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Tax Treaty Case Law around the Globe 2015

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Tax Treaty Case Law around the Globe 2015

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Australia: Hybrid entities – Resource Capital Fund III LP Case

Richard Vann

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I. Introduction

Like many other countries, Australia has had to wrestle with the tax problems created by hybrid entities for some years now. The Australian Taxation Office (ATO) issued a binding public ruling in 2011¹ arising out of a private equity IPO of one of Australia's two main department store chains. Although the ATO emerged empty handed as the money had left the country by the time it took action, it issued a series of rulings based on its analysis of the situation, two of them dealing with treaties. In relation to the treaty approach to hybrid entities, the ATO accepted the reasoning of the OECD Partnership Report² and held that US resident investors in a Cayman Islands limited partnership (LP) that was fiscally transparent for US tax purposes were entitled to the benefits of the Australia – United States Tax Treaty, even though Australia taxed the LP as a company.

As is well known, the Partnership Report and subsequent Commentary changes³ sought to provide a framework for the application of treaties to partnerships that are characterized in different ways by the relevant jurisdictions. Under these changes the OECD takes the view that where:

- the country in which the partners are resident regards an entity as a tax-transparent partnership; and
- the country in which the income arises regards it as a non-tax-transparent non-resident company;

the latter country (here Australia) should apply its treaty with the residence country of the partners.

If this were not the case, there would usually be no treaty protection as the partnership itself would not be a resident of any country for treaty purposes. Generally, under the principles of the OECD's Partnership Report an entity must be liable to tax in a country "as a resident" in order to be treated as a resident for treaty purposes. If a partnership is treated as a foreign resident company in the source country but as transparent in other relevant countries, the partnership would be a foreign resident from the perspective of the source country but would not be a resident of any other country (whether the residence country of the partners or elsewhere) as it is not liable to tax in those other countries.

1 Taxation Determination TD 2011/25. The system for public legally binding rulings is set out in AU: Taxation Administration Act 1953 Schedule 1 Part 5-5.

2 Organisation for Economic Co-operation and Development (OECD), *The Application of the OECD Model Tax Convention to Partnerships* (OECD, 1999).

3 See OECD, *Model Tax Convention on Income and on Capital* (OECD, 2014) Commentary on Article 1 paras 2-6.7, Article 4 para 8.8 and Article 23 paras 69.1-69.3 (see also paras 32.1-32.7, 34.1, 56.1-56.3). These additions to the Commentary were made in 2000.

At first glance it seemed as if the *Resource Capital Fund* case⁴ would settle the application of the Partnership Report in Australia. In the event, it did not turn out that way.

II. Facts of the case

Resource Capital Fund III LP (RCF), a Cayman Islands LP treated by the United States as tax transparent with mainly (97 %) US resident investors, acquired over 10 % of an Australian gold mining company listed on the stock exchange, though no investor in RCF it seems held a 10 % indirect interest on its own. Like most mining companies, the company's assets consisted of mining leases, mining information, plant and equipment and other assets of relatively minor value. As Australia taxes LPs as companies under domestic tax law, the ATO assessed RCF to corporate tax at the rate of 30 % on the capital gain when it sold its shares in the gold mining company. The assessment was based on rules adopted in 2006 taxing capital gains on shares where a foreign resident taxpayer held 10 % or more of the shares and the value of the company's real property assets in Australia exceeded the value of its other assets (essentially a more than 50 % test similar to the test in Article 13(4) of the OECD Model). Apart from the Partnership Report issue, the taxpayer also argued (ultimately unsuccessfully) that the real property assets of the company in question were less than the value of its other assets.

Article 4(1)(b) of the Australia-United States Tax Treaty contains a definition of resident on the US side as follows, so far as relevant:

(b) a person is a resident of the United States if the person is: ...

(iii) any other person (except a corporation or unincorporated entity treated as a corporation for United States tax purposes) resident in the United States for purposes of its tax, provided that, in relation to any income derived by a partnership, an estate of a deceased individual or a trust, 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 beneficiary, or, if that income is exempt from United States tax, is exempt other than because such person, partner or beneficiary is not a United States person according to United States law relating to United States tax.

