

## JOINT SUBMISSION BY

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

### *Draft Taxation Determination TD 2010/D7*

***Income tax: is 'Australian source(s)' 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?***

**Due date: 28 January 2011**

---

Thank you for the opportunity to comment on Draft Taxation Determination TD 2010/D7 ("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 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 the source of the profits made by a private equity fund from the disposal of the shares in an Australian corporate group is to be determined. If the final Determination is to achieve that aim, the Professional Bodies consider that the Draft TD will require amendment, as discussed below.

Unless specifically stated otherwise, all legislative references are to the *Income Tax Assessment Act 1997* ("ITAA 1997") or the *Income Tax Assessment Act 1936* ("ITAA 1936").

#### **SUMMARY**

##### **1. The conflation of the activities of separate entities**

The Draft TD attributes the activities of the private equity firm (which typically acts in a dual capacity – i.e. as (i) the general partner and (ii) the manager of the fund) and its Australian subsidiary to the fund itself, in determining the source of the profits made by the fund. It is submitted that, in all cases, it should be necessary to consider whether the private equity firm is acting: (i) in its capacity as general partner for the fund; or (ii) as the manager of the fund – i.e. is the private equity firm (or its Australian subsidiary) acting for and on behalf of the fund as an agent/partner or is it merely acting as an independent service provider? In many cases, it is likely to be an independent service provider to the fund, in which case it should not be permissible to attribute the activities of that entity to the fund itself.

In addition, the Draft TD attributes the activities that are actually undertaken by the Australian target entity (eg the making of operational improvements to the target entity's business) to the fund itself.

As a matter of law, it is not possible to conflate the activities and attributes of separate taxpayers in the manner in which the Draft TD seeks to do.

It is submitted that, in determining the source of the profits made by the fund, the focus of the enquiry should be on the activities of the fund itself and of its employees and dependent agents, rather than the activities of independent service providers.

In view of our comments below, the ATO may consider it appropriate to withdraw the Draft TD and replace it with a draft TR with a much fuller discussion of the issues, as recently occurred in relation to the issue of TR 2010/7. The issue dealt with by the Draft TD has significant ramifications for investment in Australia by non-residents, and is likely to be read by non-residents not familiar with the structure of Australian tax law as broadly covering investments in shares in Australian companies, that is, as extending beyond the area of private equity. In view of the importance of the topic and the Government's declared policy to make Australia an investment hub in the Asia-Pacific region, the ATO should provide full guidance to foreign investors in Australian shares on Australia's source rules.

## **2. Inconsistency with the relevant Australian case law on source**

The Draft TD should contain a much more detailed and in-depth analysis of the complex decision of the High Court in *Australian Machinery & Investment Co Ltd v DCT*<sup>1</sup> (*AMI*), which is the main authority in Australia for the source of income or profits arising from the disposal of shares. The Draft TD should also discuss the High Court's decision in *Esquire Nominees Ltd v FCT*<sup>2</sup>, which is the most relevant authority of more recent times.

Although the matter is by no means free from doubt, the Professional Bodies consider that, having regard to the main Australian authorities, the better view is that the source of profits arising on the purchase and sale of shares is where the taxpayer's activity takes place. In this regard, it is necessary to characterise the nature of the activities of the taxpayer and of its dependent agents, and to identify where those activities are carried on. Where those activities are carried on in multiple countries, it may be necessary to apportion the profits between the various sources.

The Draft TD examines only a narrow set of circumstances in which the fund is an active investor. The final Determination should draw a distinction between the following types of circumstances (and these could be illustrated by way of examples):

- If the fund is merely a passive investor, it is considered that the source of profits should be where the activity of the fund in making decisions about its investment in the target assets occurs (refer *Esquire Nominees*).
- If the fund (through its employees or dependent agents) actively creates a market or organises a float of shares into which shares are sold, it is considered that the profits are sourced where the activity of creating the market or floating the company occurs (refer *AMI*).
- If the fund is a passive investor but has given a mandate to another entity to manage the investment on its behalf as a dependent agent having the authority to bind the investor, it is considered that the source of the profits should be where the activities of the entity having the mandate in relation to its management of the investment are carried on.

## **3. Inconsistency with ATO Interpretative Decisions and overseas case law**

The conclusion and the reasoning of the Draft TD is inconsistent with the conclusions and reasoning of a series of ATO Interpretative Decisions that considered the source of profits from the sale of shares, options and other financial instruments. In all of those ATO IDs, the ATO expressed the view that the profits from the sale of the securities were sourced in the country where the contracts for the purchase and the sale of the securities were executed (not where the decisions to purchase and sell were made). Some of those ATO IDs also referred to a number of overseas cases in support of this proposition.

