INTERNATIONAL TAX MASTERCLASS

Issues arising from the Resource Capital Fund (“RCF”) case

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9 October 2014
Swissotel, Sydney

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1. Introduction

The purpose of this paper is to critically examine the issues arising from the recent litigation involving Resource Capital Fund III LP and the Commissioner of Taxation (the “Commissioner”) (the “RCF” case).

At the time of writing, the taxpayer’s application for special leave to appeal to the High Court is still pending.

Even though the litigation in the RCF case has not yet been finally resolved, this case is perhaps one of the most interesting international tax cases of the past 2 years, at least for the very different approaches adopted by the Federal Court (at first instance) and the Full Federal Court in relation to:

- the interpretation of tax treaties; and
- the application of Australia’s capital gains tax (“CGT”) regime for non-residents.

This case is relevant to the taxation of cross-border investments through fiscally transparent entities, and investments by non-residents (such as hedge funds and private equity funds) into Australia (particularly in the resources and property sectors). It also has important implications for the interpretation of Australia’s tax treaties where Australia and the other Contracting State adopt different approaches to taxing a “hybrid entity”.

In addition, this paper considers the potential implications of the events that have occurred in the aftermath of the RCF case, including the actions being undertaken as part of the OECD’s “Base Erosion and Profit Shifting” (“BEPS”) Project, as well as the Australian Government’s legislative response to this case.

Unless stated otherwise, all legislative references in this paper are to the Income Tax Assessment Act 1936 (Cth) and the Income Tax Assessment Act 1997 (Cth), which are collectively referred to as the “Assessment Act”.

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1 This Paper contains the views of the authors, which are not necessarily the views of Greenwoods & Freehills, the Tax Institute, or any other organisation.

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2. Factual Background

Resource Capital Fund III LP ("RCF") is a limited partnership that was formed in the Cayman Islands under the Exempted Limited Partnership Law 1991.

It is a private equity fund that makes investments in development and growth stage mining companies, including Australian mining companies.

The manager of RCF’s affairs is a Delaware limited liability company.

At all relevant times:

- RCF had:
  - one general partner (which is another Cayman Islands limited partnership); and
  - approximately 62 limited partners;
- no limited partner had a greater than 8.5% interest in the contributed capital of RCF;
- over 97% of the contributed capital in RCF was held by US residents, principally funds and institutions (including tax-exempt institutions and foundations);
- none of the limited partners, the general partner or the manager were resident in Australia for tax purposes.

In March 2006, RCF subscribed for ordinary shares in St Barbara Mines Limited ("SBM"), comprising 11.95% of SBM’s issued share capital. SBM is an Australian resident company that is listed on the Australian Securities Exchange ("ASX"). SBM conducts a gold mining business on mining tenements that it owns in Australia.

The parties agreed that, at the relevant times, SBM’s assets included the following specialised mining assets:

- mining tenements;
- mining information; and
- plant and equipment,

as well as the following general assets:

- cash and receivables;
- working capital;
- derivatives;
- other financial assets;
- goodwill and/or other intangible assets;
- tax losses.

RCF sold its shareholding in SBM in 2 tranches, in July 2007 and January 2008. Both sales occurred off-market. As a result of the sales, RCF made capital gains in the total amount of $57,637,891.
In November 2010, the Commissioner issued RCF with a notice of assessment for the year ended 30 June 2008. That assessment included a net capital gain of $58,250,000 in RCF’s assessable income. The Commissioner also issued a notice of assessment for administrative penalties (of initially 75% of the tax shortfall amount, but later reduced to 25% on the basis that RCF had been co-operative and had a reasonably arguable position). At the same time (in November 2010), the Commissioner obtained an ex parte freezing order over RCF’s remaining assets in Australia (being shares in certain other Australian mining companies).

RCF objected to the Commissioner’s assessments. Following the deemed disallowance of those objections with the passage of time, RCF appealed to the Federal Court in July 2011.

For US Federal income tax purposes, RCF is a “foreign partnership” because it is not created or organised in the US or under US Federal or state law. As a partnership, RCF is treated as a fiscally transparent or “flow-through” entity under US tax law. Therefore, the gains that RCF made from the sale of the shares in SBM were not subject to US tax in the hands of RCF itself. Rather, the gains were either subject to, or exempt from, US tax in the hands of the limited partners in accordance with their respective partnership interests in RCF.

On the other hand, for Australian income tax purposes, RCF is a “corporate limited partnership” within the meaning of s.94D(1) of the Assessment Act. By implication, pursuant to s.94J, with certain limited exceptions, RCF is treated as a “company” (ie a taxable entity) for Australian income tax purposes.

The Commissioner had accepted that, under Australian domestic tax law, RCF was not a resident of Australia. This must have been on the basis that RCF was not considered to carry on business in Australia. The parties had agreed that the gains made by RCF from selling the SBM shares were on capital account.

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2 It was accepted that the Commissioner’s original assessment was excessive, as it had ignored the transaction costs (of $612,109) that had been incurred by RCF.

3 Refer s.7701(a)(4) and (5) of the US Internal Revenue Code (“IRC”).

4 Refer s.701 of the IRC.

5 Refer s.94T of the Assessment Act.
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3. The judgment at first instance

Edmonds J (at first instance) considered that there were 2 discrete issues before the Federal Court, namely:

1. whether the assessment that was issued by the Commissioner to RCF was precluded by the *International Tax Agreements Act 1953* (Cth) (the “*Agreements Act*”), and specifically the Australia/US tax treaty (the “*Treaty*”) (the “*Treaty Issue*”); and

2. if the assessment could properly be issued, whether RCF’s capital gain from the sale of shares in SBM should be disregarded under s.855-10 of the Assessment Act, on the basis that the shares in SBM did not constitute “taxable Australian property” (“*TAP*”) as defined in s.855-15. In other words, the issue was whether the sum of the market values of SBM’s assets that were not “taxable Australian real property” (“*TARP*”) within the meaning of s.855-20 exceeded the sum of the market values of SBM’s TARP assets, such that SBM did not pass the “principal asset” test in s.855-30 (the “*TAP issue*”).

Edmonds J found in favour of RCF on both issues.

The order in which his Honour considered the above issues is somewhat curious. Presumably, his Honour regarded the Treaty Issue as the first issue to be considered because, even if the capital gain was taxable under Australia’s domestic tax law, the Commissioner had assessed the wrong taxpayer (having regard to the Treaty). However, in the authors’ view, as with any other treaty issue, it is first necessary to consider the outcomes under domestic tax law before determining whether any applicable tax treaty limits or modifies the domestic taxing rights. Therefore, the TAP Issue should arguably be the threshold issue, given that if the principal asset test in s.855-30 is not satisfied, the capital gain is not taxable under Australia’s domestic tax law and therefore the Treaty becomes irrelevant.

3.1. The Treaty Issue

3.1.1. The principles of tax treaty interpretation

In recent years, there has been some doubt about the appropriate principles for the interpretation of tax treaties which had been established by the High Court in *Thiel v FCT*7 in 1990. In that case, the High Court had held that the rules of interpretation recognised by international law (as codified by the *Vienna Convention on the Law of Treaties*) should be applied to the interpretation of tax treaties that are enacted into domestic law (by the Agreements Act), and that as a result, the Commentaries on the *OECD Model Tax Convention on Income and Capital* (“*OECD Model*”) were able to be used by Australian courts to interpret tax treaties containing clauses based on the OECD Model.

However, more recent tax cases may have suggested that there should be a more limited use of the OECD Commentaries in favour of domestic rules of statutory interpretation (refer *Russell v FCT*8, and

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7 (1990) 171 CLR 338.
8 [2011] FCAFC 10
In the 2012 extradition case of *Minister of Home Affairs of the Commonwealth v Zentai*¹⁰, the majority of the High Court said that domestic interpretation principles, not international law interpretation principles, applied to treaties incorporated into domestic law.

