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Modification to Article 13 (Capital gains) of the UN Model

Summary

This note is presented for discussion and guidance (not for final approval) at the meeting of the Committee to be held in Geneva on 15-18 October 2019.

At their meetings in April 2019, the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries as well as the full UN Tax Committee had a first discussion of paper [E/C/18/2019/CRP.9](#) (Annex A) entitled “Modification to Article 13 (Capital gains) of the UN Model,” which addresses the issue of so-called “offshore indirect transfers” (referred to as “OITs”). After discussing the paper, the Committee asked the Secretariat to prepare an additional paper that would further explore the issues raised during those meetings for further discussion at the October 2019 meeting.

This paper attempts to provide greater context and background to the many issues that were raised during the April meetings, including some background regarding the policy considerations that have shaped the allocation of taxing rights under Article 13 of the UN Model, in particular paragraph 6, which is the rule that governs the taxation of gains that are not covered in the earlier paragraphs of the Article.

This paper is organized as follows. Section I briefly describes the allocation of taxing rights on capital gains under the current UN Model Article 13. Section II introduces the concepts of “direct” and “indirect” transfers of shares in a company or similar interests in an entity located in a State. Section III discusses a number of possible reasons why OITs may take place. Section IV describes the highlights of paper [E/C/18/2019/CRP.9](#) (Annex A), which was prepared by Committee member Mr. Rajat Bansal and which proposes certain modifications to Article 13 of the UN Model. Section V recaps the discussion of paper CRP.9 that took place at the April 2019 meetings of the Subcommittee on the Model and the full Committee. Section VI attempts to describe a number of policy and administrative considerations that may have influenced the development of Article 13 in the past. Section VII frames a number of questions for the Committee to consider in light of the additional material presented in

this paper. Section VIII addresses a separate issue that has been before the Committee and that is related to the application of Article 13: the application of paragraph 5 in cases when the shares alienated are owned by a fiscally transparent entity. Annex B contains a draft prepared by the Secretariat of a possible alternative version of Article 13(4) that allows for source taxation of gains from certain OITs.

I. ALLOCATION OF TAXING RIGHTS UNDER ARTICLE 13 OF THE UN MODEL

1. Article 13 of the UN Model allocates taxing right between the two countries party to the tax convention when a resident of one State alienates property located or connected in some way to the other State, although the taxing rights permitted vary and depend on the nature of the property that has been alienated. Paragraph 1 allows unlimited taxation on gains from the alienation of immovable property by the State where the immovable property is situated. Paragraph 2 allows for taxation of gains from the alienation of movable property of a permanent establishment or fixed base, including the alienation of the whole permanent establishment or fixed base, by the State where such permanent establishment or fixed based is situated. Paragraph 3 assigns the taxing rights on gains from the alienation of ships or aircraft operated in international traffic, and to movable property related to such operation, exclusively to the State of residence of the enterprise that operates them. Paragraph 4 allows for the taxation of gains from the alienation of shares or interests in an entity that, directly or indirectly, derive more than 50 percent of their value from immovable property by the State where the immovable property is located. Paragraph 5 allows for the taxation of gains from the alienation of shares of a company by the State where the company is resident if at any time during the 365 days preceding the transaction the alienator owned a minimum percentage of the shares of the company (such percentage is negotiated bilaterally between the two countries party to the convention). Paragraph 6 provides that only the State of residence of the alienator may tax gains from the alienation of any property not covered by paragraphs 1 to 5.

II. DIRECT VS. INDIRECT TRANSFERS

2. The application of paragraph 5 is illustrated by the following example. RCo, a company resident of State R, owns 80 percent of the shares of SCo, a company resident of State S, and RCo sells the shares of SCo at a gain. Assuming that the R-S convention follows the UN Model and that the percentage that appears in paragraph 5 of Article 13 is 50%, the R-S tax convention would allow State S to tax the gain.

3. The alienations to which paragraph 5 applies are referred to as “direct transfers,” because the foreign resident directly owns the shares of, or interests in, the resident entity that are alienated.

4. If, however, the ownership structure involves a chain of ownership and the shares or interests that are alienated are those in a non-resident entity, the conditions of application of paragraph 5 are not satisfied. Assume for instance, that in the example above, RCo’s ownership of SCo is now indirect, through XCo, a company resident of State X. RCo’s alienation of its shares of XCo is referred to as an “offshore indirect transfer” (“OIT”) of its ownership of SCo. Under the current drafting of paragraph 5 of the UN Model (and not taking into account the possible application of anti-abuse rules in certain cases), State S does not have a right to tax any gains from the alienation of the shares of XCo by RCo.

5. The issue of OITs grew in prominence with the Vodafone case in India, which was decided by the Supreme Court of India in 2012. Hutchinson, a Hong Kong-based multinational company, owned the shares of a holding subsidiary in the Cayman Islands which owned the shares of Vodafone Essar Limited, an Indian operating mobile phone company. The shares of the Indian operating company had been held by the Cayman company since 1994. In 2006, a Netherlands subsidiary of the multinational telecom group Vodafone acquired the shares of the Cayman company. The Indian tax authorities sought to collect \$2.6 billion in tax on the capital gains realized by Hutchinson on the sale of the shares of the Cayman company. Vodafone disputed the tax assessment and, in 2012, the Supreme Court of India decided in favor of Vodafone, concluding that India did not have, under its domestic law, the right to tax gains from the sale by Hutchison of the shares of the Cayman company, a transaction that took place wholly outside India between parties that were not tax residents of India.

