Papers on Selected Topics in Protecting the Tax Base of Developing Countries

September 2014

Taxation of Capital Gains

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Introduction

Designing and enforcing a legal regime for taxing non-residents on capital gains realized from domestic sources is a topic of vital importance for developing countries. This is because non-capital-gain income that may be derived from a given country can generally be crystalized in the form of capital gain on the disposition of the income-generating asset.[1] This is true of most important types of income, be it rent, interest, royalty, dividend, or business profit. Taxing capital gain, therefore, is invariably needed to ensure that income from assets in one's country is properly subject to tax. In this sense, capital gain taxation is intrinsically about protecting the tax base from erosion.

There is a well-known principle that if the non-capital-gain income from an asset is taxable in a source country (e.g. because the asset is properly viewed as being located in that country), then the capital gain from the disposition of that asset should be taxable in the same country.[2] This principle, based on the equivalence of income and capital gain, is commonly used to justify taxing capital gain realized by non-residents on the disposition of immovable property and business assets used in a permanent establishment (PE) situated in the taxing country. However, the principle has not been consistently applied to other types of capital gain realized by non-residents. This inconsistency can be observed in the provisions of both the OECD and UN Model Tax Conventions themselves, and the reasons for it are not well-articulated. Moreover,

[1] The equivalence of income and capital gain is ultimately grounded in a basic tenet of modern finance theory, namely that the value of an asset simply is the present discounted value of future income that the asset can be expected to generate.

[2] See note 43 infra and accompanying text.

there are substantive disagreements (often between developing and developed countries) about what types of non-capital-gain income should be taxable in a country other than the resident country of the recipient of the income.[3] Both these factors—divergent views about where non-capital-gain income should be taxed, and inconsistencies in observing the equivalence between income and gain (and therefore between the sources of income and gain)—have led to widely divergent practices in the capital gain taxation of non-residents. The first challenge facing developing countries in designing policies in this area, therefore, may be the apparent absence of an "international norm", or confusing accounts of what such norm consists in. This chapter will suggest some basic ways for understanding the divergent practices.

A second, equally important challenge for taxing non-residents on capital gains comes from a different direction. It is that the tax can be difficult to enforce, and the dynamic of engagement between tax administrators and taxpayers in collecting the capital gains tax from non-residents can be quite different from normal tax administration. These difficulties may provoke questions about whether the likely revenue payoff from enforcing the tax justifies the resources needed for enforcement. This chapter will analyze the pros and cons of the various mechanisms for administering the capital gains tax for non-residents, and discuss ways in which voluntary compliance with the rules may be improved.

Tax avoidance poses the third challenge for taxing non-residents on capital gains. The strategies for legally avoiding a tax on capital gain imposed by a source country are not difficult to identify. They typically include treaty shopping and the use of offshore holding companies. However, the incentives of taxpayers to adopt such strategies may vary as a function of the severity of the first two challenges. If there are basic inconsistencies in the rules adopted by

[3] This could be a debate either about whether a source country should have a taxing right, or about what the source of the income is in the first place.

domestic law and by tax treaties towards capital gain taxation, and if the enforcement of such tax rules is inadequate, taxpayers may have greater incentives to engage in avoidance. Moreover, the feasibility of avoidance behavior could also depend to a substantial extent on non-tax characteristics of the business and legal environment for investing in a country: some countries witness extensive offshore markets for trading investments into them, while others do not see such markets. This chapter will discuss both specific and general anti-avoidance rules for maintaining the integrity of a tax on capital gains earned by foreigners, as well as how to choose among these rules in light of the circumstances that generate tax avoidance.

The chapter proceeds as follows. Section 1 examines the general principles for taxing non-residents on capital gains realized on the disposition of domestic assets. It considers the relationship between capital gain and other forms of income from an asset, and special issues arising from the taxation of shares of companies. It also analyzes the basic approaches for taxing capital gain adopted by various countries, especially whether to assimilate such taxation to gross-income or net-income-based taxation. Section 2 will specifically examine administrative issues in taxing non-residents' capital gains. The issues described in Sections 1 and 2 normally need to be addressed under domestic legislation. Section 3 will briefly review Article 13 of the UN Model Tax Convention as well as treaty practices among developing countries with respect to taxing capital gains. Section 4 turns to tax planning commonly adopted to avoid the tax on capital gain. It pays particular attention to policies recently adopted by a number of developing countries on taxing indirect transfers of the shares of resident companies. Finally, Section 5 examines the special issue of departure taxes for individuals. A brief Conclusion follows.

1. General Principles for Taxing Non-Residents on Capital Gains

1.1 The Economic Substance of Capital Gain

In thinking about taxing non-residents on gains realized on the disposition of domestic assets, it is useful to keep in mind what assets tend to generate capital gains in the first place—and why. For example, mass-produced durable assets (e.g. machines, computers, household appliances, vehicles, ships and aircraft) generally see their values depreciate over their useful lives, because of wear and tear and newer, better products available on the market.[4] Even the value of buildings as physical structures—if we disregard the value of the land they sit on—generally declines instead of increases. By contrast, the value of the ownership (e.g. through company shares) of businesses may increase, if the businesses are successful, as may the value of land in locations that experience economic growth. Assets that are unique in some ways, e.g. depletable resources, art, antiques and other collectibles, may also increase in value. Finally, modern financial markets create possibilities of speculation and arbitrage that can give rise to substantial gains (and losses). Many developing countries, for example, have become acquainted with "vulture funds" that buy up non-performing business loans or sovereign debts with high risks of default and realize substantial returns from them.[5]

Reflecting on the types of assets that are likely to give rise to capital gains is important for two reasons. First, it helps a source country to determine for which categories of assets it is important to reserve rights for taxing capital gains. We will come back to this issue in Section 3. Second, it enables one to appreciate the economic nature of capital gain. Essentially, in a

[4] This is pertinent to the interpretation of paragraphs 2 and 3 of Article 13 of the UN Model Tax Convention. See Section 3 below.

[5] Increases in the value of non-reproducible assets—land, natural resources, and collectibles—tend to reflect what economists call "pure rent" or "economic profit": taxing pure rent is regarded as economically efficient because it does not distort economic behavior. By contrast, gains in operating businesses and speculative gains on financial markets may represent a mixture of rent, return to risk taking, and return to managerial skills. Taxing the latter two types of returns may distort economic behavior.

competitive asset market, assets experience gain because of an increased expectation of the streams of income that they will generate. That is, between the time the owner acquired the asset and the time he or she sells it, the market (i.e. potential buyers) has come to expect the asset to generate more future income in present value terms.[6]

Capital gain that arises this way can be contrasted with some other forms of gain. One kind of nominal capital gain results from inflation: in an inflationary context, even depreciating equipment can sell for a greater nominal amount of cash than was paid for. Another kind of gain is income that has already been earned on the asset but that has been added to or reinvested in ("capitalized" with) the original asset. For example, if a corporation has retained earnings and does not distribute such earnings to shareholders, the price of its shares may go up simply because the shareholders have deferred the realization of their income, not because the corporation's business has better prospects than before.[7] If a shareholder sells his or her shares, the gain realized may simply be the income that he or she could have realized as dividend if the corporation had made a distribution. In general, the design of an income tax may need to provide special treatments for these forms of nominal capital gain. In the inflation case, the fact of inflation should ideally be taken into account in determining whether the taxpayer has any taxable income. In the case of accrued earnings realized through a sale of the asset, it may be important to treat the gain from the sale similarly with other ways of realizing the already-accrued-earnings (e.g. dividends).[8] However, it is crucial to recognize that capital gain often

[6] This increased expectation could be due to greater certainty in the future flow of income, an acceleration of the timing of the return, an increase in the absolute value of the future return or its value relative to other assets available for investment.

[7] Similarly, if a zero-coupon bond with a $100 face amount is issued for 2 years in an environment where the market interest rate is stable at 5%, no one will buy the bond initially if it is issued for more than $90.703. After a year (with the bondholder being one year closer to maturity) the bond will be worth $95.24, but the increase from $90.703 merely represents an accrual of interest, and not a change in the expectation of the bond's yield.

[8] In the bond example in the previous footnote, if the interest rate stays the same, the increases in the value of the bond in year 1 and year 2 should both be treated as interest.

comes about not because income has already accrued, but because of changed expectation of what income *will* accrue.

