR foreign fund under Subdivision 842-I is contingent upon the provision of the information statement to the Commissioner), the same three month time limit applies for the provision of the notification. Consistent with the information statement, the three month period for notifying foreign resident beneficiaries and foreign resident partners is intended to provide such entities with sufficient time to finalise their Australian tax position in the event that they are notified that they are not eligible for the IMR in respect of certain income or gains.

1.64 Given the alignment of these periods, a fund may need to provide the information statement to the Commissioner at an earlier date in order for it to have sufficient time to also notify its partners and beneficiaries. Rather than specifying different timeframes for the provision of each statement, a single time period allows individual IMR foreign funds under Division 395 to assess how far in advance the information statement will be provided to the Commissioner.

1.65 In contrast to the general information statement requirement, a failure to notify foreign resident beneficiaries or foreign resident partners will not result in an entity being precluded from being an IMR foreign fund under Subdivision 842-I.

1.66 Instead, an IMR foreign fund that fails to notify its foreign resident beneficiaries or foreign resident partners (being an entity in relation to which the fund had an obligation to provide a written notice to), will be liable to an administrative penalty under Subdivision 286-C of Schedule 1 to the TAA 1953 (which relates to penalties for failing to lodge documents on time). *[Schedule #, item 30, subsection 286-75(2BB) of Schedule 1 to the TAA 1953]*

1.67 A provision for calculating base penalties for a failure to provide the notification is included under Subdivision 286-C of Schedule 1 to the TAA 1953 because the existing provisions relate to the lodgement of approved forms or notification of certain events. Administrative penalties for failing to provide a notification to a foreign resident beneficiary or a foreign resident partner are calculated consistently with other administrative penalties under Subdivision 286-C, and will result in a fund being liable for 1 penalty unit in respect of each entity that it failed to provide the notification to for each 28 day period that it fails to comply

with the notification requirement, up to a maximum of 5 penalty units.
[Schedule #, item 31, paragraph 286-80(2)(b) of Schedule 1 to the TAA 1953]

Funds that are ‘foreign widely held entities’

1.68 Under the current law, a fund will be taken to pass the widely held test and not breach the existing concentration test if all of its membership interests are held by one or more ‘foreign widely held entities’. New rules for applying the widely held and closely held test to funds in which interests are held by foreign widely held entities are described in further detail below at paragraphs 1.122 to 1.129.

1.69 These amendments introduce a new rule that deems a fund which is itself a foreign widely held entity to pass the widely held test and not breach the closely held test (which replaces the concentration test).
[Schedule #, item 12, paragraph 842-240(4)]

1.70 This rule overcomes potential compliance or technical issues associated with tracing through foreign widely held entities to identify and quantify underlying interests. The rule is consistent with the existing foreign widely held rule given that a fund will currently pass the widely held test and not breach the existing concentration test if it is itself owned entirely by a foreign widely held entity.

1.71 Consistent with the current definition an entity will be a ‘foreign widely held entity’ under the new rules if it is:

- a foreign life insurance company at all times during the income year;
- a foreign superannuation fund that has at least 50 members;
or
- an entity established by an exempt foreign government agency for the principal purpose of funding pensions for the citizens or other contributors of a foreign country.

[Schedule #, item 12, subsection 842-240(4)]

Foreign life insurance companies

1.72 The amendments change the current reference to a ‘life insurance company that is not an Australian resident at any time during the income year’, to ‘a foreign life insurance company at all times during the income year’. *[Schedule #, item 12, paragraph 842 240(4)(a)]*

1.73 The term ‘foreign life insurance company’ describes a foreign resident company whose sole or principal business is life insurance. In the

context of the IMR, the use of this term is more appropriate for the purpose of the foreign widely held entity rules than the more restrictive ‘foreign life insurance company’ definition.

1.74 The term ‘life insurance company’ describes an entity that is registered under the *Life Insurance Act 1995* and is used in the widely held test provisions contained in the MIT withholding rules (which apply to Australian residents rather than foreign residents).

1.75 In contrast to the MIT withholding rules, under the IMR the question of whether a company is registered under the *Life Insurance Act 1995* is not directly relevant to whether they should be considered to be widely held and not breach the closely held test. Moreover, it is expected that the majority of resident and foreign resident insurance companies registered under the *Life Insurance Act 1995* would carry a trading business in Australia. As such, foreign resident ‘life insurance companies’ will generally be precluded from being IMR foreign funds despite the fact that they would pass the widely held test and not breach the closely held test.

1.76 Although a foreign life insurance company that is created or ceases to exist during an income year will not be able to satisfy the requirement that they be a foreign life insurance company ‘at all times’ during the income year, the start-up and wind-down phase rules will deem such entities to have satisfied the widely held test and to have not breached the closely held tests.