Furthermore, it is noted that, in Taxation Ruling TR 2004/15, the Commissioner considers that, in determining the tax residence of a company where a company's activity is passive investment, the company's business is carried on where high-level strategic decisions are

---

<sup>1</sup> (1946) 180 CLR 9.

<sup>2</sup> (1973) 129 CLR 177.

made in respect of its assets (which is also where its central management and control is located).<sup>3</sup> Applying this logic, it would appear to follow that, if the only activity of the fund is passive investment carried out in the one place, the source of the income of the fund should be where that activity occurs.

In the final Determination, the ATO should attempt a reconciliation of the ATO IDs and of its position in TR 2004/15, with the approach that it is proposing to adopt in the Determination. It should also refer to the overseas cases and consider their relevance (if any) in Australia.

#### **4. Form versus substance**

The Professional Bodies consider that the Full Federal Court's decision in *Thorpe Nominees Pty Ltd v FCT*<sup>4</sup> is not authority for the proposition that, in all cases, it is necessary to examine the substance of a transaction and the motives of the parties in determining the source of income or profits derived from the transaction. It is also noted that, in other cases on source (eg the Federal Court decision in *Spotless Services Limited v FCT*<sup>5</sup>), greater weight has been given to the form (rather than the substance) of the transaction. The final Determination should analyse *Spotless Services* and explain the ATO's view of the relevance (if any) and correctness of this decision, and how it is to be reconciled with the seemingly different approach adopted in *Thorpe Nominees* (given that both cases involved tax avoidance arrangements).

In addition, if the Commissioner considers that, in a particular case, a taxpayer has entered into a scheme designed to ensure that profits arising from the disposal of private equity investments are not sourced in Australia, then the appropriate course of action would be for the Commissioner to consider whether Part IVA should apply (as discussed in paragraphs 35 to 38 of the Draft TD), rather than relying on a vague notion of substance to determine the source of the profits. We note that the Commissioner abandoned the source issue in its appeal to the High Court in *Spotless Services* and relied on Part IVA alone. Accordingly, the comments in paragraphs 30 and 31 of the Draft TD (regarding the relevance of substance) should be deleted.

#### **5. Inconsistency with TD 2010/21**

Even if the approach adopted by the ATO in paragraphs 32 to 34 of the Draft TD (in weighing up the factors considered relevant) were correct, the manner in which that approach has been applied to the particular circumstances of a private equity arrangement is inconsistent with the ATO's own reasoning in Taxation Determination TD 2010/21 (which addresses the tax character of the profits from the realisation of private equity investments).

In TD 2010/21, the ATO concludes that, as the disposal of the target assets is expected and planned in advance to generate the overwhelming part of the yield for the investors and of the manager's remuneration, this factor strongly points in the direction that the target assets are held by the fund on revenue account.

Applying this line of reasoning, in circumstances where the overwhelming part of the investors' return is tied to the disposal of the target assets, one would expect (at least where the activities of the private equity fund are passive in nature) that the place where the disposal of the target assets occurs should be accorded at least a significant amount of weight in determining the source of the profits from the disposal of the target assets.

On the other hand, according to paragraph 33 of the Draft TD, the Commissioner considers that the key factors "increasing or impacting on the profit" made by the fund are:

- business ability in assessing suitable target enterprises;

---

<sup>3</sup> Refer paragraphs 9 to 11 and 25 to 27 of TR 2004/15.

<sup>4</sup> 88 ATC 4886.

<sup>5</sup> (1993) 25 ATR 334.

- making operational improvements; and
- the steps in making the acquisition of the business possible (such as arranging finance).

The Draft TD concludes that, where those activities are undertaken in Australia, the source of the profits will be in Australia.

The inconsistency between the different approaches adopted in the Draft TD and TD 2010/21 should be resolved before the Determination is issued in final.

**6. References to “limited liability partnerships” should be references to “limited partnerships”, and the precise nature of the legal arrangements should be more clearly understood**

All the references in the Draft TD to “limited liability partnerships” (including the reference in the Example to “LLP”) should be replaced with references to “limited partnerships” (“LP”). There is a clear legal difference between the two types of entity which is well understood overseas, and the entities used for private equity investments are limited partnerships which are referred to internationally as LPs (not LLPs). The Professional Bodies also request that the ATO should more clearly define the precise nature of the legal arrangements in the final Determination.

**7. Advice Co is typically not a subsidiary of Priveq LP (the fund)**

Typically, Advice Co is a subsidiary of the private equity firm (which acts as the general partner/manager of the fund), rather than a subsidiary of the fund itself. Therefore, the Example should be amended to refer to Advice Co as an Australian resident entity controlled by the general partner/manager of Priveq LP.

**8. Date of effect**

The Professional Bodies submit that the Draft TD should only apply on a prospective basis, given that the cases in this area are inconsistent, and given that the approach adopted by the ATO in the Draft TD represents a significant departure from its stance in earlier Interpretative Decisions.