To show the point of this conceptual discussion, consider a type of skepticism about the wisdom of taxing foreigners on capital gains. Because transfers of domestic assets by foreigners may be difficult to detect, and a tax on such transfer may be difficult to enforce, it is sometimes asked why the source country should bother. The asset itself is still located in the source country, and most income it generates—in the form of rent, dividend, and other periodic payments—can be more easily subjected to tax (through withholding). What does the source country lose by not subjecting the gains non-residents derive by transferring ownership of the asset? Why tax the transfer of ownership of an asset, and not just when income is received by the owner?

The answer to this skeptical question is the following. As already explained, generally, the value of an asset is determined by the stream of income it is expected to generate. If such stream of income is going to be taxed at known rates, then the value of the asset should also reflect the tax. For example, if an asset will generate $10 of income each period, and a 20% tax will be imposed on the $10 of income no matter who owns it, then the after-tax income generated by the asset is $8 per period. The value of the asset to a private owner will then be determined by the $8 return, and not the $10 return.[9] If, despite the lower price buyers are willing to pay in view of the expected tax on income, the seller *still* realizes a gain, then the seller's ownership of the asset has generated a form of income for him or her that is not captured by the tax imposed on future income.

[9] This is the idea that a tax on the income generated by an asset may be "capitalized" into the value of the asset. Economists have offered many empirical confirmations of the capitalization of different types of taxes into the value of different types of assets, e.g. real estate and company shares.

In general, the inherent connection between income and capital gain realized from an asset implies that, for tax purposes, the geographical sources for income and for gain from the same asset should be identical.[10]

1.2 Special issues in taxing company shares

Many developed countries do not tax capital gain realized by non-residents on the disposition of shares of domestic (i.e. resident) companies, with the notable exception of companies that hold domestic real estate. There are a number of independent reasons for the adoption of this policy, including a coordinated move towards residence-based taxation within the European Union,[11] the desire to align the treatment of shareholder capital gain with the policy of exempting dividends paid to nonresidents that these countries may already have adopted,[12] and the administrative burdens of enforcing the tax on non-residents.[13]

Aside from the issue of enforcement, many of these reasons may not be persuasive in the context of developing countries.[14] What may be worth remarking, instead, is that even in countries where the alienation of shares of domestic companies by nonresidents generally goes

[10] It may be that in some instances, the source of income is not clear (i.e. the "location" of the income-generating asset is not clear). In these cases, the source of any capital gain realized on the asset may also be unclear. However, the conceptual tie between income and capital gain means that the source of capital gain should rarely be more controversial than the source of income generated from the same asset.

[11] If investment flows between two developed countries are roughly equal, it makes sense for them to forego source-country taxation, save administrative costs thereby, but without losing revenue overall. See Harry Huizinga, Taxing Corporate Income Commentary, in DIMENSIONS OF TAX DESIGN: THE MIRRLEES REVIEW 894–903 (Adams et al. eds., 2010).

[12] Hugh Ault and Brian Arnold, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS, 3rd edition (2010), pp __.

[13] The U.S. originally abandoned taxing non-residents on capital gain realized on the sale of U.S. securities in 1936 for administrative reasons. See Stanford Ross, United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments, 22 TAX L. REV. 279, 293–5 (1967). Canada narrowed its range of capital gain taxation for foreigners recently in 2010 partly for the same reason. See Jinyan Li, Arthur Cockfield & J Scott Wilkie, INTERNATIONAL TAXATION IN CANADA: PRINCIPLES AND PRACTICES, 2nd ed (Toronto: LexisNexis Canada, 2011), p 184. A common law tradition of distinguishing income from capital and holding (contrary to modern tax policy recommendations) that the latter should not be taxed may also have played a role in some countries. See R. Krever, Tax Treaties and the Taxation of Non-Residents' Capital Gains, in A. Cockfield, ed., GLOBALIZATION AND ITS TAX DISCONTENTS: TAX POLICY AND INTERNATIONAL INVESTMENTS (University of Toronto Press, Toronto, 2010) pp. 212-238.

[14] For example, as capital importers, developing countries have greater reason to preserve source taxation; they may also have weaker incentives to abandon the classic corporate income tax.

untaxed, special exceptions have been made—as in the U.S., Canada, Australia, and Japan—for companies that hold domestic real estate. This is in recognition of two facts. First, as discussed above, real estate can experience substantial appreciation due to regional economic growth. Second, if dispositions of real property holding companies are not taxed, it would be too easy to avoid a tax on the capital gain realized on the disposition of real estate itself by selling the shares of holding companies. In other words, taxing the disposition of ownership interests in real-property-holding entities is felt to be crucial to preserving the capital gain tax base.

The anti-avoidance justification for taxing share sales raises numerous issues. First, taxing share sales because the real estate assets held by the target company have experienced appreciation creates the possibility of excessive taxation of such appreciation: the economic gain may be taxed at both the corporate and the shareholder levels.[15] If such excessive taxation is to be avoided, then potentially complex rules may have to be applied to ensure that gain that has been taxed at the shareholder level is not taxed again at the entity level (and vice versa).[16] No country that taxes foreigners on the disposition of companies that hold domestic real property, however, has systematically committed to mitigating such potential excessive taxation through their legal rules.[17]

Second, it is obvious that tax avoidance concerns arise not just in connection with real estate. Take, for example, an operating business the value of which has increased due to its improved prospects. It is rarely disputed that the disposition of a business run through a permanent establishment (PE) of a non-resident should be taxable in the country of the PE (paralleling the taxability of the business profits attributable to the PE). However, if a business is

[15] This rationale extends to the disposition of interest in other entities that are treated as legal persons, even if they are not subject to the corporate income tax.
[16] See David A. Weisbach, The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax, 60 TAX L. REV. 215 (2007).
[17] See Wei Cui, Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion, 33 Va. Tax Rev. 649 (2014).

operated through the form of a domestic subsidiary and is sold through a share deal, the tax on the disposition of the business would be avoided, if shares sales are not taxed. That this concern has not generally motivated a policy of taxing share sales—despite the effort in a number of countries (e.g. in the U.S. and Canada) to equate the tax treatment of branches and subsidiaries, e.g. through the branch profits tax—appears to be an instance of inconsistency.

1.3 Gross- v. net-income approaches to taxing non-residents' capital gain

As is well known, under their domestic laws, countries may tax income earned from sources within them by non-residents on either a net-income or a gross-income basis. Under net-income basis taxation, non-resident taxpayers are treated in many ways like residents: they file income tax returns on a periodic basis; report income from different sources and of different characters, as well as expenses that are associated with the various items of income and allowable as deductions; and are subject to tax rates generally applicable to domestic individuals or corporations. Under gross-income basis taxation, by contrast, non-resident taxpayer may not need to file a tax return at all: the tax imposed by the source country may simply be withheld by the payer. Even when the non-resident is required to file a tax return, it may be reporting only particular items of income earned in the source country and not all such income earned in a period, and it may not be able to claim expenses or offsetting losses. Finally, the tax rate applied to income taxed on a gross basis is typically lower, in part to reflect the decision not to allow deductions of expenses and losses. Overall, gross-income-basis taxation simplifies compliance and tax administration: the amount of gross proceeds is usually easily verifiable from the payer, whereas expenses and losses are more costly to substantiate and verify.

The decision to tax a particular type of income either on a gross- or net-income basis could depend on such administrative considerations alone.[18] However, for at least the past half century, it has been more common to tax on a net-income basis only business income attributable to a physical presence that is akin to a PE, whereas short of a PE, income derived by a non-resident is either not taxed (if it is business income) or taxed on a gross-income basis (if it consists in particular types of investment income). Moreover, net-income taxation has become associated with active business income and gross-income taxation with passive investment income.

However, capital gains realized by non-residents fit uneasily with this dichotomy. On the one hand, capital gain is often a form of passive investment income. On the other hand, the computation of the amount of gain will almost always require the taxpayer to submit information about the original cost of the investment and not just the amount of the gross proceed. In contrast to dividends, interest, and royalties, it is difficult to collect tax on capital gain through final withholding. But once the non-resident taxpayer is already required to file a tax return (it has crossed the administrative threshold), questions can be raised as to whether it is more sensible to tax on a net-income basis. This may mean allowing offsetting capital losses from the country against the capital gain; it may also mean permitting other types of expenses to be deducted. On the other hand, it may require a higher tax rate to be applied.

