TD 2010/21EC - Compendium

Ruling Compendium – TD 2010/21

This is a compendium of responses to the issues raised by external parties to draft TD 2009/D18 – Income tax: can a private equity entity make an income gain from the disposal of the target assets it has acquired?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1.	While the term 'Private Equity' or 'Private Equity Fund' is sometimes used to describe the manager of a Pooled Fund, the manager does not necessarily have any ownership interest (that is, investment) in the Pooled Fund itself. Rather the manager is responsible for supervising and administering the Pooled Fund on behalf of investors. The draft Determination does not explain or explore this important distinction, which has major implications for the tax outcomes.	The draft Determination focussed on the income tax consequences of a private equity arrangement entered into by an offshore company that acquires an Australian public company. The draft Determination does not deal with the income tax consequences of a private equity arrangement from the perspective of a manager of a pooled fund or a pooled fund itself. Income tax consequences for each of these entities will depend on the facts and circumstances of the particular case. Because each case depends on its own facts and circumstances it is not possible to provide a comprehensive ruling in respect of all private equity investment in Australia.
2.	The draft Determination is a significant departure from the ATO's previous views and practice. The ATO's long standing views and practice, expressed privately and publicly, was that such gains are on capital account. These views and practices have been relied on by Pooled Funds in entering into past transactions. If the draft Determination is intended to communicate that the default ATO proposition is now that gains in such investments are of an income nature, such a substantive change should only apply prospectively.	The draft Determination is consistent with, and merely an example of the application of, a long-standing ATO view and practice (Taxation Ruling TR 92/3).

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3.	The draft Determination identifies but fails to adequately discuss the key issue – that is, the gain will only be 'income' if it satisfies the notion 'income according to ordinary concepts'. Further analysis demonstrating whether and why gains earned by investors in Pooled Funds are income rather than capital is required.	The ATO view on the notion of income according to ordinary concepts has been developed by numerous judicial authorities and is comprehensively dealt with in Taxation Ruling 92/3. The draft Determination does not deal with the topic of whether and why gains earned by investors in pooled funds are income or capital but rather focuses on the income tax consequences of a private equity arrangement entered into by an offshore company that acquires an Australian public company
4.	The draft Determination fails to recognise that circumstances will arise where such gains will remain on capital account. Further, the draft Determination does not identify practical circumstances in which such gains will be capital – this guidance would be very useful both to ATO officers, and to the investment community.	The final Determination has had an example added to recognise the circumstances where a gain from a private equity arrangement will be on capital account.
5.	The draft Determination makes no distinction between the manager of the relevant transaction and the taxpayer being the Pooled Fund representing the interests of many superannuation and other passive investors. The ATO cannot conclude, without any substantive analysis, that the taxpayer's business, activities and intentions are identical to those of the manager: that would have profound implications for the entire asset management sector.	The draft Determination does not deal with the income tax consequences of manager of a pooled fund or a taxpayer that is a pooled fund. The draft Determination makes no conclusion in respect of the business activities of either a manager of a pooled fund or a taxpayer that is a pooled fund. The draft Determination does focus on a single transaction entered into by a corporate entity. It is acknowledged that the examples chosen by the ATO may not be representative of different transactions entered into by different entities and that each case will depend on its own facts and circumstances.

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5. cont	The draft Determination focuses on a single transaction and assumes that the relevant participant is a corporate entity. It fails to identify different transaction types, or different types of entities – such as trusts and partnerships; each of which are common investment structures for Pooled Funds. So the example transaction chosen by the ATO to illustrate its views is not representative of all such transactions.	
6.	The draft Determination and its example focus on investors from outside Australia. This is of limited assistance as the relevant taxation principles will apply also to Australian investors including those pooling the assets of Australian superannuation funds. Further, the draft Determination in incomplete in not mentioning that the Australian tax outcomes for a non-resident, in relation to any gain of an income nature, will depend on the source of the gain (because Australia's tax law does not tax a non-resident on income gains unless the source of the income is in Australia) and the relevant double tax treaty (if any). The Determination should mention these issues and further ATO guidance is required (in another ATO 'product') in relation to the source of a gain where the non-residents' relevant activities are conducted outside Australia.	The draft Determination does focus on investors from outside Australia. Draft Taxation Determination TD 2010/D7 deals with the question of the source of the gain.