6. Subsequent to the court decision, India enacted legislative changes to ensure the taxation of OITs of assets located in India. Section 9(1)(i) of India’s Income Tax Act provides that India shall tax “all income accruing or arising, whether directly or indirectly, ... through the transfer of a capital asset situated in India.” The legislative explanation of clause 9(1)(i) was amended in 2012 to explicitly cover gains from OITs:

Explanation 5 [to clause 9(1)(i) of the Act]: “For the removal of doubts, it is hereby clarified that *an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.*”

7. Thus, this change makes clear that gains from the OIT of a local Indian asset shall be deemed to be situated in India, and therefore taxable by virtue of clause 9(1)(i).

III. REASONS WHY OITs MAY OCCUR

8. OITs take place for a variety of reasons that can range from tax avoidance to legitimate business purposes. As is described below, OITs (as the term is defined above) can also result from purely portfolio cross-border investments. The various forms of OIT should be taken into account when determining the appropriate tax treaty policy to apply to OITs.

9. OITs can be used by non-resident taxpayers to avoid incurring capital gains tax in a State where an asset is located (for drafting purposes the latter is referred to in this paper as the “source State”). If, for example, a foreign company wishes to acquire a local asset that it anticipates it may later alienate at a gain, the foreign company could interpose another foreign holding company that would acquire and hold the local asset as its sole asset. By alienating the shares of the interposed holding company, the local asset can be indirectly transferred without incurring capital gains tax in the source State. Depending on the facts and circumstances of the case, anti-abuse rules, such as substance over form principles, or, in the context of the application of a double tax convention, a so-called “principle purpose test” rule such as the one found in paragraph 9 of Article 29 of the UN Model, could result in such an arrangement being considered, for tax purposes, to constitute the alienation of the local asset, and be taxed accordingly in the source State.

10. The structures and transactions described in the prior paragraph differ from other OITs that have been entered into for business or commercial purposes. For example, a multinational group may hold and actively manage a number of subsidiaries that operate in the same line of business or in the same region of the world through a common holding company. If the multinational group opts to divest of that particular line of business or of its operations in that region, it can achieve that goal by alienating its ownership of the holding company rather than separately alienating each individual lower-tier subsidiary.

11. Non-tax reasons may also motivate the structure of the transfer from the perspective of the purchaser. For example, if a buyer intends to purchase a seller’s regional or business line operations that are held under a seller’s intermediate holding company, concerns of efficiency and minimization of transactional costs will typically dictate a single transfer of shares of the holding company rather than separate acquisitions of each underlying subsidiary. Also, the purchaser may have a preference to purchase stock to avoid disrupting existing business relationships and supply chains etc. In such cases the transaction would take the form of a transfer of the shares of the intermediate owner. Similarly, one regularly sees OITs occur in the case of global mergers between two unrelated groups, where shareholders in one group

often transfer their shares in the top tier company of that group for shares in the top tier company of the acquiring group.

12. Internal restructurings within a multinational group also very frequently result in OITs. If, for example, a lower-tier subsidiary within the group changes its line of business, the parent may wish to transfer the direct ownership of that subsidiary from one holding company within the group to another to align business reporting and supervision structures. Such a reorganization would often not be a taxable event for the purposes of the domestic law of the ultimate parent, in recognition of the non-tax motivation of the transaction. Similarly, internal restructurings are a regular feature of groups that have undergone global mergers, where the acquirer group seeks to streamline often duplicative holding chains, which frequently requires transfers of acquired group intermediate holding company shares into an acquired group affiliate. Here again, the domestic law of the transferring affiliate's State will often treat that as a nontaxable event in recognition of the purely internal, business-driven need for the transfer.

13. Portfolio investments have with time become global in nature, and as a result can be an important additional source of OITs. Consider, for example, a collective investment vehicle (CIV) established in State R that is marketed to local portfolio investors. The CIV may primarily invest in shares of State R companies, but may also invest abroad, either by acquiring interests in foreign CIVs, or by acquiring shares directly in non-State R companies, in order to balance and diversify its holdings. As a technical matter, any transfer, by an investor, of its shares of, or interests in, the State R CIV constitute OITs from the perspective of the tax authorities in the countries where the underlying investments are situated.

14. Portfolio investments can result in OITs even outside of the realm of CIVs. Consider, for example, trades on the New York stock exchange of the shares of a U.S. public company that has subsidiaries in other countries. Such trades could constitute OITs from the perspective of the tax authorities of the countries where the subsidiaries are located.

IV. PAPER [E/C/18/2019/CRP.9](#)

15. In an effort to advance the discussion of the issue of OITs by the Committee, Committee member Mr. Rajat Bansal prepared paper [E/C/18/2019/CRP.9](#) (Annex A). The paper describes the OIT as an issue of growing importance to developing countries, illustrated in part by the fact that the Platform for Collaboration on Tax has issued a paper entitled "The Taxation of Offshore Indirect Transfers – A Toolkit (referred to herein as "the OIT Toolkit")" intended to provide advice to developing countries on how to address the issue. Additionally, the paper cites the following policy rationales for taxing gains from OITs: 1) the gains incurred originate from the enhancement of value in the source State; 2) taxation of gains on OITs is consistent

with the widely accepted policy to impose source tax on dividends paid to nonresident investors; and 3) many countries impose tax on OITs of immovable property, and it should not make a difference if the local asset is immovable or movable.

