ATTACHMENT B:

CAPITAL GAINS TAXATION AND INDIRECT SALES

September 24, 2014

OVERVIEW

1. Executive Summary

[To be completed last]

2. Purpose

2.1 This note addresses the issues involved in deciding whether a tax should apply to capital gains in the extractive industries and then, if there is such a tax, the note explores some of the policy and administration issues involved in covering so-called "indirect sales" – whereby assets are not themselves sold, (as in Figure 1 below), but companies or other entities (often resident offshore) holding the assets directly or through further entities are sold (see a simple example at Figure 2). The perception is often that this structuring is designed to avoid capital gains tax on the sale by having the sale occurring at the level of a company in a low or no-tax jurisdiction, rather than there being a sale in a country where the extractive assets are located.

2.2 The issues are basically (i) whether such gains from indirect sales should be treated (by the country where the mine or other extractive assets are located) in the same way as in a direct sale of extractive assets and (ii) if so, how such a tax can be effectively implemented from the perspectives of administrations and taxpayers. The term "indirect sales" is used only for convenience in this note – most countries taxing such gains apply their legislation not just to sales where money changes hands, but also to many other dispositions, such as under "swap" (such as asset for share) or "farm-out" arrangements"[1]). Similarly, as noted below at 5.30(x)(b), the reference to extractive assets refers not just to physical assets, but also to the rights appertaining to their use, such as exploration and development rights. Some countries specifically provide for information relating to the extraction (such as survey information) to be treated in the same way.

2.3 A particular issue for revenue policy-maker and administrators will therefore be effectively implementing a policy decision to tax indirect sales of valuable extractive industry interests. Implementing such a regime involves informational and administrative issues for administrations. For taxpayers, it raises issues of their liability to taxation in a country that is neither their country of residence nor where a sale occurred, as well as issues of whether they will receive the burden of taxation, but not the benefits of a deduction either directly or factored into the price paid for the extractive-related interest.

Fig. 1: A Direct Sale

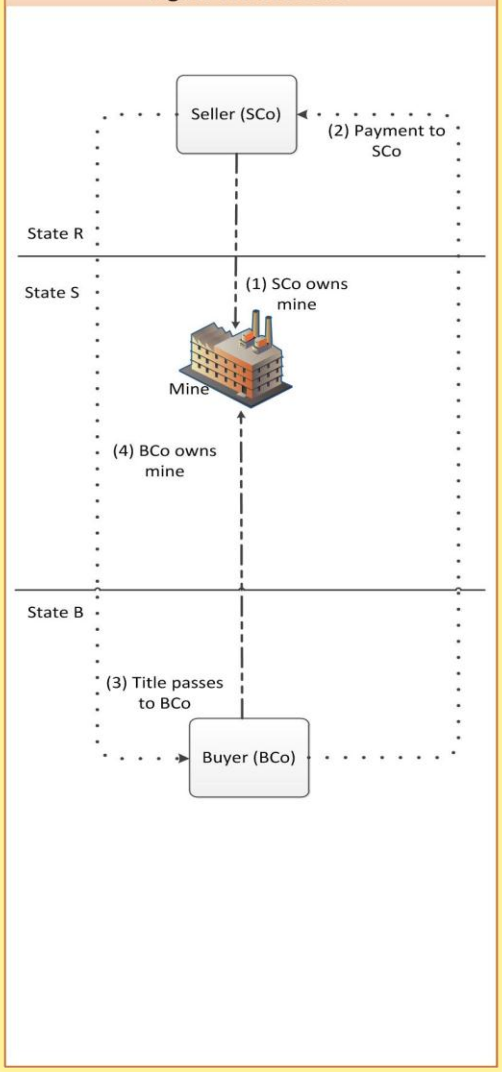
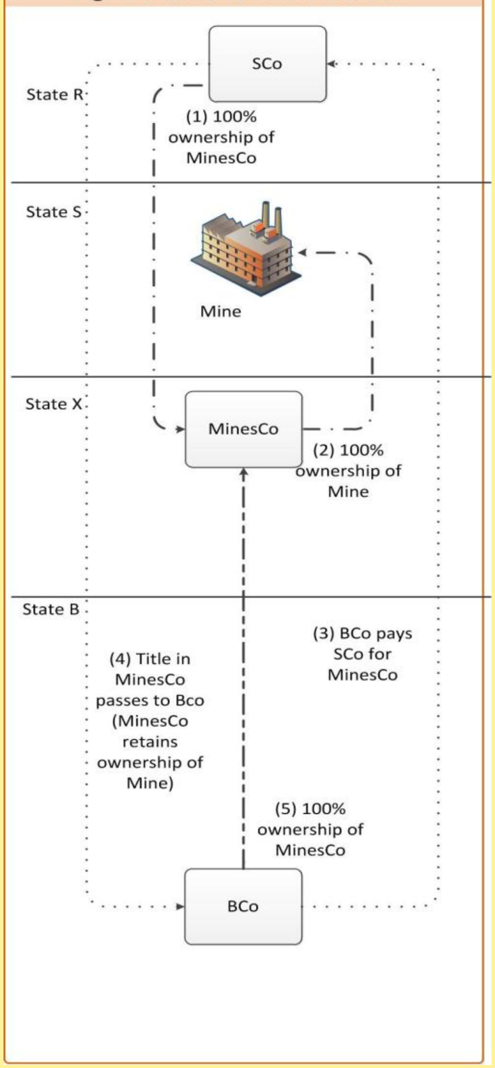


Fig. 2: One Form of Indirect Sale



[1] See the discussion in: Calder, J., *Administering Fiscal Regimes for Extractive Industries: a Handbook*, Washington, D.C, International Monetary Fund, 2014, p.87.

3. Status

3.1 This note is for guidance only. It is intended to address the issues in relatively brief form and to help build awareness of them, as well as to help put those faced with these issues in a better position to make policy and administrative decisions in relation to them. The Annex to this note gives a “decision tree” of major policy decisions that arise in this area.

4. Terms Used

UN Model = *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2011)[2]

OECD Model = *OECD Model Tax Convention on Income and on Capital (2014)*[3]

CGT = capital gains tax used generally in this note to include taxation of a capital gain either through a separate specific capital gains tax regime or through the general income tax system. […………………………..]

5. The Issues

(a) ***Should Capital Gains be Taxed?***

5.1 Before the issue of treatment of *indirect* sales arises, a first issue at the policy level is whether to tax gains made when an asset is disposed of *directly*, such as by sale, transferring, gifting or otherwise. Such a tax is referred to as a capital gains tax (CGT) in this note, although while in some countries such gains are subject to a distinct capital gains tax (whether comprehensive[4] or more specific) in others the capital gain will be covered by the general income tax provisions, rather than as a separate tax.

5.2 In a CGT what is being taxed is the *gain* made from the disposal, not the full amount received as proceeds. For a CGT to operate in a particular case, the *person* making the gain will have to be subject to the tax, the *type of asset* disposed of and the *type of disposition* will have to be covered by the tax and the *type of gain* made will have to be of a type covered by the tax.

