Private equity and TD 2011/25 – A different take on a gift horse

by John Balazs, Partner, Balazs Lazanas & Welch LLP

As St Jerome tells us, it is unwise to look a gift horse in the mouth. TD 2011/25 is just that, so let it be clear that this author welcomes the TD, even if he believes it to be fundamentally incorrect and at odds with the decision in *Russell v FCT* [2011] FCAFC 10, recently discussed by the author at 2011 WTB 44 [1647].

The TD in brief

The TD was reported at 2011 WTB 45 [1705] and discussed at 2011 WTB 45 [1683].

Essentially, the Commissioner is saying that a foreign limited partnership – which is regarded as a company and a foreign resident for the purposes of the Assessment Acts – will instead be treated as a partnership for the purposes of those Acts to the extent the partners are residents of one or more countries with which Australia has any operative double tax agreements (DTAs) if the countries in which the partners are tax resident treat the limited partnership as fiscally transparent and tax the partners or treat them as genuine exempt entities.

The Commissioner's rationale for this is essentially as follows:

- A DTA provides that Australia cannot tax the business profits of an enterprise of a resident of the other country that is not attributable to a permanent establishment of the resident in Australia.
- The Commentary on Article 1 of the OECD Model DTA says that in relation to those business profits of an enterprise that have "flowed through" a *transparent partnership* to its partners, the profits must be treated as the profits of the partners.
- As there is no observation or reservation to that aspect of the Commentary, the Commissioner will consider how the DTA country taxes its resident partners and what it considers to be a partnership and
  - if the DTA country treats the limited partnership as a partnership, and
  - taxes its resident partners on the partnership profits,

  then Australia will potentially forgo its taxing rights, if any, as regards the interposed partnership even though Australia does not otherwise treat the partnership as transparent.

An example

To illustrate his position, the Commissioner uses examples involving a Cayman Islands limited partnership (the Cayman LP).

The position can be illustrated with one example.

The Cayman LP has 4 taxpaying limited partners, A, B, C and D where:

- A is a resident of a DTA country that taxes the partners on an accrued basis and treats the Cayman LP as a transparent partnership;
- B is a resident of a DTA country that taxes the partners on amounts received and treats the Cayman LP as a non-transparent partnership;
- C is a resident of a DTA country that does not tax the partners; and
- D is a resident of a non-DTA country.

If the Cayman LP has Australian source income (but presumably no permanent establishment under A's DTA), then, as regards A's share of the taxable income, the Cayman LP will not be taxed, but as regards the balance of the taxable income, the Cayman LP will be taxed.

But is it correct?

The TD appears to contradict *Russell*.

It will be recalled that in *Russell*, the Full Federal Court said the assessable income of Mr Russell, arrived at through the fiction of the PSI rules, could not escape tax through Article 7 of the New Zealand DTA because, under the Assessment Acts, that assessable income was his and not that of the New Zealand resident entity that legally earned it.

Taking the examples used in the TD, *Russell* tells us that the net income is in fact the taxable income of the Cayman LP. Therefore, as a foreign resident that does not benefit from a DTA, the Cayman LP cannot escape liability.

The most obvious flaw in the Commissioner's approach is that it elevates the OECD Commentary to the status of overriding legislation.

Regardless of the correctness of *Russell*, there is no basis for the Commissioner's approach as the law currently stands. It appears to contradict every recent High Court decision on the interpretation of statutes, treaties incorporated into our law and the role of the Commentary.

"Partnership"?

Curiously, the TD does not apply if the transparent entity is not a "partnership". So a transparent non-partnership is useless.

That, of course, does not raise that wonderful issue regarding the definitions of "company" and "partnership" in the Assessment Acts – wherein a company is defined by reference to something that is not a partnership and a partnership is defined by reference to something that is not a company. In this instance, the basis upon which one characterises the entity is not by reference to our definitions (otherwise the TD is meaningless). However, just what is a "partnership" for the purposes of the TD is, at this stage, a matter for speculation.

No doubt, investors will look to legal systems that have partnerships, but then there is the pesky problem of whether a "partnership" that is treated as a body corporate is truly a partnership.

In conclusion

There are other issues with the TD, but the above is enough to go on with for the meantime. However, now that it is out there, those that can should use it to best effect regardless of whether it is correct.