Executive summary

A decision handed down on 5 February 2018 by the Federal Court of Australia (Resource Capital Fund IV LP v Commissioner of Taxation [2018] FCA 41) raises issues with respect to the Australian tax treatment of offshore limited partnerships (OLPs). It has ramifications for the Australian funds management industry and requires careful consideration, particularly by OLPs deriving exit gains on Australian investments.

This Tax Alert summarizes some of the propositions arising, issues in contention and, because of some practical issues that emerge from the decision, matters requiring clarification. That clarification may require timely action by the Australian Taxation Office (ATO) and potentially later by Treasury and Government.

The decision by Pagone J (the Judge) involving Resource Capital Fund IV LP (RCF IV) and Resource Capital Fund V LP (RCF V) (the RCF IV FC decision or the decision) related to exit gains made by RCF IV and RCF V on an Australian investment. The RCF IV FC decision follows earlier cases involving other RCF OLPs, notably RCF III.

The decision is subject to further hearings by the parties, specified to occur on 9 and 16 February in the orders, and it is to be expected that the Commissioner will appeal this decision (potentially on the taxable Australian property (TAP) analysis).
Considering the impact of the decision:

- Certain fund managers will take comfort from the issues decided by the Judge, while for others it may give them pause to reconsider their commercial arrangements.
- The decision goes some way toward supporting the ATO published guidance that gains made by foreign buyout funds will in many cases, though dependent on a review of relevant facts and circumstances, be revenue gains with an Australian source, and that it is appropriate to look through a fiscally transparent partnership such as a Cayman limited partnership to the country of residence of the limited partners (LPs) in determining whether to apply treaty benefits.
- It is a reminder that under Australian tax law, the LPs in an OLP are jointly and severally liable for the Australian income tax liabilities of the partnership.
- The approach to valuation matters for determining whether shares or comparable interests are TAP, and whether the value of these interests principally derive their value from Australian real estate, involves a complex analysis of a business's supply chain and intangible asset values.

As will be seen, there was a fundamental disagreement between the parties concerning whether the shares disposed of represented an indirect real property interest. Australia and its agencies have steadfastly maintained jurisdiction to tax gains made by nonresidents on such interests. Once drawn into dispute regarding this issue, it appears both parties strongly presented their case in the ensuing litigation, raising matters hitherto thought to have been settled.

This Alert addresses six key issues that emerge from the decision.

**Issues**

1. **Is a limited partnership a separate taxpayer for all purposes and was RCF III precedential on this issue?**

   RCF IV and RCF V made a gain on the disposal of their interests in Talison Lithium Limited, an Australian company engaged in the production of lithium, with projects in Western Australia and Chile. RCF IV and RCF V are Cayman Islands OLPs. The Commissioner of Taxation issued assessments to the partnerships directly, levying Australian income tax on the gains made by those funds on the disposal, and the proceedings relate to RCF IV and RCF V's objections to those assessments.

   Continued uncertainty regarding the taxation of collective investment vehicles involved in cross-border investment into Australia, particularly those that are tax transparent in their country of formation, and substantially invested into by residents of countries with sophisticated financial services industries and broad networks of tax treaties directed at the avoidance of double taxation and fiscal evasion, was again in sharp focus. In this instance, 97% of the investors in the subject funds were accepted as being tax resident in the United States (US), and thereby potentially eligible for relief from Australian tax according to the provisions of the tax treaty between Australia and the US.

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2. **Who is the taxpayer?**

   Given no precedent, the Judge undertook a detailed analysis of Division 5A of the *Income Tax Assessment Act 1936* (ITAA 1936) which deals with certain limited partnerships. The argument submitted by the applicants, and the Judge's findings on point, are remarkable as previously the ATO, the advisory community and taxpayers generally have looked at Division 5A as assimilating a limited partnership to an equivalent status as a company - that is, as a taxpayer. Other areas of the taxation laws, including those relating to franking and tax consolidated groups appear to align with that understanding.

   However, the Judge found judicial authority for the proposition that partnerships are not separate legal entities.
Division 5, which applies to partnerships that are not corporate limited partnerships (CLP) to which Division 5A applies, adopts a fiction for determining the net income or loss of a partnership “as if” it were a taxpayer and a resident. Notwithstanding that fiction, it remained the case that it is the partners that are assessed and liable for tax emerging from the partnership.

