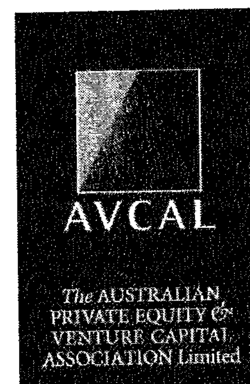
By Email - taxboard@treasury.gov.au
Mr Richard Warburton AO
Chairman, Board of Taxation

Mr John Emerson AM
Member, Board of Taxation




17th December 2007

Dear Mr Warburton and Mr Emerson

**Summary**

The Australian Private Equity & Venture Capital Association Limited (AVCAL) is a national association which represents the private equity and venture capital industries. AVCAL's members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

The vast bulk of the funds that AVCAL's members manage are invested on behalf of superannuation funds from Australia. In the current volatile market, the long term nature of private equity investing provides an important counter-balance to the public markets for investors. In addition, the industry is still mobilizing capital and investing when the public securities markets around the world are in free-fall. The industry is an important contributor to the economic well-being of Australia. As the report of the recent Senate inquiry into the industry noted: *"The committee views private equity as an opportunity to reinvigorate underperforming public companies, which will subsequently benefit Australian consumers, shareholders and workers."*

It would be an enormous disruption to the industry and its investors for there to be differing taxation treatments of gains derived directly and gains derived via managed funds. Specifically, if a superannuation fund invests in securities directly and attracts a clear statutory taxation treatment of gains via section 295-85 of the Income Tax Assessment Act of 1997, it is inappropriate to treat the gain as being on revenue account if derived via a managed fund. The superannuation fund will lose the benefit of an explicit policy setting if this happens. It would be disastrous if superannuation funds decided to withdraw their investment support for Australian fund managers as a result, and chose to invest in overseas markets where the tax regime clearly identifies such investing as being on the capital account (such as the UK and the US).

Government policy statements and the establishment of the Australian Finance Centre Forum clearly demonstrate the Government's vision for Australia to become a successful regional centre for the financial services sector. If gains from managed investment trusts become taxable as revenue it would be totally counterproductive to the Government's policy aims.

Gateway Building
Level 41, 1 Macquarie Place
Sydney NSW 2000
AUSTRALIA
Telephone +61 2 8243 7000
Facsimile +61 2 9251 3808
ABN 84 056 885 708

www.avcal.com.au

**Discussion**

1. Mr Allan Blaikie of Clayton Utz attended your consultative meeting in Sydney on 13 November 2008 on our behalf. At that meeting, you both advised that the issue raised in chapter 7 of the discussion paper has been given some priority. It is with this in mind that we advise the following.

2. Chapter 11, titled "Defining the scope of a Managed Investment Trust", at 11.11 discusses the issue of what the membership requirements should be for a managed investment trust and whether some form of look through treatment is appropriate. As has already been noted, AVCAL represents the private equity and venture capital sector. A typical private equity or venture capital fund is an unregulated, managed investment scheme. The principal reason such funds are unregulated is that such funds' investors are large, regulated superannuation funds, registered managed investment schemes and other sophisticated and professional investors, with the largest proportion being regulated superannuation funds.

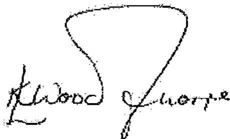
3. Presently, the great majority of private equity and venture capital funds treat their gains and losses as being on capital account for the reasons outlined in the attached discussion paper prepared by Clayton Utz. This provides consistent treatment with the treatment of Australian regulated superannuation funds, which entities make up a considerable proportion of investors in private equity and venture capital funds.

4. If your review were to exclude unregulated funds whose investors were large regulated superannuation funds and managed investment trusts the review, in AVCAL's opinion, would not realise the opportunity for significant reform in this sector and would potentially create even greater complexity and uncertainty. Moreover, if the scope of the review is extended in the way AVCAL suggests, but the outcome of the deliberations on Chapter 7 is to treat gains as being on revenue account, the outcome will be also regrettable. Specifically, this outcome would result in indirect investment by regulated superannuation funds being taxed differently than direct investment and increase their tax burden on such gains by 50%. Put simply, it would be disastrous for the industry and for the Government's efforts to promote Australia as the financial services hub of the region were such superannuation funds to withdraw their investment support for local private equity and venture capital fund managers.

