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TAX BRIEF

10 April 2019

Resource Capital Fund case again: Two steps forward, one step back in Full Federal Court

The Resource Capital group of funds is doing its best to clarify Australian domestic tax law and tax treaty treatment of private equity purchases and sales of Australian mining companies. Once again their efforts have been on the receiving end of an adverse Full Federal Court decision after winning at first instance.

The key takeaways from this important decision are:

- A limited partnership is again recognised as a "taxable entity" and is the appropriate person to be assessed on income derived through the partnership
- The ability of US limited partners to access treaty benefits is far from clear and action needs to be taken promptly by the ATO or government to address the process for partners to assert their treaty rights
- The problems are not confined to the US treaty and apply similarly to the new BEPS inspired fiscally transparent provision included in an increasing number of Australia's tax treaties and any treaty to which the OECD Partnership Report is applied
- The source of profits on exit for private equity and venture capital investors in Australia is likely to be in Australia
- Exits from resource companies continue to raise needlessly difficult issues of law and valuation

The five member bench of the court has made progress in rejecting some of the surprising views at first instance and in clarifying or at least moving forward on several difficult issues of domestic tax law and tax treaties where limited partnerships (**LPs**) are involved. At the same time it leaves some important issues unresolved such as the application of the US treaty to LPs, a workable procedure by which partners in LPs can claim treaty benefits and the treatment of downstream mining activities. As a result foreign investors are still some way from having reasonable certainty about the tax treatment of their Australian investments.

Facts and issues

Briefly the facts were as follows:

- two funds, Resource Capital Fund IV LP and Resource Capital Fund V LP (collectively RCF) held respectively 23.1% and 13.1% of the shares in an Australian resident company mining lithium which was listed on the Toronto Stock Exchange;

- the funds were formed in the Cayman Islands but the private equity group concerned was generally managed in the US although there was a related Australian entity which was more closely involved in the management of this Australian investment;
- the investors in the LPs were mainly but not only US tax residents (73 of 77 for IV LP and 130 of 137 for V LP);
- RCF exited the investment at a profit by a scheme of arrangement takeover approved by an Australian court with the purchaser being a Chinese company. There was no contest on appeal that the investment was on revenue account and the profit ordinary income.

The questions on appeal were:

- Issue 1 Are Corporate Limited Partnerships liable to tax
- Issue 2 Who was assessed
- Issue 3 Contestability of the tax
- Issue 4 Source of the profit
- Issue 5 Can RCF rely on the Australia US treaty in the current proceedings
- Issue 6 Can RCF rely on the ATO binding public ruling on Cayman LPs and the treaty in TD 2011/25 and if so was the ATO prevented from taxing the profit
- Issue 7 Valuation of taxable Australian real property

The answers are contained in a joint judgment of four of the five judges and a short generally concurring judgment from Davies J, though Davies J disagrees on one issue and does not feel it necessary to decide another two issues.

LP is the taxpayer in Australia

Issues 1 and 2 arose out of the findings at first instance that Division 5A of the *Income Tax Assessment Act 1936* (**1936 Act**) on corporate limited partnerships did not make LPs companies and taxpayers for Australian tax purposes as the division was essentially procedural, and that the assessments in question directed to RCF were in fact assessments of the partners in RCF. These findings were met with general surprise as they seemed to fly in the face of the terms of Division 5A and the income tax legislation more generally. They are duly rejected by the appeal court on that basis.

However, one advantage of the approach of the trial judge is that it avoided the practical and technical issues that arise where one treaty party regards a legal entity as the taxpayer and the other treaty party regards the members of the entity as the taxpayers.

The US regarded RCF as tax transparent with the partners as the taxpayers whereas the Full Federal Court held that RCF was the taxpayer for Australian tax law and it is the taxpayer who must object to and appeal an Australian assessment and not any other party.

But from the tax treaty perspective it is the partners being taxed in the US who want to assert rights under the treaty to prevent Australian taxing their profits.

LP cannot rely on the treaty in the proceedings

These issues are discussed by the appeal court in relation to issues 3 and 5.

It is generally necessary under tax treaties for a person to be a resident of a state to claim treaty benefits. While the term “person” is defined in the US treaty to include a partnership, the definition of a US resident so far as relevant refers to:

> *any other person … resident in the United States for purposes of its tax, provided that, in relation to any income derived by a 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 [or] partner … is not a United States person according to United States law relating to United States tax*

Over the course of the proceeding, several readings of this provision are offered:

- At first instance it was read as meaning that only the partners of a tax transparent partnership could be resident because the partnership is not a legal person (and so not a person) and is not taxed.
- The joint judgment in the appeal court points out that the definition of person includes a partnership and there is no apparent context to read it otherwise. Instead it notes that as RCF was not taxed in the US (as agreed between the parties) and "there was no evidence that the income of either partnership was 'subject to tax in the United States'", which in the context must be referring to that income being taxed in the hands of the partners, neither RCF nor the partners had established a right to treaty protection.