Countries differ widely in this regard in their approaches to taxing non-residents' capital gains. Japan and China, for example, require the reporting of a taxable capital gain by a non-resident, but still applies a reduced rate to such capital gain and does not allow offsetting losses. This can be viewed as lying in one extreme. The United States, by contrast, treats capital gain on

[18] For example, if a non-resident has a sufficient physical presence in the source country that periodic contact with the country's tax administration for purposes of filing a return and cooperating with audits is possible, then net-income taxation may be regarded as justified. Such a physical presence might be an office—possibly one that does not operate any business or at least not the business that generates the relevant taxable income—or a regular agent (even an agent that is independent). See OECD Commentary on Article 13, paragraph 27 (quoted in UN Commentary on Article 13, paragraph 6)("force of attraction" approach to taxing capital gain).

the disposition of certain real estate-related (“FIRPTA”) property realized by foreigners as though it is simply business income, and allows other losses realized in connection with a U.S. trade or business of the foreigner to be offset against such capital gain. This can be viewed as being on the opposite side of the spectrum from Japan and China.[19]

There are important arguments in favor of allowing foreigners to reduce their taxable capital gains by their capital losses from the source country. To begin, recognizing gain but ignoring losses may discourage investors from taking risks. Moreover, taking losses into account allows a more accurate measurement of the non-resident’s income realized in the country, and imparts greater legitimacy to taxing capital gains. However, allowing loss offsets does reduce the revenue potential from taxing non-residents on capital gains. Moreover, because the tax on capital gains is difficult to enforce, it may turn out that non-residents who do not have offsetting losses would demonstrate less compliance than those who do.[20]

Whether a gross- or net-income approach is taken also has consequences for the computation of the amount of capital gain on each transaction. For example, should fees paid to lawyers, accountants and investment bankers by the seller be allowed to reduce the amount recognized as the proceeds from sale, and should such fees paid by the buyer be included in the cost of their investment that can be deducted in the future? If the law treats capital gain as a form of passive income just like dividends and interest, and applies a reduced tax rate to such income earned by foreigners, then the answer should be “No”: any expense similar to expenses that cannot be deducted from dividends or interests should also not be deductible. This means that from the perspectives of the source country and of the resident country, the amount of the capital gain

[19] Canada allows the offsetting of losses from a given period from the disposition of similar investments (taxable Canadian property).

[20] However, a compliance culture may be buttressed by taxpayers who expect to be able to claim losses, and tax administration will be able to obtain information from such taxpayers. See Section 2 below.

realized on a sale can be very different.[21] From the resident country's perspective, the amount of capital gain may depend on all kinds of expenses that should either be capitalized into the cost of the disposed asset or deducted from the income realized (thereby reducing the amount of capital gain), as well as on any depreciation or other allowance that have been given in respect of the investment (which may increase the amount of capital gain or trigger the recapture of income). This should not in itself cause alarm, if one remembers that the source of the difference is that the source country treats the capital gain as a form of passive investment income, subject to a simplified method of collection.[22]

1.4 Other special issues in delineating the scope of capital gains taxation on foreigners

Should publicly-traded shares be exempt? Enormous gains may be realized on stock markets, raising the question of whether such gain realized by foreigners, for example under "qualified foreign institutional investor" regimes operated in countries like India and China, should be taxed. It used to be said that because trading on stock exchanges tends to have very high volume and frequency, it would be impossible to keep track of the gains and losses realized by investors on exchange trades. But with advancing technology and increasing uses of such technology by financial intermediaries, tracking information on gain or losses realized by investors (including foreign investors) may become less difficult.[23] Moreover, it is possible to require such financial intermediaries, and not the sellers, to act as withholding agents. In that

[21] This is recognized in OECD Commentary on Article 13, paragraphs 13-16 (quoted in UN Commentary on Article 13, paragraph 4).
[22] Contrast this with OECD Commentary on Article 13, paragraph 12 (quoted in UN Commentary on Article 13, paragraph 4) ("As a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price." However, the same paragraph acknowledges that "the Article does not specify how to compute a capital gain, this being left to the domestic law applicable.")
[23] See U.S. Internal Revenue Service Notice 2012-34, "Basis Reporting by Securities Brokers and Basis Determination for Debt Instruments and Options".

case, the decision whether to tax stock exchange gains may depend on policies on attracting foreign investment. For example, trading gains are more likely reflect risk taking rather than economic rent, and the case for allowing offsetting losses is rather strong.[24]

Whether to tax foreign exchange gain.[25] Measurements of capital gain or loss are sometimes affected by foreign exchange gains or losses. For example, local assets purchased with USD 1 million may sell later for more than USD 1 million, not because the assets have appreciated within the local market (they may even have suffered a slight loss), but because the local currency has appreciated against the US dollar. Conversely, a real capital gain may be hidden by a foreign currency loss. In designing the rules of taxing capital gains, a country will want to consider how to deal with foreign currency gains or losses. For example, if a country is expecting a steadily appreciating currency against the currency in which the investment is initially denominated, it will collect more revenue by measuring gain in the foreign currency than in the domestic currency (thereby capturing some of the gain of currency speculators). Conversely, if a country is expecting a steadily depreciating currency against the currency in which the investment is initially denominated, it will collect more revenue by measuring gain in the domestic currency.

It is worth mentioning in this connection that any capital control regime adopted by a country may create problems for non-residents to pay tax on capital gain. If the amount realized on the disposition is in foreign currency, but tax must be paid in domestic currency, then the non-resident taxpayer must be allowed to exchange the currency for purposes of the tax payment.

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[24] For gains realized on shares of resident companies listed and traded abroad, it is obviously difficult to secure cooperation from foreign stock exchanges to collect tax, even if such taxation is otherwise legitimate.

[25] See OECD Commentary on Article 13, paragraph 11 (quoted in UN Commentary on Article 13, paragraph 4)("The Article does not distinguish as to the origin of the capital gain… Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.") See also OECD Commentary on Article 13, paragraphs 16-7 (quoted in UN Commentary on Article 13, paragraph 4).

This issue does not normally arise in connection with passive income, such as dividend, interest, or royalties, which has a domestic payer: the payer in such latter cases should be able to furnish the local currency required.

2. Administering the Tax on Non-Resident's Capital gain

Administering a tax on capital gains realized by non-residents faces three simple yet fundamental challenges. First, if the sale and purchase of the asset occur between two non-residents, the execution of the transaction and the flow of funds may all take place outside the source country, making such transactions difficult to detect. Second, even if a transaction is detected, if the non-resident seller refuses to pay the tax and becomes delinquent, unless such seller has other assets in the source country, it could be very difficult to complete tax collection. Third, it may be difficult to organize tax administration around taxing capital gain. The non-resident taxpayers typically have no or little interaction with the source country's tax authority. The timing and volume of transactions may be unpredictable, as is the revenue intake from levying the tax. Such irregularity may be felt to be especially severe if tax administration in the source country is decentralized. However, none of these challenges need to be insuperable.

2.1 Detection[26]

Generally, there are two legal mechanisms that enable tax authorities to detect offshore (direct or indirect[27]) transfers of domestic assets or shares: self-reporting by the transferor, and reporting by the transferee (whether or not accompanied by withholding) or by third parties. Consider transferor self-reporting first.[28] To foster compliance, the source country may impose

[26] This and the next sub-section draw on Cui, supra note 17.
[27] Indirect transfers are discussed more extensively in Section 4 below.
[28] At the present, Australia and Japan rely on transferor reporting exclusively in detecting offshore transfers of domestic assets. While China nominally "requires" transferees or other payors of consideration (whether domestic or

penalties on non-reporting transferors. However, if the chances of detection of taxable transactions are very low, the expected cost of a penalty for nonreporting may also be too low to be effective. If most taxpayers do not comply and the tax authority fails to detect most instances of noncompliance, imposing a heavy penalty on the few detected cases will also seem unfair.

Consider now transferee reporting. If the transferee is a nonresident as well, the failure of transferee reporting would be just as hard to detect as the failure of transferor reporting. A sanction imposed upon a transferee's failure to report would, in a way, be similar to increasing the penalties on a transferor's failure to report — in both cases, the aggregate penalties on nonreporting are increased. The difference is that the transferee usually has a lot less to lose by reporting, since it is not the party paying the tax. This may be sufficient to create compliance by transferees. Interestingly, however, no government seems to have instituted transferee reporting alone (without further requiring withholding) for taxing either direct or indirect transfers. This might be seen as pointing to the perceived magnitude of the collection problem: simply having information that some foreigner engaged in a taxable transaction is of little value; the government still has to do everything to collect the tax.

For certain types of property, such as real estate, shares in companies, and sometimes even ships and aircraft (because of regulatory requirements), the country in which they are located may operate ownership registration systems. The transfers of ownership will be recorded in such systems and tax authorities may require those who maintain the systems to report the transfers.[29] In addition, third parties in the transfers of financial claims, i.e. lessees, borrowers, and companies issuing shares, often receive notice of the transfers under either legal or

foreign) to withhold on the capital gain realized on a transfer, when withholding is infeasible, the transferee or payor has not information reporting obligation.

