

TD 2008/23 - Income tax: are the active assets of a partnership, in which a foreign company is a partner, active foreign business assets of the foreign company for the purposes of the capital gains tax participation exemption provisions contained in Subdivision 768-G of the Income Tax Assessment Act 1997?

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Taxation Determination

Income tax: are the active assets of a partnership, in which a foreign company is a partner, active foreign business assets of the foreign company for the purposes of the capital gains tax participation exemption provisions contained in Subdivision 768-G of the *Income Tax Assessment Act 1997*?

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Ruling

1. No. The active assets of a partnership, in which a foreign company is a partner, are not active foreign business assets of the foreign company for the purposes of the capital gains tax (CGT) participation exemption provisions contained in Subdivision 768-G of the *Income Tax Assessment Act 1997* (ITAA 1997).¹

Example

2. *Dinky Co, an Australian resident company, acquired a share (that is not an eligible finance share or a widely distributed finance share) in Notoz Co (a foreign resident company) in January 2005 and holds a direct voting percentage of 55% in Notoz Co.*
3. *Notoz Co is a partner in a foreign hybrid limited partnership which carries on a business.*

¹ All legislative references are to the ITAA 1997 unless otherwise stated.

4. *On 30 November 2006, Dinky Co disposed of its share in Notoz Co, giving rise to a capital gain.*

5. *Dinky Co's capital gain is reduced by the active foreign business asset percentage of Notoz Co in relation to Dinky Co.*

6. *In calculating Notoz Co's active foreign business asset percentage in relation to Dinky Co, Notoz Co's active foreign business assets do not include any assets of the foreign hybrid limited partnership in which Notoz Co has an interest.*

Date of effect

7. This Taxation Determination applies 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 and 76 of Taxation Ruling TR 2006/10 Income tax, fringe benefits and product grants and benefits: Public Rulings).

Commissioner of Taxation

13 August 2008

Appendix 1 – Explanation

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

Explanation

8. Section 768-505 can reduce a capital gain or loss made by an Australian resident company and their controlled foreign companies (the holding company), when certain CGT events² happen to shares (other than eligible finance shares or widely distributed finance shares)³ that the holding company owns in a foreign company. Section 768-505 applies when the holding company holds a direct voting percentage of 10% or more in the foreign company for a specified period before the CGT event happens.⁴

9. The capital gain or loss is reduced by the 'active foreign business asset percentage' of the foreign company in relation to the holding company,⁵ which reflects the degree to which the assets of the foreign company are used in an active business. In broad terms, this is the value of 'active foreign business assets' owned by the foreign company as a percentage of the value of the 'assets included in the total assets' of the foreign company.

10. Section 768-545 sets out the rules for determining whether an asset is included in the total assets of a foreign company at a particular time. The section requires that the asset must be a CGT asset owned by the foreign company at the particular time.

11. A CGT asset is defined in subsection 108-5(1) to be any kind of property or a legal or equitable right that is not property. For the avoidance of doubt, subsection 108-5(2) specifies particular CGT assets including:

- (c) an interest in an asset of a partnership;
- (d) an interest in a partnership that is not covered by paragraph (c).

12. Subsection 768-540(1) sets out the rules for determining whether an asset will be an 'active foreign business asset' of a foreign company at a particular time. The asset must be included in the total assets of the company, and it must not be an asset of the kind covered by subsection 768-540(2).⁶ An interest in a trust or partnership is an asset that is covered by subsection 768-540(2).⁷

² CGT events A1, B1, C2, E1, E2, G3, J1, K4, K6, K10 or K11: see paragraph 768-505(1)(c).

³ Eligible finance shares (within the meaning of Part X of *Income Tax Assessment Act 1936*) and widely distributed finance shares (within the meaning of that Part) are specifically excluded from the CGT participation exemption: see paragraph 768-505(1)(b).

⁴ Paragraph 768-505(1)(a).

⁵ Subsection 768-505(2). The active foreign business asset percentage of a foreign company, in relation to the holding company, is worked out in accordance with section 768-510.

⁶ Paragraph 768-540(1)(d).

⁷ Paragraph 768-540(2)(c).

Partnership assets not included in the foreign company's total assets

13. Where a foreign company is a partner in a partnership, the partnership's assets themselves are not included in the foreign company's total assets because the foreign company does not have absolute ownership of each of the assets. When an asset is owned by a partnership, full ownership of the asset resides with the partners jointly. Each partner only has an equitable or beneficial interest in the asset, and not absolute ownership of the asset: see *Canny Gabriel Castle Jackson Advertising Pty Ltd v. Volume Sales (Finance) Pty Ltd*,⁸ where the High Court described the nature of a partner's interest in a partnership as follows:

The partner's share in the partnership is not a title to specific property but a right to his proportion of the surplus after the realization of assets and the payment of debts and liabilities. However, it has always been accepted that a partner has an interest in every asset of the partnership and this interest has been universally described as a 'beneficial interest', notwithstanding its peculiar character. The assets of a partnership, individually and collectively, are described as partnership property (Partnership Act, 1892, as amended (N.S.W.), s. 20). This description acknowledges that they belong to the partnership, that is, to the members of the partnership.

