Private Equity Tax Update - June 2024

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The recent announcement of the Australian Federal Budget has revealed notable changes to the taxation system, impacting various aspects of tax in private equity. Explore A&M's analysis of the latest developments in private equity taxation in Australia, and discover what steps professionals should take to navigate these issues effectively.

WHAT YOU NEED TO KNOW:

Foreign resident capital gains tax

The Federal Budget has proposed a widening of assets on which foreign residents will be assessed CGT, among other measures which will impact foreign residents including a notification obligation for all foreign vendors of >$20m of shares and other equity interests in Australia.

Part IVA cases (Minerva and Mylan)

Recent cases have affirmed that a tax benefit does not itself enliven Part IVA where the transaction is clearly commercially driven.

FIRB Framework

Announcements that promise to streamline FIRB for lower risk investors and transactions.

Continuation vehicles

Continuation funds are becoming an attractive alternative for fund managers to selling valuable assets in a weak market, however planning is required to ensure an efficient outcome for investors and managers.

Victorian commercial and industrial property tax

New annual Victorian tax regime introduced for commercial and industrial property owners, commencing from 1 July 2024, whilst ending stamp duty for this category of assets.

Indirect taxes and employment tax considerations

Updates on indirect and employment-related taxes which may arise in the context of acquisitions or restructures.

WHAT CAN YOU DO?

- Participate in the Government consultation on the "implementation details" of the new foreign resident CGT measures;
- Maintain contemporaneous evidence of a commercial purpose when undertaking transactions to help support against a future dispute with the ATO and monitor for an appeal to the decision in Mylan;
- Consider how FIRB changes may impact timeframes to complete new transactions;
- Consider whether a continuation vehicle can provide an optimal solution to winding down a fund without needing to sell into a weak market;
- Consider how Victorian CIPT may impact new transactions and project feasibility;
- Consider whether the financial acquisition-supply rules apply in the context of share/unit purchases or sales to foreign investors;
- Consult with tax advisors on the above matters.

FOREIGN RESIDENT CAPITAL GAINS TAX (CGT)

One of the Federal Budget proposals entitled "Strengthening the foreign resident capital gains tax regime" seeks to raise $600m over the forward estimates period (2024-25 - 2027-28) from non-residents disposing of direct or indirect interests in Australian land.

Under existing law, foreign residents are taxed on gains on Taxable Australian Property (TAP), meaning, broadly, interests in Australian land, or membership interests in an entity where more than half the value of the interest is attributable to interests in Australian land), or on their Australian sourced ordinary income. Under the proposed new law (upon which Government will consult on the implementation), the types of assets that foreign residents are subject to CGT on will be broadened, the test for TAP will be amended from a point-in-time to a 365-day testing period, and foreign residents disposing of shares and other membership interests exceeding $20m in value will be required to notify the ATO prior to the transaction being executed.

Broadening CGT asset definition

There are no details on the types of assets to which foreign resident CGT will apply under the broadened rules. The devil will, of course, be in the detail, but the new rules are expected to cover energy assets (particularly networks and renewables), data storage assets, mobile towers and other assets closely associated with land.

Notification Requirement

The ATO notification requirement is an information gathering tool, broadly requiring all foreign vendors (where the value of the equity exceeds $20m) to disclose to the ATO details of an impending exit.

For many fund managers, this has been an existing obligation already included in increasingly onerous FIRB tax conditions, but this Budget announcement codifies that obligation for most foreign PE investors into Australia, as well as for Australian fund managers advising offshore fund vehicles – and it opens the door for the ATO to disagree with the assessment of TAP, and / or dispute whether or not the gain is in fact a capital gain and not Australian-sourced ordinary income.
Further analysis of this and other measures announced in the Federal Budget can be found here.

What can you do?

1. Participate in the Government consultation on the "implementation details" of the new measures.
2. Review the protection afforded by applicable tax treaties, as amended by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

PART IVA CASES (MINERVA AND MYLAN)

In *Minerva Financial Group v Commissioner of Taxation* [2024] FCAFC 28 (Minerva), the Full Federal Court held that Part IVA did not apply to changes in distributions policy. This followed the Federal Court decision that Part IVA did not apply to a pre-IPO restructure.

A detailed summary of the decision is here.

Key points in the Minerva decision:

- Part IVA did not apply to the pre-IPO restructure to form a stapled group because there was strong evidence of expected commercial benefits on IPO.

- Decision to distribute securitisation gains from a trust (at 10% WHT) rather than a company (subject to 30% tax) as part of a stapled group was insufficient to attract Part IVA. The distribution to those unitholders allowed repayment of debt and increased capital in the stapled group which was sufficient commercial justification.

