International Tax

# Australia Tax Alert

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## Court rules on foreign limited partnerships and capital gains tax issues

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In a recent case before Australia's Federal Court, a foreign limited partnership successfully challenged a tax assessment issued by the tax authorities to the limited partnership in respect of a capital gain made on the sale of shares in an Australian mining company.

The Federal Court held in *Resource Capital Fund III LP v Commissioner of Taxation* that the relevant tax treaty authorized Australia to tax the limited partners, rather than the foreign limited partnership, on their share of the gain on the sale of the shares. The court also concluded that the shares in the mining company did not constitute "taxable Australian property" (TAP) because 50% or more of the value of the assets of the mining company were not attributable to taxable Australian real property (TARP).

The decision of the Federal Court will be of interest to foreign investors that invest in Australian mining companies or that invest in Australian assets via limited partnerships. On the basis of the decision, if limited partners are resident in a tax treaty country, the limited partners—not the limited partnership—will be liable to tax (unless the relevant treaty provides otherwise). It also would appear from the decision that mining information can form a substantial part of the value of assets of a mining company and, because such information is not TARP, shares in many mining companies may not be treated as a taxable "indirect Australian real property interest" even if the foreign investor holds a nonportfolio interest (i.e. an interest of 10% or more). The decision has significant ramifications on the taxation of investment into Australia and we understand that the Commissioner of Taxation will be filing an appeal.

### Background and facts of the case

Australian domestic law generally seeks to tax foreign residents on income sourced in Australia. However, in the case of capital gains, foreign residents generally are only liable to tax in Australia on gains derived from capital gains tax events in respect of TAP, i.e. broadly, direct interests in Australian real property (defined to include leases and mining rights) or nonportfolio interests (10% or more) in entities where the underlying value of the entity is principally attributable to Australian real property.

Resource Capital Fund III LP (RCF) was a limited partnership formed in the Cayman Islands. More than 97% of the contributed capital of the limited partnership was held by US residents, primarily funds and institutions.

Under Australian domestic law, RCF was a corporate limited partnership and treated, generally, as a company. For US tax purposes, however, RCF was “fiscally transparent” or a “flow-through entity,” such that it was not subject to US tax; instead, each US resident partner of RCF was treated under US law as deriving its proportionate share of the income of the partnership and, therefore, the liability for US tax, if any, fell on the US resident partners.

In July 2007 and January 2008, RCF sold 100 million ordinary shares held in St Barbara Limited (SBM), an Australian stock exchange-listed company that conducted a gold mining enterprise on mining tenements in Australia. In November 2010, the Commissioner issued a “default” notice of assessment for the 2008 income year to RCF, including a net capital gain in the amount of AUD 58.25 million.

## Issues considered

- **Tax treaty issue**: Whether the Commissioner could issue a notice of assessment to RCF in respect of the gain made on the sale of the shares in the mining company, or did the Australia-US tax treaty preclude that assessment; and
- **TAP issue**: Whether the gain derived should be disregarded for capital gains tax purposes because the market value of TARP assets owned by the mining company did not exceed the market value of its nontaxable Australian real property (non-TARP) assets.

## Tax treaty issue

The Federal Court held that the “alienation of property” article (article 13) of the treaty only authorized Australia to tax the US resident limited partners in RCF on their distributive shares of the gain derived from the sale of shares if the treaty and Australia’s domestic tax otherwise allowed the gain to be taxed. The treaty did not authorize Australia to tax that gain to RCF as a nontransparent company because RCF was treated as fiscally transparent for US tax purposes and the limited partners were subject to US tax on RCF’s income; accordingly, under the treaty (which is incorporated into Australian domestic law), the gain was to be treated as having been derived not by RCF, but by its limited partners, who were residents of the US for treaty purposes. The Federal Court used the Commentary to the OECD model treaty to support this conclusion.

In other words, even though Australia’s domestic law treated RCF as a separate entity and taxable in its own right, the treaty prevailed and Australia was effectively required to treat RCF as a flow-through entity for domestic law purposes, and the Commissioner was precluded under the treaty from issuing an assessment to RCF.

## TAP issue

Although the decision on the treaty issue was sufficient to allow the taxpayer to prevail on the appeal, the Federal Court went on to conclude that the shares in the mining company disposed of by the taxpayer were not an “indirect Australian real property interest” because the “principal asset test” was not passed. Under the principal asset test, when shares in a company do not constitute an indirect

Australian real property interest, any gain on disposal by a nonresident is not liable to tax under Australia's capital gains tax provisions.

In the case of SBM, the only material tangible asset of SBM (which was TARP) was the mining rights owned by SBM. After reviewing the expert valuation evidence on the valuation of each asset of SBM, the court concluded that the value of SBM's mining rights (determined as the value that could be extracted from the tenements by mining them, using a discounted cash flow basis, less the cost of re-creating the mining information and replacing the plant and equipment) was less than the value of the company's non-TARP assets, which included, in particular, mining information and plant and equipment.

This is a significant finding, with the effect that the sale of nonportfolio interests in many mining companies by nonresidents may not be liable to tax in Australia on the grounds that the majority of the assets of the companies do not constitute real property.

## Other issues

The decision in *RCF* raises a number of other questions:

- *Income or capital gain:* It is noteworthy that, despite recent views of the Australian tax authorities in respect of certain fund investors, the case was argued on the basis that the gain was a capital gain and not an income gain.
- *Application to limited partners resident in nontreaty countries:* There is no discussion in *RCF* of the treatment of a capital gain made by the limited partnership in respect of limited partners who are *not* resident in a treaty country. In previous guidance issued by the Australian tax authorities (Taxation Determination TD 2011/25), the Commissioner states that, with respect to business profits derived by a foreign limited partnership, Australian tax will be imposed in respect of the profits attributable to nontreaty country residents. The *RCF* decision indicates that 3% of the limited partners were not US residents, but there is no indication as to whether those partners were residents of treaty countries or otherwise. Nevertheless, the Federal Court found that the Commissioner was precluded from assessing the gain to RCF. Does this mean that a foreign limited partnership is not liable to tax in Australia if any one of its partners is resident in a treaty jurisdiction?
- *Determining the limited partner's share of the capital gain:* A foreign investor's share in a company will be within the Australian capital gains tax net if the share passes both the nonportfolio interest test and the principal asset test. The TAP issue in RCF addressed whether the principal asset test had been passed, but there was no discussion of the nonportfolio interest test.
- *Australian tax authorities action to enforce debts owed by nonresidents:* After issuing the default assessment to RCF, the Commissioner then sought, and obtained from the Federal Court, a freeze order on RCF's Australian assets. The Commissioner continues to seek freeze orders on the Australian assets of foreign residents to secure payment of tax which, in the Commissioner's view, is assessed to be payable by a foreign resident. Depending on the outcome of any possible appeal, the Commissioner may need to reconsider this approach, at least with regard to entities that are treated as fiscally transparent and with investors who are resident in Australian treaty partner countries.