TD 2010/20EC - Compendium

Ruling Compendium – TD 2010/20

This is a compendium of responses to the issues raised by external parties to draft 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 compendium of comments has been edited to maintain the anonymity of entities that commented on the draft Determination.

Summary of issues raised and responses

Issue No.	Issue raised	ATO Response/Action taken
1.	There should be a system of Tax Clearance Certificates in relation to offshore transfer of assets. Such a system should cover financial institutions in relation to the transfer of substantial sums of money. Taxpayers and their advisors should take steps to ensure that any offshore transactions are bona fide and have a commercial purpose.	Systemic changes are matters outside the scope of the Determination.
2.	The analysis needs to be expanded to make it clear that one has to look at the relevant counterfactuals and come to a conclusion as to whether the most appropriate counterfactual would have produced a liability to Australian taxation, thereby potentially attracting the operation of Part IVA.	Agreed.
3.	The Determination is having a detrimental effect on investment.	We are aware the public debate about the effect of the Determination.
4.	The draft Determination accords with neither the tax policy implicit in our domestic law or as modified under our concluded treaties.	We do not agree. The Determination sets out the way the domestic law operates in a particular fact scenario. Our concluded treaties do not preclude the operation of our general anti-avoidance rule.

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5.	Presumably the Cayman Island entity in the example has no commercial substance so why is it the taxpayer who is assessed. Why not the ultimate US resident investors?	See draft Taxation Determination TD 2010/D8.
6.	Taxpayers will now be required to ignore corporate residency as established under international principles and instead search for the substance of the investment as established under domestic Australian law.	The issue is whether there are genuine commercial reasons for establishing a special purpose corporate entity in a treaty country to undertake a particular transaction.
7.	It is incorrect to say that Part IVA powers are reserved by section 4 of the Agreements Act. It is more correct to say that Part IVA is the domestic enactment which is unmodified in operation by tax treaties.	The two propositions seem to be the same.
8.	The Review of Business Taxation suggested that a revised tax benefit definition was needed to deal with treaty shopping. Why is it now said that Part IVA applies to treaty shopping. Was the Review wrong or has there been a change in approach?	There has been no change in approach. It has always been considered that Part IVA may apply in a case of 'treaty shopping'.
9.	The OECD commentary suggests that notwithstanding general anti-avoidance rules treaties should adopt specific provisions to deal with particular kinds of avoidance techniques. Our general rule arguably doesn't work so we should have adopted specific rules to deal with treaty shopping events. We haven't, so conduit companies shouldn't be denied treaty benefits.	Conduit companies will not necessarily be entitled to treaty benefits if their purpose is merely to attract the operation of a particular treaty provision so as to obtain a tax benefit and the circumstances of the case otherwise attract the operation of Part IVA . The Determination describes a set of circumstances where our general anti-avoidance rule may apply.
10.	By applying Part IVA as outlined practical treaty benefits will be denied residents of Australia's treaty partners.	In cases of tax avoidance, this is correct.

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11.	The analysis of tax consequences occurring after the remission of funds up the chain is irrelevant to the application of Part IVA and the effect on Australian tax payable and should be deleted.	We do not agree.
12.	A direct investment from the US would not give rise to a tax benefit whereas an indirect investment via the Caymans does. This is odd given that the Cayman entity is used to pool the invested funds.	See draft Taxation Determination TD 2010/D8.
13.	An indirect investment into Australia via a MIT would not create an Australian liability so why should a transaction with the same effect attract Part IVA?	If an Australian sourced business profit is derived from a transaction by an entity that is not a resident of a country with whom we have a tax treaty we would seek to tax that profit.
14.	Might the use of the Cayman entity have sound commercial reasons?	Certainly.
15.	What is meant by the term 'significant commercial activity'?	The phrase is intended to distinguish a special purpose holding entity from another entity that engages in a broader range of commercial activities.
16.	The role of the Board of the intermediate offshore holding company: Is this a relevant consideration about the business activities of that company?	Yes.
17.	The rulings will deter managers from establishing in Australia and funds from investing in Australian assets. Australia could very well see itself 'cut out of' the global investment universe.	We are aware of the public debate about the effect of the Determination.