Changes to existing criteria for being an IMR foreign fund

New rule for ‘start-up phases’

1.77 In addition to the existing ‘wind-down phase’ rule, these amendments introduce a ‘start-up phase rule’ that deems a fund to satisfy the widely held test and not breach the closely held test for the income year in which it is created. [*Schedule #, item 11, paragraph 842-235(1)(a) and paragraph 842-235(2)(b)*]

1.78 Furthermore, where a fund is created in the second half of an income year, it will also be deemed to satisfy the widely held test and to not breach the closely held test for the next income year. [*Schedule #, item 11, paragraph 842-235(1)(a) and subsection 842-235(3)*]

1.79 It may be difficult for a fund to qualify as an IMR foreign fund under the widely held and closely held tests during its start-up phase because at that stage, many funds may still be in the process of attracting new investors. The start-up phase rule is designed to allow newly created funds to access the IMR during this time.

1.80 Integrity measures in respect of the start-up phase rule are also included to ensure that only funds which become IMR foreign funds ultimately receive the benefit of the start-up phase rule. These integrity rules require a fund to be an IMR foreign fund for at least one income year after an income year covered by the start-up phase rule.

1.81 In the event that a fund applies the start-up phase rule to a single income year only (because it was created in the first half of the income year), the fund will lose its status as an IMR foreign fund in respect of that income year if in the next income year it ceases to exist or is not an IMR foreign fund for that income year. *[Schedule #, item 11, paragraph 842-235(4)(a), subsection 842-235(4)(b)(i) and subsection 842-235(5)]*

1.82 Similarly, if the fund applies the start-up phase rule to two income years (because it was created in the second half an income year), the fund will lose its status as an IMR foreign fund in respect of each of those income years if it ceases to exist or is not an IMR foreign fund in either the second income year to which the start-up phase rule applied, or the following income year. *[Schedule #, item 11, paragraph 842-235(4)(a), subsection 842-235(4)(b)(ii) and subsection 842-235(5)]*

1.83 These rules ensure that investors (including a single investor) cannot move investments between newly created funds in each income year and continuously access the IMR through the start-up phase rule. Although a fund that utilises the start-up rule in a particular income year will be taken to be an IMR foreign fund at that time, these provisions will disqualify a fund's previously claimed status as an IMR foreign fund.

1.84 Where the integrity rules apply, they will have the effect of deeming the fund to have never been an IMR foreign fund, and will mean that income or gains that were previously claimed as IMR income or IMR capital gains as the result of the start-up phase rule will retrospectively lose that status and become taxable. As such, any taxpayer who obtained a benefit from the IMR as the result of the start-up phase rule applying to the fund will be required to amend any Australian income tax assessments referable to that period, or lodge Australian income tax assessments if they had not otherwise done so.

Extension of the general amendment period to ensure the start-up phase rule can be correctly applied

1.85 Under the general amendment periods, the Commissioner ordinarily has four years from the day on which a notice of assessment was issued to amend an assessment (or two years for individuals or small business entities).

1.86 The standard amendment periods do not provide the Commissioner with sufficient time to administer the integrity provisions

under the start-up phase rule because it can take up to two and a half years to determine whether a fund is ultimately eligible for the start-up phase rule (being the 18 month period potentially covered by the start-up phase rule and the next income year in which the fund must actually be an IMR foreign fund).

1.87 In cases where a taxpayer's assessment needs to be amended because a fund applied the start-up phase rule but did not ultimately become an IMR foreign fund, the Commissioner may amend an assessment within 7 years of the day on which a notice of assessment was issued. [*Schedule #, item 29, section 842-275*]

1.88 This time period is intended to strike a balance between providing certainty to taxpayers in respect of their Australian tax affairs, and providing the Commissioner with sufficient time to administer the integrity rules associated with the start-up phase rule.

Change to the rule for 'wind-down phases'

1.89 In order to use the existing wind-down phase rule for an income year, a fund must have been an IMR foreign fund throughout the previous income year. These amendments modify the existing wind-down phase rule so that in determining whether a fund was an IMR foreign fund in the previous income year, any application of the start-up phase rule is disregarded. [*Schedule #, item 11, paragraph 842-235(1)(b)*]

1.90 Given the introduction of the start-up phase rule, this change is necessary to ensure that a fund that ceases to exist in the income year immediately following an income year to which the start-up phase rule applies will be precluded from utilising the wind-down phase rule.

1.91 Because the wind-down phase rule cannot apply to an income year immediately following an income year to which the start-up phase rule applied, a fund is also prevented from applying the wind-down phase rule to satisfy the requirement under the start-up phase rule be an IMR foreign fund in respect of the next income year.

