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Committee of Experts on International Cooperation in Tax Matters
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Item 3 (e) of the provisional agenda*
Article 13: capital gains

Paragraphs 4 and 5 of article 13 of the United Nations Model Tax Convention, and relevant commentary

Note by the Subcommittee on Capital Gains**

I. Introduction

1. At the fifth annual session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 19 to 23 October 2009, a Subcommittee on Capital Gains was convened.[1]

2. The Subcommittee was mandated as follows:

The Subcommittee will analyse and make proposals for consideration by the Committee on:

(a) Rewriting the commentary on the new paragraph 5 of article 13;

(b) Addressing the abuse issues relating to paragraph 5 and the policy issues allowing reasonable restructuring;

(c) Addressing the compliance issues of paragraph 4 and the possibility of rewriting this paragraph.

The Subcommittee will present a report on its progress at the next annual session of the Committee.

3. The present note represents the requested progress report on the Subcommittee's work.

* E/C.18/2010/1.

** The views and opinions expressed in the present note are those of the Subcommittee on Capital Gains (Coordinator: Mr. Liao) and should not be taken as necessarily representing those of the United Nations.

[1] E/2009/45, para. 10.

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II. New paragraph 5 of article 13

4. The new version of paragraph 5 of article 13, agreed by the Committee at its fourth annual session, in 2008[2] reads:

> Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least _____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

5. A commentary on the new paragraph was not prepared at that time, and the Subcommittee was requested to provide proposed text for consideration by the Committee. The Subcommittee's proposal follows.

III. Proposed commentary

6. The Subcommittee proposes the following commentary to replace current paragraphs 9 to 11 of the commentary on article 13. The current paragraphs 12 and 13 of the commentary, which relate to paragraph 6 of article 13, would consequently be renumbered as paragraphs 17 and 18. Proposed paragraphs 9 to 16 are as follows:

> "9. Some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State. However, it is recognized that for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12 month period preceding the alienation, held, directly or indirectly, a substantial participation. In this context, '12 month period' means the period beginning with the date which is one calendar year earlier than the date of the alienation and ending at the time of the alienation. The determination of what is a substantial participation is left to bilateral negotiations, in the course of which an agreed percentage can be determined.

> "10. This paragraph provides for taxation of a gain on the alienation of shares as contemplated in the paragraph above but excludes gains from the alienation of shares to which paragraph 4 of article 13 of the Model Convention applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 12 month period preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12 month period.

> "11. It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to

[2] E/C.18/2008/CRP.2, para. 8, and E/2008/45, para. 49.

determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in determining the level of the alienator's direct or indirect holdings. The treaty text itself or associated documents could alternatively expand on the meaning of these concepts.

"12. The question of laying down a concessionary rate of tax (compared with the normal domestic rate) on gains arising on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of companies principally owning immovable property, has also been considered. Since the gains arising on alienation of shares being taxed in a concessionary manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialization of the country, countries may consider discussing this matter during bilateral negotiations and making necessary provision in the bilateral tax treaties.

"13. It is costly to tax gains from the alienation of quoted shares. In addition, developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares. Countries that wish to do so may include in their bilateral tax treaties the following:

> 'Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, **excluding shares in which there is substantial and regular trading on a recognized stock exchange**, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least _____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.'

The treaty text itself or associated documents could expand on the meaning of the phrases 'substantial and regular trading' and 'recognized stock exchange'.

"14. Some countries might consider that the Contracting State in which a company is resident should be allowed to tax the alienation of its shares only if a substantial portion of the company's assets are situated in that State and in bilateral negotiations might seek to include such a limitation.

"15. Other countries engaged in bilateral negotiations might seek to have paragraph 5 omitted entirely, where they take the view that taxation in the source State of capital gains in these situations may create economic double taxation in the corporate chain, thus hampering foreign direct investment. This consideration is, in particular, relevant for countries that apply a participation exemption not only to dividends received from a substantial shareholding, but also to capital gains made on shares in relation to such substantial holdings.

"16. If countries choose not to tax the gains derived in the course of corporate reorganizations, they are of course also free to do so."

IV. Abuse issues relating to paragraph 5 and policy issues relating to reasonable restructuring

7. The Subcommittee considers that the abuse issues relating to paragraph 5 and the policy issues allowing reasonable restructuring are sufficiently dealt with in the proposed commentary on the new paragraph, as well as in the section entitled "Improper use of tax treaties" in changes to the commentary on article 1 previously agreed by the Committee of Experts.[3]

V. Compliance issues for paragraph 4 and the possibility of amending the paragraph[4]

8. Article 13, paragraph 4, currently reads as follows:

> "4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:
>
> > "(1) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.
> >
> > "(2) For the purposes of this paragraph, 'principally' in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate."

9. Some of the issues which the taxpayers and tax administrations have to address in applying the paragraph are listed below:

(a) How would the taxpayer who alienates his shares know that the property of the company, whose shares he has alienated, consists principally of "immovable property" situated in a particular State and discharge his tax obligations to that State? Balance sheets are finalized as of a particular date, and reflect the position of assets on that date while the alienation may be at a date which falls between the dates of the two balance sheets;

(b) It is also possible that the location of immovable properties may not be disclosed in the balance sheets available in the public domain. Where would the taxpayer access information to determine his tax obligation? The situation may be aggravated in cases where a person transacts in shares based on price movements of scrip in a stock exchange and makes no analysis of the financials;

(c) The phrase "immovable property" used in the paragraph has not been defined. Paragraph 1 of article 13 also uses this phrase but makes an explicit reference to article 6 and therefore the definition of "immovable property" in article 6

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[3] E/C.18/2008/CRP.2, para. 12.