## DETAILED COMMENTS

### 1. The conflation of the activities of separate entities

The Draft TD does not accurately depict the nature of the relationship between the private equity firm (which is typically the general partner and manager of the private equity fund) and the fund itself. The Draft TD makes no distinction between the private equity firm acting in its capacity as a partner as opposed to acting in its capacity as the manager of the fund (or its subsidiaries)- in the case of the latter there will be a clear distinction between the private equity firm and the taxpayer (being the fund itself). The ATO cannot conclude, without substantive analysis, that the taxpayer's activities and intentions are identical to those of the manager: such a proposition would have profound and far-reaching consequences for Australia's asset management industry.

The Draft TD attributes the activities of the private equity firm (and of its Australian subsidiary) when it is acting in its capacity as a manager to the private equity fund in determining the source of the profits made by the fund. Those activities include undertaking preparatory work (eg finding suitable target entities, assessment of profitability and risk, researching the current value of the target, its potential for enhancement and subsequent sale for a profit), sourcing, negotiating and arranging the debt funding.

In this regard, paragraphs 13 and 14 state:

“13. 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 control that undertakes activity in this regard on the fund's behalf.

14. The entity is often described as an advisory firm because its activity is undertaken pursuant to contracts for advice entered into with its parent and the target entity. In this way, the activities of the target entity may be aligned with the wishes of its new owner during the holding period.”

Paragraph 32 of the Draft TD goes even further and states:

“This entity [ie the Australian subsidiary of the private equity firm] 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.”

However, in fact, a substantial part of those activities is typically undertaken by investment banks that are engaged by the private equity firm (as manager of the fund) or its Australian subsidiary as independent service providers, and the private equity firm or its Australian subsidiary merely coordinates the provision of those services in its capacity as the manager of the fund.

In addition, in all cases, it should be necessary to consider whether, in performing that role, the private equity firm or its Australian subsidiary (referred to as the “local advisory company”) is acting for and on behalf of the fund in a manner binding on the fund, or whether it is merely acting as an adviser providing services to the fund. In many cases, the local advisory company is likely to be an independent service provider to the fund, in which case it should not be permissible to attribute the activities of that entity to the fund itself.

Furthermore, the Draft TD attributes the activities that are actually undertaken by the Australian target entity to the private equity fund. Paragraph 32 lists the following activities as activities that contribute in some way to the realisation of the ultimate profit of the fund, and it suggests that these are typically undertaken “in conjunction with” the related local advisory company in Australia:

- 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.

However, the responsibility and decision-making related to restructuring the business of the target entity, and the making of operational improvements to the target entity's business, ultimately rest with the board of directors of the target entity. It is simply not correct for the Draft TD to state that the restructure of the target company is carried out by or on behalf of the private equity fund. The private equity firm (as the general partner and manager of the fund) or its Australian subsidiary often has a service agreement with the target entity, under which it may provide strategic and business advice in consideration for service fees. General partners and managers may make recommendations to the board of directors of the target entity, but it is the board of the target which ultimately makes and implements decisions regarding operational improvements and undertakes business development.

It is acknowledged that the exception to this is where there are artificial or contrived outcomes. Such cases include where the directors of the target company are the nominees of the real controllers of the target, standing aside from their role and simply rubber stamping decisions made by the real controllers (eg the private equity firm or its Australian subsidiary). However, the board of the target should still be regarded as exercising control, notwithstanding that it acts on advice, direction or recommendations from third parties (eg the private equity firm or its Australian subsidiary), provided that the board actually makes decisions for the target company independently.<sup>6</sup>

The determination of the real "controlling mind" of the target entity is a question of fact and degree, and needs to be decided on a case-by-case basis. In the absence of artificial or contrived circumstances, case law does not support a simple attribution of the activities of the general partner/manager or its subsidiaries (or of independent service providers) to the private equity fund itself. As a matter of law, it is not possible to conflate the activities and attributes of separate taxpayers in the manner in which the Draft TD seeks to do. To quote Edmonds J from the Full Federal Court decision in *FCT v BHP Billiton Finance Limited*:

"The conflation of the activities of separate entities into some fictional "group" or single entity is impermissible outside the confines of Pt 3-90 of the ITAA 1997; just as it is to determine the tax consequences of a receipt or an outgoing by a member of a group of companies by reference to the tax consequences of the receipt or outgoing by another member of that group: *Federal Coke & Co Pty Ltd v FCT* (1977) 15 ALR 449 at 459 per Bowen CJ; *Hobart Bridge Co Ltd v FCT* (1951) 82 CLR 372 at 384-385 per Kitto J"<sup>7</sup>

It is submitted that, in determining the source of the profits made by the private equity fund, the focus of the enquiry should be on the activities of the fund itself and of its employees and dependent agents, rather than the activities of independent service providers. The Draft TD should be amended to make this point clear. In addition, as noted in section 6 below, the final Determination should more clearly define the precise nature of the legal arrangements.

