TD 2008/D13 - Income tax: when is 'foreign income tax ... imposed ... on the partners, not the partnership' under paragraph 830-10(1)(b) of the Income Tax Assessment Act 1997 for the purpose of determining whether a foreign limited partnership is a foreign hybrid limited partnership under Division 830 of that Act?

This document has been finalised by TD 2009/2.

There is a Compendium for this document: **TD 2009/2EC** .

Draft Taxation Determination

Income tax: when is 'foreign income tax … imposed … on the partners, not the partnership' under paragraph 830-10(1)(b) of the *Income Tax Assessment Act 1997* for the purpose of determining whether a foreign limited partnership is a foreign hybrid limited partnership under Division 830 of that Act?

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Ruling

1. Paragraph 830-10(1)(b) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] contains two requirements: that foreign income tax is imposed on the partners of the limited partnership in respect of the income or profits of the limited partnership; and that foreign income tax in respect of the income or profits is not imposed on the limited partnership itself.

2. In determining whether foreign income tax is imposed on the partnership or the partners for these purposes, consideration must be given to characteristics specific to the limited partnership in question where they affect its status, and/or the status of the partners, as taxpayers. For example, whether the limited partnership has elected corporate or entity tax treatment which affects how the income or profits of the partnership are taxed, and/or whether it engages in activities that result in the partnership being a taxpayer, will be relevant.

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

3. The tests do not require the limited partnership or the partners to have earned actual taxable income or profits in the income year; it is only necessary to consider whether the limited partnership or the partners would be the taxpayer(s), were there such income or profits. Therefore, the requirement that income tax is imposed on the partners can still be satisfied in an income year in which the partnership has a loss for tax purposes, or only earns income that is exempt from tax. The provision does not require the partners to have an actual foreign income tax liability. It simply requires that, were the limited partnership to have income or profits that would have been taxable in the foreign jurisdiction, the tax liability would have been incurred by the partners.

4. Where the foreign country does not impose tax on income or profits or does not impose a tax on income or profits earned by limited partnerships in any circumstances, the requirement that tax is imposed on the partners cannot be satisfied.

5. The requirement that income tax is not imposed on the limited partnership is not satisfied where the limited partnership itself is subject to tax on its income or profits, for example, where it is treated as a company or a separate person (whether or not by choice) for tax purposes.

6. The requirement that income tax is not imposed on the limited partnership will not be satisfied merely by virtue of the partnership not having an actual tax liability in the particular income year, for example, because it had a loss for tax purposes. It is necessary to consider what the tax treatment of the limited partnership would have been if it had had income or profits that would have been taxable in the foreign jurisdiction.

Examples

7. The following examples assume that the entity in question satisfies the definition of 'limited partnership',[2] and that the foreign taxes referred to satisfy the definition of 'foreign income tax'.[3]

Example 1: partnership treatment

8. *LP1 is a limited partnership formed in the United Kingdom (UK). UK income tax is imposed on the partners of a limited partnership in respect of its income or profits, and no income tax is imposed on the limited partnership itself.*

9. *Therefore foreign income tax is imposed on the partners of LP1 and not on LP1 itself, and the requirements in paragraph 830-10(1)(b) are satisfied. Assuming that the other requirements of subsection 830-10(1) are satisfied, LP1 is a foreign hybrid.*

Example 1A: partnership treatment – no tax paid

10. *In a loss year for LP1, the partners will not have a tax liability in respect of the income or profits of LP1. Were there income or profits (instead of a loss), the partners would be subject to income tax on these profits. Therefore, for the purposes of paragraph 830-10(1)(b), foreign income tax is imposed on the partners.*

11. *Likewise, income tax is imposed on the partners for the purposes of paragraph 830-10(1)(b) in an income year in which LP1 derived only exempt income and as a result the partners did not pay tax on partnership income or profits.*

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[2] Subsection 995-1(1).
[3] Subsection 770-15(1).

