TD 2009/D17 - Income tax: treaty shopping - can Part IVA of the Income Tax Assessment Act 1936 apply to arrangements designed to alter the intended effect of Australia's International Tax Agreements network?

This document has been finalised by TD 2010/20.

There is a Compendium for this document: **TD 2010/20EC** .

Draft Taxation Determination

Income tax: treaty shopping – can Part IVA of the *Income Tax Assessment Act 1936* apply to arrangements designed to alter the intended effect of Australia's International Tax Agreements network?

This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Yes. However, it will depend upon whether a taxpayer has obtained, or would but for section 177F of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] obtain, a tax benefit in connection with the scheme and having regard to the factors in paragraph 177D(b) it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme.

[1] All subsequent references are to the ITAA 1936 unless indicated otherwise.

Example

2. *NV Offshore BV (Offshore) is the Dutch holding company of a newly incorporated Australian company that acquires all of the shares in Target Co, an Australian manufacturing company. An Australian consolidated tax group is then formed. Offshore is in turn owned by a Luxembourg entity that is itself owned by an entity resident in the Cayman Islands. Various United States resident investors and a private equity group control the Cayman Islands entity. Their primary purpose for acquiring Target Co is to improve its business operations in the short term and then sell the consolidated group via an initial public offering for an amount greater than the purchase price. There are no commercial reasons for using a Dutch company and a Luxembourg company as intermediate entities in the ownership chain, although there is a tax benefit in having the profit derived from the sale of the group by a Dutch company rather than the Cayman Islands entity because of the Australia–Netherlands tax treaty in relation to business profits sourced in Australia. In the absence of commercial reasons for the interposition of the Dutch and Luxembourg entities between the Cayman Islands entity and the Australian company and having regard to the factors set out in paragraph 177D(b), it would be concluded that obtaining this tax benefit was the dominant purpose of one or more persons who carried out the scheme of acquiring Target Co in the manner undertaken.*

Date of effect

3. When the final Determination is issued, it is proposed to apply to years of income both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
16 December 2009

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

4. Australia has a series of bi-lateral International Taxation Agreements which closely follow the OECD model convention. The agreements apply to persons who are residents of one or both of the contracting states and are for the stated purposes of the avoidance of double taxation and the prevention of fiscal evasion. The agreements are commonly called double tax agreements or tax treaties, although they are also intended to deal with fiscal evasion. Fundamentally, the treaties deal with the main structural bases on which sovereign states, generally speaking, build their domestic income tax systems – these are the concepts of ***residency*** and ***source***.

5. Australia seeks to tax residents on their income generally, wherever its source, whereas Australia seeks to tax non-residents only on their income sourced in Australia. Australia's tax treaties with other countries have provisions that may alter those basic rules where such agreement has been reached with the other contracting state.

6. So, for example, Article 7 of a typical treaty provides, broadly, that the profits of an enterprise of a contracting state shall be taxable only in that state unless it has a permanent establishment in the other state. In essence, absent a permanent establishment in Australia, the general position is that Australia has negotiated agreements on the basis that the residence of the taxpayer shall determine which country has the taxing rights in respect of business profits sourced in one of the contracting states.

7. Australia taxes both the income and capital gains of its residents. Where a capital gain is also an amount in the nature of income, that amount will not be taxed as a capital gain but as an income gain. For non-residents, in the absence of a business activity, acquiring and disposing of most Australian CGT assets results in an Australian exempt capital gain. However, the acquisition and disposal of assets in carrying on a business activity of buying and selling gives rise to a business profit of an income nature. This will be particularly so when the acquirer spends time enhancing the value of the assets acquired and has a known selling, or 'exit' strategy at the time of their acquisition (see Taxation Determination TD 2009/D18).

8. For residents of countries with whom Australia has a tax treaty, that business profit would only be taxable under their domestic tax rules. Australia does not seek to impose any level of taxation in this instance. It is different for residents of countries with whom we do not have a tax treaty.

9. There may be a number of reasons why an investor, or group of investors, resident in a country with which Australia has a tax treaty who wish to acquire a business asset in Australia, would not make that investment directly. The investors may create an investment vehicle, for example, a limited liability partnership or company in a tax haven country, and that entity may undertake the acquisition of the Australian business assets. Whilst this would put the taxation ramifications of the transaction beyond the terms of the tax treaty Australia might have with the investor's country of residence, the taxation position would simply be that Australia would exercise its taxing rights in respect of any subsequent business profit attributable to the disposal of the Australian assets by the tax haven resident entity.

10. So, for example, investors who are resident of the United States, or indeed a group of investors who are residents of various jurisdictions, may want to join together in creating an investment fund in the form of equity interests in an entity in the Cayman Islands. If the funds of that entity were used to acquire Australian business assets, that Cayman entity would be the relevant taxpayer for the purposes of the Australian taxation system. For residents of a non-treaty country deriving a business profit sourced in Australia, it has always been readily understood that Australia would seek to tax that profit.

11. This understanding may be responsible for arrangements involving the purchase of shares in Australian businesses where the arrangements go beyond what might be thought necessary to achieve the commercial goal of bringing various buyers together to make the purchase.