## **2. Inconsistency with the relevant Australian case law on source**

Currently, Australia's source rules comprise many judicial decisions which are very difficult to reconcile. Sometimes they seem to follow a concept of the economic connection of the income, and in other cases formal matters such as the place of contract.

---

<sup>6</sup> Refer, for example, the decision of the High Court in *Esquire Nominees Ltd v FCT* (1973) 129 CLR 177.

<sup>7</sup> [2010] FCAFC 25 at 37 per Edmonds J.

The High Court's decision in *Australian Machinery & Investment Co Ltd v DCT* ("AMI")<sup>8</sup> is the main authority in Australia for the source of income or profits arising from the sale of shares. The High Court delivered a number of different judgments in that case. It is not possible to extract a clear and unequivocal *ratio decidendi* from that case, and what it stands for is difficult to establish. Yet, the discussion of the case in the Draft TD is confined to two short paragraphs (paragraphs 24 and 25). The Draft TD should contain a much more detailed and in-depth analysis of this complex decision (which is briefly discussed below).

In *AMI*, Latham CJ expressed the strongest support for the proposition that it is necessary to take into account the situs of the shares in determining the source of the profit from the sale of those shares. Therefore, His Honour held that the profit from the sale in England of shares in Australian companies to English companies should be apportioned between English and Australian sources. Williams J also gave emphasis to the situs of shares, but the other judges seemed much less likely to give the situs much or any weight in determining the source of the profit. For example, Starke J appeared to discount the situs of the shares as a factor, and in his view the source of the profit from the sale in England of shares in Australian companies to English companies appeared to be exclusively English (the contracts for the sale of the shares having been executed in England). However, his Honour ultimately accepted the agreed variation of the order, on the basis that the assessment was to be remitted to the Commissioner in any case, and because additional facts might have emerged in working out the final result. The judgment of Dixon J (with whom McTiernan J concurred) is similar to that of Starke J, and his Honour also accepted the agreed order because of the factual uncertainties.

If the situs of shares is discounted as a factor, then the question is whether the source of the profit from the sale of shares is simply based on the place of contract, or whether it is based on the location where the relevant activity producing the profit occurs.

In *AMI*, Starke J quoted Lord Atkin's phrase from *Smidth & Co v Greenwood* (*Surveyor of Taxes*) "where do the operations take place from which the profits....in substance arise". Starke J then summarised the previous cases, suggesting that where the business consists of the making of contracts, the source of the profit is where the contracts are habitually executed. His Honour contrasted this with the situation where the business consists of a series of operations, in which case the profits arise in the place(s) where the operations occur. Lord Atkin's test is generally regarded in the UK as having moved away from formal factors such as the place of contract. Starke J did not seem to recognise this, as His Honour appeared to fall back on the place of contract test stated in previous authorities.

On the other hand, Dixon J seemed to follow the more substantive element of Lord Atkin's test (even though his Honour did not mention it), as he referred to the profit being mainly generated by the market-making activity in England. In particular, Dixon J indicated that a partial Australian source was more readily discernible if an attempt was made to find:

- how much of the value attached to the Australian shares outside England; and
- how much of that value resulted from the "operation" of the company in England and the consequent creation of a market there for shares".

Dixon J's approach bears some resemblance to the "added value test", which had been adopted and applied in a number of earlier High Court decisions on source.<sup>9</sup> This test is a variant of the "arm's length test" found in transfer pricing principles (refer Division 13 of Part III of the ITAA 1936) and in tax treaties.

The Professional Bodies consider that the approach of Dixon J in *AMI* represents the one that corresponds more closely with modern authorities on source generally and is to be preferred,

---

<sup>8</sup> (1946) 180 CLR 9.

<sup>9</sup> Refer *Comr of Taxation (WA) v D&W Murray Ltd* (1929) 42 CLR 332; *FCT v W Angliss & Co Pty Ltd* (1931) 46 CLR 417; and *Comr of Taxation (NSW) v Hillsdon Watts Ltd* (1937) 57 CLR 36.

although there remain elements of form as well as substance in the cases (as discussed in section 4 below).