[29] Note, however, that the mere transfer of legal ownership may not be sufficient to constitute an ownership change for income tax purposes under the tax laws of many countries.

contractual requirements. It may be possible to enlist such parties in reporting taxable transfers, even if they are not party to the transfer.[30]

Besides explicit sanctions, market dynamics may also create incentives to comply with reporting requirements. For example, when taxing capital gain, the source country generally needs to keep track of the tax cost or basis of the assets transferred. If the capital gain realized on a transfer has been subject to tax, the cost basis of the shares transferred should be stepped up for purposes of future source country taxation. Conversely, one can imagine a rule that provides that if a transfer has not been taxed (other than in a case where the capital gain on a transfer is positively exempted from tax, for example under an applicable treaty), then the basis of the transferred shares would, for the purpose of source country taxation, remain what it had been. That is, the transferee would not obtain a basis in the shares it acquires equal to the consideration it pays unless the acquisition has been taxed.[31] With such a rule in place, the failure to report a taxable transfer would result in the risk that the transferee, in the future when it acts as a transferor, would be taxed on gain that accrued to and was realized by previous owners. Of course, the future transfer itself will need to be reported or detected. Both the tax authority and the nonresident taxpayer may also have difficulty determining what the original basis was in the hands of previous owners.[32] Nonetheless, the risk of the conversion of a seller tax liability into a potential tax liability of the buyer (as a future seller) may well be unacceptable to many buyers.

[30] Such tactics have limits if third parties' contractual rights to notice vary widely in the market. On the other hand, a government requirement for third party reporting may induce changes in contractual terms, such that third parties will demand contractually (and receive) notice of transfers.
[31] This is different from the normal use of the concept of cost basis: the cost basis of an asset is normally determined in respect of a particular owner of the asset. However, this notion can be modified so as to keep track of the relationship of the asset to the taxing authority: which portion of the value of the asset has been subject to tax, in whoever's hands?
[32] That future transfer might also itself be exempt from tax (e.g., under treaty protection).

They would then either seek indemnity from the seller, or require, as a matter of contract, the seller to report the sale to the tax authorities and, in addition, to pay tax if required by law. [33]

2.2 Collection and Voluntary Compliance

From a collection and revenue protection perspective, transferee withholding is clearly a more powerful tool than transferee reporting. The U.S., Canada, and India each requires the transferee in a taxable direct (and, in the case of India and Canada, indirect) transfer to withhold from gross proceeds paid to the transferor, regardless of whether the transferee is domestic or foreign.[34] Each also makes the amount required to be withheld the personal tax liability of the transferee if it fails to withhold. Note that when the transferee is made personally liable for failing to withhold a tax that was in the first instance imposed on the transferor, one has merely made the implicit penalty of the no-basis-step-up treatment (which is possible even under transferor reporting) explicit.[35]

In countries with weak legal norms, a view may be held that the transferor's failure to pay tax on a transfer creates a de facto personal liability for the transferee anyway, since the tax authority could always "go after" the asset located in the country and therefore expropriate its value from the asset's present owner. Unless the transferee (new owner) is legally made liable for the tax that the transferor fails to pay, however, this kind of expropriation is against the rule of law (and is both unnecessary and unproductive for tax administration). Moreover, even when

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[33] Dynamics in the tax service market may also contribute to compliance. For further discussion, see Cui, supra note 17, at 680-1, 690-1, and 694. Because the penalties for non-reporting under China's policy of taxing indirect transfers of domestic company shares are very low, most compliance with that policy that has taken place in China since 2009 may have resulted from buyer and advisor monitoring.

[34] The U.S. rule, IRC Section 1445, requires withholding of 10% from gross proceeds. IRC § 1445 (2013); the Canadian rule, ITA Section 116, requires a significantly higher (25%) rate of withholding, but allows the transferor to pre-pay or post collateral with the government based on the amount of capital gain. Income Tax Act, R.S.C. 1985, c. 1. The Indian rule, Section 195(1) of the Income Tax Act, 1961, requires withholding simply of the amount of the tax owed, without addressing the issue of how the transferee would know how much tax is owed. Income Tax Act (195/1961) (India).

[35] Presumably, government would not regard the mere reporting of the taxable transaction as sufficient for the basis of the transferred shares to be stepped up in the hands of the transferee.

transferees are made liable for failures to withhold, it is important to observe legal distinctions. For example, if it is the tax on the capital gain realized on the alienation of a domestic company's shares that is at stake, it makes no sense to demand payment from the domestic company itself.

Several limitations of the withholding approach should also be noted. First, if the transferee is a nonresident, the imposition of a withholding obligation alone does not necessarily enhance the transferee's likelihood of compliance. And delinquent non-resident transferees create similar problems of collection with delinquent non-resident transferors. Second, withholding on capital gain also cannot generally be expected to be accurate with respect to the ultimate tax liability and therefore is likely to trigger either an application for refund or tax authority's examination. The overall compliance burden for taxing capital gains, therefore, will be increased by withholding. It also bears mentioning that any obligation to withhold could only sensibly be formulated as with respect to the gross amount paid and not the capital gain realized by the payee, because it is only infrequently that a seller would tell a buyer how much profit the seller has made.[36]

In other areas of tax administration, a key to success in collection, beyond adequate sanctions and effective enforcement powers, is the inducement of voluntary compliance among taxpayers. It would be surprising if this is not the case in levying tax on non-residents. There has not been much research on voluntary compliance on the part of non-residents, however. For example, while intuitively a lower rate of tax should produce greater voluntary compliance, it is not known *how low* the tax rate needs to be to produce enough compliance. Another suggestion is to increase the contact of non-residents with the tax authority and with other compliant taxpayers. For example, allowing losses and expenses to be taken into account in computing

[36] But see the Indian withholding requirement, Income Tax Act (195/1961) (India).

taxable gain may make the contact of nonresidents with the source country less "one-shot" in character. Finally, it may be useful to focus on improving compliance among multinationals and foreign investors that deal with the source country on a repeated basis. A culture of compliance among such taxpayers (and their advisors) may be an important step towards creating a culture of compliance among nonresident taxpayers in general.

2.3 The organization of tax administration

The occurrence of taxable transfers of domestic assets among non-residents can be erratic, which makes it hard to decide to assign dedicated tax administration personnel to collect tax on such transfers. However, non-reporting non-residents—whether they are transferors or transferees—are like domestic taxpayers who do not file tax returns: special efforts have to be made to detect them and bring them into compliance. It is not clear that the tax authority in any country has developed well-articulated strategies for dealing with this predicament. In many OECD countries, where both tax administration and the study of tax administration are generally more developed than elsewhere, the scope of capital gains taxation for non-residents tend to be limited. They therefore offer limited expertise insofar as taxing non-residents' capital gains is concerned. In the United States, for example, an IRS publication from 2010 states that a study of the collection of FIRPTA tax was only "planned" and data was "not yet available".[37] Moreover, the "planned" study was only based on returns filed by transferees who have withheld tax from the gross proceeds of sales of U.S. real estate interest (including shares of U.S. companies that hold U.S. real estate) by foreigners.[38] No data seems to be separately available to the IRS on

[37] Melissa Costa and Nuria E. McGrath, "Statistics of Income Studies of International Income and Taxes," Statistics of Income Bulletin Summer 2010 (available at http://www.irs.gov/pub/irs-soi/10intertax.pdf), p 192.
[38] Id. The most recent IRS Bulletin on Foreign Receipts of U.S. Income, relating to the year 2010, also reports only FIRPTA withholding information and no information about transferor self-assessment. Scott Luttrell, "Foreign Recipients of U.S. Income, 2010," Statistics of Income Bulletin Summer 2013 (available at http://www.irs.gov/pub/irs-soi/13itsumbulforrecip.pdf).

transferor self-reporting of sale of U.S. real property interests, and there is no sign of any data on audits (if any) of transferors and transferees. In fact, the United States did not attempt to measure nonresident taxpayer compliance until 2008, and even the new attempt to do so is designed only for individual taxpayers.[39]

For developing countries that aim to preserve their tax base consisting of income belonging to non-residents to a greater extent than OECD countries, effective tax administration strategies have to be developed indigenously. One possible approach is to centralize tax administration in this area so as to allow specialization and the economy of scale: the number of taxable transactions as well the revenue outcome will diminish if averaged over too many tax administrators, whereas a small number of specialized tax administrators may be able to deal with a relatively large number of taxable transactions because of the one-shot nature of the taxpayers involved.[40]

3. Article 13 of the UN Model Convention

Article 13 of the UN Model allocates non-exclusive taxing rights to the source country in respect of gains on immovable property (paragraph 1), business assets forming part of a PE (paragraph 2), ownership interest in entities that derive value principally from immovable property (paragraph 4), and shares that represent substantial participation in a resident company

[39] See U.S. Internal Revenue Service, "The Tax Gap and International Taxpayers," available at http://www.irs.gov/Businesses/The-Tax-Gap-and-International-Taxpayers. See also, United States Government Accountability Office, "IRS May Be Able to Improve Compliance for Nonresident Aliens and Updating Requirements Could Reduce Their Compliance Burden", GAO-10-429 (April 2010) (available at http://gao.gov/products/GAO-10-429)(IRS has not developed estimates for the extent of nonresident alien tax noncompliance).

