Stefano Simontacchi

Taxation of Capital Gains under the OECD Model Convention

With special regard to Immovable Property

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Preface

This book is the commercial version of the PhD dissertation I defended early in 2007 at the Faculty of Law of Leiden University (the Netherlands). The origins of the book can be traced back to my LL.M. studies in 1999/2000 at Leiden University. Fascinated by the research of Prof. Kees van Raad on the work of the League of Nations, and stimulated by his passion for the topic, I decided to do historical research on, and to devote my LL.M. paper entirely to, the capital gains article in the model convention drafted under the auspices of the League of Nations. My research showed the importance of further study on Article 13 of the OECD Model and was the first step of my PhD research.

I had the good fortune of meeting three very special and outstanding people without whom this manuscript would have not come into existence.

First of all, I am particularly and sincerely grateful to Prof. Kees van Raad, to whom I owe a special debt for having the honour of his friendship. Moreover, he is the best and most inspirational teacher and PhD supervisor one could wish for. He patiently encouraged and guided my research through the years, and was always available to exchange views and to share his invaluable experience and knowledge.

I extend my sincerest gratitude to Prof. John F. Avery Jones, who went far beyond his function as a member of the PhD committee. I had the privilege of benefiting from his invaluable insights and constructive criticism.

Both Prof. van Raad and Prof. Avery Jones not only found the time to read the final manuscript very thoroughly, but also to review carefully all the chapters during their evolution and to answer the many questions I raised: without their support this book would have not been possible.

I wish to acknowledge my deep gratitude to Prof. Angelo Provasoli, who introduced me to scholarly activities and instilled in me his passion for teaching and research. He always found time to support me and was a stimulus in the completion of this dissertation.

There are many other people whose valuable assistance enabled me to complete this work. I wish to especially thank Prof. Guglielmo Maisto, who encouraged, guided and supported my studies in international taxation and Jacques Sasseville and Prof. Wim Wijnen, who kindly reviewed part of the manuscript. I also want to express my gratitude to Prof. Alberto Santa Maria for his help and support. I am truly grateful to Margaret Nettinga, who not only edited the manuscript, but continuously helped me with useful comments and suggestions.

There are too many other people to thank each of them individually for their help and understanding during my years of research and writing. However, I do wish to mention the following: Severine Baranger (French case law), Jack Bernstein (Canadian regime for immovable property companies), Jim Crocker (US regime for immovable property companies), David Francescucci (Canadian tax system), Brice Gandola (French case law), Michiel van Kempen (Dutch case law), Eduardo Meloni (translations from Spanish), Federico Pacelli (treaty analysis in Chapter IV), Wolfgang Oepen (German case law), Ariane Pickering (Australian regime for immovable property companies), Howard Rothman and Barry Hertzog (US tax system), John Taylor (Australian regime for immovable property companies), Mary Voce (US tax system) and Sonia Velasco (Spanish case law and translations from Spanish).

Of course, I take full responsibility for any errors.

I would also like to thank the International Tax Center Leiden for making its research facilities available. I want to expressly mention Antonia, Bart, Erki, Maria, Renata, Rob and all the students who make the ITC building a most special place to study and do research on international taxation. I would also like to thank the staff of the IBFD and Peace Palace libraries and of the League of Nations Archives in Geneva for their kind assistance during my research.

My most special thanks go to my lovely wife and to my parents: their help, patience and support gave me the possibility of having the extraordinary experience of writing a book.

Stefano Simontacchi Leiden, Winter 2006

Introduction

SCOPE AND PURPOSE OF THIS BOOK

Increasing globalization and the related cross-border flows of capital resources make it likely that more and more people will face the issue of the taxation of transnational capital gains. Thus, over time, the role played by the OECD Model, and by Article 13 in particular, has grown in importance and will become even more important in the future. Despite this, very little attention has been devoted in the international tax literature to the systematic analysis of capital gains in relation to tax treaties.

The purpose of this book is to contribute to a comprehensive analysis of Article 13 of the OECD Model. This does not mean that the book purports to give a detailed overview of all the issues relating to capital gains. Choices had to be made about the delimitation of the scope of the book. Preference has always been given to an examination of the main issues in defining capital gains in the context of Article 13. On the one hand, the analysis of the specific paragraphs contained in Article 13 has been limited to those dealing with immovable property. This does not mean that the other paragraphs have been ignored; they have been dealt with in relation to both their interaction with the paragraphs that are specifically analysed and the issues relevant to the definition of capital gains. On the other hand, a large part of the book is devoted to the general issues that come up in defining the scope of the entire Article 13.

