



International Tax

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ATO wins appeal on treaty issues affecting Cayman limited partnership

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The Australian Taxation Office (ATO) has won its appeal in *Commissioner of Taxation v. Resource Capital Fund III LP (RCF)*, a case that has implications for nonresidents investing into Australia, especially where investing through a fiscally transparent entity or into shares in mining or other resource companies.

The facts of the *Resource Capital Fund* case are relatively simple and involved a disposal by RCF, a Cayman limited partnership, of shares in St. Barbara Mines Limited (SBM), an Australian listed company that carried out a gold mining enterprise in Australia. Approximately 97% of the limited partners in RCF were US residents. Under Australian tax law, RCF was treated as a company or taxable unit, whereas under US tax law, RCF was treated as fiscally transparent. The ATO assessed RCF on a net capital gain of AUD 58.25 million in respect of the disposal.

RCF asserted on two separate but related grounds that the ATO could not issue such an assessment to RCF. RCF argued that the assessment, if any, should be issued to the limited partners in RCF and, furthermore, that SBM was not “land rich.” The Australian capital gains tax rules apply only to a nonresident that disposes of “taxable Australian property” (TAP). Whether such a disposal occurred in this case required an analysis of the underlying assets of SBM: the shares would be considered TAP if the market values of SBM’s “taxable Australian real property” (TARP) assets exceeded the market values of SBM’s non-TARP assets. The key assets to be addressed in this regard were the mining rights, mining information and the plant and equipment. RCF asserted that the values of the non-TARP assets exceeded the values of the TARP assets.

RCF was successful at first instance, with the trial judge holding as follows:

- **Tax treaty issue:** The Australia-US tax treaty treated the gain not as derived by RCF, but as derived by the partners of RCF, and as a result, there was an inconsistency between the International Tax Agreements Act (incorporating the US treaty) and Australian domestic law. The judge’s conclusion was that the ATO was precluded from issuing an assessment to RCF and that it was the limited partners in RCF that the ATO was “authorized to tax”; and

- **TAP issue:** RCF's shares in SBM were not TAP because the market values of SBM's non-TARP assets exceeded the market values of SBM's TARP assets. Importantly, the judge held that the relevant test "requires the separate determination of the market value of each of the entity's assets; not the determination of the market value of all its TARP assets as a class and the determination of the market value of all its non-TARP assets as a class."

The Full Federal Court disagreed with both conclusions.

Treaty issue

In respect of the treaty issue, the Full Federal Court held that RCF was the relevant entity to be assessed and subject to tax, and this was not precluded by the Australia-US treaty. The lower court decision was based heavily on the OECD Commentary in respect of the application of tax agreements and fiscally transparent partnerships. By contrast, the Full Federal Court limited its analysis to a narrower point based on the acceptance by all parties that RCF was neither a resident of the US, nor of Australia. It followed that the US treaty did not apply to the gain in the hands of RCF.

On the broader issue of the OECD Commentary and fiscally transparent partnerships, the court's comments were limited. It said that "RCF is an independent taxable entity in Australia and liable to tax on Australian sourced income and the treaty does not gainsay RCF's liability to tax" (note that "gainsay" means to deny or contradict). The court said that (in the case where there were treaty benefits):

"It may be open to argument by the US partners that they should obtain the benefits of the treaty... and to apply the provisions of the treaty accordingly, as discussed in the Commentary (about which we express no view) but that consideration is a separate issue to the question of whether the effect of the provisions of the treaty was to allocate the liability for the tax on the gain differently to the Assessment Act."

In other words, the relevant OECD Commentary did not impact the allocation of the tax liability; under Australian tax law, any tax liability was allocated to RCF, and the treaty did not change that outcome.

We consider that there is no particular inference to be drawn from the absence of detailed analysis of the broader issue of the application of tax treaties and fiscally transparent partnerships. In the relevant circumstances, it was not necessary for the Full Federal Court to address that matter.

TAP (land-rich) issue

In respect of the TAP (land-rich) issue, the lower court held that the relevant testing required "the separate determination of the market value of each of [SBM's] assets." The Full Federal Court rejected that approach as "artificial," saying:

"In our opinion it is implicit that to determine where the underlying value resides in SBM's bundle of assets, the market values of the individual assets making up that bundle are to be ascertained as if they were offered for sale as a bundle, not as if they were offered for sale on a stand-alone basis....It follows that the assets should be valued on the

basis of an assumed simultaneous sale of SBM's assets to the same hypothetical purchaser, not as stand-alone asset sales."

No decision was made as to whether, under this different valuation methodology, the shares in SBM would be TAP, although the Full Federal Court said that "it would seem that in light of our reasons, the Commissioner would be successful in the appeal on the second issue." The court referred the matter back to the parties to apply the valuation opinions to the valuation methodology determined by the court.

All parties accepted that the mining information and the plant and equipment were not TARP assets. The critical valuation issue under the revised methodology was the value of the mining rights. It can be inferred from the court's comments that a larger part of the overall value of the underlying assets of SBM would be allocated to the mining rights (being a TARP asset). This aspect of the case highlights the challenges of dealing with valuation issues in tax matters. It is first necessary to ensure that the correct valuation methodology is being applied, and then to seek to apply that methodology to the (invariably competing) views of the valuation experts.

It should be noted that, in respect of disposals after 14 May 2013, proposed changes would treat mining information and other intangibles connected to mining rights as part of those mining rights, such that the value of the mining information would be attributed to a TARP asset.

Implications

The Full Federal Court decision removes some of the uncertainty that resulted from the lower court decision. While the Australian domestic tax rules that (broadly speaking) treat limited partnerships as companies are not without issues, it now seems to be the case that the liability to Australian income tax (if any) falls on the limited partnership. This gives effect to Australian domestic tax rules, notwithstanding that the application of tax treaties may be relevant to the question of the quantum of the liability in the hands of the limited partnership.

Hedge funds and private equity funds investing into Australia often are structured as limited partnerships (or other fiscally transparent entities), so this decision is of relevance to such funds. The decision of the Full Federal Court on both aspects will need to be taken into account in determining Australian tax exposures and FIN 48 positions. The next critical development in this area, especially in respect of hedge funds, is the finalization of the Australian Investment Manager Regime (IMR), which will provide an exemption from Australian tax in certain cases. It is understood that the final installment of the IMR law should be introduced into parliament in the middle of 2014.

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