Increasing use of tax-transparent entities by private groups due to BEPS

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Abstract: To date, the effect of the base erosion and profit shifting (BEPS) project is that Australian-owned private companies whose business could be affected by ecommerce are largely able to avoid high rates of foreign taxation. This allows significant deferral of Australian tax liability until the profits from the overseas activities are ultimately released into the hands of Australian resident individuals. This would often involve the use of tax haven subsidiaries of an Australian company, selling into a world market, without a taxable presence in the country of the customer. The result of implementation of one or more of the action items of the BEPS project may create a situation where Australian private companies' non-resident subsidiaries will increasingly become liable to more foreign taxes than in the past. This article examines the tax-transparent entities that might be available to owners of Australian-owned private companies in several countries, and compares the pros and cons of each.

Introduction

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final reports on action items for a coordinated global approach to reform the international tax system under the OECD/G20 base erosion and profit shifting (BEPS) project.[1]

In the context of Australian-owned private companies expanding offshore, a number of the action items may impact on such clients' future tax planning. Those actions are:

- action 1: addressing the challenges of the digital economy;
- action 3: designing effective controlled foreign company (CFC) rules;
- action 6: preventing the granting of treaty benefit in inappropriate circumstances;
- action 7: preventing the artificial avoidance of permanent establishment (PE) status; and
- actions 8 to 10: aligning transfer pricing outcomes with value creation.

As is set out in the foreword to each of the action items:

> "International tax issues have never been as high on the political agenda as they are today. Integration of national economies and markets has increased substantially in recent years, putting strain on the international tax rules, which were designed more than a century ago. Weakness in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created."

The political agenda to which the OECD refers is, of course, the fervour over the small amount of tax that mainly United States-based multinationals have paid in other high-tax countries (particularly Google, Amazon, Microsoft and Starbucks), originally agitated in the United Kingdom parliamentary committees shared by Margaret Hodge. Of course, that momentum flowed to Australia after a number of years, resulting in like interrogation of executives of those same companies about their non-tax paying behaviour in Australia. While the US is a member of the OECD, as is its multinationals which have largely been the subject of criticism, and it is the US revenue that has the most to lose by more foreign taxes being paid than have been paid to date (by virtue of having to provide a credit for foreign taxes paid), its enthusiasm for the BEPS project has been limited.

Of course, to a lesser extent than the US, to the extent that foreign countries are successful in levying tax that was previously not collectable, eg China levying tax on Australian mineral exports, the Australian revenue may or may not have a net increase. That is, BEPS is a "two-edged sword".

Most private sector commentators on the BEPS project encouraged governments to wait until the BEPS final reports were issued but, notably, the UK and Australia "jumped the gun" and introduced unilateral measures being the diverted profits tax, and the amendments to Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (the "multinational anti-avoidance law"),[2] respectively. The more countries that act inconsistently with the BEPS recommendations, the greater the chance of unrelieved double tax, and its result of discouraging foreign investment.

The political agenda is largely driven by the catchcry that multinationals should "pay their fair share" of tax in the countries in which they have customers. That is essentially an argument that the location of the customers should govern the source of the income,[3] rather than the long-established source rules, such as the place of entry into of a contract for the sale of goods by a simple merchant.[4] The catchcry essentially ignores the trend in recent years in the OECD, including Australia, to residence rather than source-based taxation. The problem is that the country of residence, eg the US and, indeed, Australia, does not levy tax on the foreign-source income until it is repatriated to the US holding company (which doesn't happen often), or when it is paid as dividends or deemed dividends to shareholders in the Australian parent. The suggestion that the relevant income will be untaxed ("stateless") income is therefore incorrect, but it is correct that the design of the tax systems of the countries of residence do not tax the foreign-source income at a point of time anywhere close to when the income is earned in the foreign country. This is truer in relation to Australian public companies that are often in a position to satisfy the shareholders needs for dividends, out of taxed domestic-sourced income,[5] compared with some private groups that do not have significant Australian-sourced income.[6]

To date

The context in which the effect of the BEPS project is to be examined in this article is that, to date, the design of the international and Australian tax systems for Australian-owned private companies whose business could be affected by ecommerce were largely able to avoid high rates of foreign taxation. This allowed significant deferral of Australian tax liability until the profits from the overseas activities were ultimately released into the hands of the ultimate "owners", being Australian resident individuals. This would often involve the use of tax havens or effective tax haven subsidiaries of an Australian company selling into a world market, without a taxable presence in the country of the customer.

Occasionally, the business model of the client would involve some physical presence in the country of residence of the customers, eg after-sales support, but invariably those services were provided by a separate legal entity to the company that was the vendor of the product, ensuring that the vendor of the product did not have a taxable presence in the country of residence of the customer.

More foreign taxes

In those circumstances where a taxable presence could not be avoided in country of residence of the customer, eg construction projects lasting a long period of time, or retail "bricks and mortar stores", it was more likely that significant foreign taxes would be incurred, in which case, the overall rate of tax payable on the profits earned in the high-tax countries, together with the lack of a foreign tax credit for those taxes in the hands of the ultimate Australian individual owners, could result in a worldwide tax rate of around 70%. For example, if the profits were earned by a US company with an Australian parent company:

$100 of profit earned by US company	US tax $35.00
Cash dividend of $100 – $35 = $65	US withholding tax @ 5% = $3.25
Cash received by Aust company (free of Aust tax — s 768-5 ITAA97)	$61.75
Cash dividend of $61.75 to Aust resident individual @ 49%	Aust tax $30.25
Total tax US$35 + $3.25 + AU$30.25 =	**$68.50**

The result is the same if an Australian resident company earned the income through a branch taxable in the US:

$100 of profit earned by Aust company	US tax $35.00
Cash available $100 – $35 = $65	US branch profits tax @ 5% = $3.25
Cash received by Aust company (free of Aust tax — s 23AH ITAA36)	$61.75
Cash dividend of $61.75 to Aust resident individual @ 49%	Aust tax $30.25
Total tax US$35 + $3.25 + AU$30.25 =	**$68.50**

In those circumstances, the use of tax-transparent entities (where the entity is not liable to tax, but its members are), eg a US limited liability company (LLC), could be structured so that the significant foreign taxes paid were creditable to the Australian resident individual ultimate owners, in which case, provided the foreign tax was lower than the top marginal rate for an individual in Australia, the worldwide tax on the foreign profits could be limited to that top marginal rate, ie currently effectively 49% compared with towards 70%.

