

Income from immoveable property: Article 6 and royalty streams

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Following the Supreme Court decision in *Fowler v HMRC* [2020] UKSC 22, the UK First-tier Tribunal has considered another case where classification of a source of income for tax treaty purposes was in issue. This time the question was classification as business profit or income from immovable property in the Canada-UK double tax treaty.

In *Royal Bank of Canada v HMRC* [2020] UKFTT 267 (TC), a Canadian bank loaned funds to a Canadian oil & gas company, to help fund the exploration and extraction of oil in the UK sector of the North Sea. At the time, licences for this activity were only issued to UK resident companies. The common practice at the time was for non-resident companies to enter into an "Illustrative Agreement" with a UK resident subsidiary licence holder. Under such agreements, the development and exploitation costs would be incurred by the non-resident parent company in return for the licence holder's share of the oil won from licensed area.

The Canadian company was in financial difficulties and sold its interest in the oilfield to the BP group. The consideration for the sale included an entitlement to royalty payments contingent on production from the oil field linked to the excess of the market price of the oil above an agreed level.

The Canadian company subsequently went into receivership, by which time, the oil price had risen, and some payments were made pursuant to the sale agreement. After the remainder of its assets were sold, the Canadian company still owed the bank about CAD \$185 million and its rights to all future payments were formally assigned to the Bank with the approval of the Canadian courts. BP subsequently transferred its interest in the field to another oil company and the bank became entitled to the royalty payments pursuant to a novation agreement between all three parties.

The bank accounted for the payments for Canadian tax as receipts of its banking business in Canada and as a partial recovery of the bad debt it had previously recognised in respect of its loan to the Canadian company.

Profits from exploration or exploitation rights

The Tribunal also had to consider whether the payments were chargeable to UK Corporation Tax under domestic law. Although the treaty question was considered first, in my view, the correct approach is firstly to consider whether the item is chargeable to tax under domestic law and then whether this is modified by treaty.

Corporation Taxes Act 2009 s 1313(2)(b) brings into charge "any profits arising to a non-UK resident company... from exploration or exploitation rights". "Exploration or exploitation rights" are defined to mean "rights to assets to be produced by exploration or exploitation activities or to interests in or to the benefit of such assets" (CTA 2009, s 1313(3)). The Tribunal rejected the taxpayer's argument that the payments were receipts of the bank's banking trade and not profits from exploration or exploitation rights. It held that the Bank has rights to the benefit of the oil won from the by virtue of the royalty payments. The judge considered that the term "benefit of" denotes a broad and less legalistic approach to the question.

Immovable property- article 6(2)

It was common ground that, although the bank had a permanent establishment in the UK, the payments in question were not attributable to that permanent establishment. UK taxing rights were dependent on qualification of the payments as income from immovable property within article 6. The article is unusual in that it is rarely construed by courts and the OECD Commentary is among the briefest for distributive articles.

Article 6(2) which is patterned on the OECD Model generally requires immovable property to be defined in accordance with the law of the Contracting State in which the property is situated. However, it includes in any event "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources". Both parties agreed that this specific inclusion in the definition determined the issue.

The taxpayer argued that this expression is concerned with a grant, not a transfer, of a right to work and that the payments must be made in consideration of the grant of the right to work to be income from immovable property. The Tribunal concluded that the definition in article 6(2) should not be confined to payments made directly to the owner of the rights in exchange for the grant of a right to exploit them.

The judge said at [55]: "I see no reason for limiting the scope of Art 6(2) to cover only payments which are made directly to the owner of the rights in exchange for the grant of a right to exploit them. The apparent purpose of granting taxing rights on profits from natural resources to the state where the resources are situated would otherwise potentially be capable of avoidance by simply granting a licence to work those resources at a price equal to the cost of the works, then the grantee assigning that right to a third party in exchange for payment of substantial royalties. The focus must be on the ultimate source of the profit and it would be irrational and inconsistent with the apparent purpose of the provision if it were possible to avoid local taxation on that profit simply by interposing an assignment of the royalty rights (possibly even to an associated company resident in a low tax jurisdiction) after they had been granted."

This analysis may be questioned on several grounds.

The right to work natural resources is, in this case, the licence granted by the UK Crown. The right to receive consideration for that right is the entitlement of the owner or other grantor under the licence or any other arrangement to be paid for conferring the right to work on another person. That right is the immovable property in question within the definition in article 6(2).

It is true that the right to work natural resources may be passed on to another by agreement such as a sublicense or other form of participation in the right. This includes, in the oil & gas industry, a farmout, where certain activities are undertaken in exchange for participation in the working of the natural resource. The working of the natural resource in undertaking those activities, distinguishes the farmee from ordinary creditors who receive payments contingent on, or by reference to, the debtor's exploitation of the natural resource.

The extended definition of immovable property in article 6(2), however, also encompasses royalty streams or entitlement to them. The right to payment from such a sub-licensee is clearly included in this. The question raised in this case whether the extended definition reaches other kinds of contractual payments where the creditor does not, and is not, entitled to work the natural resource.

The only authority cited by the Tribunal to support its conclusion is OECD Commentary which refers to income that is "indirectly derived from immovable property" without elaborating on what this means. There is nothing in the text of the article on which this Commentary can be based. This leads to questioning the interpretation of the treaty in the decision.

Treaty interpretation

Although the Tribunal recites the relevant provisions of the Vienna Convention on the Law of Treaties and key UK case law on its application to tax treaties, it may be questioned whether those principles were satisfactorily applied.

As supplementary material within VCLT article 32, the OECD Commentary may be used to confirm the ordinary meaning of terms or to provide an ordinary meaning where the general rule produces a result that is ambiguous or obscure. In this case, the statement in the Commentary is itself obscure and gives no real guidance as to which income indirectly derived from immovable property is to be included. In the banking context, the statement about income indirectly derived should be considered in light of paragraph 18 of the OECD Commentary to article 11 which makes clear that interest falls within article 11 even if the debt claim in question is secured by mortgage on immovable property and that debt claims participating in profits are regarded as loans by reference to the general character of the contract.

Consequently, analysis of the contractual arrangements is essential in determining the character of the payments to the bank. The Tribunal concluded that assignment of an element of the purchase price meant that the payments of that amount retained its character as such. This raised the question whether the purchase price on a sale of the licence was consideration for the working of, or the right to work, natural resources.

Although the purchaser of a licence normally acquires a right to work the natural resource, VCLT Article requires the ordinary meaning of terms to be interpreted in context. The presence of article 13(1) in the OECD Model and Canada's the Reservation on the article to explicitly include in its treaties, the alienation of immovable property within article 6 (absent in this treaty), suggest that the word "for" refers to the grant of the right. Paragraph 22 of the OECD Commentary to article 13 confirms the correspondence of articles 6 and 13. The context of article 6(2) includes the allocation rule in article 6(1). There, income is "from" a source when it is out of the source. Taken together, these may suggest that it is only where the right to work is conferred by its owner that article 6 is engaged. On the Tribunal's analysis, the assignment of the proceeds of sale that give rise to capital gains to a bank creditor, would result in the bank realising a gain on the disposal of the subject matter of the sale.

The Tribunal relied heavily on its formulation of the purpose of article 6, "to focus on profit derived from the exploration for or exploitation of mineral resources, whether that profit is derived directly by working the resources or indirectly by letting out the right to do". This reliance begs the question because the essential issue in this case is whether the receipt in question falls within the article. The purpose of the article is to allocate taxing rights in relation to income from immovable property. That purpose does not help explain which income the article is intended to cover.