The Judge also found that a similar framework operates in Division 5A. The fiction that the limited partnership is a company is to determine its assessable income “as if” it were a company. Liability for tax, however, continues to rest with the partners. Critical to the reasoning was Section 94V of the ITAA 1936. It provides that the partners in a CLP are jointly and severally liable for the CLP’s taxation obligations that would otherwise fall to the CLP on the basis of the fiction it is a company. The Judge’s reasoning is that the provision is consistent with a construct of Division 5A that did not require nor treat CLPs as a separate legal entity and a taxpayer. Further, the associated assessment should be issued to them, and not the partnership.

The Judge then treated the assessments and the notices of objection issued and lodged in the name of the limited partnerships so that they were taken to be issued to and lodged by each of the partners.

This RCF IV FC decision brings into sharp focus the long standing proposition of joint and several liability of LPs in a CLP to its notional tax debts, and tends to cut across the non-tax limited liability afforded to the LPs in a CLP. Specifically, where some of the LPs in an OLP are treaty qualifying (see below) and some are not, the Commissioner may be able to recover a tax liability that may be referable to a non-treaty qualifying LP from one which is: this was not in issue in the RCF IV and V proceedings. Matters relating to the enforceability of recovery proceedings against LPs in such circumstances are beyond the scope of this Alert.

3. Exit gain on revenue account, and source of gains was Australian

In 2010 and 2011, the Commissioner issued various Tax Determinations (TDs) providing his views on the taxation of private equity investments in Australia. Relevantly:

➢ TD 2010/21 provided that, while ultimately a matter of fact to be determined on a case by case basis, in many cases it is to be expected that the profit made from the disposal of shares acquired in a leveraged buyout fund will be treated as ordinary income of the fund, rather than as a capital gain.

➢ TD 2011/24 provided that the source of a gain made on the disposal of shares in a company is to be determined by, among other matters, the place of economic activity of the company, rather than solely by reference to the activities of the shareholder.

➢ TD 2011/25 confirmed that the business profits article (Article 7) of Australia’s tax treaties applies to Australian sourced business profits of an OLP which is treated as fiscally transparent in a country with which Australia has entered into a tax treaty (tax treaty country) and the LPs in the OLP are residents of that tax treaty country.

EY was involved in the process leading to development of the various TDs.

While each case will depend on its facts and circumstances, many commentators have considered that TD 2011/24 contradicted long held common law doctrines relating to source of gains (such as the primacy of the place of contract formation, the relevance of the guiding mindset of the entity disposing of the shares, including the place of these activities and of the entity’s dependent agents).

The analysis in the RCF IV FC decision on these issues, while brief, reconciles with the Commissioner’s positions in TD 2010/21 and TD 2011/24. In relation to the “source of gains,” the fact that the business and assets of the portfolio company were in Australia, coupled with the nature and extent of the business and assets, meant that substantial activities conducted in Australia were an integral part of the investment, its management, and its ultimate profit on disposal.

This aspect of the judgment is relevant to offshore funds investing into Australia, with some or all of the investment activities undertaken in Australia, and who are relying on the exit gains not having an Australian source. It is particularly relevant to those funds having some ultimate investors which are ineligible to rely on treaty benefits to exempt such gains from Australian tax under the applicable business profits article (see below).

4. Treaty application and interaction

Australia has various bilateral taxation agreements with foreign governments, under which certain taxing rights are allocated as between those governments. These include the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (US Treaty).
In TD 2011/25 the Commissioner conceded that in determining taxing rights over gains made by a private equity fund structured as a Cayman Islands limited partnership, it was appropriate to consider the country of residence of the LPs (and their ability to rely on treaty benefits in that country of residence).

RCF IV and RCF V contended that 97% of their investor base were relevantly treaty qualified. The RCF IV decision confirms the availability of treaty relief for eligible treaty resident investors in an OLP where the business profits article is the only article that properly deals with the gain (e.g., the "land rich" Article 13 does not apply - see below) and the investor does not have a relevant Australian permanent establishment. The Judge stated that there was no suggestion that each "enterprise" carried on by a relevant investor carried on business through an Australian permanent establishment. The decision did not consider the position of an LP which is itself fiscally transparent.