  While there may have been no evidence of assessments being issued to partners, the whole case seems to have been run on the premise that the US resident partners would be taxed in the US (or if exempt would be exempt on a basis other than not being a US person under US tax law) and so this conclusion seems harsh especially since in other areas the court is willing to make up for lack of evidence, see e.g. its treatment of ATO arguments that the partners could not rely on the ruling under the next heading. The joint judgment goes on to offer a further reason why RCF is not able to rely on the treaty in these proceedings – in the Resource Capital Fund III LP case, it was held that the LP itself must be a US person (that is, created in the US) as well as satisfying the subject to tax requirement in order for the LP to be entitled to US treaty benefits under the provision quoted above. As the RCF LPs were created in the Caymans they do not satisfy the US person requirement.

- However, although it was held that RCF was not entitled to assert US treaty rights, the joint judgment concludes that this does not mean that the partners cannot assert their own treaty rights at all, it's just that they cannot do so in the normal appeal proceedings against the assessment where the correct taxpayer under Australian law is the LP. If the ATO were to come after the partners for the tax under provisions allowing collection from third parties, the partners could then rely on the treaty. The ATO proffered the possibility that the partners could also commence proceedings for a declaration for which the joint judgment observed a "partner would probably have standing." In the earlier RCF litigation all that the ATO could offer to partners as a matter of procedure and then only during RCF's unsuccessful special leave application in the High Court was access to the mutual agreement procedure under the treaty, that is, no access to Australian courts. As the LP is taxed as a company, it is the one that is issued an assessment. However, unless it qualifies as a US resident under the treaty, it cannot assert treaty benefits. And the partners have no basis to be a party to these proceedings.
- Davies J by contrast disagrees with this view as she reads the words "such person" as referring back to "partnership" and not "any other person" (a view which the majority judgment also seems inclined to accept) and that the proviso is in effect a deeming that the partnership is a US resident to the extent the US resident partners are subject to tax or exempt as described in the proviso, whether or not it is otherwise a US person. On that basis Davies J concludes that RCF can rely on the US treaty in the current proceedings and presumably for that reason does not feel it necessary to express a view on issue 2. While this may push the text fairly hard, Davies J like the trial judge is more attuned to the practicalities of making the treaty work than the joint judgment.

The outcome of the joint judgment is that there is no practical way at the moment sanctioned by the court for partners to assert their treaty rights in the very proceedings where the assessment is being contested. With respect, this is not a practical or sensible response to the procedural issues, and if the courts cannot solve them then the government or the ATO should. As noted under the next heading the joint judgment concludes that when the business profits article of a tax treaty is in question the LP can by implication rely on the legally binding nature of the ATO ruling in TD 2011/25 to assert the partners' treaty rights but that is not enough to protect the partners adequately – if the LP does not want to assert those rights, e.g. because only one partners is a US resident, the partners have no obvious redress. There needs to be a clear procedural pathway for the partners to have their day in court to assert their treaty rights.

Given there is no practical way for a partner to assert their treaty rights, there is something to be said for RCF's constitutional argument (Issue 3) that as a matter of policy the result is an incontestable tax from the partners' view. This argument is given short shrift – here on the basis that RCF can challenge the assessment by appeal, but that rings fairly hollow if RCF is not allowed to raise the treaty on behalf of the partners.

The US treaty provision in question here is a one-off among Australia's tax treaties but is nonetheless extremely important given the large amount of US investment that finds its way to Australia through LPs. The procedural problem, however, is much broader than the US treaty. The modern form of treaty provision for dealing with different identification of the taxpayer by different countries is the fiscally transparent entity provision that has been making its way into bilateral treaties in recent years, e.g. Germany, New Zealand and the recently signed treaty with Israel, as well as being progressively added to about a dozen other treaties by the Multilateral Instrument, e.g. UK on 1 January 2019. This provides:

> *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*

This new provision likewise does not deal with procedural matters and the OECD Commentary on that provision also does not assist, so similar problems will arise as in RCF for LPs investing in Australia from many other treaty countries. As this new provision is intended to replicate the outcomes of the 1999 OECD Partnership Report, the same result likely applies to other treaties without any specific provisions of this kind.

