THE LAW SOCIETY OF NEW SOUTH WALES
young LAWYERS

29 January 2010

Mr Des Maloney
Australian Taxation Office
GPO Box 9977
Melbourne VIC 3001

Dear Mr Maloney

Invitation to comment on TD 2009/D17 and TD 2009/D18

Thank you for your invitation to comment on the above mentioned draft tax determinations (the ***Draft TDs***).

The NSW Young Lawyers Tax Committee is pleased to provide the attached comments on the Draft TDs.

NSW Young Lawyers is a division of the Law Society of New South Wales. Membership of the NSW Young Lawyers is free and automatic for all NSW lawyers under 36 years and/or in their first five years of practice, and law students. Membership of its committees is voluntary.

Public rulings and determinations play a vital role in providing clarity to taxpayers in relation to the application of the tax law. This clarity is of immeasurable value to taxpayers, allowing taxpayers to appropriately comply with the tax law when making business decisions.

We support any measures that provide clarity in the application and administration of laws in Australia. Accordingly, we have made comments on the Draft TDs that in our view would provide further clarity to taxpayers on the issues discussed in the Draft TDs.

The authors of these comments are Gulfam (Adam) Ahmed, Matthew Weerden and Priya Gangatharan.

If you would like to discuss any of our comments, or if have any questions, please contact in the first instance Gulfam (Adam) Ahmed either by phone on (02) 9926 0270 or by email at taxlaw.chair@younglawyers.com.au.

Yours sincerely,

Gulfam (Adam) Ahmed
Chair, Tax Law Committee
NSW Young Lawyers

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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?)

TD 2009/D18 (Income tax: can a private equity entity make an income gain from the disposal of the target assets it has acquired?)

29 January 2010

Call for comments

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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?

Summary

TD 2009/D17 would provide greater clarity to taxpayers if:

- the Part IVA analysis were extended to consider the tax implications at the investor level (for investors into the Cayman entity); and
- some of the new terms used (detailed below) could be better explained, perhaps through the use of examples.

We elaborate on these points below.

Part IVA analysis

TD 2009/D17 correctly notes that, pursuant to s4(2) of the International Tax Agreements Act 1953, the application and scope of Australia's tax treaties is subject to the operation of Part IVA. This is not in itself controversial.

The real question is how s4(2) and Part IVA would be interpreted in the situation described in the example when the situation is considered at the investor level.

Cayman Islands entities are often used to pool funds from investors in various jurisdictions. The reason for this is the Cayman Islands is a compliance neutral jurisdiction for most investors. The funds invested in the Cayman Islands entity can then be invested elsewhere.

When considered from this perspective, the Part IVA analysis for the example raises a number of further issues.

Using the example in TD 2009/D17, if the United States residents invested directly (a ***direct investment***), rather than through the Cayman Islands entity and the structure referred to the example (an ***indirect investment***), then there would be no question as to the application of Part IVA. Assuming the United States resident investors do not invest through a permanent establishment, the United States residents would not be taxed on the gain from the sale of the consolidated group.

This seems like an odd outcome. In effect the investment is the same, but in the case of a direct investment Part IVA would not apply, whereas in the case of an indirect investment it might apply. The only real difference being the indirect investment allows for the pooling of funds by investors from multiple jurisdictions, many of whom would be residents of treaty countries. In this regard, we also note also that some investors may come from non-treaty countries.

Another seemingly inconsistent outcome may arise if MITs are able to elect to treat gains as capital gains. In such circumstances, an indirect investment which involves an investment through an MIT may also be exempt from tax in Australia due to the application of Div 855. This is another situation which gives rise to the possibility that a transaction that is in effect the same as that described in the example could also take place without Part IVA applying.

We suggest that the TD 2009/D17 include an analysis of whether alternate transactions with the same economic effect but that may not give rise to the risk of Part IVA applying would affect the Part IVA analysis. Further, TD 2009/D17 should also consider whether using a Cayman Islands entity to pool funds because it is compliance neutral could, on its

own, be a 'sound commercial reason'. This would provide greater clarity to taxpayers involved in these types of transactions.

Terms used

TD 2009/D17 provides some useful guidance on the application of Part IVA to particular transactions. However, it rather unfortunately fails to define key words and concepts that are required to make sense of the ATO's views on such transactions. These vague descriptors require further elaboration.

For instance, it would be useful if the draft determination included discussion of what is meant by “significant” commercial activity. Additionally, it would be useful if the legal basis or origin of the requirement for “significant commercial activity” were also discussed.

In summary, we would suggest further discussion of the following:

- What is “significant” for the purposes of the statement in paragraph 21.
- What is “commercial activity” for the purposes of the statement in paragraph 21.
- In the context of entities that participate in transactions such as those described in the example, what types of activity would be included as “business activity” for the purposes of the statement in paragraphs 7 and 22.
- In light of our comments above, what would be included in “regulatory reasons” for the purposes of the statement in paragraph 22.
- Whether dividend flows from the Australian investments to the intermediate offshore holding company constitutes “business activity” for these purposes.

We do not have a particular view on how these terms should be defined.

Further, we would request further elaboration on:

- The role of the board of the intermediate offshore holding company in the decision to acquire or dispose of investments and whether this is relevant for a consideration of the business activities of that intermediate holding company.
- The impact on the ATO’s views where the offshore intermediate holding company has a number of investments in Australia or offshore.

TD 2009/D18 Income tax: can a private equity entity make an income gain from the disposal of the target assets it has acquired?

Summary

TD 2009/D18 would provide greater clarity to taxpayers if it included discussion on source.

Source

In TD 2009/D18, the Commissioner expresses the view that if a private equity entity does not have the intention of becoming a long-term investor to derive dividend income from its shares, and if it is carrying on a business of restructuring and floating companies, due to the regularity and repetition and size and scale of its activities, the profit from the disposal of shares in the Australian public company would constitute ordinary income.

TD 2009/D18 assumes a private equity group selling an investment in a business deal that "would otherwise have an Australian source and be subject to Australian income tax". There is unfortunately no analysis of whether the source of the profit, generated by foreign investors on their global investment, is in Australia (naturally if the source of the gain is outside Australia then different answers would arise in both the Draft TDs).

Given there are also no statutory guidelines in the Income Tax Act for determining the source of income, an expression of the Commissioner's view on when the gain on sale of the investment would be considered to be Australian sourced and when the gain would be considered to have a foreign sourced would be extremely helpful in providing clarify to investors. For the purposes of TD 2009/D18, we suggest that discussion on source should be included, and that the discussion be based on how these transactions are commonly set up.

In particular, we suggest discussion of the following:

- Private equity transactions often involve an on-shore private equity house which completes a lot of the work in relation to the investment by the private equity fund (in the example in TD 2009/D18, this would be the Cayman Islands entity). What effect, if any, does the relationship between the private equity house and the private equity fund have on the source of the income?

- Investment managers and advisors often take an active role in making decisions in relation to the investment. What effect, if any, does the role of investment managers and advisers have on source (see Trent Investments Pty Ltd v FC of T 76 ATC 4105; FCT v Radnor (1991) 22 ATR 344)?

- How is source affected in circumstances where the private equity fund does not actively participate in the management of an Australian investment company in which it holds shares?

Ideally, the Commissioner's discussion on source should also include an expression of his views on the relevance of the following key facts in any given scenario:

- Where the decision to sell shares in the Australian investment companies takes place;

- Where the contracts for sale are concluded (see Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 at 322-323);

- Where the purchase price is paid;

- Where the private equity fund's shares in the Australian investment companies are registered on a branch register outside Australia at the time of sale.