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7.	It is critically important to highlight that the particular facts of each case are pivotal, and each case must be examined on its own merits. There is no 'one size fits all' analysis in relation to all such transactions by all Pooled Funds. For this reason, the Professional Bodies request that the second sentence, stating that the facts and circumstances are critical to the outcome of the particular case, should be shown as a separate paragraph. And the discussion at paragraph 13 in the Explanation should be moved forward in the explanation.	The ATO agrees with this view. The second sentence has been shown as a separate paragraph. The placement of paragraphs within the Explanation part of the Determination does not reflect the importance of the content.
8.	The draft Determination's ruling segment and Appendix 1 explanation do not contain a sufficiently detailed analysis of what circumstances are relevant to be examined in order to determine whether, in the case of investors in Pooled Funds, the gain is properly to be characterised as income according to ordinary concepts. Importantly, the draft Determination fails to identify facts that would lead to a conclusion that the relevant gain is on capital account.	The income tax consequences for non-resident investors in pooled funds are outside the scope of the draft Determination.
9.	The draft Determination refers to a 'private equity entity' which is not defined. The draft Determination's sole example examines only one narrow set of circumstances in which a Pooled Funds holds an investment, through 'Offshore Co'. The example implicitly assumes that: • Offshore Co is a company; • Offshore Co carries on its activities as principal; • Offshore Co is an active investor; and	The draft Determination is narrowly focussed on private equity arrangements reviewed by the ATO. Other private equity arrangements may be structured in completely different ways and this Determination may not have any relevance to their particular facts and circumstances. Arrangements entered into by pooled funds including trusts and managed funds may be outside the scope of the Determination depending on the particular facts and circumstances of the arrangements that they entered into.

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9. cont	• Offshore Co intends to profit by way of restructuring and sale of the relevant investment within, presumably, a short period. These assumptions do not apply in many investments held by Pooled Funds. The draft Determination does not consider that a trust or managed fund might undertake the investment.	
10.	It is not correct for the draft Determination to state that the restructuring of the acquired company is carried out by the entity which holds the investment for the Pooled Fund. Rather, the board of directors of the acquired company is responsible to implement any change in the management of the acquired company and to encourage the acquired company to grow and develop its activities.	Whether the restructuring of the acquired company is carried out by and on behalf of and at the direction of the entity which holds the investment or independently by the board of directors of the acquired company are questions of fact and degree which will depend on the facts and circumstances of each particular case.
11.	The principles from the Myer Emporium case should be discussed in the context of Pooled Funds. In the view of the Professional Bodies the 'isolated transaction' cases decided in respect of companies cannot be applied in the same way to Pooled Funds. In addition the relationship between the holding entity, Pooled Fund and its investors is a relevant circumstance not mentioned in the draft Determination. Pooled Funds are frequently a collection of passive investments of various investors, including typically large superannuation and foreign pension funds, other collective investment entities and government entities. These investors have a long term investment horizon and a particular investment by way of a Pooled Fund is generally only one element in each investor's investment strategy and investment portfolio.	These issues are outside the scope of the draft Determination. The draft Determination deals with a particular private equity arrangement and is not a comprehensive taxation ruling that attempts to deal with all investment scenarios. Whether non-resident investors in pooled funds are passive investors with long term investment horizons involves questions of fact and degree that are outside the scope of the draft Determination.

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12.	The Professional Bodies submit that the draft Determination should be amended and the example either replaced or supplemented with another example reflecting the more usual facts and circumstances of a Pooled Fund transactions involving a restructure of the acquired company, whereby: (a) the holding entity, as investor, nominates directors in the acquired entity; (b) the investment manager of the holding entity might also nominate a director; (c) the acquired entity appoints new management of the acquired entity; and (d) operational improvements are made by the management of the acquired company, working with governance of the directors of the acquired company.	Another example has been included in the final Determination.
13.	The Determination should clarify whether the Determination is intended to apply to both resident and non-resident private equity Pooled Funds and entities.	The Determination is meant to provide guidance in respect of the ATO view on a particular type of private equity arrangement. The focus of the Determination is not pooled funds either resident or non-resident. Whether the principles discussed in the Determination could apply to them would depend on the facts and circumstances of the particular arrangements that they have entered into.

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14.	The Professional Bodies recognise that the Determination is focused on the potential characterisation of the relevant gain as income. However, the draft Determination is incomplete with no reference in paragraph 6 to the source of the gain if a non-resident Pooled Fund is the relevant investor. Even if a gain were to be classed as an income gain in some circumstances, s.6-5(3) of the ITAA 1997 provides that if the gain does not have an Australian source it is not assessable income for a non-resident. The Professional Bodies note that it would be useful to have another Determination, or Taxation Ruling, which analyses the issues relating to determining the source of a gain by a foreign investor not itself an Australian resident which: (a) is a foreign investment entity; (b) makes its investment decisions overseas; (c) is advised by a foreign manager; and (d) which makes an investment in an Australian company.	The Determination is solely focussed on the characterisation of the gain as ordinary income. If the gain did not have an Australian source it would not constitute assessable income of a non-resident. Questions in respect of the source of income are questions of fact. See draft Taxation Determination TD 2010/D7.
15.	Reference should be made to other taxation laws which affect the outcome of a transaction entered into by Venture Capital Limited Partnerships and Managed Investment Trusts.	These issues are outside the scope of this Determination.