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18.	Contrary to the Commissioner's comments in paragraphs 7 and 11 of TD 2009/D17, the collective investment vehicle 'CIV' is not put in place to manage the Australian assets or to spend time improving the value of the Australian assets. Instead, as the CIV is purely a passive investment vehicle, the CIV and any holding offshore company it may establish would not involve itself in the day to day management or restructuring of the Australian assets. Rather, in their capacity as a shareholder/investor they are obliged to remain at arm's length and their only input might be to seek to change the composition of the Australian company Board. The location of the CIV will depend on a variety of factors. Of particular importance is the need for political stability, an established legal framework and a sophisticated regulatory environment with access to high quality service providers. From a tax perspective, it is important that the CIV be formed in a jurisdiction which is tax neutral. This ensures that the investors (who, as discussed, are predominantly resident in OECD countries) are taxed on their investments only in their country of residence, rather than being subject to additional layers of taxation. It is noted that the TD 2009/D17 regularly refers to the Cayman Islands as a country through which investors hold their (indirect) Australian investments.	See draft Taxation Determination TD 2010/D8.

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18. cont	However, whilst the Cayman Islands is a tax neutral jurisdiction, this point in itself does not mean that private equity investors who invest through the Cayman Islands will not be subject to the tax laws of their countries of residence. As mentioned, the purpose of forming a CIV in a tax neutral jurisdiction – such as the Cayman Islands – is merely to prevent an additional layer of tax, not to preclude the ultimate investors from being taxed appropriately on the return from their investments in their country of residence. By treating a Cayman Islands CIV as the relevant taxpayer, we note that the Commissioner appears to be disregarding the OECD Commentary on the OECD Model Tax Convention in relation to the taxation of partnerships. AVCAL notes that the OECD commentary states that where a partnership's income has been allocated to a partner for tax purposes, a partner in a partnership should be able to obtain access to treaty benefits pursuant to a treaty between the partner's country of residence and the source country, notwithstanding that the partnership (which may be in a different country to the partner) may not be able to access the treaty benefits by virtue of its tax-transparent nature.	

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19.	Paragraph 10 of TD 2009/D17 states that where the funds of a Cayman entity are used to acquire Australian business assets, it is the Cayman entity that would be the relevant taxpayer for the purposes of the Australian taxation system. In our view, it is contradictory for the Commissioner to impute the CIV (which as discussed, is simply a passive vehicle to facilitate the investment) as the economic holder of the Australian investment, rather than the investors. We further note that the choice of the passive CIV entity as the relevant taxpayer (but not the investors) is particularly curious in light of the Commissioner's apparent ease in disregarding the existence of other legal entities in the structure, namely a Dutch company and a Luxembourg company. In our view, the Commissioner should be consistent in its analysis of private equity holding structures – if the Commissioner intends to disregard interposed entities, the Commissioner should disregard all interposed entities, including the CIV and focus on whether a tax benefit would have arisen if the relevant investors had invested directly in Australian assets.	Structuring ownership arrangements without evident commercial reason for interposing holding entities below the CIV, which seem merely to create a tax advantage, are liable to attract the operation of Part IVA.
20.	We believe that finalising TD 2009/D17 in its current form will also have wider adverse implications for Australia. The use of interposed entities to structure Australian investments is a long held practice of non-residents who, for various legal and regulatory reasons, are often not comfortable with investing in Australia directly.	There may be a variety of reasons for making particular choices about the use of entities to 'structure' investments and the domestic and international taxation consequences will differ depending on the choices made.

