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Item 3 (b) of the provisional agenda

Update of the UN Model Double Taxation Convention between Developed and Developing Countries – Article 13(5) and Transparent Entities

Note by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries

Summary

At its nineteenth session (Geneva, 15-18 October 2019), the Committee discussed section VIII of note E/C.18/2019/CRP.22 which dealt with a technical issue raised by Xiong Yan in relation to the interpretation of Art. 13(5) in cases where the shares or similar holdings that are being alienated are held by a partnership or other entity treated as transparent for tax purposes. It was then agreed that a draft Commentary clarification would be prepared by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries for discussion and approval at the twentieth session of the Committee.

This note includes the proposed Commentary changes that the Subcommittee finalized at its meeting of 14-16 February 2020.

At its twentieth session, the Committee is invited to discuss and approve the proposals included in section 4 of this note.

Article 13(5) and Transparent Entities

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1. Introduction

1. At its meeting of 11-12 October 2019, the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries discussed Section VIII of note E/C.18/2019/CRP.22 which was related to a technical issue raised by Xiong Yan in relation to the interpretation of Art. 13(5) in cases where the shares or similar holdings that are being alienated are held by a partnership or other entity treated as transparent for tax purposes. The vast majority of participants who spoke on the issue supported the interpretation included in paragraph 60 to 62 of the note and it was agreed that a proposed Commentary clarification based on these paragraphs would be drafted. This decision was endorsed by the Committee at its nineteenth session (see paragraph 36 of the report on the nineteenth session of the Committee held in Geneva on 15-18 October 2019).

2. Section 2 of this note describes the issue. Section 3 includes the analysis of that issue and the conclusion reached by the Subcommittee. Section 4 includes the draft Commentary changes prepared by the Subcommittee to address the issue.

3. At its twentieth session, the Committee is invited to discuss and approve the proposals included in section 4 of this note.

2. Description of the issue

4. The following is the issue submitted for consideration by Xiong Yan:

> I have come across a few cases in which a non-resident taxpayer derives capital gains from China through a partnership set up in its residence country which treats partnerships as fiscally transparent. The partnership holds more than 25% of the Chinese company the shares of which have been alienated, while the partner holds less than 25%. In this case, does "the percentage of the capital held by the alienator" exceed 25% or not, i.e. who is the alienator, the partner or the partnership?

5. This issue may be analyzed through the following example. RCo, a company resident of State R, holds a 50 percent interest in RPSP, a partnership that is organized under State R law. RPSP is treated under State R law as fiscally transparent, meaning that the owners of RPSP are taxed currently on the partnership's income, and the source and character of the income flows through the partnership unchanged. RPSP in turn owns 25 percent of the shares of SCo, a company resident of State S. RPSP alienates its shares of SCo and realizes a capital gain of 100. Given the fiscally transparent nature of RPSP, State R will currently tax the 100 as capital gains in the hands of the partners, thereby taxing RCo on 50.

6. The R-S tax treaty follows the UN Model. Article 13 paragraph 5 of the R-S treaty reads as follows:

> 5. 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, or comparable interests, such as

interests in a partnership or a trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least 25 percent of the capital of that company or entity.

7. Paragraph 5 of Article 13 applies to determine if State S has the right to tax the 50 of capital gains derived by RCo from the sale of its shares of SCo. Paragraph 5 applies to gains "derived by a resident of a Contracting State" and allows for taxation at source of the gains if the "alienator" satisfies the ownership requirements prescribed.

3. Analysis and conclusion

8. The specific wording of paragraph 5 could arguably be read in two different ways in the context of that example.

9. On the one hand, it could be considered that the reference to the "alienator" cannot be separated from the reference to the resident who derives the gain so that the alienator must be considered to be RCo. Since RCo only holds 12.5% of the shares of SCo (through its 50% interest in RPSP), the result of that interpretation is that the gain would not be taxed in State S under paragraph 5.

10. On the other hand, it could be considered that while RCo is the resident of a Contracting State that has derived a capital gain of 50, the alienator of the shares of SCo is RPSP. RPSP's ownership of 25 percent of the shares of SCo satisfies the requirement of paragraph 5, and accordingly, State S is permitted to tax the gain derived by RCo.

11. The latter interpretation reflects more closely the wording of paragraph 5. In the above example, RCo is the resident of a Contracting State that has derived the capital gain. However, the alienator of the shares of SCo is RPSP. RPSP's ownership of 25 percent of the shares of SCo satisfies the requirement of paragraph 5, and accordingly, SCo is permitted to tax the 50 of gains derived by RCo.

12. This interpretation also produces the right result if we assume a slightly different example under which RCo also owns directly 20 percent of the shares of SCo in addition to the 12.5 percent that it owns through RPSP. If RCo were to alienate its 20 percent direct holding of SCo shares and realize a capital gain of 80, RCo would in this case be considered both as the resident who derives the capital gain of 80 and the alienator of the 20 percent shareholding for purposes of applying paragraph 5. RCo's total holding of the shares of SCo would be 32.5 percent (20 percent plus 12.5 percent through RPSOP), and thus, the requirements of paragraph 5 would be satisfied and State S would be allowed to also tax the capital gain of 80 derived by RCo on its 20 percent shareholding.

4. Proposed Commentary changes

13. In light of the above conclusions, the following proposed paragraphs have been drafted for possible inclusion in the Commentary on Article 13:

14. It is proposed to add the following new paragraphs 12.1 to 12.5 immediately after paragraph 12 of the existing Commentary on Article 13 of the UN Model:

12.1 The right to tax under paragraph 5 depends on whether, at any time during the 365 days preceding the alienation, the alienator of the shares or comparable interests held directly or indirectly at least the specified percentage of the capital of the company or entity. In most situations, the "alienator" will be the resident who derives the gain, such as a parent company that alienates shares of its subsidiary.

12.2 In some cases, however, the alineator may be different from the resident who derives the gain. This would be the case, for instance, where the shares or comparable interests are alienated by a transparent entity.

12.3 Assume, for example, that RCo, a company resident of State R, holds a 50 percent interest in RPSP, a partnership that is organized under State R law. RPSP in turn holds 25 percent of the shares of SCo, a company resident of State S. Assume also that paragraph 5 of Article 13 of the R-S tax convention contains a 25 percent ownership threshold and that, under State R law, RPSP is treated as fiscally transparent (see the explanation in paragraph 7 of the Commentary on article 1 which quotes paragraph 9 of the Commentary on article 1 of the 2017 OECD Model). RPSP alienates all its shares of SCo and realizes a capital gain of 100. In that case, State R will tax the capital gain in the hands of its resident partners, thereby taxing RCo on 50.

12.4 In this example, for the purposes of applying paragraph 5, RCo is the resident of a Contracting State that has derived a gain from the alienation of the shares of SCo. However, RPSP, as the owner of the SCo shares, is the alienator of the shares, and as such, the relevant ownership threshold should be applied at the level of RPSP. In this example, State S may therefore tax the gain from the alienation of the shares of SCo.

12.5 In the different example where RCo held directly 20 percent of the shares of SCo in addition to the 12.5 percent held through RPSP and alienated this 20 percent direct shareholding, thereby realizing a capital gain of 80, RCo would be considered both as the resident who derived the capital gain of 80 and the alienator of the 20 percent shareholding for the purposes of paragraph 5 (in that case, RCo's total holding of the shares of SCo would be 32.5 percent, i.e. 20 percent plus 12.5 percent held through RPSP). State S would therefore be allowed to tax the capital gain of 80 derived by RCo on the alienation of its 20 percent shareholding.