TD 2010/D7 - Income tax: is 'Australian source(s)' in subsection 6-5(3) of the Income Tax Assessment Act 1997 dependent solely on where purchase and sale contracts are executed in respect of the sale of shares in an Australian corporate group acquired in a leveraged buyout by a private equity fund?

This document has been finalised by TD 2011/24.

There is a Compendium for this document: **TD 2011/24EC** .

Draft Taxation Determination

Income tax: is 'Australian source(s)' in subsection 6-5(3) of the *Income Tax Assessment Act 1997* dependent solely on where purchase and sale contracts are executed in respect of the sale of shares in an Australian corporate group acquired in a leveraged buyout by a private equity fund?

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. No. For the purposes of subsection 6-5(3) of the *Income Tax Assessment Act 1997* (ITAA 1997), source is determined having regard to all the facts and circumstances of the particular case.

Example

2. *Priveq LLP is a limited liability partnership formed in a low tax jurisdiction. It is a 'corporate limited partnership' within the meaning of that term in section 94D of the Income Tax Assessment Act 1936 (ITAA 1936) and is therefore treated as a company for Australian income tax law purposes. Assume Priveq LLP is not a resident of Australia under section 94T of the ITAA 1936.*

3. *Priveq LLP's primary purpose is acquiring shares in Australian resident companies, improving the business operations of those companies in the short term and then selling the shares for an amount greater than the purchase price.*

4. *Priveq LLP incorporates Hold Co, an Australian resident wholly owned subsidiary company. Hold Co acquires all of the shares in Target Co, an Australian manufacturing company. An Australian consolidated tax group is then formed. Prior to purchasing the shares, Advice Co, an Australian resident entity controlled by Priveq LLP, undertakes research into Target Co to ascertain its suitability for acquisition, its current value, potential for enhancement and likely subsequent sale price.*

5. *Priveq LLP seeks debt funding for the acquisition from Australian based lenders. Negotiations in respect of this funding are conducted in Australia by Advice Co.*

6. *Priveq LLP disposes of the consolidated group to New IPO Co which is then sold via an initial public offering. The contracts for the sale of the shares in Hold Co are executed outside Australia. Priveq LLP derives profits from the disposal of the shares.*

7. *Weighing up the various elements that resulted in Priveq LLP realising a profit, the Commissioner considers that the profits arising from the disposal of Hold Co have an Australian source. Although the profits ultimately arise as a result of the sale of shares through contracts executed outside Australia, the activities that, in substance, give rise to those profits take place in Australia. This includes obtaining debt funding, researching, selecting and acquiring Target Co, and enhancing its profitability and ultimate sale value.*

Date of effect

8. When the final Determination is issued, it is proposed to apply 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 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
1 December 2010

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.

Private equity

9. As a matter of practice, most private equity funds are structured as limited liability partnerships. The investors become limited partners and the private equity firm becomes the general partner, that is, the manager of the partnership.

10. The general partner is itself quite often a limited liability partnership. Most funds are organised in low tax jurisdictions. One kind of activity undertaken by private equity funds is known as a 'leveraged buyout'.

11. Essentially, the fund looks for a business that is able to be acquired and potentially resold for a profit in a relatively short period. The fund commits investors' money (equity) to partially fund the cost of the target assets. Debt (leverage) is used to fund the balance. Generally, the investment is highly geared.

12. As the fund's organiser, the private equity firm is in the business of finding suitable target assets, assembling investors, undertaking the activity of buying those assets, improving their value and then selling them. Indeed, the firm's remuneration – a management fee during the holding period and a share of the profit on disposal – reflects this process.

13. How the target assets are assessed, acquired, improved and resold will vary depending on the circumstances, but usually the private equity firm has a local entity which it owns or controls that undertakes activity in this regard on the fund's behalf.

14. The entity is often described as an advisory firm because its activity is undertaken pursuant to contracts for advice entered into with its parent and the target entity. In this way, the activities of the target entity may be aligned with the wishes of its new owner during the holding period.

