# *Federal Court considers treaty, valuation and compliance*

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## *In brief*

The recent Federal Court decision in *Resource Capital Fund IV LP v Commissioner of Taxation [2018] FCA 41 (RCF IV)* dealt with Australia's right to tax profits made by a Cayman Islands limited partnership (LP) on the sale of Australian shares.

The case raises several important points for foreign investors (particularly private equity investors) in Australian companies, and Australians investing overseas. These include:

- Investments made by United States (US) resident investors through non-US unincorporated Limited Partnerships (LPs) should have the benefit of the US-Australia Double Taxation Treaty (US Treaty).
- Even though LPs are taxed like companies from an Australian perspective, LPs are not in fact a separate taxable entity. The outcome suggests that each partner in an LP may have to submit tax returns and pay tax on investments in Australia. Urgent clarification is needed on this point from the Australian Taxation Office (ATO).
- The Court held that the sale of shares in the Australian company had an Australian source, despite the LP and its partners being located overseas. Broadly, this was due to the amount of input provided by individuals in Australia throughout the term of the investment. This is potentially a significant development for inbound investment funds.
- In valuing mining assets for the purpose of determining whether the shares were taxable Australian property (TAP) (i.e. land rich):
    - Mining leases were treated as TAP, however general purpose leases and miscellaneous licences granted under the Mining Act were not TAP.
    - Certain items of infrastructure were effectively carved out of the definition of real property.
    - For 'downstream assets' (i.e. assets used in the mine's processing and manufacturing functions), the 'netback method' was preferred to a 'top down residual approach'.

## *In detail*

Two Resource Capital Funds (RCF IV and RCF V) owned and sold shares in an Australian company, Talison Lithium Limited (Talison). Each RCF fund was a Cayman Islands LP, and were principally composed of US-resident partners, and viewed as transparent for US tax purposes. The Commissioner of

Taxation issued assessments to each fund in respect of the profit made by the fund on the sale of the Talison shares.

RCF IV should be understood in light of its predecessor, *Resource Capital Fund III LP v Commissioner of Taxation [2013] FCA 363 (RCF III)*, which had a similar fact pattern.

In RCF III, the Full Federal Court held that the sale of shares by a Cayman Islands LP was subject to Australian tax because the shares were TAP. In reaching this conclusion, the Court indicated (in obiter) that the underlying US investors in the LP may not be entitled to US treaty relief if the investment had been held on revenue account, as the Caymans LP was not itself entitled to such relief. These comments surprised inbound investors as the comments were contrary to the ATO's published guidance. The RCF III decision additionally set out some principles for valuing TAP assets which have now been distinguished in RCF IV.

***Key issues***

*Is a Limited Partnership a separate taxable entity?*

The Court in RCF IV held that LPs are partnerships and, while LPs are taxed like companies in Australia, they are not taxable entities. This outcome was not widely expected. It is a fundamental point of partnership taxation in Australia that certain 'corporate limited partnerships' are to be taxed as companies under the rules applicable to limited partnerships (Division 5A of the *Income Tax Assessment Act 1936* (Cth) (1936 Act). This has been widely understood as providing for the existence of a separate tax entity, so much so that this point was not even contested in RCF III.

On the basis that the LPs were not taxable entities, the Court determined that US treaty relief should be available to the partners in the LPs who were residents in the US (to the extent that the particular articles of the treaty are satisfied). This is a very significant shift from the outcome in RCF III, in which the LP missed out on treaty relief entirely.

The Court further noted that RCF should be able to access treaty relief under the US treaty, even if the above analysis was incorrect. The Court held that the Commissioner should have been bound by its position as set out in Taxation Determination TD 2011/25, as a result of RCF's particular fact pattern and its reasonable reliance on that public ruling. The Court's conclusion on this point was significant, as public rulings are usually broadly drafted and it is often difficult for a taxpayer to fall squarely within its parameters.

*Should underlying partners directly submit tax returns?*

Currently, corporate limited partnerships submit a company income tax return. However, the logical extension of the Court's comments in RCF IV is that its partners should instead be subject directly to tax, and accordingly should be lodging Australian income tax returns. This would clearly be a substantial burden for investors.

Some practical solutions may be available. For instance, the ATO may allow the general partner of an LP to assume responsibility for the satisfaction of the LP's obligations under Australian tax law. However, such a solution may not fully shelter limited partners from ATO recourse in the event that the general partner fails to meet those obligations.

We expect the ATO to be proactive in providing an interpretative document in the short to medium term.

*Can US partners access the treaty?*

The Court identified that in order to have the protection of the US treaty, the gain needed to fall within Article 7 (Business Profits) and not fall within Article 13 (Alienation of Property). The Court ruled that the passive investment activities of the limited partners were sufficient to qualify as an 'enterprise' for the purposes of Article 7 (applying the precedent established in *Thiess v FCT*). Whether the gain also fell

within Article 13 depended on the relative valuation of the land and non-land assets of Talison (see discussion below).

