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# Case Note – *Resource Capital Fund III LP v FCT*

A recent decision of the Federal Court has addressed a number of complex international tax issues, as well as approaches to valuing mining tenements and related assets. Of particular note was the fact the court identified 'mining information' as a separate asset with a value distinct from that of the mining tenements to which it related. Even though the Commissioner has filed an appeal against the decision, the case may present planning opportunities for taxpayers, especially those in the extractive industries.

## Factual background

The case concerned a private equity fund, the Resource Capital Fund III LP (Fund), which established a limited partnership in the Cayman Islands. However, the Fund was managed in the United States, and had mainly United States resident investors.

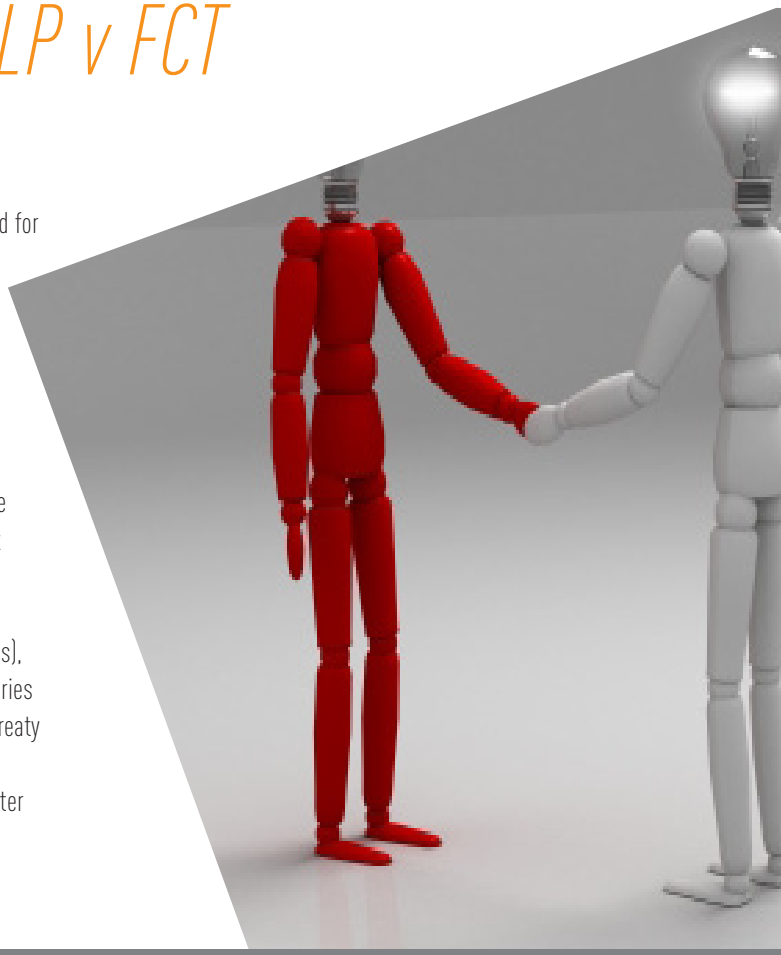
In 2007 the Fund disposed of its investment in St Barbara Mines Ltd (SBM), an ASX listed goldminer, and crystallised a $52.25 million gain. Because neither the Fund nor its investors were Australian residents, the gain on disposal of the SBM shares could only be taxable in Australia if the shares were taxable Australian property. The Commissioner took the view that the shares were taxable Australian property, and assessed the Fund for the gain.

The critical issues before the court were:

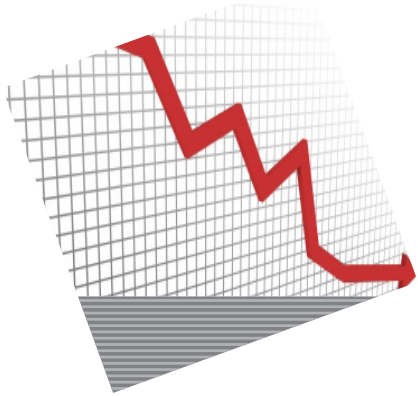
1. whether the Australia/United States double tax agreement (**DTA**) prevented the Commissioner from assessing the Fund for the gain; and
2. if the Fund could be assessed, whether the shares in SBM were taxable Australian property.