In *RCF*, Edmonds J analysed the general principles for the interpretation of tax treaties.¹¹ His Honour did so by reference to his own judgment in *Virgin Holdings SA v FCT*¹², which draws on the judgments in *Thiel, Applicant A v Minister for Immigration and Ethnic Affairs*¹³, *FCT v Lamesa Holdings BV*¹⁴, and *McDermott Industries (Aust) Pty Ltd v FCT*¹⁵.

His Honour re-affirmed the principles in *Thiel* and subsequent tax cases as being applicable to the interpretation of tax treaties, and he said:

> “In my view, nothing has occurred in the intervening period between then and now to put these principles in doubt.”¹⁶

His Honour dismissed the Commissioner’s submissions for a more limited use of the OECD Commentaries. In Edmonds J’s view, the judgment of Dowsett J in *Russell* should be read and understood in their context of responding to the appellant’s criticism of the primary judge in that case, and those comments should not be regarded as a rejection of the principles of tax treaty interpretation that had been laid down in *Thiel*.

Accordingly, in his own judgment, Edmonds J quoted extensively and relied on the OECD Commentaries that deal with the taxation of partnerships which one country treats as a company and another country as a fiscally transparent vehicle (as was the case here).¹⁷

Edmonds J’s observations regarding tax treaty interpretation were not challenged by the Commissioner on appeal to the Full Federal Court, and as such, the authors consider that they should stand.

Another issue of treaty interpretation is which version of the OECD Model Commentaries should apply in a given case, the version at the time when the relevant treaty was signed, or the current version. The OECD favours the current version, although it is not clear whether the current version means the version at the time when the relevant transaction occurred, or the time when the case is heard by a court. Edmonds J does not expressly consider the issue, but there are hints in his judgment. The paragraphs from the OECD Commentaries that Edmonds J quoted were inserted in 2000, and they were based on the OECD’s report entitled “The Application of the OECD Model Tax Convention to Partnerships” (the “Partnership Report”) dated 20 January 1999. His Honour quoted the 2000 amendments to the Commentaries from their 2005 version, which was the version in force at the time when RCF sold the shares in SBM. This indicates that his Honour regarded it as appropriate to rely on the version of the treaty in force at the time when the relevant transaction occurred.

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¹⁰ [2012] HCA 28, at paragraph 65
¹¹ Refer paragraphs [46] to [53] of his Honour’s judgment.
¹² [2008] FCA 1503
¹³ (1997) 190 CLR 225
¹⁴ (1997) 77 FCR 597
¹⁵ [2005] FCAFC 67
¹⁶ [2013] FCA 363, at [48]
¹⁷ *ibid.* at [39] and [65]-[67]
3.1.2. Edmonds J’s analysis of the Treaty Issue

On the Treaty Issue, Edmonds J held that, while Article 13(1) of the Treaty authorises Australia to tax the US resident limited partners of RCF on their respective proportionate shares of the gains made by RCF from the sale of the SBM shares, it does not authorise Australia to tax that gain in the hands of RCF. Accordingly, his Honour concluded that there was an inconsistency between the application of the Treaty and the application of the Assessment Act in relation to the entity to be taxed on the gains. This meant that, in accordance with s.4(2) of the Agreements Act, the inconsistency had to be resolved in favour of the application of the Treaty. On this basis, Edmonds J held that the Treaty precluded the issue of the income tax assessment to RCF.

The role of Article 13 of the Treaty

Article 13 of the Treaty (so far as it is presently relevant) provides:

1. Income or gains derived by a resident of one of the Contracting States from the alienation or disposal of real property situated in the other Contracting State may be taxed in that other Contracting State;

2. For the purposes of this Article:

   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:

      i. Real property referred to in Article 6;

      ii. Shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia;

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.

The Commissioner submitted that RCF was a resident of the US for the purposes of the Treaty, but that even if it was not, Article 13 of the Treaty gave Australia an unlimited taxing right over the gains from the sale of the SBM shares.

Edmonds J rejected the Commissioner’s submissions. His Honour said that RCF was not a resident of the US under US domestic tax law (for the reason mentioned in section 2 above), and by implication, RCF could not be a resident of the US under Article 4 of the Treaty.

His Honour then observed that the question of whether RCF was a US resident was not actually relevant to the outcome of the case, as RCF was treated as fiscally transparent for US tax purposes and it was not a resident of Australia.

In relation to Article 13 of the Treaty, Edmonds J said that Article 13 does not “authorise” taxation of a gain that is not made by a resident of one of the Contracting States, and Article 13(7) only “authorises” Australia to tax capital gains made by a resident of the US. Given that RCF was not a resident of the US for the purpose of the Treaty, it followed, in his Honour’s view, that Article 13 did not “authorise” Australia to tax the gain in the hands of RCF. The implication of his Honour’s reasoning is that the fact that Article 13 of the Treaty allows Australia to tax the capital gain in the hands of the
limited partners, it follows that Article 13 also prohibits Australia from taxing the limited partnership (RCF), even though for Australian tax purposes RCF is regarded as having made the gain.

With respect, the authors find Edmonds J’s reasoning on this point difficult to follow. There seems to be a *non sequitor* in the reasoning.

Edmonds J framed the issue in terms of whether the Treaty “authorises” Australia to tax the gains in the hands of RCF. It is well established that an entity (such as RCF) that is not a resident of either Contracting State is generally not entitled to the benefits of treaty protection. Indeed, Article 1 of the Treaty specifically provides that the Treaty only applies to persons who are residents of Australia or the US or both, except as otherwise provided in the Treaty.

Furthermore, tax treaties do not “authorise” a Contracting State to tax an entity in respect of an item of income or gain. Rather, the generally accepted purpose of tax treaties is to allocate taxing rights between the Contracting States over residents of one or other of the Contracting States, and then it is left up to the domestic laws of a Contracting State to impose the tax on whichever entity it chooses and in the manner that it chooses, but only to the extent permitted by the treaty. In other words, tax treaties limit the taxing rights of Contracting States by preventing a Contracting State from levying tax under its domestic law to the extent that a resident of one of the Contracting States is protected from taxation by the treaty. Indeed, it is often said that a tax treaty acts “as a shield, not a sword”. This position is confirmed several times in the OECD Commentaries.

**The OECD Commentaries and the OECD’s Partnership Report**

In support of his reasoning, Edmonds J relied on the OECD Commentaries in relation to partnerships and other fiscally transparent entities. As mentioned above, those Commentaries are derived from, and based on, the OECD’s Partnership Report of 1999. His Honour noted that the Commentary on Article 1 of the OECD Model states that, when partners are liable for tax in their country of residence on their share of the income of the partnership, it is expected that the source country (in this case, Australia) will apply the provisions of the treaty:

“As if the partners had earned the income directly so that the allocative rules in Articles 6 to 21 will not be modified by the fact that the income flows through the partnership (OECD Commentary on Art 1, para 6.6)”.

His Honour then proceeded to say that the OECD Commentary on Article 1:

“...is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident (OECD Commentary on Art 1, para 6.3)”.

His Honour also said that his interpretation of the OECD Commentaries:

“...avoids denying the benefits of the conventions applying to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or...
Edmonds J’s proposition seems to be that Australia is not entitled to tax a limited partnership on a capital gain it makes if the partnership is not resident in Australia for tax purposes and is treated as fiscally transparent by the country of residence of at least substantially all of the limited partners, where that foreign country has a tax treaty that is substantially similar to the Treaty. Rather, in that situation, his Honour’s judgment indicates that Australia should tax the gain in the hands of the limited partners in accordance with their respective interests in the partnership.

In RCF, only approximately 3% of the partnership interests were held by residents of countries other than the US and Australia. It seems from his Honour’s judgment that, in his view, the Treaty authorises Australia to tax the limited partners if at least substantially all of the partners are residents of a treaty country. It is worth considering whether Edmonds J’s decision would have been different if a higher percentage of partnership interests were held by residents of non-treaty countries (say 20% or even 50%). That is, in a situation where a substantial proportion of the partners are residents of non-treaty countries, whether Australia can tax the limited partnership on the full amount of the gain. His Honour’s reasoning suggests that, even if there had been only 1 US resident partner in RCF with a small percentage interest in the partnership, Australia would still be prevented from taxing the partnership.