[4] This part was drafted for the Subcommittee by Ms. Anita Kapur, a member of the Subcommittee.

relates to paragraph 1 of article 13. However, in paragraph 4 there is no reference to article 6. This omission inspires the view that in the absence of a definition of "immovable property" in article 3, the phrase will have to take its meaning from the domestic law. A contrary view is that some international meaning to this term in preference to the domestic law meaning should contextually apply. Another view is that paragraph 4 ensures that the taxing rights in relation to immovable property in paragraph 1 are retained in the circumstances set out in paragraph 4 and "immovable property" should be interpreted as set out in paragraph 1. Clearly, this divergence in views of the resident State and source State can cause difficulties for the taxpayer;

(d) "Principally" in relation to ownership of "immovable property" has been defined to mean the value of such "immovable property" exceeding 50 per cent of the aggregate value of all assets. The issues requiring clarification are:

(i) The date for determining such value;

(ii) Whether the value is to be taken as book value, cost or fair market value;

(iii) Which are the assets to be reckoned? That is, whether all assets as per the books are included, or even the assets not in the books such as goodwill and other intangible property;

(iv) In a situation where the "immovable property" is situated in State A and the company is a resident of State B, and the share transaction takes place between residents of State B, the tax administration of State A may not have access to information regarding such transactions to assert the taxation right, because the company whose shares are alienated is not in its territory;

(v) Tax administrations may know or may not know of abusive attempts to evade the operation of paragraph 4 of article 13, particularly by shareholders with controlling interests, as the company can borrow short term to make the value of "immovable property" at the relevant time less than 50 per cent.

10. The Subcommittee considers it necessary to ascertain the practices and legal provisions applied by various tax jurisdictions in asserting their source taxation right under article 13, paragraph 4, before considering changes to that paragraph. It is also necessary to deliberate in the Committee on the issues posed in paragraph 9 of the present paper to decide on the guidance that the commentary should provide for making the provision as effective as possible.

VI. Interpretation of the term "indirectly" in paragraph 4

11. While the Subcommittee is of the view that the term "indirectly" in paragraph 4 of article 13, poses difficulties for, and may therefore result in differences of, interpretation, it believes that according to paragraph 2 of article 3 it is left to domestic laws rather than the treaty law to define the term. The practice in the domestic law of the country of one member[5] of the Subcommittee may be of some assistance, and that practice is therefore summarized as follows for reference:

> Suppose Company A in State A holds 20 per cent of shares in Company B in State B. The asset value of Company B is 100 United States dollars, of which 40 United States dollars is the value of immovable property. Company B holds

[5] Mr. Tizhong Liao of China.

80 per cent shares in Company C. The asset value of Company C is 100 United States dollars, of which 90 United States dollars is the value of immovable property. Then for Company B:

The total asset value is 180 (100+100*80%);

The total value of immovable property is 112 (40+90*80%);

The value of immovable property versus movable property is 62 per cent.

Therefore when Company A sells its shares in Company B, State B should have the right to source taxation because more than 50 per cent of the value in Company B is from immovable property.

VII. Interpretation of the term "indirectly" in new paragraph 5

12. As with paragraph 4, the Subcommittee recognizes that the term "indirectly" in the new paragraph 5 of article 13 poses difficulties for, and may therefore result in differences of, interpretation. It considers, however, that according to paragraph 2 of article 3 it is left to domestic laws rather than the treaty law to define the term. The practice in the domestic law of one member[5] of the Subcommittee may be of some assistance, and is therefore summarized as follows for reference:

Suppose the percentage of shareholding established through bilateral negotiations is 25 per cent, the alienator shall be regarded as holding 25 per cent or more of the capital of the company, if:

(a) The alienator holds directly 25 per cent or more of the capital of the company which is a resident of the other Contracting State;

(b) The alienator holds indirectly, in a shareholding chain, 25 per cent or more of the capital of the company which is a resident of the other Contracting State. Indirect shareholding in a chain shall be computed by multiplying the shareholding percentages. For instance, if a company in State A holds 50 per cent of the shares in a company in State B, and the company in State B holds 50 per cent of a company in State C, then the company in State A indirectly holds 25 per cent (50 per cent of 50 per cent) of the shares in the company in State C. Under such circumstances, the gains derived by the company in State A from the alienation of the shares in the company in State B shall not be taxable in State C. However, if the company in State A directly holds shares of any percentage, for example 5 per cent, in the company in State C and sells the shares, the gains shall be taxable in State C;

(c) The combination of direct shareholding plus indirect shareholding reaches 25 per cent or more. For instance, if a company in State A holds 40 per cent of the shares in a company in State B, and the company in State B holds 40 per cent of the shares in a company in State C, then the company in State A indirectly holds 16 per cent (40 per cent of 40 per cent) of the shares in the company in State C. At the same time, the company in State A directly holds 10 per cent of the shares in the company in State C. Then the company in State A holds directly and indirectly 26 per cent (10 per cent plus 16 per cent) of the shares in the company in State C. Under such circumstances, the gains derived by the company in State A from the alienation of the shares in the company in State C shall be taxable in State C even if the company in State A only directly holds 10 per cent of the shares in the company in State C;

(d) The alienator's closely associated parties hold directly or indirectly 25 per cent or more of the capital of the company which is a resident of the other Contracting State. The closely associated parties usually include: (i) kinship members; (ii) dependent agencies, fiduciaries, trustees, nominees or other persons of the same or similar nature; (iii) an individual or a company that owns 100 per cent of the shares in a resident company; and (iv) a company that is wholly owned by the aforesaid individuals, companies, or other persons. Under such circumstances, the gains derived by the alienator who is a resident of a Contracting State from the alienation of his shares in the company which is a resident of the other Contracting State shall be taxable in that other State.