Changes to the 'trading business' criteria

1.92 The changes make a technical amendment to the criteria related to the carrying on of a trading business to correct the omission of the words 'in Australia'. Consistent with the original policy intent, this amendment ensures that a fund will be precluded from being an IMR foreign fund if they carry on a trading business *in Australia*, as opposed to carrying on such business generally. [*Schedule #, item 7, subparagraph 842-230(b)(i)*]

1.93 In addition to the requirement that a fund not carry on a trading business in Australia, these amendments introduce an additional rule which prevents a fund from being an IMR foreign fund for an income year if at any time during the income year it controls a trading business in Australia, or is able to directly or indirectly control the affairs or operation of a trading business in Australia. [*Schedule #, item 7, subparagraph 842-230(b)(ii)*]

1.94 This additional requirement improves the integrity of the existing trading business requirement by bringing into consideration the activities of entities that are controlled by a fund. As with the original trading business criteria, this additional rule is based upon Division 6C of the ITAA 1936. Consistent with section 102N of Division 6C (which defines a trading trust as a unit trust that either carries on a trading business, or directly or indirectly controls a trading business), the concept of ‘control’ is not a defined term. As such, the question of whether a fund controls a trading business in Australia is to be determined according to the term’s ordinary meaning.

1.95 The inclusion of this additional requirement is consistent with recommendation 5 of the Board of Taxation’s 2011 report to the Assistant Treasurer (*Review of an Investment Manager Regime as it relates to Foreign Managed Funds*), which recommended that in order to qualify for an IMR, a foreign managed fund should not carry on or control a trading business in Australia (as defined in Division 6C of Part III of the ITAA 1936).

Changes to the widely held test

1.96 In order to be an IMR foreign fund for an income year, an entity must be widely held at all times during the income year (subject to the start-up and wind-down phase rules). This test ensures that only funds that are collective investment vehicles are able to access the IMR.

1.97 The amendments make significant changes to the way the widely held test applies, namely through the introduction of special rules for counting the number of members of a fund. The amendments provide a set of rules for counting underlying members where interests in the fund are held through one or more interposed entities. (The new membership rules are discussed in detail at paragraphs 1.113 to 1.134 below).

1.98 The changes to the widely held test are intended to result in more entities that are genuinely widely held being able to satisfy the widely held test, given that such entities are more able to accurately count their underlying members.

1.99 Three of the ways that a fund can currently satisfy the widely held test are retained under the revised widely test. As such, a fund will be widely held if:

- the units or shares of the entity are listed on an approved stock exchange;
- the entity has 25 or more members (determined in accordance with the new membership counting rules); and
- the entity is of a kind specified in regulations.

[Schedule #, item 12, subsection 842-240(1)]

1.100 In respect of circumstances where an entity has 25 or more members, the part of that rule related to ignoring the objects of a trust in counting the number of members has been moved from the widely held test itself, and relocated to the provisions setting out the rules for counting members. *[Schedule #, item 12, paragraph 842-240(1)(b)]*

1.101 As the result of these changes, a fund will no longer satisfy the widely held test if one or more foreign widely held entities have a total participation interest in the fund of more than 25 per. Similarly, an entity will not be taken to be widely held because all of its membership interests are held, directly or indirectly, by one or more entities that themselves would satisfy the other components of the existing widely held test. Such funds will however be allocated a number of notional members in accordance with the new membership counting rules. *[Schedule #, item 12, subsection 842-240(1)]*

1.102 The removal of these components of the widely held test does not mean that funds that would have been widely held as the result of those aspects of the test can no longer be widely held. Those components were included in the widely held test as a proxy for counting underlying members, and are not required given the new membership counting rules.

Changes to the concentration test (renamed as the closely held test)

1.103 In order to be an IMR foreign fund for an income year, an entity must not breach the closely held test at any time during the income year (subject to the start-up and wind-down phase rules). *[Schedule #, item 4, paragraph 842-205(2)(d)]*

1.104 The closely held test operates in conjunction with the widely held test and ensures that a small number of entities do not hold a substantial proportion of the interests in a fund. This test has been renamed from the ‘concentration test’ by these amendments. This change

in terminology ensures consistency with that of the MIT withholding rules (which contain a ‘closely held’ test that performs a similar function).

1.105 In contrast to the concentration test, which applied to the total participation interests of other entities in the relevant fund, the closely held test only applies to the total participation interests of the funds’ members. This means that interposed entities that are not counted as members for the purpose of the widely held test are similarly disregarded for the purpose of applying the closely held test to the fund. *[Schedule #, item 12, subsection 842-240(2)]*

1.106 In addition to the new rules for counting a fund’s members, special rules are also included for calculating the total participation interests of those members. These rules are discussed in further detail below at paragraphs 1.113 to 1.134 and are relevant for determining whether a fund breaches the closely held test.

