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**Committee of Experts on International  
Cooperation in Tax Matters  
Eighteenth session**

New York, 23-26 April 2019

Item 3 (b) of the provisional agenda

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

*Summary*

This note is presented for discussion and guidance (not for final approval of text) at the meeting of the Committee to be held in New York on 23-26 April 2019.

The Subcommittee responsible for the update of the United Nations Model Double Taxation Convention between Developed and Developing Countries (Model) was tasked with carrying out a general review of the Model to identify and amend inconsistencies, improve the clarity, and update or remove historic passages that no longer hold relevance.

A list of possible topics that could be addressed as part of the next update of the UN Model was prepared by the Coordinator of the Subcommittee, with inputs from the Subcommittee members and the Secretariat, and circulated among Committee members for comments and was presented during the 17<sup>th</sup> session of the Committee.

Committee member Mr. Rajat Bansal prepared the attached paper outlining the key issues related to a proposal by a previous member of the Committee to amend Article 13(5) of the UN Model in respect of gains on offshore indirect transfers of assets other than immovable property situated in source country. It is not an output of the Subcommittee, but has been already shared with the Subcommittee responsible for the update of the Model, and is presented for consideration and guidance at the 18th session of the Committee.

The objective of this Paper is to not analyze merits or demerits of taxation of Offshore Indirect Transfers (OITs) by countries under their domestic law but to examine the need for and suggest a treaty provision in UN Model Convention, where one or more of the Contracting States taxes OITs of assets other than immovable property under its domestic law.

On February 20, 2019, this note was circulated for comment by the Secretariat to the Subcommittee in charge of the next revision of the UN Model. Comments were received from one Member of the Subcommittee. Those comments were taken into account in preparing this draft of the paper.

## **TAXATION OF CAPITAL GAINS ON OFFSHORE INDIRECT TRANSFERS UNDER DOMESTIC LAWS**

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

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

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

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

- The country in which an asset is located should be entitled to tax the gain on its transfer indirectly due to such gain having been realized due to value enhancement in the location country.

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<sup>1</sup> [Secretariat Note] See Chapter 4 (Indirect Transfer of Assets) of the United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries available at <https://www.un.org/esa/ffd/publications/the-united-nations-handbook-on-selected-issues-for-taxation-of-the-extractive-industries-by-developing-countries.html>.

- The right to tax returns to foreign investors in the form of dividends being accepted, the right to tax them on returns in the form of capital gains associated with a domestic source should also be accepted.
- It should not matter for tax purposes whether the underlying asset is immovable or movable.

5. Recognizing the importance of taxation of indirect transfers in particular for developing countries, the Platform for Collaboration on Tax has prepared a Toolkit on ‘The Taxation of Offshore Indirect Transfers (OITs)’<sup>2</sup>. The objective of the Toolkit is to suggest alternate approaches to the taxation of OITs by the country in which underlying asset is located, for countries that may choose to tax them.

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

## **DOUBLE TAX TREATY ASPECTS**

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

8. The consequences of this relationship between tax treaties and domestic law are that:

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

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<sup>2</sup> [Secretariat Note] See also United Nations, 2017, Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, Chapter 4 (Indirect Transfer of Assets), which the Toolkit draws on and in part responds to, available online at <https://www.un.org/esa/ffd/publications/the-united-nations-handbook-on-selected-issues-for-taxation-of-the-extractive-industries-by-developing-countries.html>

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

9. Provisions of both the UN and OECD Model Tax Conventions suggest<sup>3</sup> wide acceptance that capital gains taxation of indirect transfer of immovable assets can be imposed by the location country. The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument" or "MLI") has increased the number of tax treaties that effectively include Article 13(4) of the OECD MTC. However, at present, there is no provision to address the capital gains on indirect transfer of assets other than immovable property in source country under the two Model Conventions.

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

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

### **SUGGESTED PROVISION IN UN MODEL CONVENTION'S ARTICLE 13**

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

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

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

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<sup>3</sup> Paragraph 4 on Article 13 (Capital Gains) are similar both in the 2017 UN and 2017 OECD Model Conventions.  
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13. As the Commentary goes on to say, ‘This alternative is equivalent to saying that either or both States may tax according to their own laws and that the State of residence will eliminate double taxation under Article 23. Countries choosing this alternative may wish through bilateral negotiations to clarify which particular source rules will apply to establish where a gain shall be considered to arise.’

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

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

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

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