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Article 13: Capital gains

**COMPLIANCE ISSUES IN REGARD TO PARAGRAPH 4 OF ARTICLE 13 OF THE
UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION.**

Summary

The attached note has been prepared by Anita Kapur, a member of Committee of Experts on International Cooperation in Tax Matters (the Committee) pursuant to a mandate given by the Committee at its seventh session, in 2011 to further consider paragraph 4 of article 13, as recorded in the report of that annual session.¹

The note is prepared to assist the Committee in its discussions on these matters.

¹ EC/2011/45 at paragraph 114.

**Compliance Issues in Regard to Paragraph 4 of Article 13 of the
United Nations Model Double Taxation Convention.**

Anita Kapur

Paragraph 4 of Article 13 is extracted below for ready reference:

“4. 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 may be taxed in that State. In particular:

- (1) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.
- (2) For the purposes of this paragraph, “principally” in relation to ownership of immovable property means 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.”

2. Some of the issues with which the taxpayers and tax administrations have to grapple in applying the paragraph are listed below:

- How would the tax payer who alienates his shares know that the property of the company, whose shares he has alienated consists principally of ‘immovable property’ situated in a particular State and discharge his tax obligations to that State? Balance Sheets are on a particular date and reflect the position of assets on that date while the alienation can be at a date which falls between the two balance sheets dates.
- It is also possible that the location of immovable properties may not be disclosed in the Balance Sheets available in the public domain. Where would the taxpayer access information to determine his tax obligation? The situation may be aggravated in cases where a person transacts in shares based on price movements of scrip in a stock exchange and makes no analysis of the financials.
- The phrase ‘immovable property’ used in this paragraph has not been defined. Paragraph 1 of Article 13 also uses this phrase but makes an explicit reference to Article 6 and therefore the definition of ‘immovable property’ in Article 6 travels to paragraph 1 of Article 13. However, in paragraph 4 there is no reference to Article 6. This omission inspires the view that in absence of definition of ‘immovable property’ in Article 3, this phrase will have to take its meaning from the domestic law. A

contrary view is that some international meaning to this term in preference to the domestic law meaning should contextually apply. This potential divergence in views of the resident State and source State can cause difficulties for the tax payer.

- “Principally” in relation to ownership of ‘immovable property’ has been defined to mean the value of such ‘immovable property’ exceeding 50% of the aggregate value of all assets. The questions requiring clarification are:
 - (i) what is the date for determining such value?
 - (ii) whether the value is to be taken as book value, cost or fair market value?
 - (iii) which are the assets to be reckoned i.e. whether all assets as per books or even the assets not in the books like goodwill and other intangible property etc.?
- In a situation where the ‘immovable property’ is situated in State A and the company is a resident of State B and the share transaction takes place between the residents of State B, the tax administration of State A may not have access to information regarding such transactions to assert the taxation right, because the company whose shares are alienated is not in its territory.
- Tax administrations may know or may not know of abusive escape from the ambit, particularly by shareholders with controlling interest, as the company can borrow short term to make the value of ‘immovable property’ at the relevant time less than 50%.

3. We need to deliberate in the Committee on the issues posed in paragraph 2 above to decide on the guidance that the Commentary should provide for making the provision work. For this purpose a backgrounder is required, detailing the practices and legal provisions applied by various tax jurisdictions in asserting their source taxation right under Article 13 (4). The Committee may wish to approve the attached Questionnaire to obtain information about the country practices which can be circulated by the Secretariat and responses tabulated for further deliberations by the Committee.

Questionnaire

Compliance issues in regard to paragraph 4 of Article 13 of the U.N. Model Convention – Country practices

1. Taxpayer issues

- a) How does a tax payer in your tax jurisdiction who alienates his shares know that the property of the company, partnership, trust etc. whose shares he has alienated consists principally of ‘immovable property’ situated in a particular State and discharge his tax obligations to that State.

- b) The balance sheets of entities are on a particular date and reflect position of assets on that date while the alienation can be at a date which falls between the two balance sheets dates. How does the taxpayer know that the property of the company, partnership, trust etc. consists principally of ‘immovable property’ situated in a particular State on the date of alienation of shares?

- c) Is the location of immovable properties disclosed in the Balance Sheets of companies, partnerships, trusts, etc. available in the public domain in your State? In case the same is not available, where would the taxpayer access information to determine his tax obligation?

- d) How does the taxpayer determine his tax obligation in the situation when he transacts in shares based on price movements of scrip in a stock exchange and makes no analysis of the financials of the concerned entity?

2. Tax Administration issues

- a) The phrase ‘immovable property’ used in this paragraph has not been defined. Paragraph 1 of Article 13 also uses this phrase but makes an explicit reference to Article 6 and therefore the definition of ‘immovable property’ in Article 6 travels to paragraph 1 of Article 13. However, in paragraph 4 there is no reference to Article 6. This omission inspires the view that in absence or definition of ‘immovable property’ in Article 3, this phrase will have to take its meaning from the domestic law. How is ‘immovable property’ defined in your State?

- b) “Principally” in relation to ownership of ‘immovable property’ has been defined to mean the value of such ‘immovable property’ exceeding 50% of the aggregate value of all assets.

- i. What is the date taken by your tax administration for determining such value?

- ii. Whether the value taken by your tax administration is the book value, cost or fair market value?

- iii. Which are the assets to be reckoned, i.e. whether all assets as per books or even the assets not in the books like goodwill and other intangible property etc.?

- c) In a situation where the 'immovable property' is situated in your State and the company is a resident of the other State and the share transaction takes place between the residents of the other State, your tax administration may not have access to information regarding such transactions to assert the taxation right, because the company whose shares are alienated is not in your territory. How does your tax administration tackle such a situation?

- d) Tax administrations may know or may not know of abusive escape from the ambit, particularly by shareholders with controlling interest as the company can borrow short term to make the value of 'immovable property' at the relevant time less than 50%. What are the safeguards in your law to tackle such abusive situation?