1.107 A fund will breach the closely held test if:

- Any one of the funds members holds a total participation interest in it of 10 per cent or more (determined in accordance with the new membership counting rules); or
- The sum of any 10 or fewer of the fund’s members’ total participation interests in it is 50 per cent or more (determined in accordance with the new membership counting rules).

[Schedule #, item 12, subsection 842-240(2)]

1.108 In contrast to the concentration test, the closely held test includes a rule which examines the total participation interest of members individually to ensure that no single member holds a total participation interest of 10 per cent or more in the fund. *[Schedule #, item 12, paragraph 842-240(2)(a)]*

1.109 This additional rule improves the integrity of the closely held test (and therefore the definition of IMR foreign fund) by ensuring that a fund breaches the closely held test if one or more of its members holds a substantial proportion of its interests. In particular, the introduction of this new test mitigates integrity issues that may arise as the result of narrowing the types of interests to which the closely held applies (this change to the calculation of members’ total participation interests is discussed in further detail at paragraphs 1.130 to 1.134 below).

1.110 The other aspect of the closely held test related to the combined participation interests of 10 or fewer of the fund’s members is broadly consistent with the concentration test. The focus on the members of the fund rather than on any entity with an interest in the fund ensures that the

closely held test is better targeted. The operation of the test is also clarified to ensure that it applies to the aggregated participation interests of the relevant members, rather than to each member individually.

[Schedule #, item 12, paragraph 842-240(2)(b)]

1.111 An additional rule is also included so that certain types of entities that might otherwise breach the closely held test can be prescribed by regulation as not breaching the test. *[Schedule #, item 12, subsection 842-240(3)]*

1.112 This regulation making provision is included for similar reasons to the equivalent rule in respect of the widely held test. The provision recognises that some flexibility may be required given the specific rules for determining whether a fund is closely held and the fact that the managed funds industry utilises a broad range of investment vehicles and structures.

New rule for counting members and their total participation interests

1.113 The amendments introduce new rules for determining the members of an entity under the widely held and closely held tests, as well as the total participation interests of those members under the closely held test. *[Schedule #, item 12, subsection 842-242(1)]*

1.114 These rules significantly alter the way the widely held and closely held tests apply to a fund by disregarding interposed entities and counting underlying interest holders. In contrast to these rules, under Subdivision 960-G (general rules for determining members of entities) only those entities with direct interests are members.

Membership is traced through interposed entities to individuals

1.115 Where an individual holds an interest in a fund indirectly through one or more interposed entities, that individual is counted as a member of the fund, and any interposed entities are taken not to be members (even if they hold a direct interest in the fund). *[Schedule #, item 12, subsection 842-242(2)]*

1.116 Given that in the majority of cases, an interest a fund will ultimately be held by an individual, this rule would be expected to apply in most circumstances where some of the interests in a fund are directly held by an entity that is not an individual. Tracing through to underlying individuals in identifying the members of a fund focusses the widely held and closely held test on the interest holders that receive an economic benefit from the fund, and who therefore benefit from the fund accessing the IMR. Interposed entities that are traced through to identify underlying members are disregarded in order to prevent double counting.

1.117 The rule in respect of disregarding the objects of a trust in counting the members of a fund is moved from the widely held test itself and replicated in the specific rules related to determining the members of a fund. *[Schedule #, item 12, subsection 842-242(5)]*

1.118 Where a number of related individuals each hold a separate interest in the fund, those individuals are together treated as a single individual. Where two or more individuals are treated as one individual, that notional individual is treated as having a total participation interest in the fund equal to the sum each of the actual individual's total participation interests *[Schedule #, item 12, subsections 842-242(6) and (7)]*

1.119 These rules ensure that all members of a family are treated as a single individual for the purposes of the widely held test. Aggregation in this way is appropriate given that the widely held and closely held tests are fundamentally concerned with measuring the level of economic benefit that individuals obtain from a fund accessing the IMR, and the fact that family members will often have interrelated economic interests.

1.120 Similarly, where an entity holds a total participation interest in a fund in the capacity of nominee of another entity, the other entity is treated as also holding the nominee's interest, and the nominee and its own interest in the fund are disregarded for the purposes of applying the widely held and closely held tests to the fund. *[Schedule #, item 12, subsection 842-242(8)]*

1.121 This rule ensures that the widely held and closely held tests accurately measure the economic benefit that an individual is entitled to receive from a fund where another entity acting on the individual's behalf holds interests in the fund. To avoid double counting under those tests, to the extent they would otherwise apply to the other entity, both the entity and the interests that it holds are disregarded.

Rules for deeming members where interests in the fund are held by foreign widely held entities

1.122 Rules for counting members also apply in cases where an entity with an interest in the fund is a 'foreign widely held entity' (the test for when an entity will be a 'foreign widely held entity' is described at paragraphs 1.71 to 1.76 above). These rules are included to overcome potential issues associated with tracing through entities that themselves have a significant number of members.

