TR 2020/5 - Income tax: application of section 6CA of the Income Tax Assessment Act 1936 and Australia's tax treaties and the payer's withholding obligations

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Taxation Ruling

Income tax: application of section 6CA of the *Income Tax Assessment Act 1936* and Australia's tax treaties and the payer's withholding obligations

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Relying on this Ruling

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

Summary – what this Ruling is about

1. This Ruling applies to income which is derived by a non-resident and calculated by reference to the value or quantity of natural resources produced and/or sold. For convenience, this Ruling refers to such income as 'override royalties'.[1] Such income is typically paid by the holder of a mining right to an entity that does not have an interest in the right.

2. The Ruling sets out:

- when a payment, that is income, is calculated, in whole or in part, by reference to the value or quantity of natural resources produced in Australia for the purpose of the definition of 'natural resource income' in subsection 6CA(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) (see Part A of this Ruling)
- how the income from real property articles in Australia's tax treaties apply to override royalties (see Part B of this Ruling), and
- the circumstances in which an Australian-resident payer of override royalties is required to withhold an amount from an override royalty payment under section 12-325 of Schedule 1 to the *Taxation Administration Act 1953* (Schedule 1 to the TAA) (see Part C of this Ruling).

[1] 'Override royalty payments' and 'override royalty agreements' should be similarly construed to include payments derived by a non-resident and calculated by reference to the value or quantity of natural resources produced and/or sold, and agreements under which such payments are made (respectively).

3. The Ruling does not address:

- the application of Australia's tax treaties, other than the income from real property article
- the tax treatment of a grant, assignment or transfer of the right to receive an override royalty payment
- whether override royalty payments constitute interest or non-share dividends, or
- the tax treatment of common law royalties.

Ruling

Part A – Override royalties and 'natural resource income'

Calculated, in whole or in part, by reference to the value or quantity of natural resources produced

4. Under paragraph (b) of the definition of 'natural resource income' in subsection 6CA(1) of the ITAA 1936, income is calculated, in whole or in part, by reference to the value or quantity of resources produced[2] where the calculation is based on the level of production.

5. In working out whether the calculation of a payment is based on the level of production, it is appropriate to have regard to the contractual terms of the relevant override royalty agreement and any related agreements, and the substance of the arrangement.

6. A direct causal connection between the amount of income and the level of production is not required. As a result, income calculated by reference to a value or measure other than production (such as sales or shipping volume) may be natural resource income. For example, where it is reasonable to conclude:

- the income is calculated by reference to sales or shipping volume and the relevant agreement(s), in calculating the income treat all, or substantially all, of the relevant resources produced as having been sold or shipped (whether or not in the same income year)
- the difference between production and sales or shipping volumes arises from wastage of part of the resource between production and delivery to the customer, or
- due to the nature of the resource or the market, in practice, all, or substantially all, of the relevant

[2] Unless the context requires otherwise, the phrase 'produced, recovered or produced and recovered' in paragraph (b) of the definition of 'natural resource income' in subsection 6CA(1) is abbreviated in this Ruling to 'produced' or 'production'.

resources produced are sold or shipped (whether or not in the same year).

Example 1 – override royalty varies with changes in value of production

7. *For Co receives payments calculated as 1% of the wellhead value of petroleum produced by Aus Co. The wellhead value equals the sales proceeds less the cost of transportation downstream of the wellhead. As the payment varies with changes in the value of petroleum produced, it is calculated by reference to the value of natural resources produced.*

Example 2 – override royalty calculated by reference to all resources produced (whether or not sold)

8. *For Co provided Aus Miner Co $50 million. In exchange, Aus Miner Co is required to make payments amounting to 1.5% of the value of gas it recovers (regardless of whether that gas is sold). In the circumstances, the payment is calculated by reference to the value of natural resources produced.*

9. Income is calculated 'in whole' by reference to the value or quantity of resources produced where the income is calculated solely by reference to the value or quantity of the resources produced. Income is calculated 'in part' by reference to the value or quantity of resources produced where the income is the sum of two or more amounts, one of which is calculated by reference to the value or quantity of resources produced, or the income is a single amount which is partly calculated by reference to the value or quantity of resources produced. Where the income is calculated 'in part' by reference to the value or quantity of natural resources produced in Australia, then the whole of the payment will be natural resource income.

Meaning of 'natural resources', 'produced' and 'recovered'

10. Minerals and any other non-living resources of the land, seabed or sea, are 'natural resources' under the definition in subsection 995-1(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) irrespective of whether those minerals or resources require extensive processing to separate them from other substances or to remove impurities.

11. The meaning of the phrase 'natural resources produced, recovered or produced and recovered' depends on the nature of the resource.

12. A natural resource may be produced or recovered, or produced and recovered, by mere extraction or by separation

following extraction. Separation includes physical and chemical processes such as crushing, washing, refining and smelting.