The result of implementation of one or more of the above referred-to action items of the BEPS project may, over time, create a situation where Australian private companies' non-resident subsidiaries (which are not tax-transparent, ie they are taxpayers, referred to as "opaque" in contrast to "transparent") will increasingly become liable to more foreign taxes than in the past, raising the question of a closer examination of the use of tax-transparent entities by Australian resident private company owners, having the effect that they not achieve any Australian tax deferral, but at least limit the worldwide rate of tax to the top marginal rate for an individual in Australia. Briefly, the above referred-to action items which may result in more tax being payable in the country of residence of the customer are discussed below.

Action 1: addressing the challenges of the digital economy

The final report on action 1 essentially defers dealing with the digital economy differently from the non-digital economy. Originally, there was talk of deeming a non-resident selling product into the customers' country without any current taxable presence to have a taxable presence based on the regularity or value of sales made to customers in that country. In the end, the final report leaves it to the other action items to deal with the challenges of the digital economy and other design features which avoided a taxable presence. However, where the multinational conducting ecommerce with customers in the high-tax country has absolutely no presence there, the BEPS project, as will be seen, may have no immediate impact.

Action 3: designing effective controlled foreign company rules

From the Australian perspective, it is noted that, since 1 July 2004, the fact that an Australian CFC pays no foreign tax does not make the CFC's income attributable. Nor does the Australian CFC regime have any "substance" requirements (for example, like the UK) which require sufficient personnel on the ground in the country of residence to perform the functions of the CFC. Perhaps, in Australia, Pt IVA gives rise to the need for some "substance", but in the end this is different from a "bright line" test as applied in some other jurisdictions.

Action 3 does not stipulate that either there must be an effective minimum tax payable in the foreign countries by the CFC, or a minimum "substance" requirement, but clearly the Australian CFC system is presently favourable to obtaining tax deferral through "base" companies in tax havens compared to some other jurisdictions. Probably, it is the restrictions imposed on the European Union (EU) countries' application of the CFC rules by virtue of the decision of the European Court of Justice in *Cadbury Schweppes*[7] which have tempered the action 3 recommendations. That is, in the EU, the CFC rules can only apply where the CFCs activities are wholly artificial.

Action 6: preventing the granting of treaty benefits in inappropriate circumstances

Action 6 essentially suggests the introduction of more widespread limitation of benefits articles in double tax agreements (DTAs), or rules in DTAs which would limit the benefit of the DTA in abusive cases.

As it relates to Australian private company behaviour to date, where ecommerce has been the means of selling into high-tax countries with no "on the ground" presence required in such high-tax countries, the existence of a treaty with the country of residence of the customers would not be required in order to avoid a taxable presence. The introduction of limitation of benefits articles or more targeted anti-abuse provisions would of course impact where the presence in the country of residence of the customers would have been less than that that constitutes a PE and so not a taxable presence under the DTA, to a situation where the base company will not be entitled to treaty protection, and even a very minor presence in the country of residence of the customer will create a taxable presence.

Action 7: preventing the artificial avoidance of permanent establishment status

Again, if the method of delivery is via ecommerce with no presence in the country of residence of the customer, action 7 would be unlikely to have any impact. However, as with action 6, if the presence in the country of residence of the customer was required, the proposed expansions of the definition of "permanent establishment" would expose profits to tax in the country of residence of the customer in circumstances where the PE was previously avoided by having a different legal entity provide those "on ground" services.

Actions 8 to 10: aligning transfer pricing items with value creation

Actions 8 to 10 provide guidance on the following key areas:

- transfer pricing issues related to transactions involving intangibles;
- contractual arrangements, including the contractual allocation of risks and corresponding profits, which are not supported by the activities actually carried out; and
- the level of return to funding company provided by a capital-rich multinational enterprise group member, where that return does not correspond to the level of activity undertaken by the funding company.

Miscellaneous observations

It is worth noting that the driver of the project was the global financial crisis impact on the tax revenues of high-tax countries within the OECD.

While there has been some work done on enabling developing countries (who are not OECD members almost by definition) to obtain more tax revenue largely in the extractive industries, the BEPS project is focused on investment in OECD countries.

Combined effect of action items

Over time, the implementation of one or more of the recommendations in the BEPS final reports is likely to increase the level of foreign taxation paid by the Australian privately owned groups doing business in high-tax countries. This raises the question of a closer examination of the use of tax-transparent entities by Australian resident private company owners, having the effect that they not achieve any Australian tax deferral, but at least limit the worldwide rate of tax to the top marginal rate for an individual in Australia.

> *"Tax-transparent entities … at least limit the worldwide rate of tax to the top marginal rate for an individual in Australia."*

The issue is best illustrated by looking at what happens if an Australian resident individual earns business profits in the US personally (assuming the individual is on top marginal rates):

$100 of profit earned by Aust individual	US tax $39.60
Aust tax on $100 @ 49%	Aust tax $49.00
Credit for US tax paid[8]	($39.60)
Net Aust tax	$9.40
Total tax US$35.90 + AU$13.10 =	**$49.00**

However, to obtain limited liability and for commercial reasons, an individual won't normally want to carry on business personally or in a general law partnership.

Having a corporate trustee of a trust should provide limited liability not available to an individual or a general law partnership.

Tax-transparent entities

Where the foreign tax incurred will be high, or there might be significant start-up losses, a transparent structure will better potentially allow for a flow through of foreign tax credits (and perhaps even losses).

Australian resident trust with corporate trustee

An Australian resident trust with a corporate trustee may possibly be able to trade in the foreign country, although this will be a country-by-country issue. It is worth noting that the Australian resident trust can even have a foreign incorporated company as trustee, as long as the trustee is an Australian tax resident (because its central management and control are in Australia).

As long as the Australian resident beneficiary or beneficiaries are individuals, the tax result will be the same as had the individual(s) earned the income personally, as the beneficiary will be entitled to a credit in Australia for foreign tax paid: s 770-130(3) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). It should not matter whether the foreign country recognises that the trustee is trading as such, or for local purposes ignores the trust relationship and taxes the trustee as though it was a company trading in its own right.