14. Because partnership assets themselves are not included in the foreign company's total assets, they cannot be active foreign business assets of a foreign company.

Foreign company's interests in partnership assets are included in its total assets, but are expressly excluded from being active foreign business assets

15. The foreign company's total assets will include the foreign company's beneficial interest in each asset of the partnership, as well as any residual interest the foreign company has in the partnership, because both interests are CGT assets that are owned by the foreign company. But neither of these interests constitute an active foreign business asset of the foreign company for the purposes of section 768-540 because of the express exclusion in paragraph 768-540(2)(c) for an interest in a partnership.

16. The exclusion is broad in its coverage and encompasses both a partner's interest in the assets of a partnership and the partner's residual interest in the partnership itself. Although 'an interest in an asset of the partnership' and 'an interest in a partnership' are distinguished in subsection 108-5(2) as separate CGT assets, the specific reference in that section to both types of partnership interests is for the avoidance of doubt that both are CGT assets and to avoid double counting. The inclusion of the words 'that is not covered by paragraph (c)' at the end of paragraph 108-5(2)(d) indicates that, in the absence of the additional words, an interest in an asset of a partnership would be covered by the phrase 'an interest in a partnership' in paragraph 108-5(2)(d).

⁸ (1974) 131 CLR 321, at 327-328

17. The Commissioner considers that the exclusion in paragraph 768-540(2)(c) was intended to cover both an interest in an asset of a partnership and the residual interest in a partnership, because such interests are passive, rather than active, in nature. It is evident that in drafting this provision regard was had to the distinction between active and passive assets in the CFC 'tainted asset' concept. Paragraph 1.112 of the Explanatory Memorandum to the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (the Explanatory Memorandum) explains the rationale for excluding certain CGT assets:

Certain assets have been specifically excluded from the definition of active foreign business asset for the purposes of this measure **[Schedule 1, item 3, paragraph 768-540(1)(d) and subsection 768-540(2)]**. These specific exclusions have been broadly based on existing provisions in the income tax law that deal with the distinction between active and not active assets or income. In particular, consideration was given to the definition of 'tainted asset' in section 317 of the ITAA 1936 and the definition of 'active asset' in section 152-40 of the ITAA 1997.

18. If it had been intended that interests in partnerships were to be treated as active so that the active assets of the partnership contributed to the active foreign business asset percentage, then an interest in a partnership would have been specifically included in the definition of active foreign business assets in the same way as shares are specifically included. The Explanatory Memorandum elaborates on this point at paragraph 1.108:

Although shares are not normally considered to have an active character, they have been included within the definition of active foreign business assets for the purposes of this measure in order to facilitate the testing of subsidiary foreign companies for the presence of an active business **[Schedule 1, item 3, subparagraph 768-540(1)(b)(iii)]**. If shares were not treated as active for the purposes of this measure, then the active foreign business asset percentage of subsidiary foreign companies could not contribute to the active foreign business asset percentage of their foreign parent company **[Schedule 1, item 3, subsections 768-520(2) and 768-525(4)]**.

19. Subdivision 768-G was clearly not intended to afford the same treatment for shares in a foreign company when the shares are held indirectly via an interest in a partnership. Paragraph 1.120 of the Explanatory Memorandum states that:

Characterisation of interests in partnerships and trusts as not active means that these entities will not be looked through for the purpose of calculating the active foreign business asset percentage of a foreign company. Consequently, where the foreign company being disposed of holds an interest in a subsidiary company through a partnership or a trust, the active assets of that subsidiary company will not contribute to the active foreign business asset percentage of the foreign company. Therefore, any interest that the foreign company holds in that subsidiary company through the partnership or trust will effectively be treated as not active as the interest held by the company in the partnership or trust is a non-active asset.

20. Therefore, where a partnership is interposed between the foreign company and the active business assets, the active assets of the partnership will not be included in the 'active foreign business assets' for the purposes of calculating the foreign company's active foreign business asset percentage.

Appendix 2 – Alternative views

1 *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.*

Alternative views

21. It has been argued that the reference in subsection 768-540(2) to an interest in a partnership only covers a residual interest in the partnership itself. Accordingly, an interest in an asset of a partnership is an active asset for the purposes of calculating the active foreign business asset percentage for a foreign company. In other words, a partnership can be looked through so that the active assets of the partnership are taken into account when calculating the active foreign business asset percentage of a foreign company.

22. The alternative view is based on the premise that only assets which are CGT assets are taken into account when calculating the active foreign business asset percentage for a foreign company. CGT asset is defined in section 108-5 and expressly provides that an interest in an asset of a partnership, and the residual interest in the partnership itself, are separate CGT assets. It is argued that the reference to only one of these CGT assets in subsection 768-540(2); namely, the interest in the partnership itself means that an interest in an asset of a partnership is not covered by subsection 768-540(2). If Parliament had intended that subsection 768-540(2) should cover both CGT assets, then it would have drafted the provision to cover both limbs of the definition in subsection 108-5(2).

