TD 2011/25 - Income tax: does the business profits article (Article 7) of Australia's tax treaties apply to Australian sourced business profits of a foreign limited partnership (LP) where the LP is treated as fiscally transparent in a country with which Australia has entered into a tax treaty (tax treaty country) and the partners in the LP are residents of that tax treaty country?

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

This document has changed over time. This is a consolidated version of the ruling which was published on *26 October 2011*

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 partnership (LP) where the LP is treated as fiscally transparent in a country with which Australia has entered into a tax treaty (tax treaty country) and the partners in the LP are residents of that tax treaty country?

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Ruling

1. Yes, to the extent the business profits are treated as the profits of the partners (and not the LP) for the purposes of the taxation laws of the country of residence of the partners and the resident partners meet any other applicable tax treaty requirements.

2. The Article will also apply to the extent that a partner in a LP is itself a LP and its partners (the ultimate partners) are residents of a tax treaty country.

3. A reference in this Determination to a limited partnership (LP) 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).

4. The term 'ultimate partner' in this Determination means a tax treaty country resident with an indirect interest in the LP which derives the Australian sourced business profit. The indirect interest is held via an interposed LP.

5. This Determination does not apply where the fiscally transparent entity is not a partnership.

Example 1

6. *Cayman LP is a limited partnership formed in the Cayman Islands. The limited partners in Cayman LP are resident in a tax treaty country. The general partner of Cayman LP is a private equity firm and is also resident for tax purposes in the treaty country.*

7. *For that country's tax purposes, Cayman LP is treated as fiscally transparent, such that the profits derived by Cayman LP are treated as the profits of the resident partners, to the extent of their interest in Cayman LP. Cayman LP 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 tax law purposes. Cayman LP is not treated as an Australian resident under section 94T of the ITAA 1936.*

8. *Cayman LP acquires all of the shares in Target Co, an Australian manufacturing company. The primary purpose of the partners in Cayman LP 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 LP 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.*

9. *Article 7 of the relevant tax treaty prevents Australia from imposing 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 LP, these profits are treated as the profits of the limited partners under their home country's tax law and are not taxed in the Cayman Islands. The profits of Cayman LP will not be subject to tax in Australia to the extent the profits are treated as the profits of the limited partners in the treaty country.*

Example 2

10. *The facts are as above in Example 1 with the following additions:*

- *A limited partner in Cayman LP is another limited partnership formed in the Cayman Islands (Interposed LP);*
- *There are two limited partners in Interposed LP. One limited partner is a resident of a tax treaty country; the other is not a resident of a tax treaty country;*
- *In the Cayman Islands and the tax treaty country, neither Cayman LP nor Interposed LP are treated as taxable entities. Rather, the profits are treated as the profits of the limited partners; and*
- *Interposed LP does nothing more than distribute the profits it receives from Cayman LP to the limited partners.*

11. *In respect of the limited partner of Interposed LP resident in a tax treaty country, the result as outlined in example 1 applies. Thus, to the extent the profits derived by Cayman LP are treated as the profits of that limited partner, Article 7 will apply and Australia will not tax those profits provided the Commissioner is satisfied as to residence and other applicable treaty requirements.*

12. *In respect of the profits derived by Cayman LP that are treated as the profits of the limited partner not resident in a tax treaty country, Australian tax will be imposed.*

Example 3

13. *The facts are the same as in example 2 except that the limited partner resident in the tax treaty country is a tax exempt organisation that qualifies as a resident for the purposes of the relevant tax treaty. To the extent the profit is treated as the profit of the tax exempt organisation, Australian tax will not be imposed. Again, the Commissioner must be satisfied that the profit is treated as the profit of a tax treaty country resident and any other applicable treaty requirements must be met.*

Date of effect

14. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
26 October 2011

Appendix 1 – Explanation

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.

15. 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.

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

17. 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.[2] For example, Article 7(1) of the Norwegian convention[3], 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.

18. 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.