16. Paper CRP.9 explains that in order to tax the gains from OITs, countries must do two things.

17. First, countries must ensure that they have the ability under their domestic law to impose tax on the gains of an OIT. Countries that tax gains from OITs have taken two different approaches. The first approach is to apply judicial principles or legislative rules in abusive cases to impose tax by recharacterizing the OIT into a direct transfer of a local asset, thereby bringing the transaction into the taxing jurisdiction of the State. The second approach is to enact legislation that would impose tax on the gains of an OIT irrespective of whether an element of intentional tax avoidance can be shown.

18. Second, countries wishing to tax gains on OITs must ensure that their bilateral tax conventions are drafted in such a way that preserves their domestic law ability to impose the tax. In this regard, paper CRP.9 explains that under the existing UN Model, gains from OITs are not dealt with in paragraphs 1 through 5 of Article 13, and are therefore within the scope of paragraph 6, the rule which assigns the exclusive right to tax “residual” gains to the State of residence.

19. The paper then refers to paragraph 18 of the Commentary on Article 13 of the UN Commentary, which indicates that most Committee members from developing countries suggested the following alternative to the OECD rule concerning the taxation of residual gains:

“5. Gains from the alienation of any property other than those gains mentioned in paragraphs 1,2,3 and 4 may be taxed in the Contracting State in which they arise according to the laws of that State.”¹

¹ When this alternative was inserted in the Commentary in 2001, the alternative applied to gains from the alienation of property “other than those gains mentioned in paragraphs 1, 2 and 3” of the OECD Model. The original intention, as described in paragraph 2 of the Commentary on Article 13 of the 2001 UN Model, was to suggest an alternative version of Article 13 which “allows the source country to tax capital gains from the alienation of immovable property and from movable property that is a part of a permanent establishment or pertains to a fixed base for performing independent personal services, (2) permits gains from the alienation of ships and aircraft to be taxed only in the State of effective management of the relevant enterprises, and (3) reserves to the residence country the right to tax gains on other forms of alienable property.” It is therefore unclear whether the authors of that alternative would have agreed to the subsequent addition of paragraph 4 after that paragraph was included in the OECD Model.

20. According to the paragraph, the effect of that rule would be “that either or both States may tax according to their own laws and that the State of residence will eliminate double taxation under article 23”.

21. Paragraph 18 of the Commentary goes on to add, however, that countries pursuing this alternative “may wish through bilateral negotiations to clarify which particular source rules will apply to establish where a gain shall be considered to arise.”

22. Paper CRP.9 concludes that given the importance of taxing gains from OITs in developing countries, the UN Model should therefore be changed to replace paragraphs 5 and 6 of Article 13 by the following modified version of the alternative currently provided in paragraph 18 of the Commentary:

“Gains from the alienation of any property other than those gains mentioned in paragraphs 1,2,3,4 may be taxed in the Contracting State of which the alienator is resident. However, such gains may also be taxed in the other Contracting States if they arise therein according to the laws of that State.”

23. While this provision would retain source taxing rights on gains from OITs, its impact would be much broader in that it would allow unlimited source taxation on any residual gain as long as the gain arises in the source State according to its laws. The paper advocates that the Committee should consider this change to the Model as it is “in line with developing countries’ position on this issue.”

V. DISCUSSION BEFORE THE SUBCOMMITTEE ON THE MODEL AND THE FULL COMMITTEE IN APRIL 2019

24. Mr. Bansal presented document CRP.9 at both the meetings of the subcommittee on the Model and the full Committee during the meetings in New York in April 2019. The paper elicited a variety of views, including both expressions of support for and concerns about the proposal. The comments expressed are summarized below.

25. *Growing interest of issue among developing countries* -- One Committee member endorsed the work and the proposal, agreeing that in her view, the issue of taxing gains from OIT was in fact a growing concern among developing countries. Moreover, the OIT Toolkit issued by The Platform for Collaboration on Tax likely would mean that the number of countries that would seek domestic law changes and expanded taxing rights under their bilateral tax conventions may grow. It was appropriate, therefore, for the UN to provide guidance on the issue.

26. *Achieve parity with taxation of direct transfers* – One member of the Committee expressed the view that as a policy matter, he does not favor treaty provisions allowing taxation of gains from a direct transfer of shares of a local company. However, he observed that taxing gains from direct transfers when prescribed thresholds are satisfied has been a part of the UN Model for several years. He concluded that it would be appropriate therefore to bring the taxation of OITs in line with the taxation of direct transfers. Therefore, as a matter of parity, he supported the idea of developing such a provision for potential inclusion in the Model, although he noted that the scope of the proposal in CRP.9 significantly exceeded just OITs, and the broad reach of the proposal concerned him. In response to this parity argument, the Secretariat observed that one possible reason to distinguish direct transfers from OITs could be that imposing tax on gains from a direct transfer may be easier to apply and enforce. In contrast, taxing the gains from an OIT can be more difficult to administer, primarily because OITs are transactions that take place wholly outside the State wishing to impose tax.

27. *Achieve parity with taxation of indirect transfers of immovable property* – Some Committee members observed that the UN and OECD Model tax treaties have long allowed for the taxation of indirect transfers of immovable property. Those Committee members were of the view that the UN Model should provide the same treatment to indirect transfers of both immovable and movable property. As regards indirect transfers of immovable property, a consultant working for the Secretariat observed that his State (the United States) has a large and sophisticated tax administration and takes very seriously the issue of taxing gains from the indirect transfer of immovable property. He further observed that the United States has enacted expansive domestic law rules for taxing gains from the alienation of indirect transfers of immovable property and that the treaty policy of the United States is to retain its full ability to impose those laws in its tax treaties. With regard to the issue of OITs of immovable property, he also noted that U.S. domestic law “stops at the water’s edge” in that it only captures gains from the alienation of a U.S. real property holding company, and does not tax gains from the alienation of shares of a foreign company that owns U.S. immovable property. He surmised that one possible reason could be that the United States concluded that as an administrative matter, taxing gains from the sale of a foreign company may raise too many administrative difficulties and could not be effectively enforced.

