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/D18

Income tax: can a private equity entity make an income gain from the disposal of the target assets it has acquired?

Due date: 4 February 2010

Thank you for the opportunity to comment on Draft Taxation Determination TD 2009/D18 ("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, when transactions entered into by Pooled Funds will give rise to gains of an income nature. If the ultimate TD is to achieve that aim, the Professional Bodies consider that the Draft TD will require amendment.

EXECUTIVE SUMMARY

1. Distinguishing pooled funds and managers from companies acting as principal

While the term 'Private Equity' or 'Private Equity Fund' is sometimes used to describe the manager of a Pooled Fund, the manager does not necessarily have any ownership interest (i.e. investment) in the Pooled Fund itself. Rather the manager is responsible for supervising and administering the Pooled Fund on behalf of investors. The Draft TD does not explain or explore this important distinction, which has major implications for the tax outcomes.

2. The Draft TD is a significant departure from the ATO's previous views and practice

The ATO's long standing views and practice, expressed privately and publicly, was that such gains are on capital account. 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 gains in such investments are of an income nature, such a substantive change should only apply prospectively.

3. Inadequate analysis of 'income according to ordinary concepts'

The Draft TD identifies but fails to adequately discuss the key issue – that is, the gain will only be 'income' if it satisfies the notion 'income according to ordinary concepts'. Further analysis demonstrating whether and why gains earned by investors in Pooled Funds are income rather than capital is required.

4. Capital occasions do exist – this should be acknowledged

The Draft TD fails to recognise that circumstances will arise where such gains will remain on capital account. Further, the Draft TD does not identify practical circumstances in which such gains will be capital – this guidance would be very useful both to ATO officers, and to the investment community.

5. Inadequate analysis of isolated transactions

The Draft TD asserts that a gain made in the context of an isolated transaction can also be regarded as income. Aside from assertion, there is very little analysis in the Draft TD demonstrating when this will (and will not) be the outcome.

6. Attribution of the manager's supposed intentions to the ultimate investors

The Draft TD makes no distinction between the manager of the relevant transaction and the taxpayer being the Pooled Fund representing the interests of many superannuation and other passive investors. The ATO cannot conclude, without any substantive analysis, that the taxpayer's business, activities and intentions are identical to those of the manager: that would have profound implications for the entire asset management sector.

7. Focus on a single hypothetical set of facts

The Draft TD focuses on a single transaction and assumes that the relevant participant is a corporate entity. It fails to identify different transaction types, or different types of entities – such as trusts and partnerships; each of which are common investment structures for Pooled Funds. So the example transaction chosen by the ATO to illustrate its views is not representative of all such transactions.

8. Focus on non-resident investors does not cover the issues fully

The Draft TD and its example focus on investors from outside Australia. This is of limited assistance as the relevant taxation principles will apply also to Australian investors including those pooling the assets of Australian superannuation funds.

Further, the Draft TD in incomplete in not mentioning that the Australian tax outcomes for a non-resident, in relation to any gain of an income nature, will depend on the source of the gain (because Australia's tax law does not tax a non-resident on income gains unless the source of the income is in Australia) and the relevant double tax treaty (if any). The TD should mention these issues and 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.

SPECIFIC COMMENTS

1. Each case will depend on its own facts and circumstances

The Professional Bodies agree with the initial statements made in the draft TD that:

- A profit on disposal of assets may be included in assessable income under subsection 6-5(3) of the *Income Tax Assessment Act 1997* ("ITAA 1997") where it is income according to ordinary concepts (ordinary income); and
- Whether a profit is ordinary income will depend on all the circumstances of the particular case.

It is critically important to highlight that the particular facts of each case are pivotal, and each case must be examined on its own merits. There is no 'one size fits all' analysis in relation to all such transactions by all Pooled Funds.

For this reason, the Professional Bodies request that the second sentence, stating that the facts and circumstances are critical to the outcome of the particular case, should be shown as a separate paragraph. And the discussion at para 13 in the Explanation should be moved forward in the explanation.

2. Determination should consider the relevant circumstances in more detail

The Draft TD's ruling segment and Appendix 1 explanation do not contain a sufficiently detailed analysis of what circumstances are relevant to be examined in order to determine whether, in the case of investors in Pooled Funds, the gain is properly to be characterised as income according to ordinary concepts. Importantly, the Draft TD fails to identify facts that would lead to a conclusion that the relevant gain is on capital account. Examples of these are outlined below.