The primary focus of this book is thus the definition of capital gains in the context of Article 13. The OECD Model does not contain a definition of capital gains and, moreover, the term 'capital gains' is only found in the heading of Article 13, while the paragraphs themselves only make reference to 'gains'. Why? Is there a rationale behind this apparently inconsistent wording? This is just one of many questions concerning the definition of the scope of Article 13.

The nature of capital gains has always been debated and there is no consensus on the characterization of capital gains as income. This is also reflected in the substantial differences among the various systems as to the tax regime applied to capital gains. In this context, the drafting of treaty provisions dealing with capital gains was certainly one of the biggest challenges in international taxation. The key for interpreting Article 13 can be found in the examination of the history of the article along with the evolution of the capital gains concept in various tax systems.

The above sketch of some of the problems one has to deal with in defining the capital gains covered by Article 13 illustrates the complex interrelation of different issues that may arise. In light of this complexity and with the awareness that it would have been impossible to deal with all possible types of capital gains in enough detail, the scope of the analysis of specific paragraphs of Article 13 was limited to gains on immovable property, as well as on shares of immovable property companies.

STRUCTURE

The book is divided in two main parts. The first part contains an historical analysis of the capital gains provision in tax treaties (Chapter I) and the definition of capital gains falling within the scope of Article 13 (Chapter II). The second part then analyses in detail the treaty regime applicable to gains derived from the alienation of both immovable property (Chapter III) and shares of immovable property companies (Chapter IV).

Chapter I examines the work of the League of Nations and the treaties concluded before 1960 in order to trace the history of Article 13 and to ascertain the reason for its late introduction in a model convention (1940). Analysis of many documents (the relevance of which is not limited to capital gains) and, in particular, those related to Carroll's 1940 draft, the 1940 Hague draft and the 1940 Mexico draft clearly shows that that the work undertaken by the Fiscal Committee in 1940 significantly influenced the capital gains articles of subsequent model conventions. An explanation for the absence of a capital gains article in the 1927 and 1928 drafts is given, based on an analysis of pre-1940 tax systems.

Chapter II first attempts to provide an explanation for the lack of an international common definition of capital gains and to point out the patterns characterizing capital gains taxation. The scope of Article 13 is then addressed, with particular attention devoted to the following issues (about which proposals for changes in either the OECD Model or in the OECD Commentary are made):

- the relevance of the term 'capital gains' when used only in the heading of the article (the use of the headings in the articles of the OECD Model is analysed);
- the definition of the terms 'gains' and 'property'. The interaction between Article 7 and Article 13 is discussed, i.e. are gains derived from the alienation of inventory property covered by Article 7 or by Article 13? Why does Article 13, unlike domestic provisions, refer to 'gains' and not to 'capital gains' and why does it not require the alienated property to be a 'capital

asset'? The answer to this question includes a detailed analysis of the history of the wording of Article 13. This leads to some interesting findings (e.g. Article 13(2) is completely different from the equivalent provision of the 1946 London draft and, curiously, Article 13(2) seems to also differ from the other permanent establishment proviso); and

- the definition of the term 'alienation'. Particular attention is given to the borderline cases of unrealized gains and changes in the use of capital assets (dealt with in the recent OECD Report on the allocation of income to permanent establishments).

Chapter III analyses the attribution of taxation rights applicable to gains derived from the alienation of immovable property. Among other things, the following unresolved issues are addressed (about which proposals for changes in either the OECD Model or in the OECD Commentary are made):

- the application of Article 13(5) vs. Article 21 to gains derived from the alienation of immovable property outside the scope of Article 13(1) due to its bilateral reach (the OECD Commentary changed its position in 2003);
- the interaction of Article 7 and Article 21;
- the analysis of the relationship between the situs rule and the permanent establishment rule. Assessment of the consistency of the OECD Model with the priority of the situs rule;
- the definition of the term 'derived'. A detailed analysis is made of all the terms used by the model conventions (in all the articles) to indicate the source of the income and the person entitled to the income;
- the definition of the term 'immovable property' for purposes of applying Article 13(1). For example, is there a reason why Article 21(2) refers to the definition of Article 6(2) while Article 13(1) simply refers to Article 6?
- the definition of the term 'immovable property' under Article 6(2); and
- the definition of the term 'situated'.