As RCF was not formed in the United States it did not qualify as a resident of the United States under paragraph (iii) of the definition. Both parties accepted that it was not a US resident and the case was largely argued on this basis. As the express

⁴ AU: FCAFC, 3 Apr. 2014, *Commissioner of Taxation v. Resource Capital Fund III LP* [2014] FCAFC 37, 16 ITLR 876, reversing AU: FCA, 26 Apr. 2013, *Resource Capital Fund III LP v. Commissioner of Taxation* [2013] FCA 363, 15 ITLR 814; leave to appeal refused AU: HCA, 17 Oct. 2014, *Resource Capital Fund III LP v. Commissioner of Taxation* [2014] HCA Trans 235. The decisions have implications for some other treaty issues: the relationship of Article 7 and Article 13 of the OECD Model, the interpretation of Article 13(4) and tax treaty interpretation generally, but these are not analysed here. This note adapts in part, commentary written by the author on the case in the International Tax Law Reports, (2013) 15 ITLR 815, (2014) 16 ITLR 877.

provisions of the treaty on the treatment of partnerships did not assist, the case was argued on the basis that the matter fell generally to be dealt with by the Partnership Report.

In relation to capital gains on alienation of real property under Article 13(1), Article 13(2) of the treaty provided a definition of real property which so far as relevant is as follows:

- (b) the term “real property”, in the case of Australia, shall have the meaning which it has under the laws in force from time to time in Australia and, without limiting the foregoing, includes: ...
- (ii) shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia; ...

Although this test is in different words to the domestic law test referred to above and perhaps could be read as requiring much more than 50 % by value, no argument was addressed to that point (despite the parallel issue under domestic law being contested) and it does not seem that the investors asserted that the Australia-United States treaty would prevent Australia taxing the gain if they were entitled to the benefits of the treaty based on the principles in the Partnership Report. This is presumably because the treaty did not contain the equivalent of OECD Model article 13(5) but rather provided for the application of domestic tax law in other cases in Article 13(7):

Except as provided in the preceding paragraphs of this Article, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

Hence it is not surprising that the argument on whether RCF was land-rich was addressed to domestic law rather than to the treaty: if it were not land-rich there would be no tax under domestic law and the treaty would not be relevant. Instead RCF challenged the assessment on the basis that the Australia-United States treaty prevented the ATO from taxing RCF (even though it was not a resident of the United States) because under the Partnership Report principles, the effect of the treaty was that the US investors were the relevant taxpayers.

III. The Court decision

A. Reasoning of trial judge

Edmonds J held that the approach in the OECD Commentary which he quoted at great length applied to the Australia-United States treaty in the circumstances of RCF and that would seem to be consistent with the Commentary. What is more difficult to follow is his view that the treaty prevented Australia from taxing RCF and only permitted Australia under domestic law to tax the partners, with the result that the assessment of RCF was set aside. He said:⁵

⁵ Supra n. 4, [2013] FCA 363 para 76.

I am of the view that while art 13(1) of the Convention authorises Australia, by its domestic law, to tax the US resident limited partners in RCF on their respective distributive shares of the gain derived by them on the sale by RCF of the shares in SBM if its requirements are otherwise satisfied, it does not authorise Australia to tax that gain to RCF, the limited partnership, as a non-transparent company.

The judgment goes much further than the several other cases around the world on the OECD partnership work. The OECD Commentary on partnerships says nothing about whether giving treaty benefits based on the residence of the partners in a case like the present means that the source country has to actually assess the partners or can still assess the entity it regards as the taxpayer, here RCF. The OECD Commentaries elsewhere indicate that the details of assessment and collection of the tax are generally a matter for domestic tax law of the parties to the treaty.⁶ The Partnership Report itself is quite explicit on the issue.⁷

When taxing an item of income, the source State ... applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions. The way that the State of residence qualifies an item of income for treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income.

It is a pity that this clear statement was not added to the Commentary.

B. Reasoning on appeal

The judges on appeal accepted that the OECD Commentaries may be used in the interpretation of tax treaties but noted that the context of the OECD work on partnerships was dealing with differing country treatments of entities as transparent or not and that its purpose was to apply treaties so that treaty benefits were not denied by such different treatments. As the Australia-United States treaty applies to persons who are residents of a contracting state under Article 1, the trial judge's conclusion that RCF was not a US resident was the end of the case – the treaty simply did not apply to Australia's taxation of RCF.

The judges noted that it may have been open to the US resident partners to argue for the benefits of the treaty but the taxpayer had not mounted its case in this way and hence the court did not need to express any view on this issue. One suspects that they would have accepted the OECD approach if it had been necessary to do so but the result is that it has not yet been determined whether the Partnership Report will be accepted by the courts in Australia.

The taxpayer also relied on the ATO public ruling mentioned earlier which is legally binding on the ATO that the business profits article of a treaty between Aus-

⁶ See, for example, OECD, *supra* n. 3, Commentary on Article 6 para 4, Article 7 paras 28-32, Article 10 para 67.7, Article 13 para 3, Article 15 paras 12.3-12.4, Article 17 paras 8, 10-11 and Article 23 paras 32, 32.4.