3. Pooled Funds use various holding structures

The Draft TD refers to a 'private equity entity' which is not defined. The Draft TD's sole example examines only one narrow set of circumstances in which a Pooled Funds holds an investment, through 'Offshore Co'. The example implicitly assumes that:

- Offshore Co is a company;
- Offshore Co carries on its activities as principal;
- Offshore Co is an active investor; and
- Offshore Co intends to profit by way of restructuring and sale of the relevant investment within, presumably, a short period.

These assumptions do not apply in many investments held by Pooled Funds.

The example is followed by:

a) a comment about the outcome if Offshore Co. were carrying on a business of restructuring and floating companies; and
b) a comment about the analysis of an isolated transaction in the course of carrying on a business operation or commercial transaction.

However, the Draft TD does not consider that:

a) **A trust or managed fund might undertake the investment in question**

Pooled Fund investments might in some cases be carried out by companies, but in many cases the investments will be undertaken in the form of a trust or similar vehicle, in which the investors are superannuation or pension funds – long term investors holding assets for the retirement of Australians or foreign individuals – where the investment entity is a holder of the asset in the acquired company.

The trust or managed fund will have a trustee and a manager, but the manager's history does not require the conclusion that the gain must be 'income'. By contrast, depending on the circumstances and purpose of the relevant investor, it is well established that in analogous circumstances, the gain earned may be on capital account.

b) **The restructuring of the acquired company is not carried out by the Pooled Fund**

It is not correct for the Draft TD to state that the restructuring of the acquired company is carried out by the entity which holds the investment for the Pooled Fund.

Rather, the board of directors of the acquired company is responsible to implement any change in the management of the acquired company and to encourage the acquired company to grow and develop its activities. This has parallels with the actions of listed companies and private companies, where continuing investors may encourage the directors and management of the acquired company to improve its performance, but ultimately the board and others in the executive team of the company are responsible for the company's deciding whether to make changes and for the acquired company's performance.

The draft TD needs to consider the issue in the context of:

a) the holding entity for a Pooled Fund being a trust or managed fund comprising passive investors; and
b) the holding entity for a Pooled Fund which does not itself restructure the acquired company but encourages the acquired company management to 'be the best business that it can'.

This raises a number of additional circumstances that must be examined, as set out for example in relation to Listed Investment Companies ("LICs") in Taxation Ruling TR 2005/23. These are discussed below in more detail.

The Draft TD should reinforce that the examination of each circumstance and the relevance of each should be considered in an objective manner.

4. Whether taxpayer is carrying on a business, carrying out a business operation or a commercial transaction

The Explanation in the Draft TD refers to TR92/3 and two situations, in which an isolated gain might be ordinary income, i.e., that is it is either:

- A profit from the carrying on of a business, whether as part of that business or an isolated transaction; or
- It is a profit from a transaction entered into in carrying out a business operation or commercial transaction.

The core propositions to be considered are whether:

- the taxpayer is carrying on a business;
- the isolated transaction is in the course of the taxpayer's business;
- it is an isolated transaction in the course of carrying on a business operation or commercial transaction; or
- none of the above apply.

TR 92/3 discussed these principles from the 1987 High Court decision in the *Myer Emporium*[1] case, concerning a major company heading a group that carried on a retail trading and property development business, and in that context.

[1] FC of T v. the Myer Emporium Ltd (1987) 163 CLR 199

In the view of the Professional Bodies, these principles should be more clearly discussed in the body of the Draft TD in the context of Pooled Funds. Additionally, the principles should be more clearly set out in the analysis of the example. The TD should detail what amounts to a business operation or commercial transaction in these cases particularly given that the investor Pooled Fund may not be involved directly in the restructuring.

5. Application of "isolated transaction" cases to Pooled Funds

In the view of the Professional Bodies, the "isolated transaction" cases decided in respect of companies cannot be applied in the same way to Pooled Funds.

A significant difference between Pooled Funds and the "isolated transaction" cases on ordinary income is the absence in Pooled Funds of any core trading business. As noted, the 1987 *Myer Emporium*[2] decision related to a major company that carried on a retail trading and property development business.

By contrast, when Pooled Funds make an investment, frequently the fund makes a single investment. As recognised in TR 2005/23, it does not automatically follow that every sale of shares would be a normal operation in the course of carrying on that business. There are a number of indicia of an investment portfolio being held on capital account which must be considered, which the Draft TD does not mention.

