Indirect transfers: What is an indirect interest in immoveable property in the natural resource sector, and what is it worth?

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Two of my recent articles have examined the Australian decision in *Commissioner of Taxation v Resource Capital Fund IV LP* [2019] FCAFC 51. The articles examine the central question on the source of income earned and the tax classification and entitlement to treaty benefits of investment funds.

Real property gains

This time I consider two further issues of considerable importance, particularly in the natural resource sector. Firstly, the meaning of "real property" in articles 6(2) and 13(1) of the Australia -United States double tax treaty. The term corresponds to "immoveable property" in the OECD and UN Models but is not identical to it. Secondly, valuation issues in deciding whether "shares or comparable interests in a company", the assets of which consist "wholly or principally" of real property situated in Australia within article 13 of the Treaty. Again, this corresponds, but is not identical to, article 13(5) of the OECD Model and article 13(4) of the UN Model and which refers to interests that derive "more than 50 per cent of their value" from immoveable property.

The case 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.

Australia-US Treaty

Article 13 of the Treaty permits gains from the alienation of real property to be taxed in the state in which the property is situated. "Real property" includes for this purpose "shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia". Article 6(2) provides that (i) a leasehold interest in land is real property situated where the land to which the interest relates is situated; and (ii) "rights to exploit or to explore for natural resources shall be regarded as real property situated where the natural resources are situated or sought".   This corresponds closely to an element of the Australian domestic meaning of "Taxable Australian Property" the disposal of which by a non-resident is taxable. Both contracting states are common law jurisdictions and use the common law term, in preference to "immoveable property" in their treaties.

The Australian company held a number of mining leases, two "general purpose" leases and a "miscellaneous licence" issued pursuant to the Western Australian Mining Act 1978. Each permitted the company to do different things. The character of the leases and the licence were in issue.

The taxpayer argued that the company's operations were made up of three distinct activities: mining, processing and manufacturing and that the mining leases only authorised extraction of ore and nothing further. This is similar to the argument about the nature of mining made by the South African Revenue Service earlier this year in *Benhaus Mining v CSARS* (165/2018) [2019] ZASCA 17 (See my blog on source of 7 May 2019).

The taxpayer in the *Resource Capital Fund case* also argued that general purpose leases and the miscellaneous licence were directed at the downstream activities of manufacturing and processing, which they said, was not mining. It was also noted that the general purpose leases themselves did not purport to give rights in respect of any of the buildings on the sites but only permitted the manufacturing and processing activities undertaken in them. The trial court thus concluded that the operation comprised distinct activities, and that mining, as authorised by the mining leases, was limited to extraction or recovery of ore from the earth. The miscellaneous licence was for water.

On appeal, the Full Court found the evidence of the terms of the leases and licences to be unsatisfactory, but decided that mining leases included processing rights in addition to extraction and that processing is included in mining because it is required to win the product for the market (similar to the South African Tax Court in *Benhaus*). The court said that if that was not the case, the general purpose leases gave the right to processing.

Valuation

Once real property, as defined, is identified, a determination must be made as to whether the company's assets consist wholly or principally of real property situated in Australia. Although the critical term "principally" was not analysed the court applied the Australian domestic "principal asset test" which requires identification of (a) the total market value of the company's taxable Australian real property (TARP) assets" and (b) the total market value of its non-TARP assets. It is implicit from this that principally was interpreted to mean that real property assets exceed non-real property assets, that is more than 50% of the total value of all assets.

Correct identification of assets between these categories is essential to this exercise. It may also impact on the approach to valuation.

The tax authority's approach was to start with the purchase price for the shares, because that was a market transaction on the valuation date. That value was allocated to tangible and intangible assets. There was there was little dispute about assets other than the leases which had readily ascertainable values. They regarded goodwill was of little significance (compared to the taxpayer who considered there was goodwill valued at $8.328 million. After allocation to tangible and intangible assets, the tax authority's expert considered that the value should fall to the mining leases which were the assets that drove the company's cash flows.

On the other hand, the taxpayer's approach was to adopt a "netback method", to determine the value of ore before it was processed. This was on the basis that once the minerals were extracted from the ground, they became the property of the miner and were chattels (immovable property) and that only the mining leases were mining rights.

The taxpayer's expert first valued the project, by applying a discounted cashflow approach to the life of the mine. The expert then hypothesised the operations as divided into two notionally separate entities: (a) an Upstream Operator comprising the assets and activities "prior to the resource being extracted and severed from the ground" and (b) a Downstream Operator comprising the assets and activities "immediately post the resource being extracted and severed from the ground". Thirdly, a hypothesized long-term contract by which the Downstream Operator charged Upstream Operator its services was priced on the basis of a return of capital for the Downstream Operator.

The Full Court rejected the taxpayer's methodology because of the conclusion that we have earlier reached that the value of the mining leases lay beyond the right merely to extract minerals and that, in any event, the general purpose leases were TARP Thus, division of the operations was artificial. The court also noted that in Australia, the netback method has been used to ascertain the price of a commodity, for example, for the purpose of calculating a royalty although sometimes regarded as one of last resort.

Conclusions

The case illustrates the need for a very detailed analysis of the rights and assets in order to determine whether real (or immovable) property is involved. It also identifies a shortcoming in the rules relating to indirect transfers. Where more than half of the value of shares is reflected by immovable property situated in a particular state, all of the gain on the alienation of those shares becomes taxable. This is true whether in effect all of the value is based on such immovable property or it is only fractionally above one half of the value.

The all or nothing nature of the rule also poses difficulties where immovable property is situated in more than one state. *Resource Capital Fund* involves real property that could only be situated in Australia. Where more than one state is involved, differences in domestic law that feed into the definition for treaty purposes and different approaches to valuation may result in double taxation by two states claiming to be the source state. This double taxation is not easily resolved by existing bilateral treaties, particularly in cases where the alienate tour is a resident of a third country.