5. Changing ATO position on fiscally transparent OLPs
As noted above, TD 2011/25 accepted, in taxing gains made by a private equity fund structured as a Cayman Islands limited partnership under the treaty business profits Article 7, the need to consider the country of residence of the LPs (and their ability to rely on treaty benefits in that country of residence).

However the Commissioner had argued a contrary position in and after RCF III, including in this case. So His Honor needed to consider whether the RCF LPs could rely on TD 2011/25 to look through the fiscally transparent OLPs.

The RCF IV FC decision noted that RCF III decision considered TD 2011/25 in the context of Article 13 “land rich” analysis, but not in the context of the Article 7 business profits taxation. The RCF IV FC decision then had an extensive analysis of whether the “land rich” Article 13 provisions were applicable, which involved an analysis of Division 855 which in RCF IV was held not to apply, as discussed below.

The judgment noted “extensive unchallenged evidence” that RCF IV and RCF V relied on the ruling, so the RCF parties could rely on TD 2011/25.

6. Taxable Australian property (TAP) and “land rich” considerations
Under Division 855 of the Income Tax Assessment Act 1997 (ITAA 1997), gains made by the Cayman limited partnership on the shares in Talison Lithium Limited would be taxable in Australia where those shares comprise TAP, regardless of whether those shares are held on revenue or capital account by the relevant shareholder.

Whether shares are TAP is ultimately a valuation question, determined by calculating the proportion of the market value of the company’s assets that are direct or indirect interests in Australian real property, as compared to the market value of the company's other assets. Where the market value of the direct or indirect real property interests exceeds the market value of the other assets, the shares will be TAP, and Australia will seek to tax the gain.

The Judge held that the shares in Talison Lithium Limited were not TAP for domestic law purposes. This involved an extensive analysis of competing valuations for the taxpayers and for the ATO. The decision was reserved to allow further appearances and argument on these issues. Importantly, a mining enterprise’s aggregate value may not be attributable solely or principally to its real property interests or tenements. Significant value may be attributable to upstream processing plant, intellectual property, and other intangible assets including goodwill which is not an interest in land for the purposes of Australian income tax rules.

However His Honor did not seek to apply the similar (but slightly different) “wholly or principally” test which applies under Article 13 of the US Convention. Given His Honor decided that for Div 855 purposes, the gains were not TAP, he may have decided that an exhaustive analysis of this issue was not necessary.

Areas that will benefit from clarification
The questions emerging from the decision warranting clarification include:

1. Confirmation that no filing obligations or tax assessments will arise where all LPs are either treaty qualified and Article 7 applies or Australian resident taxpayers.
2. If LPs in an OLP are taxable, who is responsible for attending to any required filing (e.g., the GP).
3. If LPs in an OLP are taxable, who should be responsible for paying the tax (e.g., the GP and then as a matter of contract as between the GP and its LPs for the appropriate allocation of taxes between them).
4. Confirmation from the ATO that an LP will not be pursued for taxes payable by another LP on profits appropriately allocated to that other LP (i.e., joint liability rests solely with the GP).

EY has approached the ATO to register the need for clarification on these issues.
For additional information with respect to this Alert, please contact the following:

**Ernst & Young (Australia), Sydney**
- Ian Scott
  - Email: ian.scott@au.ey.com
- Andrew Sharp
  - Email: andrew.sharp@au.ey.com
- Matt Weerden
  - Email: matt.weerden@au.ey.com
- Ryan Davis
  - Email: ryan.davis@au.ey.com
- Michel Klijn
  - Email: michel.klijn@au.ey.com
- Sean Keegan
  - Email: sean.keegan@au.ey.com

**Ernst & Young (Australia), Perth**
- Matthew Davidson
  - Email: matthew.davidson@au.ey.com

**Ernst & Young (Australia), Melbourne**
- Bruno Dimasi
  - Email: bruno.dimasi@au.ey.com
- Richard Buchanan
  - Email: richard.buchanan@au.ey.com
- Carl Callenbach
  - Email: carl.callenbach@au.ey.com

**Ernst & Young (Australia), Brisbane**
- Reid Zulpo
  - Email: reid.zulpo@au.ey.com

**Ernst & Young LLP, Australian Tax Desk, New York**
- David Burns
  - Email: david.burns1@ey.com
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