We are aware that numerous other organisations, including the Taxation Institute of Australia, the Property Council of Australia and the Investment and Financial Services Association have made detailed submissions on these points. All the submissions, in one form or another, recommend that gains by managed investment trusts should be on capital account and that a statutory amendment should be introduced to confirm this. AVCAL clearly supports such a legislative confirmation of the current treatment and it commends that such legislative confirmation extend to wholesale trusts in the form discussed earlier.

We would be keen to elaborate on, or clarify, any aspect of the comments above should you so require.

Yours faithfully



Dr Katherine Woodthorpe
Chief Executive
AVCAL

# CLAYTON UTZ

Sydney Melbourne Brisbane Perth Canberra Darwin

Clayton Utz
Lawyers
Levels 19-35
No. 1 O'Connell Street
Sydney NSW 2000
Australia

PO Box H3
Australia Square
Sydney NSW 1215
DX 370 Sydney

T +61 2 9353 4000
F +61 2 8220 6700
www.claytonutz.com

16 December 2008

Dr Katherine Woodthorpe
AVCAL
Level 41 Gateway Building
1 Macquarie Place
SYDNEY NSW 2000

Our reference: 201/80081987

Dear Ms Woodthorpe

**Submission to Board of Taxation**

You have requested a summary of the taxation treatment of private equity funds for inclusion in your submission to the Board of Taxation.

**Taxation Treatment of Private Equity Funds (PE Funds)**

1. Brief Description of PE Fund

- Typically a PE Fund is established as a closed end unit trust procuring funds from wholesale and other sophisticated investors.
- The PE Fund will have maximum life of 10 years but could be extended.
- The trustee of the PE Fund may be an independent trustee.
- Funds are drawn down by the PE Fund from each investor pro rata for each separate investment and the proceeds from the realisation of each investment are returned to investors. In other words a PE Fund typically uses its capital only once before returning it to investors.
- A typical PE Fund will have between 5-15 investments and the average investment life will approximate 5 years with some investments being disposed of earlier than 5 years and some, depending on the state of capital markets, not being disposed of until the end of year 10 or even later in the event of the life of the fund being extended.
- The trustee of a PE Fund, once it satisfies itself that a share investment meets the PE Fund's selection criteria, monitors its investment's performance but typically makes no further active decision until the manager recommends realisation.
- The role of the manager is to select an investment, arrangement for any debt funding, actively supervise the performance of the investee through the Board selection process and closely scrutinise of the company's performance and determine an appropriate timing and strategy to exit the investment.

- There is no prescribed timetable for realisations, rather the manager/advisor to the trustee of the PE Fund takes a long term view of investments.

2. The trustee of a PE Fund does not carry on a business having regard to the small number of investments the PE Fund makes and the lack of any subsequent reinvestment. Thus, the only basis for treating a surplus on realisation of shares as ordinary income is on the basis of the statement in paragraph 16 of Taxation Ruling TR 92/3.

"16. If a taxpayer not carrying on a business makes a profit, that profit is income if:

(a) the intention or purpose of the taxpayer in entering into the profit-making transaction or operation was to make a profit or gain; and

(b) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction."

Put another way, in the absence of a business, two criteria must be satisfied before a gain from realisation of the above investment will be ordinary income. Firstly, the relevant transaction, in and of itself, must constitute a business operation or commercial transaction and, secondly, the investment must have been acquired with a profit-making intention. Neither of these criteria alone will be sufficient to give rise to a gain on revenue account.

Taxation Ruling TR 92/3 follows from the decision in FC of T & The Myer Emporium Limited 87 ATC 4367. The following extracts from the Myer decision indicate clearly that, absent the trustee of a PE Fund carrying on a business, it is only in special circumstances where a surplus on disposal of share investments constitutes ordinary income. Specifically, an intention by the trustee of a PE Fund to dispose of a share holding at a surplus over cost is insufficient, of itself, for such a gain to be regarded as ordinary income where the acquisition of the shareholding did not constitute a business operation or commercial transaction.