Therefore, Edmonds J’s judgment suggests that an “all or nothing” approach should be adopted. However, it is difficult to see why Australia should be prevented under the Treaty from taxing the partnership to the extent that there are partners who are resident in countries other than the US. If Edmonds J’s interpretation of the Treaty were to be adopted, it is arguable that it would be more appropriate for Australia to tax the partners who are residents of treaty countries on their respective shares of the gain, while the partnership should be taxed on the remaining balance of the gain which is attributable to partners who are residents of non-treaty countries.

The OECD’s Partnership Report of 1999 and the subsequent changes to the OECD Commentaries were designed to provide guidance on the application of the OECD Model to partnerships that are characterised differently by the relevant countries. The OECD stated that where:

- the country of residence of the partners regards the partnership as a fiscally transparent entity; and
- the country of source where the partnership derives its income regards the partnership as a non-resident fiscally opaque (ie taxable) entity,

then the source country (in this case, Australia) should apply the tax treaty with the country of residence of the partners. According to the Partnership Report (which is also reflected in the Commentary on Article 1 of the OECD Model), the partners are entitled in that situation, in respect of their share of the partnership income, to the benefits of that tax treaty to the extent that the partnership’s income is allocated to them for the purpose of taxation in their residence country.

However, with respect, the OECD does not require the source country to actually assess the partners (as opposed to the partnership) in that situation. In fact, the (current version of the) OECD Commentaries seem to leave the details of the assessment and collection of tax to the domestic tax law of the Contracting States. It is unfortunate, however, that the explicit statements in the OECD’s Partnership Report on this point are contained in Chapter III of the Report, which deals with conflicts
of qualification (refer paragraphs 102-104 of the Report), not in Chapter II (which deals with entitlements to treaty benefits).

In any event, in the case of Australia, which regards the “corporate limited partnership” as the taxable entity (under Division 5A), there does not seem to be any legislative basis for the issue of assessments by the Commissioner to the limited partners.

Furthermore, importantly, there were in fact no treaty benefits available in this case in respect of the gains from the sale of the SBM shares. Indeed, Edmonds J himself concluded that the Treaty did not protect the US resident partners from Australian taxation on the gains. Article 13 merely preserved Australia’s taxing rights in respect of those gains (irrespective of whether the gains are regarded as being derived by RCF or by the limited partners). Given those circumstances, it is difficult to understand why the Treaty would prevent Australia from taxing RCF on the portion of the gains which the US regarding as being attributable to the US resident partners. In the absence of treaty protection, it is difficult to discern any valid reasons for “looking through” RCF to the limited partners. The rationale for adopting a look through approach is to enable the partners who are residents of a country which has a tax treaty with the source State to claim the benefits of that treaty (if treaty benefits are actually available) to the extent that a share of the income of the partnership is allocated to them in their country of residence.

**Policy justification**

His Honour justified his approach on policy grounds on the basis that it would achieve the policy objective of preventing double taxation of capital gains made by US residents on the disposal of interests in Australian entities, while retaining Australia’s taxing rights. In Edmonds J’s view, the issue of an Australian income tax assessment to RCF as a limited partnership could result in double taxation of the same gain – once in the hands of RCF under Australian domestic tax law, and then again in the hands of the US resident partners under US domestic tax law. In this regard, his Honour said:

“This policy objective [of avoiding double taxation] would not be achieved if Australia is authorised under either Article 13(1), or is otherwise at large under Article 13(7), of the [Treaty] to tax the gain to RCF the limited partnership. The US resident limited partners will be liable to US tax on a capital gain without credit for the Australian tax assessed to RCF on the gain. On the other hand, by authorising Australia to tax a gain in the hands of the US resident limited partners, the [Treaty] recognises Australia’s taxing right, but at the same time provides in Article 22(1) a credit for any Australian tax suffered as a result of the exercise of that right and so prevents double taxation of the gain. In short, the policy objective is achieved rather than being frustrated under the position contended for by the Commissioner in the present case.”

However, in the authors’ opinion, this policy justification is questionable.

Firstly, it is understood that the vast majority of the US limited partners in RCF were US pension funds, which are actually exempt from tax in the US. To that extent at least, if Australia were to tax the gains in the hands of RCF, there would not be any double taxation of the gains.

Secondly, under US domestic tax law, the US resident limited partners that are not tax-exempt would be entitled to claim a foreign tax credit for the Australian tax imposed on RCF in respect of the gains.

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22 ibid. at [69]

23 In a converse situation, under Australian domestic tax law, Australian partners of a foreign partnership that is taxed in the US would be entitled to claim a “foreign income tax offset” under Division 770 for their proportionate share of the US tax levied on the income of that partnership.
Indeed, the OECD’s Partnership Report expressly requires the country of residence of the partners to provide a credit for the tax imposed by the source country on the partnership if the residence country of the partners taxes their share of the partnership income. The obligation of the residence country of the partners to provide a foreign tax credit in this situation is embodied in Article 23 of the OECD Model (Article 22 of the Treaty). In this regard, paragraph 139 of the Partnership Report states:

“The third difficulty…relates to the fact that both States impose tax upon the same income, but on different taxpayers. The issue is therefore whether State R, which taxes partner A on his share in the partnership profits, is obliged, under the Convention, to give credit for the source tax that is levied in State P on partnership P, which State P treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that State R flows-through the income of the partnership to the partners for the purpose of taxing them, it should be consistent and flow-through the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P is ignored for purposes of taxing the shares in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit.”

3.2. The TAP Issue

While Edmonds J’s conclusion on the Treaty Issue meant that it was not necessary for him to consider the TAP Issue, nevertheless his Honour proceeded to do so with the agreement of the parties because an appeal court would have the benefit of his reasoning and conclusion on the TAP Issue.

3.2.1. The relevant tests

Under Australian domestic tax law, pursuant to s.855-10 of the Assessment Act, a capital gain or loss made by a foreign resident from a CGT event is disregarded if the CGT event happens to a CGT asset that is not TAP. The various categories of TAP are set out in the table in s.855-15, and they include an “indirect Australian real property interest” (“IARPI”) (refer item 2 of the table). Under s.855-25, a membership interest (eg a share) held by an entity (the “holding entity”, eg RCF or its partners) in another entity (the “test entity”, eg SBM) is an IARPI if the interest satisfies both of the following tests:

1. the “non-portfolio interest test” in s.960-195, which requires that the holding entity and its “associates” have a membership interest of at least 10% in the test entity, at the time of the CGT event or throughout a continuous 12-month period in the 24 months before the CGT event; and

2. the “principal asset test” in s.855-30, which requires that the sum of the market values of the test entity’s assets that are “taxable Australian real property” (“TARP”) exceeds the sum of the market values of the entity’s assets that are not TARP. In this regard, TARP is defined in s.855-20 as including a “mining, quarrying or prospecting right” if the minerals, petroleum or quarry materials are situated in Australia.

3.2.2. The underlying issues

According to Edmonds J, the TAP Issue involved considering a number of underlying issues, including:
1. the proper construction of the “principal asset test”, in particular what is to be valued;

2. the hypothesis upon which the valuation is to be made, and the application of that hypothesis to the case at hand; and

3. the appropriate valuation methodologies to measure what is to be valued.\textsuperscript{24}

3.2.3. The proper construction of the principal asset test

Edmonds J examined the wording of the principal asset test in s.855-30, and the statutory context and purpose of that provision and of Division 855-30 more generally. His Honour held that the principal asset test requires a separate valuation of each individual asset of SBM, and not a valuation of all of SBM’s TARP assets as a class and all of its non-TARP assets as a class, and “certainly not” the determination of all of the company's assets on a going concern basis.

On his Honour’s interpretation, the principal asset test requires:

1. firstly, the separate determination of the market value of each asset of the entity;

2. secondly, the classification of each asset into TARP and non-TARP; and

3. finally, adding up the values of the assets in each category to determine whether the sum of the market values of the TARP assets exceeds the sum of the market values of the non-TARP assets.