Indeed, it is understood that the US, for instance, will tax the trustee of an Australian trust essentially at the top marginal rate for an individual (currently 39.6%), unless the trustee distributes income to a beneficiary, in which case, the trustee gets a deduction for the distribution, leaving the beneficiary liable to the US tax. Whether the trustee pays the US tax or the beneficiary does, the beneficiary who is entitled to the income subject to US tax will get a foreign tax income offset for the US tax.

Note that losses cannot flow through a trust for Australian purposes.

Foreign resident trust with corporate trustee

If the trustee of a trust to trade in a foreign country is a tax resident of that country, and the trust was set up and controlled by Australian residents, the trust is a "transferor trust" for Australian tax purposes, but the transferor trust provisions (Div 6AAA ITAA36) do not apply if the beneficiaries are "presently entitled" to the trust income. In that case, the Australian tax result in terms of obtaining a foreign tax credit is the same as for an Australian resident trust.

Foreign companies and limited partnerships

Generally, foreign companies and limited partnerships (LPs) are treated as companies for Australian tax purposes, and taxed as such, ie they are "opaque". However, there are important exceptions.

Division 830 – foreign hybrids

Division 830 ITAA97 allows US LLCs and some LPs and limited liability partnerships (LLPs) transparent treatment, which will allow flow through of foreign losses and foreign tax offsets. Where no tax deferral is sought through a CFC (because the natural person shareholders want the profits in their hands as soon as possible), or where the foreign business is likely to make start-up losses or incur significant rates of foreign tax, the Div 830 treatment is attractive.

A problem with the use of Div 830 where there might be significant source country tax is that it is unlikely that the hybrid will be entitled to treaty benefits, as it will not usually be regarded as a tax resident of the country in which it is formed. However, the OECD material indicates that the source country should treat the members or partners of the hybrid as the relevant taxpayers. Accordingly, Australian resident members or partners should be afforded the benefit of Australia's DTAs, but there may be administrative obstacles to obtaining that treatment.

Where the hybrid will be very useful is where the business is in the country of the formation of the hybrid. So, for example, deriving US-source trading income through a US LLC or US LLP, or UK-source trading income though a UK LLP. The same goes for New Zealand, Singapore and India. In those cases, the limited liability of the members or partners will also be assured, at least in the country of formation.[9] The total tax burden for the members or partners can never exceed the top marginal rate in Australia (unless the foreign tax exceeded the Australian tax, which is unlikely), whereas had they traded through an ordinary US or UK company, the total tax burden may exceed 60% to 70%.

For the derivation of trading income of a hybrid in a third country, if a "local face" is needed, a locally incorporated company might act as the disclosed agent of the hybrid. However, this will require the agent to derive an arm's length profit for so acting, which would not be attractive if the business in that country was not profitable, and the use of the hybrid was designed to access losses in Australia. Subject to the local tax issues with trusts, and whether central management and control is the sole determiner of place of residence of a trustee, a local company with Australian central management and control might be the trustee of a trust that trades in the local country. For Australian purposes, the trustee will be an Australian resident, and so will the trust, yet the trustee will be locally incorporated with a local address. An Australian resident beneficiary presently entitled to the foreign income of the trust will be entitled to a foreign tax offset on that income: see s 770-130(3) ITAA97.

Note an LP or an LLP is not always in the legal form of a partnership, and is sometimes a company. For example, a UK LLP is a company, whereas a Delaware LLP is a partnership, and a Delaware LP is incorporated!

What will work?

The various tax-transparent entities that might be available to owners of Australian-owned private companies in several countries are examined below. The pros and cons of each of the entities are also considered.

US LLC

The US LLC is perhaps the best-known transparent entity on a worldwide basis. It is transparent by default, but can elect to be a taxpayer, ie opaque. Because it is well known and the fact that, by default, the US does not tax the US LLC nor its non-resident (non-citizen) members on its foreign-source income, it has been recognised as a suitable vehicle for worldwide trading and investment.

US source income will be taxed in the US to its members, and not the LLC itself. If it has US source income, the members will have to file US tax returns.

It will also be treated as transparent for Australian purposes under Div 830. That is, its members are the relevant taxpayers, and not the LLC itself. As well, foreign losses will be able to be shared by the members in Australia (since s 79D ITAA36 was repealed with effect from 1 July 2008).

Foreign tax borne by the LLC is treated as borne by the members, and will be creditable to the members for Australian purposes. This follows because s 830-20 ITAA97 specifies that the tax law applies as though the company was a partnership, and is confirmed in TR 2009/6 and numerous interpretative decisions.

The US LLC can be formed in several US states, but the most common choice are for those formed in Delaware under the laws of the State of Delaware.[10] Here, the Delaware LLC requires one or more members at all times, allowing for single member LLCs. "Owners" of the LLC are known as "members".

Members, and furthermore managers, of an LLC can be a "natural person, partnership, LLC, trust, estate, association, corporation, government, custodian, nominee or any other individual or entity, whether domestic or foreign".

The members are protected from personal liability for the debts, obligations and liabilities of the LLC. This protection also extends to managers. Therefore, if the LLC incurs a debt or is sued, the member and/or manager are not personally liable and the LLC will be solely responsible for that debt, obligation or liability. However, a member or manager has the ability to agree to be personally obligated for any or all of the debts, obligations and liabilities of the LLC through an LLC agreement or other agreement.

It seems that US LLCs are specifically contemplated to be a "foreign hybrid company" for the purposes of s 830-15 ITAA97, compared with US LLPs which have hybrid status under Div 830 through being treated as a "foreign hybrid limited partnership" under s 830-10 ITAA97.

Because US LLCs are recognised worldwide, they have a distinct commercial advantage over other transparent entities (discussed below), as a utility vehicle for international trading.

In relation to Australian private groups' use of US LLCs, for both flexibility and as an added level of asset protection, an Australian discretionary trust(s) with a corporate trustee should be the members of the US LLC. Having a corporate trustee as the member provides the extra safeguard if a foreign country in which the LLC trades attempted to "pierce the corporate veil".

