ATO v TPG – preliminary thoughts for private equity in Australia

There has been considerable press in the last few days associated with the Australian Taxation Office's (ATO) attempt to impose Australian income tax on TPG. The ATO asserts that the profits made on the listing of Myer Holdings Limited (Myer) fall within the Australian taxation net.

This event represents the most significant public statement by the ATO on the taxation of private equity gains (without expressly stating the technical basis for its position).

The uncertainty created by the suddenness of the attack and the lack of detail which has been provided has the potential to dissuade prospective investors from investing into Australia or at least be a factor which they take into account when bidding for Australian assets.

For foreign funds that are already here, it means an urgent review of the positions which they may have already taken with respect to their Australian investments. For Australian funds and their investors, the revenue/capital distinction is reaffirmed as one of the most critical uncertainties affecting the profile of their investment.

In this bulletin, we outline some of the grounds on which the ATO may seek to impose Australian income tax on a foreign private equity fund as well as some key considerations for Australian funds and Australian investors as a result of these recent events.

Argument 1 – the profit is on revenue account and but for the interposition of the BV, the gain would have been made by an entity in a non-treaty jurisdiction

Is the profit on revenue account?

Since 2006, capital gains derived by non-residents have generally been exempt from taxation in Australia. Exceptions to this general rule include where the assets are land, "land-rich" companies or assets associated with a permanent establishment of the non-resident in Australia (see below).

The abolition of capital gains tax (CGT) for non-residents was never intended to exempt from taxation, gains on revenue account. For shareholders resident in certain countries (such as the Netherlands, with which Australia has entered into a double tax agreement (DTA)), the existence of revenue gains has generally not been an issue provided no permanent establishment (PE) in Australia exists. This is because the DTA prevents Australia from imposing tax on such revenue gains (eg under the "Business Profits" article). However, for persons residing in countries with which Australia has not concluded a DTA, such protection is not available.
An ATO attack on private equity style gains is likely to involve the ATO forming the view that such a
gain is on revenue account. The basis of the argument was summed up in an ATO statement on 18
November 2009 which said that "where a taxpayer's business is the purchase of assets with the
intention to later resell them at a profit, that gain, when realised, will ordinarily be income". In itself, this
argument would not be enough to characterise the gain as taxable if the gain is made by a Dutch
company eligible for benefits under the DTA, provided that company does not have an Australian PE.
Accordingly, in the case of non-resident funds investing through a jurisdiction which has an acceptable
DTA, the characterisation of the gain as being on revenue account is potentially relevant only in
conjunction with an anti-avoidance based argument.

The General Anti Avoidance Rule

If the Australian investment is held through a holding company resident in the Netherlands (eg a BV),
then it would seem that absent the existence of a PE, the only avenue for argument by the
Commissioner is that the DTA should be disapplied because of an anti-avoidance rule.

As Australia's DTA with the Netherlands does not have a specific "anti-treaty shopping" rule (unlike
more recent treaties) this means that the ATO would arguably need to rely on the Australian domestic
anti-avoidance provisions (Part IVA) to effectively deny the benefit of the treaty.

The application of Part IVA in a treaty shopping case has never been considered by the Courts, even
though the ATO could have raised such an argument in the landmark decision in Lamesa Holdings. In
that case, a Netherlands holding company was interposed between the United States investors and
the Australian investee company.

Such an ATO argument may be premised on the basis of “but for” the interposition of a holding
company in the Netherlands, the gain would have been taxable (assuming that it was on revenue
account – hence the need for the ATO to consider the character of the gain – see above). If this is the
basis of the argument then subject to the precise facts and circumstances, we believe that there are
good arguments to suggest that, particularly in the case of an initial investment and where there is
significant uncertainty as to the eventual economic outcome of that investment, that the general anti-
avoidance rule should not apply.

Argument 2 - does the non-resident have a PE in Australia?

This matter was not the key ground of attack in relation to TPG's profit on the sale of shares in Myer.
Nevertheless, PE funds need to be cognisant of its potential application.

The utility of the argument is that it does not depend on proving that the gain is on capital or revenue
account because both types of gains are taxable if the gain is connected with a PE in Australia.

PE funds need to be conscious of the role played by any of their people who are "on the ground" in
Australia to ensure no PE of the holding entity is created in Australia.

Implications for Australian funds and investors

Clearly, any attempt by the ATO to characterise private equity style gains as being on revenue account
would be relevant for domestic funds and their investors. The most significant consequence would be the
denial of the CGT discount and for those investors with capital losses, an inability to shelter gains with
those losses.

Persons for whom this characterisation should not be an issue include those taxpayers who benefit from
other provisions, such as:

- deemed capital account treatment (such as investors in MITs where the MIT makes the capital
  account election announced by the Government in the May 2009 budget);
- the deemed CGT treatment for the carried interest of a general partner of a VCLP, ESVCLP or
an AFOF or a limited partner in a VCMP; and

- exemptions from Australian income tax altogether, irrespective of whether gains are characterised as revenue or capital (eg investors in ESCVLPs and qualifying foreign investors in a VCLP).

The long term consequences of gains being characterised as revenue rather than capital in nature may also depend on whether the CGT discount remains as a result of the Henry Review into the Australian tax system.

Conclusion

These recent events have contributed to further uncertainty in relation to private equity investment into Australia. While the 2006 reforms to CGT for non-residents were intended to make Australia a more attractive place for foreign investment, this latest development represents a significant development in the opposite direction.

Not only is this an issue for non-resident investors, but if the ATO is seeking to characterise private equity gains as being on revenue account, then this has implications for domestic funds also.

Investors may be driven to seek greater certainty for future investments by investing in funds which offer deemed capital account treatment (for example where the fund qualifies for MIT treatment - the broader availability of this concession will depend on whether the MIS needs to be registered. This is something which is still subject to uncertainty). However, in the interests of certainty for investors, it is important that the technical arguments put forward by the ATO in support of its position are made publicly available in the form of a draft ruling. The ATO has indicated that it will be issuing a ruling in the next few weeks on this issue. In light of the potential for further IPO and trade sale activity in the coming year this is required urgently.

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