⁷ OECD, *supra* n. 2, para 103.

tralia and a partner's country of residence was available to the limited partners in an LP which their country of residence treated as tax transparent while Australia taxed the LP. Putting aside the issue of reliance on the ruling, the court was able to dismiss this argument on the basis that it was the capital gains article, not the business profits article which was engaged in the case.

C. Leave to appeal to High Court of Australia refused

Undaunted by its fairly comprehensive defeat in the Full Federal Court, RCF sought leave to appeal to Australia's highest court. The application was limited to the question of whether the treaty prevented the ATO from taxing the LP, which was the only avenue for taxing the capital gain under domestic law in this case. Leave was refused on the basis that:⁸

the decision of the Full Court is not attended by sufficient doubt to warrant a grant of special leave.

IV. Comments on the Courts' reasoning

A. Operation of tax treaties

Treaties are generally understood not as "authorizing" countries to tax under domestic law but as preventing them from taxing as they otherwise would under domestic law to the extent that there is a resident of a country which is party to the treaty who is protected from taxation by the treaty. It is therefore very surprising that Edmonds J frames the treaty issue in the case as noted above as a question of whether the Australia-United States Tax Treaty "authorises" the taxation of RCF especially since he held that it was not a resident of the United States and the US treaty applies to persons who are residents of one of the treaty parties. The normal understanding of tax treaties is that they allocate taxing rights over residents of one or other of the treaty parties and then domestic law levies the tax however and on whomever it wants to the extent permitted by the treaty. The appeal court was able to overturn the original decision simply by rejecting the trial judge's proposition which they seemed to find mystifying.⁹

8 Supra n. 4, [2014] HCA Trans 235, p. 15.

9 This does not mean that treaties are "exclusively relieving" in Australia, though this proposition may have been accepted in at least one case, *Undershaft (No 1) Ltd v. Commissioner of Taxation* [2009] FCA 41, 11 ICLR 652, para. 46. Australia's treaties generally contain a provision to the effect that if income can be taxed at source under the treaty, the income will be regarded as sourced in Australia for the purposes of domestic tax law which operates on source principles. The effect when the treaty is incorporated into domestic law is that it indirectly changes domestic law, in accordance with its evident intent, so that an amount is made assessable which would not be assessable in the absence of the treaty, see J.F. Avery Jones et al, *Tax Treaty Problems Relating to Source* (1998) 52 Bulletin for International Fiscal Documentation.

The reasoning in the judgment at first instance suggests that Australia would have been prevented from taxing RCF entirely even if there had been only one US partner in RCF with a miniscule interest. As noted above not all the partners in RCF were US residents. It is difficult to see why Australia should have been prevented from taxing RCF to the extent that there were partners resident in countries other than the United States. Similarly, as the judge thought that the treaty did not protect the US resident partners from Australian taxation on the gain, it is difficult to see why the treaty should have prevented Australia taxing RCF with respect to profits which the United States regarded as attributable to the US resident partners.

In reaching the conclusion that the treaty prevented Australia taxing RCF, the trial judge relied on a number of other propositions which are questionable. For example, he considered that the outcome would have been double taxation if Australia were able to tax RCF on the gain.¹⁰ US domestic tax law would give a foreign tax credit to the partners for the Australian tax on RCF on the gain (as would Australian tax law in the converse case) and the OECD interprets the OECD Model in the Partnership Report as requiring credit in the residence country of the partners for tax levied by the source country on the partnership if the residence country of the partners taxes them on the partnership income. The appeal court did not need to comment on the relief issue because of its view that the treaty simply did not apply to RCF as it was not a resident of the United States.

B. Express treaty provisions on partnerships

Australian courts are not the only ones which have found it difficult to apply the principles of the Partnership Report, even where it is accepted that those principles as set out in the OECD Commentary are applicable.¹¹ Given the frequency with which the issue nowadays arises, it makes sense to include specific provision in tax treaties dealing with the hybrid entity issue. Increasingly in recent times tax treaties have included such provisions, even though the Partnership Report cautioned against the practice.¹² The OECD as part of its base erosion and profit shifting (BEPS) work recommended in 2014 that a provision to deal with hybrid entities should be added to the OECD Model with the intention of replicating the outcomes in the Partnership Report for hybrid entities more broadly and based on the fiscally transparent entity provision found in the US Model (2006).¹³

10 Supra n. 4, [2013] FCA 363 para 69.

11 Another example is CA: *TCC TD Securities (USA) LLC v. R* 2010 TCC 186, 12 ITR 783. The conclusions in the Partnership Report remain controversial, see M. Lang and C. Staringer, *Conflicts of Characterisation General Report*, (2014) 99b cahiers de droit fiscal international 15, but the discussion here does not address this debate.