If a US LLC has an Australian resident family trust as its member, the result is the same as if an Australian resident individual earns business profits in the US personally (assuming the individual is on top marginal rates):

$100 of profit earned by US LLC	US tax $0.00
US tax paid by Australian trustee	$39.60
Aust tax paid by Australian trustee	$0.00
Aust tax on individual beneficiary $100 @ 49%	Aust tax $49.00
Credit for US tax paid by trustee	($39.60)
Net Aust tax	$9.40
Total tax US$39.60 + AU$9.40 =	**$49.00**

If, for asset protection reasons, it is not desired to put the foreign income into the hands of an Australian resident individual who may be "at risk" or for family law reasons, the trustee may decide not to make a beneficiary presently entitled to the trust income, accumulate it, and pay tax on it under s 99A ITAA36 (at top marginal rate). However, the trustee in those circumstances will be entitled to a credit for the foreign tax, and any subsequent distribution to a beneficiary out of that taxed source will not be taxable in their hands.

As the US LLC will be tax-transparent, it doesn't get the benefit of the DTAs entered into by the US, but the OECD commentary on the model DTA says that the members of the transparent entity should be given the benefit of any DTA between the source country and the country of residence of the members. For example, if the US LLC has UK source income and Australian resident members, the members should get the benefit, if any, of the UK–Australia DTA. This analysis was accepted by the Full Federal Court in *FCT v Resource Capital Fund III LP*[11] had the LP with US members been a US LP rather than a Cayman's LP.

As the US LLC is a "US person", foreign financial institutions may have to keep records of payments to it, and report same to the Internal Revenue Service under the *Foreign Account Tax Compliance Act* (US) (FATCA), unless it is transparent and has a single individual member, in which case the filing is in respect of the individual member.

LLPs

Whether a foreign LLP is incorporated or not, without the introduction of Div 830 in 2004, it would have been treated as a foreign company (by virtue of Div 5A ITAA36, introduced in 1992), and depending on the level of partner holding, such an LLP would either be an interest in a CFC (or a foreign investment fund interest until abolished on 1 July 2010).

US LLP

A US LLP is formed under the federal *Uniform Partnership Act 1997* (US) (UPA). This Act amended the previous Uniform Partnership Act to "provide limited liability for partners in a LLP". It is up to the states to adopt the latest version of the UPA. Delaware has implemented these principles through the *Delaware Revised Uniform Partnership Act* (US) (DRUPA).

Under the DRUPA it is stated that a "partnership is an entity distinct from its partners", unless otherwise stated. The LLP partnership can sue and be sued. Section 15-306 DRUPA provides that an obligation incurred by an LLP "whether arising in contract, tort, or otherwise, is solely the obligation of the partnership."

Additionally, it is stated that "a partner is not a co-owner of partnership property". The partner also has no interest in the partnership property.

US LP

See the description of a US LP under the heading "ID 2008/80" below.

UK LLP

From the Australia outbound perspective, a UK LLP is treated by s 830-15 ITAA97 as a "foreign hybrid company" (mainly on the basis that it is formed under the *Companies Act 2000* (UK): see ID 2006/331), and a UK LP is signed off as a "foreign hybrid limited company" under s 820-10 ITAA97 by TD 2009/2.

A UK LLP is a body corporate which is incorporated under the *Limited Liability Partnerships Act 2000* (UK) (LLPA). A requirement of the incorporation of the LLP is that "two or more persons associated for carrying on a lawful business with a view to profit must have subscribed their names to an incorporation document". These persons who subscribe their names on the incorporation document become the members of the LLP. However, any other person may become a member or cease to be a member of the LLP by way of agreement with the existing members, or giving reasonable notice when ceasing to be a member.

Pursuant to s 10 LLPA, s 118ZA was introduced into the *Income and Corporation Taxes Act 1988* (UK) which states that for the purposes of the Tax Acts, "a trade, profession or business carried on by a LLP with a view to profit shall be treated as carried on in partnership by its members". Furthermore, the property of the LLP shall be treated for tax purposes as partnership property.

Additionally, s 59A was introduced into the *Taxation of Chargeable Gains Act 1992* (UK) which provides that "where a LLP carries on a trade or business with a view to profit assets and dealings of the LLP shall be treated for the purposes of tax to be held by or dealings by the member respectively".

As evident from the legislation changes above, each member pays tax on their share of the profits, as they would in an "ordinary" business partnership. However, members of an LLP are not personally liable for any debts or obligations of the LLP.

UK LP

A UK LP is formed under the *Limited Partnerships Act 1907* (UK) (LPA), consisting of one or more persons as general partner and one or more persons as a limited partner, but is not incorporated. A general partner is liable for all debts and obligations of the LP, whereas a limited partner is only liable for the debts or obligations of the LP that are equivalent to the amount of capital or property value that the limited partner contributed at the time of entering into the partnership. A body corporate can be a limited partner under the LPA.

A limited partner is not to be involved with the management of the LP business. However, if a limited partner does take part in the management of the LP, he or she will be liable for all debts and obligations of the business incurred during this time. Thus, the limited partner while taking part in the management of the business will be considered as a general partner.

What should work?

NZ LP compared with UK LLP

An NZ LP is governed by the *Limited Partnerships Act 2008* (NZ) (LPANZ). The LP is formed on its registration and will continue in existence until it is deregistered. An NZ LP is incorporated (whereas a UK LP is not).

Similar to a UK LP, an NZ LP also requires at least one general partner and at least one limited partner.

Under the LPANZ, a general partner can be:

- a natural person;
- an LP;

- a partnership governed by the *Partnership Act 1908* (NZ) (with one or more natural persons as partners);
- a company; or
- an overseas company registered under the *Companies Act 1993* (NZ) (with one or more natural persons as directors), provided that each fulfil requirements under s 8 LPANZ.

The requirements under s 8 can include that the natural person lives in NZ or "lives in an enforcement country and is a director of a company registered in that enforcement country". An enforcement country is a country, state or territory outside of NZ for the purpose of the regulations to s 8(4). At this stage, only Australia is so listed.

A general partner is responsible for the management of the LP, whereas a limited partner must not be involved with the management. Both a general and limited partner do not have to make a capital contribution to the LP, unless otherwise agreed on in the partnership agreement.

The general partners of the NZ LP are jointly and severally liable for the unpaid debts and liabilities, as well as the wrongs and omissions of the LP occurring while that person is a general partner.

A limited partner will become liable to that same extent as a general partner where the limited partner takes part in the management of the LP, and the party with whom the LP was dealing believed on reasonable grounds that the limited partner was a general partner.

