Application of Treaties to Nonresidents: Taxation of Capital Gains

Diane Ring
Professor of Tax Law
Boston College Law School

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Application of Treaties to Nonresidents: Taxation of Capital Gains

This session explores the following questions:

1. Why does taxation of capital gains earned by nonresidents matter – and how can failure to tax capital gains contribute to tax base erosion?
2. How are capital gains treated by the UN Model, the OECD Model, and by countries in practice?
3. What are some of the difficulties in trying to tax capital gains of nonresidents?
4. What are some options for countries seeking to tax nonresidents' capital gains?

Impact of Capital Gains Taxation

Conversion: Taxpayers can frequently transform the income from property into capital gains.

Example #1:

- **Nonresident owns stock in a Country S corporation.**
- **If the corporation pays dividends, nonresident would expect to bear Country S withholding tax at the domestic rate or the lower treaty rate.**
- **If the corporation does not distribute dividends, then nonresident can sell the stock at a gain that reflects the undistributed dividends.**
- **If the gain on sale of the stock (presumably capital gains) does not bear Country S tax, then nonresidents have an incentive to shift dividends to capital gains.**

Impact of Capital Gains Taxation

Conversion: Taxpayers can frequently transform the income from property into capital gains.

Example #2:

- **Nonresident owns real estate in Country S.**
- **If nonresident retains the property and collects rents, the income likely will be subject to either Country S withholding tax or net basis taxation.**
- **If nonresident sells the property instead, the sale price represents the present value of the future stream of rental income.**
- **If the capital gain is not subject to Country S tax, the nonresident will have an incentive to transform rental income into capital gains.**

Tax Treatment of Capital Gains

- **Connection between Domestic Law and Treaties:**
  - Treaties do not increase the taxing power of states.
  - Thus, if domestic law does not include the power to tax the capital gains of nonresidents, then the treaty will not create that taxing power.
- **Definition of Capital Gains:**
  - No single or universal definition of capital gains.
  - Can include gains from the alienation of a wide variety of immovable and movable property, and tangible and intangible property (land, machinery, art, stock, patents, natural resource rights).
  - Status as capital gains may depend on the taxpayer and the function of the asset – thus, the same asset might generate capital gains if sold by one taxpayer and regular ordinary income if sold at a profit by another taxpayer.

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Tax Treatment of Capital Gains

- **Domestic Taxation:**

  States vary widely in their treatment of capital gains – and within states the taxation varies depending on a variety of factors. Options for taxation of capital gains include:

  - No taxation of capital gains
  - No taxation of capital gains of nonresidents
  - Exception from taxation of capital gains for certain assets (e.g., home)
  - Special rate available for capital gains meeting specified requirements
  - Taxing capital gains as part of regular income tax
  - Taxing capital gains under a separate tax
  - Taxing gains as capital or ordinary depending on the use of the asset by the taxpayer
  - Deemed gains taxed on transfer by gift, at death, or on transfer out of the country

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Tax Treatment of Capital Gains

- **Domestic Taxation:**
  - **Source of Capital Gains:**

  General Approach: A broad but not universally implemented principle is that capital gains should be taxed (as having source) in the same country that would claim source taxation over the income from the asset.

  - **Examples of the concept:**
    - Rental income v. gain on sale of the rental property
    - Royalty income v. gain on the sale of the patent
    - Dividend income v. gain on the sale of the stock

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Tax Treatment of Capital Gains

- **Domestic Taxation:**
- **Source of Capital Gains:**
- Inconsistent application of the source principle: Sometimes the source principle is invoked to justify taxation and sometimes taxation does not follow the principle. Such inconsistencies are evident both in domestic law and in the UN and OECD Model Treaties.
  - **Examples of consistent and inconsistent sourcing rules:**
  - Immovable property: capital gains sourced to where property is located – consistent with rent.
  - Business property used by a nonresident in Country S permanent establishment: capital gains sourced to Country S – consistent with business profits.
  - Gain on sale by nonresident of Country S corporation stock: capital gains not taxed in Country S, either because not source jurisdiction, or declines to tax – not consistent with dividends.
  - Gain on sale by nonresident of Country S intangible property: capital gain not taxed in Country S, either because not source jurisdiction or declines to tax – not consistent with royalties.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**
- **Treaties and Capital Gains:**
- *Allocate the taxing rights*: Primary effect of treaties on capital gains is to allocate the taxing rights as between the source and residence jurisdictions, thus the resulting possibilities:
  - Limited or unlimited right to tax capital gains for the source country (residence can also tax but must provide double taxation relief).
  - All taxing rights allocated to residence jurisdiction (source country barred from taxation regardless of underlying domestic right to tax).
  - Note: Source country jurisdiction to tax capital gains under the treaty cannot be exercised if there is no domestic law power to tax capital gains of nonresidents.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**
- **Treaties and Capital Gains:**
- *Allocate the taxing rights*: Treaty Practice
  - **Examples where allocation of taxing rights to capital gains match allocation of taxing rights to the income:**
  - Gains on directly held immovable property: Art. 13(1) in UN and OECD Models - source country may tax (consistent with rents in Art. 6).
  - Gains on assets of nonresident used in Permanent Establishment: Art. 13(2) of UN and OECD Models – source country may tax (consistent with business income in Art. 7).
  - Gains on ships and aircraft: Art. 13(3) of UN and OECD Models – only country with place of "effective management" of the enterprise can tax (consistent with shipping income in Art. 8).