[40] However, in China, where enforcement of the tax on non-residents' capital gains realized on transfers of domestic company shares (including indirect transfers, as discussed in Section 4 below) has intensified in recent years, a decentralized "bounty hunting" approach seems to have emerged, where tax administration staff in local offices take initiatives to find offshore share transfers (which is not hard to do if listed companies are involved and material transactions are required to be disclosed by stock exchanges) and collect revenue that is sizeable for that particular office, even if not for the country's tax administration as a whole. There is no systematic study of this practice, but a flavor of it can be gleaned from practitioners' reports. See, e.g. Jinji Wei, "Chinese Tax Implications of Indirect Share Transfers," Tax Management Transfer Pricing Report, Vol. 23 No. 7, 7/24/2014.

(paragraph 5). It assigns exclusive taxing rights to the place of effective management in respect of gains on ships or aircraft operated in international traffic and boats engaged in inland waterways transport (paragraph 3).[41] It then provides that the gain from the alienation of other property not specifically enumerated be taxable only in the residence state of the alienator (paragraph 6). The threshold decisions of whether capital gains should be taxed and, if so, of how they are to be taxed, are left to the domestic law of each Contracting State.[42]

The UN Commentary on Article 13 repeatedly refers to the "correspondence" between the taxation of gain and the taxation of income, and uses this "correspondence" to explain the purpose of paragraphs 1 and 2 of the Article.[43] Nonetheless, in the restrictions it imposes on source country taxing rights, the UN Model does not generally adhere to this "correspondence": instead of being a consistent implementation of the principle of similar taxation of income and gain (given their economic equivalence), Article 13 of the UN Model is very much a compromise. The most salient symptom of this compromise is the structure of the article. While the language of the UN Model, following Article 13 of the OECD Model, proceeds to delineate source country taxing rights for specific types of property, and then to provide for exclusive resident country taxation for properties not specifically enumerated, the UN Commentary on

[41] The practical significance of paragraph 3 of Article 13 is unclear. Ships, aircraft or boats as physical vehicles should generally decline in value during their useful lives, even if the rights to use them may change in value due to fluctuations in demand and supply in shipping and aviation markets. Moreover, the paragraph is limited to alienation by owners who also operate the ships, aircraft or boats; such vehicles operated by parties other than such owners (e.g. under dry lease) fall outside the scope of the paragraph. OECD Commentary on Article 13, paragraph 28 (quoted in UN Commentary on Article 13, paragraph 7)

[42] UN Commentary on Article 13, paragraph 3.

[43] "It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom." OECD Commentary on Article 13, paragraph 4 (quoted in UN Commentary on Article 13, paragraph 4). The rule that "gains from the alienation of immovable property may be taxed in the State in which it is situated…corresponds to the provisions of Article 6 and of paragraph 1 of Article 22." OECD Commentary on Article 13, paragraph 22 (quoted in UN Commentary on Article 13, paragraph 5). The taxation of gains of the business assets of a PE or fixed base "corresponds to the rules for business profits [and for income from independent personal services] (Article[s] 7 [and 14])." OECD Commentary on Article 13, paragraph 24 (quoted and supplemented in in UN Commentary on Article 13, paragraph 6).

Article 13 acknowledges that "[most] members from developing countries advocated the right of the source country to levy a tax in situations in which the OECD reserves that right to the country of residence."[44] It therefore mentions an alternative provision allowing source country taxation of gains "from the alienation of any property other than those gains mentioned in paragraphs 1, 2, 3 and 4."[45] This alternative language, adopted with modification in many actual treaties, leads to some obvious interpretive tensions for the Article, which we will discuss below.

Existing commentaries have highlighted the following aspects of the language of Article 13 as especially relevant to understanding the restrictions that the Article imposes on source country taxing right as well as the anti-avoidance principles it acknowledges.

The definition of "immovable property". "Immovable property" for purposes of Article 13 is defined by reference to Article 6, which, in the UN Model, has "the meaning which it has under the law of the Contracting State in which the property in question is situated." Article 6(2) of the UN Model explicitly states that the term "immovable property" "in any case include…rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources." This broad formulation is likely to capture the rich variety of "bundle[s] of infinitely divisible rights"[46] that may be associated with immovable property and be transferred at a gain.[47]

[44] UN Commentary on Article 13, paragraph 2.
[45] UN Commentary on Article 13, paragraph 18.
[46] Krever, supra note _, at 224.
[47] Nonetheless, Professor Richard Krever has argued that "there are remarkably wide variances in the different definitions" used in different jurisdictions, and that "civil law jurisdictions with limited [natural] resources" tend to adopt narrowest definitions. He warns that "treaties often fail to operate as broadly as domestic legislation, and domestic legislation itself may struggle to keep up with new and innovative forms of de facto property owners, including the use of rights, options, or derivatives." Therefore, he suggests that "countries seeking to retain domestic taxing rights through Article 13 must ensure, first, that domestic law is sufficiently robust to capture all gains related to real property realized by resident and non-resident taxpayers and, second, that Article 13 in their tax treaties is equally broad." Id., at 223-4.

Movable property part of a PE. Article 13(2) gives the source country taxing right on gains from the alienation of movable property forming part of the business property of a PE (or pertaining to a fixed base available for the purpose of performing independent personal services). The UN Commentary explicitly notes that "the term 'movable property' means all property other than immovable property…It includes also incorporeal property, such as goodwill, licenses, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment [or fixed base] is situated."[48] This is an important observation, because tangible movable properties—such as machines and equipment—tend to experience depreciation and thus has limited potential for capital gain. It is instead the intangible components of a business, including contracts with customers, employment contracts with skilled personnel, brand names, know-how (whether patented or not), etc. that give rise to capital gains on the sale of a business.

This broad definition of movable property under Article 13(2), however, raises a difficult interpretive issue: is moveable property that does not form part of the business property of a PE of a non-resident thereby carved out from the scope of taxation under Article 13? Consider the vulture fund that has sold a portfolio of non-performing loans at a handsome gain. The loans may be viewed as movable property in the fund's business or, depending on the fund structure, they may be held as investment assets but nonetheless are "moveable property" in the sense defined above. The fund may have no PE in the country where the business borrowers are located. Does Paragraph 2 of Article 13 imply that the vulture fund's gain is not taxable in the country of the debtors?[49] Since whatever is not immovable property will be regarded movable property, unless there is a subsequent paragraph in Article 13 that prescribes a specific rule (e.g. for ships, aircraft, and shares), one might infer that capital gain taxation (without PE) is precluded by paragraph 2.

[48] OECD Commentary on Article 13, paragraph 24 (quoted in UN Commentary on Article 13, paragraph 6):
[49] Similar questions can raised for transfers of lease contracts with domestic lessees, or of licenses with domestic licensees, and so on, where the lessor, licensor, etc. has no PE in the source country.

If this is right, and if under the same treaty, interest on loans (and rent or royalty from leases, licenses, and other agreements and covered by the Royalties article) remain taxable in the source country, a sharp inconsistency between the treatments of income and of gain from the same asset would result.

As discussed below, this difficulty is not necessarily resolved even the contracting states agree to retain residual taxing right for the source state over gains not otherwise enumerated in Article 13.

Entities holding immovable property directly or indirectly. Article 13(4) in the UN Model provides taxing right over "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" to that State. Clause (b) of the paragraph defines "principally" in relation to ownership of immovable property to mean that "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." The UN Commentary notes that the provision

> "is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company. In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State…In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns

the immovable property directly or indirectly, such as, through one or more interposed entities."