The NZ LP is interesting as it doesn't require audit or publication of accounts, which are big drawbacks with the UK LLP.

While the NZ LP would probably not have any attraction inbound to Australia (as the ATO will take the view that as it is "transparent"), any treaty benefits will apply as between Australia and the country of residence of the respective partners (as per the OECD work on "transparent" entities).[12] This at least has the benefit of the ATO regarding it as a partnership rather than a company,[13] so, in the outbound scenario, they can hardly argue that it is a company! In fact, ID 2011/12 and ID 2011/13 note that art 1.2 of the 2009 Australia–NZ DTA (effective March 2010) requires transparent treatment. This should be so even if the income is sourced in a third country.

A NZ LP should be a "foreign hybrid limited partnership" to which Div 830 applies. This has apparently not been the subject of any binding ruling by the ATO. However, considerable comfort that a body corporate can nonetheless still be treated as a foreign limited hybrid partnership, is ID 2008/80 (which isn't a binding public ruling), which says a Delaware LP (which is a body corporate like an NZ LP) would still be treated as a "foreign limited hybrid partnership".

ID 2008/80

ID 2008/80 provides:

Limited partnerships in Delaware are governed by the DRUPA which forms Chapter 17 of Title 6 to the Delaware Code. Section 17-1105 DRUPA provides that "in any case not provided for" reference may also be made to the DRUPA which forms Chapter 15 of Title 6 to the Delaware Code.

An LP is formed under the *Delaware Revised Uniform Limited Partnership Act* (US) (DRULPA) by executing a certificate of limited partnership. Under the Delaware legislation, an LP has the following features:

- the LP and the limited partners are bound by the partnership agreement (s 17-101(10) DRULPA);
- the partnership agreement may provide for classes or group of limited partners with voting rights as specified in the partnership agreement (s 17-302 DRULPA);
- the LP has a separate legal existence which continues until the certificate of limited partnership is cancelled (s 17-201(b) DRULPA);
- a limited partner is not liable for the obligations of an LP unless they participate in the control of the partnership business (s 17-303(a) DRULPA);
- a general partner is jointly and severally liable for obligations of the partnership (though a judgment creditor can only claim against the assets of the general partner in certain circumstances) (s 17-403 DRULPA and s 15-306 DRUPA);
- the profits and losses of the LP are allocated, and distributions made, among the partners as provided in the partnership agreement or, if no provision is made, on the basis of the partner's contributions (ss 17-503 and 17-504 DRULPA);
- property acquired by the partnership is property of the partnership (s 15-203 DRUPA) and a partner has no interest in specific partnership property (s 17-701 DRULPA); and
- a partnership interest can be assigned and an assignment does not dissolve the LP (s 17-702 DRULPA).

Reasons for decision

ID 2008/80 further provides:

For an LP to be a foreign hybrid LP, it must satisfy all of the requirements in s 830-10, including meeting the definition of "limited partnership".

"Limited partnership" is defined, as relevant, in s 995-1 ITAA97 to mean:

> "(a) an association of persons (other than a company) carrying on business as partners or in receipt of *ordinary income or *statutory income jointly, where the liability of at least one of those persons is limited; or"

As each limited partner's liability is limited under the LP agreement, the LP will be an LP if it is "an association of persons (other than a company) carrying on business as partners or in receipt of ordinary income or statutory income jointly".

An LP formed under the DRULPA has features both commonly associated with a business carried on by partners as partners and with a company. In particular, while separate legal entity status is more commonly associated with companies,[14] this feature of itself does not necessarily lead to characterisation as a company. Rather, the question remains as to whether the business is being carried on by the relevant persons as partners (as opposed to by the separate legal entity on its own behalf).[15]

In this particular case, there are a number of features which favour characterisation of the LP as a partnership. These include:

- the relationship is formalised through, and governed by, a partnership agreement (as opposed to a memorandum of association);
- the LP does not have perpetual succession in the same manner as a company, insofar as the partnership is formed for a fixed period of time and will be terminated on bankruptcy, and so on, of the general partner;
- the business is managed by a general partner on behalf of the partners;
- the inclusion of additional partners requires the general partner's consent (and as the general partner is acting on behalf of the partners, this carries with it the implied consent of all partners);
- similarly, assignment of a partnership interest requires the consent of the general partner; and

- at the end of each accounting period, the profits of the LP are allocated to each partner for distribution or reinvestment in the LP, indicating that the profits belong to the partners as they arise.

The business is organised and conducted more in line with how a partnership operates than a company and the profits, as they arise, belong to the partners indicating that it is the partners carrying on the business and not the separate legal entity. Therefore, despite the fact that the partnership has separate legal status, the predominance of characteristics favours classification as a partnership.

Some other comparisons

As a Delaware LLP is not incorporated, it has an easier road to be treated as a "foreign limited hybrid partnership". Presumably, the Sydney based and owned law firm, Balazas Lazanas & Welsh LLP (a Delaware LLP), relies on Div 830.

New Zealand LPs' non-resident partners will not be liable to NZ tax on non-NZ source income. Likewise, the UK LP and LLP regarding non-resident partners and foreign income. However, the problem that happens with a Hong Kong or Singapore company is apparent here too, ie any NZ source income will be taxed in NZ (although, presumably, NZ would allow a credit for third country taxation).

Note that an NZ LP under s 12 LPANZ has the capacity to "carry on or undertake any business *or activity*, do any act, or entry into any transaction", whereas the UK LLP under s 2(1)(a) LLPA is to "carry on a lawful *business with a view to profit*".

If the LP is not to carry on business, then the effect in the UK of s 118ZA of the *Income and Corporation Taxes Act 1988* (UK) appears to provide partnership treatment only to the business profits, and so investment income appears to be taxed to the UK LLP itself as a body corporate at corporate rates, and regardless of source. In NZ, once it is an NZ LP, the members seem to get partnership treatment regardless of the nature of the income.

For both the UK LLP and the NZ LP, there doesn't seem to be a requirement that any member be resident in the respective jurisdiction, only that there be a registered office in the respective jurisdiction, although in the case of the NZ LP, as service can be effected to the registered office or the registered office of the general partner, it was perhaps assumed that the general partner would be an NZ resident company.