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Tax Treatment of Capital Gains

- **Treaty Taxation:**
- **Treaties and Capital Gains:**
- *Allocate the taxing rights*: Treaty Practice
  - **<u>Examples</u> of mixed allocation of taxing rights:**
  - **Gains on indirect sale of immovable property: Art. 13(4)**

    UN Model Approach – gains from alienation of stock, or an interest in a partnership, trust, or estate if entity's property consists "principally of immovable property" in Country S may be taxed in Country S.

    Note:

    1. **"principally" means value exceeding 50% of the aggregate asset value held by the entity.**
    2. **Country S taxing rights on disposition of the indirect ownership interest do not apply if the property is used in the entity's business activities – unless in the entity is engaged in the business of management of immovable properties. Art. 13(4)(a).**

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Tax Treatment of Capital Gains

- **Treaty Taxation:**
- **Treaties and Capital Gains:**
- *Allocate the taxing rights*: Treaty Practice

<u>Examples</u> of mixed allocation of taxing rights:

- **Gains on indirect sale of immovable property: Art. 13(4)**

  UN Model Approach – Examples:

- Nonresident holds stock in a corporation whose sole asset is Country S land. If nonresident sells the stock at a gain, Country S may, pursuant to the UN Model, tax that gain, assuming the corporation is engaged in the management of immovable property.
- Nonresident holds a partnership interest in a partnership that owns Country S land, and this lands constitutes 70% of the value of the partnership. If nonresident sells the partnership interest, Country S may, pursuant to the UN Model, tax the capital gain on the disposition of the partnership interest, assuming the partnership is engaged in the management of immovable property.

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Tax Treatment of Capital Gains

- What seems to be the driving purpose of this treaty allocation rule?
- What does it miss?
- Now, consider the OECD treatment:

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Tax Treatment of Capital Gains

- Treaty Taxation:

– **Treaties and Capital Gains:**

***Allocate the taxing rights*: Treaty Practice**

Examples of mixed allocation of taxing rights:

– **Gains on indirect sale of immovable property: Art. 13(4)**

– **OECD Model Approach** – gains from alienation of stock may be taxed in Country S if the shares derive "more than 50 percent of their value directly or indirectly from immovable" in Country S.

» **How do the UN and OECD Models differ?**

- Scope of entity ownership covered.
- Activities performed by the corporation and their use of the underlying immovable property.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**

– **Treaties and Capital Gains:**

***Allocate the taxing rights*: Treaty Practice**

<u>Examples</u> of mixed allocation of taxing rights:

– **Gains on indirect sale of immovable property: Art. 13(4) :**
OECD Model Approach – Examples:

- Nonresident holds stock in a corporation whose sole asset is Country S land. If nonresident sells the stock at a gain, Country S may, pursuant to the OECD Model, tax that gain.
- Nonresident holds a partnership interest in a partnership that owns Country S land, and this lands constitutes 70% of the value of the partnership. If nonresident sells the partnership interest, Country S may not, pursuant to the OECD Model, tax the capital gain on the disposition of the partnership interest. See OECD. Art. 13(5) gains from alienation of property not otherwise specified shall only be taxable in residence jurisdiction.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**

– **Treaties and Capital Gains:**

***Allocate the taxing rights*: Treaty Practice**

<u>Examples</u> of mixed allocation of taxing rights:

– **Gains on indirect sale of certain shares: Art. 13(5) of ONLY the UN Model:**

- If nonresident holds stock in a Country S corporation, then gains on the disposition of the stock may be taxed by Country S if within the 12 month period preceding the disposition, the nonresident held "directly or indirectly at least __ per cent [percentage set by treaty] of the capital of that company."
- Example: In a treaty context in which Art. 13(5) specifies a threshold of 80%, if nonresident owns 82% of a Country S corporation, and sells the stock at a gain, Country S may tax that gain regardless of the specific composition of assets held by the corporation.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**

– **Treaties and Capital Gains:**

***Allocate the taxing rights*: Treaty Practice**

<u>Examples</u> of exclusive residence country taxation of capital gains: Consider the array of circumstances under both the OECD and UN Model treaties in which capital gains will not be taxable in the source country:

1. Movable property not part of a Country S permanent establishment (regardless of where income from the asset would be sourced). Examples – patent, copyright.
2. Stock where 50 percent or less of the value of the corporation derives from Country S immovable property.
3. Interest in an entity other than a corporation – under the OECD Model.
4. Interest in an entity where the entity is not engaged in the business of management of immovable properties – under the UN Model.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**

– **Treaties and Capital Gains:**

- *Defining Capital Gains*: No definition in UN or OECD Model Treaties
- *Treaty avoids need to define capital gains*: Scope of treaty allocation of rights to tax capital gains is determined by treaty phrasing: "gains" from the "alienation" of "property", where various limits are placed on the type of property in the treaties (e.g., movable, immovable, indirectly held under specific requirements).
- *"Alienation" in both Models includes*: sale, exchange, partial alienation, expropriation, transfer to company in exchange for stock, sale of a right, gift, and passing of property on death.
- *Alienation not currently taxed under domestic law*: If the alienation is not treated as a taxable event under the domestic law of the jurisdiction granted taxing rights, then that jurisdiction simply fails to exercise taxing rights granted under the treaty.
- *Nature or origin of capital gain*: The Models do not distinguish among the generators of gain, for example gain due to speculation, long term growth, or depreciation of national currency.

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Tax Treatment of Capital Gains

- **Treaty Taxation:**

– **Treaties and Capital Gains:**

***Differing tax bases*: Source and residence jurisdictions may both have taxing rights and calculate the tax base differently.**

<u>Examples</u>:

- **Taxpayer R, a resident of Country R, purchases immovable property located in Country S. If Taxpayer R sells the property for more than cost, Country S may chose to calculate the gain as gross proceeds without regard to cost. Country R may chose to calculate gain as the gross proceeds minus cost.**
- **Or, Country S may not permit Taxpayer R to offset its Country S capital gains by Country S capital losses.**
- **Or, Country S may tax Taxpayer R on gross proceeds minus cost, but not allow the deduction of additional related expenses (e.g., lawyer fees, bank fees).**

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Tax Treatment of Capital Gains

- **Treaty Taxation:**

– **Treaties and Capital Gains:**

***Conflicts of Qualification*: Country R corporation, with a subsidiary in Country S, receives payment on liquidation of its subsidiary. Country R views the payment at as a capital gain (for which is has exclusive right to tax under the treaty) and Country S views the payments as a dividend (for which Country R would be obliged to provide double tax relief under the treaty). See OECD Comm. Art. 13, Para. 31.**

- Unresolved – can lead to double taxation because Country S will tax as dividend and Country R will tax as capital gains and provide no double tax relief.
- OECD Model Commentary position: if the core of the conflict is different underlying domestic law classification of the payment, and if Country S is properly applying the treaty for the type of payment it sees (i.e. a dividend), the Country R should provide double tax relief. (OECD Comm. Art. 23 A & B. Para. 32.3). At present, UN Model Commentary does not address conflicts of qualification.

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

– **Three factors may contribute to the difficulties that countries experience in taxing nonresident capital gains:**

(1) Enforcement

(2) Tax avoidance strategies

(3) Developed country trends in capital gains taxation

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

(1) ***Enforcement:*** Source countries face several challenges in trying to enforce taxation of a nonresident's capital gains:

- ***Detection:*** Awareness of the alienation and resulting gain
- ***Collection:*** Inability to secure payment of tax
- ***Administrative Burden:*** Decision as to type and amount of enforcement resources devoted to identifying capital gains and collecting tax due

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

  (1) *Enforcement:*

– ***Detection:***

  - **Most difficult if both buyer and seller are nonresidents – funds all outside source jurisdiction.**
  - **Can still be difficult if buyer is a resident – depending on location of purchase funds, and reporting and documentation required of source country buyer.**

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

  (1) *Enforcement:*

– ***Detection:***

  Options:

  – ***Self reporting by nonresident seller*: Could be encouraged by penalties for failure to report – but if likelihood of detection is very low, penalties for nonreporting may be inadequate to prompt compliance (and may seem extremely harsh for the very few taxpayers caught).**
  – ***Reporting by purchaser:* If transferee is nonresident too, same problems as above. Caveat – because buyer does not bear tax, it may be more willing to report than the seller. If only a reporting burden on buyer – the collection challenge remains.**
  – ***Reporting by third parties:* Where third parties are integral to the transaction, e.g., property whose ownership must be registered, such as real estate, stock, ships, aircraft, then the third parties maintaining the registry may be required to report transactions.**
  – ***Tax consequences to nonreporting:* If source country refuses to allow an increase in basis when property is sold yet the capital gains are not reported, then the purchaser (who might find it difficult to avoid source country tax) will be unwillingly to pay the FMV because the purchaser is effectively taking over the seller's tax burden.**

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

  (1) *Enforcement*:

- ***Collection:***
  - **If the source country has limited control over the seller, then even knowledge of the alienation and resulting capital gains does not ensure collection of tax. For example, if nonresident seller has no other assets or accounts in the source country that can be seized, then collection of tax remains difficult.**

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

  (1) *Enforcement*:

- **Collection:**

  Options:
  - **<u>Final gross basis withholding by transferee</u> – typically at a reduced rate.**
    - ***Limits on effectiveness:* Nonresident transferee**
  - **<u>Interim gross basis withholding by transferee</u> – with nonresident transferor retaining option of filing a net basis return to reduce tax and secure a partial refund (either before or after the withholding).**
    - ***Limits on effectiveness:* Increases compliance burden because nonresident transferor needs to file to ensure taxed only on gain.**
  - **<u>Net basis tax filing obligation and payment by transferor directly</u>.**
    - ***Limits on effectiveness:* Makes most sense for nonresidents with many contacts and economic connections to the source country, and/or for nonresidents with source country losses it hopes to offset, or is engaged in business in the source country and more broadly subject to net basis taxation.**

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Tax Treatment of Capital Gains

➢ **Difficulties in Taxation and Possible Options:**

(1) *Enforcement*:

– **Administrative Burden:**

- **Not clear which countries have effective enforcement and compliance strategies.**
- **Data from countries with established tax administrations and with a tradition of reporting and evaluating success in tax administration offer little evidence.**
- **Efforts to identify repeat/high volume nonresident taxpayers, e.g., multinationals or frequent foreign investors, may usefully focus audit and compliance resources.**
- **Context specific consideration of how to design enforcement: centralized expertise, decentralized enforcement.**

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Tax Treatment of Capital Gains

➢ **Difficulties in Taxation and Possible Options:**

(2) *Tax Avoidance Strategies:* Although explicit nonreporting may be the most obvious path for nonresident to avoid source country taxation of capital gains, other techniques are available:

– **Examples:**

- *Holding companies in jurisdictions with favorable tax treaties:* Even if source country generally seeks to tax gain on disposition of certain assets, the country likely has treaties not reflecting that position.
- *Indirect transfer:* Holding the asset through one or more layers of domestic or foreign entities, where source country does not tax indirect transfers.
- *Manipulation of taxing thresholds:* Where source country imposes taxation on a nonresident's capital gains on alienation of, for example, stock in a company with more than 50% of its value in immovable source country property, then taxpayer may engage in short-term strategies to nominally reduce the percentage of assets represented by immovable property.

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Tax Treatment of Capital Gains

- **Difficulties in Taxation and Possible Options:**

  ***(3) Developed Country Trends*:** Overall low levels of source country taxation of capital gains may in part reflect decisions, experiences, policy choices and tradeoffs made by developed countries that might not support the same conclusion for capital importing countries:

  - Developed country preferences for residence based taxation
  - EU move towards more residence based taxation on certain intercorporate payments
  - Developed country interest in exempting dividends and providing parallel treatment for capital gains
  - Developed country experience with administrative burden of taxing nonresident capital gains

Tax Treatment of Capital Gains

- **Taxation of Capital Gains of Former Residents:**

  ***Key Concern*:** State preserves its taxing rights regarding capital gains that accrued while a taxpayer was resident in the state, and before taxpayer became a nonresident.

  Options:

  - **Exit tax:** imposed at departure through deemed alienation by departing taxpayer (i.e. taxpayer treated as if sold property).
  - **Trailing Tax:** former residence jurisdiction reserves the right to tax certain capital gains if the now-nonresident taxpayer alienates assets within a specified number of years of departure.

Thank you

Diane Ring