TD 2010/D8 - Income tax: does the business profits article (Article 7) of Australia's tax treaties apply to Australian sourced business profits of a foreign limited liability partnership (LLP) where the partners in the LLP are residents of a country with which Australia has entered into a tax treaty and the LLP is treated as fiscally transparent in the country of residence of the partners?

This document has been finalised by TD 2011/25.

There is a Compendium for this document: **TD 2011/25EC** .

This determination contains references to repealed provisions, some of which may have been re-enacted or remade. The determination has effect in relation to the re-enacted or remade provisions. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten.
Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

Draft Taxation Determination

Income tax: does the business profits article (Article 7) of Australia's tax treaties apply to Australian sourced business profits of a foreign limited liability partnership (LLP) where the partners in the LLP are residents of a country with which Australia has entered into a tax treaty and the LLP is treated as fiscally transparent in the country of residence of the partners?

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This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Yes, to the extent the business profits are liable to tax in the hands of the partners in their country of residence and the partners meet any other applicable tax treaty requirements. However, the tax treaty will only be applied where the Commissioner is satisfied that the partners are persons who are residents of that country for the purposes of the tax treaty.

2. A reference in this draft Determination to a limited liability partnership (LLP) includes a reference to an entity that is not a resident of Australia and satisfies the definition of limited partnership in section 995-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Example

3. *Cayman LLP is a limited liability partnership formed in the Cayman Islands. The limited partners in Cayman LLP are resident in a country with which we have a tax treaty. The general partner of Cayman LLP is a private equity firm, and is also resident for tax purposes in the treaty country.*

4. *For that country's income tax purposes, Cayman LLP is treated as fiscally transparent, such that income derived by Cayman LLP is liable to tax in the hands of their resident partners, to the extent of their interest in Cayman LLP. Cayman LLP is also a 'corporate limited partnership' within the meaning of that term in section 94D of the Income Tax Assessment Act 1936 (ITAA 1936) and is therefore treated as a company for Australian income tax law purposes. Cayman LLP is not treated as an Australian resident under section 94T of the ITAA 1936.*

5. *Cayman LLP acquires all of the shares in Target Co, an Australian manufacturing company. The primary purpose of the partners in Cayman LLP for acquiring Target Co is to improve its business operations in the short term and then sell Target Co via an initial public offering for an amount greater than the purchase price. This activity is undertaken through an independent agent acting as such in Australia in the ordinary course of its business. Cayman LLP derives profits from the sale of Target Co at a price higher than that for which it was acquired. These profits are Australian-sourced and are not attributable to a permanent establishment in Australia.*

6. *Article 7 of the relevant tax treaty prevents Australia from imposing income tax on profits of an enterprise of the other country unless such profits are attributable to a permanent establishment in Australia. Although the profits in this example are derived by Cayman LLP, these profits are liable to tax in the hands of the limited partners under their home country's income tax law and are not taxed in the Cayman Islands. Therefore, provided the Commissioner is satisfied that the partners of Cayman LLP are residents of that treaty country, the treaty will be applied such that the profits of Cayman LLP will not be subject to tax in Australia to the extent the limited partners are liable to tax in the treaty country on those profits and they meet any other applicable requirements under the relevant tax treaty.*

Date of effect

7. 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 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
1 December 2010

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.

Tax treaties without specific rules for transparent entities

8. Where a foreign resident taxpayer derives Australian-sourced income, such income is, prima facie, included in the taxpayer's assessable income under subsection 6-5(3) of the ITAA 1997.

9. However, Australia's right to tax Australian-sourced income may be limited by the application of one of Australia's tax treaties.