> "**Several different strands of thought have combined to deter courts so far from accepting the simple proposition that the existence of an intention or purpose of making a profit or gain is enough in itself to stamp the receipt with the character of income**. The first was the notion that the realization of an asset was a matter of capital, not income. The second was the apprehension that windfall gains and gains from games of chance would constitute income unless the concept of income, apart from income from personal exertion and investments, was confined to profits and gains arising from business transactions. And the third notion, itself associated with the idea that the carrying on of a business involves a systematic series of recurrent acts or activities, was that a gain generated by recurrent transactions is income, whereas a gain generated by an isolated transaction is capital." **(Our emphasis)**
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> "In the United Kingdom, Schedule D of the *Income Tax Act 1918* (U.K.) reinforced these
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> [4368]
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> notions. The Schedule seemingly confined the concept of income to (a) profits or gains from any trade, profession, employment or vocation, and (b) annual profits and gains from investments, though "trade" is defined so as to include every "manufacture,

adventure or concern in the nature of trade". These provisions naturally provoked the question: Was a profit made on an isolated transaction of purchase and sale income, if the purchase was made with the intention, or for the purpose, of making the profit, even though the transaction was not one entered into in the course of carrying on a business?

In *Jones* v. *Leeming* (1930) A.C. 415, the House of Lords answered this question in the negative. There was a finding that the taxpayer never meant to hold the land bought as an investment. Nevertheless it was found that the transaction "was not a concern in the nature of trade". This led to the conclusion that a profit on an isolated sale, not being an adventure in the nature of trade, was a capital accretion (at p. 430). Central to the reasoning was the view that in order to constitute a trading or business transaction, an element of recurrence or repetition is needed and that the intention or purpose of making a profit or gain is not enough. Viscount *Dunedin* said (at p. 423):

"The fact that a man does not mean to hold an investment may be an item of evidence tending to show whether he is carrying on a trade or concern in the nature of trade in respect of his investments, but per se it leads to no conclusion whatever."

And Lord *Buckmaster* (at p. 420) discounted the suggestion that a profit made on the sale of an asset acquired in the expectation that it would rise in value (and presumably result in a realized gain) is income. To him all that was involved in such a case was the realization of a capital asset.

On the other hand in *Edwards (Inspector of Taxes)* v. *Bairstow* (1956) A.C. 14 joint venturers who engaged in an isolated transaction of buying and selling a complete spinning plant, with a view to making a profit, having no intention of using the plant or deriving income from it, were held liable to income tax on the profit made on resale. Lord *Radcliffe* concluded (at pp. 36-37) that it was a profit from an adventure in the nature of a trade because the joint venturers had no intention of using the machinery and therefore did not buy it to hold as an income-producing asset or to consume it or for the pleasure of enjoyment; and, instead of having any intention of holding the plant, they planned to sell it even before they bought it. This they did, making a net profit, as they hoped and expected to do. In his Lordship's opinion this was "inescapably, a commercial deal in second-hand plant".

In rejecting the argument that the profit was not income because it arose from an isolated transaction, Lord *Radcliffe* observed (at p. 38):

"... that circumstance does not prevent a transaction which bears the badges of trade from being in truth an adventure in the nature of trade. The true question in such cases is whether the operations constitute an adventure of that kind, not whether they by themselves or they in conjunction with other operations, constitute the operator a person who carries on a trade. Dealing is, I think, essentially a trading adventure, and the respondents' operations were nothing but a deal or deals in plant and machinery."

The judgments in some of the English decisions naturally reflect the language of the United Kingdom statutory provisions, which have no precise counterpart in this country. However, over the years this Court, as well as the Privy Council, has accepted that profits derived in a business operation or commercial transaction carrying out any profit-making scheme are income, whereas the proceeds of a mere realization or

> change of investment or from an enhancement of capital are not income; *Ruhamah Property Co. Ltd.* v. *F.C. of T.* (1928) 41 C.L.R. 148 at pp. 151-152, 154; *McClelland* v. *F.C. of T.* 70 ATC 4115 at pp. 4120-4121; (1970) 120 C.L.R. 487 at pp. 495-496; *London Australia Investment Co. Ltd.* v. *F.C. of T.* 77 ATC 4398 at pp. 4402-4403; (1977) 138 C.L.R. 106 at pp. 115-116; and see *Whitfords Beach.*
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> The proposition that a mere realization or change of investment is not income requires some elaboration. First, the emphasis is on the adjective "mere" (*Whitfords Beach,* at ATC pp. 4046-4047; C.L.R. p. 383). Secondly, profits made on a realization or change of investments may constitute income if the investments were initially acquired as part of a business with the intention or purpose that they be realized subsequently in order to capture the
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> [4369]
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> profit arising from their expected increase in value — see the discussion by *Gibbs* J. in *London Australia,* at ATC pp. 4403-4404; C.L.R. pp. 116-118. It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realization. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition, of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction."