19. In the examples described in paragraphs 6 to 13 of this Determination, any Australian sourced profit is derived by Cayman LP. Under Australia's domestic tax law, Cayman LP 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 LP and in Interposed LP treats those limited partnerships as fiscally transparent and the profit of those partnerships is treated as the profit of the partners.

OECD Model

20. 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.

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[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.

[2] Note that the Business Profits Article in Australia's tax treaties also provides that where profits include items of income or gains that are dealt with by another Article of the relevant treaty, that other Article will generally have priority over the Business Profits Article.

[3] *The Convention between Australia and the Kingdom of Norway for the avoidance of double taxation with respect to taxes on income and the prevention of fiscal evasion* [2007] ATS 32.

21. The Commentary on Article 1 of the OECD Model 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. In applying the relevant tax treaty, Australia recognises that the domestic tax law of treaty partner countries may require flow-through tax treatment to Australian sourced income derived through an interposed fiscally transparent entity.

22. 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.

23. 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 Commentary on Article 1 of the OECD Model means that such profits are treated as the profits of the partners.

24. Australia has not lodged an Observation on any aspect of the Commentary on Article 1 of the OECD Model. 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.

25. The OECD Model Commentary does not specifically define the term 'partnership'.[4] What is intended to be within that term varies between countries, particularly between common law countries and civil law countries. In line with the OECD Model Commentary, the Commissioner will acknowledge how the particular tax treaty country taxes the residents in applying the treaty and what that tax treaty country considers to be a partnership. Therefore, the Commissioner will apply the relevant tax treaty in line with the above Commentary on Article 1 of the OECD Model where the partners, resident in the tax treaty country, are partners in an entity regarded as a partnership for the purposes of the applicable commercial laws of that tax treaty country. That partnership must also then be fiscally transparent in that tax treaty country.

26. 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.

[4] However, the report by the Committee on Fiscal Affairs entitled 'The Application of the OECD Model Tax Convention to Partnerships' (1999) provided, in paragraph 2, that the references to 'partnerships' in that report covered entities that 'qualify as such under civil or commercial law as opposed to tax law'. Thus, it is to be assumed that the OECD were using the term in a similar way in the Commentary to Article 1 of the OECD Model.

27. Thus, the same result outlined in paragraph 23 above still obtains where:

- a LP is organised in a country with which Australia does not have a tax treaty;
- the partners reside in a country with which Australia does have a tax treaty; and
- the LP is treated as fiscally transparent in the tax treaty country.

28. The tax treatment of the LP in its country of formation is not necessarily relevant in determining whether and how the tax treaty between the country of residence of its partners and Australia applies.

29. However, if the LP is formed in a country with which Australia has a tax treaty and that country treats the LP as a resident and taxes the LP on its profits, Australia will be obliged to afford tax treaty benefits under that tax treaty to that LP itself in respect of the Australian sourced business profits.

30. 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' tax treaty benefits where partnerships are interposed may include specific provisions to deal with this situation. Subject to a tax treaty containing such provisions, the Commissioner accepts that the principle outlined in paragraph 6.3 of the Commentary applies

Single LP interposed between tax treaty resident and Australian business profit

31. To the extent the business profits of a LP have flowed through to the partners and are treated as the profits of the partners in their country of residence and the partners meet any other applicable tax treaty requirements, the Commissioner will treat the profits as the profits of an enterprise of a partner. Therefore, where the profits are not attributable to an Australian permanent establishment, those profits will not be taxed in Australia providing that the Commissioner is satisfied that each of the partners of the LP is a resident of a country with which Australia has a tax treaty.

LPs interposed between tax treaty country residents and the LP deriving the Australian sourced business profit

32. The OECD Model Commentary does not specifically deal with layers of partnerships. In typical private equity arrangements it is common to see limited partnerships that are partners in the limited partnership that derives the relevant business profit. Where the profits actually allocated to the tax treaty resident can be regarded as having 'flowed through' from the deriving LP, the Commissioner considers that the principle applicable to partnerships more generally as set out in the Commentary still applies.