'In Australia'

13. Natural resources will be produced in Australia when all of the material processes of production occur in Australia.

14. In working out whether an override royalty is calculated wholly or partly by reference to the value or quantity of production **in Australia**, the relevant production is all of the material processes of production which occur until the point at which the override royalty is determined.

Part B – Tax treaties

Scope of the income from real property articles

15. The income from real property articles in Australia's tax treaties will not apply to override royalties in circumstances where subsection 6CA(1) of the ITAA 1936 would not otherwise apply to the override royalty. In relation to override royalties, the scope of the income from real property articles is no wider than section 6CA.

General position for tax treaties

16. The large majority of Australia's income tax treaties contain an 'Income from real property' article which treats as real property 'a right to receive variable or fixed payments either as consideration for or in respect of the exploitation of, or the right to explore for or exploit, mineral, oil or gas deposits, quarries or other places of extraction or exploitation of natural resources'.

17. Under that article, payments calculated by reference to the value or quantity of natural resources produced are 'in respect of' the exploitation of natural resources. This means that 'natural resource income' under subsection 6CA(1) of the ITAA 1936 will be income from real property under the majority of treaties.

United States treaty

18. The Australian treaty with the United States of America (US treaty)[3] is an exception to paragraphs 16 and 17 of this Ruling.[4] Under the US treaty, income from real property includes income from rights to exploit or to explore for natural resources. Recipients of

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[3] *Convention Between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* [1983] ATS 16

[4] The Australian treaties with Ireland, Malta and the Republic of Korea are also exceptions to the above general position. This Ruling does not cover these treaties.

override royalty payments who do not hold the right to exploit or explore for natural resources do not derive income from real property for the purposes of the US treaty.

Example 3 – override royalty not derived from rights to exploit natural resources

19. *Aus Co owns a production licence issued by a State Government, entitling it to produce oil and gas from an onshore field. For monetary consideration, Aus Co enters into a deed granting US Co a right to 10% of the value of oil and gas produced from the field. US Co does not obtain any proprietary interest in the production licence. US Co's right to payment is not derived from the real property, being Aus Co's rights to exploit the oil and gas under the production licence. Therefore, the income received by US Co is not income from real property for the purposes of the United States treaty.*

Assessability of override royalty payments

20. An override royalty payment to which subsection 6CA(1) applies is deemed to have an Australian source, and will be included in the recipient's assessable income under paragraph 6-5(3)(a) of the ITAA 1997.

Part C – Withholding on natural resource income

21. Where subsection 6CA(1) of the ITAA 1936 applies to an override royalty payment, the conditions in subsection 12-325(1) of Schedule 1 to the TAA will be satisfied.

Date of effect

22. This Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation
9 December 2020

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Section 6CA overview

23. Non-residents that derive natural resource income are subject to Australian income tax on that income as subsection 6CA(3) deems that income to have been derived from a source in Australia for, in the present context, the purposes of section 6-5 and 6-10 of the ITAA 1997. Also, subsection 6CA(2) deems natural resource income to be attributable to sources in Australia for the purposes of Divisions 5 and 6 of Part III of the ITAA 1936.

24. The definition of natural resource income in subsection 6CA(1) , to the extent that definition is relevant to this Ruling, states:

> ***natural resource income*** means income that:
>
> (a) is derived by a non-resident; and
>
> (b) is calculated, in whole or in part, by reference to the value or quantity of natural resources produced, recovered or produced and recovered, in Australia after 7 April 1986; …

Part A – Override royalties and 'natural resource income'

Calculated, in whole or in part, by reference to the value or quantity of natural resources produced

25. Australian courts have said the phrase 'by reference to' covers a wider range of connections than phrases such as 'by reason of', which are limited to connections of a causal nature.[5] Typically, however, a causal connection between the level of production of natural resources and the amount of the override royalty will be sufficient to satisfy the requirement that the payment be calculated by reference to the value or quantity of natural resources produced.

26. This is consistent with the Explanatory Memorandum to the Taxation Laws Amendment Bill (No.4) 1986 (the EM) which introduced section 6CA into the ITAA 1936, which states (emphasis added):

> The amendments proposed by this Bill will mean that, subject to the exception outlined below, income that is **directly related** to the exploitation of Australia's natural resources and that is derived by a non-resident (referred to as "natural resource income") will be subject to full Australian tax. The amendment will apply to payments

[5] *Republic of Croatia v Snedden* [2010] HCA 14 at [25]; *Macedonian Teachers Association of Victoria Inc v Human Rights & Equal Opportunity Commission & Anor* [1998] FCA 1650.

of natural resource income made after 7 April 1986 and which are **based on** the level of production and recovery of natural resources after that date.

