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Tax Insights

Resource Capital Fund decision

Snapshot

In a long and complex judgement (Resource Capital Fund IV LP v Commissioner of Taxation [2018] FCA 41), the Federal Court has overturned assessments issued by the Australian Taxation Office (ATO) to Resource Capital Fund IV LP ("RCF IV") and Resource Capital Fund V LP ("RCF V") in connection with their disposal of shares in Talison Lithium Limited ("Talison Lithium"). However, a number of key issues were decided in favour of the ATO. Further, the case has not yet been finalised with the Court remitting the matter back to the ATO for reconsideration.

The Court provided clarity on the operation of the business profits article (Article 7) of the Australia / US double tax treaty, but the judgement has raised issues as regards the interaction of the alienation of property article (Article 13) and the Australian domestic law. Significantly, the court rejected that limited partnerships were separate taxable entities under Australian domestic law.

The case raises many questions for private equity funds, any group structure with a limited partnership, and all foreign investors into companies with Australian land or mining operations. Many of those questions may not yet have a final answer.

Facts

RCF IV and RCF V were established as limited partnerships in the Cayman Islands. Substantially all of the limited partners were resident in the United States.

Each of the partnerships entered into a management agreement with RCF Management LLC to manage the operations and investments through an investment committee. RCF Management LLC was incorporated in Delaware and was based in Denver, Colorado.

RCF Management LLC entered into an agreement with Resource Capital Funds Management Pty Ltd ("RCF Management (Aust)") for the latter to provide administrative and management services for a fee. RCF Management (Aust) was an Australian resident company with employees based in Australia.

RCF IV and RCF V disposed of shares and interests in Talison Lithium in March 2013. The Commissioner immediately issued notices of assessment to "Resource Capital Fund IV LP" and "Resource Capital Fund V LP", and sent the notices to the General Partner of each fund. The assessment for RCF IV ascertained a taxable amount of A$116,835,066 with tax payable thereon (at 30%) of A$35,050,519. The assessment for RCF IV ascertained a taxable amount of A$61,577,787 and tax payable thereon of A$18,473,336. The ATO correspondence referred to the disposal of taxable Australian property, indicating that the ATO proceeded on the basis that the taxable amount was a capital gain (and not an ordinary income gain).

Who was the taxpayer?

The first issue was to identify the taxpayer under Australian domestic law. This required an analysis of Division 5A of the Income Tax Assessment Act 1936, the object of which is expressed to be to provide for certain limited partnerships to be treated as companies for tax purposes.

The ATO maintained that the provisions of Division 5A contemplated that RCF IV and RCF V were to be treated as taxable entities and were able to be assessed to tax in that capacity. The applicants submitted that the partners were the relevant taxpayers.

Whilst earlier proceedings involving RCF IV and RCF V, and a separate case involving RCF III, had proceeded on the basis that the limited partnerships were taxable entities, the judge held that those Courts had not expressly considered the issue, so there was no relevant precedent.

Pagone J held that "None of the provisions [in Division 5A] expressly create a new legal person or expressly provide for there to be a new taxable entity". He concluded that the partners were the relevant taxpayers under Australian law.

This conclusion was a surprise. Division 5A (introduced about 25 years ago) had generally been seen to have the effect that certain limited partnerships were to be treated as if they were companies and treated as taxpayers for Australian tax purposes. The contrary conclusion appears to technically require the ATO to issue assessments to each and every partner, and to assess each partner at the relevant rate of tax depending on the character of each partner (eg, company or individual, resident individual or non-resident individual, sovereign wealth fund, etc). This raises a number of practical administrative concerns for the ATO and compliance complexities for taxpayers.

Australian tax character of the gain

Under Australian tax law, a profit on the sale of shares may have the character of ordinary income or be a gain on capital account. This will depend upon relevant facts and circumstances, evidence and intention. In 2010, the ATO issued a Tax Determination specifically considering this issue in the context of a private equity fund and concluded that the gain was likely to be an income gain.

However, in this case, it seemed that the ATO proceeded at the assessment stage on the basis that the gain was of a capital nature, and was to be assessed under the Australian capital gains tax rules. However, after analysis of the evidence, Pagone J held the amounts received by the RCF IV and the RCF V partners were income according to ordinary concepts.

Under Australian tax law, a non-resident will be subject to tax on an amount of income if that income has a source in Australia. The Court again considered extensive evidence, which identified relevant connections which pointed both towards an Australian source and away from an Australian source. Whilst it is possible for a gain to be partly sourced in Australia, the Court held that the various factors point to the gain being wholly from an Australian source.

As a result of these conclusions, the partners were subject to Australian income tax on their share of the gain.

Impact of Australia / US double tax treaty

The next question was the impact of the Australia / US double tax treaty. An important point in this analysis was that it was not contended by the ATO that the taxpayers had a permanent establishment in Australia.