5.3. It is recognized that policy decisions for or against taxing capital gains comprehensively will inevitably include reasons related in practice to passive assets rather than active assets. Such reasons might not be immediately relevant to the extractives sector, but are relevant to the wider issue of whether a comprehensive tax on

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[2] Available at http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

[3] Available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en

[4] In practice no CGT is completely comprehensive – the term is used here to mean a relatively comprehensive system of taxation of capital gains.

capital gains is introduced. The “active” nature of some holdings upon which gains are made is more relevant to the issue considered below at 5.30(ii) of whether there should be an exception for extractive industry assets.

5.4. In policy terms, there are many reasons why capital might be taxed, and not all of them will be directly relevant to sales of extractive assets or even other corporate assets. Reasons usually given *for* taxing such gains when made include the following:

(i) The need for base broadening – with a trend to wider bases and lower rates amongst many countries. The benefits from ownership of property and other forms of capital may not otherwise be as comprehensively taxed as income and consumption and expanding the tax base in this direction may also have lower economic costs than a rise in tax rates on income items;[5]

(ii) The concern that if there is no CGT (or even taxation at a lower rate), income will be shifted to capital, because of the inequities in treatment between income and such gains, thus distorting economic decisions. This is so called lack of horizontal equity between two persons earning the same amounts, one through a capital gain and one through normal income, ,such as wages or normal business profits. In fact a CGT should reduce an incentive, even within the class of capital assets, to investing in those most likely to produce capital gains.[6] Without CGT, there is a lack of neutrality in the system that prefers capital returns over normal income and creates incentives towards conversion of normal income into capital gains, or encourages converting, or appearing to convert, the former into the latter. Horizontal equity demands that individuals in similar economic circumstances should bear a similar tax burden irrespective of the form the accretion of economic power takes. In other words, taxpayers should bear similar tax burdens, irrespective of whether their income is received in the form of wages, or capital gain. In this context, the exclusion of capital gains from the income tax base fundamentally undermines the horizontal equity of the tax system. Even a country such as New Zealand, which has no comprehensive capital gains tax, nevertheless has effectively removed the capital/revenue distinction for debt instruments and taxes all gains as they accrue.

(iii) Such distortions can also lead to speculation and inflation of preferred classes of investments (such as the housing sector). This leads to inefficient allocations of resources, as well as the waste of human capital in re-characterizing income as capital gains and in combatting such attempts. The application of scarce resources to tax planning and tax avoidance is a dead-weight loss to society;

(iv) The richest persons (including corporates) will be most likely to make significant capital gains, and to tax capital gains reflects their greater ability to pay (as well as to convert income to capital). This is so called lack of vertical equity and it arises because one taxpayer is likely to have proportionately more capital returns, while the other earning the same amount is likely to rely more on normal income. Vertical equity connotes that taxpayers with greater ability to pay taxes should bear a greater burden of taxation. It is commonly accepted that capital gains accrue disproportionately to higher income individuals. Thus, including capital gains in taxable income contributes to the progressivity of the income tax system, while

[5] *A Tax System for New Zealand’s Future, Report of the Victoria University of Wellington Tax Working Group* (“New Zealand Tax Working Group Report”), 2010, p 16. Available at http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf

[6] New Zealand Tax Working Group Report, p 63.

enabling government to pursue other tax policy objectives, premised on widening tax bases and reducing standard tax rates;

(v) A comprehensive CGT represents a "safety net" that taxes economic gains that would avoid taxation as normal income. It thus implements a more comprehensive concept of taxable "income" than might apply on normal concepts, such as in case law. In some countries, the law might in fact already reflect this more comprehensive approach to "income tax"; and

(vi) Not taxing such gains (and with no corresponding deductions allowed) will not necessarily speed up the point when income is returned, as other means may be adopted to delay the operation coming into profit.

5.5 Reasons usually given for *not* taxing such gains when made include the following:

(i) That a comprehensive CGT may be too difficult to administer and the potential savings and investment distortions and other efficiency implications that may arise from a partial CGT (such as an over-encouragement to invest in domestic housing if there is an exemption for one's residence) ;[7]

(ii) The difficulty in identifying disposal events comprehensively;

(iii) The complexity of many comprehensive CGT regimes, especially for developing countries, with high costs to comply with them (for taxpayers) and to administer them (for the Revenue Administration). One US Senator stated in 2012 that: "[W]e must consider complexity. Experts tell us that about half the U.S. tax code – more than 20,000 pages – exists solely to deal with capital gains. That complexity, as well as the wide gap between the tax rates on income and capital gains, invites people to use all kinds of shenanigans to game the system"[8] (although this comment also reflects the problems causes by not taxing or differently taxing income);

(iv) Capital gains taxes are in a sense "voluntary" taxes, unlike (or at least more than) income taxes. Only if a taxpayer chooses to dispose of assets will they operate in respect of those assets. Economic decisions as to disposal will therefore be distorted by such a tax;

(v) The "bunching effect" - the gain is realized in the year of disposal sale and potentially pushes a taxpayer into a higher marginal tax rate than if an unrealized gain had been taxed each year. This only applies to taxpayers subject to marginal rates and can be avoided by lower rates, but the latter raises the issue of the equity as between taxation of income and gains and the ability to pay the tax in the absence of actual sale proceeds;

(vi) If the tax operates only on sale rather than on accrual (as it almost inevitably does in countries with a special tax on capital gains, with common exceptions for some assets more readily taxed on accrual),

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[7] See New Zealand Tax Working Group Report at page 11 Recommendation 6. http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf

[8] Baucus, M. (2012, Sep. 20). *Opening Remarks from Committee on Finance and Committee on Ways and Means: Tax Reform and Capital Gains*. http://www.finance.senate.gov/imo/media/doc/20120920%20MSB%20Opening%20Statement.pdf as cited in Phelan,J, "Preferential Treatment of Capital Gains", *2013 Contemporary Tax Journal 182* (Spring/ Summer).

there will still be differing treatment to that given to income, and some distortion of savings and investment decisions will remain;

(vii) The difficulty in accurately accounting for the component of a “gain” which is really due to inflation for assets held over many years;

(viii) That on a broad view the asset is already sufficiently taxed through income taxes, payroll or other taxes, taxes on salaries and transactions created as part of the economic activity, taxes on externalities such as environmental damage and so forth;

(ix) In particular, as the gain on which capital gains tax is paid forms part of the value of assets that are generally deductible against future income tax paid, it delays the payment of those taxes on income (because those deductions have to be exhausted) and therefore only represents a timing benefit to a revenue authority, but may impact some investment decisions; and

(x) Not taxing capital gains encourages investments (both domestic and international) by allowing them to occur at a lower economic cost, which in turn creates jobs and facilitates economic growth, although specific evidence of such a causative relationship is difficult to find.

(b) ***If Capital Gains are taxed, how should that be done?***

5.6 A **country’s domestic tax laws** could tax capital gains through:

(i) A **stand-alone Capital Gains Tax** on the gain made through the sale: CGT could be a comprehensive CGT where the disposal of any kind of assets would be subject to taxation. But also, a specific CGT could be configured, aiming to tax only certain assets or transactions. A comprehensive CGT could have exemptions or “rollovers” delaying the point of taxation for certain types of assets or in certain types of events. Such exceptions can distort economic decisions in favour of certain types of assets, but a country may regard that as appropriate to encourage investment in that area. In practice it would be very rare for the CGT regime to exempt assets used in resource extraction, particularly the exploration and extraction rights and the extractive facility itself, from the operation of CGT.

