Clarity for fund investors in complex RCF case

5 April 2019

In brief

The Full Federal Court of Australia recently handed down its decision in Resource Capital Fund IV LP v Commissioner of Taxation [2019] FCAFC 51. This decision comprehensively overturns the 2018 first instance decision of Resource Capital Fund IV LP v Commissioner of Taxation [2018] FCA 41, which held that certain gains made by a foreign resident fund (RCF IV) on the sale of shares in Talison Lithium Limited should not be taxable in Australia.

The decision addresses a number of complex international tax issues, and clarifies the tax treatment of limited partnerships. The RCF case will be important for foreign investors who are considering investing in Australia. There are numerous technical aspects of the case which may affect investment decisions, including the availability of treaty relief and how an investment is managed on an ongoing basis.

In detail

The decision related to the disposal by two corporate limited partnerships, Resource Capital Fund IV LP (**RCF IV**) and Resource Capital Fund V LP (**RCF V**), from their sale of shares in Talison Lithium Ltd (**Talison Lithium**) under a scheme of arrangement.

The judgement considered a number of issues which are relevant to a variety of taxpayers, including inbound investors through fiscally transparent entities, private equity investors, non-resident sellers and indeed even any taxpayers in the energy and mining industry.

Are corporate limited partnerships liable to tax?

The judges confirmed that corporate LPs are taxable entities. Unpaid tax can be collected from individual partners in the event of non-payment by the LP.

This overturns the decision of the lower court, which held that limited partnerships were not taxable entities. The previous decision caused some concern, as it suggested that individual partners of foreign LPs technically may be required to lodge separate Australian income tax returns. As a result of the Full Federal Court's finding on this point, it was also concluded that the LP was the appropriate taxpayer for assessment purposes, and that the LP had standing in Court to object to such an assessment. This is a sensible outcome.

Were gains from the sale of shares Australian sourced?

The Court at first instance had held that the gains made by RCF IV on the sale of shares in Talison Lithium Limited were sourced in Australia for tax purposes. The Full Federal Court upheld this conclusion.

This point is notable because there were activities undertaken both in Australia and overseas. The activities undertaken overseas included the following:

- most, if not all, of the key decisions made by RCF IV were made by an investment committee located in Denver, Colorado (with Australian members dialling in)
- the shares in Talison Lithium were listed on the Toronto stock exchange
- negotiations leading up to the sale of the shares and interests in Talison Lithium Limited took place outside Australia, and
- consideration for the sale of the shares and interests was received outside Australia and was denominated in Canadian dollars.

However, both the primary judge and the Full Federal Court thought that certain other factors gave the gain an Australian source. These most notably included the following:

- the underlying assets of Talison Lithium Limited were located in Australia (i.e. mining assets)
- the investment strategy of RCF IV "comprised not merely a passive holding of shares, but an acquisition of shares and then a restructure and management of the underlying business in order to secure a better profit from a future sale", with these 'management' activities being undertaken by a related RCF entity in Australia, and
- the sale of the shares was made binding by "the convening of the scheme meeting, the approval at that meeting of the scheme of arrangement, the approval of that scheme by the Court, and the lodging of the order of the Court with the Australian Securities and Investment Commission", all of which took place in Australia.

Importantly, these decisions did not pay heed to the fact that the relevant 'management' activities were undertaken by a separate RCF entity operating in Australia. The management activities undertaken by the separate RCF entity were instead effectively imputed to the offshore taxpayers, and the Court broadly swept past the surrounding circumstances to find factors that pointed to an Australian source.

The Full Federal Court reiterated that source analysis is highly dependent on the facts of each individual case. However, it seems that the fact that the Scheme was in Australia (including Court approval and meetings) and the location of the mine was pervasive to the conclusion reached. However, there is an obvious risk that the Australian Taxation Office (ATO) reviews this decision and forms a view that its hand has been strengthened, particularly in contexts involving either court-managed sale mechanisms (e.g. a scheme of arrangement) or private equity vendors.

Availability of treaty relief

The lower Court had held that the underlying partners of the RCF IV fund were able to claim protection under the Australia-United States (US) Double Taxation Agreement (**Treaty**) in their own right. As the original decision additionally concluded that those partners were the relevant taxpayers, this enabled the partners to claim Treaty relief for the purposes of the assessment dispute.

The Full Federal Court agreed that the underlying partners were able to claim the protection of the Treaty, however concluded that RCF IV itself was not. As the fund itself was considered to be the relevant taxpayer, the Full Federal Court concluded that the partners were not competent to argue that the assessments at issue were in breach of the Treaty. Notably, Davies J (dissenting on this point) concluded that RCF IV itself should have been able to claim Treaty relief; however this point was carried by the remaining four judges.

This position effectively reverses the position taken in the first instance, and it appears to limit the availability of Treaty relief in similar circumstances to recovery proceedings or collateral recovery proceedings. This appears to be clear in respect of Cayman Islands LPs with US-resident limited partners, however the precise application of treaty law to other fund structures and investor jurisdictions will need to be considered on a case by case basis.

Indirect investment in real property

The key question in the case was which Article of the US treaty would apply to tax the business profits of the LP. For present purposes, it was necessary for the Full Federal Court to determine whether the proceeds currently at issue fell within Article 13 of the Treaty (relating to real property investments) - if

they did, then the taxpayer could not rely on TD 2011/25. In doing this, Article 13 was treated as functionally equivalent to Division 855 of the Income Tax Assessment Act 1997 (although the Court noted that this was not the technical position, rather Division 855 was being used as a proxy test to determine the position).

