UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION

10th SESSION OF THE COMMITTEE OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS

“ARTICLE 13” (CAPITAL GAINS)

THE PRACTICAL IMPLICATIONS OF **PARAGRAPH 4**

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BACKGROUND

- Decision to include a PAPER ON COUNTRY PRATICES was taken in October, 2013 during the 9th Session.
- Practical aspects of implementation of Paragraph 4 of Article 13 of United Nations Model Convention collated through a Questionnaire.

UN MODEL
vis-à-vis
OECD MODEL

- First 3 paragraphs of the UN Model Convention are similar to the first 3 paragraphs of the OECD Model.
- Paragraph 4 of the UN Model Convention broadly corresponds to paragraph 4 of the OECD Model.
- Paragraph 5 is a distinct provision in the United Nations Model Convention.
- Paragraph 6 is the same as paragraph 5 of the OECD Model Convention but adjusted to take into account the insertion of the additional paragraph.

ARTICLE 13 – EXPLAINED - 1

- Lays down the rules for allocation of taxing rights between the residence state and the source state in the context of capital gains.

- **The General Rule**: Gains from the alienation of property are taxable in the state of which the alienator is a resident.

- **Exceptions:** provided in para 1, 2, 3, 4 and 5

ARTICLE 13 – EXPLAINED - 2

- **Para 4 of Article 13 of UN Model:** Gains from alienation of shares of a company or of an interest in a partnership, trust or estate, deriving their value directly or indirectly <u>principally</u> from immovable property situated in a Contracting State may be taxed in that State.

- ‘principally’ in relation to ownership of immovable property means the value of the immovable property exceeding 50 percent of the aggregate value of all assets owned by the company, partnership, trust or estate.

- Exclusion from para 4-such entities whose property consists directly or indirectly principally of immovable used by them in their business activity but not immovable property management company, partnership etc.

ARTICLE 13 – EXPLAINED - 3

- It allows a Contracting State to tax a gain on an alienation of shares of a company or on an alienation of interests in other entities, the property of which consists principally of immovable property situated in that State.

- **Purpose of Article 13 (4)**: to prevent the avoidance of taxes on the gains from the sale of immovable property through incorporation of a company or entity in other state to hold such property.

OBJECTIVE OF THE NOTE

- Analysis of Country Practices and highlight legislative and administrative measures for effective implementation of paragraph 4

- CATEGORISATION OF COUNTRY PRACTICES

  i. TAXPAYER ISSUES
  ii. TAX ADMINISTRATION ISSUES
  iii. OTHER ISSUES

COUNTRY PRACTICES ON TAXPAYER ISSUES - 1

Knowledge about the nature of the property

- Determination by the alienator of shares of a company, partnership, trust, etc. whether the property of that company or partnership etc consists <u>principally</u> of ‘immovable property’ situated in a particular country.

- The knowledge from the financial statements of the company or directly from the company itself :- accuracy dependent on the comprehensiveness of the financial reporting or the influence of that shareholder (substantial or significant).

COUNTRY PRACTICES ON TAXPAYER ISSUES - 2

Knowledge about the nature of the property – *cont..*

- Australia, Netherlands and South Africa: “connected” entities are expected to know the segmentation of assets of that company into immovable property assets.

- FIRPTA Rule in US: Deeming fiction of any interest in a domestic company as a US real property interest (USRPI) unless the taxpayer establishes otherwise and any gain recognised from the disposition of such interest is subject to U.S. federal income tax.

COUNTRY PRACTICES ON TAXPAYER ISSUES - 3

Alienation of assets between two balance sheet dates. Such alienation of assets is tackled by

- Increasing the frequency of disclosure (monthly or quarterly)
- Fixing a **“look back period”** of 3 or 5 years, (China and US)
- Allowing the taxpayer to submit the audited accounts for the financial year closest to the date of alienation, (Malaysia)
- Calculation of immovable property’s portion in company assets on the balance sheet on the last working date prior to the date of alienation of shares (Russian Federation)

COUNTRY PRACTICES ON TAXPAYER ISSUES - 4

Public disclosure of location of immovable properties of the companies

- Public disclosure of location of immovable properties of the companies, e.g., in the balance sheets, and the access by the taxpayer.

- Access easy in certain types of industries, like, mining, infrastructural industries etc., for others only values of such immovable properties derived from financial statements.

- Generally all countries (except Mexico, which says such information is available in public domain) admit difficulty in obtaining this information, except from the company itself.

COUNTRY PRACTICES ON TAXPAYER ISSUES - 5

Share transactions based on price information only

- Transaction in shares based on only price information and not on the basis of financials of a company: Full responsibility on taxpayer to get complete information.