The most relevant authority of more recent times is the High Court's decision in *Esquire Nominees Ltd v FCT*<sup>10</sup> (although this case is not referred to in the Draft TD, it should be). This case concerned the source of dividends, rather than of a profit on disposal of shares. Dividends were paid through a series of companies which had no activities other than the ownership of the next company in the chain (apart from the company which was the ultimate source of the profits and which carried on an active business). Of the 3-1 majority in the High Court, 2 judges (Barwick CJ and Menzies J) discounted the situs of shares in determining the source of dividends. The third member of the majority (Stephen J) did not find it necessary to decide the matter because everything was in one place. Relevantly for present purposes, in his judgment, Barwick CJ noted the following:

“Further, a company may make profits without trading in goods or commodities or for that matter in securities. It may make profits simply by investment and may do so though its investment portfolio consists only of shares in one other company or even of all the shares in one other company. In such a case its net income from its investment will be its profits. Further, in my opinion, the place where the company makes its investment income will be the place where it has its central management and control. It will, of course, be different in the case of a company conducting manufacturing or trading activities. In the case of such companies, the place where these activities are carried on can be seen in fact to be the geographical source of the profits these activities yield.”

The Commissioner has come close to accepting this view in Taxation Ruling TR 2004/15 (regarding the tax residence of companies). The Commissioner considers that the place of business carried on by a company has to be viewed separately from the place of central management and control of the company, except where the company's activity is passive investment, in which case the company's business is carried on where high-level investment decisions are made in respect of its assets (which is where its central management and control is located).<sup>11</sup> If the only activity of the company is passive investment carried out in the one place, it would seem to follow that the source of the income of the company is where that activity occurs.

Although the matter is by no means free from doubt, the Professional Bodies consider that, having regard to the main Australian authorities most directly concerned with profits arising on purchases and sales of shares, the source of such profits is where the taxpayer's activity takes place. In this regard, it is necessary to characterise the nature of the activities of the taxpayer and of its dependent agents, and to identify where those activities are carried on. Where those activities are carried on in multiple countries, it may be necessary to apportion the profits between the various sources.

The Draft TD examines only a narrow set of circumstances in which the fund is an active investor. If the focus of the analysis is on the activities of the fund itself and of its employees and dependent agents only (as it should be), then there will be many private equity arrangements where the fund should properly be characterised as a passive investor in the target assets.

Thus, the Professional Bodies believe that the final Determination should draw a distinction between the following types of circumstances (and these could be illustrated by way of examples in the Determination):

- If the fund is merely a passive investor, it is considered that the source of profits should be where the activity of the fund in making decisions about its investment in the target assets occurs (refer *Esquire Nominees*).

---

<sup>10</sup> (1973) 129 CLR 177.

<sup>11</sup> Refer paragraphs 9 to 11 and 25 to 27 of TR 2004/15.



- If the fund (through its employees or dependent agents) actively creates a market or organises a float of shares into which shares are sold, it is considered that the profits are sourced where the activity of creating the market or floating the company occurs (refer *AMI*).
- If the fund is a passive investor but has given a mandate to another entity to manage the investment on its behalf as a dependent agent having the authority to bind the investor, it is considered that the source of the profits should be where the activities of the entity having the mandate are carried on in relation to managing the investment.

### 3. Inconsistency with ATO Interpretative Decisions and overseas case law

Paragraph 31 of the Draft TD states that:

“...while the place of execution of the contracts is of some relevance, the cases illustrate that it is not of itself determinative. The weight to be attached to this factor is to be considered relative to all relevant factors, including those occurring before and during the investment”.

The Professional Bodies note that the conclusion and the reasoning of the Draft TD is inconsistent with the conclusions and reasoning of a series of earlier ATO Interpretative Decisions that considered the source of profits from the sale of shares, options and other financial instruments.<sup>12</sup> In all of those ATO IDs, the ATO expressed the view that the profits from the sale of the securities were sourced in the country where the contracts for the purchase and the sale of the securities were executed (not where the decisions to purchase and sell were made).

For example, in ATO ID 2004/904, a non-resident company from a country with which Australia does not have a tax treaty actively traded in shares and options on the ASX. The company had no staff or office in Australia. A non-resident director of the company made all purchase and sale decisions offshore, and the Australian brokers (acting as independent agents of the company) had no authority to execute transactions binding on the company without specific instructions from that director. The only judgment from *AMI* that is referred to in the ATO ID is that of Starke J in *AMI*, and His Honour is said to have held that the relevant source rule in such a case is “where a business habitually enters into and carried out those contracts with a view to profit”. However, as discussed in section 2 above, Starke J ultimately accepted the agreed variation of the order, on the basis that the assessment was to be remitted to the Commissioner in any case, and additional facts might emerge.

The Professional Bodies believe that the *AMI* case is not authority for the proposition for which it is cited by the ATO (in the ATO IDs and also in the Draft TD). The Australian resident taxpayer in *AMI* had an agent operating in England with a broad discretion and who was executing all transactions under powers of attorney on behalf of the taxpayer. Moreover, as discussed in section 2 above, the High Court’s decision in *AMI* is very complex, and the judges adopted different lines of reasoning on source, none of which amount to a majority view. Starke J was the only judge in *AMI* who would have regarded the place of contract as determinative on the question of source.