Chapter IV is devoted to the case of gains derived from the alienation of shares of immovable property companies, which, since 2003, is expressly dealt with in Article 13(4). The chapter examines the origin and the nature of the provision in the context of the OECD Model. The chapter, which also makes reference to existing domestic immovable property provisions (in the United States, Canada and Australia), highlights the issues relating to the interpretation and application of Article 13(4), such as:

- the definition of immovable property, in light of the absence of a renvoi to Article 6(2);
- the definition of shares;
- the definition of immovable property company (e.g. definition of 'immovable property', determination of the sources from which shares derive value, when the requirement must be met, direct and indirect derivation of value); and
- the problems relating to the application of the provision, with particular reference to the collection of information.

This chapter analyses in detail some inconsistencies in Article 13(4) and in this respect changes in either the OECD Model or in the OECD Commentary are proposed:

- the interaction between Article 13(4) and Article 13(2). There seems to be an inconsistency in the case of the alienation of shares of an immovable property company that form part of the business property of a permanent establishment;
- the value test. It is argued that it is not appropriate in the case of capital gains taxation;
- the effects of the introduction of Article 13(4) on the attribution of taxation rights between the contracting states; and
- the interaction of Article 13(4) with substantial interest provisions.

Author's Note

This book adopts in broad lines the Harvard system of citation. References in the footnotes to books, articles and other similar materials are to the author and year in brackets, followed by the term 'at' and the page or section number(s) where appropriate, e.g. M.B. Carroll, [1940], at 40. Full references are then provided in the bibliography. In the case of more than one reference by an author for the same year of publication, a distinction is made through the use of letters after the year of publication, e.g. M.B. Carroll, [1940a] and M.B. Carroll, [1940b], etc.

Cross-references to other parts of the book are by section number followed by a reference to the chapter, e.g. see section 2.2 of Chapter IV.

Documents are ordinarily quoted in full in the footnotes. When abbreviated in the text the abbreviation is also used in the subsequent footnotes. The main abbreviations can be found in the bibliography in brackets.

For simplicity's sake, when reference is made to a paragraph of a treaty article and this paragraph is not numbered (as is the case in many old models and treaties), reference is made as if there were a number, i.e. instead of 'first paragraph of Article 12', reference is made to Article 12(1).

As discussed in detail in Chapter II, the definition of the term 'capital gains' is rather complex and there is no common definition in the various tax systems. In this book the term 'capital gains' is generally used to refer to 'gains derived from the alienation of property', i.e. the terminology employed by Article 13 of the OECD Models since 1963.

Many of the model conventions drafted under the auspices of the League of Nations and many treaties use the term 'real property' instead of the term 'immovable property' contained in the OECD Model. Differences in meaning are not explored, since the scope of this book is confined to an analysis of Article 13 of the OECD Model.

The manuscript was closed on 1 January 2006.

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Chapter I

The Capital Gains Article in the Model Conventions Drafted Under the Auspices of the League of Nations

1. INTERNATIONAL DOUBLE TAXATION AFTER WORLD WAR I

The increase in the level of domestic taxation in many states that took place after World War I had the effect of drawing attention to the problem of juridical double taxation.[1] Commercial and industrial organizations made it known from the

1. See, among others, J.G. Herndon, [1932], at 7 et seq., where the author points out that:

> In the days when rates of tax on income were very low, there was no particular hardship upon persons who were subjected to taxation under the laws of more than one country. With, however, the tremendous increase in tax rates caused by the burden of the World War, the pressure upon persons whose income was subject to tax by different governments became very severe, in some cases running to more than 100 per cent on certain parts of one's income. Indeed even now, when excess profits taxes have been eliminated by substantially all of the governments of the world, very heavy rates still apply to corporation profits and to interest on corporation bonds.

See also M.B. Carroll, [1939], at 6 et seq. Carroll summarizes the issue as follows:

> Although prior to the world war there had been a few provisions in national tax laws and in bilateral treaties between Central European States for the prevention of double taxation, the general movement to remove this serious obstacle to commerce did not begin until after the war, when the leading nations turned their attention again to foreign trade. Many countries had increased their tax rates to the maximum, and business enterprises which ventured into the territory of other States in order to market