# Limited Partnerships and Treaty Benefits – Resource Capital Fund IV: Pagone J and Full Federal Court

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# 1. Introduction

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 through limited partnerships (LPs). Once again their efforts have been on the receiving end of an adverse Full Federal Court decision[1] after winning at first instance.[2]

The five-member bench of the Full Court has made progress in rejecting some of the surprising views of the primary judge (Pagone J) 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, the judgments in the Full Court leave some important issues unresolved such as the application of the Australia-United States income Tax Treaty (1982) (Australia-US tax treaty) to LPs, a workable procedure by which partners in LPs can claim treaty benefits and the treatment of downstream mining activities in applying provisions equivalent to article 13(4) of the OECD Model. As a result, foreign investors are still some way from having reasonable certainty about the tax treatment of their Australian investments.

# 2. Facts of the case

Briefly the facts were that two funds, Resource Capital Fund IV LP and Resource Capital Fund V LP (collectively RCF) held[3] respectively 23.1% and 13.1% of the shares in an Australian resident company which was listed on the Toronto Stock Exchange. The company had a 100% subsidiary carrying on its main business of lithium mining. Lithium is an unstable element which has to be converted from its presence in an ore body into another compound to be useful for other purposes (which – probably – turns out to be significant in the case).

The funds were formed in the Cayman Islands but the private equity group concerned was generally managed in the United States 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 takeover under a scheme of arrangement approved by an Australian court with the purchaser being a Chinese company.

1 AU: Federal Court of Australia (Full Court), 2 April 2019, *Commissioner of Taxation v Resource Capital Fund IV LP* [2019] FCAFC 51 (RCF IV (2019)). The taxpayers' application for special leave to appeal to the High Court of Australia was refused.

2 AU: Federal Court of Australia, 5 February 2018, *Resource Capital Fund IV LP v Commissioner of Taxation* [2018] FCA 41 (RCF IV (2018)).

3 The limited partnerships were members of a consortium which acquired the assets of a bankrupt Australian mining company. The corporate structure for the investment went through several iterations before RCF came to hold the shares in the listed company that were sold.

Unusually compared to many other countries Australia generally taxes LPs as companies under domestic tax law rather than as tax transparent – or at least that is what everyone thought before the decision at first instance in this case.

## 3. Decision at first instance and questions on appeal

At first instance Pagone J held that:

1. The partners in RCF were the relevant taxpayers in Australia;[4]
2. The profits were on revenue account and were assessable as ordinary income subject to the impact of the Australia-US tax treaty;[5]
3. The profits were sourced in Australia;[6]
4. The partners could assert treaty rights under the Australia-US tax treaty;[7]
5. The business profits article applied to exempt the partners from Australian tax as it was agreed by the parties that there was no PE in Australia (to the extent that the business profit was not covered by another distributive rule);[8]
6. The partners could rely on an Australian Taxation Office (ATO) public ruling TD 2011/25 (on Cayman LPs and the treaty) which stated that in analogous circumstances Australia could not tax the profit as the LP did not have a PE in Australia unless the alienation of property article applied;[9]
7. The profits would fall within article 13 (alienation of property) of the Australia-US tax treaty with the result that Australia had the right to tax them if the shares were "real property";[10]
8. The shares were not "real property" within the extended meaning in article 13(2)(b)(ii) which meant that article 13 did not apply but the business profits article applied with the result that Australia could not tax the profits and the taxpayer won.[11]

There was no contest on appeal that the profit on the investment was ordinary income as opposed to capital gain. The reasoning of the judge at first instance is discussed in more detail below in the context of those issues that were raised on appeal. The questions on appeal according to the court were:

- Issue 1 Are Corporate Limited Partnerships liable to tax
- Issue 2 Who was assessed

4 RCF IV (2018), paragraphs 9–18.

5 Ibid paragraph 50. Under Australian domestic law gains made in carrying on a business are considered to be "ordinary income" and are included in a taxpayer's assessable income under Income Tax Assessment Act 1997 s6-5. Where the gain is also the product of a "CGT event" it could also prima facie give rise to a capital gain. In these circumstances Income Tax Assessment Act 1997 s118-20 would normally prevent double taxation by reducing the capital gain to zero.