Edmonds J acknowledged that “the value of a business on a going concern basis valued by reference to the present value of predicted earnings of the business may be greater than the … aggregate of the individual market value of each identifiable asset comprising the business”.\textsuperscript{25} However, his Honour did not express an opinion about whether the difference between those amounts represents goodwill in the legal sense. His Honour indicated that, if the difference is goodwill in the legal sense, and therefore property of SBM, it is a non-TARP asset, whereas if it is not goodwill in the legal sense and therefore not property of SBM, it would be neither a TARP asset nor a non-TARP asset. Ultimately, it did not make any difference in Edmonds J’s conclusion on the TAP Issue which view was to be adopted.

However, with respect, there is nothing in Division 855 to suggest that an asset which is taken into account for the purposes of that Division is confined to “property”. In fact, in ATO Interpretative Decision ID 2012/14, the ATO has previously stated its view that “an ‘asset’ of an entity for the purposes of the principal asset test in section 855-30 of the ITAA 1997 is anything recognised in commerce and business as having economic value to the entity …. for which a purchaser of the entity’s membership interests would be willing to pay.”\textsuperscript{26}

Edmonds J said that if a going concern valuation of SBM is used as a surrogate for undertaking separate valuations of that company's individual assets on a stand-alone basis, then there would be an overstatement of those values, resulting in a distortion of the market values of the TARP assets and/or the non-TARP assets. In his Honour’s view, this approach is not permissible because it “jumbles’ the value of goodwill, or the marriage value of the assets, with its sources”.

\textsuperscript{24} ibid. at [80]

\textsuperscript{25} ibid. at [97]. His Honour cited the High Court’s decision in \textit{FCT v Murry} (1998) 193 CLR 605 at [49] as support for this proposition.

\textsuperscript{26} The Commissioner has adopted the same meaning of “asset” in Taxation Ruling TR 2004/13 in the context of the tax consolidation regime in Part 3-90 of the Assessment Act.
3.2.4. The valuation hypotheses

The principal asset test calls for a determination of “market value”. There was consensus among the valuation experts called by both parties (the “Experts”) that the appropriate formulation of “market value” is the one derived from the leading High Court case of Spencer v The Commonwealth, namely:

“The value that would be agreed, in an open and unrestricted market, between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm’s length”.27

The parties also agreed that the above formulation of market value is subject to the so-called “highest and best use test”, namely the price which the “hypothetical prudent purchaser would entertain, if he desired to purchase [the asset] for the most advantageous purpose for which it was adapted”.28

The Experts agreed that the highest and best use of SBM’s specialised assets was in a business of mining the reserves in SBM’s mining tenements. However, they disagreed on precisely what applying this hypothesis entailed in the present case. Edmonds J preferred RCF’s approach of valuing each asset on a stand-alone basis as a starting point, but he said that this approach needs the further assumption that, in valuing the mining information and the plant & equipment, the hypothetical purchaser of these assets already owns the mining tenements. The implication of this assumption is that the hypothetical purchaser is able to use the mining information and the plant & equipment in a manner consistent with the most advantageous purpose for which it is adapted or its “highest and best use” (ie in a business of mining the reserves in SBM’s tenements).

3.2.5. The valuation methodologies

According to Edmonds J, adoption of the above hypotheses meant that different valuation methodologies needed to be adopted for different assets.

In relation to the mining information, his Honour considered that the market value would be in a range (the “bargaining zone”) between:

- a low point of zero, being the amount that the hypothetical seller of the information could realise from the sale of the information to an entity that does not own the mining tenements; and
- a high point, being the cost (measured in terms of outlay and time delay) to the hypothetical purchaser (as the owner of the mining tenements) of re-creating the information.29

In the case of plant & equipment, his Honour considered that a similar methodology would be appropriate, except that the low point of the range should be the “sale-for-removal” price (not zero).30

In both cases, his Honour agreed with RCF’s submission that the appropriate valuation point in the range is the half-way point, as it is this value which allocates the benefit of the immediate acquisition of the asset equally between the hypothetical seller and the hypothetical purchaser (on an assumption of equal bargaining power).

In relation to the mining tenements, his Honour considered that the market value should be determined as the value which could be extracted from the tenements by mining them (determined by

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27 Spencer v The Commonwealth (1907) 5 CLR 418 at 432 (Griffiths CJ), 441 (Isaacs J)
28 Spencer at 440-441 (per Isaacs J)
29 RCF [2013] FCA 363, at [106] and [156]-[157]
30 ibid. at [107] and [158]-[159]
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reference to the discounted cash flows ("DCF"), less the cost (outlay as well as time delay) of re-creating the mining information and replacing the plant & equipment (these assets not being offered for sale under the hypothesis).\textsuperscript{31}

His Honour cited \textit{Commissioner of State Taxation (WA) v Nischu Pty Ltd} (1991) 4 WAR 437 ("Nischu"), a decision of the Full Supreme Court of Western Australia in the context of stamp duty, as support for this valuation methodology. That case had decided that a statutory provision requiring the value of a mining tenement to be determined for stamp duty purposes required the separate valuation of that asset on a stand-alone basis.

In \textit{RCF}, all of the Experts started with a measure of the market value of SBM's total assets and proceeded to the value of the mining tenements as a residual item after deducting the value of the non-TARP assets. Edmonds J endorsed this approach, but his Honour agreed with RCF's submission that the market capitalisation method was unreliable for the purpose of measuring the market value of SBM's total assets. His Honour preferred the DCF method for this purpose.

3.2.6. The classification of SBM's assets

It was common ground that:

- SBM's mining tenements were the only material tangible assets of SBM which were TARP; and
- the mining information and plant & equipment were non-TARP assets.

The Experts took different views regarding the classification of the "gold premium" (ie the difference between the value of the shareholders' interests in a gold company based on its market capitalisation and the value of the company based on the DCF method). Edmonds J held that the gold premium is arguably not an asset of the company at all and should therefore be excluded from the calculation of the TARP/total assets ratio. His Honour said that, even if it is an asset of the company, it is a non-TARP asset.\textsuperscript{32} However, his Honour did not need to express a concluded view on this point because he rejected the market capitalisation method as unreliable.

Edmonds J held that, having regard to the classification of SBM's assets (as TARP, non-TARP, and neither), and their relative market values, SBM did not pass the principal asset test in s.855-30 at either of the relevant dates.

Accordingly, his Honour concluded that the capital gains made by RCF from the sale of the SBM shares were disregarded under Division 855.

\textsuperscript{31} \textit{ibid.} at [105].

\textsuperscript{32} \textit{ibid.} at [111].
4. The judgment of the Full Federal Court

On appeal, the Full Federal Court overturned the primary judge and found in favour of the Commissioner on both the Treaty Issue and the TARP Issue.

4.1. The Treaty Issue

In respect of the Treaty Issue, the Full Federal Court held that the assessment of RCF on the gains from the sale of the SBM shares was not precluded by the Treaty.

4.1.1. The error made by the primary judge

The Full Court considered that Edmonds J had made an error in concluding that Australia was authorised, under Article 13(1) of the Treaty, to tax the limited partners of RCF, rather than RCF itself:

“The error [of the primary judge] was in the conclusion that it therefore follows that it is the limited partners of RCF, not RCF the limited partnership, that Australia is authorised to tax under Art 13(1) of the DTA.”

4.1.2. The proper interpretation of the Treaty

The Full Court acknowledged that it was appropriate to have regard to the OECD Commentaries to assist in interpreting a tax treaty.

However, in the Full Court’s view, the context of the OECD Commentaries was the recognition of the difficulties in applying tax treaties in relation to partnerships, where one Contracting State treats the partnership as a separate taxable entity, while the other Contracting State treats the partnership as a fiscally transparent vehicle and taxes the partners. Their Honours noted that the purpose of the OECD Commentaries in relation to partnerships was to ensure that tax treaties are applied in such a way that treaty benefits are not denied merely due to the differing treatment of partnerships by the Contracting States.