As to the events that trigger a CGT liability, there might be some capital gains tax events where concessional treatment is considered appropriate to facilitate investment where a concession is not seen as abusive of the CGT system. For example some types of corporate restructuring within a corporate group may be treated as not creating a CGT event, even if they technically appear to result in a disposition. Liability may be deferred, for example, unless and until there is a disposal to an unrelated party. Even if such an approach is taken, it might only apply in circumstances where the restructuring will not lead to reduced CGT liability at a later stage. This issue is specifically considered below (at paragraphs 5.23 and following) in the context of indirect sales. Obviously, if there are different rates for capital or income gains, or if the rules operate differently there will be clear incentives to “convert” capital gains to income gains or vice versa.

(ii) **A Corporate Income Tax (CIT) that encompasses capital gains:** Assuming that the benefit of the asset’s sale is necessarily registered in the Profit & Loss account, such gain would be taxed for domestic CIT purposes if the seller is a company considered to be a tax resident or if it is an international company operating through a Permanent Establishment in the country. Under this scenario, the gain would be integrated in the general income tax base and the corporate income tax rate would apply.

At this point, countries wishing to relieve the tax burden (such as part of the general investment climate, or because they believe sales of such assets may encourage more motivated, better equipped sellers) could allow for tax deductions directly related with the sale, provided certain requirements are met. However, the current trend is for wider tax bases (rather than narrower bases) combined with lower rates.

For CIT purposes, capital gains could also be considered separate from other sources of rent, being taxed at the general tax rate or at a different rate, depending on country policies towards investment. In this regard, lowering tax rates applicable to capital gains could encourage transactions that otherwise would not be viable in terms of tax cost, although it also carries with it the risk of income gains being converted to capital gains.

(c) ***Should Gains in the Extractive Industries Have a Special Treatment?***

5.7. An argument often put against taxing capital gains in this area, although it could be considered an argument against capital gains tax generally and is, on that basis, addressed above, is that as a capital gain is achieved because of the potential profits of the facility in the future, and because those profits can still be taxed over time through income based tax, a tax on the gain is economically unjustified and merely brings forward payments, which may not be in the best interests of investment climates and country development. The economic benefit realized by the seller of assets (as a separate taxpayer) should be taxable.

5.8. Some countries might consider that unrelieved capital gains taxation might be inappropriate to the class of actively used assets to encourage investments in certain circumstances. For example Australia has an active assets capital gains tax reduction of 50%, but only for small business. Canada also has certain exemptions for certain types of active businesses, but again only for small business. South Africa does not tax capital gains on the disposal by individuals of small businesses under certain circumstances. While an exemption might be possible for gains made on extractive industry assets generally, particularly where returns might, at least in early years, be more marginal, such exemptions are not at all common in practice. Perhaps this is because of public expectations that such gains should in principle be shared with the country through taxation, and perhaps also on the basis that if a main reason for not having a CGT is to encourage investment, the reasoning may not hold in the case of projects that would go ahead even without this measure, a common perception in relation to extractive projects.

5.9. More likely than a special exemption for the extractive industries then, is that countries *without* a general capital gains tax will have a provision bringing gains in that sector into the tax base. Kenya for example has suspended the operation of their CGT since 1985, but has recently introduced legislation imposing a 10 per cent final tax on residents (20 per cent non-final on non-residents) for gains on the transfer of shares or property interests in oil and gas, mining or prospecting companies.

5.10. Other countries which do not have a general tax on capital gains often have special extractive industry legislation, such as New Zealand's provisions that in effect ignore the normal distinction between capital and income returns on asset sales so that capital gains are treated as income. The New Zealand provisions include, for example, information obtained as a result of exploratory or prospecting activities. However, there are some exceptions in the case of sales of shares in very closely held corporations.

5.11. One important factor in the general taxation of capital gains in the extractives industry is probably the widespread public view that sales of large scale extractive facilities should bring a return to the government, especially as profits are often seen as "a long way down the road". There are other factors in this debate. There are widespread concerns (whether justified or not in particular cases) about profit shifting, through internal transactions and the engagement of multinational corporations active within international financial and commodities markets, and how this may prevent their operations ever apparently coming into substantial profit. There are also concerns that concessions given on other taxes as an incentive to invest and which are often not public, may in any case mean that the theoretically delayed income taxes will never be paid.

5.12. Even if it is the case that this aspect of capital gains is often not understood, there will be a timing difference between the receipts that may be especially significant for developing countries, and the time value of money advantages the country gaining early receipt. There is also great suspicion (justifiable or not in particular cases) about whether companies that are actually generating profit are paying taxes on that basis, especially with international concern at profit shifting.

"It is often argued that it is politically unfeasible in developing countries not to tax billion dollar sales of the right to exploit national resources. One of the very few ways that a government can extract revenue from extractive sector projects that will not generate a profit for years or even decades is to impose a tax on capital gains.

The early injection of substantial revenue from capital gains taxes is obviously very welcome. In some cases it is seen as a major victory over powerful international companies and a redress to generous tax concessions offered in the original contracts. The significance of capital gains tax payments is often not well understood. In most countries, the capital gains tax is deductible against future assessments of taxable income. This means that a capital gains tax is not an additional source of government revenue. It does enable the government to bring forward some future revenue. But it also generates additional deductions against company taxable income. Securing early revenue in advance of production delays the onset of profit based taxes (IRPC) and pushes back the date when government revenues will become significant. The resulting offset in medium-term government revenues is considered, if it is even considered at all, a small price to pay for substantial early revenue."

'Taxing "Capital Gains" in Mozambique's Extractive Sector', Centre for Public Integrity, May 2014 (http://www.cip.org.mz/cipdoc/307_Spinformacao_2014_04_en.pdf)

(d) ***Farm-out and Farm-in Agreements***

5.13. One distinctive characteristic of the extractive industry is that investors often spread their risks by carrying out large natural resource operations jointly[9]. Often these joint ventures are formed after one party has already engaged in substantial activities to acquire licenses and conduct exploration activities. As a result of such activities, the value of the initial investment in the extraction project may have substantially increased. To attract other investors to share in the cost and risk of developing the project, the initial investor will need to transfer a portion of the project to the investor. How a country's tax system treats the formation of a joint venture to develop an extractive project will often have consequences on the decision to go forward with the development opportunity.

5.14. One aspect of this sharing of risks is that of "farm-out" agreements. These are agreements where a party with an oil or gas interest termed "the Farmor" agrees to assign part of an interest to "the Farmee" in exchange for certain contractually agreed services. Typically these services include drilling a well to a certain depth, in a certain location, in a certain timeframe and the agreement also typically stipulates that the well must obtain commercial production. After this contractually agreed service is rendered, the Farmee is said to have "earned" an assignment. This Assignment comes after the services were completed, and is subject to the reservation of an overriding royalty interest in favor of the Farmor.[10] From the Farmee's perspective these are known as "farm-in agreements".

[9] Jack Calder (2014). *Administering Fiscal Regimes for Extractive Industries: A Handbook*. Washington, D.C: International Monetary Fund.