6 Ibid paragraph 51–53.

7 Ibid paragraphs 54–64.

8 Ibid paragraphs 54–75.

9 Ibid paragraphs 65–75.

10 Ibid paragraphs 76–79.

11 Ibid paragraphs 80–124.

- Issue 3 Contestability of the tax
- Issue 4 Source of the profit
- Issue 5 Could RCF rely on the Australia-US treaty in the current proceedings
- Issue 6 Could 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.[12]

The answers are contained in a joint judgment of four[13] of the five judges and a short generally concurring judgment from Davies J, although Davies J disagrees on one issue and does not consider it necessary to decide another two issues.

# 4. The Full Court Decision

## 4.1. LP is the taxpayer in Australia – Issues 1 and 2

At first instance it was argued that the partners in RCF were the taxpayers in Australia not the LP. Pagone J adopted this view in his judgment, starting from the undoubtedly correct proposition that partnerships are not generally legal persons in Australia[14] and based on his reading of the tax legislation dealing with LPs. He regarded the relevant provisions as treating LPs as companies for essentially procedural purposes but not as creating a separate taxable entity.[15] The relevant assessments were regarded by the judge as being directed against the partners not against RCF.[16] The judge also decided that the earlier RCF cases which had proceeded on the contrary basis did not decide as a matter of precedent that LPs are companies for Australian tax purposes.[17]

The judge was obviously troubled by the concept of a legal construct which did not amount to a legal person being a taxpayer. Conceptually, however, there does not seem to be any reason why a legal construct which is not treated as a legal person generally in Australian law cannot be treated as a taxpayer/entity for tax purposes (or vice versa), although it is then necessary to spell out how to make connections between the relevant construct and human action. Australian tax law indeed is full of examples (such as the definitions of “company”, “partnership” and “trustee” for tax purposes) which are variations on this theme.

Issues 1 and 2 in the appeal arose out of these findings at first instance which were met with general surprise as they seemed to fly in the face of the terms of the spe-

12 RCF IV (2019), paragraph 4.
13 Besanko, Middleton, Steward and Thawley JJ.
14 RCF IV (2018), paragraph 3.
15 Ibid paragraphs 9–18.
16 Ibid paragraphs 19–22.
17 Ibid paragraphs 5–8.

cific legislative rules on LPs and the income tax legislation more generally. They are duly rejected by the appeal court on that basis.[18]

## 4.2. Source of income – Issue 4

As the profit on sale was accepted on appeal as being ordinary income the question of source is relevant to its assessment under Australian domestic tax law (as opposed to CGT where the question is whether the asset is taxable Australian property). The trial judge quoted the usual Australian authorities about source being "a practical, hard matter of fact" and noted that while the Income Tax Assessment Act 1997 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 organized and carried out in Australia. On balance the trial judge considered the latter facts led to the income being sourced in Australia.[19]

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.[20]

## 4.3. Could RCF rely on the treaty in the appeal proceedings – Issues 3 and 5

At first instance, given the decision that the profits were taxable under domestic law aside from the Australia-US tax treaty, the next questions involved whether the treaty or the legally binding ATO ruling on it, protected the partners from tax. Pagone J considered the issues both on the merits and on to what extent the ruling was binding on the ATO, concluding against the ATO on both questions.

The starting point of the treaty issue was whether the partners could assert treaty benefits. This was the difficulty in the case which prompted the line of argument

18 RCF IV (2019), paragraphs 5–41.
19 RCF IV (2018), paragraph 53.
20 RCF IV (2019), paragraph 66.

discussed above about who was the taxpayer in Australia. The United States taxed those partners resident in the United States and it was they who wished to assert rights under the tax treaty between Australia and the United States, not the (few) partners not resident in the United States. The judge's view that the partners were the relevant taxable entities in Australia meant that the problem of asserting treaty rights largely went away since the United States took the same view under its tax law.[21]

By contrast the approach taken by the appeal court on issues 1 and 2 raised technical and practical problems which it discussed in relation to issues 3 and 5. On the question of who claims treaty benefits it is generally necessary under tax treaties for a person to be a resident of a contracting state to claim benefits. While the term "person" is defined in article 3(1) of the Australia-US tax treaty to include a partnership, the definition of a US resident in article 4(1)(b)(iii) 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

This provision was an earlier variant (see article 4(1)(b) of the US Model 1981) of the fiscally transparent entity provision that first appeared in article 4(1)(d) of the US Model 1996 (subsequently moved to article 1 of the US Model 2006 and 2016), and is the origin of the new provision in article 1(2) of the OECD Model.

