

TD 2010/21 - Income tax: can the profit on the sale of shares in a company group acquired in a leveraged buyout be included in the assessable income of the vendor under subsection 6-5(3) of the Income Tax Assessment Act 1997?

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Taxation Determination

Income tax: can the profit on the sale of shares in a company group acquired in a leveraged buyout be included in the assessable income of the vendor under subsection 6-5(3) of the *Income Tax Assessment Act 1997*?

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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. The profit from the disposal of shares in a company group acquired in a leveraged buyout (LBO) may be included in the assessable income of the vendor under section 6-5(3) of the *Income Tax Assessment Act 1997* (ITAA 1997)¹ where the profit is income according to ordinary concepts (ordinary income). This may also be the case when the vendor is a non-resident private equity entity and the profit arises from an Australian source.

2. Whether a profit so gained will be ordinary income or a gain of a capital nature will depend on all the circumstances of the particular case. The facts of each case can vary and each case has to be determined on its own merits.

¹ All subsequent legislative references are to the ITAA 1997 unless indicated otherwise.

3. Where a private equity entity that has acquired shares in an Australian company is a resident of a country with which Australia has a tax treaty, the business profits article will determine which country has the taxing rights in respect of any profit that is of an income nature. 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 sourced business profits.² (See, however, Taxation Determination TD 2010/20 in relation to treaty shopping arrangements, where the income gains may properly be taxed in Australia).

4. A profit made by a private equity entity resident in a non-treaty country from the disposal of shares in an Australian company acquired for the purpose of profit-making by sale in a commercial transaction (such as a LBO with a short to medium term time frame) will constitute ordinary income for the purposes of subsection 6-5(3). The relevant profit-making purpose is that of the non-resident private equity entity itself. It is a matter of considering the facts and is, therefore, an objective purpose that is to be determined. It is not the purpose of the ultimate non-resident investors who hold shares in that entity either directly or through other entities, although their subjective purpose may well be to make such a profit. Paragraph 7 of Taxation Ruling TR 92/3 states that:

The relevant intention or purpose of the **taxpayer** (of making a profit or gain) is not the subjective intention or purpose of the taxpayer. Rather, it is the taxpayer's intention or purpose *discerned from an objective consideration of the facts and circumstances of the case.* (bolding and emphasis added)

Paragraph 19 of this Determination deals with private equity entities that are limited liability partnerships.

5. 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 Gains and losses on CGT assets that are not taxable Australian property are disregarded: subsection 855-10(1).

Example 1

6. *Offshore Co is a Cayman Islands entity. Its equity is primarily owned indirectly by non-Cayman Islands resident investors. Offshore Co acquires an Australian public company in a LBO with the intention of restructuring its activities and re-floating the company on the Australian Securities Exchange within a three year time frame. It will have low or negative returns until the realisation of the investment because of interest costs and management expenses. Offshore Co's profit from this arrangement arises from carrying out a commercial transaction entered into for the purpose of profit-making by sale rather than from a mere realisation of assets. 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). The characterisation of this gain as constituting ordinary income is not changed because the non-resident investors in Offshore Co may be superannuation funds and managed funds that indirectly hold interests in Offshore Co.*

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

Example 2

7. *An off-shore pooled investment trust mainly comprising investors that are non-resident superannuation and pension funds acquired a controlling interest in an Australian entity that holds large scale infrastructure assets through an on-market acquisition. The trust is open-ended and is not required to return funds to investors within a particular or indicative timeframe. The manager of the trust, whilst having sufficient controlling interest, does not directly participate in the management of the Australian entity but encourages the acquired entity to act independently to maximize long-term returns and value by making operational improvements. There was no pre-conceived plan to dispose of the controlling interest at a profit at the time of acquiring the interest. Due to changing financial circumstances arising from the need to fund the retirement of non-residents from the trust and adjust to increases in the cost of capital arising from the global financial crisis, the trust decides to dispose of its interests in the Australian entity. In these circumstances the profit would constitute a capital receipt rather than income according to ordinary concepts and would not be assessable under section 6-5.*

Date of effect

8. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation1 December 2010

Appendix 1 – Explanation

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

Relevant income tax law

9. If 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.

10. 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*⁴ that:

It is quite a well settled principle in dealing 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 value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?