10. Specifically, paragraph 1 of the Business Profits Article (generally Article 7) in Australia's tax treaties[1] allocates source country taxing rights in respect of the profits of an enterprise where the enterprise carries on business in the source country through a permanent establishment (PE) there, but only to the extent that such profits are attributable to the PE in the source country. For example, Article 7(1) of the 2006 Norwegian Convention contained in Schedule 23 of the *International Tax Agreements Act 1953* states:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

11. This paragraph and its equivalent in each of Australia's tax treaties prevents Australia from taxing profits of an enterprise resident in another country where the enterprise does not have a PE in Australia or to the extent the profits of the enterprise are not attributable to a PE in Australia. An 'enterprise of a Contracting State' is defined in Article 3(1)(j) of the Norwegian Convention as

> an enterprise carried on by a resident of a Contracting State

12. In the example described in paragraphs 3 to 6 of this draft Determination, any Australian sourced income is derived by Cayman LLP. Under Australia's domestic tax law, Cayman LLP is treated as a company and thus a taxable entity in its own right. However, the tax law of the country of residence of the partners in Cayman LLP treats Cayman LLP as fiscally transparent and the partners are liable to tax on the income in their own hands. .

13. In dealing with the inherent difficulties associated with the differing treatment of partnerships in different countries, paragraph 6.3 of the commentary on Article 1 of the OECD Model states the following principle:

> ... that the State of source should take into account, as part of the factual context in which the treaty is to be applied, the way in which an item of income, arising in its jurisdiction is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident.

[1] All of which are based on Article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model). References in this draft Determination to the OECD Model Tax Convention and its Commentaries are those as at 22 July 2010.

14. The OECD Model Commentary provides for the source country to acknowledge how income arising in its jurisdiction is treated in the country of residence of persons claiming the benefits of the Convention. Australia recognises that the domestic tax law of treaty partner countries may require flow-through tax treatment to Australian source income derived through an interposed entity.

15. The effect of the principle outlined at paragraph 6.3 of the Commentary on Article 1 of the OECD Model is expressed at paragraph 6.4 which states:

> Where… income has 'flowed through' a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as 'paid' to the partners... Hence the partners, in these circumstances, satisfy the condition, imposed in several Articles, that the income concerned is 'paid to a resident of the other Contracting State'. Similarly the requirement, imposed by some other Articles, that income or gains are 'derived by a resident of the other Contracting State' is met in the circumstances described above.… Following from the principle discussed in paragraph 6.3, the conditions that the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.

16. The Commentary goes on to discuss partnership cases involving three States, and provides, at paragraph 6.5:

> Where a partner is a resident of one State, the partnership is established in another State and the partner shares in partnership income arising in a third State then the partner may claim the benefits of the Convention between his State of residence and the State of source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his State of residence.

17. Australia has not lodged an Observation on any aspect of the Commentary on Article 1 of the OECD Model as it relates to partnerships. Nor has Australia lodged any other Reservation or Observation indicating Australia's position is in any way different to that of the OECD Model or its Commentaries outlined above.

18. Accordingly, in relation to profits of an enterprise that have 'flowed through' a transparent partnership to its partners, application of the principle in paragraph 6.3 of the OECD Model Commentary means that such profits are treated as income of the partners.

19. Thus, to the extent the business profits of a LLP are liable to tax in the hands of the partners in their country of residence and the partners meet any other applicable tax treaty requirements, the Commissioner will provide treaty benefits to each of the partners of the LLP providing that the Commissioner is satisfied that each of the partners of the LLP is a resident of a country with which we have a tax treaty.

20. This result still obtains in instances where a LLP is organised in a country with whom Australia does not have a tax treaty, but the LLP is treated as fiscally transparent in, and the partners reside in, a country with which we do have a tax treaty. The tax treatment of the LLP in its state of formation (if different to the state of residence of the investor) is not necessarily relevant in determining whether and how the tax treaty between the state of residence and Australia applies.[2]

[2] Note, however, that if the LLP is formed in a country with which Australia has a tax treaty and that country treats the LLP as a resident and taxes the LLP on its profits, Australia will also be obliged to afford treaty benefits under that tax treaty to that LLP in respect of the Australian sourced business profits: See paragraph 6.5 of the Commentary on Article 1 of the OECD Model.

21. Paragraph 6.3 of the Commentary on Article 1 of the OECD Model indicates that States who are unable to agree with an interpretation that affords 'flow-through' treaty benefits where partnerships are interposed may include specific provisions to deal with this situation. The Commissioner accepts that the principle outlined in paragraph 6.3 applies when interpreting a tax treaty that does not include specific provisions to deal with interposed partnerships.

