E/C.18/2019/CRP.22

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this paper. Section VIII addresses a separate issue that has been before the Committee and that is related to the application of Article 13: the application of paragraph 5 in cases when the shares alienated are owned by a fiscally transparent entity. Annex B contains a draft prepared by the Secretariat of a possible alternative version of Article 13(4) that allows for source taxation of gains from certain OITs.

I. ALLOCATION OF TAXING RIGHTS UNDER ARTICLE 13 OF THE UN MODEL

1. Article 13 of the UN Model allocates taxing right between the two countries party to the tax convention when a resident of one State alienates property located or connected in some way to the other State, although the taxing rights permitted vary and depend on the nature of the property that has been alienated. Paragraph 1 allows unlimited taxation on gains from the alienation of immovable property by the State where the immovable property is situated. Paragraph 2 allows for taxation of gains from the alienation of movable property of a permanent0(2)[(P)-3(a)4

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the foreign resident directly owns the shares of, or interests in, the resident entity that are alienated.

4. If, however, the ownership structure involves a chain of ownership and the shares or interests that are alienated are those in a non-resident entity, the conditions of application of paragraph 5 are not satisfied. Assume for instance, that in the example

Under the current drafting of paragraph 5 of the UN Model (and not taking into account the possible application of anti-abuse rules in certain cases), State S does not have a right to tax any gains from the alienation of the shares of XCo by RCo.

5. The issue of OITs grew in prominence with the Vodafone case in India, which was decided by the Supreme Court of India in 2012. Hutchinson, a Hong Kong-based multinational company, owned the shares of a holding subsidiary in the Cayman Islands which owned the shares of Vodafone Essar Limited, an Indian operating mobile phone company. The shares of the Indian operating company had been held by the Cayman company since 1994. In 2006, a Netherlands subsidiary of the multinational telecom group Vodafone acquired the shares of the Cayman company. The Indian tax authorities sought to collect $2.6 billion in tax on the capital gains realized by Hutchinson on the sale of the shares of the Cayman company. Vodafone disputed the tax assessment and, in 2012, the Supreme Court of India decided in favor of Vodafone, concluding that India did not have, under its domestic law, the right to tax gains from the sale by Hutchison of the shares of the Cayman company, a transaction that took place wholly outside India between parties that were not tax residents of India.

6. Subsequent to the court decision, India enacted legislative changes to ensure the taxation

through the transfer
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with the widely accepted policy to impose source tax on dividends paid to nonresident investors; and 3) many countries impose tax on OITs of immovable property, and it should not make a difference if the local asset is immovable or movable.

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may tax according to their own laws and that the State of residence will eliminate double taxation

26. *Achieve parity with taxation of direct transfers* One member of the Committee expressed the view that as a policy matter, he does not favor treaty provisions allowing taxation of gains from a direct transfer of shares of a local company. However, he observed that taxing gains from direct transfers when prescribed thresholds are satisfied has been a part of the UN Model for several years. He concluded that it would be appropriate therefore to bring the

intangible rights (such as a license to provide cell phone services), which she referred to as

29. A representative from the business community observed that in fact, the proposal treaty provision would effectively make paragraphs 1, 2, 4 and 5 of Article 13 of the UN Model totally

41. *Potential for multiple taxation* A policy concern that was mentioned by some Committee members during the April meeting may have also influenced the historical treaty practice for taxing capital gains, and gains from OITs in particular the risk of multiple taxation. That is, the taxation of an OIT should result in an increase in the cost basis of the local asset. This would be appropriate because the rationale of taxing an OIT is that it in essence constitutes a sale of the local asset.

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procedure, or at least requiring the competent authorities to negotiate and publish procedure for the application of the provision, including how double taxation would be relieved in both Contracting States.

44. *Potential for unrelieved double taxation* In addition to the potential for multiple taxation, the taxation of OITs also raises the question of whether double taxation would be sufficiently relieved even in cases when there are not multiple source countries and when a step-up in basis is allowed. Consider, for example the case of the transfer of ownership of the shares of RCo, a company resident of State R between two parties also resident of State R. RCo holds an interest in SCo, a company resident of State S. From the perspective of State S, this transaction has given rise to an OIT. It is unclear if, as a policy matter, State R would be willing to provide relief from double taxation to the State R company that sold its interest in RCo for what is reasonably viewed as a wholly domestic transaction. State R may therefore refuse to include an obligation to provide relief from double taxation in its tax treaty with State S.

45. Just as the obligation to allow an increase in the cost basis requires explicit wording in the tax treaty, the treaty may also require an explicit provision to ensure that double taxation is sufficiently relieved resulting from an OIT. In the example described above, it is likely that under the local law of State R, the transaction would give rise to domestic source income. Accordingly, in order to adequately alleviate double taxation, State R would need to accept to provide a foreign tax credit. While the wording of Articles 23 A and 23 B of the UN Model automatically provides for relief of double taxation where a treaty provision allows source taxation, a number of States depart from the
necessary for these States to ensure that relief is provided in these cases.