Several readings of this provision are offered in the judgments in this case. 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 subject to tax.[22] 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.[23] Instead it notes that as RCF was not taxed in the United States (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. As a result neither RCF nor the partners had established a right to treaty protection.[24] While there may have been no evidence of tax assessments being issued to partners in the United States, the whole case seems to have been run on

21 RCF IV (2018), paragraphs 54–64.
22 Ibid paragraphs 59–64.
23 RCF IV (2019), paragraphs 69–70.
24 Ibid paragraph 70.

the premise that the US resident partners were taxed in the United States (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 decisions on scant evidence as noted below.

Rather than elaborating this conclusion, the joint judgment on appeal goes on to offer a further reason why RCF is not able to rely on the treaty in these proceedings, the holding at first instance in the previous RCF case that the quoted part of the definition has a dual requirement that the LP itself be a US person (that is, created in the United States) as well as the tax requirement in the proviso.[25] As the RCF LPs were created in the Caymans they do not satisfy the US person requirement and thus cannot claim treaty benefits under this provision. Unlike that earlier decision, RCF did not apparently submit that alternatively it could rely on the approach in the Partnership Report which applies equally to partnerships created in the residence state of the partners and in third states. The implication seems to be that benefits flow under the provision quoted above for the LP or not at all under the Australia-US tax treaty.

According to the joint judgment this conclusion does not mean that the partners cannot assert their own treaty rights, just that they cannot do so in the normal appeal proceedings like the present against the assessment. 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 in argument that the partners could also commence proceedings for a declaration on which the joint judgment observed that a "partner would probably have standing."[26] 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.[27]

The outcome of the joint judgment is that there is at present no practical way 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. Hopefully courts in other countries with very strict procedural rules about who can challenge tax assessments will provide better outcomes. In Australia it may require a change to domestic law if the suggested route of declaration proceedings is found by a subsequent court not to be available.

25 Ibid paragraphs 71–74.
26 Ibid paragraph 75.
27 AU: High Court of Australia, 17 October 2014, *Resource Capital Fund III LP v Commissioner of Taxation* [2014] HCATrans 235, pp 8, 12–14 available at http://www.austlii.edu.au/au/other/HCATrans/2014/235.html.

Davies J, by contrast, disagrees with this view as she reads the words "such person" in article 4(1)(b)(iii) 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 Australia-US tax treaty in the current proceedings and presumably for that reason does not feel it necessary to express a view on issue 2.[28] 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.

In the light of the joint judgment's conclusion there is something to be said for RCF's position on issue 3 that the result is an incontestable tax from the partners' view (which may raise constitutional issues in Australia but only in a very narrow range of cases). As usual this argument is given short shrift – here on the basis that RCF can challenge the assessment by appeal,[29] but that rings very hollow if RCF is not allowed to invoke the treaty on behalf of the partners.

## 4.4. RCF can only rely on the ATO binding ruling if the alienation of property article is not applicable – Issue 6

The ATO legally binding public ruling TD 2011/25[30] on the topic determined that if the relevant income was covered by the business profits article and was derived through an LP with partners resident in a treaty country which regarded the LP as tax transparent, then those partners were not taxable in Australia on their share of the LP income if the LP did not have a PE in Australia. Pagone J noted that the ATO in the case in effect argued to the contrary of the ruling.[31] He held that the ruling did bind the ATO, as RCF produced extensive unchallenged evidence that it and the partners had relied on the ruling in this case, which was another reason for finding in favour of the taxpayer, subject to the question whether the alienation of property article applied.[32]