23. The Commissioner does not accept this argument for two reasons. Firstly, the Commissioner cannot reconcile the alternative view with the general statement in paragraph 1.120 of the Explanatory Memorandum that 'the characterisation of interests in partnerships and trusts as not active means that these entities will not be looked through for the purpose of calculating the active foreign business asset percentage of a foreign company'.

24. The Commissioner has considered the argument that paragraph 1.120 of the Explanatory Memorandum can be read narrowly as simply saying that if a share in a foreign company is held by a partnership, the assets of that foreign company will not contribute to the active foreign business asset percentage. However, the Commissioner cannot see how the paragraph can be read so narrowly. An interest in a partnership does not have to be classified as passive to ensure that it does not contribute. If a share in a foreign company is held by a partnership, the assets of that foreign company will not contribute to the active foreign business asset percentage in any event. This is because the share in the foreign company will have a nil value as a result of the direct voting percentage requirement being failed.

25. The second reason why the Commissioner does not accept the alternative view is that the provisions in Subdivision 768-G need to be construed having regard to the controlled foreign company (CFC) provisions contained in Part X and section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936).

26. The classification of assets as passive in Subdivision 768-G of the ITAA 1997 is based on the classification of assets as not active for the purposes of the CFC provisions in Part X of the ITAA 1936: see paragraph 17 of this Determination to the distinction between an active and a passive asset having been drawn in particular from the definition of 'tainted asset' in section 317 of Part X of the ITAA 1936. An 'interest in a partnership' is treated as not active under the CFC rules and having regard to its context there, the phrase encompasses both an interest in an asset of a partnership and the residual interest in the partnership itself.

27. The concurrent introduction of the CGT participation exemption provisions in Subdivision 768-G of the ITAA 1997 and amendments to section 23AJ of the ITAA 1936 was intended to ensure that capital gains attributable to the disposal of certain foreign active assets were treated consistently.⁹ That is, a capital gain would not be subject to Australian tax regardless of whether the asset were disposed of by a foreign company and the gain repatriated back to an Australian resident company as a dividend: section 23AJ of the ITAA 1936; or the gain was realised by the Australian resident company by way of sale of shares in the foreign company: Subdivision 768-G of the ITAA 1997.¹⁰ Conversely, a dividend paid by a foreign company indirectly through a partnership or trust to an Australian resident company is not exempt from tax under section 23AJ of the ITAA 1936, regardless of whether the dividend was paid out of profits generated by the foreign company from the sale of active assets. Likewise, under the CGT participation exemption provisions, an Australian resident company cannot reduce a capital gain made from the disposal of shares in a foreign company to the extent that the gain is referable to active assets held directly or indirectly by a partnership or a trust.

⁹ See paragraphs 1.6 and 1.7 of the Explanatory Memorandum.

¹⁰ See Taxation Determinations TD 2008/24 and TD 2008/25 for the Commissioner's view on the application of section 23AJ of the ITAA 1936 to a dividend paid by a company (not being a Part X Australian resident) to an Australian resident company who receives it in its capacity as a partner in a partnership or a trustee of a trust.

References

Previous draft:

TD 2007/D6

Related Rulings/Determinations:

TR 2006/10; TD 2008/24; TD 2008/25

Subject references:

- capital gains tax
- CGT asset
- CGT participation exemption
- controlled foreign companies
- foreign company
- interest in a partnership
- interest in an asset of a partnership
- interest in a trust
- partnership
- share
- trust

Legislative references:

- ITAA 1936 23AJ
- ITAA 1936 Pt X
- ITAA 1936 317
- ITAA 1997 108-5
- ITAA 1997 108-5(1)
- ITAA 1997 108-5(2)
- ITAA 1997 108-5(2)(c)
- ITAA 1997 108-5(2)(d)
- ITAA 1997 152-40
- ITAA 1997 Subdiv 768-G
- ITAA 1997

- ITAA 1997 768-505
- ITAA 1997 768-505(1)(a)
- ITAA 1997 768-505(1)(b)
- ITAA 1997 768-505(1)(c)
- ITAA 1997 768-505(2)
- ITAA 1997 768-510
- ITAA 1997 768-520(2)
- ITAA 1997 768-525(4)
- ITAA 1997 768-540
- ITAA 1997 768-540(1)
- ITAA 1997 768-540(1)(b)(iii)
- ITAA 1997 768-540(1)(d)
- ITAA 1997 768-540(2)
- ITAA 1997 768-540(2)(c)
- ITAA 1997 768-545
- Partnership Act 1892 (NSW) 20
- TAA 1953

Case references:

- Canny Gabriel Castle Jackson Advertising Pty Ltd v. Volume Sales (Finance) Pty Ltd (1974) 131 CLR 321; (1974) 48 ALJR 271; (1974) 3 ALR 409

Other references:

- Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004

ATO references

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