28. *Scope of the proposal* -- A number of speakers expressed concern about the breadth of the proposal, observing that, as CRP.9 acknowledges, the proposed change would allow for source taxation on more than just gains from OITs. One Committee member observed that rather than adopting such a broad rule as a response to a narrow issue, the Committee should first have a discussion to identify those assets or classes of assets that should be the focus, which could potentially allow the Committee to draft a narrower rule. She further observed that the Toolkit paper prepared by the Platform for Collaboration on Tax appeared to focus on a narrower group of assets that would primarily include immovable property and some local

intangible rights (such as a license to provide cell phone services), which she referred to as “immovable property plus.”

29. A representative from the business community observed that in fact, the proposal treaty provision would effectively make paragraphs 1, 2, 4 and 5 of Article 13 of the UN Model totally meaningless. With respect to paragraph 4 and 5 in particular, the proposal would allow for taxation of gains on direct share sales even in cases when the ownership thresholds in these paragraphs have not been satisfied. Therefore, as a technical and drafting matter, a State wishing to use the proposed rule could simply include current paragraph 3 (which assigns the taxing right over gains from the alienation of ships and aircraft operated in international traffic to the State of residence of the airline or shipping enterprise) with the proposed alternative provision, and in doing so the treaty would effectively allow the source taxation of all other capital gains without specifying what is the source of these gains.

30. *Tax all OITs or only tax in cases of abuse?* – The Committee had an initial debate on the issue of whether gains from OITs should always be taxed as a general matter, or if they should only be taxed in cases of perceived abuses. One Committee member explained that the policy of her State was to only tax gains from OITs in cases of perceived abuse. Her State accomplishes this by using a substance over form rule to recharacterize an OIT as a direct transfer of the local asset. She expressed the concern that rules permitting taxation of all OITs could have the undesirable effect of hindering foreign direct investment. For these reasons the Committee member was of the view that the UN Model should not be changed in the way proposed, and that the matter should be dealt with bilaterally, as opposed to trying to address the issue in the UN Model.

31. *Leaving source of the capital gain to be determined under domestic law* – A number of speakers at the April meetings expressed concern with the idea of leaving to domestic law the definition of the source of the gains to which the proposal would apply, citing that doing so does not provide clarity in the treaty text as to when the provision would apply, and more importantly that the treaty should not give the source State unfettered ability to unilaterally change the scope of the provision simply by making changes to its domestic law. Accordingly, if the Committee decided to move forward with a rule that would generally allow for source taxation of residual gains, these speakers urged that a rule be drafted that defined the source of the gains. One speaker noted that it may be challenging to draft a source rule that would apply when the underlying local asset is movable.

32. *Administrability* – At least one Committee member expressed concerns that a rule allowing for source taxation of gains from an OIT could be difficult to effectively administer. An OIT is a transaction that takes place wholly outside the source State. It could therefore be difficult for the source State to even be aware that the transaction has taken place. This could be particularly true if the OIT has taken place several tiers up in a chain of ownership. Further,

as there is no payment from the source State, withholding would not be a readily available mechanism to bring taxpayers into the compliance net.

33. In response to these comments, Mr. Bansal noted that a State wishing to tax gains from OITs can adopt information reporting requirements, as India has done, to bring the existence of OITs to the attention of the tax administration.

34. *Concerns about double taxation* – During the April meeting a number of Committee members expressed the concern that the proposal could lead to unresolved double taxation. The speakers did not go into detail, but it is conceivable that double taxation could result a number of ways if the proposal were adopted. For example, in the case of an alienation of the shares of a company that holds subsidiaries in several different countries, double taxation could result if those countries asserted overlapping tax on the same amount of capital gain. Additionally, in the case of an OIT that involves a sale that takes place entirely within the residence State (that is, the transferor, transferee and the holding company are all residents of the same State), that State may, as a policy matter, reject the idea of providing a foreign tax credit for what it sees as a wholly domestic transaction. Mr. Bansal responded that these issues should not be a concern in practice, citing that in his view, the problems do not arise when source countries impose tax on OITs of immovable property, and thus the same will be true for OITs more generally.

35. *What is the history behind the UN Model's allocation of taxing rights on residual capital gains exclusively to the residence State?* – At the conclusion of the April discussions, Mr. Bansal noted that the Model does not articulate a policy reason why Article 13 paragraph 6 assigns exclusive taxing rights to the residence State. Mr. Bansal asserted that it should not be simply taken as given that residual gains can be taxed only by the residence State, and that in deciding how to handle the issue of OITs, the Committee should debate the policy underpinning paragraph 6 generally. The Secretariat acknowledged that neither the UN nor the OECD Model Commentaries articulates the policy that underlies paragraph 6, and further noted that some research into the matter may be helpful in determining how to proceed.

VI. SOME POSSIBLE HISTORICAL PERSPECTIVES ON ARTICLE 13 PARAGRAPH 6 OF THE UN MODEL²

² The contents of this section were drawn heavily from Wei Cui, “Taxation of non-residents’ capital gains”, Chapter III in *United Nations Handbook on Selected Issues in Protecting The Tax Base of Developing Countries*, Second edition, New York, 2017 (page 127).