6. Relevance of investor intentions

In addition to examining the circumstances of the Pooled Fund's holding entity, the relationship between the holding entity, Pooled Fund and its investors is also a relevant circumstance, which is not mentioned in the Draft TD.

Pooled Funds are frequently a collection of passive investments of various investors, including typically large superannuation and foreign pension funds, other collective investment entities and government entities. These investors have a long term investment horizon and a particular investment by way of a Pooled Fund is generally only one element in each investor's investment strategy and investment portfolio.

Investment in Pooled Funds provides payment/distribution of dividends and other amounts during the holding period in the underlying investment and as a return following the eventual disposal of that investment. It is the expected enhanced combined return on investment that attracts investment into Pooled Funds.

Investors in Pooled Funds take a long term investment view of their strategic investments which are designed to deliver value and returns to their investors in accordance with the long term objectives of their investors. Pooled Funds may hold a single investment or non-portfolio interests in investments, which are not traded but are held for between 3 and 5 years (in some cases longer but rarely shorter), and on average for 4.5 years[3]. Funds returned following the disposal of the underlying investments would be expected to be reinvested by the investors in accordance with these long term objectives, including potentially in new Pooled Fund investments. Support for the relevance of the intention of investors can be found for example in *FCT v Radnor*[4]:

> "... it remains true today that in determining whether an activity is properly to be characterised as a business activity, it will be relevant that the activity is one undertaken by a taxpayer in the position of a trustee who is obliged, in accordance with his obligation of prudence, to ensure

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[2] FC of T v. the Myer Emporium Ltd (1987) 163 CLR 199

[3] Senate Standing Committee On Economics 2007 reference into Private equity investment and its effects on capital markets and the Australian economy, report available at http://www.aph.gov.au/senate/committee/economics_ctte/completed_inquiries/2004-07/private_equity/report/index.htm

[4] Federal Commissioner of Taxation v Radnor Pty Ltd (1991) 102 ALR 187

> that the assets under his control are preserved for the benefit of the beneficiaries. In such a case the fact of realisation will not enable an inference to be drawn so readily, that his acquisition of the security was undertaken for a purpose of profit-making[5]"

The different characterisation of the manager's intentions and the investor entity's intentions is well known in Australian tax law. The capital characterisation of an Australian property trust, or infrastructure trust, or share investment trust, is not neutralised by the fact that the manager might also manage other trusts' or entities' affairs, including the other entities' trading activities.

If the Draft TD were to attribute the background of other activities of the manager to the intention of the investors and the relevant trust, this would have far-reaching consequences for Australia's asset management industry.

7. The holding entity does not involve itself in day to day management or restructuring

It would be highly unusual for an entity holding the Pooled Fund's investment to be in the business of restructuring and making operational improvements to an investment as suggested by the example.

The Professional Bodies submit that the Draft TD should be amended and the example either replaced or supplemented with another example reflecting the more usual facts and circumstances of a Pooled Fund transactions involving a restructure of the acquired company, whereby:

a) the holding entity, as investor, nominates directors in the acquired entity;
b) the investment manager of the holding entity might also nominate a director;
c) the acquired entity appoints new management of the acquired entity; and
d) operational improvements are made by the management of the acquired company, working with governance of the directors of the acquired company.

8. Application of TD to non-resident and resident entities

While neither the title of the Draft TD nor its content limits the application of the TD to investors in Pooled Funds that are not residents of Australia, much of the discussion is focused on the application of Australia's double tax treaties and the exemption for non-residents in Division 855 of the ITAA 1997.

The TD should clarify whether the TD is intended to apply to both resident and non-resident private equity Pooled Funds and entities.

9. Source of gains, where non-residents are involved

The Professional Bodies recognise that the TD is focused on the potential characterisation of the relevant gain as income.

However, the Draft TD is incomplete with no reference in paragraph 6 to the source of the gain if a non-resident Pooled Fund is the relevant investor. Even if a gain were to be classed as an income gain in some circumstances, s.6-5(3) of the ITAA 1997 provides that if the gain does not have an Australian source it is not assessable income for a non-resident.

The Professional Bodies note that it would be useful to have another TD, or TR, which analyses the issues relating to determining the source of a gain by a foreign investor not itself an Australian resident which:

a) is a foreign investment entity;
b) makes its investment decisions overseas;
c) is advised by a foreign manager; and
d) which makes an investment in an Australian company.