The ATO also provided the following additional analysis in ATO ID 2004/904:

“Where, as in this case, the business is one of buying and selling shares and options, the relevant processes which contribute to the earning of the profit are the making of contracts for the purchase and sale of shares and options.

---

<sup>12</sup> Refer ATO Interpretative Decisions 2002/903 (withdrawn), 2002/913 (withdrawn), 2003/676, 2004/563 (withdrawn), 2004/814 (withdrawn), and 2004/904. These ATO IDs have been withdrawn mainly because the foreign loss quarantining rules have since been repealed, but the ATO has indicated that it maintains the view expressed in these ATO IDs in relation to previous income years.

In such cases, it may be that more weight should be put on the place of the contract for the purchase and sale. Although the skill and judgement exercised by the director in the purchase and sale of shares and options contributed to the profits, they are immaterial in determining the source, since the question is not why but where the profits are made – *D&W Murray Ltd v Commissioner of Taxation (WA)* (1929) 42 CLR 332.

The purchase and sale of shares normally involves entering into contracts and the contract is formed where the final act regarded as completing the contract occurs – *Tallerman and Co Pty Ltd v Nathan's Merchandise (Vic) Pty Ltd* (1957) 98 CLR 93. Thus, where the postal acceptance rule applies, the contract is considered to be made in the place where the acceptance is posted, and in other cases the contract is made at the place where acceptance is communicated to the offeror.

When the process of purchase and sale of shares and options are examined, weighting needs to be given to the following factors in determining the source of the profits:

- the essence of the taxpayer's business. In this case, the essence of the taxpayer's business is regularly entering into contracts for the purchase or sale of shares and options
- activities that actually realise the profit, that is, sale of shares and options
- place where the contracts for purchase or sale of shares and options are concluded, that is, contracts are concluded in Australia
- location of the stockbroker who concludes the buy or sell order: the location of the stockbroker is in Australia
- location of the entities whose shares or options are traded, that is, in Australia

Though the director of the taxpayer company makes the decision as to when to purchase or sell the shares and options, this has minimal weighting in determining the source. The source is determined by where the profits are made. It is the buying and selling of shares and options undertaken in Australia, where the contracts are concluded, that actually realise the profit.

As all the important factors relating to the realisation of the profit take place in Australia, it follows that the source of the profit is in Australia.”

ATO ID 2004/814 (withdrawn) also quoted the following passage from the judgment of Lord Bridge of Harwich in the Privy Council decision in *Commissioner of Inland Revenue v Hang Seng Bank Ltd* (on appeal from Hong Kong):<sup>13</sup>

“...one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.”

This passage was quoted in support of the proposition that the place of contract is determinative of source in cases where the taxpayer buys and sells securities. In that case, the Privy Council held that the profits of a Hong Kong bank from buying and selling securities

---

<sup>13</sup> (1991) 1 AC at 322-323

in overseas markets, for example London and Singapore, through independent brokers were sourced outside Hong Kong (where the trades were executed), even though Hong Kong was where the decisions to buy and sell were made and instructions given. The Privy Council rejected the “operations test” put forward by the Commissioner of Inland Revenue, and held that the relevant test was not where the taxpayer carried on its operations as a whole, but where the particular contracts of purchase and sale were “effected”.

In support of the same proposition, ATO ID 2002/903 (withdrawn) quoted the following passage from the judgment of Sir Arthur Wilson in the Privy Council decision in *Lovell & Christmas Ltd v Commissioner of Taxes (Vict.)* (on appeal from New Zealand):<sup>14</sup>

“In the present case their Lordships are of the opinion that the business which yields the profit is the business of selling goods on commission in London.....The moneys received by the appellants....are paid to them under the contract of sale effected in London.”

The Privy Council held in that case that a profit made by selling goods on commission, or by buying goods and then selling them, is derived entirely from the place where the goods are sold. This decision was also cited with approval by Starke J in *AMI* as supporting his view that, “where the essence of the business ordinarily consists in making certain classes of contracts and in carrying those contracts into operation with a view to profit or income then...the business is carried on within the locality where such contracts are habitually made which is the source of the profit or income”.

While these overseas cases were considered relevant in the ATO IDs, curiously there is no mention of them in the Draft TD.

The ATO’s views in the ATO IDs are inconsistent with the conclusion and the reasoning in the Draft TD. They are also not fully consistent with TR 2004/15 (albeit that ruling did not concern source as such). The ATO IDs placed emphasis on the place where the contracts for the purchase and the sale of securities were executed in determining the source of the profits from the sale of the securities.

The Professional Bodies submit that, in the proposed Determination, the ATO should attempt a reconciliation of the ATO IDs and of its position in TR 2004/15, with the approach it has adopted in the Draft TD. It should also refer to the overseas cases and consider their relevance (if any) in Australia, given that they were decided on quite differently worded legislation.