Source taxation

15. Australia's income tax system, broadly speaking, seeks to tax residents of Australia on their ordinary and statutory income derived directly or indirectly from all sources, whether in or out of Australia. Foreign residents are taxed on their ordinary income derived directly or indirectly from all Australian sources and their statutory income from all Australian sources. (Foreign residents may also be taxed on ordinary and statutory income on some basis other than having an Australian source, but this is not presently relevant.)

16. Where the foreign resident is resident of a country with which Australia has a tax treaty, profits arising from an arrangement of the type described above would generally constitute 'profits of an enterprise' for the purposes of the relevant tax treaty and fall within that tax treaty's Business Profits Article. Under paragraph 1 of that Article, Australia as the source country may not tax the profits of an enterprise unless the enterprise carries on business in Australia at or through a permanent establishment here and those profits are attributable to that permanent establishment.[1]

17. However, where the private equity fund has been organised in a non-treaty country and to the extent that the partners of the private equity fund are not residents of a country with which Australia has a tax treaty or not able to substantiate that they are residents of one of Australia's tax treaty partners (see draft Taxation Determination TD 2010/D8), the source of the profit from the disposal of shares acquired in a private equity backed leveraged buyout is crucial to determining whether an Australian tax liability exists.

18. Determining the source of an item of income is a matter of fact to be determined with regard to the facts and circumstances of each case.

19. In *Nathan v. FC of T,*[2] Isaacs J said:

> The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.'[3]

20. In *Tariff Reinsurances Ltd v. Commissioner of Taxes (Vic),*[4] Rich J said that both the form and substance of a transaction are relevant to the question of source:

> We are frequently told, on the authority of judgments of this court, that such a question is 'a hard practical matter of fact'. This means, I suppose, that every case must be decided on its own circumstances, and that screens, pretexts, devices and other unrealities, however fair may be the legal appearance which on first sight they bear, are not to stand in the way of the court charged with the duty of deciding these questions. But it does not mean that the question is one for a jury or that it is one for economists set free to disregard every legal relation and penetrate into the recesses of the causation of financial results, nor does it mean that the Court is to treat contracts, agreements and other acts, matters and things existing in the law as having no significance.[5]

21. In *Spotless Services Limited & Anor v. FC of T,*[6] Lockhart J said:

> The cases demonstrate that there is no universal or absolute rule which can be applied to determine the source of income. It is a matter of judgment and relative weight in each case to determine the various factors to be taken into account in reaching the conclusion as to source of income.[7]

---

[1] Subject to modifications, the business profits/permanent establishment principle is common to all of Australia's tax treaties and is based on Article 7(1) of the OECD Model Tax Convention on Income and on Capital as at July 2010. Furthermore, where the business profits are attributable to a permanent establishment in Australia, the tax treaty may deem the source of the business profits to be Australia. See, for example, Article 27(1)(a) of the US Convention.
[2] (1918) 25 CLR 183.
[3] At 189-190.
[4] (1938) 59 CLR 194.
[5] At 208.
[6] 93 ATC 4397.
[7] At 4409.

22. On appeal to the Full Federal Court,[8] Beaumont J agreed with Lockhart J's views and said:

> As has been noted, Lockhart J stated, correctly in my view, that the test to be applied in determining the source of income is to 'search for the 'real source' and to judge the question in a practical way'. As his Honour went on to say (at ATC 4409-10), it is a matter of 'judgment' and 'relative weight' in each case to determine the various factors to be taken into account in reaching this conclusion. I also, with respect, agree with his Honour's statement (at ATC 4410 – cited above) as to the relative importance, for present purposes, of the place or places where the contract was made and the money lent.[9]

23. Thus, to summarise, as Bowen CJ said in *FC of T v. Efstathakis*:[10]

> … the answer is not to be found in the cases, but in the weighing of the relative importance of the various factors which the cases have shown to be relevant.[11]

24. In *Australian Machinery and Investments Company Ltd v. Deputy Commissioner of Taxation (WA)*[12] the taxpayer (a Victorian company) acquired mining interests in Western Australia which were sold to Australian companies in return for shares in those companies. It then sold the shares in those companies in the United Kingdom (UK) in return for cash or shares in UK companies. It then sold the shares in the UK companies in the UK for a profit.