Issue 6 occupies the longest part of the judgment on appeal. Like the trial judge the appeal court reaches the conclusion that RCF can potentially rely on the ATO public binding ruling TD 2011/25 and so indirectly on the partners' rights under

28 RCF IV (2019), paragraphs 236–242.
29 Ibid paragraphs 49–50.
30 Available on the ATO legal database at https://www.ato.gov.au/law/view/pdf?DocID=TXD%2FTD201125%2FNAT%2FATO%2F00001&filename=law/view/pdf/pbr/td2011-025c1.pdf&PiT=99991231235958. The ruling is made legally binding on the ATO by Taxation Administration Act 1953 Schedule 1 section 357-60.
31 RCF IV (2018), paragraph 65.
32 Ibid paragraphs 66–75.

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 Australian tax legislation makes rulings binding on the ATO 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 Australia-US tax treaty on the alienation of property did not apply.[33] That leads to a lengthy analysis taken up below about the operation of article 13 and the meaning of taxable Australian real property in Australian domestic tax law.

Unfortunately the ATO went out of its way to try to prevent a finding that RCF could rely on the Ruling, though without success (compared to some other issues where the ATO was invited to but did not take up arguments which the court thought may have merit). 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 Australia-US tax treaty and thus failed to satisfy their onus of proof, which under Australian tax law is on the taxpayer.[34] The court rejected this argument on the grounds of it having 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 in relation to the ATO argument here that there was evidence the partners were US residents.)[35] The ATO also argued that RCF was not US resident and so was excluded from reliance on the ruling[36] 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.[37]

## 4.5. Alienation of property article in the tax treaty

On this question the trial judge was faced with the difficult questions arising in the application of the alienation of property article – difficult because they combine the domestic meaning of real property, a treaty extension of that meaning[38] and then a further extension in the treaty implementing legislation.[39] Pagone J

33 RCF IV (2019), paragraphs 81–95.
34 Ibid paragraph 88.
35 Ibid paragraphs 89–92.
36 Ibid paragraph 88.
37 Ibid paragraph 94.
38 Article 13(2)(b)(ii) of the treaty deemed "real property" for treaty purposes to include "shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia".
39 International Tax Agreements Act 1953 s3A which has the effect of extending the scope of articles such as Article 13(2)(b)(ii) of the 1982 Australia – United States Tax Treaty to indirect interests held through one or more interposed companies or other entities.

adopted another unusual approach when considering the interaction of Article 13 of the treaty and domestic law on *capital gains* in the Income Tax Assessment Act 1997 Division 855. He said:[40]

> 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, not capital gain. With respect, this gets the questions back to front. In a tax treaty case the general approach (putting aside the Australian treaty sourcing rule – see the chapter in this volume on that issue) 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. Since the inception of the federal income tax, Australian domestic law has contained provisions taxing Australian source business gains of foreign residents as ordinary income.[41] The treaty limited Australian taxation of those gains to those attributable to an Australian permanent establishment of the foreign resident except where another article (such as article 13) allowed Australia to tax those gains.

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 decision).[42]

In the present litigation, the appeal court went along with the approach of the trial judge even though it noted the approach "may not be entirely correct"[43] because that is what the parties wanted and they had argued the case on that basis.[44] With respect this also is not helpful in clarifying an important area of law in Australia.

40 RCF IV (2018), paragraph 78.

41 The provisions had been: Income Tax Assessment Act 1915 ss10 and 14(1)(a); Income Tax Assessment Act 1922 s13(1) and s16(a); Income Tax Assessment Act 1936, s25(1). After the 1982 Australia – United States Tax Treaty came into force equivalent taxing provisions were enacted in Income Tax Assessment Act 1997 s6–5.

42 AU: Federal Court of Australia (Full Court), 3 April 2014, *Commissioner of Taxation v Resource Capital Fund III LP* [2014] FCAFC 37, paragraphs 25–31.

43 RCF IV (2019), paragraph 101 where the majority judgment notes that Division 855 was not strictly speaking relevant as the case concerned ordinary income not capital gains or statutory income.

44 Ibid paragraph 102.