1.123 In order to overcome potential compliance or technical issues related to the general tracing requirement, foreign widely held entities are deemed to have a notional number of members who are themselves individuals for the purposes of applying the membership counting rule in

the widely held and closely held tests to a fund. [*Schedule #, item 12, paragraph 842-242(3)(a)*]

1.124 Deeming the notional members to be individuals has two important effects. Firstly, these notional individuals are counted as members of the fund. Secondly, because all of the membership interests in the foreign widely held entity are taken to be held by individuals, the requirement to trace through the interests of any entities that are interposed between the foreign widely held entity and actual individuals is removed.

1.125 The number of notional members of a foreign widely held entity is worked out by determining its total participation interest in the fund, multiplying that number by 50 and rounding the result to the nearest number. [*Schedule #, item 12, paragraph 842-242(3)(b)*]

1.126 The rule effectively allocates 50 individual members to a foreign widely held entity, meaning that if a single foreign widely held entity holds a total participation interest of 50 per cent or more in a fund, the fund will pass the widely held test (as such a fund will be taken to have half of the widely held entity's 50 members). Consistent with the MIT withholding rules, the number 50 is used as this is generally the minimum number of members that such an entity must have in order to qualify as one of the listed widely held entities.

1.127 Because the closely held test applies to the total participation interests of each member (which include the notional members of a foreign widely held fund who are taken to be members of the fund), an additional rule is included to allocate each of the notional members a total participation interest in the fund.

1.128 The total participation interest of each notional member in the fund is calculated by dividing the foreign widely held entity's total participation interest in the fund by the number of notional members. [*Schedule #, item 12, paragraph 842-242(3)(c)*]

1.129 Because a foreign widely held entity will itself always be taken to have 50 members, this rule will generally result in the notional members of the fund each having a total participation interest of 2 per cent in the fund (such members will however have less than a 2 per cent interest if the number of notional members in the fund is rounded up).

Voting interests are disregarded in calculating direct participation interests

1.130 Both the widely held and closely held tests rely upon the identification of interests held in a fund by other entities. Such interests may be held directly by certain entities (for example by individuals or foreign widely held entities), as well as indirectly by those entities through

one or more interposed entities. To the extent that the widely held and closely held tests require the identification or calculation of a direct participation interest of one entity in another entity, direct participation interests that are voting interests are not counted. [*Schedule #, item 12, subsection 842-242(9)*]

1.131 Disregarding voting interests in this way recognises that the role of the closely held test is to ensure that the IMR is not able to be used by a fund that is a vehicle for pursuing the economic interests of small group of investors. If voting interests are counted under the closely held test, funds in which economic interests are in fact sufficiently diverse could be prevented from being IMR foreign funds.

1.132 It is not uncommon for a significant proportion of the voting rights in a fund to be retained by a small number of entities that are responsible for the management of the fund. For example, in the case of a fund that is a corporate limited partnership, it would not be unusual for the majority of the voting rights in the fund to be retained by a general partner (who might exercise those rights directly, or delegate that function to an agent acting in their capacity as a fund manager).

1.133 Although the removal of voting interests will permit a small group of members to retain significant voting rights, the introduction of the 10 per cent rule (referred to at paragraphs 1.107 to 1.109 above) prevents the IMR from applying to funds in which a substantial proportion of the economic benefit resides in a single member.

1.134 In contrast to the closely held test, the widely held test does not generally measure the quantum of the interest that a member has in a fund. This rule will however mean that an individual or foreign widely held entity that only holds a voting interest in a fund will not be counted as a member of the fund. As with the closely held test, this outcome is appropriate because widely held test is intended to determine the number of entities that have an economic interest in a fund.

Changes to financial arrangements covered by section 842-245

1.135 In addition to modifications to the criteria that a fund must satisfy in order to qualify as an IMR foreign fund, these amendments also change the types of financial arrangements to which the IMR applies.

Changes to the portfolio interest requirement

1.136 Currently, in order for a return or gain from a financial arrangement to qualify as IMR income or an IMR gain, the financial arrangement must satisfy the criteria set out in section 842-245. Under that section, a return or gain from a financial arrangement cannot be IMR

income or an IMR capital gain if the financial arrangement is with an entity in which an IMR foreign fund holds a total participation interest of 10 per cent or more.

