5 April 2019

Global Tax Alert

Australia: Taxation of exit gains made by offshore funds – RCF IV appeal

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Executive summary

On 2 April 2019, the Full Federal Court of Australia in *Commissioner of Taxation v Resource Capital Fund IV LP*[1] clarified a number of issues raised by the Federal Court single judge (Pagone J) decision in *Resource Capital Fund IV LP v Commissioner of Taxation*[2] relating to exit gains made by Cayman CLP vehicles Resource Capital Fund (RCF) IV and V on an investment in shares in lithium producer Talison Lithium Limited.

This Tax Alert summarizes certain international taxation propositions arising, issues in contention and matters requiring clarification. A separate Tax Alert will cover the valuation issues explored in the decision, as pertains to the mining and metals sector.

Relevantly, for fund managers, the Full Federal Court decision confirms:

- Treaty qualified investors investing via fiscally transparent limited partnership structures may take comfort from the Full Federal Court decision as it confirms that the limited partners (LPs) are entitled to rely on treaty benefits.
- An offshore corporate limited partnership (CLP) is the entity which can be assessed and is liable to pay tax.

- The determination of the source of a gain on the disposal of shares by an offshore CLP fund remains dependent on the specific facts and circumstances, however it appears that the place of contract formation for the disposal is a central consideration.
- The decision is also a reminder that under Australian tax law, the LPs in an offshore CLP are jointly and severally liable for the Australian income tax liabilities of the partnership.

It is expected that the ATO will issue a decision impact statement in due course to clarify their view on the judgment. EY has reached out to the ATO and will continue to liaise with them.

Detailed discussion

Relevant facts

In March 2013, RCF IV and V made a gain on the disposal of their interests in Talison Lithium Limited, an Australian company engaged in the production of lithium, with projects in Western Australia and Chile. RCF IV and V are Cayman Islands corporate limited partnerships (CLPs). The Commissioner of Taxation issued assessments to the partnerships directly, levying Australian income tax on the gains made by those funds on the disposal, and the proceedings relate to RCF IV and V's objections to those assessments.

Continued uncertainty regarding the taxation of collective investment vehicles involved in cross-border investment into Australia, particularly those that are tax transparent in their country of formation, and substantially invested into by residents of countries with sophisticated financial services industries and broad networks of tax treaties directed at the avoidance of double taxation and fiscal evasion, was again in sharp focus. In this instance, 97% of the investors in the subject funds were accepted as being tax resident in the United States (US), and thereby potentially eligible for relief from Australian tax according to the provisions of the Australia-US tax treaty.

As will be seen, there was a fundamental disagreement between the parties concerning whether the shares disposed of represented an indirect real property interest. Australia and its agencies have steadfastly maintained jurisdiction to tax gains made by nonresidents on such interests. Once drawn into dispute regarding this issue, it appears both parties "took no prisoners" in the ensuing litigation, dragging into debate matters hitherto thought to have been settled.

This Alert highlights four key issues that emerge from the decision.

1. Is a corporate limited partnership a separate taxpayer liable to tax?

The first instance Judge held that a CLP was not a "taxable entity," as it had no legal existence outside of the contractual arrangements existing between the general partner and the limited partners. Therefore only the partners (be they general or limited) could be brought to tax on the profits or gains of the partnership.

The Full Federal Court has overturned this position, confirming:

- Nowhere in the legislation does the concept of "taxable entity" appear.
- A CLP is both a "taxpayer" and a "person" for the purposes of Part IVC of the *Taxation Administration Act 1953*.
- Because the Australian tax law requires the computation of the CLP's tax liability be determined as though the CLP were a company, it is appropriate for the tax assessment to be issued to the CLP.

This aspect of the decision is likely to be welcome news for LPs in offshore CLPs, as the first instance decision arguably required them to file income tax returns in Australia to access treaty benefits. The Full Federal Court has confirmed that the taxpayer is the CLP itself, with the joint and several liability enlivened by section 94V of the *Income Tax Assessment Act 1936*, merely acting as a collection mechanism in the event that there is a shortfall of tax payable by the partnership itself.

2. Is the gain on the disposal of shares in a portfolio company Australian sourced ordinary income?

Taxation Determination (TD) 2011/24 provided that the source of a gain made on the disposal of shares in a company is to be determined by, among other matters, the place of economic activity of the company, rather than solely by reference to the activities of the shareholder.

