JOINT SUBMISSION BY

The Institute of Chartered Accountants in Australia, The Taxation Institute of Australia, CPA Australia, The National Institute of Accountants and Taxpayers Australia

Draft Taxation Determination 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?

Date due: 4 February 2010

Thank you for the opportunity to comment on Draft Taxation Determination TD 2009/D17 ("the Draft TD").

The high level 'Executive Summary' below is followed by specific comments which expand on these views and raise other technical matters. The Professional Bodies can elaborate on any aspect if required.

The Draft TD refers to 'Private Equity'. The Professional Bodies take this as a reference to the practice of many investors including superannuation and pension funds, insurance funds, mutual funds, sovereign funds and other institutional and non-institutional investors together (in collective investment vehicles) to make specific investments or classes of investment through pooling of investment capital allocated for that purpose. Private equity investment does not involve merely investment banks investing on their own account. Given the wide ambit of the potential application of the Draft TD, a more accurate and descriptive term for such investment activity may be Pooled Fund. That term is used in this submission.

It is worth noting that the term 'Private Equity' or 'Private Equity Fund' is sometimes incorrectly used to describe the manager of a Pooled Fund, without considering that the manager does not necessarily have any ownership interest (i.e. investment) in the Pooled Fund itself.

The Professional Bodies consider that taxation rulings and tax determinations should provide general guidance about the ATO's view of the correct interpretation of tax laws; and in the present context, how Part IVA may apply to transactions entered into by Pooled Funds. If the ultimate TD is to achieve that aim, the Professional Bodies consider that the Draft TD will require amendment.

EXECUTIVE SUMMARY

1. The Draft TD 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 TD does not refer to the complexities and relevant factors sufficiently.

2. 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 TD 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.

3. The Draft TD 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.

4. 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 TD is inconsistent with the purpose of the treaties.

5. The Draft TD 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 TD 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 TD that Part IVA will not apply in every case.

6. 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.

7. The Draft TD identifies the wrong taxpayer.

In effect, the Draft TD asserts that Pooled Fund transactions are structured in a particular way to avoid tax, but the Draft TD then seeks to impose tax on an entity within the structure that the Draft TD 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.

SPECIFIC COMMENTS

1. Each case will depend on the facts and circumstances

The Professional Bodies agree that the application of Part IVA will depend upon the particular facts of each case. Part IVA will only apply where:

a) a taxpayer has obtained, or would but for section 177F of the *Income Tax Assessment Act 1936* ("ITAA 1936") obtain, a tax benefit in connection with the scheme and
b) 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.

Unfortunately, whilst recognising that each case will depend on its own unique facts, the Draft TD fails to acknowledge that this means that Part IVA will not apply to all transactions. Nor does the Draft TD identify any circumstances in which Part IVA will not apply.

2. Dominant purpose, determined objectively

The relevant purpose must be the dominant purpose, determined objectively.

The Professional Bodies submit that the Draft TD, in both the Ruling section and explanation, should refer to the important requirement that the relevant 'purpose of enabling a tax benefit' must be the dominant purpose of the scheme in order for Part IVA to apply. In particular the Draft TD should make specific reference to section 177A(5) that:

> "A reference in this Part to a scheme or a part of a scheme being entered into or carried out by a person for a particular purpose shall be read as including a reference to the scheme or the part of the scheme being entered into or carried out by the person for 2 or more purposes **of which that particular purpose is the dominant purpose**." (emphasis added)

Whether the relevant purpose is the dominant purpose is critical in the application of Part IVA to the facts and circumstances of every transaction.

Further, the analysis of purpose in applying Part IVA requires the objective determination of the dominant purpose, based on the unique facts of each particular case. Even in situations where there may be a tax benefit, there may be other commercial purposes. The analysis, particularly in relation to transactions such as the sole example in the Draft TD, will be inadequate without reference to the unique facts of the particular case and the weighing of those facts in determining the dominant purpose, particularly by reference to the section 177D(b) factors.

It is expressly stated in the sole example given in the Draft TD that relevant parts of the structure have no commercial rationale.

This over-simplifies the analysis by expressly limiting the example to a single tax-based purpose, the Draft TD ignores the possibility of multiple purposes in other cases and has the consequence that there is no proper analysis of dominant purpose. This considerably diminishes the practical guidance the Draft TD might otherwise provide.

The Professional Bodies submit that the example contained in the Draft TD is not accurate and is incomplete. For that reason the Draft TD is misleading to taxpayers and to officers of the ATO who might refer to the document when considering the application of Part IVA to Pooled Fund transactions. For example, no analysis is presented of the potential commercial drivers of Pooled Fund transactions, the identity and location of investors, or the overall incidence of tax and taxing rights. The statements which are highlighted below do not reflect major commercial features of such transactions and lead to an inappropriate analysis and decision in the example:

> *"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 commercial reasons for the interposition of the Dutch and Luxembourg entities*** *between the Cayman Islands entity and the Australian company and having regard to the 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 acquiring Target Co in the manner undertaken."*

3. ATO processes in complex Part IVA situations

The application of Part IVA is the subject of extensive ATO internal process and guidelines, and (except in limited circumstances) a referral to the GAAR panel is required if Part IVA is to be applied in a particular circumstance, as set out in PS LA 2005/24.