The Full Court considered paragraph 4 of the Commentary on Article 1 of the OECD Model, which identifies as the “first difficulty” the extent to which a partnership is entitled to the benefits of the treaty. That paragraph states:

“Under Article 1, only persons who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. While paragraph 2 of the Commentary on Article 1 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4.”

Edmonds J had found that RCF was not a resident of the US for the purpose of the Treaty. The Full Court held that it followed from this finding of fact that the Treaty did not apply to RCF at all, as RCF was neither a resident of the US, nor a resident of Australia, for the purpose of the Treaty:

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33 Commissioner Of Taxation v Resource Capital Fund III LP [2014] FCAFC 37
34 ibid. at [25]
35 Ibid.
“It follows from that finding that the Treaty does not apply to the gain in the hands of RCF because RCF was neither a resident of the US nor a resident of Australia... The Commissioner’s argument that the Treaty does not apply because RCF was not a resident of either of the contracting States should be accepted.” 36

Therefore, Australia’s domestic taxing right in relation to RCF was not limited in any way by the Treaty.

The Full Court then said:

“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. There is no inconsistency between the Treaty and the provisions of the Assessment Act with respect to the taxation of gains in the hands of RCF. The inconsistency is between US tax law and Australian tax law with respect to the tax treatment of RCF. To put it another way, the inconsistency relates to the imposition of the liability for the tax of the gain, with the consequence that the provisions of the Treaty apply differently between Australia as the source country and the US as the place of residence of many of RCF’s partners.” 37

In other words, the OECD Commentaries in relation to partnerships do not impose any particular requirements regarding the assessment and collection of the tax liability – under Australian domestic tax law, any tax liability in respect of the gains from the sale of the SBM shares was allocated to RCF, and the Treaty did not change that outcome. In this case, the inconsistency was between:

- US domestic tax law, which treated RCF as fiscally transparent and attributed to the partners the liability for any tax payable on the gains made by RCF; and

- Australian domestic tax law, which treated RCF as a separate taxable entity taxed as a company.

There was no inconsistency between the outcome under Australian domestic tax law and the outcome under the Treaty. Thus, s.4(2) of the Agreements Act had no operation in this case and did not prevent Australia from taxing RCF.

4.1.3. The availability of treaty protection for the partners

In relation to the availability of treaty protection for the partners in RCF, the Full Court merely noted the following:

“It may be open to argument by the US partners that they should obtain the benefits of the [Treaty] on the basis that it was appropriate for Australia to view the gain as derived by the partners resident in the US, and to apply the provisions of the [Treaty] accordingly, as discussed in the OECD 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.” 38

In the circumstances, their Honours did not need to consider whether the US resident partners were entitled to the benefits of the Treaty because the taxpayer had not mounted its case in that way. The Treaty Issue had been framed simply in terms of whether the Commissioner was precluded from issuing an assessment to RCF in respect of the gains from the sale of the SBM shares. This is not surprising at all because, as discussed in section 3.1.2 above, there were in fact no treaty benefits available in this case in respect of the gains from the sale of the SBM shares. Article 13 merely

36 ibid. at [26]
37 ibid. at [29]
38 ibid. at [30]
preserved Australia’s taxing rights in respect of those gains (irrespective of whether the gains are regarded as being derived by RCF or by the limited partners).

Nevertheless, it appears from the tone of the paragraph quoted above that, in an appropriate case (where treaty benefits are actually available to the US resident partners), their Honours would have been prepared to accept the availability of those benefits for the partners.

An example of a case where treaty protection should be available for the US resident partners (subject to the “limitation on benefits” in Article 16) is where the partnership derives royalty income from Australian sources. Under Australian domestic tax law, the rate of Australian withholding tax applicable to the royalty income is 30%, but pursuant to Article 12(2) of the Treaty, the rate of Australian withholding tax should be limited to 5%.

4.1.4. Taxation Determination TD 2011/25

Before the Full Court, RCF also argued that it had relied on Taxation Determination TD 2011/25 by conducting its case in this proceeding in accordance with the Determination, and that the Commissioner was legally bound in this case by that Determination. In TD 2011/25, the Commissioner stated his view that the “Business Profits” Article (Article 7) of Australia’s tax treaties applies to Australian sourced business profits of a foreign limited partnership, where the limited partnership is treated as fiscally transparent in a country with which Australia has entered into a tax treaty and the partners are residents of that treaty country, but only to the extent that:

- the business profits are treated as the profits of the partners (and not the partnership) for the purpose of the tax laws of the residence country of the partners; and

- the partners meet any other applicable tax treaty requirements.

The Full Court dismissed this submission because it was the “Alienation of Real Property” Article (Article 13), not the “Business Profits” Article (Article 7), which was relevant in this case, and the TD “says nothing about taxing rights in relation to gains dealt with under Article 13”. Accordingly, the Court found it unnecessary to decide whether the taxpayer had “relied” on the TD for the purpose of s. 357-60 of Schedule 1 to the Taxation Administration Act 1953 (Cth).

The authors find it difficult to understand how adopting the “look through” approach of TD 2011/25 could have advanced RCF’s case, given that Article 13 merely preserved Australia’s taxing rights in respect of the gains from the sale of the SBM shares (even if the gains were regarded as being derived by the limited partners). Whereas Article 7 can provide treaty protection from source country taxation, Article 13 (or at least the parts of Article 13 that were relevant in RCF) actually preserved source country taxing rights.

4.1.5. What would be the outcome on the Treaty Issue if the facts are different?

On one view, the decision in RCF should be confined to its facts, particularly the feature of a capital gain arising from the disposal of an investment in an Australian company with predominantly TARP assets such as Australian real estate and mining rights (which would not be a common feature of private equity investments in Australian operating businesses). In those circumstances, an investor who is resident in a treaty country is likely to be taxable in Australia on their share of the gain, as most of Australia’s tax treaties would not protect the investor from Australian CGT in those circumstances.

39 ibid. at [35]
In *RCF*, the parties had agreed that the gains made by RCF from selling the SBM shares were on capital account. If the Commissioner had argued in the alternative that the gains were on revenue account, then it would have been necessary to consider whether the “source” of the gains was in Australia (according to Australian domestic tax principles). Having regard to the cases and ATO pronouncements on the source of gains from the disposal of securities (many of which are difficult to reconcile), this would not have been an easy question to resolve. Furthermore, it would have been necessary to consider whether the gains would be deemed to have an Australian source in any case by virtue of the “source deeming” rule in Article 27(1) of the Treaty, which states:

“Income derived by a resident of the United States which, under this Convention, may be taxed in Australia shall for the purposes of the income tax law of Australia and of this Convention be deemed to be income from sources in Australia.”

If (as the Full Court held) SBM is TARP-rich, such that the Alienation of Real Property Article (Article 13), rather than the Business Profits Article (Article 7) is relevant, then it could be said that under the Treaty the gains from selling the SBM shares “may be taxed in Australia”. The consequence of this finding may have been that the gains should be deemed (for the purposes of both the Treaty and Australian domestic law) to be Australian sourced, and therefore taxed in Australia.

In the case of more common private equity investments that involve the disposal of a non-TAP asset on revenue account, there should be no change in the Australian tax treatment of the gain on disposal:

- An investor holding their investment in the Australian company directly from a treaty country should continue to generally be entitled to the benefits of the treaty to protect the profit from Australian tax by virtue of the “Business Profits” Article.

- If an investor who is resident in a treaty country invests in the Australian company indirectly through a foreign limited partnership established in a non-treaty country (such as the Cayman Islands) which the residence country of the investor treats as fiscally transparent, the investor will need to continue relying on the protection afforded by TD 2011/25 in order to obtain the benefits of the treaty between Australia and their country of residence.

In this regard, it should be noted that one important feature of TD 2011/25 is the Commissioner’s requirement that the General Partner of the foreign limited partnership should provide the information necessary to satisfy the Commissioner that a limited partner is a resident of a treaty country and is therefore entitled to treaty protection.

Given the distinction that was drawn by the Full Federal Court between the Business Profits Article and the Alienation of Real Property Article, the authors believe that it is unlikely that the Commissioner would see any need to change his views in TD 2011/25 once the RCF litigation has been finalised. TD 2011/25 only applies if the Business Profits Article is relevant.