12. Whilst no particular adverse taxation conclusions ought to follow from the use of a Cayman Islands entity to invest into Australia, the use of more complicated structures to make the same investment may require a broader consideration.

13. For example, rather than make a direct purchase from the Cayman Islands of the Australian assets, the Cayman Islands entity may make an equity investment of its funds in a shelf company resident in another tax haven, which may then make an equity investment into a shelf company resident in a country with whom Australia has a tax treaty. (European resident interposed entities are often used.) The treaty country resident then capitalises an Australian company intended to be the holder of the target assets. (It is this new Australian holding entity that is ultimately the entity sold by the tax treaty country resident parent.)

14. There may be sound commercial reasons for creating this pattern of holding interests in a variety of jurisdictions. However, where none is apparent, it naturally requires consideration of why these interposed entities are there. For example, if a Dutch company buys and sells Australian assets and makes a business profit, the Australia–Netherlands tax treaty provides that the profit would be assessed in the Netherlands. If a Cayman Islands entity or a Luxembourg entity made a business profit on a similar transaction, the profit is assessable in Australia.

15. Under Australia's tax treaty with the Netherlands a business profit derived from Australian sources is taxable in the Netherlands, not Australia. The Netherlands domestic tax law, however, provides a participation exemption for mere holding companies that make capital gains or receive dividends from their subsidiaries. There is also a European Union tax directive regarding the non-imposition of withholding tax in respect of dividends paid from subsidiaries to their EU resident parent. In these circumstances if the Dutch holding company is owned, for example, by a Luxembourg holding entity, then one can see that a business profit that otherwise is taxable in Australia might be argued to have become a non-taxable gain in the Netherlands, a tax free dividend in Luxembourg, and then a tax free dividend to the Cayman Islands owner of the Luxembourg shelf company.

16. The characterisation of certain profits derived that are, for Australian taxation purposes, considered to be business profits, which in the Netherlands may well be characterised as mere capital gains in terms of Dutch tax jurisprudence, may explain the desire in tax terms to have the profits derived by a Dutch resident entity rather than its Luxembourg parent or its indirect Cayman Islands holding company.

17. The taxation considerations behind this kind of 'structuring', must be recognised as occurring in the intended absence of the application of the Australia–United States tax treaty to the transaction. The question arises whether Australia's domestic tax laws otherwise operate to overcome these kinds of arrangements.

18. The application and scope of Australia's tax treaties is subject to the operation of the general anti-avoidance provision, Part IVA of the ITAA 1936 (Part IVA). That is to say, while section 4 of the *International Tax Agreements Act 1953* (Agreements Act) incorporates within it the ITAA 1936 and the *Income Tax Assessment Act 1997*, and its provisions have effect notwithstanding anything inconsistent in those Acts, subsection 4(2) of the Agreements Act reserves that position in respect of the operation of Part IVA.

19. Where an arrangement is put in place merely to attract the operation of a particular tax treaty in the context of a broader structuring arrangement, this may be a scheme or a part of a scheme which otherwise satisfies the terms of Part IVA, and any tax benefit obtained in relation to such a scheme may be cancelled.

20. In the circumstances discussed above, a scheme involving the mere interposition of holding companies between an entity, resident in the Cayman Islands, and an Australian holding company for the target assets, gives rise to a tax benefit for the Cayman Islands entity. That benefit is the non-inclusion in the Cayman resident's assessable income of the Australian sourced business profit.

21. The application of Part IVA necessarily requires consideration of the particular facts of each case. However, 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. The application of section 177D in Part IVA as a practical matter will therefore, in the absence of other relevant matters, depend on the presence or absence of non-Australian tax considerations and their weight, when considered in accordance with the section 177D factors. 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.

22. More specifically, when:

(a) all the ultimate equity investors are equity holders in the Cayman Islands entity;

(b) each of the interposed entities is a mere holding company, that is, it's primary undertaking is to legally own the shares of the next company in the chain;

(c) each has little or no other business activity; and

(d) there are no regulatory reasons for these companies to be there,

it is difficult to see any commercial purpose for the structure used.

23. In terms of paragraph 177D(b):

- the manner of the acquisition involves an unnecessary hierarchy of holding companies;
- the form of the scheme is different to its substance. Commercially the substance of the scheme is the use of funds pooled in the Cayman Islands for an Australian acquisition whereas the form it takes involves the interposition of two entities between the Cayman Islands and Australia;
- the result of the scheme in relation to the operation of the ITAA 1936 is to remove the taxing point from Australia to the Netherlands;
- the consequence for the Cayman Islands entity is the indirect derivation of a gain that would otherwise have an Australian source and be subject to Australian income tax; and
- all the entities in the scheme are related parties.

Appendix 2 – Your comments

24. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

25. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**29 January 2010**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2009/D18

Subject references:

- anti avoidance
- double tax agreements
- international tax
- non-resident entities
- schemes & shams
- tax benefits under tax avoidance schemes
- treaties

Legislative references:

- ITAA 1936
- ITAA 1936 Pt IVA
- ITAA 1936 177D
- ITAA 1936 177D(b)
- ITAA 1936 177F
- ITAA 1997
- International Tax Agreements Act 1953 4
- International Tax Agreements Act 1953 4(2)

ATO references

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