27. As outlined in the EM, the intent of the provision is to include income that is **directly related** to the exploitation of Australia's natural resources. A payment will be directly related to the exploitation of natural resources where the payment is **based on** the level of production or recovery of natural resources.

28. In working out whether the calculation of a payment is based on the level of production the Commissioner will have regard to the relevant circumstances, including the conduct of the parties, the relevant agreement(s) and the substantive outcome (meaning its effects from a practical and business point of view). Therefore, payments will be natural resource income where they are calculated by reference to a measure other than production, but the payments are nonetheless **based on** the level of production.

29. This is consistent with the purposive approach to legislative interpretation[6], and ensures that the purpose for the introduction of section 6CA of the ITAA 1936, as outlined in paragraph 26 of this Ruling in the EM, is achieved. Support for the purposive approach is found in *Attorney-General (WA) v Marquet*[7] where in considering the construction of the provisions of the *Electoral Distribution Act 1947* (WA) the majority of the High Court commented that '[t]he evident purpose of the provision should not be defeated by preferring form over substance.'

Meaning of 'natural resources', 'produced' and 'recovered'

30. The terms 'produced' and 'recovered' are not defined in the ITAA 1936 or ITAA 1997. *The Shorter Oxford Dictionary*[8]defines 'produce' to mean 'Of country, region, process, etc: yield or supply (a commodity etc)'. It defines 'recover' to mean 'Get, obtain, get hold of; collect, gather up'. Whether a particular natural resource has been produced or recovered depends on both the nature of the resource and the relevant processes used.

31. A natural resource will generally be found in the earth's crust embedded in other substances. The resource will typically be extracted, for example by drilling and blasting, along with those other substances. On extraction, multiple natural resources may have been produced or recovered. This is because a substance extracted may itself be a natural resource and may also contain several different substances that are each natural resources.

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[6] As required by section 15AA of the *Acts Interpretation Act 1901.*
[7] [2003] HCA 67 at [52].
[8] Oxford University Press, 2004, *Shorter Oxford English Dictionary: on historical principles*, 6th edn, Oxford University Press Inc, New York.

Part B – Tax treaties

32. Many of Australia's tax treaties contain an article dealing with 'income from real property', although the article may have other headings in particular tax treaties, for example 'income from immovable property' or 'income from land'. In this Ruling, these articles are referred to collectively as 'income from real property' articles.

'Exploitation' of natural resources

33. All income from real property articles in Australia's tax treaties use the terms 'exploitation' or 'exploit' in the context of the exploitation of natural resources. These words are not defined in the tax treaties and Australian domestic tax law nor is there any common law guidance on the meaning of the word in the present context. *The Shorter Oxford Dictionary* defines 'exploit' as '… *verb trans*. Work (a mine); make use of (natural resources)…'.

34. This meaning of exploit aligns with the meaning of natural resources 'recovered' or 'produced' as those terms are used in sections 6CA of the ITAA 1936 and section 12-325 of Schedule 1 to the TAA.

35. In certain contexts, the exploitation of resources may involve processes or activities that occur after a natural resource is produced. For example, it might include activities related to the marketing or distribution of the natural resource. In the context of the income from real property articles, it is appropriate to confine the word 'exploitation' to mean 'recovered' or 'produced'.

36. Therefore, in the context of override royalties, the exploitation of natural resources has the same scope as the 'recovery' or 'production' of natural resources.

37. This interpretation is consistent with the EM and the associated withholding provisions of former Division 3B of the ITAA 1936, which were replaced with section 12-325 of Schedule 1 to the TAA. The EM states that (emphasis added):

> The amendments proposed by this Bill will mean that … income that is directly related to the **exploitation** of Australia's natural resources and that is derived by a non-resident (referred to as "natural resource income") will be subject to full Australian tax.

General position for tax treaties

38. Article 6 of the Canadian treaty[9] is representative of the majority of income from real property articles.

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[9] *Convention between Canada and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* [1981] ATS 14.

39. Under Article 6(1) of the Canadian treaty, Australia may tax income from real property if the real property is situated in Australia. The definition of real property includes at paragraph 6(2)(b:

> a right to receive variable or fixed payments either as consideration for or in respect of the exploitation of, or the right to explore for or exploit, mineral, oil or gas deposits, quarries or other places of extraction or exploitation of natural resources.

'As consideration for' the exploitation of natural resources

40. The phrase 'as consideration for' has a wide meaning and must be construed in the context in which it appears.

41. The phrase implies a direct connection, in that the right to receive the payments is, in whole or part, consideration for the exploitation or the sale of the right to explore for or exploit natural resources.

'In respect of' the exploitation of natural resources

42. The phrase 'in respect of' has a very wide meaning[10] and must be construed in the context in which it appears.

43. The phrase connects two subject matters. There must be 'some discernible and rational link'[11] between the two subject matters, and the connection must be material and not merely coincidental or extraneous.[12] In the context of the relevant income from real property articles, the two subject matters are:

- a right to receive payment, and
- the exploitation of the relevant natural resource.

