Source of income: “proximate origin” – “originating cause” of profit earned

Kluwer International Tax Blog
May 7, 2019

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Please refer to this post as: Jonathan Schwarz, ‘Source of income: “proximate origin” – “originating cause” of profit earned’, Kluwer International Tax Blog, May 7 2019, http://kluwertaxblog.com/2019/05/07/source-of-income-proximate-origin-originating-cause-of-profit-earned/

Some issues tax issues never go away. The source of income or gain is one of them. Two recent decisions, one Australian, and the other South African, have considered this fundamental issue. Both cases involve the natural resource sector. Each relates to a fact pattern that is frequently found in the sector. Correct identification of the source was a key issue in both cases. The location of the source was also key in the Australian decision.

Cayman Island limited partnerships

Commissioner of Taxation v Resource Capital Fund IV LP [2019] FCAFC 51 concerned a gain from the sale of shares in an Australian incorporated public company listed on the Toronto Stock Exchange by two Cayman Island limited partnerships whose partners included residents of the United States. The Australian company’s business exploration, extraction and production of lithium in Western Australia. Shares in the Australian company were sold pursuant to a takeover by another Australian company under a scheme of arrangement under Australian corporate law and sanctioned by the Australian courts.

The gain was treated as income rather than a capital gain on the disposal of a capital asset. In determining the source of that income, the Full Federal Court of Australia noted that the only two sources of income are doing of acts or the possession of property and that the source is “that from which income is produced by the taxpayer’s own acts of derivation or ownership” (*Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177).

Connecting factors

Among other arguments, the partnerships contended that the income did not have a source in Australia and was therefore not taxable there. The foreign connecting factors were considerable:

- investment decisions and negotiations, monitoring of the investment and decisions and negotiations regarding the disposal of the investment were made by an investment committee of the general partner outside Australia;
- before making important decisions, an investment committee of the general partner took advice from the management company, RCF Management, outside of Australia;
- the limited partners could not and did not take any part in the management of the partnership and were passive investors;
- the shares were listed and freely tradable on the Toronto Stock Exchange; and
- the consideration was paid on behalf of a Chinese company and was payable and received outside Australia in Canadian dollars.

Australian connecting factors included: The management company subcontracted functions to an Australian affiliate, RCF Management Australia which maintained an office in Australia from which the partnership investments were managed. Employees of the Australian manager played an active role in the management, including the ultimate disposal, of the investment. They frequently participated in investment committee meetings from Australia and prepared the papers for consideration and decision by the investment committee. The court noted that the nature of the investment contemplated the acquisition of a business to be restructured, made profitable and then disposed. This is typical of private equity funds.

The court decided that the “acts … of ownership” included the “active management” in Australia of an Australian mining company for the benefit of each of the limited partnerships. This included participation as a shareholder, at least by proxy, in the shareholder meetings ordered by the Australian court in Australia as part of the scheme of arrangement.

The court concluded that what bound the partnerships was not the entry into a contract of sale overseas but the convening of the scheme meeting, the approval at that meeting of the scheme of arrangement, the approval of that scheme by the Court, and the lodging of the order of the Court with the Australian Securities and Investment Commission. The court decided that the location of the scheme is analogous to the place where the contract was made.

In addition to the acts of ownership, the partnerships’ “enforceable right” to the proceeds of sale of arose from the scheme of arrangement in Australia.

The court held that the scheme of arrangement was the “proximate origin of the profits earned” and along with other connections with Australia, the source was in Australia.

When is mining the source of income?

In *Benhaus Mining v CSARS* (165/2018) [2019] ZASCA 17, the Supreme Court of Appeal of South Africa similarly upheld the longstanding view that the source of income, is the “originating cause of their being received as income”, which is “the work the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them” (*Commissioner for Inland Revenue v Lever Bros* 1946 AD 441). The question was whether the provision of certain mining services to third parties that held mining rights for a predetermined fee constituted mining operations as the source of income.

The services rendered at seven different mines under eight contracts included establishing sites for open cast mining, and fencing them off; constructing workshops; constructing and maintaining access roads, and haul roads; removing and stockpiling topsoil; excavating and stockpiling material extracted from the ground; removing waste; constructing storm water drainage; blasting mineral-bearing ore; delivering the ore to the client’s premises for processing; and rehabilitating the mining area after extraction. In return, Benhaus was paid a fee, based on the amount of ore delivered to the client’s processing plant.

The court examined three stages in open cast chrome mining:

First stage: removal of topsoil and overburden (material overlying a mineral deposit), blasting the rocks to expose the mineral reef, extracting the ore, crushing and screening it, and delivering it to the processing plant.

Second stage: milling and washing of chromotite ore.

Third stage: melting higher concentrate ore in a furnace to separate waste from metal to produce ferrochrome.

The tax authority argued that Benhaus was not engaged in the entire process of mining chrome mining because it did not itself process or trade in the mineral. This was on the basis that mere extraction is not enough to render a contractor who earns a fee for extraction as engaging in mining operations. “The contractor is not in the trade of mining; rather it is in the trade of servicing a miner’s requirements by the extraction of material.” It also agued that isolation of the mineral is required in addition to its extraction. On this basis, the source of the taxpayer’s income was services rather than mining operations.

The court however concluded that the first stage constitutes mining (upholding the views of mining tax expert and author Marius van Blerck in *Mining Tax in South Africa*). The later final treatment of the mineral for its better utilization is manufacturing and not mining (this is consistent with Australian case law on the same question). As a result, the contract miner qualified for deductions for the significant capital expenditure incurred. Since all the activities were in South Africa, the location of the source was not in issue.

Fund management implications

The *Resource Capital Fund* decision has significant implications for investment management outside the natural resource sector. Fund management activities were undertaken in and outside Australia. The foreign activities had no impact on the location of the source of income once the “proximate cause” was found to be in Australia. This is an all or nothing analysis. The kind of exit from an Australian investment that a foreign fund might undertake without giving rise to an Australian source where there is management activity is unclear. How would an Australian as opposed to a foreign IPO be treated? I will return to other critical aspects of the case on entity characterisation and access to treaty benefits in another blog.