[10] Austin W Brister (2013). "Farmout Agreements: The Basics, Negotiations and Motivations". Available at: http://www.oilandgaslawdigest.com/ogagreements/farmout-agreements-basics-negotiations-motivations/

From the United States Internal Revenue Service Oil and Gas Handbook:*

1. Frequently promoters, accountants, lawyers, geologists, operators, and others receive an interest in an oil and gas drilling venture in return for services rendered. These services may have been rendered in acquiring drilling prospects, evaluating leases, packaging the drilling program, or, in general, administrative services such as formation of partnerships, filing with Securities and Exchange Commission (SEC), and other functions.
2. It is a common practice for the promoter or sponsor of a drilling package to acquire part or all of the interest in the drilling venture in return for services. GCM 22730, 1941–1 CB 214, provided that the receipt of an interest in a drilling venture in return for capital and services furnished by a driller and equipment supplier was not taxable on receipt. This ruling provided for the "pool of capital" doctrine that is widely quoted in oil and gas tax law. The same reasoning has been extended to geologists, petroleum engineers, lease brokers, accountants, and lawyers who receive an interest in an oil or gas drilling venture in return for services rendered. This doctrine resulted from the court decision in *Palmer vs. Bender*, 287 U.S. 551 (1933); 1933–1 C.B. 235; 11 AFTR 1106; 3 USTC 1026.
3. The "pool of capital doctrine" is widely accepted by accountants and lawyers and is still quoted to justify the tax-free receipt of property for services. Subsequent changes in the tax laws, and subsequent court cases, have significantly limited the use of GCM 22730. […]

8. While the pool of capital doctrine is still viable in specific factual circumstances, it does not equate to a special exemption from IRC 83 for the oil and gas industry. Generally, for the pool of capital doctrine to apply, all of the following must occur:
   A. The contributor of services must receive a share of production, and the share of production is marked by an assignment of an economic interest in return for the contribution of services.
   B. The services contributed may not in effect be a substitution of capital.
   C. The contribution must perform a function necessary to bring the property into production or augment the pool of capital already invested in the oil and gas in place.
   D. The contribution must be specific to the property in which the economic interest is earned.
   E. The contribution must be definite and determinable.
   F. The contributor must look only to the economic interest for the possibility of profit.

* At 4.41.1.2.3.1 (Services Performed for Oil and Gas Property Interest), available at: www.irs.gov/irm/part4/irm_04-041-001.html

(e) Taxation of gains from “indirect sales” as an option

5.15. It is a policy decision for each country whether it should address gains made from indirect sales, but there are increasing expectations, including from the broader citizenry, that if direct sales of a mine or other extractive facilities are subject to taxation on the gains made, an indirect sale should have the same effect in revenue terms, despite the lack of any change in the direct ownership of the assets, and the separate legal entity status of distinct companies in the chain of ownership. The value of such extractive facilities is no doubt one reason for the particular focus on such facilities as is the diminishing nature of the extracted resources. It is fair to say, however, that the informational and other compliance and administrative issues in taxing indirect sales are not often discussed in detail in such debates.

5.16. Those arguing against taxation of indirect sales often express the view that because of the separate legal entities involved, taxing such sales happening in a foreign country and which do not have one of your residents as a party to the sale, in effect constitutes an extraterritorial taxing right over foreign economic activity by foreign people.

5.17. Unless officials can be confident that anti-abuse rules applied by the courts - such as a general anti-avoidance rule (GAAR) - will be applied to indirect sales just as for direct sales (and such a situation might be rare, especially in view of the many possible non-tax related reasons for an indirect sale) more specific domestic legislation would be necessary to achieve this result.

5.18. There are other reasons favouring specific domestic legislation rather than reliance on a GAAR, including that it can be more precise about who must bear the compliance obligations, and what the obligations are. It can, for example, focus on related party sales, minimum shareholdings and off-stock exchange sales to limit the impact on those who are not perceived as the major problem and who might have limited ability to know that a regulated indirect sale of land in another country has occurred. Finally, it need not depend on a “purpose” test (which can be difficult to prove), but more “scientifically” treat an indirect sale as equal to a direct sale irrespective of the purpose of the sale..

5.19. Any such legislation needs to be seen in the context of a country’s tax treaty network. Tax treaties cannot give a taxing power that does not exist in domestic legislation, but they can either allow it to be exercised or can prevent it from being exercised. It is therefore important that a country’s tax treaties preserve that country’s right to apply the domestic legislation in that treaty relationship. It is also strongly advisable that all treaties consistently preserve these rights, otherwise there would be an inducement to use “treaty shopping” techniques to have the sale occur in a state against which the domestic legislation of the other state is overridden by treaty rules (i.e. where no taxing right is preserved). This issue is discussed further below (from paragraph 5.26 onwards).

(f) The Issue of Symmetry

5.20. Whatever approach is taken to the application of a general or specific capital gains tax provision, a factor in the policy decision is the possibility of asymmetries of treatment. From the revenue perspective, a country will not want to allow deductions for the purchase of a mine, and yet be unable to tax profits made, while on the other hand, it may deter economic activity if gains are taxed but no deductions are available for the cost of acquiring an asset. Some countries address this, in the context of indirect sales, by deeming a sale and then a reacquisition immediately before the sale, thus confirming a liability to domestic tax, but also a deduction for the cost of the deemed acquisition.

However, in indirect purchase transactions the purchaser would as a general rule not be the entity conducting the extractive business and should not be able to claim a deduction, unless it on-sells the indirect interest. In that case the actual purchase price will be deductible against sale proceeds of the indirect interest in the extractive business.

If countries frame their indirect sales legislation relatively narrowly, to deal with what are perceived as abusive cases (less likely to involve unsuspecting buyers and sellers and more likely to involve a purpose of avoiding tax on a sale) they may be less willing to grant symmetrical benefits to the buyer.

5.21. Countries will also take different views on whether to ensure symmetry in treatment of taxpayers by either (i) taxing gains to the Seller but allowing a deduction for the Buyer or (ii) not taxing the Seller and not granting deductions to the Buyer. The former might be preferred by those preferring payments as early as possible, and with less concern at the budgetary implications of the "lumpiness" and difficulty in predicting such payments. The latter approach might be preferred by countries confident that any profit will be properly recorded and will be taxed in practice, and which regard such profits as more readily calculated and more predictable over time.

5.22. Some countries might consider, however, that even if a comprehensive CGT is appropriate in most cases, there should be exceptions, such as by exempting particular transactions or granting "rollover relief". It is possible that some countries would see this as appropriate to attract investment in the extractive industries, or to encourage conduct of extractive operations by those most motivated and best equipped to effectively and efficiently extract the resources, and meet relevant contractual and other legal requirements. Although it does not necessarily follow, of course that a new operator will lead to more productive operations (and it may lead to job losses and cost cutting of course) there have been instances where new owners have unlocked the potential of an operation previously thought marginal or where the initial operators do not have the financial backing or expertise to properly exploit a site's potential.

(g) ***Indirect Sales and Corporate Structuring***

5.23. There may be many business reasons for a corporate restructuring, such as adapting to changes in markets, the way in which the business is conducted, or in management approaches. Restructuring could be undertaken in preparation for a share market float, to prepare for a sale of some or all of the business, or to raise capital, for example. Such a restructure can lead to dispositions and could lead to an "indirect sale" of an asset in another country.