The foregoing extract from Myer illustrates a number of useful points. Principally, whilst accepting a different statutory construction, it draws a parallel between the UK tax treatment of gains on isolated purchases and profitable resales and the relevance of the "badges of trade" (Edwards (Inspector of Taxes) v. Bairstow (1956) A.C. 14) and Australian courts' treatment of similar transactions and the importance in Australia of context. Specifically, Australian courts focus on whether the gain is made in the context of a business operation or commercial transaction. Myer, particularly the extract from Lord Radcliffe's judgment in Edwards v Bairstow, adopts the view that, absent such a gain occurring in the context of a business, a gain on the purchase and resale must have other business characteristics to turn a gain from a speculative transaction into ordinary income, notwithstanding the fact that the gain arose out of a profit-making intention.

Moreover, UK authorities post Edwards v Bairstow continue to treat purchases and sales of shares acquired with profit making intent as affairs of capital. That is, such transactions do not exhibit the "badges of trade" necessary to stamp a resultant gain with the character of income. The relevant UK authorities include Salt v Chamberlain (H.M. Inspector of Taxes) 53 TC 143 where it was said :

> "Where the question is whether an individual engaged in speculative dealings in securities is carrying on a trade, the *prima facie* presumption would be as Pennycuick J. suggested in the *Lewis Emanuel* case, that he is not. It is for the fact-finding tribunal to say whether the circumstances proved in evidence or admitted take the case out of the norm."

The decision of Salt v Chamberlain also discusses the decision in Lewis Emanuel & Son, Ltd v White (H.M. Inspector of Taxes) [1965] 42 TC 369 to illustrate the point that a large volume of activities would be required before it could be established that speculative gains on securities constitute ordinary income or, as in the case, that losses might be deductible.

Also, the UK tax treatment of PE Funds based on the UK law outlined in Myer and subsequent decisions, is to record gains on disposals of shares as capital gains. Although the preferred UK vehicle is a limited partnership, the situation for investors is as described in:

> "Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest; 25 July 2003"

Specifically, according to the Memorandum of Understanding, a typical UK private equity limited partnership makes capital gains on its share investments and flows the gains through to investors which treat such distributions as capital gains.

3. Also, if the UK "badges of trade" test were applied to an Australian PE Fund, there is a real question as to whether a different conclusion to that reached in the UK should result. As discussed above, UK law indicates that the activities of a trustee of a PE Fund with respect to the acquisition and disposition of shares would not exhibit the "badges of trade" necessary to stamp gains with a revenue character. Australian judicial consideration of this specific issue is limited and, although a number of Australian cases have considered whether dealings in shares constitute a business (eg London Australia Investment Company Limited v FCT 77 ATC 4398), such decisions have little relevance where, as in this case, it has been accepted that no business is being carried on.

If the UK "badges of trade" are specifically examined and applied to an Australia PE Fund, it is submitted that an identical outcome to that in the UK would be reached. Using the "badges", the following analysis arises:

(a) ***The subject matter of the realisation***

As already noted, the presumption in the UK is that shares are not normally the subject of a taxable realisation in the context of the "badges of trade" and so, on the subject matter point, a conclusion that PE Fund gains and losses are capital in nature is apparent.

(b) ***Length of period of ownership***

The average length of ownership of shares held by Australian PE Funds is, we understand, approximately 5 years and, on occasion, with holding periods of less than 1 year or longer than 10 years. Overall, the length of the ownership period would imply a capital rather than a revenue transaction. Moreover, the anecdotal evidence from the few transactions where a holding has been realised within a year suggest an external event has caused the realisation rather than a planned exit.