12. *For example, if LP1 derived only foreign source income, and all the partners were non-residents of the UK, the partners would not be taxed on the partnership income or profits. However, the requirement that the UK law imposes tax on the partners (rather than the partnership) will be satisfied because, if there were taxable income or profits (that is, UK sourced income or profits), the partners would have been taxed.*

13. *Further, in a year in which the partners had unrelated deductions which offset the taxable income from LP1 (for example interest expenses on an investment property), the partners would not pay tax on the partnership income or profits. However, the income of LP1 is assessable income of the partners that would have been taxable in the foreign jurisdiction. Therefore, for the purposes of paragraph 830-10(1)(b), foreign income tax is imposed on the partners.*

14. *In each of these cases, assuming that the other requirements of subsection 830-10(1) are satisfied, LP1 is a foreign hybrid.*

Example 2: elective tax treatment – company treatment

15. *LP2 is a limited partnership formed in the United States which, pursuant to the Internal Revenue code 'check the box' regulations, has chosen to be treated as a domestic corporation. It is understood that, where a limited partnership makes such a choice, United States income tax is imposed on the partnership, and not on the partners.*

16. *In this case foreign income tax is imposed on LP2 on its income or profits, and therefore the requirements in paragraph 830-10(1)(b) are not satisfied, and as a result LP2 is not a foreign hybrid.*

Example 2A: elective tax treatment – partnership treatment

17. *In a subsequent income year LP2 elects, under the 'check the box' regulations, to be taxed as a partnership. Income tax will be imposed on the partners, and not the limited partnership, in respect of the income or profits of the partnership in the United States in relation to that income year*.

18. *Therefore, for that year, the requirements in paragraph 830-10(1)(b) will be satisfied*. *Assuming that the other requirements of subsection 830-10(1) are satisfied, LP2 is a foreign hybrid.*

Example 3: income tax because of activities

19. *KG1 is a limited partnership formed in Germany (a kommanditgesellschaft) which performs business activities at its fixed base in Germany, such that it is a 'taxpayer' for German trade tax purposes*.

20. *German trade tax would be imposed on KG1 in respect of its 'trade profits'*.

21. *As German trade tax is imposed on KG1, the requirement in paragraph 830-10(1)(b) that foreign income tax is not imposed on the limited partnership is not satisfied, and as a result KG1 is not a foreign hybrid*.

22. *It is understood that, as well as trade tax being imposed on KG1, German income tax would be imposed on the partners in respect of the income of KG1. However, this does not result in KG1 satisfying the requirements of paragraph 830-10(1)(b).*

Example 3A: income tax because of activities – loss year

23. *In a subsequent income year, KG1 incurs a loss for trade tax purposes, and therefore does not have any income or profits that result in a trade tax liability for the particular income year*.

24. *However, because KG1 performs business activities at a fixed base in Germany, if KG1 had had income or profits (instead of a loss), KG1 would have been subject to German trade tax. Therefore, for the purposes of paragraph 830-10(1)(b), foreign income tax is imposed on KG1.*

25. *Therefore paragraph 830-10(1)(b) is not satisfied by KG1 in a loss year, and as a result KG1 is not a foreign hybrid*.

Example 3B: income tax because of activities – activities not performed

26. *In a later year, KG1 ceases to carry on business activities at a fixed base in Germany. KG1 is therefore no longer a taxpayer for German trade tax purposes, and German trade tax cannot be imposed on KG1 in respect of its income or profit*.

27. *The partners are still subject to German income tax on the income of KG1.*

28. *For that year, the requirements in paragraph 830-10(1)(b) will therefore be satisfied in respect of KG1*. *Assuming that the other requirements of subsection 830-10(1) are satisfied, KG1 is a foreign hybrid.*

Example 4: no income tax

29. *LP3 is a limited partnership formed in Country X*.

30. *Country X does not impose tax on income or profits in any circumstances*. *Therefore, the requirement in paragraph 830-10(1)(b) that income tax is imposed on the partners is not satisfied, and as a result LP3 is not a foreign hybrid*.

Example 5: certain entities not taxed

31. *ELP1 is an exempted limited partnership formed in Country Y at all times*.

32. *Country Y imposes a tax on income but the tax is not imposed on the income or profits of exempted limited partnerships in either the hands of the exempted limited partnership or the partners.*

33. *An exempted limited partnership is prohibited from engaging in transactions with residents of Country Y. An exempted limited partnership will cease to be an exempted limited partnership if it engages in transactions with residents of Country Y with the result that the partners of the limited partnership will be subject to tax on the income or profits of the partnership.*

34. *For the income year in which ELP1 qualifies at all times as an exempted limited partnership of Country Y, foreign income tax is not imposed on the partners of ELP1 for the purposes of paragraph 830-10(1)(b) as the foreign income tax does not apply to any income or profits of ELP1. As a result, ELP1 is not a foreign hybrid*.

Example 6: only tax certain classes of income

35. *LP4 is a limited partnership formed in Country Z. Country Z has an income tax that applies to income earned from transactions with residents of Country Z and exempts all other income. In relation to limited partnerships formed in Country Z any applicable Country Z tax liability in respect of partnership income is a liability imposed on the partners, and not on the partnership itself.*

36. *LP4 does not, and does not propose to ever, transact with residents of Country Z. Therefore the partners will not have a liability for income tax in Country Z*.