5.24. Some countries provide capital gains relief for dispositions arising from certain corporate restructures, such as between related companies. South Africa's intra-group roll-over relief is an example. A policy issue is whether any indirect sales legislation should receive similar relief where there is in effect no sale to a third party. This could perhaps be done by deferring any liability until there is a sale to an unrelated party or a transaction that could result in the intent of the law being subverted.

5.25. In relation to its Circular 698, for example, China is reported to be considering addressing these issues by providing relief for internal group restructures that meet a reasonable business purpose test. Factors that a country might examine in such a situation might be whether the restructure is purely among related companies, whether it would alter the operation of the indirect sales legislation (such as by reducing the proportion of assets that are classified as immovable property, as compared with other assets) or whether it would otherwise reduce the capital gains liability.

(h) ***What are the Double Tax Treaty Aspects?***

5.26. 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 (not, in the view of some, for the benefit of the revenue). This means that if domestic law provides for the taxation of offshore indirect sales, any 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 allows the domestic law to operate as intended or restricts its operation to the advantage of a taxpayer.

5.27. The consequences of this relationship between tax treaties and domestic law is that;

(i) If there is no domestic law in place taxing gains from indirect sales, the treaty will not address the deficiency by creating a taxing right;

(ii) Any treaty right for the country where the assets indirectly sold are located will merely represent an unexercised right to taxation unless and until the domestic law is amended to tax indirect sales;

(iii) A treaty right to tax need not have all the detail of the domestic law, but as it needs to be at least as wide in operation as the domestic law it should be broadly expressed (as in the UN and OECD Model Conventions discussed below from paragraph 5.28 onwards); and

(iv) 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, and any attempt to change that by amending domestic law may be a treaty override contrary to the terms of the treaty.

5.28. Assuming domestic law on taxation of indirect sales is in place or is being kept open as a possibility, the question is then whether the treaty limits such an exercise of taxing rights and thereby overrules the legislation to some degree. To consider that issue, the provisions on Capital Gains (often Article 13) of a specific tax treaty have to be studied:

Capital Gains under the UN Model: Article 13

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

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:

(a) 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.

(b) For the purposes of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding fifty percent of the aggregate value of all assets owned by the company, partnership, trust or estate.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of __ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

… and under the OECD Model: Article 13

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

Definition of “Immovable Property in Article 6 of the UN Model (and in the OECD Model):

2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

(i) ***Article 13 (Capital Gains) and Indirect Sales***

5.29. Assuming the sort of indirect sale illustrated in Fig. 2 of Section 2 of this note, how might the basic provisions of Article 13 noted above apply?

Paragraph 1 would not obviously apply, as there is no alienation of the immovable property itself, at least directly. The anti-avoidance rules provided for in the Commentaries to Article 1 of the UN and OECD Model Conventions may in some countries allow for coverage of indirect sales, but this will rarely be clear, and may widely be regarded as an interpretation no longer open under paragraph 1 where there is a specific provision on indirect sales, because of the presence of paragraph 3. This reflects the common legal principle that specific coverage with limitations implies that a more general coverage is not intended.

Paragraph 2 would not apply, as the shares sold are not effectively connected to the permanent establishment, comprised by the extractive facility.

Paragraph 3 would obviously not apply, as it relates to ships and aircraft.

Paragraph 4 specifically applies to address indirect sales of immovable property. The UN version of the Paragraph differs, as noted above, from the OECD version. This paragraph (often referred to as the "land-rich" entities provision) is considered in more detail in paragraph 5.30 below.

Paragraph 5 would only apply to shares in "land-rich" companies themselves, not to other interests of a type referred to in Paragraph 4 (such as interests in trusts). The Paragraph only applies if they are shares in a company resident in the country seeking to tax the sale (i.e., the state where the underlying mine or other facility is located). That will usually not be the case.

Paragraph 6 merely confirms that unless the country where the extractive facility is located has a taxing right preserved by the preceding paragraphs, only the residence state of the seller of the shares can tax profits made, and that will usually be another country.

(j) ***Shaping an Effective Land-rich Entities Regime in Domestic Law and in Paragraph 13(4) of Tax Treaties***

5.30 There are many choices involved in relation to a specific "indirect sale" provision in a tax treaty, and of course the results of those choices will have to be negotiated with other countries, many of whom will have differing views. The choices include:

(i) Whether to have a specific indirect sales provision at all:

   a. As noted above, unless there are domestic law provisions giving taxing rights or negotiators want to ensure that any such future legislation will not be rendered ineffective in a treaty relationship, there is little point negotiating for a provision such as this where the other negotiating party does not seek it. The other side will almost inevitably seek some concession from your preferred text in return for a treaty provision that may not advance your country's policy interests and revenue base.

b. The advantage of a specific provision is that there is a clear coverage of indirect sales – unless there are court decisions on the coverage of indirect sales under Paragraph 1 in a country (something that is likely to be very rare). It reduces the risk of an interpretational difference between two countries that leads to both claiming competing taxing jurisdiction under Paragraph 1, and possible unresolved double taxation. This could negatively impact the investment climate.

c. A potential disadvantage of a special provision is that, because of the specific requirements before it can apply (noted in more detail in the next subparagraph) it can not only reduce the likelihood of a purposive, anti-avoidance approach to paragraph 1 by the courts, but can also serve as a (not easily amended) "road map" for avoidance.

(ii) Whether there should be an exception for immovable property used in an extractive business:

a. The UN Model provides at Paragraph 4(3) that:

"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."

b. It is not entirely clear what the central phrase "used … in its business activities" means. On one view, any holdings of mines and other facility, as well as mining leases and other related immovable property leases would inevitably fall outside the scope of the indirect sale provision, as they are actively being used in business activities. On another view, however. more is required, since merely holding an asset, for example. is not a use in *one's own* (as a distinct legal entity) business activities. Further, Company A owning Company B that holds an asset does not mean that Company A is *using* Company B's asset in *its* (i.e. Company A's) business activities. On this view, there has to be direct active use, not just a passive holding. In other words, indirect holdings are explicitly addressed by this paragraph, but "indirect use" through the mining operator further down the chain is not treated as a *use* in its business activities by the company higher up the chain, perhaps several companies removed.

c. The Commentary does not address the interpretation of this provision, added as part of the UN Model as amended in 1999 and published in 2001, in any detail, but some support for the latter view can be found in the Commentary comments that: "[Paragraph 4] is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company." And that: "[i]t also decided to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities." [11]

d. On the other hand, those opposed to the latter interpretation would point out that the paragraph may have little meaning if it were the correct interpretation, as companies rarely if ever themselves "use" the assets of their subsidiaries in their operations. They would also point to the discussion of

[11] Page 233, at Paragraph 8.

the same issue in the OECD Commentary at paragraph 28.7" "Also, some States consider that the paragraph should not apply to gains derived […] where the immovable property from which the shares derive their value as immovable property (such as a mine or a hotel) in which a business is carried on. On this view, indirect sales which in effect looks through the separate entity structure should also look through that structure to find that use of an asset in business by the company situated in the country claiming taxing rights should, in the terms of Article 13(4), mean that asset is not included as an immovable asset in any calculations required by that Article.

e. If such a provision is used there needs to be a common understanding between the treaty partners about the scope of the provision, and its particular impact on the extractive industries.