Another reason to refer to PS LA 2005/24 is that it highlights that there may be sound commercial reasons for particular structures to be used and these are relevant to the analysis and application of Part IVA to tax benefit, dominant purpose etc. As the PS LA 2005/24 notes:

> "69. The identification of a tax benefit necessarily requires consideration of the income tax consequences, but for the operation of Part IVA, of an 'alternative hypothesis' or an 'alternative postulate'. **This is what would have happened or might reasonably be expected to have happened if the particular scheme had not been entered into or carried out. This alternative hypothesis or postulate also forms the background against which the objective ascertainment of the dominant purpose of a person occurs in accordance with section 177D**. The alternative hypothesis(es) or postulate(s) is referred to in this practice statement as the 'counterfactual(s)'.
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> "74. In applying the reasonable expectation test to identify the counterfactual(s), it may be useful to consider the following:
> • **the most** straightforward and **usual way of achieving the commercial and practical outcome of the scheme (disregarding the tax benefit)**;
> • **commercial norms, for example, standard industry behaviour**;
> • social norms, for example, family obligations;
> • **behaviour of relevant parties before**/after **the scheme** compared with the period of operation of the scheme; and
> • the actual cash flow." *(emphases added)*

The Professional Bodies submit that the eventual TD must make specific mention of the PS LA 2005/24 and the ATO processes – if only to acknowledge that the application of Part IVA requires a detailed analysis, and is not as clear cut as the TD simple example or discussion suggest.

Further concerns about the example are discussed below. These concerns are significant because they colour the analysis of each of the eight factors for purposes of paragraph 177D(b).

4. The tax benefit – which entity is considered where ultimate investors are in treaty countries

The Draft TD lacks clarity as to when a tax benefit would arise. For example, the recent decision in *AXA Asia Pacific Holdings Ltd v FCT* 2009 ATC 20-151 makes it clear again that the identification of the counterfactual is a critical part of the analysis. There is a real question as to whether it might reasonably be expected that the investment would ever have been made directly from a Cayman entity.

Section 177C(1), a reference to the obtaining by a taxpayer of a tax benefit in connection with a scheme is to be read as a reference (relevantly) to:

> "(a) an amount not being included in the assessable income of the taxpayer of a year of income where that amount would have been included, or **might reasonably be expected to have been included**, in the assessable income of the taxpayer of that year of income if the scheme had not been entered into or carried out; or"

In this context, why does the analysis in the Draft TD example ATO look through the Netherlands and Luxembourg entities in the example but stop at the Caymans? Why does the example stop at the Caymans entity when the assumed facts in that example say a US ultimate investor decides to set up a Caymans entity?

The Draft TD simply does not consider why US investors (who are entitled to treaty protection in their own right) would structure an investment through the Cayman Islands. As discussed below, the reasons for the structure have little to do with Australian tax and more to do with US tax issues and also regulatory issues. This goes back to the counterfactual, which is relevant not only for purposes of identifying the tax benefit if any and also in considering the dominant purpose of the investor Pooled Fund.

Why do US investors simply not invest directly? The answer lies in US tax considerations and regulatory issues not avoidance of Australian tax.

5. The source of the gain is very relevant in determining the tax benefit

Paragraphs 4 and 5 in the explanation in the Draft TD correctly identify the critical significance of the 'source' of the gains when considering the application of Australian tax to non-residents.

However, there is no mention in the example or in the later analysis that there would be no Australian tax liability if the gain by the non-resident is not sourced in Australia. Nor does the analysis address whether in the particular example, the gain was sourced in Australia; and why.

The Professional Bodies do not expect an exhaustive analysis of source issues in the Draft TD but:

a) The Draft TD needs to refer with greater clarity to the relevance of the source of the gain in the analysis of whether there is a tax benefit and in the analysis of the dominant purpose: and

b) The ATO needs to provide a considered view of when a non-resident entity will be considered to have an Australian-sourced gain. For example, will the gain be Australian sourced even when the Pooled Fund is established, centrally managed and controlled and operated from overseas; invests in an Australian company which has its own management and board of directors; and the Pooled Fund does not take any direct role in the management of the Australian company?

6. Other relevant factors in the Part IVA analysis

As the Draft TD notes, there may be sound commercial reasons for particular structures to be used and these are relevant in determining whether there is a tax benefit, what is the dominant purpose, and for other aspects of the analysis and application of Part IVA.

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, the Professional Bodies 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).

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 TD 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 TD 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.

The TD, 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[1].

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 TD would not provide an additional tax benefit which the Commissioner could deny under Part IVA. These aspects are not reflected in the Draft TD.

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[2] 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:

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[1] E.g. ATO ID 2002/1088, ATO ID 2008/62

[2] Offshore Financial Centers Offshore Financial Centers, IMF Background Paper, Prepared by the Monetary and Exchange Affairs Department, June 23, 2000 - http://www.imf.org/external/np/mae/oshore/2000/eng/back.htm

- 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."

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

The Professional Bodies understand that the investment in Pooled Funds is a conventional form of investment structure internationally. Structures similar to those in the Draft TD 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 TD 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.

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, the Professional Bodies 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 TD, 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.

7. 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, the Professional Bodies 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 TD.

If, however, the ATO intends to use this TD 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 TD should not have retrospective application.