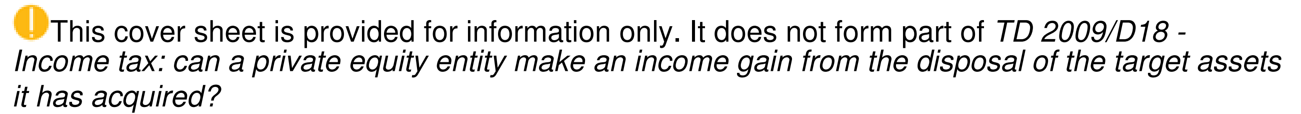
TD 2009/D18 - Income tax: can a private equity entity make an income gain from the disposal of the target assets it has acquired?



This cover sheet is provided for information only. It does not form part of *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 document has been finalised by TD 2010/21.

There is a Compendium for this document: **TD 2010/21EC** .

Draft Taxation Determination

Income tax: can a private equity entity make an income gain from the disposal of the target assets it has acquired?

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.

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Ruling

1. Yes. The profit from the disposal of such assets may be included in the assessable income of the private equity entity under subsection 6-5(3) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] where the profit is income according to ordinary concepts (ordinary income). When a profit will be ordinary income and therefore included in the assessable income will depend on all the circumstances of the particular case.

2. Where the private equity entity that has acquired Australian target assets is a resident of a country with whom Australia has a tax treaty, the business profits article will determine which country has the taxing rights in respect of that profit. It is generally the case that the country of residence of the profit maker will be entitled to tax those profits. Accordingly, non-resident private equity entities in treaty countries will not usually be subject to tax on their Australian business profits.[2] (See, however, draft Taxation Determination TD 2009/D17 in relation to treaty shopping arrangements, where the income gains may properly be taxed in Australia).

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[1] All subsequent legislative references are to the ITAA 1997 unless indicated otherwise.
[2] Whether that is so will depend on the terms of the business profits article in the relevant tax treaty: refer to the *International Tax Agreements Act 1953*.

3. If the profit is not ordinary income a capital gain or capital loss from the disposal of most CGT assets is disregarded for Australian income tax purposes if made by a non-resident of Australia.[3] CGT assets that are not taxable Australian property are exempt assets: subsection 855-10(1).

Example

4. *Offshore Co, acquires an Australian public company with the intention of restructuring its activities and re-floating the company on an Australian Stock Exchange. Offshore Co does not have the intention of becoming a long term investor to derive dividend income from its shares. 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 will constitute ordinary income. Even if Offshore Co's profit from this arrangement is regarded as a profit from an isolated transaction (for example because Offshore Co is a special purpose vehicle that carries out only this one operation) that transaction was still entered into in the course of carrying on a business or in carrying out a business operation or commercial transaction. Consequently, the profit constitutes income according to ordinary concepts for the purposes of section 6-5 (See Taxation Ruling TR 92/3 Income tax: whether profits on isolated transactions are income).*

Date of effect

5. 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

[3] Whether that is so will depend on whether the target assets held by the private equity investment entity are taxable Australian assets: refer to Division 855.

Appendix 1 – Explanation

➊ ***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.***

Relevant income tax law

6. Where a taxpayer enters into a profit making transaction in Australia in the course of carrying on a business or in carrying out a business operation or commercial transaction, the profit can be included in its assessable income under subsection 6-5(3) even if the profit arises from the sale of a CGT asset that is not taxable Australian property.

7. When a profit will itself be an income gain and therefore included in the assessable income of a resident of a non-treaty country will depend on all the circumstances of the particular case. The starting point in this area of the law is the statement of the Lord Justice Clerk (the Right Honourable J.H.A. Macdonald) in *Californian Copper Syndicate (Limited and Reduced) v. Harris* (1904) 5 TC 159 at 165-166 that:

> It is quite a well settled principle, in dealings with questions of Income Tax, that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit ... assessable to Income Tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. ... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of values by realising a security, or is it a gain made in an operation of business in carrying out a scheme of profit-making?