- If an investor in the Australian company is resident in a non-treaty country, then it would be necessary to consider whether the “source” of the gain is in Australia (in which case it would be taxable in Australia). Again, having regard to the cases and ATO pronouncements on the source of gains from the disposal of securities, this may not be an easy question to resolve.\(^{40}\)

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\(^{40}\) Refer Taxation Determination TD 2010/21.
4.1.6. What if RCF had been established in the US?

If RCF had been established under US law (e.g., a Delaware limited partnership), then it would have qualified as a “domestic” partnership for US Federal income tax purposes, and it would have been treated as a resident of the US for US domestic tax purposes.

In the Federal Court, Edmonds J (at first instance) expressed the view that his decision would have been exactly the same if RCF had been a resident of the US under US domestic tax law. In this regard, his Honour said:

“This same approach and conclusion would be reached even if RCF was a resident of the US for the purposes of its tax and therefore a resident of the US for the purposes of the Convention under Art 4(1)(b)(iii) because it would, nevertheless, be fiscally transparent under US law with the liability for tax falling on the limited partners. So much explains my agreement with the Commissioner’s submission recorded in [55] above that ultimately it does not matter in the present case if RCF is resident within the meaning of Art 4(1)(b)(iii) or not. It is the limited partners of RCF, not RCF the limited partnership, that Australia is authorised to tax under Art 13(1) of the Convention.”41

However, his Honour’s above comments appear to be inconsistent with the provisions of the Treaty. Under Article 4(1)(b)(ii) of the Treaty, a person (which includes a partnership) who is resident in the US for US domestic tax purposes is also resident in the US for the purpose of the Treaty, provided that in relation to any income derived by the partnership:

“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, if that income is exempt from United States tax, is exempt other than because such person, partner ... is not a United States person according to United States law relating to United States tax.”

Accordingly, if RCF had been established in the US, then it would have been resident in the US for the purpose of the Treaty to the extent of around 97% (representing the percentage of contributed capital held by the US resident investors). On that basis, the Treaty would have applied to RCF to the extent of 97%. However, given that no treaty protection was available under Article 13 in respect of the gain, the ultimate outcome should have been the same, that is, Australia should have retained its domestic taxing rights in respect of the full amount of the gain.

If Edmonds J’s approach were correct, then it is conceivable that his Honour may have been more willing to find that the Treaty did not preclude the issue of the assessment to RCF.

4.2. The TAP Issue

4.2.1. The approach adopted by the Full Court

As mentioned in section 3.2.3 above, Edmonds J had held (at first instance) that the principal asset test in s.855-30 requires a separate determination of the market value of each of the assets of the tested entity, not a valuation of groups of assets by class, and not a valuation of all assets as a going concern.

On appeal, the Full Federal Court rejected Edmonds J’s interpretation of the principal asset test. Instead, their Honours postulated that the principal asset test requires the assets of the tested entity
to be valued on the hypothesis that they were offered for simultaneous sale as a bundle of assets to the same hypothetical purchaser.

The Full Court considered the statutory context and the purpose for which SBM’s assets were to be valued, that is, to determine whether SBM’s underlying value is principally in its TARP assets. Their Honours said:

“In light of the statutory context and purpose, 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. The reference to ‘the sum’ of the ‘market values’ does not, even in its literal terms, require the ascertainment of the market value of each relevant asset separately, and then upon their ascertainment, an arithmetical calculation. The statutory criterion referred to in s 855-30(2) can still be applied by considering the matter on the basis of an assumed simultaneous sale of SBM’s assets to the same hypothetical purchaser. In our opinion there is insufficient indication in the language and context of s 855-30 to found what is, in our respectful opinion, the artificial conclusion for which RCF contended.

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 separate sales.”

Their Honours believed that Edmonds J fell into error by failing to give due recognition to the statutory context and purpose, and by following the approach in *Nischu* (a stamp duty case).

In the authors’ opinion, when compared to the approach adopted by the Federal Court at first instance, the approach adopted by the Full Court appears to be more consistent with the statutory context and purpose of the principal asset test, which is “to define when an entity’s underlying value is principally derived from Australian real property” (refer s.855-30(1)).

The methodology adopted by the Full Federal Court favoured the Commissioner. This is because the expert valuation evidence in this case indicated that, on the hypothesis of a simultaneous sale of all of SBM’s assets as a bundle, the single hypothetical purchaser could expect to acquire the mining information and the plant & equipment for an amount less than their re-creation costs with minimal delay. This had the effect of substantially lowering the value of the non-TARP assets, such that the TARP assets would constitute the majority value of the company.

Nevertheless, the Full Court initially left it for the parties to determine whether they wished to raise any further valuation issues in the proceedings.

The parties could not reach agreement on whether SBM passed the principal asset test on the first disposal date (July 2007).

Therefore, the matter returned to the Full Federal Court – see *Resource Capital Fund III LP v FCT (No 2) [2014] FCAFC 54*. The taxpayer argued that the appropriate valuation method for the mining information and the plant & equipment as at July 2007 should be the mid-point between the replacement value and the scrap value. However, in a brief judgment, the Full Court dismissed the taxpayer’s proposed valuation method, on the basis that it involved an “unsupported and speculative proposition”. While the Full Court agreed that the hypothetical purchaser could expect to pay an amount less than the replacement value, the taxpayer had not discharged its burden of proving how much less.

This meant that the Commissioner had succeeded on the TARP Issue on both of the relevant dates, and the Commissioner’s appeal was allowed.

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42 ibid. at [51]
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At the time of writing, the taxpayer has applied for special leave to appeal to the High Court.

4.2.2. The differences between the domestic law tests and the Treaty tests

The “principal asset” test

It is noteworthy that Article 13 (the “Alienation of Real Property” Article) of the Treaty also contains a principal asset test. The Treaty expresses the test in terms of whether “the assets of [the entity] consist wholly or principally of real property situated in Australia” (refer Article 13(2)(b)).

In RCF, the case was argued entirely on the basis of the domestic principal asset test. That test is expressed in terms of whether “the sum of the market values of the test entity’s assets that are taxable Australian real property exceeds the sum of the market values of its assets that are not taxable Australian real property” (refer s.855-30(2)). The domestic test is clearly a more than 50% test.

It is arguable that, due to the reference to “principally” in Article 13 of the Treaty, the Treaty test requires a higher threshold than the domestic test. However, in the authors’ opinion, although the tests are framed slightly differently, the Treaty test should be interpreted in a similar manner to the domestic test, that is, on a majority value basis.

The “non-portfolio interest” test

There was one important difference between the domestic test and the Treaty test. Division 855 contains the “non-portfolio interest test” in s.960-195 for the purpose of determining whether, under Australian domestic law, Australia has taxing rights over a capital gain made by a non-resident. This test requires the “holding entity” to have an interest of at least 10% in the “test entity” on an associate-inclusive basis. On the other hand, the Treaty contains no such threshold.

In RCF, no limited partner had a greater than 8.5% interest in the contributed capital of RCF, but the taxpayer (RCF) itself held more than 10% of the shares in SBM at the relevant dates.

As discussed above, the scope of the question on the Treaty Issue that the Court was asked to consider was limited, ie whether the issue of the assessment to RCF was precluded by the Treaty. Edmonds J held that the capital gains should have been assessed in the hands of the limited partners (not in the hands of RCF). His Honour did not need to consider the actual treatment of the capital gains in the hands of the limited partners, for example, whether they would pass the non-portfolio interest test. This raises the question of how the non-portfolio interest test should be applied to the limited partners if Edmonds J’s conclusion on the Treaty Issue is correct.

Under the definition of “associate” in s.318, an associate of a partner in a partnership includes the partnership and every other partner. On the other hand, an “associate” of a shareholder in a company includes the company only if the shareholder and/or any of its other associates has either a “majority voting interest” or sufficient influence” over the company.

Therefore, if the “look through” approach adopted by Edmonds J on the Treaty Issue were to be extended to Division 855, then RCF should be either disregarded entirely or it should be treated as an ordinary partnership.