11. The Full High Court observed in *Federal Commissioner of Taxation v. The Myer Emporium Ltd.*⁵

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.* 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.

*(*Whitfords Beach* 150 CLR at 366-367, 376; 82 ATC at 4036-4037, 4042; 12 ATR at 695-696, 705)

⁴ (1904) 5 TC 159 at 165-166.

⁵ (1987) 163 CLR 199 at 209-210, 87 ATC 4363 at 4366-7, (1987) 18 ATR 693 at 697.

12. 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

13. In March 2007, the Senate referred an inquiry into private equity investment to the Standing Committee on Economics. Its comprehensive report in August 2007 contains background information and analysis of the private equity industry. The underlying purpose of private equity involvement in LBOs is to acquire shares in a target group with the view to improving the value of that group and for it to be resold at a profit. An important consideration is the significant use of debt (leverage) as a predetermined feature of the LBO funding arrangement such that the investment in the company group is to be realised and funds returned to lenders and investors within a foreseeable (that is, short to medium term) time frame.

14. The Commissioner understands that private equity LBO acquisitions involve:

- the direct or indirect acquisition of interests (such as shares) in a target entity (such as a company) using investor equity and substantial borrowed amounts (leverage);
- 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; and
- the acquisition of those interests with the intention of resale at a profit and the subsequent realisation of a profit.

15. The Commissioner understands that returns on this type of private equity investment would depend on:

- (i) increasing 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.

16. A key component of private equity as an asset class for institutional investors is that assets must be realised after a period of time, which will vary depending on the investment strategy.

17. 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 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.

18. 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 assets would usually be disregarded for Australian income tax purposes if made by a non-resident of Australia. Gains and losses on CGT assets that are not taxable Australian property are disregarded: subsection 855-10(1).

19. The private equity entity may be treated differently, however, if it is a limited liability partnership (LLP). We will follow, broadly speaking, Organisation for Economic Co-operation and Development practice in this regard when the 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 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 when a fiscally transparent entity is used, see draft Taxation Determination TD 2010/D8.

Appendix 2 – Alternative View

20. It has been suggested that the majority of investors in private equity entities that undertake LBOs are institutional investors who are 'passive' investors and that it is therefore inappropriate to conclude that the purpose of the private equity acquirer of the target assets is that of profit-making by resale rather than the derivation of a capital profit from the mere realisation of the fund's assets.

21. We do not agree. It is the entity's purpose in undertaking the acquisition and disposal of its assets discerned objectively from all the circumstances that will determine the character of its profits or gains. See paragraphs 7 and 38 to 44 of Taxation Ruling TR 92/3 in this regard. We do not accept that it is reasonably open to overlook the investment drivers of this form of private equity activity. This is a particular form of asset class and one where the overwhelming majority of the yield is estimated, in advance, to be derived from the sale of the target assets themselves. These are contractual arrangements between the investors and the private equity fund manager. The manager oversees the LBO process. It is appropriate to note that apart from a management fee, the overwhelming part of the manager's remuneration is envisaged to be a percentage of the profit derived upon the disposal of the target assets and that the limited partners' yield is also overwhelmingly, if not entirely, sourced from the disposal proceeds.

References

Previous draft:

TD 2009/D18

Related Rulings/Determinations:

TR 92/3; TR 2006/10; TD 2010/D8;
TD 2010/20

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)
- International Agreements Act 1953
- TAA 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 references:

- Inquiry into the Private Equity Investment and its Effects on Capital Markets and the Australian Economy, Australian Senate, March 2007
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ATO references

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