- For publically listed shares, some information about the financials of that company may be in public domain and access is easy for substantial shareholding.

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 1

Definition of “Immovable Property”

- Words “immovable property” not defined in Article 13 (4): Need to refer to domestic laws of States.
- For many countries the “immovable property” or “real property” is defined to mean land and unsevered products and structures attached to land.
- In some countries, no legal definition of “immovable property” exists.

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 2

Personal property is treated as "real property" (US) when

- The personal property is used in mining, farming and forestry
- The personal property is used in improvement of real property (e.g., construction equipment)
- Personal property is used in operation of a lodging facility
- The personal property is used by a lessor in leasing of furnished office or other work space to lessees

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 3

Date reckoned for determining the threshold

- For most countries, the date of alienation or transfer is reckoned for determining the threshold value.
- However, in some countries, the "look back" rule applies, e.g., China and US.
- For some others, the closest reporting date is taken into account.

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 4

Method of valuation of assets

- Whether book value, cost or fair market value of the assets of a company etc. to be reckoned to determine the value of assets.
- No standardised response.
- **Book value**: China, Mexico and the Russian Federation.
- For some other countries, it is **fair market value.**

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 5

Type of assets to be included in valuation

- Whether assets on the books or assets not in the books, such as, goodwill or other intangible assets are also to be reckoned?
- In most countries, only book assets are reckoned.
- Azerbaijan, Mexico, Netherlands, Norway, South Africa and US: All assets, including intangible assets, e.g., goodwill, are included in valuation of assets.

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 6

Information about non-resident-to-non-resident transfer of shares

- This information is difficult to get, except:
  - Through collaboration between the two countries involved
  - Through a specific requisition from the company itself
  - Through disclosure by seller
- Efficiency of the tax administrators will determine access to this information.
- Some countries require periodic updating of shareholding or approval from the Government authorities for such transfer (Australia, Brazil, Malaysia).

COUNTRY PRACTICES ON TAX ADMINISTRATION ISSUES - 6

Abusive escape by shareholders by changing the asset threshold through debt

- How to know the abusive escape where a company borrows short term to slip below 50% threshold?
- What are the safeguards in the domestic law?
- Invocation of general anti-avoidance provisions: Australia, Japan, Norway, South Africa.
- Debt is not reckoned to reduce the immovable property assets below 50% threshold or allowed subject to some safeguards: China, Malaysia, Mexico and US

COUNTRY PRACTICES ON OTHER ISSUES

- Whether the domestic legislation covers alienation of shares in companies only or these extend to other interests, such as, those in partnerships or trusts?

- For majority, all interests are covered.

- For some countries, like China and Zambia, cover alienation of shares in companies only.

COUNTRY PRACTICES

Actions taken or proposed to be taken to further improve the integrity and robustness of foreign residents' regime in relation to disposal of source country real property interests:

- **Australia**: Would introduce a 10% withholding tax with effect from July, 2016.
- **U.S.**: The circumstances, when the shares are treated as real estate interests, should be appropriately circumscribed looking at the spirit of the UN Convention and no mechanical application of 50% test.

CONCLUSION

Following implementation issues relating to paragraph 4 of article 13 emerge:

- No definition of **immovable property**.
- Lack of information with the **alienator that the share of a company** or interest in any other entity derives its value directly or indirectly principally from immovable property situated in a particular State.
- Ascertaining the **value of immovable property** on the date of alienation of shares or interest which may fall between the two balance sheet dates.
- Whether **book value or fair market value** to be adopted for ascertaining the tax liability
- Whether all **the assets** appearing in the balance sheet are to be taken or assets not appearing in the book, such as, goodwill etc., are also to be taken into account for the determining tax liability.
- How to ensure payment of taxes when the transaction is between **two non-residents**.

CONCLUSION – *cont..*

Therefore,

- It is essential for the countries including paragraph 4 in their treaties to have **enabling provision in their domestic law**.

- Countries should put in place a regulatory framework for **comprehensive financial reporting** by the company or other entities to ensure disclosure of the details of immovable property owned by them in their jurisdiction.

- More **transparency in the valuation principles**, segment accounting reports and location of immovable properties necessary to tackle the issue of avoidance of taxes covering the cases under Paragraph 4 of Article 13.

CONCLUSION – *cont..*

- More clarity required in domestic law on **ascertaining the value of immovable property** on the date of alienation of shares or interest, falling between two balance sheet dates, adoption of book value, cost or fair market value for ascertaining the tax liability.

- Clear enunciation of rules required for **reckoning of intangible assets, such as, goodwill**, etc. for the purposes of valuation of total assets.

- Use of **effective exchange of information**.

THANK YOU