(iii) Whether gains on such a sale should be deemed to be sourced locally:

a. Where there is legislation it should provide that the gains made are sourced locally when the immovable property is located locally. This could be limited to the proportion of the gains that reflects the proportion of the value of shares sold corresponding to the proportion of local immovable property to other assets.

b. In tax treaty terms, the domestic legislation will not by itself ensure that the gain is treated as sourced in the country of the immovable property asset. To avoid double taxation based on source it is therefore important to specifically address such sales in treaties, such as in some form of Article 13(4) provision which specifically allows the country of the asset a taxing right. Of itself it will not prevent a third country with which no treaty exists from claiming source taxing rights under its own law.

c. While some provision such as Article 13(4) is needed to preserve the taxing right, the specific rule deeming such gains as locally sourced should be placed in domestic law.

(iv) Whether an indirect sale provision should extend beyond sales in shares:

a. If the indirect sales provision is confined to the sale of company shares, it would be easy to avoid it (such as by using a unit trust, and selling units). The UN Model was thus revised in 1999 (published in 2001) to extend the rule to trusts, partnerships and estates. The OECD Model has an option at paragraph 28.5 to cover "shares or comparable interests". There seems to be increasing use of these sorts of extensions. There may be some benefits in a clause blending these two provisions such as to cover "shares in companies as well as [similar] interests in trusts, partnerships, estates and the like".

b. The specific rule extending taxing rights beyond sales of shares to cover other interests would need to be reflected *both* in the treaty provision preserving the taxing right and in the specific domestic legislation - to ensure that the treaty right is implemented in practice.

(v) What valuation method should be used:

a. Paragraph 4*(b)* of Article 13 of the UN Model provides that: *(b)* For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate. This is merely repeated in the Commentary on that Article, without more elaboration of how it is to be applied in practice..

b. The OECD Commentary on Article 13 provides at paragraph 28.4 that: “paragraph 4 allows the taxation of the entire gain attributable to the shares to which it applies even where part of the value of the share is derived from property other than immovable property located in the source State. The determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).

c. It seems that practice on whether countries use Fair Market Value or Book Value as the valuation method is very varied. Some countries have a blended requirement that allows the latter to be used in some circumstances unless there is any reason for a shareholder to suspect that it does not fully reflect the underlying value of the immovable property, as compared with other assets. Many, probably most countries do not seem to include intangibles in the calculation, perhaps in part because of the difficulty of accurately calculating this.

(vi) Whether there should be an exception for shares quoted on a [relevant] stock exchange:

a. This is sometimes used as a mechanism to reduce compliance costs (and administration costs) in cases where there is a genuine share market transaction. It would usually be defined to include at least the share markets of the two treaty countries, and in the case of domestic legislation operating even without a treaty, the legislating country’s stock exchange(s) . However, critics would say that this has no bearing on ensuring that indirect sales are taxable in the same way as direct sales.

b. The specific exception for such on-market sales would only need to be reflected in the domestic legislation if there is a taxing right such as under Article 13(4), since it narrows rather than extends the treaty right.

(vii) What should be the percentage of the gain taxed:

a. The provisions in the UN and OECD Models allow, when the company meets the requisite test for domestic immovable property holdings, for taxing of the whole gain, not just the percentage of it relating to immovable property in the taxing jurisdiction, but some countries provide a moderating effect in their domestic laws so that only that percentage is taxed.

(viii) How can abuses be addressed within Article 13(4):

a. Some countries provide that the gain will be taxable if the percentage test for immovable property was met at any time in the year before sale – this is to prevent manipulation of indirect assets held temporarily when the sale occurs.

b. The question has sometimes arisen about whether Article 13(4) may still apply, if a company borrows money just before the share sale to dilute the percentage of assets constituted by immoveable property. Some countries take the view that as the OECD Commentary states at paragraph 28.4 that debt should not be taken into account in the valuation of the property of the company, the moneys borrowed should not be taken into account to dilute the percentage of immovable property interests. Others more specifically address this, as many do not see the implication as flowing necessarily from the OECD Commentary. This part of the OECD Commentary is not quoted in the UN Model Commentary in any case.

(ix) What are the possibilities for limiting the compliance difficulties in taxing capital gains:

a. One of the difficulties is that of how a shareholder will know if the test of indirectly held immovable property subject to taxation on indirect sales has been met in a particular country. As it is often not clear whether the information could be effectively requested from the company, especially at a particular point of time, and as knowledge of immovable property held is not enough, the taxpayer would need to know where it is held. Even access to balance sheets may not indicate all of the assets of a company, or whether they are properly classed as "immovable" under relevant legislation. For these sorts of reasons, a number of countries such as Australia (10 per cent) and the US (5 per cent) have *de minimis* standards in their domestic law so that small shareholders (portfolio investors) are not burdened by this requirement. South Africa has a 20 per cent threshold test for the taxpayer and related parties' total holdings. These sorts of provisions may be especially relevant in the case of non-corporate vehicles, where less information is usually publically available, though controlling interests may be more common.

b. As noted above, some countries such as China do not apply the laws where the shares are openly traded on certain stock exchanges, such as those in the treaty countries, thus reducing compliance and administration costs.

c. South Africa only applies its legislation to non-residents where 80 per cent or more of the market value of the holdings (shares in the case of a company) derives from South African immovable property (otherwise than held as trading stock), and where the non-resident (together with related parties) holds directly or indirectly 20 per cent or more of the shares in the company or ownership or right to ownership of another entity.

d. Recognizing that the percentage of assets may vary over time, some countries allow shareholders to take the proportions from the most recent accounts (i.e. not on the day of the sale) unless they have reason to believe that the accounts will not reflect the reality on the day of sale. Malaysia, for example, allows the taxpayer to submit the audited accounts of the company for the financial year which is closest to the date of the sale. In the United States, if there is a sale between two balance sheet dates, the U.S. corporation must nevertheless be able to demonstrate whether it is a US Real Property Holding Company (the US legislative term for a "land-rich company") on the date of sale. A U.S. corporation can rely on the most recent balance sheet (*i.e.* quarterly, monthly, *etc*.) and determine whether there was a material shift in value or whether an additional relevant date was triggered in between the balance sheet date and the date of sale by the foreign taxpayer.

(x) What is the importance of the domestic meaning of "immovable property":

a. Countries seeking to tax indirect sales resulting in capital gains, and having treaty clauses similar to Article 13(4) need to take stock of their domestic law meaning of the term "immovable property". This is especially because the term "immovable property" is not defined in Article 13. This means that it either (i) looks to domestic law unless the context requires otherwise; or else (ii) follows the definition in Article

6. The definition in Article 6 is not expressed (unlike the Article 3 definitions) to apply for the purposes of the Convention as a whole, but unlike the definitions of dividends, interest and royalties, it is also not expressed to apply only for the purposes of the Article (i.e. Article 6).

b. Most therefore regard the Article 6 definition as applying to Article 13, by inference. This takes us back to the meaning in domestic law, but ensures that, whatever domestic legislation says, would mean that "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources" are covered by the definition.

c. To guard against an interpretation that the term "immovable property" takes its meaning from domestic law only, with no "supplementation" from the Article 6 definition, countries should consider reflecting the Article 6 definition coverage, as a minimum, in domestic law. They might also consider it helpful to specifically clarify in domestic law the tax treatment of rights relating to the mining/oil or gas production, including reconnaissance and/or exploration related rights as well as the extraction (i.e. development) licenses themselves, and possibly surveys and other non-public information pertaining to the immovable property.

d. It should be noted that the reference is to the domestic law "meaning" of immoveable property" and in some countries it might not be considered necessary to specifically define "immovable property" because the meaning of the term is sufficiently clear. As noted in the box below, Australia has legislated that the term "immovable property" encompasses the term "real property" more commonly used in Australian law.