(c) ***Frequency of transactions***

As already noted, the small number of transactions that a typical PE Fund invests in again suggests a capital rather than revenue transaction. The typical PE Fund is closed ended and proceeds from divestments are distributed rather than reinvested. As such, the transactions do not have the hallmark of revenue transactions.

(d) ***Supplementary work in relation to the property***

The trustee does nothing to alter the nature of the shares acquired. As noted above, the monitoring and management of a PE Fund's investment portfolio is typically undertaken by the manager (not the trustee). Furthermore, to the extent any changes are made in the management or operation of the investee company they are implemented by the board of the investee company. The investee company directors are selected by the managers of the PE Fund with a view to ensuring that the company can be made more profitable by reference to its capital structure and by the strategic management of the enterprise. In this respect, the manager may assist the investee company with the implementation of classic private equity disciplines, including improved individual accountability, KPIs, fact-based reporting and the sale of non-core assets. The manager may also undertake rigorous weekly and monthly reporting to ensure the required disciplines are taking hold.

(e) ***Circumstances responsible for realisation***

Typically, realisation occurs when the manager believes that every effort has been made to maximise the prospects of the underlying business and that these efforts are reflected in the present value of the shares or the PE Fund has reached the end of its term. The manager then makes an appropriate recommendation to the trustee. This aspect, in terms of a private equity transaction characterisation, is essentially neutral as far as the nature of the gain or loss is concerned.

(f) ***Motive at time of acquisition***

As already noted, though a shareholding may be acquired with the ultimate prospect of disposal at a profit. Furthermore, in the absence of the other "badges of trade", the profit-making intention demonstrated by the private equity model is insufficient to result in a finding that a revenue gain rather than a capital gain arises.

4. It is also useful to consider the operation of section 15-15 of the Income Tax Assessment Act 1997 and its predecessors in the Income Tax Assessment Act 1936. In terms of gains from isolated transactions, the High Court in Myer held that such gains can be assessable both as ordinary income under section 25(1), where the transaction could be considered to constitute a business operation, and as statutory income under section 26(a). Since that time, section 26(a) has been replaced by section 25A and then by section 15-15. Section 15-15 now only applies to profits from profit-making undertakings or plans which are not assessable as ordinary income under section 6-5 (that is, where the transaction constitutes a business operation) **and** do not arise from the sale of property acquired after 20 September 1985. The explanatory memorandum to the bill which introduced section 15-15 contains an explanation of these changes which is relevant not

only to the scope of section 15-15 but also to the scope of section 6-5. In particular, the explanatory memorandum states as follows:

> *"The existing law (section 25A) includes in assessable income:*
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> *profits from a sale of property acquired for profit-making by sale; and*
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> *profits from carrying on any profit-making undertaking or plan.*
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> *Capital gains tax (CGT), introduced in 1985, provided for a new treatment of profits from the sale of property. As a consequence, section 25A only applies to a sale of property if the property was acquired before CGT was introduced."*

5. Given the above statement and the fact that Myer concerned a transaction which occurred prior to the introduction of CGT, it is no longer necessary to extend the concept of income to include profits arising on the disposal of property, as such gains are now covered by CGT. The new regime differentiates between short term capital gains (less than 12 months) and gains on holdings longer than 12 months. The former are taxed as ordinary income firstly, without the benefit of indexation and subsequently without the benefit of the reduced rate of tax on capital gains.

6. The result is, in our opinion, that there is no substantial judicial authority for the conclusion gains made by the trustees of a PE Fund are on income account and there is nothing to suggest that the principle established in Charles v FCT 90 CLR 598 should be displaced in the context of PE Funds. Moreover, as the extract from Parsons suggests, UK notions of the meaning of income in this context have become part of our law. In the result, it would be surprising if Australian courts would come to a view contrary to the UK practice where private equity transactions are on capital account.

> "[3.6] *Whitfords Beach* is a landmark decision in holding that the part of the ordinary usage meaning of income concerned with the notion of profit from an isolated business venture is some of the meaning of income for purposes of the Assessment Act. Gibbs CJ and Mason J decided the case by the application of that notion." (1982) 150 CLR 355 Parsons Income Taxation in Australia.

Yours faithfully

**Allan Blaikie, Partner**
+61 2 9353 4201
ablaikie@claytonutz.com