36. This section describes a number of policy and administrative issues that may have influenced the formation of Article 13 in the past.

Policy considerations that may have historically influenced Article 13 paragraph 6

37. One policy argument that favors broad taxation of capital gains at source establishes a connection between the streams of income produced by an asset and the ultimate alienation of the asset. According to this argument, as a pure matter of policy, if source taxation of income (e.g. business profits, income from immovable property, dividends, interest and royalties) generated from an asset is permitted in the double taxation convention, it follows that capital gains from the alienation of the asset should also be permitted. In addition to consistency, doing otherwise could create opportunities for avoidance of tax on the streams of income by deferring the payment of the income and instead alienating the asset at an appreciated value.

38. The argument that the treatment of capital gains in a tax treaty should be consistent with the taxation of the streams of income produced by an asset is, as an initial matter, particularly relevant to the UN Model. Given that the UN Model contemplates source taxation on business profits of a permanent establishment/fixed base, dividends, interest, royalties and fees for technical services, under this argument, it follows that a consistent treatment approach would also allow for taxation at source of capital gains.

39. *Economic differences between categories of assets may argue for different tax treatment of different types of capital gains* – Nevertheless, applying one blanket rule allowing taxation at source on all capital gains could ignore the fact that as an economic matter, different types of assets appreciate (and depreciate) differently over time. For example, durable industrial assets such as machines, computers and vehicles will typically diminish in value over their useful lives from wear and tear. Buildings and other physical structures will also depreciate over time. In contrast, assets such as land, depletable resources and rights to those resources may increase in value over time, as would ownership of an interest in a business, if the business is successful over time. Such an acknowledgement of how the value of different classes of assets change over time may underscore the importance of being able to take into account capital losses as a matter of equity, especially in the case of assets that depreciate with time.

40. Recognizing the economic differences between categories of assets also may demonstrate the relatively greater importance of retaining taxing rights on gains from certain types of assets (e.g. immovable property and a controlling interest in a business) than from other classes of assets. An extension of this argument could conclude that paragraphs 1, 2, 4 and 5 have retained source taxation rights on the most critical classes of gains, with the taxation of the residual classes of gain being of lesser importance, and thus taxable only in the residence State.

41. *Potential for multiple taxation* – A policy concern that was mentioned by some Committee members during the April meeting may have also influenced the historical treaty practice for taxing capital gains, and gains from OITs in particular – the risk of multiple taxation. That is, the taxation of an OIT should result in an increase in the cost basis of the local asset. This would be appropriate because the rationale of taxing an OIT is that it in essence constitutes a sale of the local asset.

42. Ensuring a proper increase of the cost basis in the local asset is especially important in the context of OITs, so that future OITs (either of the same offshore entity or of another offshore entity in the chain of ownership) do not result in multiple taxation of the same amount of gain. This is an issue of fundamental importance, as a primary purpose of tax treaties is to avoid double taxation (both economic and juridical double taxation). In fact, precedence exists for including in tax treaties the obligation to allow an increase in the cost basis of a local asset when there has been a deemed alienation of the asset. Article 13 paragraph 7 of the 2016 model tax treaty of the United States, which allows for deemed alienations of local property held by an individual if that individual expatriates, provides an example of such an election to increase the cost basis of the asset:

“7. Where an individual who, upon ceasing to be a resident (as determined under paragraph 1 of Article 4 (Resident)) of one of the Contracting States, is treated under the taxation law of that Contracting State as having alienated property for its fair market value and is taxed in that Contracting State by reason thereof, the individual may elect to be treated for purposes of taxation in the other Contracting State as if the individual had, immediately before ceasing to be a resident of the first-mentioned Contracting State, alienated and reacquired such property for an amount equal to its fair market value at such time.”

43. Multiple taxation of the same economic gain could also arise for reasons other than a failure to increase the cost basis in the local asset. This would be especially true in a situation in which several countries have the practice of taxing OITs, and when offshore entities own local assets in several different countries. Consider, for example, an offshore company that is part of a multinational group and that holds operating subsidiaries in five different countries in one region of the world. If the regional business is sold through a liquidation of the holding company, an OIT has occurred from the perspective of the countries where the operating subsidiaries are located. The tax administrations of those countries may have competing views as to how much gain they are each entitled to tax. Extensive exchanges of information and consultations via the mutual agreement procedure might be required, and a failure to agree on an allocation of the capital gains could lead to the taxation of the same economic gain by multiple countries. This may argue for accompanying any treaty provisions allowing for taxation of gains from OITs with robust dispute resolution provisions in the mutual agreement

procedure, or at least requiring the competent authorities to negotiate and publish procedure for the application of the provision, including how double taxation would be relieved in both Contracting States.

44. *Potential for unrelieved double taxation* – In addition to the potential for multiple taxation, the taxation of OITs also raises the question of whether double taxation would be sufficiently relieved even in cases when there are not multiple source countries and when a step-up in basis is allowed. Consider, for example the case of the transfer of ownership of the shares of RCo, a company resident of State R between two parties also resident of State R. RCo holds an interest in SCo, a company resident of State S. From the perspective of State S, this transaction has given rise to an OIT. It is unclear if, as a policy matter, State R would be willing to provide relief from double taxation to the State R company that sold its interest in RCo for what is reasonably viewed as a wholly domestic transaction. State R may therefore refuse to include an obligation to provide relief from double taxation in its tax treaty with State S.