The requirement for an Australian partnership to carry on a business with a view to profit was confirmed by the ATO in TR 93/32, otherwise the treatment is that of co-owners, which may not allow differential treatment of profits from that of losses. See most recently, Fletcher and Lindley & Banks texts, to which the TR refers.[16] In contrast to an Australian partnership, as the NZ LP is a foreign body corporate, deemed to be a partnership for tax purposes, it does not seem to matter that it does not carry on business.

The partners should usually be natural persons (or perhaps trusts for natural persons) to access losses or foreign tax offsets. This must be decided on a case-by-case basis, as it may depend on where losses can be used.

Since 2003, LLPs in some Australian states have also been able to be incorporated for some purposes, and Div 5A was amended to take that into account.

Singapore LLP

Under the Singapore *Limited Liability Partnerships Act* (2005), an LLP has perpetual succession, and is a separate legal entity from its partners. It is capable of suing and being sued, having a common seal, as well as acquiring, owning and disposing of property.

An individual or a body corporate may be a partner of a Singapore LLP, as long as there are at least two partners. However, there can be fewer than two partners for a period of less than two years. If a Singapore LLP continues business with fewer than two partners for more than two years, the person will be personally liable for any obligation of the LLP incurred during that period.

Generally, an obligation of a Singapore LLP "whether arising in contract, tort or otherwise, is solely the obligation of the LLP". These obligations and liabilities are met through the property of the LLP.

The Singapore LLP should be a "foreign hybrid limited partnership" to which Div 830 applies. This has apparently not been the subject of any binding ruling by the ATO. However, ID 2008/80 states that a Delaware LP is a "foreign hybrid limited partnership", notwithstanding that it is incorporated, on the basis that it has more features of a partnership than a company, which gives considerable comfort. There is no reason to think that the same analysis does not apply to a Singapore LLP, but as the ATO has not ruled on that issue, it is impossible to provide absolute certainty without such a binding ruling. It should be noted that ID 2008/80 refers to *Major (Inspector of Taxes) v Brodie*,[17] which confirmed that a Scottish partnership, which under Scots law is a separate entity, is nonetheless a partnership for UK tax.

That Singapore taxes the partners and not the incorporated partnership is the other main requirement for Div 830 treatment. The fact that Singapore tax will not be payable in a loss year does not affect that conclusion: TD 2009/2.

Until the introduction of Div 770 ITAA97 on 1 July 2008, foreign losses were quarantined, but they are now generally available subject to any specific limitations.

A specific limitation on the ability to offset foreign losses from the Div 830 hybrid against Australian or other foreign-source income of the partner, as provided for in s 830-45 ITAA97 to "loss exposure amounts", is mainly designed to prevent the use of limited recourse funding of the LLP, which can have the result that the revenue or capital losses of the LLP may exceed the "loss exposure amounts" in s 830-60 ITAA97.

The LLP provides limitation for any liability over and above the contributed capital, eg against suits for uninsured product liability, or for uninsured negligence which might be far larger than the contributed capital but if incurred on revenue account would, absent the loss limitation rule in s 830-45, have been available as incurred, even if they could not have been paid for by the partners of the LLP.

To ensure that the losses are in fact all deductible to the limited partners, it will be necessary that the partnership agreement makes clear that the funds contributed by the limited partners are contributions "for at least 180 days", as is referred to in step 1(b) of the method statement in s 830-60(1), and are minuted and accounted for as such, rather than as loans to the LLP. That is, the agreement needs to make clear the general partner is not responsible to fund those losses, and the limited partners are to fund losses, for example, for at least two years, and that the funding not be reimbursable to the limited partners.

Indian LLP

Under the *Limited Liability Partnership Act 2008*, an Indian LLP is a body corporate, the members of which are taxed as partners. Each partner's liability is limited to their capital contributed. There is no limit on the number of partners. However, an LLP requires at least two designated partners who are individuals, where at least one of the designated partners is a resident of India. If all of the partners of the LLP are bodies corporate, at least two individuals must be nominated to act as a designated partner.

Similar to the Singapore LLP, if the LLP continues business with one partner for a period greater than six months and the partner had knowledge of carrying on business alone, that partner will be personally liable for the obligations of the LLP that occurred during that period.

The Indian LLP should be a "foreign hybrid limited partnership" to which Div 830 applies. This has apparently not been the subject of any binding ruling by the ATO. As with the Singapore LLP, ID 2008/80 states that a Delaware LP is a "foreign hybrid limited partnership", notwithstanding that it is incorporated, on the basis that it has more features of a partnership than a company, which gives considerable comfort. There is no reason to think that the same analysis does not apply to an Indian LLP, but as the ATO has not ruled on that issue, it is impossible to provide absolute certainty without such a binding ruling.

German KG

A German Kommanditgesellschaft (German KG), referred to in ID 2007/47, is a "foreign hybrid limited partnership" under Div 830.[18] It has a general partner who manages the business and two limited partners (a managing limited partner and the nominee company) who are only liable to the extent of their contributed capital. The managing limited partners, along with the general partner, are responsible for the "activities, management and control of the German KG".[19] Often, the general partner is a company (GmbH), in which case, the limited partnership is styled, GmbH & Co KG.

A German KG is not taxed in any country as a resident, including Australia. Tax payable in relation to a German KG is the liability of the partners to pay "German income tax in respect of their share of taxable income". Therefore, Germany taxes the partners on the profits of the KG and not the KG itself.

Danish K/S

A Danish limited partnership (Kommanditselskab, or K/S) does not appear to be incorporated, and must have one partner in an EU country. In that case, if the Danish limited partnership does not carry on business in Denmark, the place of taxation will be the place of tax residence of partners. It should be a "foreign hybrid limited partnership" under Div 830. The K/S will not pay the corporate tax in Denmark if the above conditions are met. A Danish limited partnership shall consist of at least two partners, one of which shall be a general partner registered in Denmark and the other(s) may be offshore companies. A partnership is managed by its director. Director's tasks can be performed by a general partner or by any natural person appointed as its attorney. Usually, a partnership is registered with the minimal capital of €100. Information on the company's directors, and its general and managing partners is open to the public. Information on the owners of the partnership is not indicated in the open register.

> *"... despite the fact that the [Delaware LP] has separate legal status, the predominance of characteristics favours classification as a partnership."*

What won't work?

