Australian court rules that limited partners are the relevant taxpayers for gains realized by a limited partnership

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In brief

The Australian Federal Court recently held in *Resource Capital Fund III LP v Commissioner of Taxation [2013] FCA 363 (April 26, 2013)* (*RCF*) that the limited partners of a Cayman Islands limited partnership (LP), not the LP itself, are the relevant taxpayers with respect to the gain the LP made on its disposal of an Australian investment.

Essentially, the *RCF* case confirms that it is possible to look through an LP to identify the relevant taxpayer for purposes of applying a tax treaty. Therefore, when US investors invest into Australia through an LP, they might be able to apply the Australia-US double tax treaty when determining whether the gain on disposal of the Australian investment by the LP should be subject to Australian tax.

In detail

The Australian Federal Court on April 26 upheld RCF's appeal against the Commissioner who had disallowed RCF's objection to the assessment of income tax and penalties. The appeal to the Federal Court primarily concerned the Australian tax treatment of a capital gain made by a private equity fund (RCF) on the sale of shares in an Australian mining company.

The facts

RCF was a Cayman Islands LP formed in the Cayman Islands with more than 97% of the LP's contributed capital held by US residents, principally funds and institutions. For US tax purposes, RCF was treated as a 'fiscally transparent' or 'flow-through' entity not subject to US tax.

During the 2008 tax year, RCF sold shares in St Barbara Mines Ltd (SBM).

The Commissioner assessed RCF (as a company) for the gain on the sale. The Commissioner reasoned that RCF was not an Australian resident, and that the capital gain was not exempt from the capital gains tax (CGT) under the non-resident CGT exemption because the market value of SBM's assets that relate to Australian land or interest in land exceed the market value of the company's other assets and RCF owned more than a 10% interest in SBM.

The issues

The principle issues considered by the Federal Court were:

- whether the Commissioner was prevented from issuing an assessment to RCF because of the Australia-US double tax treaty; and
- whether the capital gain should be disregarded under the Australian domestic CGT exemption discussed above;

this issue turned on various valuation methodologies regarding the Australian land assets.

The decision

The Court allowed RCF's objection against the assessment on the basis that issuance of the assessment to RCF was precluded by the tax treaty. The Court reached this view based on general principles of interpretation of double tax treaties established in case law.

The Court noted that the purpose of the tax treaty is to avoid double taxation of income of US and Australian residents and that this policy objective would not be achieved if Australia was authorized under Article 13 of the tax treaty (taxation of income or gains from the alienation of 'real property'), to tax the gain to RCF. This was because the US resident limited partners in RCF would be liable to US tax without credit for the Australian tax assessed to RCF on the gain.

The Court said that by authorizing Australia to tax a gain in the hands of the US-resident limited partners in RCF, the tax treaty recognized Australia's taxing right while providing, in Article 22(1), a credit for any Australian tax suffered as a result if the exercise of that right. This therefore prevents double taxation of the gain.

The Australian Taxation Office (ATO) had previously released Taxation Determination TD 2011/25, which is consistent with the Court decision. The ATO believes the tax treaty applies to Australian-source business profits of a foreign LP when the limited partners are resident in a country with which Australia has a tax treaty (treaty country) and the LP is treated as fiscally transparent under the treaty country's tax laws.

In light of its conclusion that the tax treaty prevented the Commissioner from assessing RCF on the gain, the Court did not have to consider whether the Australian CGT exemption is available with respect to disposal of the SBM shares.

Although the judgment did confirm that it is possible to look through an LP, it did not provide any commentary on:

- Whether RCF held the investment in SBM on 'revenue' or 'capital' account; the judgment refers to all gains arising to RCF as capital gains. This may imply that the foreign private equity fund held its investment on capital account. This is inconsistent with the ATO's statement in Tax Determination TD 2010/21 that gain realized by a foreign private equity fund is generally on revenue account, but this issue does not appear to have been raised in the *RCF* case
- Whether the gain arising on the share disposal had an Australian source
- Whether RCF was required to file an Australian income tax return with respect to the gains attributable to the limited partners in countries that do not have a tax treaty with Australia.

The takeaway

The *RCF* case confirms that when US investors invest into Australia through an LP, they might be able to apply the Australia-US tax treaty when determining whether the gain on disposal of the Australian investments should be subject to tax in Australia. This requires the LP to be treated as a 'fiscally transparent' entity for US tax purposes.

It is not known whether the Commissioner will appeal the Federal Court decision. We will continue to monitor developments in this case.

Let's talk

For a deeper discussion, please contact:

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