45. Just as the obligation to allow an increase in the cost basis requires explicit wording in the tax treaty, the treaty may also require an explicit provision to ensure that double taxation is sufficiently relieved resulting from an OIT. In the example described above, it is likely that under the local law of State R, the transaction would give rise to domestic source income. Accordingly, in order to adequately alleviate double taxation, State R would need to accept to provide a foreign tax credit. While the wording of Articles 23 A and 23 B of the UN Model automatically provides for relief of double taxation where a treaty provision allows source taxation, a number of States depart from the Model's wording of these Articles and it might be necessary for these States to ensure that relief is provided in these cases.

Administrative considerations that may have historically influenced Article 13 paragraph 6

46. *Detection* – As was raised by some Committee members as well as representatives of the Secretariat during the April meeting, as an administrative matter, it could be difficult for the source State to know that an OIT has taken place, because it involves a transaction that has taken place wholly outside of the source State. This could be particularly true in situations when an OIT takes place several tiers up a chain of ownership. In his paper, Wei observes that as a general matter, well-crafted tax rules should attempt to maximize compliance by taxpayers. If taxpayers come to the view that a transaction could go undetected by the local tax administration, as could be the case with an OIT several tiers up the chain and thus, quite removed from the local asset, the taxpayer might conclude that there is little risk involved by not complying with a rule that would tax the gains of the OIT in the source State.

47. Tax administrations could impose information reporting requirements to facilitate the detection of OITs. The obligation to report the transaction could be imposed on either of the parties engaged in the transaction, on the local asset (or a local agent who acts as custodian of

the local asset), or on certain third parties. Each of these alternatives has its advantages and disadvantages. As an initial matter, a self-reporting requirement on the transferor would seem logical, as the transferor would have full knowledge that the transaction took place, and may also possess elements of information necessary to effectively calculate the amount of the capital gain. In addition, the transferor would likely be the party liable for the tax, as it has earned the capital gain. However, if the transferor is legally liable for the tax, and the chances of the transaction being detected are otherwise low, non-compliance may become an issue. If, on the other hand, the reporting requirement is imposed on the transferee, compliance might improve if the transferee is not himself liable for the tax, although the transferee may not possess the necessary information to effectively calculate the amount of capital gain.

48. It would seem logical to impose the reporting requirement on the local asset, as it is the party that is physically located within the State seeking to impose the tax, and moreover, it already likely has a relationship as a taxpayer with the tax administration. However, while it is situated within the jurisdiction imposing the tax, the local asset may have no involvement with, or knowledge of, the OIT, and therefore may not be the most suitable party upon whom to impose the reporting requirement. Nevertheless, some tax administrations have adopted this approach. For example, the Indian tax administration has issued Notification No. S.O. 2226, which requires the local Indian asset (referred to in the notice as the “Indian concern”) to maintain detailed information about its ownership structure, and to submit information regarding an OIT within ninety days of the execution of the transfer.

49. The income tax administration of Chile, another State that has enacted laws that tax OITs of assets located in Chile, has adopted an information reporting requirement in its Form 1921. The instructions to that form explain that there is an initial obligation to report information related to an OIT on three parties: the foreign transferor, the foreign transferee, and the local company. However, in the event that the transferor submits the required information, both the transferee and the local entity are no longer obligated to submit information.³

50. *Collection* – Another administrative consideration as regards capital gains taxation could be related to the collection of the tax. Whereas dividends, interest and royalties can effectively be taxed on a gross-basis by requiring withholding at the time of payment, this method is problematic in the context of capital gains. When an asset is sold, the amount paid represents the gross proceeds of the sale. Determining the amount of capital gains that should be taxed requires a determination of the alienator’s cost basis in the asset, as well as any associated

³ The consultant who prepared this paper contacted the Chilean tax administration to invite any comments or input it would like to share with the Committee regarding its experience with Form 1921. Unfortunately, these comments have not been received in time to be included in this document. However, they will be prepared in a separate note for the Committee for consideration at the October 2019 meetings.

expense, capital losses or depreciation. Accordingly, an accurate and equitable taxation of capital gains may argue for net-basis taxation and the filing of a tax return.

51. A general view that capital gains taxation is most properly achieved through the filing of a tax return may argue that taxation at source of capital gains should therefore require a sufficient nexus of the non-resident to the source State. This may in part have influenced the existing UN Model Article 13. That is, it could be said that the instances in which source taxation is allowed under Article 13: ownership of real property or an interest in real property, having a permanent establishment or fixed base, and owning a substantial interest in a local company each constitutes sufficient nexus to impose net basis tax through the filing of a local tax return.

52. The context of OITs raises an even more fundamental collection challenge: even if a source State chose to impose gross-basis withholding but at a lower rate to mitigate the inability to claim deductions and cost basis etc, the payment of the gross proceeds from the sale will have originated from outside the source State. Attempting to tax on any basis a payment from an extra-territorial source can be difficult to effectively achieve as an administrative matter.

VII. NEXT STEPS

53. In light of the additional material in this paper to be considered along with CRP.9, the Committee is invited to have further discussion on the following fundamental questions:

- Should the UN Model be modified to allow for taxation at source of all capital gains, with the exception of gains from the alienation of ships or aircraft operated in international traffic?
- Should paragraph 18 of the existing Commentary to Article 13 be redrafted to clarify the scope of the alternative that is provided in that paragraph?
- If the Committee wishes to tax OITs only in cases of abuse, would the wide adoption of the PPT be sufficient to address the issue?
- Should a targeted provision for the source taxation of some OITs be drafted? Such a targeted provision for OITs might include: a) a requisite level of ownership by the transferor of the offshore company whose shares are being alienated; b) determining the source of the gains; c) allowing for a step up in the cost basis of the local asset; and d) an obligation to resource the gain to the extent necessary to relieve double taxation.