On the first construction (where RCF is disregarded entirely), none of the partners would pass the non-portfolio interest test because each limited partner’s interest in RCF is less than 10%. As a
consequence, Australia would not have a taxing right over the capital gains in the hands of the limited partners.

On the other hand, if RCF were to be treated as an ordinary partnership, then each limited partner would pass the non-portfolio interest test, as all of the partners would be associates of each other. The consequence of this would be that, under Australian domestic law, Australia would have a taxing right over the capital gains.

However, if Edmonds J’s look through approach does not extend to Division 855, then assuming that none of the partners are otherwise associates of each other, none of the partners would pass the non-portfolio interest test. This is because given that RCF is a “corporate limited partnership” under Division 5A, it is deemed to be a company and its partners are deemed to be shareholders for most purposes of Australian domestic law.

The Full Federal Court did not need to address this issue because their Honours took the view that the assessment of RCF as a taxable entity under Division 5A was not precluded by the Treaty.

Paragraphs 79-92 of the OECD’s Partnership Report discuss issues of conflicts of qualification, but they do not provide any clear guidance. Those paragraphs merely discuss the difficulties involved in the application of a tax treaty where the treaty benefits depend on certain characteristics or attributes of the taxpayer, as the Contracting States may have different views regarding the extent to which the partnership should be recognised in applying such benefits.

These issues may be explored in a future case.

4.2.3. Some general observations regarding market valuations

The Full Federal Court in RCF emphasised that the starting point in market valuations is always the relevant statutory context. The ATO’s publication “Market valuation for tax purposes” (which is often referred to as the ATO’s Market Valuation Guidelines) also notes that “although the law frequently refers to market value, the meaning of that term will depend on its statutory context. In each instance you will need to take into account the context in which the term is used, and pay particular attention to its definition of any specific requirements in that context.”

However, the RCF case serves to highlight the challenges that taxpayers continue to encounter in the practical application of the general test of market value derived from Spencer v The Commonwealth, in a particular statutory context. The very fact that the single instance judge and the Full Court disagreed on the implications of the statutory context demonstrates that it is very difficult to predict precisely what the relevant statutory context requires in the absence of case law.

The ATO’s Market Valuation Guidelines indicate that “to determine the market value you should always use the most appropriate valuation methodology.” However, even if there is agreement on the meaning of the relevant statutory context, valuations inherently call for the exercise of subjective judgment, and what one valuer may regard as an appropriate valuation methodology in any given situation does not necessarily correspond with the methodology that another valuer may consider appropriate in the same situation.

Furthermore, even if the experts agree on the appropriate valuation methodology in a given situation, they invariably arrive at different views regarding the market value. For example, in RCF, the total market value of SBM’s assets at the relevant dates as determined by the Experts using the DCF model varied significantly.
5. The aftermath of RCF

5.1. The Treaty Issue – the relevance of actions being taken under the BEPS Project

On 16 September 2014, the OECD released its 2014 deliverables of the Action Plan on the OECD/G20 Base Erosion and Profit Shifting (“BEPS”) Project. The BEPS Project is designed to create a single set of co-ordinated international tax rules to stop the erosion of tax bases and the artificial shifting of profits by multinational enterprises to low-tax jurisdictions. Two of the reports released by the OECD have significant implications for the application of tax treaties to “hybrid entities”.

5.1.1. Action 2 “Neutralising the Effects of Hybrid Mismatch Arrangements”

Paragraph 131 of the report on Action 2 “Neutralising the Effects of Hybrid Mismatch Arrangements” (the “Hybrid Report”) notes that some countries have found it difficult to apply the conclusions of the OECD’s Partnership Report of 1999. The RCF case certainly shows that to be the case. Further, the OECD’s Partnership Report did not expressly address the application of tax treaties to entities other than partnerships.

Accordingly, Chapter 9 of the Hybrid Report (which is headed “Treaty provision on transparent entities”) proposes to include in the OECD Model a new Article 1(2), as well as several paragraphs of related Commentary. The Hybrid Report states that the purpose of these changes will be to ensure that, for the purposes of the OECD Model, the income of entities that one or both Contracting States treats as fiscally transparent for tax purposes is treated in accordance with the principles of the Partnership Report. This is said to ensure that the benefits of tax treaties are granted “in appropriate cases”, and that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.

The proposed new Article 1(2) of the OECD Model reads as follows:

“For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State. [In no case shall the provisions of this paragraph be construed so as to restrict in any way a Contracting State’s right to tax the residents of that State.]”

The last sentence (which appears in square brackets) constitutes an exception that is relevant where the transparent entity is regarded as resident and not fiscally transparent in the source country. The Hybrid Report indicates that this exception is not necessary if the “saving clause” proposed by Action 6 is adopted (see below).

Paragraph 26.13 of the Hybrid Report indicates that, “by providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention”. In other words, the paragraph ensures that the resident to whom the income of the fiscally transparent entity is attributed by the domestic law of the residence country will be entitled to access the benefits of the tax treaty in
respect of the attributed income (subject to any anti-abuse provision, such as a “limitation on benefits” clause in the treaty).

If the proposed new Article 1(2) were to be inserted in the US Treaty, 97% of the gains made by RCF from the sale of the SBM shares would be treated as income of the US resident limited partners for the purposes of the US Treaty. However, this should not change the outcome of the RCF case because as previously mentioned, there were no benefits available under the Treaty in respect of those gains. Rather, Article 13 of the Treaty merely preserves Australia’s domestic taxing right over those gains.

However, in an appropriate case where benefits are available under the Treaty, the above paragraph would ensure that the US resident limited partners obtain the benefits of the Treaty. For instance, if RCF were to derive Australian-sourced royalty income, the US resident limited partners should be entitled to the benefit of the Treaty limitation (in Article 12) on the rate of Australian tax on the royalties.43

A practical example is proposed to be inserted into paragraph 26.7 of the Commentary on Article 1 of the OECD Model to illustrate this point:

“Example: State A and State B have concluded a treaty identical to the [OECD Model]. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such a case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.”

Even though the proposed new Article 1(2) would not change the outcome of the RCF case, the proposed new insertions into the Commentary on Article 1 of the OECD Model would put it beyond doubt that the mechanisms for the assessment and collection of tax should be left to the domestic laws of the Contracting States. In particular, the proposed new paragraph 26.15 of the Commentary states:

“The paragraph only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterises entities for the purposes of its domestic law. In the example in paragraph 26.7 above, whilst paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A’s tax will be payable by the entity. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and will not change the fact that the entity is the relevant taxpayer for the purposes of State A’s domestic law.....”

[emphasis added]

This paragraph makes it clear that, in RCF, there was nothing in the Treaty to preclude the issue of an assessment to RCF as the relevant taxable entity.

It is noted that Australia already has an Article 1(2) in its 2009 tax treaty with New Zealand which is very similar to the proposed new Article 1(2) of the OECD Model.

43 Refer also to the example in the proposed new paragraph 26.7 of the Commentary.

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5.1.2. Action 6 – “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances”

The other significant development since the RCF case is the release of the report on BEPS Action 6 “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” (the “Treaty Abuse Report”) on 16 September 2014. Paragraph 53 of the report proposes to insert a “saving clause” in the OECD Model as a new Article 1(3), which is framed as follows:

“This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23, 24 and 25 and 28.”

The saving clause derives from US tax treaty practice, and it is designed to confirm the general principle that the treaty does not limit a Contracting State’s right to tax its own residents (eg under its “controlled foreign companies” regime), subject to a number of specific exceptions.

One of the most significant specified exceptions to the saving clause is the residence country’s obligation under Article 23 of the OECD Model to provide relief from double taxation where income of a resident of that country may also be taxed by the other country in accordance with the treaty.

The effect of the saving clause in the context of hybrid entities is that, where the entity is regarded as resident and not fiscally transparent in the source country, the source country retains the right to tax the hybrid entity. This clause would not change the outcome of the RCF case, because even though RCF was not treated as a fiscally transparent entity under Australian domestic tax law, it was common ground that it was not a resident of Australia (the source country). However, if RCF had been a resident of Australia (by virtue of carrying on business in Australia), then a saving clause would have confirmed Australia’s right to tax RCF on the gains made from the sale of the SBM shares.