33. Accordingly, the applicable tax treaty benefits should be available where the Australian business profit is ultimately treated as the profit of a partner and that profit has not been treated as the profit of any other entity when it is distributed through each of the interposed partnerships. That is to say, paragraph 6.4 of the Commentary on Article 1 of the OECD Model is to be applied as giving the same result to an ultimate partner as it would to a partner investing directly in the LP to which the business profit is paid.

Practical Administration

34. There are practical issues in satisfactorily ascertaining ultimate partners, their residence and their share of the Australian business profit. Furthermore, where the interposed entities are resident in tax treaty countries, the application of those tax treaties also needs to be considered.

35. Similarly, where the partners of a LP are resident in different countries (and Australia may not have a tax treaty with all those countries), treaty benefits only arise for partners resident in tax treaty countries. Again, it is a practical matter of ascertaining residence and the appropriate proportion of business profit which is to be taxed in accordance with the relevant tax treaty.

36. The conditional nature of the availability of tax treaty benefits for partners in partnerships 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.

37. 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.

38. All tax administrations have difficulties tracing through partnerships organised in non-treaty countries. Difficulties also arise where there are multiple LPs interposed between the business profit and the partner, and where the partners do not all reside in the same country. Where tax 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 Determination.

39. As a consequence, the onus must be on the general partner of any involved LP to demonstrate that a limited partner is a resident of a tax treaty country. The OECD was alert to the problem of tracing and conceded the difficulty of affording treaty benefits where the residence of partners was obscure. Like all member countries, Australia considers it inappropriate to afford tax treaty benefits under the Business Profits Article where the residence of the partners cannot be determined. Countries with which Australia has a tax treaty have no single methodology available to easily discern the residence of partners in these kinds of cases. Necessarily, it will therefore be a matter for the general partner (fund manager) to discuss their circumstances with the Commissioner on a case by case basis.

40. Industry discussions have confirmed that the environment for obtaining relatively scarce funds for this kind of private equity activity is very competitive and that fund manager's investor/client base in leveraged buy-out arrangements is a relatively small group. It has also been widely suggested that funds are sourced pre-dominantly from investors who are resident in treaty countries. Accordingly, it is envisaged that in nearly all cases fund managers will be aware of the details of the residence of their ultimate investors. Some funds will, of course, have provided identifying information to our treaty country partner's revenue agency in any event.

41. To avoid the potential for assessing action, fund managers should assemble as much information as is available to them as soon as practicable after an acquisition has been made and forward that information to the Commissioner. Once it has been determined where the ultimate partners reside, the Commissioner will provide advice to the fund manager as to what arrangements, if any, will need to be put in place to ensure treaty obligations have been met. Given the relatively stable partnership arrangements typically put in place, the initial information exchange ought to be the limit of a limited partner's (fund manager's) compliance obligations unless a material change in the partnerships' members occurs.

42. In the absence of the provision of sufficient identifying information and, 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 on any subsequent assessment. The Commissioner will consider other available remedies, if necessary.

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

References

Previous draft:

Previously issued as a Draft Taxation Determination TD 2010/D8

Related Rulings/Determinations:

TR 2006/10; TD 2010/D7

Subject references:

- double tax agreements
- international tax

Legislative references:

- ITAA 1936 94D
- ITAA 1936 94T
- ITAA 1936 255
- ITAA 1997 6-5(3)
- ITAA 1997 995-1
- TAA 1953 Sch 1 260-5

Other references:

- Commentaries on the Articles of the OECD Model Tax Convention, 22 July 2010
- OECD Model Tax Convention on Income and on Capital, 22 July 2010
- OECD Committee of Fiscal Affairs, 'The Application of the OECD Model Tax Convention to Partnerships',1999, Volume II loose-leaf version OECD Model Tax Convention, p. R(15)-1
- Norwegian convention [2007] ATS 32 Art 7

ATO references

NO:	1-2II4QK2
ISSN:	1038-8982
ATOlaw topic:	Income Tax ~~ Double tax agreements