Similarly, in *Mylan Australia Holding Pty Ltd v Commissioner of Taxation* (No 2) [2024] FCA 253 (Mylan), the Federal Court held that Part IVA did not apply to a debt 'pushdown' on acquisition using a Holdco/Bidco structure.

A detailed summary of the decision is here.

Key points in the Mylan decision:

- Part IVA did not apply to the Holdco/Bidco structure. Similar to *Minerva*, the Federal Court placed heavy emphasis on contemporaneous evidence of commercial purpose in finding Part IVA did not apply.

- The judgment frequently relied upon contemporaneous documents available to understand Mylan's intentions at the time of the transaction, highlighting the importance of contemporaneous evidence and documentation being maintained at the time transactions are undertaken.

What can you do?

1. Remember that contemporaneous evidence of a commercial purpose is critically important in defending against a later dispute with the ATO.
2. Monitor for any ATO appeal to the decision in Mylan, but possibly not Minerva.

FIRB FRAMEWORK

The Australian Federal Government has announced changes to Australia's foreign investment framework, dedicating increased resources to screening and monitoring "higher risk" Foreign Investment Review Board (FIRB) applications into perceived national interest sectors. An accompanying Foreign Investment Policy document has since be released detailing the reforms.

Under the updated process, FIRB scrutiny will be informed by consideration of the following trio of considerations:

- **Who** are the investor(s);
- **What** is the target(s);
- **How** is the transaction(s) structured.

While communicated as promoting streamlined applications for lower risk investors, and reforms aimed at incentivising investment (i.e., fee refunds for unsuccessful participants in a bid process), the tax conditions imposed on FIRB applications are increasingly becoming more onerous.

What can you do?

1. Assess indicative FIRB review period and how they may impact a transactional timeline.
2. Ensure tax advisors are part of discussions with lawyers regarding FIRB.

CONTINUATION VEHICLES

A number of fund managers (from VC through to PE) are facing the expiration of the fund, in circumstances where an outright disposal of the assets may not be convenient (whether that is due to IPO markets, general M&A activity being down, or otherwise). These fund managers are contemplating optimal strategies for winding down their funds, and are increasingly looking to transfer those assets into continuation funds so that the fund manager and investors can maintain exposure to them, rather than sell them off into a challenging market.

Transferring assets into a continuation fund brings about many challenges from a tax perspective. One of the biggest challenges tends to involve ensuring that the process does not result in a “dry tax” charge (i.e., a tax liability with no cash released with which to pay it) for investors who look to stay exposed to the asset, given that there is often no available CGT roll-over for this type of transaction. In addition, the General Partner has to consider the tax impact of a crystallisation of carried interest entitlements, which can be problematic where the carry recipients receive their entitlement in the form of an interest in the continuation fund

Fund managers that proactively plan for this situation are better equipped to ensure that investors and the General Partner are not unexpectedly left with a large tax liability. Before establishing future funds, fund managers should also consider whether the fund can be structured from the outset in a way that allows carry recipients’ carried interest entitlements to be “rolled” over to a continuation fund without triggering a tax liability.

What can you do?

1. Consider whether a continuation vehicle can provide an optimal solution for winding down funds.
2. Engage tax advisors to discuss structuring options for a fund to allow for tax efficiency when transferring assets into a continuation fund.

INTRODUCTION OF VICTORIA COMMERCIAL AND INDUSTRIAL PROPERTY TAX

From 1 July 2024, commercial and industrial property will be subject to only one final round of stamp duty. Once that stamp duty is paid, property will become part of a new tax system, the Commercial and Industrial Property Tax (CIPT) and no stamp duty should apply for future transactions (provided it remains commercial or industrial). Instead, the CIPT will become payable annually from the 31 December after the tenth anniversary of the final stamp duty payment.

The legislation specifically prohibits landowners from passing on CIPT to renters and tenants, which may be important when considering the impact of CIPT for a purchaser on future transactions. Furthermore, whilst the CIPT rate is 1%, a lower rate of 0.5% applies to build to rent land, that being land that is eligible for a BTR benefit within the meaning of the Victorian Land Tax Act 2005. Please contact us if you would like further details of the CIPT regime.

It is important for taxpayers to understand how CIPT may impact their ongoing annual costs when looking to purchase Victorian commercial and industrial property from 1 July 2024. It may be worthwhile to consider what future property developments or rezoning may occur in the local area as well as what commercial and industrial property sales have recently been completed (or will occur in the near future). These may allow you to anticipate the potential shift in value or the degree of any upward trend in value to make the best-informed decision when looking to buy Victorian commercial and industrial property.