Based on the specific facts and circumstances pertaining to RCF IV and V, the Court held that the gain made by RCF IV and V was ordinary income with an Australian source. The analysis around the nature of the profit (as revenue or capital gain) and the source of gains (as being Australian or foreign to Australia) is and remains a factual question.

Simply because the specific factual circumstances of RCF IV were decided this way does not mean that all private equity exits by offshore CLPs will necessarily result in the same conclusion.

The taxpayer brought in evidence that:

- The investment committee was based in Colorado
- The shares in the portfolio company were listed on the Toronto stock exchange
- The decisions and negotiations leading up to the sale took place outside of Australia
- The limited partners in the fund were passive

The Full Federal Court was not persuaded by those facts, and noted at paragraph 60:

RCF Management Australia employees played "an active role in the management, including the ultimate disposal, of the investment". And whilst it is true that those employees were not employed by [the taxpayer], they were employed by a company which, inferentially, was ultimately controlled by [the taxpayer] or, at the very least, existed to serve the interests of [the taxpayer]. In substance as a "practical" matter, those employees helped manage the investment in Talison Lithium for [the taxpayer].

A central factor appears to have been that the divestment by RCF IV and V of its shareholding in Talison Lithium was made pursuant to an Australian Court approved Scheme of Arrangement, leading the Full Federal Court to conclude that the proximate source of the emerging profit was in Australia.

A private equity fund structured as an offshore CLP would unlikely exit a portfolio company by an Australian court approved Scheme of Arrangement, raising the question whether an Initial Public Offering (IPO) in Australia might have an Australian source (by reference to the amount of Australia-centric activity required to undertake an Australian IPO).

Our view continues to be that the source of the gain made on every divestment will be determined on its specific facts and circumstances, and the question of source should only be relevant to the extent to which treaty benefits are not available to investors.

3. Is an offshore limited partnership able to rely on the Australia-US Double Tax Agreement (DTA)?

In order to rely on the DTA, and following on from the conclusion that the appropriate taxpayer was the offshore CLP rather than the LPs, the majority of the Full Federal Court required RCF IV and V to be both a tax resident and liable to pay tax in the US. The Court did not consider the fact that the central management and control of the fund being located in the US (in and of itself) is sufficient for the purposes of tax residency under the DTA.

RCF IV and V did not tender any evidence to suggest that the tax residency of RCF IV or V was in the US, and the Court acknowledged that the offshore CLP was incorporated in the Cayman Islands and governed by the local laws of that jurisdiction.

As such, in the facts before the Court, RCF IV and V were unable to rely on treaty benefits directly at law. However, that does not mean the treaties are irrelevant to the analysis for the reasons below.

4. Application of treaty benefits to investors, and the Commissioner is bound by his tax rulings

TD 2011/25 confirmed that the business profits article (Article 7) of Australia's tax treaties applies to Australian sourced business profits of an offshore CLP which is treated as fiscally transparent in a country with which Australia has entered into a tax treaty to which the LPs are residents.

The Full Federal Court has confirmed that treaty qualified investors in a Cayman Islands CLP are entitled to benefit from treaty relief on exit gains realized on Australian assets. That is, if treaty benefits apply to an investor, and the relevant article is the business profits article (as opposed to the alienation of real property article), then LPs can rely on the treaty to allocate taxing rights to their home country.

While the Full Federal Court was equivocal as to whether TD 2011/25 was correct at law to allow the CLP itself to rely on treaty benefits (as opposed to the limited partners), it confirmed that RCF IV and V were nevertheless entitled to rely on the Ruling, as the Australian tax law provides that the Commissioner is bound by a ruling that applies to a taxpayer and upon which that taxpayer has relied.

Accordingly, the Commissioner is bound by his conclusions in the Ruling for any taxpayer who has relied on it, including a CLP with treaty-qualified LPs.

This appears to be a sensible administrative practice because it would seem to be inefficient to collect Australian income tax from an offshore CLP only for the LPs to file in Australia to seek a refund of their proportionate share of the tax assessed on the limited partnership. Accordingly, the ATO should retain the administrative concession provided by TD 2011/25, or alternatively release an administrative guideline, to provide certainty that their approach will remain unaltered following the decision.

As noted above, EY has reached out to the ATO, and will continue to liaise with them on these matters.

Endnotes

1. [2019] FCAFC 51.
2. [2018] FCA 41.

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EYG no. 001615-19Gbl

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