25. The court said that the source of the profits on the sale of the shares in the Australian companies in the UK arose from a series of operations carried on with a view to a profit. Since the operations were carried on partly in Australia and partly in the UK, the profit on sale was to be apportioned between those two sources.

26. Latham CJ quoted a passage from the judgment of Rich J at first instance:

> I feel no doubt that if a person, trading in wares which are locally situated in one country, makes a profit by selling them in another country, the source of his profit is in part the wares and in part the contracts of sale, and the locality of the source is in part the locus of the wares and in part the locus of the contracts.[13]

27. *Thorpe Nominees Pty Ltd v. Federal Commissioner of Taxation*[14] (*Thorpe*) concerned whether the profits on the sale of land were assessable where Australian residents were parties to the sale of land located in Australia. The contract of sale was executed in Switzerland (under a scheme the Court found was primarily aimed at avoiding Australian tax).

28. Lockhart J decided that as a matter of substance, the source was Australia rather than Switzerland. The activities in Switzerland were merely 'part of a pre-arranged plan' to avoid tax in Australia. It was relevant that there was no particular reason for choosing Switzerland as opposed to any other country outside Australia other than the attraction of low tax rates.

---

[8] *FC of T* v. *Spotless Services Limited & Anor.* 95 ATC 4775.
[9] At 4789.
[10] 79 ATC 4256 at 4259.
[11] At 4259. Affirmed by Lockhart J in *Spotless Services Limited & Anor v. FC of T* 93 ATC 4397 at 4409.
[12] (1946) 180 CLR 9.
[13] At 16.
[14] 88 ATC 4886.

29. Burchett J stated:

> What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs. …
>
> The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income – where it came from – as a businessman would perceive it.
>
> If the matter is approached in this way in the present case, the substantial considerations point in unison to the selection, from the elements which culminated in the income being derived, of the solid facts and circumstances existing in Australia. The legal acts performed in Switzerland were ineffective in themselves to achieve anything – they were wholly dependent for their force upon Australian lands and events, and upon the persons who conceived them in Australia and also returned to consummate them here.[15]

30. *Thorpe* is authority for the importance of looking at the substance of the transaction as a whole rather than adhering to rules about certain types of transactions.[16] This may be particularly so where it is plain that the transaction was structured so as to avoid tax in Australia.

31. Thus, while the place of execution of the contracts is of some relevance, the cases illustrate that it is not of itself determinative. The weight to be attached to this factor is to be considered relative to all relevant factors, including those occurring before and during the investment. Also, the relevance of this factor may diminish relative to other factors where the arrangement is structured to avoid source taxation.

32. There are a number of steps and activities undertaken during a leveraged buyout arrangement, all of which contribute in some way to the realisation of the ultimate profits. These include:

- Undertaking preparatory activities, including those pertaining to factors such as assessments of profitability and risk.

  In the usual case, a holding and subsidiary company, at least, will have been incorporated prior to the acquisition of the target assets. The advisory company and sometimes an associated management and administration company will have been set up and already undertaking or co-ordinating certain activities.

  Prior to the purchase of the target assets, a significant amount of work will have been done in Australia in determining the suitability of the particular business sought to be acquired. Its current value and its potential for enhancement and subsequent sale at substantial profit will have been exhaustively researched. This analysis is a broad undertaking and much of it will, if not actually undertaken by the resident advising entity owned or controlled by the private equity firm organising the proposed buyout investment, have been certainly co-ordinated by that entity. This entity is in effect doing the business of the private equity firm (and general partner) in Australia and it will have an on-going role in ensuring that the target business is conducted in the manner consistent with the aims of the new owners.

[15] At 4897.
[16] In particular, from the judgments of Lockhart J at 4893 and Shepherd J at 4895.

- Sourcing and negotiating the funding.

  If the debt (leverage) required to fund the purchase of the target assets is from Australian lenders, it may be presumed that some level of negotiation and discussion will have occurred between the private equity firm's Australian connections and the lenders.

- Executing the purchase and sale contracts.
- Making the payments.

  The equity component of the purchase price (that is, the amount of money coming from the partners of the private equity fund) will be usually forwarded after it has been decided to make the purchase of the target assets. As this will, in form, be the amount paid for shares in a company already controlled by the private equity firm, the firm is able to determine whether that company makes the fund an offer to subscribe for its shares or whether the fund makes an offer to acquire shares in that company.