#### **4. Form versus substance**

The Draft TD discusses the Full Federal Court’s decision in *Thorpe Nominees Pty Ltd v FCT*<sup>15</sup>, and paragraph 30 states:

“*Thorpe* is authority for the importance of looking at the substance of the transaction as a whole rather than adhering to rules about certain types of transactions. This may be particularly so where it is plain that the transaction was structured so as to avoid tax in Australia.”

In a similar vein, paragraph 31 states:

“...the relevance of this factor [the place of execution of contracts] may diminish relative to other factors where the arrangement is structured to avoid source taxation.”

The Professional Bodies consider that *Thorpe Nominees* is not authority for the proposition for which it is relied on by the ATO. That case did not establish a general principle that, in all

---

<sup>14</sup> [1908] AC 46 at 52-53

<sup>15</sup> 88 ATC 4886

cases, it is necessary to examine the substance of a transaction and the motives of the parties in determining the source of income or profits from the transaction.

It is also noted that, in other cases on source, greater weight has been given to the form (rather than the substance) of the transaction. An example of such a case is *Spotless Services Limited v FCT*.<sup>16</sup> At first instance, the Federal Court had to consider the source of interest income under an elaborate scheme where the taxpayers deposited funds with a Cook Islands bank (EPBCL), the deposit being secured by a letter of credit from the Singapore branch of Midland Bank. Eventually, the case went to the High Court and was decided on Part IVA. The judge at first instance (Lockhart J, the same judge as in *Thorpe Nominees*) was confirmed on the source issue by the Full Federal Court, and the Commissioner did not pursue the source issue in the High Court.

Paragraph 21 of the Draft TD only quotes the following passage from Lockhart J's judgment at first instance:

"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."

The Draft TD does not mention that, in his judgment, Lockhart J also made the following comments:

"In my opinion where the source of interest payable under a contract of loan lies at the heart of the judicial inquiry, the place or places where the contract was made and the money lent are of considerable importance.....

The event which concluded the contract and bound the parties was the delivery of the cheque in the Cook Islands on behalf of the Spotless companies to EPBCL and the receipt of the certificate of deposit by them through their agent, Mr Levy....

There are other facts and circumstances that in my view point strongly in the direction of the conclusion that the interest was derived by the taxpayers in the Cook Islands. The borrower, EPBCL, was incorporated in the Cook Islands and carried on business there. It did not carry on business in Australia. The deposit was repaid, together with interest, less withholding tax, from the Cook Islands. It is impossible to ignore the legal effect of the arrangements entered into by the parties with respect to the lending of the money.

....The source of the interest derived by the taxpayers from the making of the loan was the Cook Islands."

It is submitted that the proposed Determination should analyse the Federal Court's decision in *Spotless Services* and explain the ATO's interpretation of this decision including its relevance (if any) to the issue of source of profits on sale of shares, and how it is to be reconciled with the apparently different approach adopted by the Federal Court in *Thorpe Nominees* (given that both cases involved tax avoidance arrangements and the same judge).

In addition, if the Commissioner considers that, in a particular case, a taxpayer has entered into a scheme designed to ensure that profits arising from the disposal of private equity investments are not sourced in Australia, then the appropriate course of action would be for the Commissioner to consider whether the general anti-avoidance rules in Part IVA should apply (as discussed in paragraphs 35 to 38 of the Draft TD), rather than relying on a vague notion of substance (which does not find any general support in the case law) to determine the source of the profits as the ATO did in *Spotless Services*. Accordingly, the abovementioned comments in paragraphs 30 and 31 of the Draft TD should be deleted.

---

<sup>16</sup> (1993) 25 ATR 334

## 5. Inconsistency with TD 2010/21

Even if the approach adopted by the ATO in paragraphs 32 to 34 of the Draft TD (in weighing up the various factors considered relevant) were correct, the manner in which that approach has been applied to the particular circumstances of a private equity arrangement is inconsistent with the ATO's own reasoning in Taxation Determination TD 2010/21.

TD 2010/21 (which was issued in final at the same time as the Draft TD was issued) deals with the question of whether the profit from the disposal of shares in a target company acquired in a leveraged buy-out is on revenue account. In TD 2010/21, the ATO asserts that one of the relevant (and very important) factors in identifying the tax character of the profits from the realisation of private equity assets is the investment drivers (refer paragraph 17). In this regard, paragraph 21 states:

“...[T]he overwhelming majority of the yield is estimated, in advance, to be derived from the sale of the target assets themselves.....[A]part 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...the limited partners' yield is also overwhelmingly, if not entirely, sourced from the disposal proceeds.”