An Australian Definition:

A capital gains tax asset is *taxable Australian real property* if it is:

(a) Real property situated in Australia (including a lease of land, if the land is situated in Australia; or

(b) a mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry rights are situated in Australia.

(Section 855-20 *Income Tax Assessment Act 1997*).

Note: draft legislation (the *International Tax Agreements Amendment Bill 2014*) was introduced into the Australian Parliament on 17 July 2014. It would clarify that the term "immovable property" encompasses "real property" to the extent that an Australian treaty provides that immovable property has the meaning it has under domestic law.

The meaning of immovable property in South Africa:

The capital gains tax provisions *inter alia* apply to the following assets of a person who is not a resident:

- immovable property situated in the Republic held by that person
- any interest or right of whatever nature of that person to or in immovable property situated in the Republic.

An interest in immovable property situated in the Republic includes any equity shares held by a person in a company or ownership or the right to ownership of a person in any other entity or a vested interest of a person in any assets of any trust, if—

(*a*) 80 per cent or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and

(*b*) in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20 per cent of the equity shares in that company or ownership or right to ownership of that other entity.

A Case in Point: Peru

By Law no 29663 of February 15 2011,capital gains of non-residents of Peru from the indirect transfer of ownership or participations in Peruvian companies is treated as sourced in Peru and taxable in Peru.

The indirect transfer is deemed to occur if shares from a non-resident company are transferred and that company owns shares of a resident company, directly or through other companies, as long as (i) over the 12 months prior disposal the market value of the domiciled company's shares held by the non-domiciled company directly or through other companies equals 50 per cent or more of the market value of shares of the non-domiciled entity, or (ii) the non-domiciled entity resides in a tax haven.

Peruvian resident companies must report any indirect sales to the Peruvian Tax Administration by foreign affiliates. If the transferor is not a resident, the domestic company will be jointly and severally liable for any capital gains tax arising from the indirect sale.

There was criticism that very small transactions would be caught by the legislation, provided that the transfer resulted in capital gain for a non-resident company owning the shares.

In July of 2011 Law 29757 provided some relief. An indirect sale would only be taxable if the transaction represented a transfer of 10 per cent or more of the non-resident company's interest in its investment in Peru. The 10 per cent threshold is determined by amalgamating any disposals over a 12-month period (to reduce the chances of sales little by little over a twelve month period).

Law 29757 also addressed issues of the *amount* of the taxable capital gain. In general, the basis of shares acquired before the February 16 2011 effective date of Law 29663 would be the greater of: (1) the market value of the shares as of February 15, 2011; or (2) the acquisition cost or the value of the equity if acquired without consideration. Market value, if the shares were listed on a stock exchange, would be the stock exchange price at the close of February 15, 2011, or the last published quotation.

For shares not listed on a stock exchange, the value of the shares at the time when they were added to the company's balance sheet is used, based on an audited balance sheet of the non-resident company. The balance sheet could not be dated earlier than February 15, 2010.

Other changes were new provisions that:

> (i) limited the deemed Peruvian sourced income to the proportion of the value of the shares sold which represents the indirect Peruvian interests (i.e.) the gain on the shares as a whole would not be taxed where part of the value relates to unrelated investments.
>
> (ii) those paying or crediting income as a result of the indirect transfer of shares are deemed to be withholding agents, and in such case the company whose shares are indirectly sold is not jointly or severally liable.

6. Issues of Identification

6.1 The first issue is how does one even know about the indirect sale, especially an overseas sale (as it usually will be)?

(i) It is possible that information may come to light in an automatic exchange of information (though developing countries at this stage do not have many such arrangements) or by a spontaneous exchange from another country, but this is not likely to happen often either. Where treaty relationships exist information could be sought from treaty partners, but that would usually only happen after there was an initial awareness of the sale, and at least some of its details.

(ii) Officers in the revenue collection agency should keep up to date with industry news and conducting regular internet searches for sets of key words such as the names of mines, the word "mine" and the country name have some value, but are necessarily reliant on luck. Commercial databases may assist as might details of foreign takeovers required under domestic law or notifications of changes required under extractives legislation. In one Chinese case a public announcement was found on the website of the buyer, announcing the completion of the acquisition of the Chinese company, but without mention of the intermediate holding company, a Hong Kong special purpose vehicle with little substance.[12]

(iii) Other potential pointers to an indirect sale might include changes in enterprise names, changes in directors, and changes in tax auditors.[13] It has been noted that companies that have been listed on international stock exchanges, subsequent to structuring, are more prone to detection, and that accountants may be required to "provision" for a potential tax liability of the selling entity.[14]

(iv) Some countries have imposed reporting obligations on companies to report when they are indirectly sold or where there are major changes in shareholding or on shareholders (usually only those in a control situation – because the requirements can cast heavy obligations on the shareholder to know what business the company is conducting) to report to authorities a sale affecting local property.

(v) To be effective, even requirements to notify of major shareholding changes (say of those above 10 per cent) would need to provide that changes over a period of time (12 months or longer in some cases) to prevent several sales of 9 per cent in a short being time not having to be reported. The OECD BEPS Action Plan notes this issue in its discussion paper on Action 6:[15]

> 47. Art. 13(4) allows the Contracting State in which immovable property is situated to tax capital gains realized by a resident of the other State on shares of companies that derive more than 50% of their value from such immovable property.

[12] Circular 698: The China's Anti-tax Avoidance Measures for Offshore SPVs , 23 August 2010, Cadwalader, Wickersham and Taft LLP. Available at: http://www.cadwalader.com/CN/assets/client_friend/CWT_C&FMemo_SAFECir698).pdf ("Cadwalader, Wickersham and Taft ")

[13] Cadwalader, Wickersham and Taft.

[14] Cadwalader, Wickersham and Taft.

[15] BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Public Discussion Draft, 14 March 2014, OECD. Available at http://www.oecd.org/ctp/treaties/treaty-abuse-discussion-draft-march-2014.pdf

48. Paragraph 28.5 of the Commentary on Article 13 already provides that States may want to consider extending the provision to cover not only gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, which would address one form of abuse. It was agreed that Art. 13(4) should be amended to include such wording.

49. There might also be cases, however, where assets are contributed to an entity shortly before the sale of the shares or other interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in one Contracting State. In order to address such cases, it was agreed that Art. 13(4) should be amended to refer to situations where shares or similar interests derive their value primarily from immovable property at any time during a certain period as opposed to at the time of the alienation only.

(v) Further, reporting requirements on ownership of interest would need to apply at more than one level, to ensure that the reporting requirements are not avoided by having the changes occur further up a string of companies. The intention of such “indirect” sales being covered would need to be clear in the legislation.