What can you do?

1. Forecast the ongoing cost of CIPT when considering the purchase of commercial or industrial property in Victoria.
2. Consider future developments or rezoning proposals in Victoria.

MANAGING MULTIPLE LAYERS OF STAMP DUTY IN THE CONTEXT OF A NEW FUND RAISE

It is common (if not the default position) for fund managers to begin making investments between first close and final close of a new fund.

Queensland and Western Australia stamp duty rule treat the shares of a landholder company under an uncompleted agreement as being owned by the purchaser. This means that an upstream entity (such as one or more of the upstream PE funds) could also be a WA landholder or fall within the Queensland trust look through rules.

This may mean that changes at the fund level between signing of the share sale contract to completion could inadvertently trigger additional stamp duty.

There may be mechanisms to manage this issue subject to commercial and legal considerations.

What can you do?

1. Consider how changes at the fund level may trigger stamp duty in Queensland and Western Australia.
2. Engage your tax advisor in discussions to consider mechanisms to mitigate this risk.

CONTRACTOR DETERMINATION

The distinction between 'contractor' and 'employee' continues to be a hot topic in the M&A space. There is often a high level of contention between whether a contractor is in fact a contractor for tax purposes, evident in the recent *ZG Operations Australia Pty Ltd v Jamsek & Ors and Construction, Forestry, Maritime, Mining and Energy Union v Personnel Contracting Pty Ltd* cases.

Recent changes to the Fair Work Act (legislated, but not in force until 26 August 2024) will mean that we have a legislated definition to work with, but it only applies to the Fair Work Act, not broadly across tax, superannuation or workers' compensation. As a result, from August, a mismatch between the Fair Work Act and tax law can exist.

To mitigate any risk that employees are incorrectly considered contractors, companies should review all their contractor arrangements. The best way for companies to be compliant with all employment tax obligations is to have written contracts in place for all contractors and to ensure that the contracts are comprehensive and accurately reflect the practicalities of the relationship.

It is also important to be vigilant for independent contractors who fall within the extended definitions for superannuation and payroll tax purposes.

Other important employment tax considerations in the context of M&A are considered in detail here.

What can you do?

1. Review all contractor arrangements and ensure comprehensive, documented contracts are in place that clearly set out the nature of the relationship.
2. Engage employment tax expertise to identify employment tax risks in the context of M&A.

FINANCIAL ACQUISITION-SUPPLY AND GST REGISTRATION REQUIREMENT

Under Australian GST law, the making of a financial supply is defined to include the provision, acquisition or disposal of an interest in or under securities (e.g. shares in companies and units in trusts). It is not difficult to appreciate that when shares or units are being sold or issued, the entity selling or issuing the shares or units is making a financial supply. What is more perplexing is the recipient or purchaser of such shares or units is also making a financial supply (i.e., the "financial acquisition-supply").

As no GST liabilities would arise on the making of a financial supply, both the seller (or issuer) and the purchaser (or recipient) of securities may then move on quickly from a GST perspective to other more pressing matters on the transaction. Nevertheless, if such securities have been acquired by an Australian holding entity from a non-Australian income tax resident with no business presence in Australia, the Australian holding entity is then making a GST-free financial supply (as opposed to an input taxed financial supply) and can become required under the GST Act to be registered for GST, even if the Australian holding entity makes no other supplies in carrying on its enterprise. This is notwithstanding that no GST liabilities would arise on the making of a GST-free supply.

The above implication can also occur if the Australian holding entity carrying on an enterprise were to sell securities to an overseas purchaser, or issue securities to an overseas parent or investor, and makes no other supplies in carrying on its enterprise.

Under Australian GST law, an entity with an Australian business presence carrying on an enterprise for GST purposes is required under the GST Act to be registered for GST if its annual GST turnover is A$75,000 or more (which includes the making of GST-free supplies, and easily exceeded in most transactions), and such an entity is liable to penalties for failure to register for GST when required under the GST Act.

It is not all downside though, as once GST registered, an entity can claim input tax credits, to the extent entitled, on any GST that may be incurred on costs associated with transactions, noting there may be no GST liabilities arising on the "revenue/income" side, and recognising there are some compliance costs with having to prepare and file periodic GST returns.

What can you do?

1. Consider whether the financial acquisition-supply rules apply in the context of share/unit purchases or sales to foreign investors.
2. Ensure you satisfy GST registration requirements and consider entitlement to claim input tax credits for GST incurred in transactions.

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