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Tax Insights

Limited Partnership structure defeated in D Marks case

Snapshot

On 22 June 2016, the Full Federal Court (the Court) decided in *D Marks Partnership v Commissioner of Taxation [2016] FCAFC 86* that a purported limited partnership structure failed to qualify for tax treatment as a Corporate Limited Partnership (CLP). The Court upheld the decision of the Administrative Appeals Tribunal (AAT) and assessments made by the Australian Taxation Office (ATO) on the grounds that, under Queensland state law, a limited partnership did **not** exist and therefore the arrangement was not a CLP for tax purposes.

In the Court's view, the arrangement needed to satisfy the general partnership state law requirement to be "carrying on a business in common with a view to profit" as a pre-condition to qualify as a CLP under Division 5A of *the Income Tax Assessment Act 1936 (ITAA 1936)*.

The fact that the parties held a certificate of registration as a limited partnership under state laws was **not** conclusive evidence of its existence as a limited partnership, and thus as a CLP. As a result of the arrangement not being treated as a CLP, it was not treated as a company for tax purposes.

This decision has the potential for widespread implications on arrangements purporting to be an Australian limited partnership and a Division 5A CLP, and requires a risk-assessment of facts and circumstances surrounding the arrangement, and in particular, the initial establishment of such structures.

The Facts

On 10 October 2003, Quintaste Pty Ltd (Quintaste) as general partner and the trustee of the David Marks Trust as limited partner entered into a "Deed of Limited Partnership" (the Deed) to establish the D Marks Partnership (the Partnership).

Pursuant to the Deed, the liability of the limited partner was limited to the initial capital contribution of $99. The Deed also stated that the purpose of the parties included that they engage in business, but crucially, it was accepted that the parties **did not**:

- carry on any business for profit; and
- have between them, the relation of carrying on business in common with a view of profit under general law.

On 24 October 2003, the Partnership was registered under the Queensland limited partnership law (*the Partnership (Limited Liability) Act 1988 (Qld) (PLLA)*), pursuant to which a "certificate of formation and composition" was issued. The Partnership was in receipt of certain dividend income and loans from the day of registration through to 2005.

The Issues

The principal issue was whether the Partnership was a limited partnership under section 995-1 (amongst other issues) of the *Income Tax Assessment Act 1997 (ITAA 1997)* and a CLP for the purposes of Division 5A of *ITAA 1936*.

Was there a Corporate Limited Partnership?

A Division 5A CLP is broadly treated as a company (taxable entity) for Australian tax purposes.

In order to qualify as a CLP, the arrangement must be "limited partnership" which requires that the liability of at least one of the partners is limited. This limitation is conferred by state law.

The taxpayers argued that the registration certificate issued under the *PLLA* confirmed the status as a limited partnership (and thus a CLP). However, in line with the AAT, the Court found that the arrangement also needed to satisfy the Queensland general partnership law requirement to be carrying on a business in common with a view to profit as a pre-condition to qualify under Division 5A.

The Court (by majority) reasoned that the definition of a limited partnership in the *PLLA* applies only to associations that are partnerships, as the definition expressly begins with the phrase *"A limited partnership* ***is a partnership that exists****…."*. This indicates that there must be a partnership in place **prior** to that arrangement being conferred with the status of a limited partnership.

Given that it was accepted that the two parties did not carry on business with a view to profit, the pre-condition of there being a partnership in existence, in order for the limited partnership legislation to operate, was not met. It followed that if there was no limited partnership, there could not be a CLP under Division 5A.

Conclusive evidence

The Court (by majority) rejected the taxpayers' argument that the production of the limited partnership registration certificate provided **conclusive evidence** of its formation.

In the Court's view, the conclusivity was limited to the date of formation, and does not "extend to confer conclusivity of the association being a limited partnership if the association which had sought registration was not a partnership".

ATO view

The decision is consistent with views expressed by the ATO almost a decade ago, in Taxation Determination (TD) 2008/15. The TD had concluded that persons who do **not** carry on a business in common with a view to profit could **not** be a CLP. In the ATO's view, one of the requirements to be a limited partnership under Australian state laws is that the association is a partnership under the general law which, in itself, requires that the association be carrying on a business in common with a view to profit.

Implications

Inbound financing

Entities such as limited partnerships are an area of focus both internationally, as part of the OECD's BEPS work on hybrids, and domestically, in light of impending anti-hybrid rules that are expected in Australia from 1 January 2018.

Further, the ATO has identified cross-border related party financing arrangements as a current focus area. The ATO has also been successful in two recent cases (*Orica Limited v Commissioner of Taxation* [2015] FCA 1399 and *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092) focusing on related party cross-border financing issues, involving transfer pricing and the general anti-avoidance rule.

An example of the use of Australian CLPs is by certain foreign companies financing new or existing Australian operations. In Australia, CLPs would be treated as a company and be eligible to be part of a tax consolidated group, whilst the CLP may be treated as a flow-through entity for foreign tax purposes. This can effectively create a DD (double deduction) outcome.

"Those seeking registration as limited partnerships ***need not have commenced trading*** *(and, therefore, need not yet have incurred liabilities) but they must* ***have done sufficient to create the relations between themselves of 'carrying on a business in common with a view of profit'"****.*

The Court's decision requires taxpayers to review limited partnership structures, depending on the specific facts and circumstances of each case. Some key questions to risk-assess structures:

- What is the relevant state law that governs the formation and registration of the limited partnership and is it on all fours with the Queensland law considered in this case?
- The D Marks decision focuses on the need for there to be a pre-existing partnership at general law prior to formation and registration as a limited partnership. However:
  - The decision provides no guidance on how this question is to be tested. What would be sufficient to create the relations between parties of carrying on a business in common with a view of profit?;
  - Is the issue limited only to the "point in time" prior to formation and registration, or is there also an ongoing requirement in respect of the general law partnership status?
- What evidence is available to establish that a partnership existed prior to the limited partnership formation and registration process?
- What are the Australian and foreign tax consequences if the arrangement is not to be treated as a Division 5A CLP?
- What are the interactions with the tax consolidations rules if an arrangement fails to be treated as a Division 5A CLP?

Small and Medium Enterprises (SME)

The D Marks case also brings attention to the risks of CLP arrangements in the SME sector. In this regard, the ATO has also been examining the use of CLPs that may be at risk of circumventing the Division 7A (deemed dividend) rules, as outlined in Taxpayer Alert (TA) 2007/5.

It appears that the ATO is concerned about the use of closely-held CLPs, and how such entities interact with other provisions of the tax law, including Division 7A. Where CLP arrangements have been used in this context, taxpayers should also review their arrangements.

Contacts

David Watkins
Partner

Tel: + 61 2 9322 7251
Email:
dwatkins@deloitte.com.au

Vik Khanna
Partner

Tel: + 61 3 9671 6666
Email:
vkhanna@deloitte.com.au

Mark Hadassin
Partner

Tel: + 61 2 9322 5807
Email:
mhadassin@deloitte.com.au

Claudio Cimetta
Partner

Tel: + 61 3 9671 7601
Email:
ccimetta@deloitte.com.au

Spyros Kotsopoulos
Partner, Deloitte Private

Tel: + 61 2 9322 3593
Email:
skotsopoulos@deloitte.com.au