Despite the anti-avoidance intent of paragraph 4, it has been argued that it may not encompass all the ways in which non-residents may employ tax structures to avoid taxation. "A convertible debt or option, for example, may not be viewed by a court to constitute an interest in a company, but merely a claim to a company's property in the former case or a right over a shareholder or the company in the latter."[50] It has therefore been suggested that a source country may want to subject such claims against a company holding immovable property situated in it also to capital gains taxation.[51] At the same time, it does not appear that countries have generally enacted the anti-avoidance measures permitted by Article 13(4). For example, as discussed in Section 4 below, surprisingly few countries—in the OECD[52] or in the developing world—have enacted domestic law for taxing transfers of foreign companies ("indirect transfers"). The mere language of Article 13(4), therefore, sheds little light on the design of anti-avoidance.

Finally, Article 13(4) in the UN Model carves out from source country capital gains taxation transfers of interests in "entities whose property consists directly or indirectly principally of immovable property used by them in their business activities" (but not an immovable property management company, partnership, trust or estate). The reason for this carve-out, presumably, is that entities that use immovable property in their business activities are not formed for purposes of avoiding the tax on the sale of immovable property. However, relatively few treaties involving developing countries have adopted this carve-out. Nor has

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50 Krever, supra note__, at 229.

51 Canada defines taxable Canadian property (TCP, i.e. property the gain on which realized by a nonresident is taxable in Canada) as including "an option in respect of" other TCP, "whether or not the property exists". Income Tax Act, RSC 1985, c 1 (5th Supp), s 248. [In an obscure case, however, a judge held that for there to be an option with respect to a property the issuer of the option must own the property. Placrefid Ltd. (TCC, 1986) aff'd (FCTD, 1992)]

52 The OECD Model Convention contains a somewhat similar provision for source country taxation of the shares of real estate holding companies, including shares of non-resident companies.

Article 13 of the OECD Model adopted a similar carve-out. An obvious reason is that there are important types of companies the value of which derive predominantly from real property, e.g. hotel and resort operators, operators of shopping malls and even of restaurants and cinemas, and, of course, companies that extract natural resources. The appreciation in the value of the shares of such companies is likely to reflect the appreciation of the underlying real property, and it is not at all obvious why the source country should give up taxing right over such shares. This carve-out can also be regarded as a special case in the inconsistent treatment between PEs and subsidiaries of non-residents, mentioned in Section 1.2 above and further discussed next.

Substantial participation in a company. The Commentary on the UN Model Convention Article 13 notes that "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." It then claims 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.[53] This position is reflected in paragraph 5 of Article 13 of the UN model, where the percentage deemed to constitute substantial participation is to be established through bilateral negotiations. Paragraph 5 allows that the substantial holding (which leads to taxability) may be "indirect", partly as an anti-avoidance device.[54]

Under the OECD Model Convention, the alienation of shares of companies other than those holding domestic real property assets is not taxable in the country of residence of the companies. As discussed in Section 1.2, this produces differential treatment between PEs and

[53] UN Commentary on Article 13, paragraph 9.

[54] "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 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." UN Commentary on Article 13, paragraph 11.

subsidiaries, and seems to ignore the anti-avoidance argument for taxing both asset and share sales.[55] Article 13(5) of the UN Model can be viewed as constituting an improvement in this regard. What is less clear, especially in view of the analysis of enforcement and compliance in Section 2 above, is why administrative considerations dictate a percentage ownership approach to having a threshold for taxing the alienation of shares. For example, if it is the burden of filing a tax return by the non-resident that is at issue, a monetary amount (i.e. exclusion of small gains) seems to be more appropriate.

The Commentary on the UN Model Convention also points out arguments against taxing listed shares (that it is "costly", and that "developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares".[56]) It goes on to suggest language for carving out traded shares from the scope of taxation under paragraph 5. The cost of taxing exchange-traded shares and the policy of boosting domestic stock markets, however, seem to be issues better addressed through domestic law. There seems to be little need or justification for negotiating reciprocal agreement one by one with treaty partners.

Residual taxing power. Article 13(6) of the UN Model Article, like 13(5) of the OECD Model, gives the residence state exclusive taxing rights over assets not covered by the preceding paragraphs of the article. However, as mentioned, the UN Commentary has noted the preferences of developing countries to retain taxing power over assets not specifically enumerated. Such preferences are also reflected in the treaty practice of many countries—and not just developing ones.[57] This is not surprising, insofar as the previous paragraphs of Article 13 do not capture all

[55] See Weisbach, supra note 16.
[56] UN Commentary on Article 13, paragraph 13.
[57] A recent study of Article 13 offer as examples of treaties that permit the source state to tax gains from the alienation of property that is not otherwise covered by Article 13, the tax treaties concluded by Australia (1989 to

important elements of the capital gains tax base for the source country (recall the discussion at the beginning of Section 1), and insofar ceding such residual taxing rights would create disparate treatment between income and game from the same asset.

The way in which residual taxing power can be preserved until Article 13, however, remains a problematic issue. The UN Commentary on Article 13 proposes the language: "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" (emphasis added). The question can be raised as to what constitutes gain "mentioned" in a previous paragraph. Consider the gain from the alienation of shares that fall below the ownership threshold set by the contracting state in a provision similar to Article 13(5) of the UN Model. Article 13(5) only says that the gain realized on the alienation of shares above the threshold is taxable in the source state. Is gain realized on the alienation of shares below the threshold thereby "mentioned"? If one takes the position that it is not, then the residual taxing power paragraph essentially erases the line drawn in Section 13(5): it is almost as though Section 13(5) is deleted in its entirety.[58] Read this way, the approach to drafting in Article 13 would strike many readers as unusual (and unnatural), and even source country tax authorities may have refrained from "reading away" distinctions made in the previous paragraphs of Article 13 if residual taxing power is reserved under Article 13(6).[59]

2003), Argentina, Brazil, China (the tax treaties with Australia, Canada, the Czech Republic, Germany, Hungary, India, Japan, Malaysia, the Netherlands, New Zealand, Nigeria and Thailand), India (the tax treaties with Canada and the United States) and Turkey (the tax treaties with Canada, Italy, Singapore and Spain). Jinyan Li and Francesco Avella, Article 13 : Capital Gains - Global Tax Treaty Commentaries (IBFD 2014), section 3.1.6.2 ("Other cases dealt with by domestic law").

[58] A similar question can be raised about the 50%-of-assets threshold for real property holding entities in Article 13(4).

[59] An alternative interpretation is that what is reserved is taxing right over types of property not referred in a previous paragraph. This interpretation is made explicit in some treaties. For example: "Gains derived by a resident of a Contracting State from the alienation of *any property other than that* referred to in paragraphs 1 through 5 and arising in the other Contracting State may be taxed in that other Contracting State." (emphasis added) Thus shares of resident companies are a type of property already covered by Article 13(5), and the alienation of shares below the

4. Preventing Non-Residents' Avoidance of the Tax on Capital Gains

Section 2 identified detection of taxable transfers and enforcement against delinquent taxpayers as the main challenges for administering the tax on non-residents' capital gains. These are the types of challenges more frequently discussed in connection with tax evasion, but for non-residents and for taxing capital gains, the line between tax avoidance and tax evasion is especially blurry: it takes little effort for the taxpayer to hide the relevant taxable transactions and to dodge enforcement (efforts the undertaking of which normally distinguishes the tax evader). This may be one reason why tactics for avoiding the tax on capital gains are generally fairly crude. Another reason is that, as discussed in Sections 1 and 3, both domestic laws of various countries and tax treaties may sometimes give the impression that ceding source country taxing right over capital gains (e.g. from company shares and from the transfer of other financial claims or intangibles) is normal. But once such concessions are made, taxpayers can be expected to exploit them.

4.1 Treaty Shopping

One obvious strategy for avoiding capital gains tax is setting up holding companies that otherwise serve little or no business purpose in jurisdictions with treaties that contain favorable provisions on the taxation of capital gains. Even for countries that generally take the position of taxing transfers of shares of domestic companies (whether all transfers or transfers of substantial

threshold would not be taxable even under Article 13(6). The question is then what is a "type of property" previously referred to. For example, does Article 13(2) refer to all movable property, or only movable property used in a business, or, even more narrowly, only movable property used in a business conducted by a PE? As discussed above, the reading of Article 13(2) as referring to all movable property would make the class of "property other than that referred to" in a previous paragraph nearly empty. On the other hand, reading it as referring to "movable property used in a business conducted by a PE" would mean that erasing the distinctions drawn in (and therefore the point of) that paragraph.

ownership, per Article 13(5) of the UN Model), some of their treaties may exempt such transfers. Still fewer treaties may exempt the transfer of shares of real estate holding companies (contrary to Article 13(4) of the UN Model).[60] And a developing country may not always be able to negotiate the retention of residual tax rights under Article 13(6).