RCF can only rely on the ATO binding ruling if the alienation of property article is not applicable

Like the trial judge the appeal court on issue 6 reaches the conclusion that RCF nonetheless can potentially rely on the ATO ruling TD 2011/25 on a very similar factual scenario, and so indirectly on the partners' rights under the treaty but only because of the way the ruling is expressed to apply to the income generally (and not confining the benefit to the partners) and of the way the legislation makes rulings binding on the terms in which they are written. As the ruling in its terms is on the business profits article and conditioned on another article not applying, the court concluded that RCF could only rely on it if article 13 of the US treaty on the alienation of real property did not apply (see further below).

Unfortunately the ATO went out of its way to try to prevent this result, though without success. The ATO argued for the first time in the case on appeal that it was necessary for RCF to show that the partners were US residents and that they were not prevented from obtaining treaty benefits under the limitation of benefits rules in article 16 of the US treaty and thus failed to satisfy their onus of proof. The court rejected this argument for being made too late as otherwise RCF could have provided evidence to the contrary. (The approach of the court here is not easy to reconcile with its requiring the partners to prove they paid US tax discussed above – the court considered that in relation to this ATO argument there was evidence the partners were US residents.) The ATO also argued that because RCF was not US resident it was excluded from reliance on the ruling but because of the way rulings bind the ATO and one of the examples in the ruling concerning a Caymans LP, the ruling was regarded by the court as implying that the LP is treaty protected in Australia and can rely on the ruling.

This ATO approach is unfortunate because the ATO seeks to assure foreign taxpayers that it will stand by this ruling but then when a matter gets to court seeks to use every possible argument, including ones that are bound to fail, for denying such benefits. As the judgment concludes that RCF cannot in law rely on the treaty apart from the ruling, the only basis for a limited partnership to assert treaty benefits is by applying the ATO's administrative approach even though this decision suggests that there is no basis at law to do so. If the Full Federal Court's decision stands, there needs to be a better approach – ideally a legislative fix to ensure that the LP on behalf of the treaty based partners is able to assert treaty benefits should be made.

Source of income

As RCF's profit was accepted as being on revenue account the question of source is relevant to its assessment under domestic law (issue 4), as opposed to CGT where the question is whether the asset is taxable Australian property.

The trial judge quoted the usual authorities about source being a practical hard matter of fact and noted that while the *Income Tax Assessment Act 1997* (**1997 Act**) added the words "directly or indirectly" to the provision taxing non-residents on ordinary income sourced in Australia those words did not add anything to the existing law under which both proximate and non-proximate factors were relevant to source.

Many relevant facts occurred overseas (decisions and oversight of the investment, listing of the shares that were sold on the Toronto Stock Exchange, and negotiation and settlement of the sale transaction overseas in Canadian dollars) but the assets effectively sold were all in Australia, there was also on-the-ground management of the investment and supervision of the company in Australia in the interests of RCF, and the sale transaction involved a court approved scheme of arrangement that was organised and carried out in Australia. On balance the trial judge considered the latter facts led to the income being sourced in Australia.

The appeal court by contrast adopted an approach that the proximate cause was most relevant to the determination of source and that this approach pointed to the on-the-ground supervision and management and the scheme of arrangement, though they also said that as source is a matter of fact there was no reason to disturb the finding by the trial judge.

The ATO is no doubt pleased that, in a general sense, the decision confirms the approach in its public ruling TD 2011/24 on source in the private equity context, but there is little in the way of specific guidance in the judgment on how to draw these lines. The example in that ruling had more of the facts in Australia and so in this case source is a more finely balanced issue which could yet go against the ATO if there is a further appeal.

So it is perhaps surprising that the treaty sourcing rule in the US treaty was not raised in the case, given that the ATO has recently twice successfully litigated the source issue on the basis of the sourcing rule in Australia's treaties. Or perhaps not, as the US treaty also contains an apparently conflicting rule which is common in US treaties and is usually referred to as the "anti-aggravation" rule.

The sourcing rule is to the effect that anything Australia can tax to a US resident under the treaty is deemed for the purposes of Australian domestic tax law to be sourced in Australia even if it would not otherwise have an Australian source. The anti-aggravation rule says that the treaty "shall not restrict in any manner any exclusion, exemption, deduction, rebate, credit or other allowance" provided by domestic law. Does this cover the domestic law source rule? This is another area of uncertainty for US private equity and venture capital investors in Australia under the US treaty.

Note that the recently signed treaty with Israel does not contain the usual sourcing rule and that the 2019 budget announced that a general sourcing rule presumably to the effect of the treaty sourcing rule will be included in the *International Tax Agreements Act 1953* (**Agreements Act**) when the Israel treaty is legislated into domestic law. This likely signals a change in the drafting approach but not in the policy that if a treaty permits Australia to tax a non-resident, then the income is deemed to be sourced in Australia for domestic law purposes.

