Investment funds- Tax classification and entitlement to treaty benefits

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Jonathan Schwarz (Temple Tax Chambers; King's College London)

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Commissioner of Taxation v Resource Capital Fund IV LP [2019] FCAFC 51 addressed a number of fundamental international tax issues. The case concerned a gain from the sale of shares in an Australian incorporated public company listed on the Toronto Stock Exchange by two Cayman Island limited partnerships whose partners included residents of the United States. In my May 7, 2019 blog, I examined the principle of source in relation to extractive industries. This time, entity classification and access to treaty benefits is under the microscope.
The tax classification of the limited partnerships and entitlement to treaty benefits were key issues that affect all investment fund arrangements.

Corporate limited partnerships liable to tax

Under Australian domestic tax legislation, certain limited partnerships are treated as companies for tax purposes. This treatment is underpinned by provisions that treat interests in corporate limited partnerships as shares and distributions of corporate limited partnerships are treated as dividends.

On the other hand, partnerships generally are required to file a return of partnership income, the partnership is not be liable to pay tax thereon. Instead, the partners who are liable to tax on their respective shares of the partnership income.

Federal Court of Australia – Full Court concluded that it was the limited partnerships who were correctly assed for the tax on partnership income on the basis that a corporate limited partnership is treated as a company for taxation purposes and this includes it being an entity which is liable to pay income tax. Nonetheless, since the limited partnership is not a legal person as a matter of general law, if a corporate limited partnership is liable to pay an amount of tax, the partners are jointly and severally liable for the tax.

Access to treaty benefits

In contrast to the Australian position, each partnership was a fiscally transparent entity for United States tax purposes. Neither partnership was liable to pay income tax in the United States.

Article 3(1)(a) of the Australia-United States double tax treaty expressly includes a "partnership" in the definition of the term "person", unless the context otherwise requires.

Article 4(1)(b)(iii) of the treaty DTA defines a resident of the United States as a "… 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.

The meaning of the undefined term "partnership" in Article 3(1)(a), including whether the domestic meaning was required by reason of Article 3(2), or what that domestic meaning might be, was not considered by the court. Instead the court focussed on the definition of resident in Article 4(1)(b)(iii). The majority judgement ruled that that the context did not require the meaning of "person" in Article4(1)(b)(iii) to exclude a partnership. The majority judgement concluded that, since there was no evidence that either partnership was a US person under US domestic law nor that the income of either partnership was "subject to tax in the United States, the partnerships were not US residents for purposes of the treaty.

Individual partners v partnership access to treaty benefits

Despite this conclusion the majority (Besanko, Middleton, Steward and Thawley JJ) concluded that each United States resident partner was capable of invoking the treaty, but not in relation to the appeal by the limited partnerships before the court.

This will come as some relief to investment funds of this kind. The reasoning underpinning this conclusion is, however, difficult to follow. The majority considered that US resident partners "had the legal capacity to invoke the [treaty] in recovery proceedings or in collateral recovery proceedings … assuming the requirements for [treaty] protection are otherwise made out. The tax authority also accepted that such partners could also seek, in an appropriate case, declaratory relief concerning the possible application of the treaty to their individual shares of the partnership profits. This conclusion is despite the fact that such partners cannot rely on the treaty in relation to the liability of a limited partnership which is deemed to be a company for Australian tax purposes because in such a case it is the limited partnership and not the partners who is the taxpayer. A not wholly dissimilar approach was taken by the Tax Court of Canada in *TD Securities (USA) LLC v The Queen*, 2010 TCC 186 (CanLII).

In a minority judgement, Justice Davies, concluded that a corporate limited partnership, as distinct from the partners, could rely on the treaty. This was on the basis that the deemed corporate status of the partnership displaces the general law for Australian income tax purposes. Adopting a detailed analysis by reference to the principles of treaty interpretation, he considered that Article 4(1)(b)(iii) of the treaty treats a partnership as a US resident if, and to the extent that, its income is subject to US tax in the hands of its US resident partners (or is exempt for reasons other than that such partners are not US resident). In essence, the article did not require the partnership itself, as a separate person (for Australian tax purposes) to be a US resident when the partnership is treated as transparent for US tax purposes.

In the author's view, the analysis of Justice Davies is more compelling. It provides a more rational reconciliation of the mismatch in treatment between the two states.

More modern treaties that adopt Article 1(2) of the 2017 OECD Model and Article 3 of the BEPS MLI straightforwardly address the issue by permitting treaty benefits in such circumstances where the entity is transparent under the laws of either contracting state.

Article 13 and indirect transfers

Whether Article 13 of the Australia-United States treaty authorised Australia to tax the ordinary income gain from the share sale, was dependent on whether the assets of the company consisted "wholly or principally of real property situated in Australia" within the meaning of Article 13(2)(b)(ii) of the treaty. This topic is becoming of increasing importance and on to which I will return in another blog.