TD 2010/20 - 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?

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

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?

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953.*

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant 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.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

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 any countervailing commercial reasons for the interposition of the Dutch and Luxembourg entities between the Cayman Islands entity and the Australian company, having regard to the eight 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 interposing the conduit entities in the context of acquiring Target Co.*

Date of effect

3. This Determination applies to years of income commencing 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.

4. Australia has a series of bi-lateral International Taxation Agreements which closely follow the Organisation for Economic Co-operation and Development (OECD) Model Tax 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 its 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 these 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 gain is 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 a disregarded Australian 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 2010/21).

8. For residents of countries with which Australia has a tax treaty, and absent a permanent establishment in Australia, 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 and who wish to acquire a business asset in Australia, would not make that investment directly. The investors may create an investment vehicle in a low-tax jurisdiction, and that entity may undertake the acquisition of the Australian business assets. With the possible exception where that acquiring entity is a limited liability partnership, (see paragraph 20 of this Determination), this would put the taxation ramifications of the transaction beyond the terms of the tax treaty Australia might have with the investors' 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 low-tax jurisdiction 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 entity in the Cayman Islands. If the funds of that entity were used to acquire Australian business assets, that Cayman Islands entity would be the relevant taxpayer for the purposes of the Australian taxation system. For entities resident 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, we have seen Cayman Islands entities make an equity investment of their funds in a shelf company resident in another low-tax jurisdiction, which may then make an equity investment into a shelf company resident in a country with which 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 its tax treaty country resident parent.)

14. Where no sound commercial reasons for creating this pattern of holding interests in a number of jurisdictions is apparent, it naturally requires consideration of why these interposed entities between the Cayman Islands entity and Australia 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. We understand, however, that the Netherlands domestic tax law provides a participation exemption for mere holding companies that make a gain upon the sale of shares in a subsidiary company. There is also a European Union tax directive regarding the non-imposition of withholding tax in respect of dividends paid from subsidiaries to their European Union 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, explains 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 entity.

17. 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.

18. 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 which otherwise satisfies the terms of Part IVA, and any tax benefit obtained in relation to such a scheme may be cancelled.

19. In the circumstances discussed above, a scheme involving the interposition of holding companies between an entity resident in the Cayman Islands and an Australian holding company of the target assets may give rise to a tax benefit for the Cayman Islands entity in respect of an otherwise assessable Australian sourced business profit.

20. A tax benefit may not arise, however, if the Cayman Islands entity is a limited liability partnership (LLP). We will follow, broadly speaking, OECD practice in this regard when the fund's limited partners are residents of a country with which we have a Double Tax Convention and which treats the partnership as fiscally transparent for the purposes of its tax system. Treaty benefits will be afforded those treaty country resident limited partners where their residence can be verified. Practical difficulties in this regard will need to be overcome. Where information enabling the verification of residence is not disclosed, the LLP will be assessed to tax. For a detailed discussion of the application of tax treaties where a fiscally transparent entity is used, see draft Taxation Determination TD 2010/D8.

Part IVA

21. For a detailed explanation of the Commissioner's general approach to the application of Part IVA, see Law Administration Practice Statement PS LA 2005/24.

22. 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.

23. In the example described in paragraph 2 of this Determination, the relevant scheme is the interposition of the Luxembourg and Netherlands entities between the Cayman Islands entity and the newly created Australian resident company which is used to acquire the target assets.

24. The tax benefit is the amount that would have been included in the assessable income of the Cayman Islands entity had the scheme not been entered into.

25. That is to say, but for the scheme, an assessable business profit would have been derived by the Cayman Islands entity and not by a resident of a country with which we have a tax treaty. As discussed in *F C of T v. Hart*[2] (*Hart's* case) (per Gummow and Hayne JJ at page 4614) this is the comparative inquiry required by Part IVA.

26. It has been asserted that the appropriate alternative postulate would be a direct investment from the United States (US) in the target assets rather than via the Cayman Islands entity. However, even assuming that it may be appropriate to hypothesize an alternative that does not include the relevant taxpayer, a direct investment is improbable given the stated purpose of the Cayman Islands entity and the variety of structures put in place above that entity to accommodate the various commercial and US tax needs of the interest holders in the Cayman Islands entity.

27. These interests may be held by entities associated with the private equity firm arranger itself, with both taxable and tax exempt US resident investors and with taxable and tax exempt non-US resident investors. US tax considerations have a significant, if not dominant role in shaping these arrangements and the use of LLPs (including non-US resident partnerships) controlled by the investors and interposed between the investors and the Cayman Islands entity is routine. It is highly unlikely that alternative structures would be used that would expose the participants to different US tax consequences.