Tax treaties with specific provisions for transparent entities

22. Some of Australia's tax treaties incorporate specific provisions dealing with partnerships and other fiscally transparent entities. Where specific provisions exist, regard must be had to those provisions in the appropriate tax treaty context to determine how each treaty and, in particular, the Business Profits Article, applies.

23. The insertion of Article 1(2) in the 2009 New Zealand Convention is an example of an agreed approach to problems of asymmetry that can arise. Other examples include Article 4(1)(b)(iii) of the United States Convention and Article 4(5) of the 2008 Japanese Convention.

Practical administration

24. The conditional nature of the availability of treaty benefits for partners in LLPs was clearly stated twice in the OECD's 1999 Report 'The application of the OECD Model Tax Convention to Partnerships' (the OECD Report). At paragraph 50, the OECD Report provides in respect of the facts set out in Example 2 of that Report:

> *Such cases, in which the partners are not residents in the State where the partnership has been organised, raise additional difficulties for tax authorities wishing to verify a taxpayer's entitlement to treaty benefits. Clearly, states should not be expected to grant the benefits of tax conventions in cases where they cannot verify whether a person is truly entitled to these benefits.*

25. In relation to Example 10 of the OECD Report, paragraph 78 of the Report provides:

> *As already noted, States should not, however, be expected to grant the benefits of a tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus if State P is a tax haven from which State S cannot obtain tax information, the application of the provisions of the S-R Convention will be conditional on State S being able to obtain all the necessary information from the partners or from State R. In such cases, State S might well decide to use the refund mechanism for the purposes of applying the limitation of tax provided for in Article 10 even though it normally applies this limitation at the time of the payment.*

26. Practical difficulties arise where a partnership is organised in a non-treaty country, especially in a country with which Australia does not have a Tax Information Exchange Agreement in force, and the residence of the partners is not able to be verified. Where treaty benefits are to be provided, the Commissioner must be satisfied that the Business Profits Article of the relevant tax treaty applies to each of the partners in accordance with the conditions specified in paragraph 1 of this draft Determination.

27. Without the co-operation of the partners of a LLP it is difficult, practically speaking, to verify who are the recipients of the partnership's profits or their place of residence. As such, and in line with the concerns expressed in the OECD Report, the Commissioner considers it inappropriate to afford treaty benefits (that is, under the Business Profits Article) where the residence of the partners cannot be established. When the residence of the partners is unable to be verified by the Commissioner as being in a treaty partner country, the income derived by the LLP is assessable in Australia in the hands of the LLP itself.

28. In this regard, where appropriate, the Commissioner will apply section 255 of the ITAA 1936 or section 260-5 of Schedule 1 to the *Taxation Administration Act 1953* to third parties to secure the debt. The Commissioner will consider other available remedies if necessary.

29. If the Commissioner is satisfied subsequently that partners in the LLP are resident in a treaty partner country, and that treaty benefits are available, a refund of the tax collected can be sought.

Appendix 2 – Your comments

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

31. 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 Australian Taxation 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:	**28 January 2011**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- international tax
- double tax agreements

Legislative references:

- ITAA 1936 255
- ITAA 1936 94D
- ITAA 1936 94T
- ITAA 1997 6-5(3)
- ITAA 1997 995-1
- TAA 1953 Sch 1 260-5
- International Tax Agreements Act 1953 Sch 4 Art 1(2)
- International Tax Agreements Act 1953 Sch 23 Art 3(1)(j)
- International Tax Agreements Act 1953 Sch 2 Art 4(1)(b)(iii)
- International Tax Agreements Act 1953 Sch 6 Art 4(5)
- International Tax Agreements Act 1953 Sch 23 Art 7(1)

Other references:

- OECD Model Tax Convention on Income and Capital
- OECD Model Tax Convention and its Commentaries, 22 July 2010
- The Application of the OECD Model Tax Convention to Partnerships, 1999

ATO references

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