

***TD 2011/24 - Income tax: is an 'Australian source' 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?***

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# Taxation Determination

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Income tax: is an ‘Australian source’ 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?

**❶ This publication provides you with the following level of protection:**

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. 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.
2. Factors that the Commissioner will consider when determining source in any such case include:
  - the activities undertaken by the fund, or on the fund’s behalf, in making any improvements to the Australian corporate group;
  - where those activities are undertaken;
  - the nature of any agreements between the entities;
  - the extent and nature of any control or involvement in the management of the Australian corporate group;
  - where the purchase contracts and sale contracts are executed; and

- the form and substance of the purchase payments.

**Example**

3. *Priveq LP is a limited 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. Priveq LP is not a resident of Australia under section 94T of the ITAA 1936. The general partner of Priveq LP is also not a resident of Australia.*
4. *Priveq LP's main activities consist of securing debt finance on advantageous terms, acquiring shares in companies and improving the business operations of those companies with the ultimate goal of selling the shares for an amount greater than the purchase price.*
5. *Priveq LP directs Advice Co, an Australian resident entity associate of the general partner, to undertake research into Target Co, an Australian manufacturing company to ascertain its suitability for acquisition, its current value, potential for enhancement and likely subsequent sale price. Priveq LP then incorporates Hold Co, an Australian resident wholly owned subsidiary company. Hold Co acquires all of the shares in Target Co. An Australian tax consolidated group, consisting of Hold Co and Target Co, is then formed.*
6. *Priveq LP seeks debt funding for the acquisition from Australian based lenders. Negotiations in respect of this funding are conducted in Australia by Advice Co.*
7. *Priveq LP stipulates to Hold Co that Target Co must restructure its business operations. Hold Co facilitates this in consultation with Priveq LP. As a direct result of the restructure, the net assets of Target Co increased, as did the value of the tax consolidated group.*
8. *By contract negotiated in Australia and signed overseas, Priveq LP 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 LP derives profits from the disposal of the shares.*
9. *Although the profits ultimately arise as a result of the sale of shares through contracts executed outside Australia, the source of the profits are the activities effecting a greater return over the purchase price. These activities include obtaining debt funding, researching, selecting and acquiring Target Co, and enhancing its business operations and profitability and ultimate sale value. These activities are conducted in Australia.*
10. *Weighing up the various elements that resulted in Priveq LP making a profit, the Commissioner considers that the profits arising from the disposal of Hold Co have an Australian source. Different facts will, of course, potentially yield different results.*

**Date of effect**

11. 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).

## 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.*

### Private equity

12. Most private equity funds are structured as limited partnerships. The investors become limited partners and a private equity firm becomes the general partner, that is, the manager of the limited partnership.

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

14. In a leveraged buyout, the private equity firm looks for a business that is able to be acquired, improved and sold for a profit. The private equity 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.

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

16. 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 these activities on the private equity fund's behalf.

17. The local entity is often described as an advisory firm because its activity is usually undertaken pursuant to contracts for advice entered into with the general partner and the target entity or a holding entity. In this way, the activities of the target entity may be aligned with the wishes of its new owner during the holding period. Whether the arrangements result in an Australian permanent establishment of the general partner or the limited partner will depend on all the circumstances of the case.

### Source taxation

18. 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.<sup>1</sup> (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.)

19. Determining the source of an item of income is a matter of fact to be determined having regard to the facts and circumstances of each case. This was originally stated by Isaacs J in *Nathan v. FC of T*.<sup>2</sup>

<sup>1</sup> Subject to the application of any treaty or other agreement given the force of law by the *International Tax Agreements Act 1953*.

<sup>2</sup> (1918) 25 CLR 183.

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.<sup>3</sup>

20. In *Tariff Reinsurances Ltd v. Commissioner of Taxes (Vic )* (Tariff),<sup>4</sup> 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.<sup>5</sup>

21. In *Spotless Services Limited & Anor v. FC of T* (Spotless),<sup>6</sup> 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.<sup>7</sup>

22. On appeal to the Full Federal Court,<sup>8</sup> 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.<sup>9</sup>

23. Thus, to summarise, as Bowen CJ said in *FC of T v. Efstathakis*:<sup>10</sup>

... 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.<sup>11</sup>

24. It has been suggested that in a leveraged buy-out undertaken by a private equity firm, it is the contracts effecting the purchase and sale of the target company that alone gives rise to any profit resulting from the sale and hence the source of that profit is the place at which those contracts are executed. However, as the case law quoted above shows, the question of the source of income is always one of fact. Given this, the suggestion that the place of execution of a contract will always determine source is not sustainable.

