Australia: Hybrid entities – Resource Capital Fund III LP Case

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I. Introduction

Like many other countries, Australia has had to wrestle with the tax problems created by hybrid entities for some years now. The Australian Taxation Office (ATO) issued a binding public ruling in 2011[1] arising out of a private equity IPO of one of Australia's two main department store chains. Although the ATO emerged empty handed as the money had left the country by the time it took action, it issued a series of rulings based on its analysis of the situation, two of them dealing with treaties. In relation to the treaty approach to hybrid entities, the ATO accepted the reasoning of the OECD Partnership Report[2] and held that US resident investors in a Cayman Islands limited partnership (LP) that was fiscally transparent for US tax purposes were entitled to the benefits of the Australia – United States Tax Treaty, even though Australia taxed the LP as a company.

As is well known, the Partnership Report and subsequent Commentary changes[3] sought to provide a framework for the application of treaties to partnerships that are characterized in different ways by the relevant jurisdictions. Under these changes the OECD takes the view that where:

- the country in which the partners are resident regards an entity as a tax-transparent partnership; and
- the country in which the income arises regards it as a non-tax-transparent non-resident company;

the latter country (here Australia) should apply its treaty with the residence country of the partners.

If this were not the case, there would usually be no treaty protection as the partnership itself would not be a resident of any country for treaty purposes. Generally, under the principles of the OECD's Partnership Report an entity must be liable to tax in a country "as a resident" in order to be treated as a resident for treaty purposes. If a partnership is treated as a foreign resident company in the source country but as transparent in other relevant countries, the partnership would be a foreign resident from the perspective of the source country but would not be a resident of any other country (whether the residence country of the partners or elsewhere) as it is not liable to tax in those other countries.

1 Taxation Determination TD 2011/25. The system for public legally binding rulings is set out in AU: Taxation Administration Act 1953 Schedule 1 Part 5-5.

2 Organisation for Economic Co-operation and Development (OECD), *The Application of the OECD Model Tax Convention to Partnerships* (OECD, 1999).

3 See OECD, *Model Tax Convention on Income and on Capital* (OECD, 2014) Commentary on Article 1 paras 2-6.7, Article 4 para 8.8 and Article 23 paras 69.1-69.3 (see also paras 32.1-32.7, 34.1, 56.1-56.3). These additions to the Commentary were made in 2000.

At first glance it seemed as if the *Resource Capital Fund* case[4] would settle the application of the Partnership Report in Australia. In the event, it did not turn out that way.

II. Facts of the case

Resource Capital Fund III LP (RCF), a Cayman Islands LP treated by the United States as tax transparent with mainly (97 %) US resident investors, acquired over 10 % of an Australian gold mining company listed on the stock exchange, though no investor in RCF it seems held a 10 % indirect interest on its own. Like most mining companies, the company's assets consisted of mining leases, mining information, plant and equipment and other assets of relatively minor value. As Australia taxes LPs as companies under domestic tax law, the ATO assessed RCF to corporate tax at the rate of 30 % on the capital gain when it sold its shares in the gold mining company. The assessment was based on rules adopted in 2006 taxing capital gains on shares where a foreign resident taxpayer held 10 % or more of the shares and the value of the company's real property assets in Australia exceeded the value of its other assets (essentially a more than 50 % test similar to the test in Article 13(4) of the OECD Model). Apart from the Partnership Report issue, the taxpayer also argued (ultimately unsuccessfully) that the real property assets of the company in question were less than the value of its other assets.

Article 4(1)(b) of the Australia-United States Tax Treaty contains a definition of resident on the US side as follows, so far as relevant:

> (b) a person is a resident of the United States if the person is: …
>
> (iii) any other person (except a corporation or unincorporated entity treated as a corporation for United States tax purposes) resident in the United States for purposes of its tax, provided that, in relation to any income derived by a partnership, an estate of a deceased individual or a trust, such person shall not be treated as a resident of the United States except to the extent that the income is subject to United States tax as the income of a resident, either in its hands or in the hands of a partner or beneficiary, or, if that income is exempt from United States tax, is exempt other than because such person, partner or beneficiary is not a United States person according to United States law relating to United States tax.