7. Enforcement Issues

7.1 If there is a taxable disposition, how can the tax debt be enforced in practice? The indirect sale generally takes place outside the jurisdiction where the property (such as a mine) is located and usually neither the buyer nor the seller is a resident.

(i) While both the UN and OECD Models now contain optional Assistance in the Collection of Tax Debt Articles for countries wanting to provide for this in bilateral tax treaties, and there is a multilateral OECD/ Council of Europe Convention on Mutual Administrative Assistance in Tax Matters on the subject, this is not yet something most developing countries have provision for in their bilateral or multilateral relationships.

(ii) One approach taken has been to deem, where there is a change of underlying ownership of a certain amount (10 per cent in one case) that there has been a disposal and reacquisition of exploration and development rights. This would lead to a domestic capital gains event (the responsible taxpayer will have to be made clear). Depending on the legislation there might be necessary re-approvals required such as for export licenses.

(iii) Alternatives include joint and several liabilities of the seller and buyer for the tax debt, or else a tax obligation on the indirect buyer of the assets. The theory is that publicizing an indirect sale regime will put the buyer (exercising due diligence) on notice and the sale price will reflect that. There may have to be legislation imposing obligations on the mine etc. operator (such as in the capacity of as a withholding agent in respect of interest or dividends payable to shareholders / owners of the operating company) and imposing a specific lien upon the facility in the event of non-payment.

(iv) One alternative allowing non-payment at certain time after the payment becomes due to be a factor in denying export licenses for the minerals, oil, gas etc. produced by the facility. The latter sort of provision is a very serious step, and it would need to preserve normal taxpayer rights under domestic law for contesting a tax debt.

(v) However, this sort of response may not be possible (or may be possible, but with substantial damages possible) because of contractual obligations, stability clauses, governing Investment Protection treaties and so forth. Any consideration of a regime to address indirect sales should consider any possible effect of these obligations in any case. As always the balance between addressing abuses of the system must be balanced with not creating too much uncertainty or investment risks for basically compliant taxpayers.

(vi) One particular aspect of this is that any tax payable in the country of the mine or other facility may not be viewed as properly creditable in a treaty partner – they may view the gain as sourced offshore. While any indirect sales legislation should specifically indicate that the gain is treated as domestically sourced, to prevent issues in the courts, other countries may not accept that, leading to possible double taxation that will have some impact on the investment climate.

8. For More Information….

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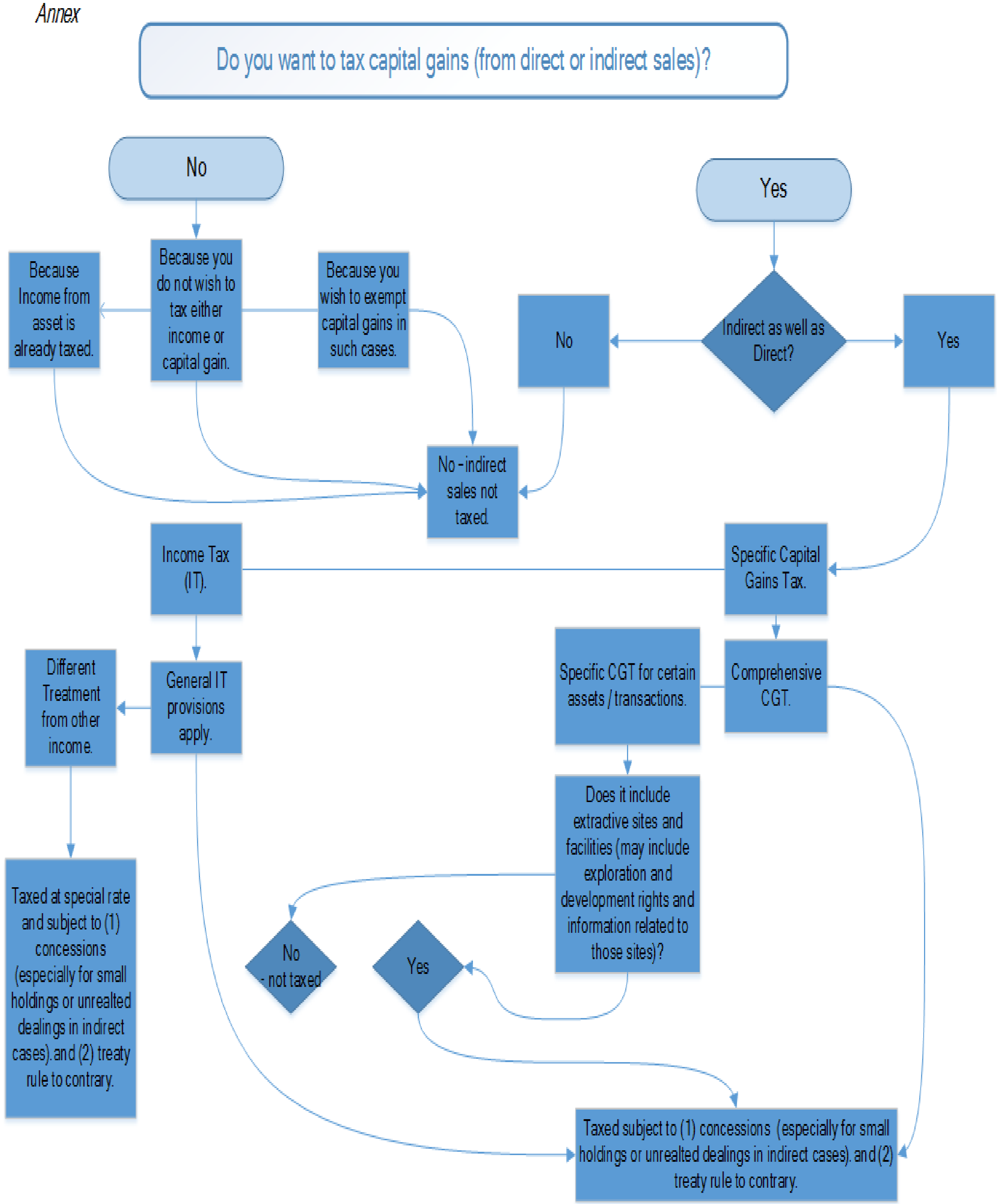
Internal Revenue Service, 'Simontacchi, S. Immovable Property Companies as Defined in Paragraph 13(4) of the OECD Model, 206 Bulletin of International Taxation, 2006, Vol. 60 No 1, 29.

Annex


Do you want to tax capital gains (from direct or indirect sales)?
No
Because you do not wish to tax either income or capital gain.
Because Income from asset is already taxed.
Because you wish to exempt capital gains in such cases.
No - indirect sales not taxed.
Yes
Indirect as well as Direct?
No
Yes
Income Tax (IT).
Specific Capital Gains Tax.
General IT provisions apply.
Different Treatment from other income.
Taxed at special rate and subject to (1) concessions (especially for small holdings or unrealted dealings in indirect cases). and (2) treaty rule to contrary.
Comprehensive CGT.
Specific CGT for certain assets / transactions.
Does it include extractive sites and facilities (may include exploration and development rights and information related to those sites)?
No - not taxed
Yes
Taxed subject to (1) concessions (especially for small holdings or unrealted dealings in indirect cases). and (2) treaty rule to contrary.