Labuan LP or LLP

Labuan LLPs are incorporated, whereas Labuan LPs are not. As it is the LP or the LLP itself and not the partners who are taxed in Labuan, it cannot be a "foreign hybrid limited partnership" (even if it is otherwise treated as an LP), as it is the partners who must be subject to tax, not the LLP.

Bermudan LP

The ATO has issued ID 2006/149 which determined that a Bermudan LP is not capable of being a foreign hybrid LP as the partners are not subject to tax in Bermuda. However, a UK LLP or NZ LP partners will be subject to UK or NZ tax, respectively, if the LLP has UK or NZ source income, respectively.

Cayman LLP

In *FCT v Resource Capital Fund III LP*,[20] the taxpayer, RCF, was a limited partnership formed in the Cayman Islands under the *Exempted Limited Partnership Law 1991* (revised in 1997 and 2001) pursuant to a written partnership agreement dated 17 January 2003. Its general partner was Resource Capital Associates III LP, a limited partnership formed in the Cayman Islands, and its affairs were managed by RCF Management LLC, a Delaware LLC, in Denver, US. More than 97% of the contributed capital of RCF was held by US residents, principally funds and institutions. At all material times, RCF was comprised of one general partner and 61 or 62 limited partners. No limited partner had greater than 8.5% interest in the contributed capital of RCF.

The Cayman Islands does not tax LPs or their members. In the case, the issues included whether RFC could be taxed in Australia, and the Full Federal Court said (reversing the primary judge) that it could on the basis that it was not entitled to benefits of the US–Australia DTA. For present purposes, however, RCF could not be a foreign hybrid limited partnership as its partners were not subject to tax in the Cayman Islands, and so could not satisfy s 830-10(1)(b) ITAA97 (compare a US LP where the partners are taxable in the US on US source income).

Proposed Cayman LLC

The Cayman Islands has announced that it is going to create an LLC entity along the lines of a US LLC. However, probably like the Bermudian LP, the problem will be that the members will not be liable to any Cayman's tax, and so won't be capable of being a foreign hybrid limited partnership.

NZ look-though company

An NZ look-though company is an entity incorporated in NZ (hereafter, NZ LTC) and does not purport to be a limited partnership. Accordingly, as a "foreign hybrid limited company" can only be incorporated in the US, or designated by regulation, of which only a UK LLP has so far (treated by the ATO as a company), it cannot get partnership treatment in

Australia under Div 830. Therefore, losses will not flow through to shareholders.

As it will be a CFC with respect to Australian shareholders (there must be fewer than five), if it has no attributable income, then the shareholders' entitlement to take the profits will be a dividend, and as an NZ LTC, it will not pay NZ tax unless the source of the income is NZ. The problem is that any third country tax borne by the NZ LTC (and not by the shareholders) will not be creditable to the Australian shareholders.

If the NZ LTC only derives NZ source income and the shareholders pay the NZ tax, that tax should be creditable to the Australian shareholders, as they have borne it.

Civil law structures

Civil law structures have characteristics of both companies and trusts. Generally, they will have legal personality and exist in perpetuity, but do not have shareholders or members, and may exist for a purpose, or for persons, or both.[21] Generally, the founder will not have a property interest in such entities, and so their succession will not be governed by the testator's will, but will be dealt with in the documentation of the civil law entity itself.

To the extent that such civil law structures were treated as transparent by Australia, eg as a trust, such structures might be considered as vehicles to provide foreign tax credits (but not flow of losses) to their owners. Note that a foreign resident trust (or entity treated as one) will enable a beneficiary to have access to a foreign tax credit if the beneficiary is presently entitled to its net income.

The most well known of the civil law entities are the stiftung (foundation) and the anstalt (establishment),[22] created under the law of Liechtenstein.

The stiftung is similar in many respects to a purpose trust,[23] although it is incorporated. The stiftung is managed by a council of members, which most often is originally appointed by the founder. At least one person on the council must be resident in Liechtenstein. The stiftung's greatest use is not in holding significant assets, but rather as acting as the holder of shares in traditional domestic or offshore entities that are used as management companies.

The Liechtenstein anstalt is an entity which has no members, participants or shareholders, and is a sort of hybrid between a corporation and a stiftung. An anstalt can have beneficiaries. The principal practical difference between an anstalt and a stiftung is that an anstalt can conduct all kinds of business activities.[24]

For present purposes, the problem is that, as the stiftung cannot carry on a business even though it might be treated as a trust for Australian purposes, we are looking at a business vehicle in the current context.

Foundations of the civil law type have also existed for some time in Austria, Cyprus, Italy, Finland, Germany, the Netherlands (stichting), Netherlands Antilles, Spain, Sweden (stiftelse), Switzerland, Panama (1975), and more recently in St Kitts (2003), Nevis (2004), Bahamas (2005), Anguilla (2006), Antigua and Barbuda (2006), Malta (2006), Jersey (2009), and Labuan and Malaysia (2010).

Memec Plc v IRC[25] dealt with the UK tax characterisation of a German silent partnership. The approach taken was to analyse the characteristics of the civil law entity, and to equate it as closely as possible to the common law entity that it most closely resembles.[26]

Dreyfus v CIR[27] held a French "Société en Nom Collectif" to be a company for UK tax purposes.[28]

Ryall (Inspector of Taxes) v Du Bois Co Ltd[29] held a German "Gesellschaft mit beschraenkter Haftung" (GmbH) to be a company for UK tax purposes.[30]

The ATO has shown a marked reluctance to tackle this issue. As far as the author can find, it has not sought to deal in detail[31] with foreign civil law foundations.[32] In relation to Dutch stichtings, ID 2007/42 reaches the conclusion that they are trusts, based on *Harmer v FCT*.[33] In relation to anstalts, there is no ruling available, but PS LA 2007/7 says, at example 2, that an anstalt "limited by shares" will be a company.[34]

In Private Ruling 77367, the ATO concludes that a Dutch cooperative is a corporate entity from which s 23AJ ITAA36 dividends may be available.[35]

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References

1 See the OECD's website at www.oecd.org/ctp/beps-about.htm.

2 Part IVA overrides DTAs: s 4(2) of the *International Agreements Act 1953*.

3 Which is now the clearly established guideline for VAT/GST: see "International VAT/GST guidelines", Third Meeting of the OECD Global Forum on VAT, 5-6 November 2015, Paris.

