

# Tax Insight



## Foreign investors into Australia under the microscope

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On 26 October 2011 the Australian Taxation Office (ATO) issued final tax determinations (TDs), setting out its views concerning two major tax issues. The TDs relate to inbound investment into Australia by managed funds and, in particular, private equity (PE) investors, and deal with:

- ▶ The source of PE gains ([TD 2011/24](#))
- ▶ Availability of tax treaty relief for certain limited liability partnership (LP) partners ([TD 2011/25](#))

Early drafts issued in December 2010 broadly stated that the general anti-avoidance rule Part IVA can apply to set aside interposed entities in double tax treaty countries (TD 2010/20) and that PE gains are revenue, not capital, gains (TD 2010/21). The TDs also finalise other drafts (TD 2010/D7 and TD 2010/D8) released in 2010, and apply to years of income both before and after the date of issue.

The TDs contain positive elements, notably with regard to treaty relief for limited partners resident in a treaty country where they have invested through a fiscally transparent LP. However, the Commissioner has clearly not changed his position on a number of key points, which we examine below.

The TDs reveal critical ATO thinking and provide an action plan for reviewing existing and structuring further investment into Australia.

In particular, the ATO documents confirm that precise outcomes will depend on the facts and circumstances of individual structures. PE funds need to take a considered approach to transactions and structures in relation to both previous and ongoing investments, including pre-acquisition steps.

We recommend that you meet with your Ernst & Young advisor to discuss the ATO positions, impacts for your business, and next steps.

## Overview

The tax determinations TD 2011/24 and TD 2011/25 have confirmed the final views of the ATO in relation to source and fiscally transparent entities for inbound investment by managed funds. They provide that the contract is only one factor to be considered in determining the 'Australian source' of PE gains and that foreign investors can benefit from Australia's tax treaties when investing through a foreign limited partnership (LP), where the LP is treated as fiscally transparent in a tax treaty country. However, the practical issues associated with determining when treaty relief is available may be considerable.

These issues are significant for tax risk management. Consideration should be given to the identification of an action plan for structuring investment into Australia, given the ongoing ATO focus on foreign PE funds investing in Australia, and to help you prepare for likely ATO inquiries and potential intervention in relation to transactions.

## Whether source of private equity gains depends solely on where buy/sell contracts are executed

The final TD 2011/24 states the ATO view that in some cases, gains on the disposal of an investment by a foreign owner can be Australian sourced, even where the contracts for purchase and sale of shares are executed outside of Australia. In many respects the ATO's position on this point has not changed from the 2010 draft.

The final TD identifies six factors that the ATO considers relevant when determining source in this context:

- ▶ The activities undertaken by the fund, or on the fund's behalf, in making any improvements to the Australian corporate group
- ▶ Where those activities are undertaken
- ▶ The nature of any agreements between the entities
- ▶ The extent and nature of any control or involvement in the management of the Australian corporate group
- ▶ Where the purchase contracts and sales contracts are executed
- ▶ The form and substance of the purchase payments

The analysis in the TD seems unclear as to the precise meaning and application of some of the above factors in particular circumstances.

The ATO appears to be relying heavily on some of the judicial comments in the case of *Thorpe Nominees Pty Ltd v FCT* in determining source, based on where a business person would perceive the source to be. However in our view the analysis must:

- ▶ First identify the precise business activities of the foreign PE fund
- ▶ Identify which of these are carried on by dependent agents that are located in Australia (if any)
- ▶ Only then determine, based on the respective activities, whether any of the gain should be considered to be sourced in Australia.

Some of the factors listed above suggest that the ATO is seeking to attribute activities carried on by the investee entity's management team to the foreign PE investor entity, as well as activities carried on by entities that have been remunerated for services on an arm's length basis.

In our view, the cases the ATO uses as support for determining source in this context do not reflect the extent of the concepts contemplated in the TD. We expect that these views could be challenged, particularly where the general partner carries on activities outside Australia that add significant value to the investee entity.

The solitary example in the TD considers a PE LP formed in a low tax jurisdiction which buys and sells an investment in an Australian company using foreign executed contracts, but has:

- ▶ A wholly owned Australian holding company
- ▶ Services performed in Australia by associated entities, including debt arranging

The ATO concludes that the profits have an Australian source after “weighing up the various elements that resulted in the LP realising a profit” including the debt funding, research and selection of the investment and “enhancing its profitability and ultimate sale value”. The example glosses over the roles of the different parties involved in the investment and its activities. Therefore, while the TD’s high level analysis may have merit, its particular application suffers from an incomplete analysis of the nature and activities of PE investments. This issue was raised in submissions in response to the draft TD, however, the dynamic appears to have been overlooked by the ATO.

The final TD no longer raises the potential application of the general anti-avoidance provisions, other than to refer to a case where there was a pre-arranged plan to ‘avoid tax’ in Australia.

In our view, the TD, an attempt to apply basic tax law principles, may ultimately offer little assistance to PE investors seeking certainty for the tax treatment of their Australian investments. It does, however, indicate the need for extensive documentation of roles and responsibilities as part of investment structuring, and is a reminder to develop and maintain appropriate analyses and documentation for tax positions taken.

