# Taxation Update

## Taxation Uncertainty on Foreign Private Equity



Tuesday, 27 May 2014

**Taxation Uncertainty on Foreign Private Equity**

A recent decision of the Full Federal Court (*FC of T v Resource Capital Fund III LP* [2014] FCAFC 37 (3 April 2014)) highlights the mismatch between what the ATO will do in litigation seeking to collect tax (in that case, against a Cayman Islands Limited Partnership), as against the views it has expressed in a binding public ruling (TD 2011/25 which says that the proper taxpayers were the members of a Cayman Island Limited Partnership where the LPs profit is on revenue account). It is also the sequel to the profits made on the Myer float leaving the country the day before the ATO sought freezing orders in that case.

As the Cayman Islands is a popular jurisdiction for foreign private equity funds, any ultimate appeal in this case will be important not only for such funds investing into Australia, but also as a judicial precedent of interest world-wide on the interpretation of double tax agreements (DTAs) with reference to the OECD Commentary on its Model DTA.

Myer Float

In the Myer float case, Texas Pacific Group had structured its clients' investment into the Myer Emporium department store chain, via a Cayman Islands entity into a Luxembourg entity, which in turn owned a Dutch company, which was the investor into Australia. After having failed to stop the profits on the re-listing of Myer from leaving Australia, the ATO issued three binding public rulings so its position on that type of transaction would be publicly known. TD 2010/20, TD 2010/21 and TD 2011/24 do not refer to specific taxpayers, but they are clearly directed at the Myer situation. TD 2010/20 said that the proper taxpayer in that case, was the Cayman Islands entity as the general anti-avoidance provision applied to allow the ATO to disregard the interposed entities. TD 2010/21 said that the profit was on revenue rather than capital account. TD 2011/24 said the profit had an Australian source.

Double Tax Issue

The effect of the decision in the *Resource Capital Fund III LP* case is to potentially double tax the capital gain made by Resource Capital Fund III LP (RCF), in circumstances where a double tax agreement (DTA), according to the OECD Commentary, should have prevented that result.



Level 14/565 Bourke Street Melbourne Vic 3000 - Phone 03 9614 7707 Fax 03 9614 6676

It is not yet known whether the taxpayer will seek special leave to appeal to the High Court.

The decision concerned a private equity fund investment into an Australian listed mining company, structured as a Cayman Islands limited partnership, of which 97% of the members were acknowledged to be US resident parties. The first question was whether the Australia /United States DTA had the effect of preventing Australia from taxing the limited partnership (which for Australian domestic tax purposes is treated as a company), and whether it also had the effect of allowing Australia to tax the limited partners. The parties agreed that the profit was on capital account, which was not a foregone conclusion if regard was had to TD 2010/21 directed at the Myer situation. At first instance Edmonds J said in relation to the two questions, Yes and Yes. On appeal, the Court held unanimously, No and the second question was not necessary to answer.

Who is the proper taxpayer?

The dispute arose because the ATO assessed the limited partnership, and not the partners. It appears that it would have done that because at the time it raised the assessment, it would not have known who the limited partners were, and it had obtained freezing orders to prevent the profits being remitted overseas, to avoid the embarrassment suffered by the ATO in Nov 2009 concerning the profits made on the Myer float leaving the country the day before the ATO sought freezing orders in that case.

Taxable Australian Property

The second issue dealt with in *Resource Capital Fund III LP* case was whether the shares in the investee company, St Barbara Mines Limited, were "taxable Australian property" under Div 855, which turned on whether the value of the underlying "real property" assets of St Barbara Mines Limited was more than 50% of its total assets. The issue was the valuation methodology. The appeal court overturned Edmonds J on that issue also. For present purposes, it is only necessary to observe that unlike the previous private equity dispute concerning the profits made on the Myer float being on revenue account (see TD 2010/20), it was not in contest in the *Resource Capital Fund III LP* case, that the gain was on capital account.

Freezing Orders

TD 2011/25 was the finalisation of a draft taxation determination TD 2010/D8 which draft issued on 1 Dec 2010 i.e. less than a month after the ATO sought the freezing orders against RCF (see *FC of T v Resource Capital Fund III LP* [2010] FCA 1247). Press reports on 15 Dec 2010 indicated that a confidential settlement resulting in lifting of the freezing orders took place, apparently in return for the assessments being reduced in quantum. The reports don't say whether RCF gave any security to the ATO in return, but it is highly unlikely that that the ATO would have agreed to release the freezing order without obtaining significant security.