4 *Grainger & Son v Gough* [1896] AC 325; *Lovell and Christmas Ltd v FCT* [1908] AC 46; *FCT (WA) v D & W Murray Ltd* [1929] HCA 21. The domestic-source rules were argued to be affected by Australia's DTAs, as often the DTAs said that any income which Australia *may* tax were deemed to be sourced in Australia. Clearly, that was only an issue when there was a relevant DTA. The domestic law until recently (Div 13 ITAA36) specified that if the Commissioner was entitled to make a transfer pricing adjustment (treaty or no treaty), he was also entitled to determine the source of the income (s 136AE ITAA36). But where the parties were unrelated and dealing at arm's length, there was no domestic basis for the application of Div 13 and therefore, no ability of the Commissioner to deem the source, eg where an non-resident was selling into Australia via ecommerce, with no presence whatsoever in Australia. The current transfer pricing provisions (Subdiv 815-B ITAA97) do not change that, and interestingly, don't contain a like deemed source provision. The recent decision in *Chevron Australia Holding Pty Ltd v FCT* [2015] FCA 1092 at [61] confirms previous decisions that DTAs do not provide an independent taxation power, and so there is an even stronger argument now that unless the domestic law is changed to deem a source of income, the entry into treaties allowing Australia to tax certain income and deem it to be source in Australia does not result in taxation of that DTA deemed source of income, without a change to the domestic law. It is noted that the OECD model DTA does not contain a general deemed source of income provision (although it does deem source of interest income to be the state of residence of the payer), and so there is no general OECD guidance in the Commentary to the model DTA.

5 Established listed entities usually started out with an Australian business.

6 Recently formed private ecommerce companies may have started with an international business.

7 2006 E.C.R. 1-7995 (Case C-196/04).

8 The Australian tax at 49% is made up of ordinary income tax of 45%, plus Medicare levy of 2%, and the temporary Budget repair levy of 2% (said to be payable up to 1 July 2017). Note that the foreign income tax offset is available against the Medicare levy due to s 90-1 of Sch 1 of the *Taxation Administration Act 1953* (Cth), and against the temporary Budget repair levy as it is defined to be additional income tax by s 34 of the *Income Tax Rates Act 1986*.

9 See K Fletcher, "Incorporated limited partnerships: venture capital's contribution to legal development", (2004) 17 *Australian Journal of Corporate Law* 157, particularly footnote 76.

10 S 18-101(6) of the Delaware *Limited Liability Company Act*.

11 [2014] FCAFC 37.

12 See TD 2011/25 with regard to *TPG Newbridge Myer Ltd v DCT* [2011] FCA 1157.

13 See ID 2011/12 and ID 2011/13.

14 For example, see *Rose v FCT* (1951) 84 CLR 118.

15 For example, see *Major (Inspector of Taxes) v Brodie* [1998] STC 491 at 498.

16 Also now see *NR Allsop Holding Pty Ltd as General Partner of Q Uniform Partnership and FCT* [2015] AATA 654, currently on appeal.

17 [1998] STC 491 at 498.

18 In ID 2008/61, the conclusion is reached that an Irish CCF is a trust. ID 2006/91 reached the conclusion that a Korean Japja Hoesa was a limited partnership but could not satisfy the requirements to be a "foreign hybrid limited partnership", and then the ATO changed its decision and concluded that it was

a company in ID 2010/27 and withdrew the earlier ruling.

19 ID 2007/47.

20 [2014] FCAFC 37.

21 See, generally, A Schurti, chapter on Liechtenstein in *Offshore trusts*, Centre for International Legal Studies, Salzburg, Kluwer, 1995, pp 228-230.

22 Also see CCH, *International offshore financial centres* (looseleaf), ¶LIE1-035 and ¶1-036.

23 HMRC TDSI mailshot 6-17 May 2004 says, for UK tax purposes, they will be treated as trusts. Also see P Baker, "Beneficiaries of trusts and foundations", (2007) VII(3) *ITPA Journal*.

24 HMRC TDSI mailshot 6-17 May 2004 says, for UK tax purposes, they will be treated as companies. The US has released a letter ruling AM2009-012 on 16 Oct 2009, which says that, generally, a Liechtenstein anstalt will be treated as a business entity (corporate), whereas a Liechtenstein stiftung will be treated as a trust.

25 [1998] STC 754.

26 As observed by Prof. Burns "Harmonization of Australian's anti-deferral regimes", presented to IFA Melbourne, 12 June 2007. Also see *Dicey, Morris & Collins on the conflict of laws*, 14th ed, Sweet & Maxwell, London, 2006, ¶30-010. *Memec* was recently applied in *Swift v Revenue & Customs* [2010] UKFTT 88 (TC), to find contrary to HMRC's longstanding position that it was opaque, that a US LLC was transparent for UK tax purposes. HMRC appealed successfully, reported as *HMRC v George Anson* [2012] UKUT 59 (TCC), but the decision at first instance has now been restored by the Supreme Court of the United Kingdom: *Anson v HMRC* [2015] UKSC 44.

27 [1929] 14 TC 560.

28 See, particularly, *Tax Bulletin*, December 2000, pp 576-577 now treats a Société en Nom Collectif as transparent for UK tax purposes.

29 [1933] 18 TC 431.

30 Which status it is also treated under *Tax Bulletin*, December 2000.

31 By the issue of a public ruling, ie taxation ruling or determination. The ATO seems to have argued for, and it was accepted by the taxpayer in the Australian case of *Mulherin v FCT* [2013] FCAFC 115 at [25], that the Liechtenstein Foundation in that case was a trust (indeed, an Australian resident trust), whereas in *The Queen v Sommerer* 2012 FCA 207 at [42]-[43], the Canadian Federal Court of Appeal doubted that the Austrian Foundation in that case was a trust (but rather was a company), but neither party wished to proceed on that basis.

32 Refer generally to *The private foundations handbook*, edited and with an introduction by Milton Grundy, ITPA, 2007.

33 [1989] FCA 432.

34 While the conclusion is the same as HMRC, these days, most anstalts are not "limited by shares". The Board of Taxation identified the characterisation of anstalts as an "urgent issue" in 2004.

35 As noted in Watkins and Rodi, "Foreign entities – characterisation and treatment for Australian tax purposes", TIA NSW Div, International Tax Masterclass, 18 September 2008.