As RCF was not formed in the United States it did not qualify as a resident of the United States under paragraph (iii) of the definition. Both parties accepted that it was not a US resident and the case was largely argued on this basis. As the express

4 AU: FCAFC, 3 Apr. 2014, *Commissioner of Taxation v. Resource Capital Fund III LP* [2014] FCAFC 37, 16 ITLR 876, reversing AU: FCA, 26 Apr. 2013, *Resource Capital Fund III LP v. Commissioner of Taxation* [2013] FCA 363, 15 ITLR 814; leave to appeal refused AU: HCA, 17 Oct. 2014, *Resource Capital Fund III LP v. Commissioner of Taxation* [2014] HCA Trans 235. The decisions have implications for some other treaty issues: the relationship of Article 7 and Article 13 of the OECD Model, the interpretation of Article 13(4) and tax treaty interpretation generally, but these are not analysed here. This note adapts in part, commentary written by the author on the case in the International Tax Law Reports, (2013) 15 ITLR 815, (2014) 16 ITLR 877.

provisions of the treaty on the treatment of partnerships did not assist, the case was argued on the basis that the matter fell generally to be dealt with by the Partnership Report.

In relation to capital gains on alienation of real property under Article 13(1), Article 13(2) of the treaty provided a definition of real property which so far as relevant is as follows:

> (b) the term "real property", in the case of Australia, shall have the meaning which it has under the laws in force from time to time in Australia and, without limiting the foregoing, includes: …
> (ii) shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia; …

Although this test is in different words to the domestic law test referred to above and perhaps could be read as requiring much more than 50 % by value, no argument was addressed to that point (despite the parallel issue under domestic law being contested) and it does not seem that the investors asserted that the Australia-United States treaty would prevent Australia taxing the gain if they were entitled to the benefits of the treaty based on the principles in the Partnership Report. This is presumably because the treaty did not contain the equivalent of OECD Model article 13(5) but rather provided for the application of domestic tax law in other cases in Article 13(7):

> Except as provided in the preceding paragraphs of this Article, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

Hence it is not surprising that the argument on whether RCF was land-rich was addressed to domestic law rather than to the treaty: if it were not land-rich there would be no tax under domestic law and the treaty would not be relevant. Instead RCF challenged the assessment on the basis that the Australia-United States treaty prevented the ATO from taxing RCF (even though it was not a resident of the United States) because under the Partnership Report principles, the effect of the treaty was that the US investors were the relevant taxpayers.

III. The Court decision

A. Reasoning of trial judge

Edmonds J held that the approach in the OECD Commentary which he quoted at great length applied to the Australia-United States treaty in the circumstances of RCF and that would seem to be consistent with the Commentary. What is more difficult to follow is his view that the treaty prevented Australia from taxing RCF and only permitted Australia under domestic law to tax the partners, with the result that the assessment of RCF was set aside. He said:[5]

5 Supra n. 4, [2013] FCA 363 para 76.

> I am of the view that while art 13(1) of the Convention authorises Australia, by its domestic law, to tax the US resident limited partners in RCF on their respective distributive shares of the gain derived by them on the sale by RCF of the shares in SBM if its requirements are otherwise satisfied, it does not authorise Australia to tax that gain to RCF, the limited partnership, as a non-transparent company.

The judgment goes much further than the several other cases around the world on the OECD partnership work. The OECD Commentary on partnerships says nothing about whether giving treaty benefits based on the residence of the partners in a case like the present means that the source country has to actually assess the partners or can still assess the entity it regards as the taxpayer, here RCF. The OECD Commentaries elsewhere indicate that the details of assessment and collection of the tax are generally a matter for domestic tax law of the parties to the treaty.[6] The Partnership Report itself is quite explicit on the issue:[7]

> When taxing an item of income, the source State … applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions. The way that the State of residence qualifies an item of income for treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income.

It is a pity that this clear statement was not added to the Commentary.

B. Reasoning on appeal

The judges on appeal accepted that the OECD Commentaries may be used in the interpretation of tax treaties but noted that the context of the OECD work on partnerships was dealing with differing country treatments of entities as transparent or not and that its purpose was to apply treaties so that treaty benefits were not denied by such different treatments. As the Australia-United States treaty applies to persons who are residents of a contracting state under Article 1, the trial judge's conclusion that RCF was not a US resident was the end of the case – the treaty simply did not apply to Australia's taxation of RCF.

The judges noted that it may have been open to the US resident partners to argue for the benefits of the treaty but the taxpayer had not mounted its case in this way and hence the court did not need to express any view on this issue. One suspects that they would have accepted the OECD approach if it had been necessary to do so but the result is that it has not yet been determined whether the Partnership Report will be accepted by the courts in Australia.

The taxpayer also relied on the ATO public ruling mentioned earlier which is legally binding on the ATO that the business profits article of a treaty between Aus-

6 See, for example, OECD, supra n. 3, Commentary on Article 6 para 4, Article 7 paras 28-32, Article 10 para 67.7, Article 13 para 3, Article 15 paras 12.3-12.4, Article 17 paras 8, 10-11 and Article 23 paras 32, 32.4.