37. *However, if the partnership were to earn income from transactions with residents of Country Z, the partners would be subject to tax. Therefore, for the purposes of paragraph 830-10(1)(b), foreign income tax is imposed on the partners. Assuming that the other requirements of subsection 830-10(1) are satisfied, LP4 is a foreign hybrid.*

Date of effect

38. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
24 September 2008

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Explanation

39. The foreign hybrid rules in Division 830 were introduced to address some unintended consequences and high compliance costs for investors in certain foreign entities that were taxed as partnerships in the country in which they were formed, but taxed as companies in Australia.[4]

40. As a company for Australian tax purposes,[5] the foreign entities were potentially subject to the controlled foreign company (CFC)[6] or the foreign investment fund (FIF)[7] regimes, but because of their partnership treatment in the foreign country, unintended consequences could arise. For example, a foreign entity was not necessarily considered a resident of the country in which it was formed, which could result in the CFC rules applicable to unlisted countries applying for the purposes of attribution of the foreign entity's income, even though it may have been comparably taxed in the foreign country.[8] There were also difficulties for the Australian resident members in claiming foreign tax credits for foreign tax paid by them on the entity's income.[9]

41. Following the introduction of Division 830, an entity that qualifies as a foreign hybrid is treated as a partnership, rather than a company, for Australian income tax purposes.

42. In order for a 'limited partnership'[10] to qualify as a foreign hybrid, it must be a 'foreign hybrid limited partnership'. Section 830-10 sets out the conditions that a 'limited partnership' must meet in order to be a 'foreign hybrid limited partnership'. One of these conditions is that:

> …foreign income tax (except credit absorption tax or unitary tax) is imposed under the law of the foreign country on the partners, not the limited partnership, in respect of the income or profits of the partnership for the income year…[11]

43. This test is intended to distinguish those limited partnerships that are taxed as partnerships in the country in which they were formed from those that are taxed as a separate person. Paragraph 9.25 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 7) 2003 (the Explanatory Memorandum) explains the intention of the requirement as follows:

> …the limited partnership must be treated, for the purposes of the tax law of the foreign jurisdiction in which it was formed, as a partnership (i.e. foreign tax must be imposed on the partners). It is the fact that the limited partnership is treated on a flow-through basis in the foreign jurisdiction (i.e. as a partnership) which causes the mismatch problems for the application of the CFC and FIF provisions. It is only these limited partnerships that are to be afforded foreign hybrid limited partnership treatment…

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[4] The Explanatory Memorandum at 9.5 – 9.6.
[5] Certain limited partnerships are deemed to be companies for Australian tax purposes by Division 5A of Part III of the ITAA 1936.
[6] Part X of the ITAA 1936.
[7] Part XI of the ITAA 1936.
[8] The Explanatory Memorandum at 9.4 – 9.5. Also refer TD 2004/31.
[9] The Explanatory Memorandum at 9.124.
[10] Limited partnership' is defined in subsection 995-1(1).
[11] Paragraph 830-10(1)(b).

44. The Explanatory Memorandum supports the view that this provision raises a threshold question concerning the basis of partnership taxation in the relevant foreign country. The question is concerned with whether the limited partnership or the partners are the taxpayer(s) in the foreign country, rather than whether tax is actually paid by either of them. This is evidenced by the use of the word 'imposed' rather than requiring, for example, that foreign income tax has been paid.[12]

45. Both the wording of the provision, and the policy intent expressed in the Explanatory Memorandum, require:

- that the foreign country imposes some form of income tax; and
- that it is imposed on the partners in relation to the income or profits of the partnership.

46. Accordingly, the provision cannot be satisfied where the foreign country does not impose an income or profits tax, nor where such a tax does not apply to the partners of a particular type of entity. The policy intent is that the partners are *the relevant taxpayers* in relation to their share of the partnership income or profit derived by a limited partnership formed in that country.

47. Some countries may have an income tax regime, but subject a particular class of taxpayers to a nil rate of tax. Where all income of any kind is subject to a nil rate of tax, no income tax is being imposed in any circumstances on the income or profits derived by any limited partnership in such a jurisdiction. Income tax is not imposed on the partners as the foreign tax laws operate with the effect that the partners of a limited partnership will not be liable for income tax in any circumstances, irrespective of the income or profits earned by the partnership.