Division 855 relevantly provides that a gain on the sale of shares will be captured where the shares satisfy the 'principal asset test' (inter alia). This requires the value of the shares to be principally derived from 'Taxable Australian Real Property' (**TARP**), which is a concept that includes 'mining, quarrying or prospecting rights'.

The original decision concluded that certain general purpose leases and miscellaneous licences held by Talison Lithium Limited were not 'mining, quarrying or prospecting rights' for the purposes of section 855-20. This term is defined as including:

a. an authority, licence, permit or right under an Australian law to mine, quarry or prospect for minerals, petroleum or quarry materials; or
b. a lease of land that allows the lessee to mine, quarry or prospect for minerals, petroleum or quarry materials on the land; or
c. an interest in such an authority, licence, permit, right or lease; or
d. any rights that:
   i. housing and welfare) that are on the land concerned or are used in connection with operations on it; and
   ii. are acquired with such an authority, licence, permit, right, lease or interest.

The primary judge concluded that this definition captures rights in respect of mining itself, and rights in respect of 'building or improvements' associated with ancillary operations. The primary judge then concluded that the general purpose leases and miscellaneous licences indirectly held by Talison Lithium Limited only gave rights in relation 'downstream operations' (e.g. processing) rather than rights to mining or rights to the building themselves.

Critically, following a close reading of the relevant Western Australian legislation and the terms of all relevant leases, and a close inspection of the activities undertaken at the relevant site, the Full Federal Court concluded that the term 'mining' in this instance should capture downstream processing functions (at [167]). Accordingly, the general purpose leases and miscellaneous licences that enabled Talison Lithium Limited to undertake those downstream activities constituted rights of the relevant type, and were therefore TARP. This enabled the gain to satisfy the requirements of Division 855 and Article 13.

In the context of Division 855, an expansive interpretation of the definition of 'mining, quarrying or prospecting right' can be problematic as it will bring more assets within the Australian CGT net. However, the reasoning applied by the Full Federal Court in this respect, could be useful for taxpayers in other circumstances including, for example, determining whether an intangible statutory right is a depreciable asset under the capital allowances provisions.

Given the Full Federal Court's findings in respect of the nature of the underlying assets (i.e. that the general purpose leases and fixtures on those leases were TARP), the primary judge's conclusions in respect of valuation were not relevant to the determination of whether the shares represented an indirect Australian real property interest. However, for good measure, the Full Federal Court did comment on two aspects of the primary judge's conclusion on valuation.

Firstly, the Full Federal Court found that the "netback method" was *"inapt to determine the value of the assets"* and that the methodology *"could at best only accidentally happen upon"* the market value (applying the *Spencer* hypothetical purchaser test). The basis of this finding was largely factual and turned largely on the Court's finding (above) that the netback method presupposed an artificial distinction between upstream and downstream operations. However, the Court did seem to make a more general finding that the netback method was not well suited to resolving the statutory question required by Division 855 of valuing the assets in the context of the simultaneous sale of all of the test entity's assets to a single purchaser.

Secondly, and potentially less controversially, the Full Federal Court also took issue with the primary judge's finding that the value of the relevant mining leases could not have regard to cash flows which were

attributable to years beyond the lease expiration date. The Full Federal Court found that these cash flows (or indeed the possibility of the cash flows) were attributable only to the possibility that the mining leases may be renewed and therefore it was the mining leases which made possible the generation of those cash flows. Therefore the Full Federal Court found that the value relating to these cash flows was attributable to, and inhered in, the relevant mining leases.

This decision drives home the granularity of detail that is required when determining the application of Division 855 to mining interests. These factors should be taken into account both at the time of disposal, and up front at the time of drafting and agreeing the terms of mining and exploration leases. Although uncertainty remains, taxpayers should be able to consider these aspects and seek to align their arrangements to their commercial profile.

The takeaway

There are both positive and negative aspects of this decision. The decision around the tax treatment of corporate limited partnerships will provide much needed clarity for fund investors.

However, aspects of the decision around source and treaty relief may create more confusion for non-resident investors and may require taxpayers to consider their particular circumstances in light of the decision.

Aspects of the judgement relating to the characterisation of the mining leases, and market valuations are specific to the facts and circumstances of the case, but reinforces the importance of tendering evidence and detailed consideration of applicable State legislation.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Chris Morris, Sydney
+61 (2) 8266 3040
chris.j.morris@pwc.com

Mark O'Reilly, Sydney
+61 (2) 8266 2979
mark.oreilly@pwc.com

Ellen Thomas, Sydney
+61 (2) 8266 3550
ellen.thomas@pwc.com

Peter Collins, Melbourne
+61 (3) 8603 6247
peter.collins@pwc.com

Jonathan Malone, Sydney
+61 (2) 8266 4770
jonathan.r.malone@pwc.com

Stuart Landsberg, Brisbane
+61 (7) 3257 5136
stuart.landsberg@pwc.com

© 2019 PricewaterhouseCoopers. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers a partnership formed in Australia, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity. This publication is a general summary. It is not legal or tax advice. Readers should not act on the basis of this publication before obtaining professional advice. PricewaterhouseCoopers is not licensed to provide financial product advice under the Corporations Act 2001 (Cth). Taxation is only one of the matters that you need to consider when making a decision on a financial product. You should consider taking advice from the holder of an Australian Financial Services License before making a decision on a financial product.

Liability limited by a scheme approved under Professional Standards Legislation.
WL127057726