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16.	If the draft Determination is intended to suggest that all or most Pooled Funds were taxable on such gains as ordinary income, the Professional Bodies submit that would amount to a substantive change which should only apply prospectively. If the draft Determination is intended to alert investors to the need to consider the relevant facts and circumstances in their own case, then it must be adjusted to have regard to the submissions noted above by the Professional Bodies.	The draft Determination does not suggest that all or most pooled funds would be taxable on such gains as ordinary income, but rather to demonstrate that in some circumstances a gain can constitute ordinary income. Investors do need to consider the relevant facts and circumstances in their own case.
17.	Rather than the Determination merely confining itself to a commercial transaction otherwise than the course of business it would be constructive to address the acquisition as a stand alone transaction involving the intention of resale at a profit. If this was so then in addition to addressing this in the Explanation I would suggest that the third bullet point in [10] read along the following lines: T*he acquisition of that interest with the intention of resale at a profit and the subsequent realisation of a profit.*	The final Determination will be modified accordingly.

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18.	In order to prevent fiscal leakage from offshore dealings, especially in tax havens, in the future, it may be an option for the Government to introduce legislation to require the issue of a Federal Income Tax Clearance Certificate ('FITCC') in respect of offshore transfers of assets, especially where tax havens are used. A tax clearance certificate basically certifies that all amounts for which the taxpayer is liable to the Commonwealth have been paid, or that the Commonwealth has accepted some form of security for the payment of the tax liability from the taxpayer prior to substantial sums of monies being transferred and or wired to offshore entities and to offshore financial centres. Where there is a failure by a taxpayer to obtain a TCC, it is suggested that the taxpayer in his or her own personal capacity would be liable for any amounts that would have been due and payable from the date of settlement of the transaction. Moreover, it is suggested that the ATO should be given power to seek an immediate freezing of financial assets in such situations. Such an order would restrain the taxpayer from dissipating and or transferring assets overseas until all taxes are covered, both at the Federal and State level. It is also suggested that a TCC should also cover financial institutions in dealing with transfers of substantial sums of monies. In other words, the banks should also be responsible about their compliance obligations with respect to an Income Tax Clearance Certificate, making certain that prior to wiring proceeds; it seeks the consent of the ATO to do so.	This issue is a matter for Government and outside the scope of this Determination.

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19.	Taxpayers and their advisors should take a number of steps to ensure that any offshore transactions are bona fide and are capable of explanation by reference to ordinary commercial business dealings. Some of these steps are: • Ensure that the tax advisor has a proper letter of engagement with the client in outlining the work to be undertaken by the advisor; • Ensure the tax advisor is informed at all times of offshore transactions entered into by the client to ensure that they are commercially appropriate from a tax perspective; • Ensure that there is proper documentation relating to any offshore transaction to indicate the bona fides of the transaction; • Ensure the taxpayer is fully briefed and aware of any issues that may be sensitive or subject to investigation by the ATO or other authorities in relation to tax avoidance or tax havens; • Ensure that where there are other parties to an offshore transaction that the taxpayer is fully aware of the other parties integrity and role in the transaction; • Ensure that where there is a difference of opinion on an issue between a taxpayer and their advisor that there is appropriate documentation held by the taxpayer and advisor to reflect the outcome and the course of action decided upon; • Ensure that the taxpayer is made aware of any risks associated with questionable transactions and the risks of penalties that may be imposed;	These issues are outside the scope of the Determination.