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21.	**The draft Determination provides a simplistic and incomplete overview of complex law** The operation of Part IVA is complex. The ATO has a long and comprehensive ATO Practice Statement Law Administration PS LA 2005/24 'Application of General Anti-Avoidance Rules' which considers Part IVA and ATO processes to ensure integrity of Part IVA determinations, including the General Anti Avoidance Rules (GAAR) panel. The brief draft Determination does not refer to the complexities and relevant factors sufficiently.	The Determination describes a particular set of circumstances that may attract the operation of Part IVA. It is not a decision to apply Part IVA. Reference will be made in the final Determination to the Practice Statement.
22.	**Possible significant departure from the ATO's previous views and practice** The ATO's long standing views and practice, expressed privately and publicly, were that Part IVA was not automatically applicable to such Pooled Funds transactions. 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 Part IVA will apply, any such significant change in view should only apply prospectively.	We are not saying that pooled fund transactions automatically attract Part IVA. We are saying that particular features of certain kinds of arrangements may attract the operation of Part IVA.

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23.	**The draft Determination fails to consider whether the income has an Australian 'source'** If the ultimate investor in the Pooled Fund is a non-resident entity, the question of source is critical to consideration of Part IVA. Australia has no right to tax a non-resident investor, unless the source of the income is Australian. So Part IVA will have no application to a non-resident unless the source of the income is Australian. 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 Determination is premised on the profit being an Australian sourced business profit. It does not apply if the source is ex-Australian. For a discussion of the source question see draft Taxation Determination TD 2010/D7.
24.	**Investors in Pooled Funds are predominantly located in Tax Treaty countries** The majority of investors in Pooled Funds are from countries with which Australia has existing tax treaties. In an investment context, the purpose of these treaties is to ensure that, except in specific circumstances, the individual investors are only taxed according to the taxation laws applicable in their country of residence. As currently drafted, the draft Determination is inconsistent with the purpose of the treaties.	Interposing conduit entities, including in the Netherlands, seems to be for the dominant purpose of obtaining an Australian tax benefit. This is inconsistent with the objective of our domestic law and our tax treaties whereas the Determination is consistent with the objectives of our domestic law and our tax treaties.

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25.	**The draft Determination acknowledges that each case depends on its own unique facts, but the analysis proceeds on the basis of a single limited set of facts** The draft Determination contains only one very narrow example. It does not identify those circumstances which tend against or preclude the application of Part IVA. Indeed, there is no concession anywhere in the draft Determination that Part IVA will not apply in every case.	The Determination is intended to deal only with a particular fact pattern.
26.	**The example transaction is not representative** The example transaction chosen by the ATO to illustrate its views is not representative of all such Pooled Fund transactions, and fails to recognise the commercial factors that may drive a particular transaction structure.	The Determination is intended to deal with a particular fact pattern in the circumstances where there are no evident commercial factors for interposing conduit entities.
27.	**The draft Determination identifies the wrong taxpayer** In effect, the draft Determination asserts that Pooled Fund transactions are structured in a particular way to avoid tax, but the draft Determination then seeks to impose tax on an entity within the structure that the draft Determination criticises. However the focus ought to be on the end investors being the foreign superannuation funds and institutional investors – if the particular transaction structure was not adopted, the taxed entity would not have participated in the transaction and Part IVA could not apply to it. This is relevant for purposes of analysing the tax benefit as well as the dominant purpose.	The Determination takes the facts as described and asserts that within those arrangements are steps that constitute a scheme to which Part IVA may apply. See draft Taxation Determination TD 2010/D8 for a broader discussion about fiscally transparent entities.