On this basis, the ATO concludes that, as the disposal of the target assets is expected and planned in advance to generate the overwhelming part of the investment yield for the investors and also for the manager, this factor strongly points in the direction that the target assets are held by the fund on revenue account (rather than on capital account).

Applying this line of reasoning, in circumstances where the overwhelming part of the investors' return and of the manager's remuneration is tied to the disposal of the target assets, one would expect (at least where the activities of the private equity fund are passive in nature) that the place where the disposal of the target assets occurs should be accorded at least a significant amount of weight in determining the source of the profits from the disposal of the target assets.

On the other hand, according to paragraph 33 of the Draft TD, the Commissioner considers that the key factors “increasing or impacting on the profit” made by the private equity fund are:

- “business ability in assessing suitable target enterprises;
- making operational improvements; and
- the steps making the acquisition of the business possible (such as arranging finance).”

On this basis, paragraph 34 of the Draft TD concludes:

“Where these activities are undertaken in Australia, as we understand they are in a typical leveraged buyout arrangement, the source of the profits will be Australia. The execution of the contracts are simply the acts which crystallised the return and do not, in substance, affect the increase in return upon investment.”

The Professional Bodies request that the inconsistency between the different approaches adopted in the Draft TD and TD 2010/21 be resolved by the ATO before the Determination is issued in final.

## 6. References to “limited liability partnerships” should be references to “limited partnerships”, and the precise nature of the legal arrangements should be more clearly understood

Paragraph 9 of the Draft TD indicates that, “as a matter of practice, most private equity funds are structured as limited liability partnerships”, which have a general partner and a number of limited partners. However, as a matter of fact, most private equity funds are structured as

*limited partnerships* (not limited liability partnerships).<sup>17</sup> Therefore, all the references in the Draft TD (including the reference in the Example to “LLP”) to “limited liability partnerships” should be replaced with references to “limited partnerships” (“LP”).

The Professional Bodies note that the use of foreign limited partnerships in private equity structures raises difficult questions regarding the interaction of Division 5A of Part III of the ITAA 1936 (dealing with corporate limited partnerships), tax treaties, and partnership law.<sup>18</sup> For example, many foreign limited partnerships are formed under laws modelled on the *Delaware Revised Uniform Limited Partnership Act*. As such, they are legal entities in their own right, they are treated as “corporate limited partnerships” under Australia’s domestic tax law (refer Division 5A), and the general partner is usually an agent of the limited partnership (not of the investors). On the other hand, according to TD 2010/D8, for the purposes of the tax treaty between Australia and the country of residence of the investors, the limited partnership is treated as fiscally transparent. The Professional Bodies request that the ATO should more clearly define the precise nature of the legal arrangements in the final Determination.

#### **7. Advice Co is typically not a subsidiary of Priveq LLP (the fund)**

In the Example in the Draft TD, Advice Co (referred to as the “local advisory company” in the Explanation section of the Draft TD) is presented as an Australian resident entity controlled by Priveq LLP (ie the offshore fund). However, typically, Advice Co is a subsidiary of the private equity firm (which acts as or provides the general partner/manager of the fund), rather than a subsidiary of the fund itself. Therefore, the Example should be amended to refer to Advice Co as an Australian resident entity controlled by the general partner/manager of Priveq LP.

#### **8. Date of effect**

As noted above, there is no conclusive binding authority in Australia on the source of profits from the disposal of shares, and the cases in this area are difficult to reconcile. Furthermore, to date, the only official ATO pronouncements on the source of profits from the disposal of shares were the Interpretative Decisions discussed above, all of which emphasised the place of execution of contracts as the most relevant factor in identifying the source of the profits in those cases. The approach adopted by the ATO in the Draft TD represents a significant departure from its stance in the Interpretative Decisions.

Therefore, the Professional Bodies submit that the ATO’s views in the Draft TD should only apply prospectively.

---

<sup>17</sup> A number of countries have both forms, and limited liability partnerships (“LLPs”) are distinct from limited partnerships (“LPs”). In an LLP all partners are allowed to have limited liability, while a limited partnership requires at least one unlimited partner and other partners are allowed to assume the role of passive and limited liability investors. As a result, the LLP is typically used for businesses where all investors wish to take an active role in management. LLP structures are not used for private equity arrangements. As the commonly used international terminology for the kind of entities used in private equity is LP, the ATO should follow that terminology, particularly given that the draft TD is addressed to foreign investors. For further details, refer Avery Jones et al., “Characterization of Other States’ Partnerships for Income Tax” *Bulletin – Tax Treaty Monitor*, July 2002, page 288 (in particular sections 2.6.2 and 2.6.3)

<sup>18</sup> Refer Avery Jones et al., “Characterization of Other States’ Partnerships for Income Tax” *Bulletin – Tax Treaty Monitor*, July 2002, page 288