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19. cont	• Ensure that the client and taxpayer are aware of new TIEA's and their effect on their offshore business activities; and • Ensure that there is trust between the taxpayer and their advisor. If this is not possible serious thought must be given to a cancellation of the professional engagement either by the taxpayer or their advisor.	
20.	TD 2009/D18 is fully consistent with previous ATO advice – in particular, that contained in TR 92/3. Whether TR 92/3 sits comfortably with the basis upon which a tax on capital gains was introduced into our taxation system is another question altogether. However, the ATO certainly cannot be accused of being inconsistent in its advice, although I do question the extent to which that advice has been applied in practice in drawing the line between capital gains and ordinary income.	Yes, the ATO is consistent on this matter. TR 2009/D18 merely applies the principles in TR 92/3 to a private equity arrangement. Interrelationships between TR 92/3 and the CGT law are broader questions.
21.	It is uncontroversial that the character of a receipt is to be assessed in the hands of the particular taxpayer (refer *Scott v. FCT* (1966) 14 ATD 286 and *The Federal Coke Company v. FCT* 77 ATC 4255). Where the taxpayer is a company, it is necessary to look to the 'controlling mind' of the company (refer *FCT v. Whitfords Beach Pty Ltd* 82 ATC 4031), which in most cases will be the company's board of directors. Case law does not permit a simple attribution of the investment manager's purpose to that of a taxpayer. While GP's and managers may make recommendations to an investee company, it is the board of that investee entity that makes the decision and has ultimate responsibility. Context is important.	The determination of the controlling mind of a company is a question of fact that has to be decided on a case by case basis. We agree that context is important.

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22.	An ATO proposition that the activities of the PE industry are sufficient to characterise any gain as falling on revenue account cannot be sustained. Investors would primarily comprise superannuation funds, governments, sovereign wealth funds and endowment funds. These passive investors, investing patient long-term capital, are usually legally restricted from being involved in any investment decisions at the fund level. They are long-term investors, often with significant long-tail superannuation and pension obligations that have allocated a portion of their total funds under management to the alternative asset class of private equity for the purposes of diversification and risk management. The facts do not bear out any proposition that the PE sector comprises a group of investors who collectively identify underperforming companies in foreign jurisdictions to acquire those shares, restructure the activities of the company and, in turn, sell the shares at a profit.	The Determination should not be taken as supporting a proposition that all gains from private equity arrangements are on revenue account. Each arrangement has to be considered on its merits in accordance with its own particular facts and circumstances. The Determination does not focus on the Australian income tax consequences for passive investors who reside in countries with which Australia has a double tax agreement.
23.	The responsibility and decision making related to restructuring the business of the investee rests with the board of the investee company. The GP or manager often has a service agreement with the investee company under which it may provide strategic and business advice for which it would be paid a fee. However, any decision is that of the board of the investee. As a matter of law it is not possible to conflate the intention of two separate taxpaying entities.	The total facts and circumstances of the particular arrangement would have to be taken into account. The existence of a service agreement between an investee and the investor would not be determinative that the responsibility and decision making necessarily resided with the board of directors of the investee company.
24.	The ATO should include in TD 2010/D18 an example of when a gain may be considered to be on capital account, in order to provide some 'balance' to the technical analysis and	An example has been provided in the final version of the Determination of when the gain would be considered to be clearly on capital account. The gain in the example provided in the submission may be on capital

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	conclusions reached. We provide the following as an example for the ATO to consider: A Cayman Islands collective investment vehicle (CCIV) is established to pool investment funds of various pension, superannuation funds, sovereign wealth funds, and endowment funds for investors that are primarily resident in North America and the UK. The fund is a closed-end fund and has a finite investment life of seven to ten years. The CCIV has an investment management agreement with a private equity firm. The CCIV has made investments in Asia, Latin-America and in Europe. In 2006, the CCIV made an investment in a Luxemburg company which in turn invested in a Dutch company that acquired all of the shares in a Singaporean telecommunications company.	account but we unable to provide the level of certainty being sought by saying that the gain would necessarily be on capital account. Is the investment a leveraged buyout? Are the shares acquired with the intention of re-selling them for a profit? The ATO would need to give detailed consideration to all the facts and circumstances surrounding this type of arrangement in order to form a view in respect of whether the gain from the IPO would be on revenue or capital account.

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24. cont	A recommendation is made to the CCIV in 2007 to invest in a small Australian telecommunications and information technology company (OziComTel). One reason underpinning the recommendation is the potential for a Pan-Asian telecommunications company. Consistent with previous practice, a structure is established whereby the CCIV invests in a Luxembourg company which in turn invests in a Dutch company which will acquire all the shares in OziComTel. On acquisition of the shares in OziComTel, the board of OziComTel is changed to include two independent directors plus the CEO of the business, an employee of the private equity firm and a director with significant telecommunications experience. The board of OziComTel embarks upon a process to restructure the business. This includes closing down unprofitable business lines. Several additional businesses are acquired over a three year period to take advantage of converging technologies and the need to provide content on a variety of platforms. These businesses include a content provider, pay TV and streaming content provider. Four years after acquisition of the OziComTel, a re-rating of telecommunications stocks occurs on a global basis. In June 2011 an investment bank proposes to the board of OziComTel a break up of the business given the attractiveness of pay TV providers to other participants in the market and having regard to their need for content. The Board of OziComTel rejects this recommendation. Six months later (December 2011) a different investment bank puts a proposition to the board of	