Since a separate chapter in this volume deals with the abuse of treaties, there is no need to dwell on the issue here. Just one comment is worth making in connection with Article 13. Unlike some of the other distributive articles in tax treaties (regarding e.g. interest, dividend, royalties, and increasingly frequently, other income), which generally deploy the concept of beneficial owner as a way of preventing treaty abuse, the capital gains article generally does not refer to beneficial owners. This by no means implies that a more permissive attitude towards treaty shopping is intended with respect to capital gains. Instead, it merely reflects the fact that the drafting of the article uniformly refers to capital gains "derived by" residents of a contracting state, and never employs the phrase "paid to". And it is this latter phrase that led to the (perceived) need to stress the qualification of the payee as a beneficial owner in the other distributive articles.[61]

4.2 Indirect Transfers[62]

As discussed in Section 1.2, if the transfer of an asset is taxable, but the transfer of ownership interest in an entity that holds the asset is not taxable, then the tax on the transfer of the asset can be indefinitely deferred (thus essentially avoided) by using a holding entity. This logic applies no matter how many layers of holding entities are involved and regardless of

[60] The carve-out for companies that use domestic real property in their businesses contained in to Article 13(4) of the UN Model is not often adopted, but where it is, it also gives rise to incentives for treaty shopping.
[61] A rare anti-avoidance provision specifically addressing capital gains is found in Article 14(6) of the Ghana-Italy Tax Treaty of 2004: "The provisions of this Article shall not apply if the right giving rise to the capital gains was created or assigned mainly for the purpose of taking advantage of this Article."
[62] This section is based on Cui, supra note 17.

whether the holding entity (or entities) is (are) domestic or foreign. This is why Article 13(4) of the UN Model permits the country where immovable properties are located to tax foreigners on transfers even of foreign entities, if such entities principally hold, directly or indirectly (e.g. possibly through multiple layers of holding companies), the immovable properties. However, it is relatively infrequent for countries to adopt domestic law provisions of taxing non-residents on the disposition of shares of foreign companies, whether generally or for real estate holding companies. There are several possible explanations for this. First, many developed countries where anti-tax-avoidance policies are most established have chosen not to tax non-residents on capital gains, on grounds unrelated to tax avoidance.[63] Second, using offshore holding companies to make an investment in a given country may be tax-inefficient for investors from that country (unless domestic investors can evade home country taxes by going offshore). Thus for any asset market where domestic investors are dominant, it may be unlikely for that asset market to move offshore. This is probably the reason why the United States (unlike Canada, Australia, and Japan) has not adopted rules for taxing indirect transfers of U.S. real property interests: any foreigner investing in U.S. real estate will want to use investment structures that future U.S. buyers would not reject.[64] Third and more generally, there may be other legal factors that either pull the legal structures for foreign investment onshore or push them offshore.[65] Where such other considerations favor using onshore structures, the attraction of offshore structures in terms of helping to avoid the capital gains tax may be outweighed.

In the last few years, a number of non-OECD countries, including India, China, Indonesia, Peru, Chile, Panama, and the Dominican Republic, adopted the policy of taxing foreigners on the sale of interests in foreign entities that hold directly or indirectly the shares of

[63] See supra notes 11-13.
[64] See Cui, supra note 17, 664-6.
[65] Id. 666-671.

resident companies.[66] While the background to these policy developments may be very diverse,[67] what is likely common among them is that there are active offshore markets for trading investments into these jurisdictions, making tax avoidance through indirect transfers a natural strategy.

The current approaches to taxing indirect transfers illustrate a well-known dichotomy in legal design for anti-avoidance, namely the use of specific anti-avoidance rules (SAARs) and general anti-avoidance rules (GAARs). The crucial distinction is that under a SAAR, the content of the legal rule applicable to the relevant circumstances is specified ahead of time, so that it is clear what the outcome of applying the rule will be. By contrast, GAARs tend to be statements of principle, and how the legal standard is applied can only be known after the fact. India's policy illustrates the SAAR approach. The 2012 amendment of the Income Tax Act of India provided that "any share or interest in a company or entity registered or incorporated outside India shall be deemed to be … situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India." Therefore, the transfer of such shares would result in the realization of income accruing or arising in India and taxable to a nonresident transferor.[68] In contrast, China determines the taxability of an indirect transfers on the basis of an *ex post* determination. Under the relevant administrative guidance,[69] in cases where "an offshore investor makes abusive uses of organizational forms or arrangements indirectly to transfer the equity interest in a Chinese resident enterprise, and such arrangements are without a reasonable business purpose and entered into to avoid enterprise income tax obligations," tax agencies are

[66] Id, 654-6.
[67] In India, for example, the policy developed as a consequence of the Vodafone case, adjudicated by India's Supreme Court and which provoked parliamentary action. In China, by contrast, the taxation of indirect transfers was launched by a piece of informal administrative guidance.
[68] It has been proposed that "substantially" be defined to mean 50% or more of the total value of a company's assets.
[69] Often referred to as "Circular 698". Guoshuihan [2009] No. 698, Notice on Strengthening the Management of Enterprise Income Tax Collection on Proceeds from Equity Transfers by Non-resident Enterprises (promulgated by State Administration of Taxation, 2009) (China)

authorized to “recharacterize an equity transfer according to its business substance, and disregard the existence of the offshore holding company which is used for tax planning purposes.” That is, only a tax authority can determine the taxability of an indirect transfer, and such determination is to be made explicitly on the basis of a finding of tax avoidance motives. The statutory basis of this determination has been attributed the GAAR in China’s Enterprise Income Tax Law.[70]

Using the GAAR to deal with potentially abusive indirect transfers has turned out to be unsatisfactory in China in many respects, for the fundamental reason that indirect transfers of shares of Chinese companies occur too often. Many of the entities used in offshore structures for investing into China neither serve substantial functions nor display bona-fide, operational business purpose. In this context, the determination that many of the holding companies serve no genuine business purpose, or that whatever business purpose they serve pales in comparison to the potential tax savings though indirect transfers, can be made in a much more routine fashion than case-by-case examinations permit. There are reports of a backlog of indirect transfer cases across China, in which foreign entities have reported indirect transfers already carried out, are prepared to make tax payments, but are kept waiting indefinitely by local tax authorities who have yet to make the determination that the transfers are taxable. Furthermore, over-reliance on GAAR creates too many opportunities for negotiation between taxpayers and authorities. An industry of tax advisors on indirect transfers has emerged, whose routine tool of trade is to persuade foreign parties who have made indirect transfers first to hire them to report the transfers, and then to pay them literally to “negotiate” with Chinese tax authorities about the taxability of the transfers, often regardless of whether the position of nontaxability has any merit.

[70] Enterprise Income Tax Law art. 47 (2008) (China). The statutory language provides: “Where an enterprise enters into [an] arrangement without reasonable commercial purpose and this results in a reduction of taxable gross income or taxable income, tax agencies shall have the authority to make adjustments using appropriate methods.” An “arrangement without a reasonable commercial purpose” has been defined as one “the primary purpose of which is to reduce, avoid or defer tax payments.” Regulation on the Implementation of the Enterprise Income Tax Law, art. 120 (2008) (China).

These phenomena are consistent with the theory that, when a type of transaction which the law wishes to regulate occurs often, it is socially more efficient to spell out the content of law ahead of time, thus minimizing the costs for regulated subjects, legal advisors, and enforcement personnel of interpreting the law.[71] Thus SAARs are likely to be a superior way of dealing with the majority of indirect transfers, while a GAAR should be reserved for the relatively rare cases that are not properly dealt with by SAARs.

However, the existing SAARs adopted by various countries for taxing indirect transfers—in Australia, Japan, and Canada for real property holding companies, and in India for all companies that hold sufficient assets in India—suffer from some obvious problems. An important aspect of this approach for taxing indirect transfers is that transfers of shares of foreign entities by nonresidents are treated as giving rise to items of *per se* taxable income: any capital gain on such transfer is explicitly stipulated to have a domestic source. Take Canada for an example. If Foreign Company *A* derives more than 50% of the fair market value of its shares directly or indirectly from real or immovable property situated in Canada, then the shares of *A* constitutes "taxable Canadian property," and any capital gain realized on the disposition of shares of *A* is deemed to arise in Canada. Suppose now that *A* is wholly owned by another foreign company, *B*, and *B* has no assets other than *A*'s shares. The shares of *B* would also constitute "taxable Canadian property". Any capital gain realized on the disposition of *B* shares is therefore also taxable income in Canada, and is legally distinct from the capital gain that has accrued to or been realized on *A* shares. If the capital gain on the disposition of the shares of *A* (by *B*) has been taxed in Canada, that does not prevent the capital gain realized on the disposition of the shares of *B* (by *B*'s shareholder) from being taxed in Canada (or vice versa).