[5] Hill J at para 40

10. References to other relevant taxation laws which affect the outcome of a transaction

The Professional Bodies note the reference in paragraph 3 of the Draft TD that a non-income capital gain or loss will be disregarded if Div.855 of ITAA 1997 applies, which is included for completeness.

In the same way, the Draft TD should also refer to other relevant taxation rules which will affect the outcome including:

a) trust and partnership structures (including Venture Capital Limited Partnerships) used by Australian resident Pooled Funds which might affect the tax outcome; and
b) the ability of certain Australian trusts to elect irrevocably for capital gains treatment for tax purposes. This Budget 2009 announcement is, at time of writing, an exposure draft of a Bill - Tax Laws Amendment (2010 Measures No. 1) Bill 2010: MIT capital treatment – to introduce into ITAA 1997:

    Division 275—Australian managed investment trusts
    Subdivision 275-A: Choice for capital treatment of MIT gains and losses
    Subdivision 275-B: Carried interests in MIT

   However that Bill is likely to pass through Parliament in February 2010, presumably before this Draft TD is finalised.

11. Date of effect

The ATO's long standing views and practice, expressed privately and publicly, was that such gains can be on capital account. These views and practices have been relied on by Pooled Funds in entering into past transactions.

For example, in 2007, in the Senate Standing Committee on Economics 2007 reference into private equity investment and its effects on capital markets and the Australian economy, in hearings the Commissioner and Deputy Commissioner Ms Jan Farrell produced an ATO diagram of typical private equity transactions[6]. Ms Farrell and the Commissioner were asked about this revenue issue and the Commissioner quite properly stated there is no one single answer as the ATO was moving into its compliance plan actions[7]:

> "[E11] Senator JOYCE— Right. You talked about capital account and revenue account. All these organisations are in the business of buying and selling companies. They are not in the business of holding them for the long term. They are buying and selling companies. If that is the primary role, rather than the long-term holding of it, is the question ever raised—and I suspect that it would never be—that you might decide to move towards revenue account?
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> **Mr D'Ascenzo**—You asked me this at a Senate estimates hearing, Senator, and I said that we would look at that issue as part of our review.
> ... We are talking about a program that starts in 2007-08. One of the aspects of the question about whether something is on capital account or revenue account is the question that you raised."

and later, in response to then-Senator Murray

> **"Mr D'Ascenzo**— ... There is no more difficult area of determination in tax law than the capital-income dichotomy. ... It was always thus, and it applies not just to private equity but across the whole gamut of that distinction. To say whether the law is clear in that distinction is difficult. It has been thus: we have pronouncements by high courts and others that we

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[6] Senate Standing Committee On Economics 2007 reference into Private equity investment and its effects on capital markets and the Australian economy, Hansard transcript of hearings on 9 August 2007, page E5 , available at
http://www.aph.gov.au/senate/committee/economics_ctte/completed_inquiries/2004-07/private_equity/index.htm

[7] op cit. Hansard, page E18

> use as criteria to analyse the facts. At the end of the day, you do that as properly as you can and you come to a conclusion which you believe to be the correct conclusion, having regard to a proper weighing of those facts against the legal principles that have been established.[8]"

This is wholly consistent with legal analysis. As noted by Neil J. Young QC, former judge in the Federal Court, reviewing related decisions[9]:

> "The effect of all these authorities was summarised by the late Justice D G Hill in 1995 when he said, extrajudicially, that the
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>> determination of capital and income, whether in the field of assessability or deductibility, will involve a close examination of all the circumstances, a common sense appreciation of all guiding factors and a balancing of all relevant considerations."[10]

If the Draft TD is intended to suggest that all or most Pooled Funds were taxable on such gains as ordinary income, the Professional Bodies submit that would amount to a substantive change which should only apply prospectively.

If the Draft TD is intended to alert investors to the need to consider the relevant facts and circumstances in their own case, then it must be adjusted to have regard to the submissions noted above by the Professional Bodies.

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[8] Op.cit. Hansard, page E18

[9] The Historical Significance Of The High Court's Decision In Federal Commissioner Of Taxation V The Myer Emporium Ltd, Neil J Young QC, 2006 Annual lecture to Melbourne University Law School, Melbourne University Law Review Vol 31(1) http://www.tax.law.unimelb.edu.au/download.cfm?DownloadFile=0039BDA5-1422-207C-BA9968D32C0DDAA3

[10] Justice D G Hill, 'Income and Capital: Have the Goal Posts Been Moved?' (1995) 4 Taxation in Australia: Red Edition 8, 11 (emphasis omitted).