1.137 These amendments change the mechanism for measuring the level of interest that an IMR foreign fund has in the other entity. Rather than measuring the total participation interest that is held (which includes indirect interests held through interposed entities), the revised rules apply the non-portfolio interest test contained in section 960-195. [*Schedule #, item 17, paragraph 842-250(1)(c)*]

1.138 An entity will be taken to have a non-portfolio interest in another entity if the sum of its direct participation interests in the other entity and the direct participation interests of its associates in the other entity is 10 per cent or more. The focus on direct participation interests under the non-portfolio interest test better targets the type of interest that an IMR foreign fund has in the other entity. Moreover, the aggregation of associates' interests ensures that an entity cannot circumvent the IMR rules by interposing a number of subsidiaries which each hold a separate portfolio interest in an entity (although under the current rules, an entity that structured in this way would possibly breach the concentration test, the closely held test now applies to underlying members rather than all entities).

1.139 In contrast to the current test (which prevents certain financial arrangements from being covered by section 842-245 where an IMR foreign fund has a total participation interest of 10 per cent or more), the treatment that follows from an IMR foreign fund having a non-portfolio interest applies to any financial arrangements that the fund has with that entity. As such, if another arrangement or a combination of arrangements result in the IMR foreign fund having a direct participation interest of 10 per cent or more in the other entity, the IMR foreign fund will have a non-portfolio interest in determining the treatment of all of the financial arrangements that it has with the other entity.

1.140 These amendments extend the existing conduit income measure (element 2) to cover financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest. As such, the non-portfolio interest test is not included in the criteria related to financial arrangements to which the IMR applies. This has the effect of broadening the range of returns or gains that can qualify as IMR income or IMR capital gains. [*Schedule #, items 13 and 14, subsection 842-245(1), subsection 842-245(2)*]

1.141 The non-portfolio interest test is however introduced under the rules relating to IMR income. Under those provisions (discussed in further detail below at paragraphs 1.159 to 1.168), the non-portfolio interest test performs a new role in respect of applying the IMR income rules to

returns or gains from financial arrangements with entities in which an IMR foreign fund has a non-portfolio interest.

1.142 In contrast, whether an amount relates to a financial arrangement with an entity in which an IMR foreign fund holds a portfolio interest or a non-portfolio interest is no longer relevant for determining whether the amount is an IMR capital gain or IMR capital loss (IMR capital gains and IMR capital losses are discussed in further detail below at paragraphs 1.170 to 1.173).

General alignment with Division 855

1.143 Division 855 provides foreign residents with an exemption from capital gains tax in respect of gains that are made from assets that are not taxable Australian property (TAP). The table to section 855-15 sets out the CGT assets that are TAP. These assets include taxable Australian real property, indirect Australian real property interests, CGT assets used in carrying on a business through an Australian permanent establishment, as well as options or rights to acquire any one of those assets.

1.144 The definition of TAP also includes a CGT asset covered by subsection 104-165(3). An IMR foreign fund cannot hold CGT assets of this kind because section 104-165 applies to individuals only (who cannot qualify as IMR foreign funds because of the widely held and closely held tests).

1.145 One of the principal objectives of the IMR is to remove the potential uncertainty faced by foreign resident investors investing through widely held foreign managed funds in determining whether a return or gain made in Australia is on revenue or capital account. As a general proposition, this is achieved by ensuring that where a return or gain would be exempt under Division 855 if it were made on capital account, it will be exempt if it is instead made on revenue account.

1.146 In some circumstances, the IMR provides an exemption from Australian tax for capital gains from certain TAP assets. To the extent this exemption applies, a similar exemption for returns or gains that are made on revenue account applies in relation to TAP assets of that kind. Where, taking into account the operation of both Division 855 and the IMR, a foreign resident's capital gains from certain TAP assets continue to be taxable in Australia, the IMR does not exclude comparable returns or gain that are made on revenue account.

1.147 The manner in which the IMR operates to otherwise preserve Australia's taxing rights of TAP is described below.

Taxable Australian real property

1.148 Taxable Australian real property (TARP) consists of assets such as Australia real property, leases over Australian real property, and rights over minerals located in Australia. The IMR cannot apply to returns or gains from CGT assets that are themselves Australian real property because of the requirement that a return or gain must be in relation to a financial arrangement.

1.149 The existing rule in respect of derivative financial arrangements in respect of TARP is modified so that financial arrangements that are themselves TARP (such as leases over Australian real property or mining rights) will not be covered by the IMR. [*Schedule #, item 15, paragraph 842-245(3)(a)*]

1.150 Although this rule applies to IMR income and IMR capital gains, a gain or loss from a financial arrangement that is also TARP cannot be an IMR capital gain or an IMR capital loss. Those rules each require the return or gain from a financial arrangement to be a CGT asset covered by item 3 of the table to section 855-15 (or an option or right to acquire a CGT asset of this kind), and that table item is explicitly precluded from applying to CGT assets that are also TARP.

Indirect Australian real property interests

1.151 An indirect Australian real property interest is a non-portfolio interest in an entity whose assets are principally comprised of taxable Australian real property (for example, a land-rich company).