[71] See Louis Kaplow, Rules versus Standards: An Economic Analysis, 42 DUKE L J. 557 (1992).

Interestingly, neither Canada, Australia, Japan, nor the Commentaries on the OECD and UN Model Tax Conventions, has addressed this problem of multiple taxation arising from the taxation of indirect transfers of real estate. Nor do they (or the United States, in its law taxing the transfer of U.S. companies that hold U.S. real property) deal with an issue of proportionality: if the shares of holding Company derive only 50% of their fair market value from domestic assets, under most of the existing SAARs, *all* of the capital gain realized on the sale of the shares is taxable in the country of the location of the underlying assets. Although the recent Shome Report in India recommends that any gain realized on a taxable indirect transfer should be taxed only in proportion to the value of the Indian assets relative to the entity's global assets, this is still different from taxing the gain on the transfer only to the extent attributable to gain realized on the underlying Indian assets.[72]

Are governments justified in their indifference about these problems? One view is that the decision of how many layers of intermediate companies are interposed between the domestic asset and ultimate investors is in the control of the taxpayers, as are decisions to make dispositions at different levels. If governments are wary of convoluted and opaque offshore structures to begin with, they have no reason to go out of their way to make sure that tax is neutral with respect to the choice of organizational structure in offshore corporate groups.[73] While this argument is probably correct in itself, there is an important competing consideration. As discussed in Section 2, taxing foreigners on capital gains raises significant challenges for enforcement. If the tax on indirect transfers leads to arbitrary tax consequences because of unmitigated multiple taxation, taxpayers may respond not by simplifying offshore corporate

[72] Draft Report on Retrospective Amendments Relating to Indirect Transfer, Expert Committee (2012) (India), available at www.incometaxindia.gov.in/archive/DraftReport_10102012.pdf.
[73] Advanced income tax systems tend to aim to be neutral with respect to such choices when the structures are domestic or "onshore", adopting special regimes such as corporate consolidation and disregarding intra-group transactions.

structures, but by non-compliance and evasion. If a government wants to maintain the credibility of its anti-avoidance regime without committing indefinite resources to enforcement, it should try to maximize voluntary compliance. Rationalizing the rules for taxing indirect transfers — including by mitigating the multiple taxation of the same economic gain — seems to be one strategy for increasing voluntary compliance.

Notably, China's policy for taxing indirect transfers, though problematic in adopting an approach of case-by-case determination, inadvertently suggests a solution to the problems characterizing the existing SAARs. In China, indirect transfers become taxable only after they have been determined by tax authorities to be, in economic substance, direct transfers. The layers of offshore holding companies, instead of creating separately and distinctly taxable assets under Chinese law, must be disregarded. This implies[74] that if the shares of a Chinese company are treated as having been disposed of indirectly through the transfer of an offshore entity, the fact that the indirect transfer has been subject to tax should be reflected by adjusting the tax cost or basis for the Chinese company's shares.[75] This eliminates the possibility of taxing the same economic gain multiple times as a result of multiple layers of indirect transfers. Moreover, the tax on an indirect transfer would always necessarily be proportional. The source country will only get to tax any gain represented by the excess of (1) the portion of the purchase price paid on the indirect transfer that is allocable to the shares of the target company in the source country

[74] Not all Chinese tax policymakers, administrators or advisors have grasped these implications. Since the adoption of 698, parties have been more focused on *when* indirect transfers are taxable and not *how*.

[75] For example, suppose that Foreign Investor S forms an offshore company P with equity capital of 200. P in turn contributes 200 of equity capital to Chinese company Q. When the value of Q shares grows from the initial value of 200 to 250, S sells the shares of P for 250 to buyer B. If China decides to disregard the existence of P to tax S on the sale, and S is liable for tax on the gain of 50, then the tax basis or cost of Q shares in the hands of P, and of B, should each be adjusted to 250. If either P disposes Q shares now for 250, or B disposes of P shares for 250, there should be no further tax for either P or B.

regarded as transferred indirectly, over (2) the tax basis, for the source country's purposes, of such shares of the target company.[76]

Overall, it seems possible to improve on all existing practices for taxing indirect transfers by taking the SAAR approach (if indirect transfers occur frequently), while modifying it to incorporate the Chinese approach of treating all indirect share sales as sales of the underlying domestic assets.[77] To implement this approach consistently can be technically complex, and adjusting the tax basis of assets held by an entity to reflect the transfers of interests in the entity by its owners (so as to avoid multiple taxation of the same economic gain) had only recently become feasible for entities with a large number of owners in the U.S. through specialized accounting software.[78] However, if publicly listed entities are excluded from a tax on indirect transfers, so that most taxable indirect transfers only involve entities with few owners, the complexity may be manageable. And the exclusion of shares of publicly listed entities from a tax on indirect transfers is independently justifiable, since they are unlikely to be used mainly for tax avoidance purposes.

5 Taxing Former Residents' Capital Gains[79]

When the residence of a taxpayer changes on emigration, the taxing rights of the former residence state also change. Following the change of residence, the former residence state's taxing rights are reduced to those of a source state. In order to preserve the right to tax gains accrued while the taxpayer is a resident, many countries impose an "exit tax" and/or a "trailing

[76] In more technical terms, disregarding an offshore entity and taxing an indirect transfer is essentially a matter of treating a sale of shares (of the offshore entity) as a sale of underlying assets (i.e. the shares of a target resident company).
[77] This is discussed as the "ex ante, look-through" approach in Cui, supra note 17, Section V.
[78] I am grateful for this information from Mr. Ameek Ashok Ponda, adjunct professor at Harvard Law School.
[79] The following paragraphs consist in excerpts from Jinyan Li and Francesco Avella, Article 13: Capital Gains - Global Tax Treaty Commentaries (IBFD 2014), Section 2.1.8. They will be further developed after discussion with workshop participants.

tax” and rely on a treaty provision to preserve the taxing rights of the former residence state and prevent double taxation.

Exit taxes (also referred to as “departure taxes”) are taxes that countries levy immediately before a person ceases to be a resident. Under an exit tax, assets owned by an emigrant are deemed to be alienated at market value and reacquired at a cost equal to that value. For instance, under the Australian domestic law exit tax rules, a person ceasing to be resident is deemed to dispose of assets other than taxable Australian assets, on which non-residents are taxed, at market value. Individuals may elect not to be taxed on exit in which event taxation is deferred until actual disposition, but, rather, at the cost of tax on the full capital gain, including gains accruing after ceasing to be a resident. Similarly, Australia deems a person who becomes a resident to acquire assets other than taxable Australian assets at market value on becoming a resident. Canadian rules are largely similar to the Australian ones.

However, in the absence of coordination between the treaty states, a problem regarding the potential double taxation of the accrued gain may arise. This occurs when the property is actually alienated and the current residence state taxes the entire gain, computed by reference to the historical cost basis, which includes the gain that has been subject to the exit tax in the former residence state. Countries with exit taxes, such as Australia, Canada, the Netherlands, South Africa and the United States, may include special provisions in their tax treaties to resolve the problem of double taxation. This is usually realized by allowing the taxpayer to use a tax cost for the asset in the new residence state equal to its market value at the time of the change in residence.

Trailing taxes are taxes levied after a change of residence over assets that would normally not otherwise be taxed in the hands of a non-resident, but are usually taxed under domestic law if alienated within a given period following the change of residence (generally 5 to 10 years). A country may have both a trailing tax and an exit tax if a taxpayer has an election to be subject to the exit tax or remain liable to tax for the full gain realized on actual alienation following the change of residence.

Trailing taxes create two problems. First, the former residence state's taxing right is, in the absence of a special provision, denied by article 13 of the OECD Model if the former residence state has no jurisdiction to tax particular gains under a tax treaty as a source state. Countries with only a trailing tax may preserve the operation of the tax for a given period. Second, many tax treaties that permit the former residence state to impose a trailing tax do not require the new residence state to make a corresponding adjustment to the cost base.