Administrative considerations that may have historically influenced Article 13 paragraph 6

46. *Detection* As was raised by some Committee members as well as representatives of the Secretariat during the April meeting, as an administrative matter, it could be difficult for the source State to know that an OIT has taken place, because it involves a transaction that has taken place wholly outside of the source State. This could be particularly true in situations when an OIT takes place several tiers up a chain of ownership. In his paper, Wei observes that as a general matter, well-crafted tax rules should attempt to maximize compliance by taxpayers. If taxpayers come to the view that a transaction could go undetected by the local tax administration, as could be the case with an OIT several tiers up the chain and thus, quite removed from the local asset, the taxpayer might conclude that there is little risk involved by not complying with a rule that would tax the gains of the OIT in the source State.

47. Tax administrations could impose information reporting requirements to facilitate the detection of OITs. The obligation to report the transaction could be imposed on either of the parties engaged in the transaction, on the local asset (or a local agent who acts as custodian of

expense, capital losses or depreciation. Accordingly, an accurate and equitable taxation of capital gains may argue for net-basis taxation and the filing of a tax return.

51. A general view that capital gains taxation is most properly achieved through the filing of a tax return may argue that taxation at source of capital gains should therefore require a sufficient nexus of the non-resident to the source State. This may in part have influenced the existing UN Model Article 13. That is, it could be said that the instances in which source taxation is allowed under Article 13: ownership of real property or an interest in real property, having a permanent establishment or fixed base, and owning a substantial interest in a local company each constitutes sufficient nexus to impose net basis tax through the filing of a local tax return.

52. The context of OITs raises an even more fundamental collection challenge: even if a source State chose to impose gross-basis withholding but at a lower rate to mitigate the inability to claim deductions and cost basis etc, the payment of the gross proceeds from the sale will have originated from outside the source State. Attempting to tax on any basis a payment from an extra-territorial source can be difficult to effectively achieve as an administrative matter.

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Does the Committee wish to explore the drafting of such an alternative provision (see Annex B)?

VIII. APPLICATION OF ARTICLE 13 PARAGRAPH 5 IN THE CONTEXT OF SHARES THAT ARE OWNED BY FISCALLY TRANSPARENT ENTITIES

54. Ms. Yan Xiong, a current member of the Committee, submitted the following issue for consideration:

on-resident taxpayer derives capital gains from China through a partnership set up in its residence country which treats partnerships as fiscally transparent. The partnership holds more than 25% of the Chinese company the shares of which have been alienated, while the partner holds less

55. The issue submitted by Ms. Xiong to the Secretariat may be analyzed through the following example. RCo, a company resident of State R, holds a 50 percent interest in RPSP, a partnership that is organized under State R law. RPSP is treated under State R law as fiscally transparent, meaning that the owners of RPSP are

and the source and character of the income flows through the partnership unchanged. RPSP in turn owns 25 percent of the shares of SCo, a company resident of State S. RPSP alienates its shares of SCo and realizes a capital gain of 100. Given the fiscally transparent nature of RPSP, State R will currently tax the 100 as capital gains in the hands of the partners, thereby taxing RCo on 50.

56. The R-S tax treaty follows the UN Model. Article 13 paragraph 5 of the R-S treaty is as follows:

Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or a trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least 25 percent of the capital of

57. Paragraph 5 applies to determine if State S has the right to tax the 50 of capital gains derived by RCo from the sale of its shares of SCo.

satisfies the ownership requirements prescribed.

58. The specific wording of paragraph 5 could arguably be read in two different ways in the context of that example.

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separated from the reference to the resident who derives the gain so that the alienator must be considered to be RCo. Since RCo only holds 12.5% of the shares of SCo (through its 50% interest in RPSP), the result of that interpretation is that the gain would not be taxed in State S under paragraph 5.

60. On the other hand, it could be considered that while RCo is the resident of a Contracting State that has derived a capital gain of 50, the alienator of the shares of SCo is

paragraph 5, and accordingly, State S is permitted to tax the gain derived by RCo.

61. The latter interpretation reflects more closely the wording of paragraph 5. In the above example, RCo is the resident of a Contracting State that has derived the capital gain.

shares of SCo satisfies the requirement of paragraph 5, and accordingly, SCo is permitted to tax the 50 of gains derived by RCo.

62. This interpretation also produces the right result if we assume a slightly different example under which RCo also owns directly 20 percent of the shares of SCo in addition to the 12.5 percent that it owns through RPSP. If RCo were to alienate its 20 percent direct holding of SCo shares and incur a capital gain of 80, RCo would in this case be considered both as the resident who derives the capital gain of 80 and the alienator of the shares for

percent (20 percent plus 12.5 percent through RPSOP), and thus, the requirements of paragraph 5 would be satisfied and State S would be allowed to tax the capital gain derived by RCo.

ANNEX A: E/C/18/2019/CRP.9

TAXATION OF CAPITAL GAINS ON OFFSHORE INDIRECT TRANSFERS UNDER DOMESTIC LAWS

1. Tax treatment of offshore indirect transfers

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.

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

[5]. 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

[5] [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-tax/F2 9.96 7E0 1 rg220887188005200brg03g2278 8/5200b04 T.76 101.04 Tm0 0 1 rg0 0 1 RG[(-)] TJETQ0.00

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

> resident. However, such gains may also be taxed in the other Contracting State if they ar

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.

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.