Under the treaty, the partners may be entitled to relief under Article 7(1) (business profits) if the gain is characterised as a "business profit of an enterprise". The Court readily held that the gain made by the partners was to be treated as a "business profit of an enterprise". This was not surprising given previous decisions in Australia. As a result, treaty relief was available under Article 7(1).

If Talison Lithium and its subsidiaries had no Australian land assets, this would have been the end of the matter. In other words, the clear Australian taxing rights (an income gain sourced in Australia) would have been trumped by the operation of the business profits article, to prevent Australian taxation.

However, the business profits conclusion is subject to Article 7(6) which can give priority to another article – relevantly Article 13 dealing with the alienation of real property. If Australia is allocated taxing rights under Article 13, that conclusion would apply in priority to the relief under Article 7.

Article 13, consistent with normal OECD practice, allowed Australia to tax the disposal of:

- real property situated in Australia, and
- under an extended meaning of real property - "shares … in a company, the assets of which consist wholly or principally of real property in Australia".

Relevant facts in this regard was that Talison Lithium was essentially a holding company owning only shares in subsidiaries, however lower tier subsidiaries held the licences and other assets used in the mining and processing of lithium, predominantly in Australia.

The Court undertook significant analysis of the extended meaning of real property, and the Australian specific issue which arises due to the 1999 amendment to insert section 3A in the International Tax Agreements Act. Section 3A is effectively a unilateral amendment of many of Australian's double tax treaties. The Court upheld the operation of section 3A, and said that the "effect and intent of section 3A … are clear and apply to extend the construction and operation of Article 13 … to alienation or disposal of real property indirectly by the partners of RCF IV and RCF V by their disposal of shares".

The Commissioner argued that the gain could be taxed under Division 855, section 855-15, item 2. This is testing whether the shares in Talison Lithium which were disposed of are indirect Australian real property interests, or more simply, whether Talison Lithium was Australian land rich. However, the ATO also asserted that it could tax under section 855-15, item 1, which deals with a direct disposal of taxable Australian real property (TARP), including mining rights.

The analysis of Article 13, section 3A and Division 855 is somewhat difficult to follow. The Court preferred the taxpayer's valuation evidence in respect of the values of TARP assets and non-TARP assets, and concluded that Talison Lithium was not relevantly Australian land rich. Therefore, the assessments raised on that basis were excessive.

However, the judgement also dedicated considerable analysis to item 1. Pagone J concluded on this matter by saying that "there is to be excluded from the taxable value of the capital gain, the value attributable to the [assets] used in the processing operations rather than in the mining". This comment appears to indicate that Pagone J concluded that there may be amount that remains taxable, albeit reduced to "exclude" part of the gain referred to in the assessments. Given his earlier conclusion, presumably any amount would be taxable as ordinary income, and not as a Division 855 capital gain.

The Court set aside the assessments as issued, and remitted the matter back to the ATO "for reconsideration in accordance with these reasons". As a result, the matter is not yet completed, and further hearings are expected to finalise the matter.

Some implications

The decision made very clear findings on some key issues – some of which will be welcomed by taxpayers whilst other findings may be the cause for concern:

- That such limited partnerships are not taxable entities, but rather the partners are the relevant taxpayers. This finding will have implications that go well beyond fact patterns involving private equity funds
- That the gain was on income account and not capital account
- That the gain was wholly sourced in Australia: there was no consideration in the judgement that the gain may only be partly sourced in Australia
- That in the absence of underlying land assets, the US resident partners are eligible for treaty benefits under the business profits article. This is the clearest Australian judicial authority on the interaction of tax treaties and fiscally transparent entities.

On the other hand, the analysis on the interaction of Article 7, Article 13, section 3A and Division 855, has raised more questions that it has answered. Clarification is required on the potential Australian tax exposures on share exits where there is some value attributable to underlying Australian land assets. Further, the case is another example of the difficulties that taxpayers, the ATO, Courts and valuers have in determining the allocation of value as between land and non-land assets.

The decision, whilst not yet finalised, may be the subject of an appeal, and the some of these positions may be revised on appeal. Further, it is possible that there may be legislative amendments if aspects of the decision are not consistent with Government policy.

Some of the areas to monitor are:

- The Division 5A conclusion goes well beyond private equity funds. Many corporate and investment structures will include limited partnerships (whether as inbound investment vehicles, as Australian formed vehicles or as outbound vehicles used by Australian investors). In all structures involving limited partnerships, prior period tax positions should be revisited in light of the comments made as regards the role of Division 5A.
- Taxpayers should continue to monitor the finalisation of the case and any appeal, the ATO response and any Government reaction.
- In particular, inbound investment funds should consider what compliance and reporting obligations may arise for partners, given the views on Division 5A

- In respect of the disposal of shares in companies with Australian land or with Australian mining activities, the technical positions remain uncertain after this case. Further, the allocation of value as between assets remains open to many competing views. Vendor taxpayers in this space will need to consider the best way to obtain certainty as to the Australian tax profile.

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