44. A right to receive payments under an override royalty agreement essentially arises from the exploitation of the natural resources and this aptly demonstrates the discernible and rational link to exploitation. The exploitation is the very thing that crystallises the foreign resident's right to receive the payment. The connection in this situation is material and is not merely coincidental or extraneous.

45. The task is to characterise the nature of the right and its link to exploitation. It is not to analyse the relationship between the parties, nor the reasons for, nor the transactions which gave rise to, the right to receive the payments.

46. For example, a right to receive income may be granted for the provision of finance, or in satisfaction of some other liability, however, the right to receive the payment is still 'in respect of' the exploitation

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[10] *Technical Products Pty Ltd v State Government Insurance Office* [1989] HCA 24 (*Technical Products*), per Brennan, Deane and Gaudron JJ.
[11] *Technical Products,* per Brennan, Deane and Gaudron JJ.
[12] *Technical Products,* per Dawson J.

of natural resources if the payment is calculated by reference to the value or quantity of natural resources produced.

47. This interpretation is consistent with the Explanatory Memorandum to the International Tax Agreements Amendment Bill 1999 which introduced the first Amending protocol to the Malaysian treaty into Australian law. That Explanatory Memorandum explains that the income from real property article applies to payments which are natural resource income for Australian tax purposes:

> 2.25 The inclusion of the words 'or in respect of' in relation to natural resources are intended to ensure that Australia may tax payments which are 'natural resource income' for Australian tax purposes.
>
> 2.26 Natural resource income includes payments which, unlike royalties, are based on a contractual arrangement and not on the holding of any proprietary right in the natural resources concerned. The inclusion of the words 'or in respect of' therefore ensures that the definition of land includes not only payments in consideration for *the right* to exploit or to explore for natural resources, but also payments in relation to those resources where there is no proprietary right to explore/exploit the resources concerned.

48. There is no requirement for the foreign-resident recipient to have, or to have had, a proprietary interest in the underlying rights to explore for or exploit natural resources, or to have or to have had any role in exploiting natural resources.

United States treaty

49. For present purposes, the US treaty provides that income from real property includes income from '*rights to exploit or to explore for natural resources … '*.

50. Under the US treaty, an override royalty payment is not income from real property where the recipient does not hold the right to exploit or explore for natural resources.

Part C – Withholding on natural resource income

51. The words 'worked out wholly or partly by reference to the value or quantity of natural resources produced or recovered in Australia' in subsection 12-325(1) of Schedule 1 to the TAA have the same meaning as 'calculated, in whole or in part, by reference to the value or quantity of natural resources produced, recovered or produced and recovered, in Australia' in paragraph (b) of the definition of 'natural resource income' in subsection 6CA(1) of the ITAA 1936.

52. Accordingly, the views set out in Part A of this Ruling in relation to paragraph (b) of the definition of 'natural resource income' in subsection 6CA(1) of the ITAA 1936 also apply to the withholding rules in section 12-325 of Schedule 1 to the TAA.

Appendix 2 – Detailed contents list

53. The following is a detailed contents list for this Ruling:

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References

Previous draft:
TR 2016/D3

Related Rulings/Determinations:
TR 2006/10

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- ITAA 1936 6CA(1)
- ITAA 1936 6CA(2)
- ITAA 1936 6CA(3)
- ITAA 1936 Div 3B
- ITAA 1997 6-5
- ITAA 1997 6-5(3)(a)
- ITAA 1997 6-10
- ITAA 1997 995-1(1)
- TAA 1953
- TAA 1953 Sch1 12-325
- TAA 1953 Sch1 12-325(1)
- Acts Interpretation Act 1901 15AA
- Electoral Distribution Act 1947 (WA)
- Convention between Canada and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income [1981] ATS 14
- Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income [1983] ATS 16

Cases relied on:
- Attorney-General (WA) v Marquet [2003] HCA 67; 217 CLR 545; 78 ALJR 105; 202 ALR 233
- Macedonian Teachers Association of Victoria Inc v Human Rights & Equal Opportunity Commission & Anor [1998] FCA 1650; 91 FCR 8; 160 ALR 489
- Republic of Croatia v Snedden [2010] HCA 14; 241 CLR 461; 84 ALJR 334; 265 ALR 621
- Technical Products Pty Ltd v State Government Insurance Office [1989] HCA 24;167 CLR 45; 63 ALJR 392; 85 ALR 173; 8 MVR 385

Other references:
- Explanatory Memorandum to International Tax Agreements Amendment Bill 1999
- Explanatory Memorandum to Taxation Laws Amendment Bill (No.4) 1986
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