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28.	**The tax benefit – which entity is considered where ultimate investors are in treaty countries** Why do US investors simply not invest directly? The answer lies in US tax considerations and regulatory issues not avoidance of Australian tax.	We accept this claim in part. The choice to invest via a resident Cayman entity may be driven by US tax considerations and regulatory issues. The choice to use interposed European subsidiaries seems to be to avoid Australian tax.
29.	**Other relevant factors in the Part IVA analysis** In considering the counterfactuals for purposes of Part IVA, the existence of any tax benefit and the dominant purpose, as noted in PS LA 2005/24, in relation to Pooled Funds and Collective Investment Vehicle (CIV) structures, we submit that the analysis should have regard to at least the following additional relevant factors. **(a) The identity of the ultimate investors in private equity transactions** As the Commissioner will be aware, the primary investors in Pooled Funds are institutional investors such as superannuation funds and pension funds in North America and from European countries together with Sovereign Wealth Funds. These entities are subject to their own particular tax treatment in their own countries – which are also likely to have entered into tax treaties with Australia. If each investor invested into Australia directly rather than through a Pooled Fund, they would undoubtedly have access to those treaty benefits (in the case of the superannuation and pension funds for example) or would have been exempt from Australian tax (in the case of Sovereign Wealth Funds for example).	See draft Taxation Determination TD 2010/D8.

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29. cont	The investors do not invest directly, instead placing funds with various professional managers across many different asset classes of which Pooled Funds are just one. The investors invest through CIVs, typically through trusts or similar CIVs. In the draft Determination example, the relevant CIV is 'Offshore Co'. By taxing the CIV, the ATO will effectively be subjecting the individual investors to tax in Australia, and then separate tax treatment in their own countries. Further, the investors may not receive any credit or other relief in their own countries for any Australian tax paid because technically, the tax is borne by a different entity. The investors are not focused on the avoidance of taxation as their dominant purpose. Rather, from a tax perspective, any structure should be tax neutral – that is the structure should not result in the transaction being taxed at a higher rate than if the investor had invested directly. **(b) Whether investors may receive treaty benefits even through intermediary Cayman Island entities** A further aspect which the draft Determination should consider is that in certain circumstance the investors may be able to obtain treaty relief based on double tax agreements entered into between their country of residence and Australia even through a Cayman Island intermediary entity. This is relevant for both tax benefit and dominant purpose aspects of Part IVA.	See draft Taxation Determination TD 2010/D8.

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29. cont	The Determination, and the ATO more generally, should consider whether, for example the US considered the Cayman entity as a flow through entity, Australia should recognise the residency of the investor in the treaty country and grant the relevant treaty benefits even where Australia would see the intermediary Cayman Island entity not a look through entity under domestic Australian provisions. The Commissioner should have regard to the fact that US investors in their perception of Australian tax profiles would have been influenced by Australia's membership in the OECD and the apparent practice of various countries in the OECD to allow pass through treatment where an entity is regarded as a separate taxable entity in the country of source and as transparent for taxation purposes in the country of residence. This principle is recognised in the OECD Partnership report from 1999 and in the commentary to Article 4 of the OECD Model Convention but also recognised in a number of ATO interpretive Decisions. If the investors would have obtained treaty protection from gains on disposal in case of a direct investment from the Cayman Islands (rather than via a third treaty country), the additional structures attacked by the draft Determination would not provide an additional tax benefit which the Commissioner could deny under Part IVA. These aspects are not reflected in the draft Determination.	

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29. cont	**(c) The commercial and historical factors in the use of a Cayman Islands structure in private equity transactions** It is important in the analysis to note that avoidance of the host countries' capital gains tax or income tax on divestment is not the primary driver of the structure of Pooled Fund transactions. Cayman Islands entities are not used for the dominant purpose of tax avoidance in such structures. Rather, the Cayman Islands has developed into a major offshore financial centre (OFC) in relation to the investment of funds pooled from various classes of investors in North America and Europe. The discussion in the IMF Background Paper 'Offshore Financial Centers' prepared by the Monetary and Exchange Affairs Department provides a practical definition of an OFC as: a centre where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. Thus OFCs are usually referred to as: • Jurisdictions that have relatively large numbers of financial institutions engaged primarily in business with non-residents; • Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and • More popularly, centers which provide some or all of the following services: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.	The submitter has acknowledged that US tax considerations are a key factor in the use of Cayman Islands CIVs. We accept that a purpose of so doing is the desire to avoid the operation of US attribution rules.