TD 2011/25 (consistent with the draft) ruled that "business profits" of a Cayman Islands limited partnership that had treaty country residents (e.g. US persons) as its members, was not subject to Australian tax, but rather the members were, on the basis of a consideration of the OECD Commentary on the treatment of tax transparent partnerships under DTAs. The Full Court held that TD 2011/25 did not bind the Commissioner as it only discussed Article 7 "business profits" and not Article 13 "capital profits". However, the Full Court failed to note that the logic of TD 2011/25 was equally applicable to capital gains under Article 13.

With the greatest respect, it seems that the Full Court has not been prepared to apply the OECD Commentary when to do so may have resulted in a release of whatever security the ATO may have held, without the certainty that the limited partners would pay any tax,

which on the basis of the OECD Commentary, might properly have been payable by them. However, the Full Court did not reach its conclusion on the basis that the Commentary cannot override the wording of the DTA, but on the premise that the DTA has no effect on the application of the Australian domestic law, because RCF was not a tax resident of the US.

Double non-taxation

Private equity is said to often be raised from US pension funds, who don't pay tax in the US. The case decision does not reveal the composition of the membership of RCF, but if they were largely US pension funds, if RCF didn't have a liability to Australian tax, it might have resulted in what is now referred to as "double non-taxation". This is a significant focus on the current OECD Base Erosion and Profit Shifting (BEPS) project. Whilst originally it was stated that DTAs were for the purpose of prevention of double taxation, and secondly, for the prevention of fiscal evasion, the concept that DTAs are not to give rise to "double non-taxation" is relatively new. The whole push against the likes of Google is that for source countries to give up taxing rights in favour of the country of residence, the country of residence should exercise its right to tax. In the case of the US that foreign source income isn't taxable in the US until paid back to the US (which such companies don't generally do), and indeed in Australia's case, if a company such as Google was an Australian resident, the dividends coming back to the parent company would not be taxable even then (s23AJ), but only on on-payment to resident shareholders.

How to tax limited partners?

The other unstated issue in the decision is that had the US resident members of RCF held their interest in St Barbara Mines Limited directly, only those with at least a 10% indirect interest in that company would have been potentially liable to Australian capital gains tax.

By holding their interest through RCF, another issue under the Australian domestic law is that the member of RCF would not make a capital gain for Australian domestic law purposes, just because RCF did. Even when they had their membership interest redeemed, at that time their membership interest may not have been "taxable Australian property" as RCF at that time may not have held any direct or indirect interest in "taxable Australian property".

Alternatively, distributions to members of RCF out of the Australian source capital gain would be taxable to non-resident members in the deemed company, as an assessable dividend (s44(1)(b)(i)), but as RCF was not a resident, there would be no requirement for RCF to withhold dividend withholding tax (Sch 1 s12-210 TAA).

Further in the alternative, if the profit of the US parties was not a capital gain, nor a dividend, there would potentially be scope for Australia to tax those parties on the basis that they had "other income" with an Australian source, which Australia is permitted to tax under Art 21(3) of the Australia / US DTA.

Summary

So in summary, the Full Court decision could have been justified on the basis that the OECD Commentary should only be followed if Australia had the right to tax the members of RCF under the Australian domestic law, but that issue was left unresolved.

Another reason the Full Court could have given for not following the OECD Commentary, is it is sometimes made up as the OECD goes along. The OECD has changed the Commentary to deal with emerging issues without changing the text of the Model DTA. For instance, the justification of the use of controlled foreign corporation (CFC) rules as not offending DTAs (Commentary at [23] inserted in 2003) is a rationalisation of the member States of their practice,

arguably, in direct contradiction of a more natural reading of the text of the DTAs.

It is hoped that if the taxpayer seeks special leave to appeal to the High Court, it will get a better reaction than the denial of special leave from the decision in *Russell v FC of T* [2011] FCAFC 10, which was another case which could have explored the interaction of DTAs with the domestic law.

*As the Cayman Islands is a popular jurisdiction for foreign private equity funds, any ultimate appeal in this case will be important not only for such funds investing into Australia, but also as a judicial precedent of interest world-wide on the interpretation of DTAs with reference to the OECD Commentary.*

*Pointon Partners has significant expertise in international and domestic tax.*

If you have any further queries regarding the above, please contact Robert Gordon or Tony Pointon of our office.

**Written by:** **Robert Gordon**
rmg@pointonpartners.com.au
**Reviewed by:** **Tony Pointon**
adp@pointonpartners.com.au

Direct your enquiries to the above or your contact at **Pointon Partners**:
www.pointonpartners.com.au

**If you find this article of interest, forward to a colleague.**