Paragraph 177D(b)

28. In the example described in paragraph 2 of this Determination, the manner in which the scheme was entered into or carried out is to create a company resident in the Netherlands to hold the shares in a newly created Australian company which is to be the domestic owner of the target assets. The Netherlands entity is to be owned by a company resident in Luxembourg. However, the manner of the acquisition of the Australian assets, commercially speaking, involves an unnecessary hierarchy of holding companies.

29. The insertion of these two entities into the holding structure is explicable only by taxation consequences thought to follow from their use. Each of the interposed entities is a mere holding company. That is, its primary undertaking is to legally own the shares of the next company in the chain. Each has little or no other business activity and there are no regulatory reasons for these companies to be there.

30. The form and substance of the scheme do not align. The legal form it takes involves the creation and interposition of two entities between the Cayman Islands and Australia. Commercially and economically these entities do not add anything. The use of funds pooled in the Cayman Islands entity for an Australian acquisition could be direct and economically, this is what is happening. The private equity firm's interest in the Cayman Islands entity (as a general partner) may be described as the controlling mind of the arrangement.

31. The time at which the scheme is entered into corresponds with the timing of the acquisition and holding period of the target assets. That is, these entities have no other commercial undertakings and serve no commercial or other economic purpose before, during and after the holding period.

[2] 2004 ATC 4599.

32. The result in relation to the operation of the Act that would have been achieved by the scheme is to remove the taxing point from Australia to the Netherlands by the creation of an assessable business profit in the hands of the Dutch company, rather than an assessable business profit in the hands of the Cayman Islands entity, had the scheme not been entered into or carried out.

33. The only material change in the financial position of the relevant taxpayer arises as a consequence of the tax benefit itself. 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. That is, the non-inclusion in the assessable income of the entity of the business profit and the consequent tax saving that this entails.

34. It follows that a material change in the position of the various interest holders in the relevant taxpayer will be the receipt of a profit share unencumbered by an Australian tax liability.

35. All the parties to the scheme are business associates. All the parties to the scheme are related parties. All equity investors are equity holders in the Cayman Islands entity.

36. Weighing these various matters, particularly in light of no obvious commercial reasons for the scheme, leads to the objective conclusion that the persons who entered into or carried out the scheme did so for the purpose of enabling the Cayman Islands entity to obtain a tax benefit in connection with the scheme.

37. That is, and similar to the state of affairs in *Hart's* case, when the eight matters are examined they tend toward the same conclusion as does the manner in which the scheme was entered into, or they are neutral. As in *Hart's* case, none point against the conclusion set out above.

Appendix 2 – Alternative View

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

38. It has been asserted that in an example such as is described in paragraph 2 of this Determination, the use of European Union interposed entities (that is, the scheme) is merely 'industry practice' and is not done for tax reasons. However, this kind of structuring is discussed widely in the literature as being 'tax efficient' and just because it might be 'standard' practice does not mean that it is not explicable by a dominant purpose of obtaining a tax benefit. Indeed, as no commercial purpose is asserted (or apparent) for its use, and the tax reason for so doing is manifest, it would not be a surprising outcome that upon an analysis of the eight matters in paragraph 177D(b) the requisite conclusion as to the purpose of the persons who carried out the scheme will be apparent.

39. It has also been asserted that the whole of the arrangements entered into, as an alternative to a direct investment from the US, is done solely to avoid US tax. The proposition is that the relevant alternative hypothesis (that is, a 'direct investment') is one that does not disclose a tax benefit.

40. We accept that the use of the Cayman Islands entity may be largely or even solely due to US tax considerations. It may be, therefore, and contrary to our understanding, that it is necessary in this regard for the Cayman Islands entity to be in receipt of a dividend rather than a business profit. This would explain the use of a Luxembourg entity. That entity's gain could be passed on to its parent as a dividend. But that does not explain, in terms of US tax, the interposition of the Netherlands entity which holds the Australian assets. Even if the Luxembourg entity held the assets and received an Australian sourced business profit directly and had not invested via the Netherlands it could still pay a dividend to its Cayman Islands parent.

41. Accordingly, if it were necessary to deal with the assertion about the 'whole arrangement', a relevant tax benefit has still been derived from an alternative narrower scheme of simply interposing the Netherlands entity. This scheme would be to ensure that a business profit subsequently arising from the sale of the Australian assets by a Luxembourg holding entity would not be subject to tax in Australia but rather in the Netherlands because of Article 7 of the tax treaty between Australia and the Kingdom of the Netherlands.

References

Previous draft:

TD 2009/D17

Related Rulings/Determinations:

TR 2006/10; TD 2010/21; TD 2010/D7

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)

Case references:

- FC of T v. Hart 2004 ATC 4599

Other references:

- Law Administration Practice Statement PS LA 2005/24

ATO references

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