7 OECD, supra n. 2, para 103.

tralia and a partner's country of residence was available to the limited partners in an LP which their country of residence treated as tax transparent while Australia taxed the LP. Putting aside the issue of reliance on the ruling, the court was able to dismiss this argument on the basis that it was the capital gains article, not the business profits article which was engaged in the case.

C. Leave to appeal to High Court of Australia refused

Undaunted by its fairly comprehensive defeat in the Full Federal Court, RCF sought leave to appeal to Australia's highest court. The application was limited to the question of whether the treaty prevented the ATO from taxing the LP, which was the only avenue for taxing the capital gain under domestic law in this case. Leave was refused on the basis that:[8]

> the decision of the Full Court is not attended by sufficient doubt to warrant a grant of special leave.

IV. Comments on the Courts' reasoning

A. Operation of tax treaties

Treaties are generally understood not as "authorizing" countries to tax under domestic law but as preventing them from taxing as they otherwise would under domestic law to the extent that there is a resident of a country which is party to the treaty who is protected from taxation by the treaty. It is therefore very surprising that Edmonds J frames the treaty issue in the case as noted above as a question of whether the Australia-United States Tax Treaty "authorises" the taxation of RCF especially since he held that it was not a resident of the United States and the US treaty applies to persons who are residents of one of the treaty parties. The normal understanding of tax treaties is that they allocate taxing rights over residents of one or other of the treaty parties and then domestic law levies the tax however and on whomever it wants to the extent permitted by the treaty. The appeal court was able to overturn the original decision simply by rejecting the trial judge's proposition which they seemed to find mystifying.[9]

8 Supra n. 4, [2014] HCA Trans 235, p. 15.

9 This does not mean that treaties are "exclusively relieving" in Australia, though this proposition may have been accepted in at least one case, *Undershaft (No 1) Ltd v. Commissioner of Taxation* [2009] FCA 41, 11 ITLR 652, para. 46. Australia's treaties generally contain a provision to the effect that if income can be taxed at source under the treaty, the income will be regarded as sourced in Australia for the purposes of domestic tax law which operates on source principles. The effect when the treaty is incorporated into domestic law is that it indirectly changes domestic law, in accordance with its evident intent, so that an amount is made assessable which would not be assessable in the absence of the treaty, see J.F. Avery Jones et al, *Tax Treaty Problems Relating to Source* (1998) 52 Bulletin for International Fiscal Documentation.

The reasoning in the judgment at first instance suggests that Australia would have been prevented from taxing RCF entirely even if there had been only one US partner in RCF with a miniscule interest. As noted above not all the partners in RCF were US residents. It is difficult to see why Australia should have been prevented from taxing RCF to the extent that there were partners resident in countries other than the United States. Similarly, as the judge thought that the treaty did not protect the US resident partners from Australian taxation on the gain, it is difficult to see why the treaty should have prevented Australia taxing RCF with respect to profits which the United States regarded as attributable to the US resident partners.

In reaching the conclusion that the treaty prevented Australia taxing RCF, the trial judge relied on a number of other propositions which are questionable. For example, he considered that the outcome would have been double taxation if Australia were able to tax RCF on the gain.[10] US domestic tax law would give a foreign tax credit to the partners for the Australian tax on RCF on the gain (as would Australian tax law in the converse case) and the OECD interprets the OECD Model in the Partnership Report as requiring credit in the residence country of the partners for tax levied by the source country on the partnership if the residence country of the partners taxes them on the partnership income. The appeal court did not need to comment on the relief issue because of its view that the treaty simply did not apply to RCF as it was not a resident of the United States.

B. Express treaty provisions on partnerships

Australian courts are not the only ones which have found it difficult to apply the principles of the Partnership Report, even where it is accepted that those principles as set out in the OECD Commentary are applicable.[11] Given the frequency with which the issue nowadays arises, it makes sense to include specific provision in tax treaties dealing with the hybrid entity issue. Increasingly in recent times tax treaties have included such provisions, even though the Partnership Report cautioned against the practice.[12] The OECD as part of its base erosion and profit shifting (BEPS) work recommended in 2014 that a provision to deal with hybrid entities should be added to the OECD Model with the intention of replicating the outcomes in the Partnership Report for hybrid entities more broadly and based on the fiscally transparent entity provision found in the US Model (2006).[13]

10 Supra n. 4, [2013] FCA 363 para 69.

11 Another example is CA: TCC *TD Securities (USA) LLC v. R* 2010 TCC 186, 12 ITLR 783. The conclusions in the Partnership Report remain controversial, see M. Lang and C. Staringer, *Conflicts of Characterisation General Report*, (2014) 99b cahiers de droit fiscal international 15, but the discussion here does not address this debate.

12 Supra n. 2, paras. 43-46.

13 OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements* (OECD, 2014), pp. 85-92.