1.152 Given that Australian real property interests require a non-portfolio interest in an entity, the restriction of the current rules to financial arrangements with entities in which an IMR foreign fund holds a total participation interest of less than 10 per cent will generally have the effect of excluding any financial arrangement that the IMR foreign fund has with another entity in which it holds an indirect Australian real property interest.

1.153 Although the total participation interest test is removed from the criteria for financial arrangements, the existing rule in respect of derivative financial arrangements over indirect Australian real property interests is modified (consistent with changes in respect of TARP), so that a financial arrangement that is an indirect Australian real property interest will not be covered by the IMR. [*Schedule #, item 15, paragraph 842-245(3)(a)*]

1.154 Although this rule applies to IMR income and IMR capital gains, a gain or loss from a financial arrangement that is also an indirect Australian real property interest cannot be an IMR capital gain or an IMR capital loss. Those rules each require the return or gain from a financial

arrangement to be a CGT asset covered by item 3 of the table to section 855-15 (or an option or right to acquire a CGT asset of this kind), and that table item is explicitly precluded from applying to CGT assets that are also indirect Australian real property interests.

Options or rights to acquire TAP assets

1.155 Currently, the IMR specifically excludes derivative financial arrangements that relate to either taxable Australian real property or indirect Australian real property interests. This restriction is broadly maintained, although it is amended to refer a financial arrangement that ‘relates to’ a CGT asset that is TARP or an indirect Australian real property interest. [*Schedule #, item 15, paragraph 842-245(3)(a)*]

Application of the IMR to certain TAP assets

1.156 Although the IMR generally seeks to ensure Australia retains its taxing rights over returns or gains from TAP assets, an exception to this is the extension of the capital gains tax exemption in circumstances for gains on CGT assets that are used in carrying on a business through an Australian permanent establishment.

1.157 This was a key component of element 2 of the IMR which was designed to ensure that foreign funds that use Australian intermediaries are not subject to Australian tax on certain income that, in the absence of the Australian intermediary, would otherwise be foreign sourced income. However as indicated above, these amendments extend this aspect of element 2 of the IMR to financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest, regardless of whether the return or gain is made on revenue or capital account.

1.158 The application of the IMR to these types of assets is discussed at paragraphs 1.164 to 1.168 (for IMR income) and paragraph 1.172 (for IMR capital gains) below.

Changes to IMR income

1.159 To qualify as IMR income under the current rules, a return or gain from a financial arrangement must otherwise form part of an IMR foreign fund’s assessable income as the result of it being Australian sourced income because it is attributable to an Australian permanent establishment of the fund which exists only because the fund engaged an Australian intermediary. Given the types of financial arrangements that are currently covered by section 842-245, an amount can only be IMR income if it is a return or gain from a financial arrangement with an entity in which the IMR foreign fund holds a total participation interest of less than 10 per cent.

1.160 These amendments make two important changes to the criteria for IMR income. The first relates to implementing element 3, which removes the requirements in respect of permanent establishments for financial arrangements with entities in which an IMR foreign fund holds a portfolio interest. The second key change extends element 2 of the IMR (the conduit income measure), so that it applies in relation to financial arrangements with entities in which the IMR foreign fund has a non-portfolio interest.

1.161 A result of these changes is that the treatment of a return or gain from a financial arrangement as IMR income will vary depending on whether the financial arrangement is with an entity that an IMR foreign fund holds a portfolio or a non-portfolio interest. In order to facilitate this distinction, the non-portfolio interest test is included in the rules relating to IMR income. [*Schedule #, item 17, paragraph 842-250(1)(c)*]

Financial arrangements with entities in which an IMR foreign fund holds a portfolio interest

1.162 If a return or gain is attributable to a financial arrangement that an IMR foreign fund has with an entity in which it does not hold a non-portfolio interest, the return or gain will be IMR income (provided that the financial arrangement is covered by section 842-245) to the extent that it would have otherwise been included in the assessable income of the fund.

1.163 This outcome is achieved by limiting the existing requirements in respect of permanent establishments to financial arrangements with entities in which the IMR foreign fund holds a non-portfolio interest.

Financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest

1.164 Where an IMR foreign fund holds a non-portfolio interest in another entity, returns or gains from financial arrangements with that other entity will only be IMR income if they are attributable to an Australian permanent establishment of the fund that exists solely as the result of the IMR foreign fund engaging an entity that is Australian resident to habitually exercise a general authority to negotiate and conclude contracts on its behalf. [*Schedule #, items 17, 18 and 19, paragraph 842-250(1)(c), subparagraph 842-250(1)(c)(i) and subsection 842-250(1A)*]

1.165 These amendments ensure that the conduit income measure under element 2 of the IMR is extended to apply to financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest.