*When does a share sale have an Australian source?*

Determining whether gains have an Australian source is a notoriously difficult exercise to be applied to the specific facts. There are many share transactions involving Australian assets which would not typically have an Australian source.

The Court in RCF IV however, found that the proceeds of the sale did constitute income from an Australian source as a result of the 'substantial activity' undertaken in Australia. The result of this decision is that inbound investors should adopt a more cautious approach to determining whether Australian source issues arise, particularly when the investment in question demands the presence of significant investor activities in Australia (for instance, where significant investment management activities occur in Australia, including those undertaken through a subcontractor).

Although the decision is not perfectly clear, the Court indicated that the following factors might suggest an Australian source on disposal of shares:

- If the investment is not merely passively held, but is being 'restructured, made profitable and then disposed'.
- If the investor or an associate of the investor maintains a local office or retains local employees.
- In the case of foreign funds, Australian participation in Investment Committee meetings.
- Participation of investor representatives on the Board of the underlying company in which the investment is being made.
- Australian involvement in developing the investment strategy (e.g. exit plans).
- Use of an Australian regulatory framework at the time of exit (e.g. a scheme of arrangement under the *Corporations Act 2001* (Cth)).

None of the above factors in isolation should be considered to be determinative of source, but investors should identify whether any are present when undertaking an analysis of the source of a gain from a share transaction.

*How should an investment in Australia be valued?*

RCF IV concerned the sale of shares in an Australian company which, in turn, operated a mining, processing and manufacturing business. It was accepted by all parties that the RCF funds made a gain upon the sale of those shares.

The Court was called upon to determine whether that gain fell within the ambit of Article 13 of the US treaty and Division 855 of the *Income Tax Assessment Act 1997* (Cth) (1997 Act), and therefore fell outside of the protection of Article 7. The Court held that Article 13 was sufficiently broad to protect the application of Division 855, despite some differences in wording.

For the purposes of the Division 855 analysis, it was necessary for the Court to review expert testimony on the valuation of the assets across the various business lines of the Australian company, and particularly to determine whether the value attributable to real property assets exceeded the value attributable to non-real property assets.

The Court set down some helpful conclusions regarding the real property identification and valuation process, including the following:

- A range of leases that were only tangentially connected with the mining process did not qualify as ‘mining, prospecting or quarrying rights’ for the purpose of Article 6 of the US treaty and Division 855 of the 1997 Act.

- A number of structures erected on those leases constituted ‘chattels’ instead of ‘real property’ (potentially expanding the precedential value of the *TEC Desert Pty Ltd v Commissioner of Sate Revenue* case).

- The RCF III decision did not stand for the proposition that particular valuation methodologies were inherently unsuitable for determining a hypothetical sale price. Accordingly, valuers should not be needlessly shackled from using the appropriate method, including the ‘netback’ method.

Overall, the Court preferred RCF’s expert testimony, and therefore determined that the value of the real property assets of Talison did not exceed the value of the non-real property assets of Talison. On this basis, Article 13 of the US Treaty did not apply to the gains made by the RCF funds, and treaty protection was therefore available under Article 7.

This decision is likely to be useful to taxpayers in future Division 855 valuation disputes, particularly in a mining context.

*Effect on outbound investors*

Identifying the precise impact of this decision on outbound investors is similarly complicated.

The key impact on outbound investors is likely to lie in the Court’s new understanding of corporate LPs. Partnership-style entities are popular investment pooling tools in many foreign jurisdictions, and complications on this front may place Australian businesses and investors at a competitive disadvantage. Particularly:

- It is not clear how the amended understanding of corporate LPs should interact with the controlled foreign corporation regime. Previously, issues have arisen in relation to the ability of look-through entities to satisfy the ‘active income’ test, which has given rise to adverse attribution consequences (and even double tax).

- Similarly, it is not clear what role is left for the suite of investment vehicles introduced by the Australian Government over the past several years. For instance, if all corporate LPs are to be taxed as a partnerships, is there any purpose to the foreign hybrid entities established by Division 830? Conversely, are those entities going to be more useful than ever, simply as a means of avoiding the uncertainty surrounding corporate LPs?

The above rules are notoriously complex, and it will take some time before the ramifications of this position have been fully explored.

## The takeaway

RCF IV clarifies some difficult international tax issues confronting inbound investment structures (particularly from the US) by stating that US partners can access treaty benefits when investing in Australia through a foreign LP. The matter also provides some helpful guidance in respect of land valuation. However, the case potentially gives rise to some significant practical hurdles going forward, particularly in relation to determining the source of Australian-related transactions, and ensuring that investors are conscious of all their tax compliance and tax payment obligations.

Similarly, RCF IV raises several questions regarding the role of corporate LPs in outbound investment structures. The full scale of this issue is difficult to predict.

At this stage it is not clear whether the Commissioner will appeal the decision, however we hope that a decision impact statement will be forthcoming, which may shed some light on the issues identified above.

## *Let's talk*

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


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