Does the Committee wish to explore the drafting of such an alternative provision (see Annex B)?

VIII. APPLICATION OF ARTICLE 13 PARAGRAPH 5 IN THE CONTEXT OF SHARES THAT ARE OWNED BY FISCALLY TRANSPARENT ENTITIES

54. Ms. Yan Xiong, a current member of the Committee, submitted the following issue for consideration:

“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?”

55. The issue submitted by Ms. Xiong to the Secretariat 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.

56. The R-S tax treaty follows the UN Model. Article 13 paragraph 5 of the R-S treaty is 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.”

57. Paragraph 5 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.

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

59. 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.

60. 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.

61. 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.

62. 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 incur 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 shares 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 tax the capital gain derived by RCo.

ANNEX A: [E/C/18/2019/CRP.9](#)

TAXATION OF CAPITAL GAINS ON OFFSHORE INDIRECT TRANSFERS UNDER DOMESTIC LAWS

1. Tax treatment of offshore indirect transfers – in essence, the sale of an entity owning an asset located in one country by a resident of another – has emerged as a significant issue in many developing countries. Pros and cons of allocating taxing rights over indirect transfers have been analyzed by policy makers around the world. The concern often expressed is that by using the principle of separate legal personality, and tax planning through residence of companies and similar entities, multinational enterprises (MNEs) may, in substance, change the ownership of an asset located in a developing country without triggering the corresponding taxation of the economic profits from the ownership change in that developing country. The issue has been found to arise in respect of extractive industries⁴, real estate holdings as well as telecommunication assets amongst others.

2. What is often said to amount “in substance” to the sale of an asset in the developing country (which may otherwise attract tax on the profits) is therefore transformed into an offshore sale of a foreign holding company (which may hold the developing-country asset directly or through other foreign companies) usually to an offshore buyer. The claim is then usually made that the developing country lacks the jurisdiction under the domestic law to tax such an “extraterritorial” event not involving its own tax residents and not directly involving assets in that country. A further claim is often made that even if domestic law allowed taxation on indirect transfer of assets, a tax treaty between the developing country and the country of the transferor company overrides any domestic taxing right the developing country might otherwise have had.

3. Some countries take positions that judicial or legislative anti-abuse rules, such as a general anti-avoidance rule (GAAR), apply to indirect transfers. For example, the People’s Republic of China’s State Administration of Taxation issued new administrative guidance on application of their GAAR in 2015 to re-characterize an indirect transfer of certain properties as a direct transfer of the same. The anti-abuse rule would, however, reach the gain on offshore indirect transfer, only if intentional tax avoidance regarding the transaction could be shown. Moreover, such rules are limited in scope as they would not provide that the gain in question should be taxed as a matter of principle, on the basis of a substantive right to tax in the location

⁴ [Secretariat Note] See Chapter 4 (Indirect Transfer of Assets) of the United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries available at <https://www.un.org/esa/ffd/publications/the-united-nations-handbook-on-selected-issues-for-taxation-of-the-extractive-industries-by-developing-countries.html>.

country. Many countries therefore have domestic law provisions to tax gains on offshore indirect transfers irrespective of there being an element of intentional tax avoidance.

4. Reasons for exercise of taxing rights over capital gains on indirect transfers of assets other than immovable property have also included the following-

- The country in which an asset is located should be entitled to tax the gain on its transfer indirectly due to such gain having been realized due to value enhancement in the location country.
- The right to tax returns to foreign investors in the form of dividends being accepted, the right to tax them on returns in the form of capital gains associated with a domestic source should also be accepted.
- It should not matter for tax purposes whether the underlying asset is immovable or movable.

5. Recognizing the importance of taxation of indirect transfers in particular for developing countries, the Platform for Collaboration on Tax has prepared a Toolkit on ‘The Taxation of Offshore Indirect Transfers (OITs)’⁵. The objective of the Toolkit is to suggest alternate approaches to the taxation of OITs by the country in which underlying asset is located, for countries that may choose to tax them.

6. Countries such as Canada, Australia and Japan amongst others already tax indirect transfers with respect to immovable property, while many others such as India, China, Indonesia and Peru amongst others tax foreigners on sale of interests in foreign entities that hold assets indirectly in those countries.

DOUBLE TAX TREATY ASPECTS

7. A tax treaty would come into play only if the domestic law of Contracting State otherwise supports taxation of capital gains on indirect transfers. Tax treaties are generally regarded as not creating taxing rights that do not exist in domestic law, but they can prevent or limit the operation of domestic law where that is for the benefit of taxpayers of the countries entering those treaties. This means that if the domestic law of a country provides for the taxation of offshore indirect transfers, the tax treaty between that country and the country of residence of the seller of the interest will need to be examined to see if it (i) allows the domestic law to

⁵ [Secretariat Note] See also United Nations, 2017, Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, Chapter 4 (Indirect Transfer of Assets), which the Toolkit draws on and in part responds to, available online at <https://www.un.org/esa/ffd/publications/the-united-nations-handbook-on-selected-issues-for-taxation-of-the-extractive-industries-by-developing-countries.html>

operate as intended; or else (ii) restricts the operation of the domestic tax law to the advantage of a taxpayer covered by the treaty.