Alienation of property article in tax treaty

On the topic of whether article 13 of the treaty was applicable in the case, the trial judge adopted another unusual approach when considering the interaction of article 13 of the treaty, a related provision in the Agreements Act and domestic law on capital gains in Division 855 of the 1997 Act. He said:

> *the better view is that Division 855 is permitted within the terms of Article 13(1) notwithstanding that different terms are used in Division 855 to achieve the imposition of tax permitted to Australia by Article 13(1).*

This led the trial judge to read article 13 as if it incorporated Division 855, even though he had already held that RCF's profit was ordinary income. With respect, this gets the questions back to front. In a tax treaty case the general approach (putting aside the treaty sourcing rule referred to above) is to ask whether Australia can tax the ordinary income or capital gain under domestic law apart from the treaty, and then whether the treaty prevents or limits taxation that would otherwise arise under domestic law. That is, the application of ordinary income or the operation of the capital gains tax for non-residents is considered first and it is only if tax would arise under domestic law that the treaty normally becomes relevant. The language of "permitted", while accurate in one sense, is apt to mislead as was made clear in earlier RCF litigation where the Full Federal Court found that the trial judge who had used similar language had erred in taking it as meaning that Australian domestic tax law could only tax the partners and could not tax the LP. The court held that the treaty did not have that effect and the question was whether the treaty limited Australian tax that otherwise was payable (which had not been argued to be the case on the taxpayer's side in that earlier case).

In the present litigation, the appeal court in relation to issue 6 went along with the approach of the trial judge even though it noted the approach "may not be entirely correct" because that is what the parties wanted and they had argued the case on that basis. With respect this also is not helpful in clarifying an important area of law in Australia.

There are two alternative routes by which a similar conclusion may be reached. Article 13 has a definition of real property giving it "the meaning which it has under the laws in force from time to time in Australia" which could then (on the view that "laws" means or includes the tax laws of Australia) lead to the definition of real property in Division 855 even though it is not directly applicable to the taxation of the taxpayer. Alternatively that definition also includes the meaning of real property in article 6 and article 6 in turn picks up a leasehold interest in land, which as it is not further defined could under article 3(2) "have the meaning that it has under the laws of" Australia.

By not exploring these alternatives but rather going down the very unlikely route adopted by the trial judge, the appeal court has not really taken the issue any further forward. In this context it is worth noting that the recent treaty with Israel has made a change to article 13 compared to previous Australian practice, by deleting the word "capital" from the residual clause in article 13. This would seem to have the effect that the residual clause in future will also cover revenue profits, which is probably not the case under the US treaty (another unresolved issue).

The trial judge and appeal court did agree in rejecting one of RCF's arguments on the interpretation of article 13, namely the incorporation of the article 6 concept of real property by the first inclusive extension applied to the subsequent extensions and not just the main part of the definition. Because of the way the judgments proceeded directly to domestic law from article 13, as explained under the next heading, it does not seem that this interpretation significantly affected the outcome in this case but it may in other cases.

Meaning of real property

By this unusual route the appeal court was led to the definitions of taxable Australian real property (**TARP**) and indirect Australian real property interests in Division 855 which in turn raised two further issues – which property of the Australian company was TARP and did the value of that property exceed the value of its remaining property. There was no argument about whether the requisite 10% interest was held by RCF as required by the definition of indirect Australian real property interest, even though at the partner level it is likely that each partner held less than 10%. While this issue was referred to in earlier RCF litigation it was not raised on this occasion.

On the TARP issue the definition of real property in domestic law specifically includes “a lease of land” and “a mining, quarrying or prospecting right” with the latter in turn defined by the general definitions section in the 1997 Act. The company had 13 mining leases and 2 general purpose leases, which gave rise on the facts to two interrelated questions: (a) were the general purpose leases real property; and (b) did the mining leases cover processing activities. The trial judge regarded the mining leases as real property but as not covering processing activities, while the general lease covering processing was not real property and the general purpose lease relating to a tailings dam was (probably) real property.