- Actively managing the investment in the target entity and making operational improvements such as streamlining the target entity's activities and financing to improve the investment return.
- Undertaking business plan development and management support activities during the period of investment in the target company.

These last two factors are typically undertaken in conjunction with the related local advisory company in Australia.

33. When determining the source of profits, the relative weight to be given to each element will be a question of fact in every case. However, the Commissioner considers that key factors increasing or impacting on the profit are:

- the business ability in assessing suitable target enterprises;
- making operational improvements; and
- the steps making the acquisition of the business possible (such as arranging finance).

34. Where these activities are undertaken in Australia, as we understand they are in a typical leveraged buyout arrangement, the source of the profits will be Australia. The execution of the contracts are simply the acts which crystallized the return and do not, in substance, affect the increase in return upon investment.

Part IVA

35. In some cases, taxpayers may implement a plan designed to ensure that profits arising from the divestment of private equity investments are not sourced in Australia. If the taxpayer has successfully structured the arrangements in such a way so as to require the conclusion that the profit upon the disposal of its interest in the Australian group does not have an Australian source, the Commissioner will consider whether the general anti-avoidance rules in Part IVA of the ITAA 1936 may apply.

36. Part IVA of the ITAA 1936 allows the Commissioner to cancel a tax benefit obtained in connection with a scheme carried out for the purpose of enabling a taxpayer to obtain that benefit.

37. In the example described in paragraphs 2 to 7 of this draft Determination, if it were to be concluded that had the subscription contract and the sale contract for the shares in Hold Co been entered into in Australia the profit would have had an Australian source, then a scheme that merely involves entering into contracts outside of Australia may be said to have been carried out (subject to paragraph 177D(b) of the ITAA 1936) for the purpose of enabling *Priveq LLP* to obtain the tax benefit of not having what would have been an Australian sourced profit included in its assessable income.

38. The question then arises whether the sole or dominant purpose of so doing, having regard to the 8 factors in paragraph 177D(b) of the ITAA 1936 was to obtain that tax benefit. That conclusion may be open when, amongst other things, it is understood that whether Hold Co is caused to issue shares in itself to a related party upon an offer being made to it, or whether Hold Co makes an offer to issue shares in itself to a related entity, is a legal distinction of some importance – particularly in considering the first four factors in paragraph 177D(b). The same issue arises upon the sale of the Hold Co shares by its owner prior to the ultimate sale of the target assets.

Appendix 2 – Your comments

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

40. 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 Australian Taxation 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:	**28 January 2011**
Contact officer:	**Des Maloney**
Email address:	**des.maloney@ato.gov.au**
Telephone:	**(03) 9285 1480**
Facsimile:	**(03) 9285 1943**
Address:	**Australian Taxation Office** **GPO Box 9977** **MELBOURNE VIC 3001**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2010/D8

Subject references:

- international tax
- double tax agreements

Legislative references:

- ITAA 1936 94D
- ITAA 1936 94T
- ITAA 1936 177D(b)
- ITAA 1936 Pt IVA
- ITAA 1997 6-5(3)

Case references:

- Australian Machinery & Investment Co Ltd v. Deputy Commissioner of Taxation (1946) 180 CLR 9
- FC of T v. Efstathakis 79 ATC 4256; (1979) 9 ATR 867
- FC of T v. Spotless Services Limited & Anor 95 ATC 4775; (1995) 32 ATR 309
- Nathan v. Federal Commissioner of Taxation [1918] HCA 45; (1918) 25 CLR 183
- Spotless Services Ltd v. FC of T 93 ATC 4397; (1993) 25 ATR 344
- Tariff Reinsurance Ltd v. Commissioner of Taxes (Vic) (1938) 59 CLR 194
- Thorpe Nominees Pty Ltd v. Federal Commissioner of Taxation 88 ATC 4886; (1988) 19 ATR 1834

Other references:

- OECD Model Tax Convention on Income and on Capital, July 2010.

ATO references

NO: 1-2GT9QQK
ISSN: 1038-8982
ATOlaw topic: Income Tax ~~ Double tax agreements