<sup>3</sup> At 189-190. See also *FCT v. Mitchum* [1965] HCA 23 at paragraph 18; (1965) 113 CLR 401 at 407 per Barwick CJ, and *Esquire Nominees Ltd v FCT* [1973] HCA 67 at paragraph 30; (1973) 129 CLR 177 at 192 per Gibbs J.

<sup>4</sup> [1938] HCA 21; (1938) 59 CLR 194.

<sup>5</sup> CLR at 208.

<sup>6</sup> 93 ATC 4397; (1993) 25 ATR 344.

<sup>7</sup> At ATC 4409; ATR 359.

<sup>8</sup> *FC of T v. Spotless Services Limited & Anor.* 95 ATC 4775; (1995) 32 ATR 309.

<sup>9</sup> At ATC 4789; ATR 321.

<sup>10</sup> [1979] FCA 28; 79 ATC 4256 at 4259; (1979) 9 ATR 867

<sup>11</sup> FCA at paragraph 16; ATC 4259; ATR 870. Affirmed by Lockhart J in *Spotless Services Limited & Anor v. FC of T* at ATC 4409; ATR 359.

25. As Rich J said in *FC of T v United Aircraft Corporation*:<sup>12</sup>

As the question to be determined in this case is a question of fact a decision on one set of facts is not binding and is often of little help on another set of facts. In *Premier Automatic Ticket Issuers Ltd. v Federal Commissioner of Taxation...* and *Tariff Reinsurances Ltd. v Commissioner of Taxes (Vict.)...* - cases which may, perhaps, be regarded as borderline cases – the Court considered that, on the facts in each case, the contract should be regarded as the sole source of income and that therefore the locus of the contract was the locus of the source. But it does not follow that, in every case where a contract is one of the sources, the contract should be regarded as the sole source.<sup>13</sup>

26. In both cases referred to by Rich J in the passage above, the court considered that the source of the income was the contract. That is, the contract created and embodied the rights giving rise to the income.<sup>14</sup> Similarly, in *FC of T v Spotless Services Limited & Anor*,<sup>15</sup> the certificate of deposit was the ‘critical document’<sup>16</sup> as it was this that gave rise to the rights vested in the taxpayer. The place where that contract was executed was therefore determinative of geographical source. Though other facts were considered, the contract was considered the ‘most significant’.<sup>17</sup>

27. By contrast, in *Thorpe Nominees Pty Ltd v. Federal Commissioner of Taxation*<sup>18</sup> (Thorpe), the fact that the contract was executed in Switzerland was not considered determinative. 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.

28. 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.<sup>19</sup>

<sup>12</sup> [1943] HCA 50; (1943) 68 CLR 525.

<sup>13</sup> CLR at 538.

<sup>14</sup> See *Premier Automatic Ticket Issuers Ltd v. FC of T* [1933] HCA 51; (1933) 50 CLR 268 at 286 per Rich J; at 292 per Starke J; *Tariff Reinsurances Ltd v. Commissioner of Taxes (Victoria)* CLR at 206 per Latham CJ.

<sup>15</sup> 95 ATC 4775; (1995) 32 ATR 309.

<sup>16</sup> At ATC 4791; ATR 323 per Beaumont J quoting from Lockhart J at the first instance.

<sup>17</sup> *Ibid.*

<sup>18</sup> 88 ATC 4886; (1988) 19 ATR 1834.

<sup>19</sup> At ATC 4897; ATR 1846.

29. In *Australian Machinery & Investment Co Ltd v Deputy Commissioner of Taxation*,<sup>20</sup> the taxpayer acquired mining interests in Western Australia which were sold to other Australian companies in exchange for shares in those companies. Subsequently, the taxpayer entered into contracts in the United Kingdom for the sale of the shares in Australian companies in exchange for cash or shares in UK companies. The taxpayer then sold in the UK the shares in the UK companies for a profit. The sales of shares took place in the UK.