8. The consequences of this relationship between tax treaties and domestic law are that:
- If there is no domestic law in place taxing gains from indirect transfers, the treaty will not address the deficiency by creating a taxing right;
 - Any treaty right conferred to the country of location of the assets subject to an indirect transfer merely represents an unexercised right to taxation unless and until the domestic law is amended to tax indirect transfers;
 - A treaty right to tax need not have all the detail of the domestic law, but it needs to be broadly expressed if it is to cover all the situations foreseen under domestic law; and
 - The treaty may limit the operation of domestic law to the extent that the right preserved is narrower than domestic law or no taxing right is preserved.

NEED FOR A SPECIFIC PROVISION UNDER TAX TREATIES/ MODEL TAX CONVENTIONS TO GRANT TAXING RIGHTS TO SOURCE COUNTRY OVER OITS

9. Provisions of both the UN and OECD Model Tax Conventions suggest⁶ wide acceptance that capital gains taxation of indirect transfer of immovable assets can be imposed by the location country. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI") has increased the number of tax treaties that effectively include Article 13(4) of the OECD MTC. However, at present, there is no provision to address the capital gains on indirect transfer of assets other than immovable property in source country under the two Model Conventions.

10. Developing countries that have chosen to exercise right to tax capital gains arising on indirect transfers of assets other than immovable property under their domestic laws would therefore fail to tax gains on such transfers in cases where the transferor is a resident of a country with which there is a tax treaty having capital gains provision along the lines of the current UN or OECD Model Convention provisions. This is because the indirect transfer of assets other than immovable property would be governed by the residuary clause i.e. paragraph 6 of Article 13 of UN Model Convention, which provides that the gains from alienation of any property other than those explicitly covered under paragraphs 1 to 5 of Article 13 would be taxable only in the State of which the transferor is resident.

⁶ Paragraph 4 on Article 13 (Capital Gains) are similar both in the 2017 UN and 2017 OECD Model Conventions.
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11. Where the countries have chosen to exercise the right to tax OITs under their domestic law, litigation has also occurred on the issue of position under the tax treaty. The problem has got compounded due to OITs being often considered as tax avoidance and base erosion devices and consequent reference by tax authorities to general anti abuse rules under domestic law or the tax treaty to deny the treaty benefit. For this reason and also due to the justification for allocation of taxing right over OITs to developing countries, there is a need to provide a specific provision in the UN Model Convention to clearly allocate taxing right over indirect transfers involving assets other than immovable property to source country.

SUGGESTED PROVISION IN UN MODEL CONVENTION'S ARTICLE 13

12. An alternative formulation of paragraph 5 of Article 13 is suggested in paragraph 18 of the UN Model Commentary on Article 13(5) as follows. It would preserve, to the source State, taxing rights over capital gains in respect of a residuary class of assets:

“Gains from the alienation of any property other than those gains mentioned in paragraphs 1, 2, 3 and 4 may be taxed in the Contracting State in which they arise according to the law of that State.”

As mentioned in the Commentary, this formulation was suggested by “most members from developing countries”.

13. As the Commentary goes on to say, ‘This alternative is equivalent to saying that either or both States may tax according to their own laws and that the State of residence will eliminate double taxation under Article 23. Countries choosing this alternative may wish through bilateral negotiations to clarify which particular source rules will apply to establish where a gain shall be considered to arise.’

14. The alternative suggested in paragraph 18 of UN Model commentary on Article 13 by developing countries means taxation of gains on alienation of all residuary category of assets by source State if the gains arise therein as per its laws. This formulation would also provide taxing rights over gains arising from offshore indirect transfers of assets to the country where such assets are situated. As per the Commentary, it has been left to bilateral negotiations to clarify which particular source rules apply to establish where a gain shall be considered to arise. This appears to be unnecessary as the formulation provides taxing rights to the source State if gains arise therein as per domestic laws. In other words, source rule is provided in the formulation itself. For additional clarity, modified version of alternate provision as below may be considered for replacing Article 13(6) of UN Model Convention:

“Gains from the alienation of any property other than those gains mentioned in paragraphs 1,2,3,4 may be taxed in the Contracting State of which the alienator is

resident. However, such gains may also be taxed in the other Contracting State if they arise therein according to laws of that State. “

This provision would not only preserve primary taxing rights over OIT gains to the source country but would also preserve primary taxing rights to the source country over gains to location or from all other residuary kind of assets the same arise therein as per domestic laws. This is in line with developing countries’ position on this issue.

15. This matter is placed before the Committee for its consideration as to whether the formulation suggested in paragraph 13 above may substitute the existing paragraph 6 of Article 13 of Model Convention.

ANNEX B

The Secretariat has prepared, for discussion purposes, the following alternative version of Article 13(4), which is intended to allow for taxation at source of gains from certain OITs.

With redlines:

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from **any combination of**
 - a) immovable property, as defined in Article 6, situated in that other State,
 - b) **shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other State,**
 - c) **movable property forming part of the business property of a permanent establishment or fixed base situated in the other State, and**
 - d) **a right granted under the law of the other State that is used or exercised exclusively or almost exclusively in the other State.**

Clean:

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from any combination of
 - a) immovable property, as defined in Article 6, situated in that other State,
 - b) shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other State,
 - c) movable property forming part of the business property of a permanent establishment or fixed base situated in the other State, and
 - d) a right granted under the law of the other State that is used or exercised exclusively or almost exclusively in the other State.