8. The Full High Court in *FC of T v. the Myer Emporium Ltd* (1987) 163 CLR 199 at 209-210, 87 ATC 4363 at 4366-7, (1987) 18 ATR 693 at 697:

> Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a 'one-off' transaction preclude it from being properly characterized as income (*Whitfords Beach* 150 CLR at 366-367, 376; 82 ATC at 4036-4037, 4042; 12 ATR at 695-696, 705). The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.

9. In TR 92/3*,* the Commissioner ruled as follows in relation to transactions with a profit making purpose:

> 15. If a taxpayer carrying on a business makes a profit from a transaction or operation, that profit is income if the transaction or operation:
>
> (a) is in the ordinary course of the taxpayer's business (see paragraph 32 for an explanation of the circumstances in which a transaction is in the ordinary course of business) – provided that any gross receipt from the transaction or operation is not income; or
>
> (b) is in the course of the taxpayer's business, although not within the ordinary course of that business, and the taxpayer entered the transaction or operation with the intention or purpose of making a profit; or

(c) is not in the course of the taxpayer's business, but

(i) the intention or purpose of the taxpayer in entering into the transaction or operation was to make a profit or gain; and

(ii) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction.

16. If a taxpayer not carrying on a business makes a profit, that profit is income if:

(a) the intention or purpose of the taxpayer in entering into the profit-making transaction or operation was to make a profit or gain; and

(b) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction.

Private equity investments

10. The Commissioner understands that a typical private equity acquisition involves:

- the direct or indirect acquisition of interests (such as shares) in a target entity (such as a company), often by a non-resident private equity entity;
- the holding of those interests for a period during which operational improvements are usually made (such as improving the management and cost structure of the target entity) to increase earnings over the life of the investment and improve the value of the target entity;
- the subsequent sale of the target assets (see paragraph 12 of this draft Determination).

11. The Commissioner understands that returns on a typical private equity investment depend on three factors:

(i) cash flows from operations;

(ii) operational improvements to increase earnings over the life of the investment; and

(iii) disposing of the shares of the target entity for a higher amount than was originally paid.

12. A key component of private equity as an asset class for institutional investors is that assets are typically realised after some period of time, which will vary depending on the investment strategy. Private equity acquisitions are typically realised by:

(i) an Initial Public Offering with shares of the company being offered to the public;

(ii) a merger or acquisition – the company is sold for either cash or shares in another company; or

(iii) a recapitalisation where cash is distributed to the shareholders (the financial sponsor) and its private equity funds.

See generally *Wikipedia: Private Equity*.

13. Whether the profit from the realisation of private equity assets will be ordinary income will depend on the circumstances of each particular case. These circumstances will include a weighing up of the relevant importance of each of the three factors driving returns, 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. TR 92/3 sets out guidance on the factors to be taken into account in determining whether a profit from a transaction is ordinary income.

14. If the profit made on the disposal of the Australian target assets is not ordinary income, a capital gain or capital loss from the disposal of the asset would usually be disregarded for Australian income tax purposes if made by a non-resident of Australia. CGT assets that are not taxable Australian property are exempt assets: subsection 855-10(1).

Appendix 2 – Your comments

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

16. 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**
Contact officer:	**Des Maloney**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 92/3; TR 2006/10; TD 2009/D17

Subject references:

- capital gains
- capital gains tax
- capital losses
- CGT assets
- CGT taxable Australian assets
- double tax agreements
- income
- international tax
- isolated transactions
- profit-making purpose
- profits

Legislative references:

- ITAA 1997
- ITAA 1997 6-5
- ITAA 1997 6-5(3)
- ITAA 1997 Div 855
- ITAA 1997 855-10(1)
- TAA 1953
- International Tax Agreements Act 1953

Case references:

- Californian Copper Syndicate (Limited and Reduced) v. Harris (1904) 5 TC 159
- FC of T v. the Myer Emporium Ltd (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693

Other reference:

- Wikipedia

ATO references

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