## Foreign investors other than PE Funds

The TD and its example focus on source issues for PE funds. It is not intended to consider the source issues for other foreign investors, such as managed funds investing into shares in listed Australian companies. Foreign investors in such cases might draw comfort from the ATO’s listing of the factors, which, taken together, are relevant when considering the source of gains, particularly to the extent that it confirms that place of contract may not be the sole determinant of the source of profits arising from a sale of Australian securities.

## Tax treaty relief for partners in foreign limited partnerships

TD 2011/25 broadly aligns the ATO treatment of treaty resident investors which invest through a fiscally transparent limited partnership (LP) with OECD guidance first released more than a decade ago. The TD considers investments made by foreign residents of countries with which Australia has a double tax treaty (treaty investors), made through an interposed limited partnership (LP) that is tax transparent in the country of the investor’s residence. The TD states that tax treaty relief may be available to the treaty investors under the business profits article in respect of gains on disposals, where the terms of the treaty are otherwise satisfied. The example relates to a Cayman Islands LP with treaty country investors.

The TD focuses on the treatment of interposed partnerships. It does not refer to the use of interposed companies such as LLCs in non-treaty countries and other fiscally transparent or blocker entities between the ultimate investors and the Australian investees. As a result, the TD has no formal application to interposed companies.

Nevertheless, the TD demonstrates ATO awareness that behind the interposed entities are often ultimate investors located in tax treaty countries and “ ... funds are sourced predominantly from investors who are resident in treaty countries ... . Some funds will of course, have provided identifying information to our treaty country partner’s revenue agency in any event.”

There may be scope to negotiate reduced Australian tax outcomes in relation to interposed non-transparent entities, by applying look-through treatment which involves disclosure to the ATO of the ultimate investors in treaty countries. This may be so where the principles set out in TD 2011/25 are applied together with those

set out in TD 2010/20 (dealing with Treaty Shopping and Part IVA). In our recent experience, the Commissioner's attitude to intermediary non-transparent feeder entities to a Cayman LP fund is influenced by the quantum of tax potentially at risk and possibly also the nature and residence of the ultimate investors.

## **Look-through treatment with no safe harbour**

The TD restricts treaty benefits only to LP partners that are residents of treaty countries. The TD contains an example of a partner, not a treaty resident, and states that the LP profit will be subject to Australian tax to the extent that it is attributable to limited partners in non-treaty jurisdictions. This resolves our concerns as the draft TD was unclear on this issue.

We had hoped that the final TD might include a 'safe harbour' whereby, provided a certain percentage of the investors were resident in treaty countries, a gain by the relevant LP would be subject to treaty protection. However, the TD has no such safe harbour, which is unfortunate.

The TD emphasises the need for fund managers, or general partners, to assemble as much information as is available to them as soon as practicable after an acquisition has been made and to provide this to the ATO. Once the ATO is satisfied as to where the ultimate partners reside, the ATO will advise what, if any, arrangements need to be in place to ensure that the treaty benefits are available.

Based on our experience, where the amount of tax involved and the percentage of non-treaty investors are both low, the ATO has shown a propensity to take a pragmatic approach and allow relief. In our view, this outcome is more likely where the LP and their advisors engage with the ATO early and on a genuine and fully transparent basis.

## **ATO views backed by continued compliance activity**

The ATO's compliance activities should be factored into tax risk management actions in conjunction with this new tax guidance.

In the absence of the provision of sufficient identifying information, the TD maintains the Commissioner's intention, "where appropriate", to secure amounts assessed from third parties using its administrative powers or "other available remedies". The Commissioner has not been dissuaded from taking such action notwithstanding the outcry arising from his recent actions relating to PE investments.

The ATO has stated that it will continue to focus significant compliance activities on PE arrangements to determine whether foreign entities comply with Australian tax obligations. The ATO's planned scrutiny of PE transactions was included in the 2011-12 annual compliance program. The ATO also wrote to taxpayers connected with private equity investment in December 2010 to highlight its compliance strategy.

Recent ATO actions include those reported against US-based Resource Capital Funds (RCF) and RCF action in turn against the ATO. The ATO has also continued to pursue TPG Capital in respect of the 2009 float of department store Myer, with initial success in a Federal Court action to recover its assessment by changing tack to attack the Australian management who were directors of the offshore TPG entities. However, that decision was subsequently overturned.

## **Action required**

PE funds and their managers should discuss their strategy with their advisors around whether and when to engage with the ATO.

PE managers should review their current and historical Australian investment structures and strategies in light of the ATO final TDs and continuing ATO action, and consider the potential impact of these developments.

In addition, where possible, PE funds should ensure that they receive the necessary information from their ultimate investors when establishing their investment structure.

For PE funds structured as LPs, managers should consider whether treaty resident investors may be able to avail themselves of look-through treatment.

Funds with structures and investors using interposed entities other than LPs should consider an approach to the ATO to explore alternative ways to agree the Australian tax position.

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