48. However, the scope of the requirement that foreign income tax is imposed on the partners, and is not imposed on the limited partnership itself, is not a broad proposition to be answered by reference solely to general principles of the foreign income tax law. The words 'in respect of the income or profits of the partnership' requires that a nexus, or a discernable and rational link,[13] be demonstrated between the income or profits *of the partnership in question* and the basis on which tax is imposed on *that* income or profit in the relevant country. In the majority of cases this should not be difficult to identify.

49. A further issue in this statutory context is what is meant by 'the income or profits of the partnership'. If read narrowly, these words could prevent the provisions applying in years in which partnership losses arise. However, the foreign hybrid rules make special provision for the tax treatment of the partners of a foreign hybrid in a year in which the limited partnership makes a tax loss.[14] This demonstrates the intention that a limited partnership can be a foreign hybrid in an income year in which it suffers a loss, being an income year in which no partner would pay foreign income tax on the partnership's income or profits.

50. These specific contextual factors, in addition to the threshold nature of the provision, indicate that 'income or profits' is a broad concept capable of encompassing an income year in which there is no 'net' income or profit. Thus, in determining whether the condition in paragraph 830-10(1)(b) is satisfied, regard should be given to the hypothetical question of where the tax liability would rest if there were income or profits of the partnership of the kind that would have been taxable in the foreign jurisdiction.

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[12] Which is used in the foreign income tax offset provisions (section 770-70).
[13] *Technical Products Pty Ltd v. State Government Insurance Office (Qld)* (1989) 167 CLR 45 at 47.
[14] Subdivision 830-C.

51. Similarly, if a limited partnership only earned income that was not subject to tax in an income year (for example, because the foreign income tax is only imposed on a narrow class of income that the partnership did not earn, or because the income falls into a specific exemption), the limited partnership would have no income or profits for income tax purposes. It is considered that this is simply another example of how a limited partnership may have no net income or profit for an income year. Therefore, it is appropriate to treat a nil income or profit year in the same way as a loss year. That is, for the purpose of applying paragraph 830-10(1)(b) to a limited partnership in a year in which it has no taxable income or profit, it is necessary to look to where the tax liability would rest if there had been income or profits of the kind that would have been taxable in the foreign jurisdiction.

52. Adopting the broad approach of looking to who would incur the liability if there had been income or profits of a kind that would have been taxable supports the policy intent of reducing compliance costs for investors in these types of entities.[15] This interpretation ensures that entities will not move between satisfying and not satisfying the definition of foreign hybrid limited partnership from year to year merely by reference to yearly profitability or because of the kind of income earned in any particular year, and therefore potentially having their tax treatment change, and having to consider the special rules that apply when an entity changes status.[16]

53. The words 'for the income year' after the words 'in respect of the income or profits of the partnership' could be taken to suggest a need to look at the partnership's income or profits in the particular year. However, in light of the context discussed above, it is considered appropriate to read the words 'for the income year' as qualifying the whole of paragraph 830-10(1)(b), rather than just to the immediately preceding words. That is, there is a requirement to test who income tax would be imposed upon if income or profits had been derived and would have been subject to tax in each income year.

54. In short, the provision primarily directs inquiry to the way in which the tax laws of the foreign country apply to the type of entity in question in the particular income year on the hypothesis that the partnership derived income or profits of a kind that would have been taxable in the foreign jurisdiction, rather than to the specific taxable income of the limited partnership and its partners for that year.

[15] The Explanatory Memorandum at 9.5.
[16] Subdivision 830-D.

Appendix 2 – Your comments

55. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

56. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**24 October 2008**
Contact officer:	**Catherine Radley**
Email address:	**catherine.radley@ato.gov.au**
Telephone:	**(02) 6216 2502**
Facsimile:	**(02) 6216 1250**
Address:	**Australian Taxation Office** **PO Box 9977** **Civic Square, ACT, 2608**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2004/31

Subject references:

- foreign hybrids
- foreign hybrid limited partnership

Legislative references:

- ITAA 1997
- ITAA 1997 770-15(1)
- ITAA 1997 770-70
- ITAA 1997 Div 830
- ITAA 1997 830-10
- ITAA 1997 830-10(1)
- ITAA 1997 830-10(1)(b)
- ITAA 1997 Subdiv 830-C
- ITAA 1997 Subdiv 830-D
- ITAA 1997 995-1(1)
- ITAA 1936 Pt III Div 5A
- ITAA 1936 Pt X
- ITAA 1936 Pt XI

Case references:

- Technical Products Pty Ltd v. State Government Insurance Office (Qld) (1989) 167 CLR 45

Other references:

- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 7) 2003

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