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29. cont	As the ATO will be aware, through its interactions with other OECD tax jurisdictions and revenue authorities, many key OECD and European countries have participation exemptions for non-resident investors that sell interests in entities in their jurisdictions. Cayman Islands CIV entities are nevertheless used to invest into investments in those OECD countries. **(d) The fact that a Cayman Islands, Luxembourg and Netherlands/Belgium structure is the conventional form of private equity investment structure internationally** We understand that the investment in Pooled Funds is a conventional form of investment structure internationally. Structures similar to those in the draft Determination example are commonly used by CIVs and managers of Pooled Funds. Such structures have evolved so that the use of Cayman, Luxembourg and Netherlands (or alternatively Belgian) entities as intermediaries between the ultimate investors pooling their funds and the final investment is widespread. The reasons for the widespread use of a Netherlands or Belgian structure for example, are not for the elimination or avoidance of capital gains taxes on the divestment of the target investment. The draft Determination fails to address these issues, but simply assumes or asserts that there are no commercial reasons for the existence of these entities as part of the transaction structure.	We understand and agree. The Determination is criticised for noting that no apparent commercial reason for the interposed European conduit entities is evident, but it is also noteworthy that none is being suggested by the submitter. What are the commercial reasons for using the European conduit entities?

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29. cont	The structure of a Luxembourg and Netherlands or Belgian entity below the Cayman Islands CIV is very well known to North American and international investors. North American and European pension funds and institutions and their advisers know the structure. The Netherlands entity also allows efficient funding structures in relation to interest payable in relation to many European private equity transactions. Thus, we understand, any organisation looking to establish a CIV for cross border investment of funds sourced from the US or Europe, including funds sourced from pensions funds, superannuation funds, institutional and sovereign fund investors, would normally consider this conventional structure as its first option. **(e) The commercial substance of the entities is consistent with commercial norms** As the PS LA 2005/24 notes, the 'commercial norms, for example, standard industry behaviour' are relevant to Part IVA analyses. The comment at para. 22 of the draft Determination, in relation to the entities supporting the Pooled Fund, that '(c) each has little or no other business activity' needs to be reconsidered given that the commercial activities, by entities in standard acceptable structures which apply in cross border investment vehicles, will typically be consistent with the requirements applicable for other countries and for the regulatory and other objectives of the Pooled Fund. As noted, these issues are relevant in the analysis both of tax benefit and of dominant purpose.	The Determination seeks to outline the likely tax consequences of entering into arrangements whose purpose appears to be the avoidance of otherwise payable Australian income tax. The particular arrangements entered into are not 'standard acceptable structures' for Australian tax purposes.

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29. cont	**(f) Conclusion and Date of effect** A complete and thorough analysis of the surrounding facts and circumstances must be undertaken when considering whether Part IVA applies to a particular transaction. Importantly, those facts include the identity, location and purposes of investors utilising Pooled Funds when making international investments; and the source of any income flows. The relevant facts also include the particular tax consequences for those investors if the investment were individually made directly by each of them. Considered in that light, we submit that the use of CIVs and their particular locations does not lead to an automatic conclusion that there is a tax benefit for purposes of Part IVA, nor that there is a dominant purpose of tax avoidance and does not give rise to the application of Part IVA in the manner asserted in the draft Determination. If, however, the ATO intends to use this Determination to communicate a default ATO position that any inbound investor Pooled Fund using an entity located in the Netherlands etc. raises a presumption that Part IVA applies, that would amount to a changed position on the part of the ATO. In such a situation the Professional Bodies submit that the eventual Determination should not have retrospective application.	We agree that the use of CIV's does not lead to any automatic Australian tax conclusions. The Determination does not set a 'default' position in relation to inbound investors using an entity located in the Netherlands and does not articulate a changed ATO position.