## Did the DTA prevent the Commissioner from assessing the Fund for the gain?

Before addressing the specific question before it, the court made a range of observations on the interpretation of international tax treaties. It confirmed that such treaties should be interpreted by reference to international legal principles concerning treaty interpretation (rather than domestic statutory interpretation rules), and that such principles permitted reference to OECD commentaries on tax treaties. Although this is the generally accepted view of treaty interpretation, it had been questioned following a recent Federal Court decision,1 and comments made by the High Court in Minister for Home Affairs v Zentai.[2]



1 *Russell v Federal Commissioner of Taxation* (2011) 190 FCR 449
2 (2012) 289 CLR 644



Turning to the substantive issue in dispute, the court concluded that the DTA operated such that only the Fund's investors could be assessed for the gain, and that the Fund itself could not be assessed. The reason for this was that the relevant article of the DTA stated that only United States residents could be assessed for the gain. Although the Fund was treated as a company under Australia's domestic tax law, it was a fiscally transparent, 'flow through' entity for United States tax purposes. The OECD commentary expressed the view that this 'flow-through' treatment prevented the Fund from being a United States resident, and consequently it could not be assessed for the gain. The DTA operated such that only the Fund's investors who were United States residents could be assessed for the gain.

## Were the shares taxable Australia property?

The court's conclusion on the DTA point was sufficient for the Fund to be successful. However the court went on to consider whether the SBM shares sold were taxable Australian property.

The Fund's shares in SBM could only have been taxable Australian property if the value of SBM's Australian real property assets exceeded the value of its non-real property assets. Both parties accepted that SBM's only Australian real property assets were its mining rights. The balance of its assets were not Australian real property assets. In light of this, one might have expected the resolution of this question to have involved a simple comparison of the values of SBM's assets. However the court's decision demonstrates the complexities involved both in identifying the relevant assets, and in determining their market value.

The court rejected the Commissioner's argument that SBM's assets should be valued by reference to the company's entire value if sold as a going concern. It viewed such an approach as flawed because it did not reflect the value of SBM's specific assets, but rather the value of SBM in its entirety.

When assigning value to SBM's individual assets, the court confirmed that SBM's mining information should be identified and valued separately to its actual mining rights. In other words, the information and knowledge SBM had gained from its exploratory activities had a value separate to that of the mining rights to which the knowledge was applied. Although the mining rights were Australian real property, the mining information was not.

The court discussed valuation methodologies regarding SBM's various assets in considerable detail, analysing the approaches of different experts called to give evidence for the parties. One key message to take from this discussion is the method for valuing mining tenements. It used the discounted cash flows from SBM's mining operations as a starting point. It then subtracted the 'cost' of re-creating SBM's mining information and replacing its plant and equipment. The remaining amount was the market value of SBM's tenements. This approach lends to a lower value for the tenements, primarily because the cost of re-creating SBM's mining information was substantial.

Because of this, the court found that the value of SBM's non-real property assets exceeded that of its real property assets. Consequently the Fund's gain could not be taxed even if the DTA did not apply.

## Subsequent developments

As we have mentioned, the Commissioner has already filed an appeal against the decision. But, perhaps pre-empting the outcome of any appeal, the government announced a legislative measure as part of the 2013/14 Budget that will reverse aspects of the case. It will amend the test for determining whether an asset is taxable Australian property. Mining, quarrying or prospecting information, know-how and goodwill will be valued together with the mining rights to which they relate. In essence, this means that these assets will be treated as though they are real property assets for the purposes of the particular division.

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## Implications for taxpayers

Despite the government's announcement, the court's approach presents a number of planning opportunities around the valuation of mining assets. The approach could be particularly useful for landholder duty purposes. In most jurisdictions duty is calculated by reference to the value of mining tenements, but not of any mining information. It may be possible to rely on this case to attribute a lower value to mining tenements and hence reduce a landholder duty liability.

A further opportunity relates to the acquisition of mining assets (tenements, information etc). Taxpayers undertaking such transactions could potentially allocate a higher proportion of a purchase price to mining information rather than mining tenements. The cost of mining information is likely to be immediately deductible rather than simply a depreciation deduction, so this strategy can accelerate tax deductions. We note that this strategy is not a new development; however the court's decision arguably confirms the technical reasons behind its use.

We recommend that businesses undertaking mining acquisitions consider these strategies when negotiating transactions.

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