12 Supra n. 2, paras. 43-46.

13 OECD/G20 Base Erosion and Profit Shifting Project, *Neutralising the Effects of Hybrid Mismatch Arrangements* (OECD, 2014), pp. 85-92.

The reasoning underlying the initial OECD caution is well illustrated by the RCF case. Both the 1953 and 1982 treaties between Australia and the United States contained provisions on partnerships. The 1982 provision has already been quoted, see II above. The 1953 provision was the subject of comment by the trial judge in RCF:¹⁴

Under art II(1)(g) of the 1953 Convention, a partnership created or organised in or under the laws of the US (a US domestic partnership) was a resident of the US for the purposes of the 1953 Convention whether or not the partners were liable to US tax on the income of the partnership. If the partners in the US domestic partnership were foreign companies (ie, incorporated outside the United States) and the partnership income was not effectively connected with the conduct of a trade or business carried on in the US, neither the partnership (because it was fiscally transparent) nor the partners would be liable to US tax on the partnership income, but because the partnership was a resident of the US for the purposes of the 1953 Convention, it was entitled to the benefits of the 1953 Convention vis-à-vis Australian source income. The negotiators of the [1982] Convention were conscious of this anomaly when drafting art 4(1)(b)(iii); thus, under the Convention, even a US domestic partnership will only be a resident of the US for the purposes of the Convention to the extent that the income of the partnership is subject to US tax in the hands of a partner or, if that income is exempt from US tax, is exempt other than because such partner is not a US person according to US law relating to US tax.

The problem with the 1953 provision was that it gave treaty benefits even if there was no US taxpayer liable to tax in the United States. As demonstrated by the RCF case the 1982 provision had the opposite vice of being too narrow in the sense of achieving a similar outcome to the Partnership Report; it only operated to give treaty benefits to the LP directly if both the LP and the partners were resident under US domestic tax law. As RCF was a Cayman Islands LP, the 1982 provision did not apply to it.

Clearly it was possible to argue on the wording of the Australia- United States Tax Treaty (1982) that its express provision on partnerships excluded the operation of the Partnership Report principles to the extent that they were more extensive. Neither party took this position and the courts seemed willing to accept the view that the Partnership Report was relevant to the partners, though the Full Federal Court expressly indicated that it was not deciding this issue. While the provision now proposed by the OECD is designed to overcome this particular issue, the same issue will arise to the extent that it is more limited than the principles in the Partnership Report.

Even if the general principles are the same (though the proposed OECD provision will be broader insofar as it will apply to an item of income rather than on an entity basis and by extending to other hybrid entities besides partnerships), it remains to be seen whether it will solve the many treaty issues that arise for hybrid entities. Again, an example of such an issue was raised by the trial judge in discussing

¹⁴ Supra n. 4, [2013] FCA 363, para. 43.

whether the Australia- United States treaty was to be applied with respect to the LP or with respect to the partners in reference to Article 10(2)(a) (which is similar to Article 10(2)(a) of the OECD Model though referring to 10 % of voting power rather than 25 % of capital and omitting the reference to a partnership). He said:¹⁵

The [US] Technical Explanation 2001, discussing art 10 of the Convention, provides that '[c]ompanies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity (Technical Explanation 2001, art 6). This is consistent with the US position that ownership measurement is performed on a look-through basis ...

From Australia's perspective RCF was a company which directly held more than 10 % of the voting shares in the Australian mining company that it sold. If RCF had been a US resident partnership and had received a dividend, it would seem clear from the Australia – United States treaty provision on partnerships quoted in II above, that RCF was the person claiming treaty benefits under Article 10 and hence it is arguable that it should have been entitled to the reduced rate of tax under Article 10(2)(a). The US Technical Explanation language quoted by the judge is common in US Technical Explanations generally and is drawn from the Technical Explanation to the US Model 2006. There, however, it is justified by reference to the fiscally transparent entity provision in that Model from which the OECD proposed provision is derived, whereas in the RCF case it had to be derived from general principles (as the equivalent partnership provision in the treaty did not apply since RCF was not a US partnership) and arguably would not have produced the same result if RCF had been a US partnership.¹⁶

This discussion is not intended to provide conclusions on these issues but simply to point out that the proposed OECD provision will raise as many questions as it answers, and currently many of the questions are not dealt with explicitly or implicitly in the proposed Commentary to accompany the new provision.¹⁷