The appeal court’s decision on this issue occupies 35 pages of the 78 pages of the judgment, and mainly revolves around the specific nature of mining related leases and whether the processing activities in this case fell within the definition of “mining, quarrying or prospecting right”. Nevertheless the appeal court was unable to reach a definitive decision on all questions because of a lack of critical evidence in the form of the actual terms of the leases. It thought the mining leases probably covered processing activities, but that if they did not, the general purpose lease covering processing activities was TARP on two grounds, namely that it was “a right to mine minerals for the purposes of subpara (a), or perhaps subpara (b)” of the definition of mining, quarrying or prospecting right and that it was a lease of land. Because so-called “leases” related to mining are often not technically a lease of land, the joint judgment of the appeal court made clear that the second ground was not critical to their overall conclusion and Davies J refrained from expressing any view of this ground.

It is apparent from the judgment that many of the questions covered in the lengthy analysis are contentious and that another court may decide them differently. The main general concern is the view that processing is part of mining as there are many other cases where processing has not been so treated. The court suggests that this result may flow from the particular chemical nature of lithium (it never exists in its raw state as it is chemically unstable) and that the extraction of lithium from the ore and its incorporation into another stable compound was accordingly an inherent part of the mining process. To what extent this will apply to others types of mining is not clear.

Valuation

As noted above the characterisation of assets as TARP or not led into the relative values of the TARP and non-TARP assets of the company (issue 7 in the appeal court decision), which was the subject as always of expert evidence. The ATO valuer treated all leases as TARP, took the sale price of the shares as the value of all assets of the company and subtracted the non-TARP assets over which there was little disagreement on value (except in a minor way goodwill) to get a value of the TARP assets in excess of the non-TARP assets. RCF’s valuer used a life of mine discounted cash flow method, separating the company’s activities into upstream (mining which is TARP) and downstream (processing which is non-TARP), calculated the value of the downstream assets (using assumed returns on capital and including various adjustments one being for the period after the current mining leases expired in 2028 which was assigned to downstream activities) and subtracted the downstream value to get the upstream (TARP) value (using a net back method to find the value of the mined but unprocessed ore at the crossover point from mining to processing).

The appeal court rejected the approach of RCF's valuer for several reasons. First, following from the discussion under the previous heading the approach misclassified assets between TARP and non-TARP as it excluded the general purpose lease relating to processing and the assets used for processing from TARP, whereas the appeal court held they were TARP. Secondly, the netback method had not before been used for mining and although this did not exclude it automatically, it was "inapt to provide a reliable answer to the value of the mining leases" and TARP assets. In particular, there was no justification for the upstream/downstream divide, given the processed product that was the end purpose of the mining due to the particular nature of lithium. Thirdly the method used fictional rather than real assets at critical points especially the adjustment for post 2028 mining and also misallocated the post 2028 value adjustment to downstream activities.

It seems that the appeal court thus accepted the ATO valuer, or it may be that RCF was seen as failing to discharge its onus on the valuation issue. As in some other sections of the judgment, while the outcome on specific points is usually clear, how those points combine to produce the overall conclusion on a particular issue is not.

More fundamentally the RCF case shows that the characterisation of mining company assets and valuation of such assets continue to be constantly recurring problems in state and federal revenue laws. The RCF cases and the recent High Court stamp duty decision on similar issues in the Placer Dome Inc. case may suggest that revenue authorities, which in the past did not fare well on valuation issues in litigation, are now being more successful before the courts.

Conclusion

Given the contentious nature of the issues raised in the RCF appeal and the continuing litigation on them for some time now, the use of a 5 person court by the Federal Court in this appeal is welcome as it can produce a more authoritative decision. Such courts are being used more frequently in tax cases over recent years.

It is unfortunate, however, that litigation tactics and both parties pushing many specific issues seem to get in the way of the courts being able to resolve some important issues satisfactorily.

- When many issues are on the table, the evidentiary demands for their full resolution are enormous and it turns out here with the benefit of hindsight that important evidence was missing on some issues, for example, the terms of the leases.
- Multiple issues also produce many alternative pathways to the resolution of a case, meaning that the parties will often agree on certain answers which may turn out to be wrong or at least questionable – in this case the agreement to use Division 855 to interpret article 13 without adequately exploring the basis for doing so means that we are still a long way from clarity on the operation of tax treaties with respect to foreign investors.
- Australia's treatment of most LPs as companies for tax purposes creates constant problems when most countries from which investment into Australia originates treat them as tax transparent, in particular the interpretation of the specific US treaty provision on the issue and a practical procedure by which foreign partners in LPs may assert their treaty rights remain unresolved by the RCF decision.
- When shares in mining companies are involved characterisation of assets and valuation issues are particularly acute, and consume enormous resources on both sides, without solving similar issues for future cases.

These difficulties suggest that the time has been reached for greater efforts to be made by the ATO and the tax profession to come up with solutions or at least resolution pathways to the thicket of technical and practical issues involved.

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G&HSF document ID 511141294

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