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24. cont	OziComTel recommending that given the global re-rating of telecommunications stocks, the board should consider an IPO of the entity on the ASX. Three months later the Dutch company sells all but 10 percent of its interest in OziComTel by way of an IPO. The remaining 10 percent interest is escrowed for a period of 12 months after listing. The Dutch company immediately repatriates the proceeds arising from the disposal of the 90 percent. The funds are repatriated through the Luxembourg company to CCIV and then to the investors in CCIV.	
25.	The determination contained in paragraph 13 of TD 2009/D18 that whether the profit from the realization of private equity assets will be ordinary income 'will depend on the circumstances of each particular case' leads to an interpretation uncertainty which will deter investments.	We are aware of the public debate about the effect of the Determination. The purpose of the Determination is to alert investors that it unwise to assume that profits from this kind of activity will always be only on capital account.

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25. cont	Furthermore, the case law cited in the draft determination of Californian Copper Syndicate (Limited and Reduced) v. Harris (1904) 5 TC 159 compounds this uncertainty in accepting that what separates an investment from what might be termed an investment business 'may be difficult to define, and each case must be considered according to its facts'. We note the statement that 'where an owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit…assessable to income tax'. We believe that this is the stronger rationale for supporting the view that investments in securities should be potentially differentiated from trading in securities. Private equity institutional investors believe that a private equity fund which adds value to an investment by active management should be treated no less favourably than a passive investor. The draft determination does not discuss what reliefs and allowances would be applicable to investors in a private equity fund if investments are to be assessed to income tax. Would these also be applied to investments on a case by case basis and how would a group be defined for the determination and calculation of such allowances? The effects of the determination could not only be uncertainty and reduced inward investment but could be increased tax arbitrage which would be undesirable for underlying businesses.	

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25. cont	Investment into Australian private equity backed businesses and by Australian fund managers is global. Investors are typically institutional and require investment vehicles to be in accordance with the tax laws of their own jurisdictions, and for these laws to be applied with dependable clarity. Until we have such clarity and on a basis comparable with other OECD countries active in the private equity industry, Australian businesses are likely to suffer a downturn in investment support.	
26.	In TD 2009/D18, the Commissioner expresses the view that if a private equity entity does not have the intention of becoming a long-term investor to derive dividend income from its shares, and if it is carrying on a business of restructuring and floating companies, due to the regularity and repetition and size and scale of its activities, the profit from the disposal of shares in the Australian public company would constitute ordinary income. TD 2009/D18 assumes a private equity group selling an investment in a business deal that 'would otherwise have an Australian source and be subject to Australian income tax'. There is unfortunately no analysis of whether the source of the profit, generated by foreign investors on their global investment, is in Australia (naturally if the source of the gain is outside Australia then different answers would arise in both the draft Determinations).	See draft Taxation Determination TD 2010/D7.

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26. cont	Given there are also no statutory guidelines in the Income Tax Act for determining the source of income, an expression of the Commissioner's view on when the gain on sale of the investment would be considered to be Australian sourced and when the gain would be considered to have a foreign sourced would be extremely helpful in providing clarify to investors. For the purposes of TD 2009/D18, we suggest that discussion on source should be included, and that the discussion be based on how these transactions are commonly set up. In particular, we suggest discussion of the following: • Private equity transactions often involve an on-shore private equity house which completes a lot of the work in relation to the investment by the private equity fund (in the example in TD 2009/D18, this would be the Cayman Islands entity). What effect, if any, does the relationship between the private equity house and the private equity fund have on the source of the income? • Investment managers and advisors often take an active role in making decisions in relation to the investment. What effect, if any, does the role of investment managers and advisers have on source (see *Trent Investments Pty Ltd v. FC of T* 76 ATC 4105; *FCT v. Radnor* (1991) 22 ATR 344)?	

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26. cont	• How is source affected in circumstances where the private equity fund does not actively participate in the management of an Australian investment company in which it holds shares? Ideally, the Commissioner's discussion on source should also include an expression of his views on the relevance of the following key facts in any given scenario: - Where the decision to sell shares in the Australian investment companies takes place; - Where the contracts for sale are concluded (see Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 at 322-323); - Where the purchase price is paid; - Where the private equity fund's shares in the Australian investment companies are registered on a branch register outside Australia at the time of sale.	