C. Procedural issues in claiming treaty benefits

Australian tax law provides relatively strict rules on who may challenge action by the ATO; for a tax assessment, generally only the taxpayer may appeal against an

- 15 Supra n. 4, [2013] FCA 363, para. 73. The current Article 10 was substituted by a 2001 Protocol which is why the reference is to that year. The 1982 definition of resident quoted at II above remained unchanged by the Protocol so far as relevant here.
- 16 Further issues would also arise under Article 10(2)(a) of the OECD Model regarding the meaning of "holds directly" (which also appears in the Australia – US treaty) and the exclusion of partnerships (which does not).
- 17 The International Tax Group is currently preparing an article on the variety of issues which hybrid entities raise in a treaty context and to what extent they may be answered by the proposed new provision and Commentary.

assessment made in relation to the taxpayer.¹⁸ Hence if the partners in RCF wish to raise their treaty rights under Partnership Report principles in relation to an Australian tax assessment on RCF, the question is how would the issue come before the court. Probably RCF could raise the issue, but it may not be willing to do so and there is no immediately obvious way under tax law for the partners to force it to do so. For example, if RCF only had one small US investor and mainly investors from non-treaty countries, it may not be interested in appealing on the treaty issue for the benefit of that investor alone.

This procedural issue may have influenced the reasoning of the judges, although it only came to be clearly articulated in the application for leave to appeal to the High Court of Australia. If it is the case that the partners have no standing to assert their treaty rights under normal domestic appeal procedures because RCF is the taxpayer, then one has some sympathy with the view of the trial judge that domestic law should be required to assess the partners directly and not RCF. Similarly, the equivocation of the Full Federal Court on whether the partners could raise Partnership Report principles to avail themselves of treaty benefits may reflect concerns about procedure.

In the application for leave to appeal, counsel for the taxpayer put this matter clearly:¹⁹

... because of the way in which the assessment has been raised on the collective relationship, the partners are unable to test properly their individual liability to tax.

This concern was not directly addressed by the ATO's counsel though there was some general discussion of the partners challenging the assessment.²⁰ The only clear avenue identified by the ATO was the mutual agreement procedure and counsel for the taxpayer not unreasonably maintained:²¹

we would respectfully say that that is not an appropriate solution. It is a matter for individual negotiation in individual cases between the Australian Tax Office and the US Internal Revenue Service, and that is inappropriate as a principal solution to the issue.

Counsel for the ATO made reference to the practical material in the ATO's ruling on the application of Partnership Report principles to Article 7 of tax treaties, but this simply tells the partners (and LP) what information the ATO needs and undertakes that refunds will be made if necessary; it provides nothing on the legal means of enforcing the partner's treaty rights. Because it is a legally binding public ruling, presumably taxpayers and the courts will find a means of

18 AU: Income Tax Assessment Act 1936, s. 175A(1). Courts in recent times have sought to overcome procedural hurdles, but it is not automatic that a way will be found.

19 Supra n. 4, [2014] HCA Trans 235, p. 14.

20 Supra n. 4, [2014] HCA Trans 235, pp. 12-13.

21 Supra n. 4, [2014] HCA Trans 235, p. 8.

giving effect to the ATO's legal obligations arising from the ruling but that avenue will not be available for other articles such as Article 13 which was at issue in the RCF case.

V. Conclusion

The RCF case raises a number of issues in relation to the principles in the OECD Partnership Report. While the judgments do not finally settle the status of those principles in Australia, they point more to approval of the principles than rejection of them.

The treaty concerned in fact had a specific provision dealing with partnerships which did not apply to the LP in question and the judgments seem to accept that Partnership Report principles could still apply even in the presence of a treaty provision. The possibility that such provisions effectively exclude the operation of Partnership Report principles is not addressed. With the OECD now proposing the adoption of a fiscally transparent treaty provision in the OECD Model, the judgments are interesting for their comments on potential problems in existing variants found in tax treaties. They indirectly raise a number of issues and it is unclear whether the OECD proposal and its Commentary will solve these. The case is a timely reminder of the caution expressed in the Partnership Report about express treaty provisions.

Finally, and only at the end of the appeal process in the RCF case, procedural questions were raised about how partners in an LP which is regarded as fiscally transparent by their residence country can assert their treaty rights under Partnership Report principles when the source country regards the LP as a foreign resident company and as the taxpayer. The only concrete solution discussed in the RCF proceedings is the mutual agreement procedure, which is hardly satisfactory since tax treaties are designed to give taxpayers enforceable rights under domestic law. At the moment in Australia, the partners can probably enforce their treaty rights domestically when Article 7 is in question because of a legally binding public ATO ruling, but otherwise they will often be relying on the good faith of the ATO.

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