30. 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.<sup>21</sup>

31. In *Esquire Nominees Ltd v FC of T*, which dealt with the source of a dividend paid through a series of holding companies, Barwick CJ said that the location of the share was 'in no way identified or connected with the earning or the making of the fund which is the source of the declared dividend'.<sup>22</sup> Rather, the source of the dividend was the place where profit making process was undertaken by the company that issued the shares.<sup>23</sup>

32. A leveraged buyout arrangement is one in which the private equity firm, as the general partner, either actively undertakes, or causes to be undertaken, a number of activities as part of a pre-determined strategy to derive profits. Between the purchase and sale of a particular target entity, there are a number of other transactions and elements to such arrangements.

33. In a leveraged buy-out arrangement, the elements to the transaction culminating in the profit 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. An advisory company and sometimes an associated management and administration company will have been set up and already undertaking or co-ordinating certain activities in Australia;
- 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 a profit will have been 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 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;

<sup>20</sup> [1946] HCA 65; (1946) 180 CLR 9.

<sup>21</sup> CLR at 16.

<sup>22</sup> [1973] HCA 67 at paragraph 12 per Barwick CJ. Menzies J also discounted the location of the share, at paragraph 10. Stephen J found it unnecessary to decide whether the location of the share was an element as all factors pointed to Norfolk Island as the source of income – at paragraph 13.

<sup>23</sup> At paragraphs 13-16.

- 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. A similar presumption might also be appropriate where overseas lenders are involved;
- Executing the purchase contracts;
- Making the purchase payments. The equity component of the purchase price (that is, the amount of money coming from the partners of the private equity fund) will usually be 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;
- Working closely with the target entity's management in 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. This may also include attracting new managers to supplement the existing management team; and
- Executing the sale contracts.

34. The Commissioner understands that many of these elements are typically undertaken in conjunction with the related local advisory company in Australia.

35. The arrangements described above are more properly viewed as a series of activities where the contract of sale is but the final element crystallising the profit. In such instances, the Commissioner considers that given the nature of the test to be applied, it is not appropriate to focus on the final element of that series of activities to the exclusion of all others.<sup>24</sup> Leveraged buyout arrangements of the type described above are therefore not instances where the sole source of the profit is the initial purchase and ultimate sale contract.

36. In such a case, the significance of the activities undertaken in Australia, relative to the profit, will be examined and the source of the profit determined accordingly. Where everything but the execution of the purchase and sale contracts is conducted in Australia, by or at the direction of the private equity firm acting as general partner of the fund as per the example in paragraphs 3 to 10 above, the Commissioner considers that the source of the profit is Australia.

37. Because each arrangement is different and different facts will yield different results, it is not possible to exhaustively specify when the profit will be wholly Australian sourced or wholly sourced overseas or when, and to what extent, the profit will be apportioned. The Commissioner's view is, however, that the location of the contracts is not necessarily determinative and each arrangement will be considered on its facts.

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<sup>24</sup> See *Commissioners of Taxation v Kirk* [1900] AC 588; quoted with approval in *FC of T v W. Angliss & Co Pty Ltd* [1931] HCA 32; (1931) 46 CLR 417, at 423 per Starke J.

## References

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*Previous draft:*

Previously issued as a Draft Taxation Determination TD 2010/D7

*Related Rulings/Determinations:*

TR 2006/10; TD 2010/D8; TD 2011/19

*Previous Rulings/Determinations:*

*Subject references:*

- international tax
- double tax agreements

*Legislative references:*

- ITAA 1936 94D
- ITAA 1936 94T
- ITAA 1997 6-5(3)
- TAA 1953

*Case references:*

- Australian Machinery and Investments Company Ltd v. Deputy Commissioner of Taxation (WA) [1946] HCA 65; (1946) 180 CLR 9
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- ATO ID 2010/54
- ATO ID 2004/904
- ATO ID 2004/563
- ATO ID 2003/676

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NO: 1-2IHYY8R

ISSN: 1038-8982

ATOlaw topic: Income Tax ~~ Double tax agreements