5.2. The TAP Issue – the Government’s legislative responses

Australia’s tax policy (at least since Division 855 was enacted in 2006) has been to ensure that gains made by foreign residents on direct or indirect interests in Australian real property (including mining rights) can be subject to Australian tax. After Edmonds J delivered his judgment in RCF at first instance, the (former) Federal Government became concerned that his Honour’s interpretation of Division 855 could have the potential to erode Australia’s tax base, where foreign investors holding interests in Australian real property also hold information or other non-TARP assets that enable the real property to be used in more valuable ways.

Therefore, in response, on 14 May 2013, as part of the Federal Budget for 2013-2014, the former Government announced various measures to improve the integrity of Australia’s tax regime for non-residents.44 On 6 November 2013, the current Government (which was elected in September 2013) confirmed that it intends to proceed with these measures.45 These measures are discussed below.

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44 Refer Attachment B to the former Assistant Treasurer’s Media Release no. 71 dated 14 May 2013
45 Refer item 9 of the table headed “Proceed as announced” in the Attachment to the Joint Media Release dated 6 November 2013 by the Treasurer and the Assistant Treasurer.
5.2.1. Proposed changes to the principal asset test

The treatment of mining intangibles – the “Valuation Measure”

Firstly, to “clarify” Australia’s taxing rights over IARPIs, the former Government announced its intention to make changes to the principal asset test in Division 855. Relevantly, intangible assets connected to the mining, quarrying or prospecting rights (notably, information, rights to such information, and goodwill) were proposed to be treated as part of the rights to which they relate, and therefore as TARP, for the purpose of the principal asset test in determining whether an interest in an entity is an IARPI (the “Valuation Measure”).

This proposed change was explained as being “due to a number of recent cases where a foreign investor disposed of an interest in Australian mining operations without being subject to capital gains tax” on the argument that the majority of the value of the mining operation was attributable to mining information (a non-TARP asset), as opposed to the right to extract natural resources (which is a TARP asset).

The Valuation Measure was proposed to apply to CGT events occurring on or after 14 May 2013.

On 3 April 2014, the Full Federal Court handed down its judgment in favour of the Commissioner in the RCF case, but (as discussed in section 4.2.1) it gave the parties the opportunity to consider the reasons in the judgment and to raise any further valuation issues that needed to be raised. On 2 May 2014, the Full Court handed down its final orders in the case in favour of the Commissioner, but there was speculation as to whether the taxpayer might apply for special leave to appeal to the High Court. On 13 May 2014, as part of the Federal Budget for 2014-2015, the current Government indicated that it has decided to defer the enactment of the Valuation Measure, and to assess whether this measure is actually necessary once the RCF litigation has been finalised.46

Even though the taxpayer’s special leave application in RCF has not yet been decided, the Government believes that the courts have provided their final decision in relation to the TAP Issue (presumably because the taxpayer’s special leave application is only in relation to the Treaty Issue). Therefore, on 17 July 2014, the Government indicated that it has decided to defer the enactment of the Valuation Measure “until the effect of the decision has been analysed”.47

It will be interesting to see whether the Government does ultimately proceed to enact the Valuation Measure (particularly given the current Government’s apparently minimalist attitude to law change). If this measure is ultimately enacted, it would be worth considering how (if at all) it might interact with the Real Property Article of Australia’s tax treaties. Much will depend on:

- how it is implemented in domestic law (eg whether it is effected by amending the definition of “real property”, or by merely changing the required method of valuation); and
- the precise wording of the relevant treaty.

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46 Somewhat curiously, this announcement was contained in the Explanatory Memorandum to Exposure Draft legislation which was released on Budget night. Refer paragraphs 1.17 and 1.18 of the Explanatory Memorandum to Exposure Draft Tax and Superannuation Laws Amendment (2014 Measures No. 3) Bill 2014.

47 Again, curiously, this announcement was contained in paragraph 3.24 of the Explanatory Memorandum to the Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014 (which was introduced to Parliament on 17 July 2014).
The Anti-duplication Measure

The second measure that the former Government announced was proposed changes to the principal asset test so that assets resulting from transactions between members of the same tax-consolidated group would be disregarded in determining whether the interests in an entity are IARPIs (the “Anti-duplication Measure”). The purpose of this measure was said to be ensuring that intra-group dealings (such as loans) are not used to generate non-TARP assets, thereby resulting in the duplication of the value of the non-TARP assets of the group. This change was proposed to apply to CGT events occurring on or after 14 May 2013.

On 13 May 2014, as part of the Federal Budget for 2014-2015, the current Government released Exposure Draft Tax and Superannuation Laws Amendment (2014 Measures No. 3) Bill 2014, which contained the draft legislative provisions to implement the Anti-duplication Measure, but with one important modification. This measure would no longer be confined to transactions between members of the same tax-consolidated group, but rather it would now extend to interests held by foreign residents in unconsolidated entities where the CGT event happens on or after 13 May 2014. The Anti-duplication Measure would continue to have effect for interests held in a tax-consolidated group where the CGT event happens on or after 14 May 2013. The rationale for extending the operation of the Anti-duplication Measure to unconsolidated entities was that the potential for the values of assets to be duplicated is not limited to assets being created from transactions between members of a tax-consolidated group; rather it arises from the operation of the principal asset test itself.

The Anti-duplication Measure was finally enacted on 25 September 2014 as Part 1 of Schedule 3 to Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014. The operative provision is the new s.855-32, and it seems to have a more limited scope than was originally proposed in the Exposure Draft. In particular, the provision (as enacted) only applies if an arrangement comes into existence under which a non-TARP asset is created in an entity, and a corresponding liability is created in another entity (most commonly a loan).

A simple example illustrates the operation of the new s.855-32. Assume that an entity (Hold Co) advances a loan to its 100%-owned subsidiary to enable the subsidiary to purchase Australian land. As a result, Hold Co would then have 2 assets: the loan to its subsidiary and the underlying land. In the absence of the new s.855-32, if Hold Co also owns some other assets that are non-TARP, the value of the TARP assets would represent less than 50% of the value of the non-TARP assets, with the effect that the shares in Hold Co would not be IARPI. However, by virtue of this new provision, the market value of the loan asset would be disregarded for the purpose of determining whether Hold Co passes the principal asset test.

5.2.2. The proposed non-final withholding regime

Given the practical difficulties that the ATO faces in recovering Australian tax liabilities from foreign entities (such as RCF) that may not have any significant physical assets in Australia, the former Government proposed the introduction of a non-final withholding regime for disposals of “certain taxable Australian property” by foreign residents with effect from 1 July 2016. Broadly, where a foreign resident disposes of certain types of TAP (presumably including IARPIs), the purchaser will be required to withhold and remit to the ATO an amount equal to 10% of the purchase price as a non-final withholding tax. The seller will then have to apply to the ATO for a refund of the withheld amount to the extent that the seller considers that it does not have an Australian tax liability in respect of the
sale. The withholding regime will extend to disposals that generate gains on revenue account (not just capital account).

It is noted that a number of other countries (including the US, Canada, and Singapore) have had a similar withholding mechanism for many years.

The Government proposed consulting publicly on the design and implementation of the regime with a view to minimising compliance costs. There are, of course, many questions that will need to be resolved in relation to this proposal, including:

▪ what types of transactions will be caught;

▪ how will the purchaser know that the seller is a non-resident;

▪ how will a purchaser determine whether an asset is TAP, whether the seller has a 10% or greater interest in a TARP-rich entity, and whether an entity is TARP-rich;

▪ whether the regime will apply to transactions between non-residents;

▪ what type of evidence will be needed to convince the ATO to refund the withheld amount;

▪ whether a seller will be able to prevent the withholding by obtaining prior clearance from the ATO where the seller is selling at a loss, or has an established presence or other assets in Australia; and

▪ what the penalties will be for failing to withhold when required.