1.166 In addition to the existing requirements in respect of permanent establishments, further rules are included to ensure that the conduit income measure applies to foreign assets only. A return or gain from a financial arrangement that is attributable to an Australian permanent establishment of the necessary kind will *not* be IMR income if the return or gain would have been Australian sourced in the event that the fund negotiated or concluded the contracts on its own behalf, rather than taking on the Australian intermediary that gave rise to fund having an Australian permanent establishment. [*Schedule #, item 19, subsections 842-250(1B) and 842-250(1C)*]

1.167 This additional rule is included to ensure that conduit income measure cannot apply to assets that would give rise to Australian sourced income had the fund invested in them directly. For example, where a fund enters into a financial arrangement with another foreign entity (in which it holds a non-portfolio interest), it would be expected that by disregarding the activities undertaken on its behalf by an Australian intermediary, that the returns or gains to the fund would be taken to have a foreign source. Such amounts would be IMR income of the fund, even though they would have an Australian source having regard to the activities undertaken by the entity through its Australian permanent establishment.

1.168 In contrast, if an IMR foreign fund received a return or gain from a financial arrangement with an Australian resident entity that was listed on the Australian stock exchange (and in which it held a non-portfolio interest), the return or gain would be expected to be Australian sourced income irrespective of whether the IMR foreign fund engaged the Australian intermediary or not. As such, the return or gain will not qualify as IMR income under the conduit income measure.

IMR deductions

1.169 Although other changes have not been made to the provisions related to IMR deductions, these amendments modify the way in which they apply given their reliance on other provisions (such as those defining IMR income and IMR capital gains).

Changes to IMR capital gain and IMR capital loss

1.170 Division 855 exempts foreign residents from capital gains tax in respect of gains from CGT assets that are not TAP. Given the coverage of Division 855, the exemption from capital gains tax under the IMR in relation to IMR capital gains is much more limited than that provided for IMR income (the exemption for IMR income is largely to align treatment of returns and gains on revenue account with the treatment currently provided under Division 855).

1.171 The IMR does however provide an exemption from capital gains tax in respect of some CGT assets that are TAP. This exemption is limited to those CGT assets that are covered by item 3 of the table to section 855-15, being CGT assets that are used in carrying on a business through an Australian permanent establishment, and that are not also taxable Australian real property or indirect Australian real property interests. The IMR also disregards capital gains from CGT assets that are options or rights to acquire CGT assets of this kind.

1.172 The change to, and removal of, the non-portfolio interest test from the financial arrangement criteria in section 842-245 expands the application of the IMR capital gains provisions to gains from financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest. As IMR capital gains only relate to CGT assets that are used in carrying on a business through a permanent establishment in Australia, the permanent establishment rules contained in the IMR capital gains and IMR capital loss provisions continue to apply to gains from financial arrangements with entities in which an IMR foreign fund holds a portfolio interest.

1.173 These amendments introduce minor wording changes to the IMR capital gain and IMR capital loss rules that require a gain or loss to be from a financial arrangement that is covered by section 842-245 as well as subsection 842-255(3) itself (which imposes the requirement that the financial arrangement be a CGT asset covered by item 3 of the table in section 855-15 or by item 4 of that table insofar as it relate to item 3). These changes clarify the relationship between the relevant provisions but do not change their substantive application. [*Schedule #, items 22, 24, 25, 26 and 27, paragraph 842-255(1)(b), paragraph 842-255(2)(b), subsection 842-255(3), paragraph 842-255(3)(a), paragraph 842-255(3)(b)*]

Other technical amendments

References to ‘resident of Australia’

1.174 Subdivision 842-I currently contains a number of references to an entity being ‘a resident of Australia’. This term ‘resident of Australia’ is defined in the ITAA 1936, whereas the ITAA 1997 (in which Subdivision 842-I is located) used the term ‘Australian resident’ (which itself refers to the ITAA 1936 definition). These amendments update the references to ‘resident of Australia’ to ensure that Subdivision 842-I uses the correct terminology. [*Schedule #, items 5, 17, 20, 21 and 23, paragraph 842-215(2)(a), paragraph 842-250(1)(b), paragraph 842-255(1)(a), paragraph 842-255(2)(a), paragraph 842-255(2)(a)*]

Pre-2012 IMR income and pre-2012 IMR capital gains

1.175 The rules in respect of pre-2012 IMR income and pre-2012 IMR capital gains draw directly on the provisions related to financial arrangements covered by section 842-245. These amendments change the types of arrangements covered by that section by removing the total participation interest test. To ensure that the pre-2012 IMR income and pre-2012 IMR capital gains rules continue to apply as intended, a specific rule is included to disregard the removal of that test from section 842-245 for the purposes of determining an IMR foreign fund's pre-2012 IMR income and pre-2012 IMR capital gains. *[Schedule #, item 28, subsection 842-270(2A)]*