

Tax Brief

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ATO Christmas present for private equity

On 16 December 2009 the ATO released two draft tax rulings on the main issues arising in its notorious recent court action involving the private equity group, TPG (though that case is not mentioned by name of course). The rulings effectively leave the revenue capital treatment and treaty shopping issues to case by case treatment, though making clear the ATO view of the TPG situation.

The TPG saga

The newspapers have contained a lot of discussion on the ATO attempt to tax the profits made by this private equity group in the recent float of Myer. The Myer shares sold were held by a Dutch BV (private company) that in turn was owned by a Luxembourg SARL (private company) that was owned by a Caymans company. This last Caymans entity was apparently used to pool funds from investors in various jurisdictions. The Myer shares were sold by the Dutch BV just prior to the float to an Australian selling company which then transferred them to the participants in the Myer float.

Capital or revenue

This issue is dealt with in draft ruling TD 2009/D18. The description of private equity in the draft has been gleaned from that renowned authority, Wikipedia, which has attracted some wry comment in the *Wall Street Journal*.

Following the changes to the taxation of non-residents in 2006, if the sale of shares in an Australian company by a non-resident through an IPO is on capital account, the seller will not be subject to Australian CGT unless either:

- the non-resident has a permanent establishment (PE) in Australia to which the capital gain is attributable; or
- the company is (Australian) land rich.

The ATO has not yet asserted that the Dutch BV is liable to tax presumably on the basis that Myer is not land rich and the Dutch BV did not have a PE in Australia. The managers of the private equity fund may have such a PE (which may or may not lead to taxation of the managers' profits on the transaction

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depending on the circumstances) but this will normally not constitute a PE of the seller (in the TPG case the Dutch BV).

If the sale of shares is on revenue account, the non-resident seller will be taxable under domestic law if the income is sourced in Australia.

The conclusion in the draft ruling is that the revenue/capital issue depends on the facts, based on 'weighing up of the relevant importance of the three factors driving returns [cash flow, operational improvements to increase earnings, and disposing of the target entity for a profit], the investment strategy agreed to by the parties before acquiring the assets and the legal form and substance of the arrangements and structures used to implement these strategies'. The draft contains an example concluding that the profit is on revenue account which no doubt is the ATO view of the TPG case.

While the ATO quotes case law and its main ruling on the capital/revenue issue, it makes no attempt to relate the matters referred to in the quotation in the previous paragraph to that case law and ruling. The case law suggests that the critical factor is the purpose with which the asset was acquired – for disposal at a profit (revenue) or for other purposes such as long term holding (capital).

Although the draft ruling does not say so, this view has impacts for domestic as well as foreign private equity funds in the form of trusts. For domestic funds, the classification of a gain being on revenue account means that its local investors will not benefit from the CGT discount and for non-resident investors means that trustees may have had a withholding obligation that they have failed to meet.

Treaty shopping

This issue is dealt with in draft ruling TD 2009/D17.

A series of cases in Australia has established that Australia cannot tax profits on sales of shares by a resident of a country with which Australia has a tax treaty if:

- the treaty is one of Australia's pre-1987 treaties or a post-2006 treaty;
- the profit is not attributable to a PE in Australia; and
- the company is not 'land rich'.

As the Dutch treaty is a pre-1987 treaty, Australia would not generally have taxing rights over the gain made by the Dutch BV in the TPG case unless Part IVA applies. Australia does not have double tax treaties with either Luxembourg or the Caymans.

Australia's general anti-avoidance rule in Part IVA is expressed to override its tax treaties. In the TPG case the ATO has issued assessments under Part IVA to the Luxemburg SARL and the Caymans company on the basis that the Dutch BV was interposed as part of a scheme to take advantage of the protection afforded by the Dutch treaty and therefore avoid Australian tax. This approach effectively

treats the Caymans company as the ultimate recipient of the funds and ignores that the investors in the Caymans entity were most likely pension funds based in countries with which Australia has a tax treaty.

While the ATO acknowledges in the draft ruling that there are many reasons why the Caymans is used as a base for collecting funds and for interposing companies in other countries, it suggests that Part IVA will be applied even if the ultimate investors are based in countries with which Australia has tax treaties which would prevent taxation of the ultimate investors. Whilst this may be a technically correct view of Part IVA, it does not seem an appropriate case for the ATO to exercise its discretion to apply Part IVA.

The draft ruling notes that it depends on the precise circumstances whether Part IVA is applicable but it contains an example which is almost exactly the structure in the TPG case and concludes that Part IVA is applicable. The draft states 'in the absence of any significant commercial activity in a treaty country by a company resident in that jurisdiction, the presence of a company in that jurisdiction in the context of a cross-border structure is normally to be explained by taxation considerations. If there are relatively few, or no advantages to be obtained from the presence of a company in the relevant jurisdiction other than the exemption from Australian tax, this will point to the conclusion that obtaining a tax benefit is the dominant purpose of one or more participants in the scheme.'

Source

Although both ATO draft rulings refer to the need for Australian source in the case of profits on revenue account, there is no discussion of the issue though there seems to be an assumption that there is an Australian source. Australian law on the source of profits on the sale of shares, as with many source issues, is not clear. The source of profits on sales of shares may be where:

- the contracts are made and carried out;
- where the substantive selling activity takes place; or
- where the investment decisions are made; or
- some combination of the above.

The ATO has issued a number of interpretative decisions to the effect that the source of profits on listed shares is the country where the shares are listed on the basis that the contracts by the brokers operating through the exchange will be made there.

In the TPG case it is necessary to focus on the sale by the non-resident company (ie Dutch BV) not the selling company. If that occurred outside Australia the ATO will need to reject its normal place of contract view to give the profit a source in Australia. As the sale by the Dutch BV was dependent on the substantive selling

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activity by the selling company in Australia, this may add weight to an argument that the source of the gain was in Australia.

Comment

Whatever the merits of the legal arguments, many observers took the 2006 changes to the CGT regime to indicate that Australia no longer wished to tax non-residents on sales of shares in companies, whether Australian or foreign, unless the company was land rich or the shares were held through a PE in Australia. It certainly is odd to have a different international tax treatment of profits on revenue and capital account. It has been reported overseas that the action of the ATO in relation to TPG is likely to result in a freeze on buy-outs by foreign private equity funds.

The Australian Government has recently released draft legislation to allow 'managed investment trusts' (MITs) to be able to elect that all gains on shares will be treated as capital gains which may be relevant to private equity funds in the form of trusts. For a detailed description see our recent tax brief at http://www.gf.com.au/477_828.htm. However:

- it is unclear whether domestic private equity funds will fall within the definition of a MIT; and
- foreign private equity funds will, at this stage, not qualify as a MIT, and therefore will be unable to make the election.

There are also currently no transitional provisions that would allow an existing investment held by a non-resident to be re-structured to fall within these concessions in a tax free manner. That is, uncertainty will remain for existing investments and this uncertainty may mean that investors are unwilling to invest in Australia even if the new rules are enacted in an appropriate manner.

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