Papers on Selected Topics in Protecting the Tax Base of Developing Countries

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Taxation of Capital Gains

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Introduction

Designing and enforcing a legal regime for taxing non-residents on capital gains realized from domestic sources is a topic of vital importance for developing countries. This is because non-capital-gain income that may be derived from a given country can generally be crystalized in the form of capital gain on the disposition of the income-generating asset.[1] This is true of most important types of income, be it rent, interest, royalty, dividend, or business profit. Taxing capital gain, therefore, is invariably needed to ensure that income from assets in one's country is properly subject to tax. In this sense, capital gain taxation is intrinsically about protecting the tax base from erosion.

There is a well-known principle that if the non-capital-gain income from an asset is taxable in a source country (e.g. because the asset is properly viewed as being located in that country), then the capital gain from the disposition of that asset should be taxable in the same country.[2] This principle, based on the equivalence of income and capital gain, is commonly used to justify taxing capital gain realized by non-residents on the disposition of immovable property and business assets used in a permanent establishment (PE) situated in the taxing country. However, the principle has not been consistently applied to other types of capital gain realized by non-residents. This inconsistency ca

there are substantive disagreements (often between developing and developed countries) about

domestic law and by tax treaties towards capital gain taxation, and if the enforcement of such tax rules is inadequate, taxpayers may have greater incentives to engage in avoidance. Moreover, the feasibility of avoidance behavior could also depend to a substantial extent on non-tax characteristics of the business and legal environment for investing in a country: some countries witness extensive offshore markets for trading investments into them, while others do not see such markets. This chapter will discuss both specific and general anti-avoidance rules for maintaining the integrity of a tax on capital gains earned by foreigners, as well as how to choose among these rules in light of the circumstances that generate tax avoidance.

The chapter proceeds as follows. Section 1 examines the general principles for taxing non-residents on capital gains realized on the disposition of domestic assets. It considers the relationship between capital gain and other forms of income from an asset, and special issues arising from the taxation of shares of companies. It also analyzes the basic approaches for taxing capital gain adopted by various countries, especially whether to assimilate such taxation to gross-income or net-income-based taxation. Section 2 will specifically examine administrative issues in taxing non-residents' capital gains. The issues described in Sections 1 and 2 normally need to be addressed under domestic legislation. Section 3 will briefly review Article 13 of the UN Model Tax Convention as well as treaty practices among developing countries with respect to taxing capital gains. Section 4 turns to tax planning commonly adopted to avoid the tax on capital gain. It pays particular attention to policies recently adopted by a number of developing countries on taxing indirect transfers of the shares of resident companies. Finally, Section 5 examines the special issue of departure taxes for individuals. A brief Conclusion follows.

1. General Principles for Taxing Non-Residents on Capital Gains

1.1 The Economic Substance of Capital Gain

In thinking about taxing non-residents on gains realized on the disposition of domestic assets, it is useful to keep in mind what assets tend to generate capital gains in the first place—and why. For example, mass-

comes about not because income has already accrued, but because of changed expectation of what income *will* accrue.

To show the point of this conceptual discussion, consider a type of skepticism about the wisdom of taxing foreigners on capital gains. Because transfers of domestic assets by foreigners may be difficult to detect, and a tax on such transfer may be difficult to enforce, it is sometimes asked why the source country should bother. The asset itself is still located in the source country, and most income it generates—in the form of rent, dividend, and other periodic payments—can be more easily subjected to tax (through withholding)

In general, the inherent connection between income and capital gain realized from an

untaxed, special exceptions have been made—as in the U.S., Canada, Australia, and Japan—for companies that hold domestic real estate. This is in recognition of two facts. First, as discussed above, real estate can experience substantial appreciation due to regional economic growth. Second, if dispositions of real property holding companies are not taxed, it would be too easy to avoid a tax on the capital gain realized on the disposition of real estate itself by selling the shares of holding companies. In other words, taxing the disposition of ownership interests in real-property-holding entities is felt to be crucial to preserving the capital gain tax base.

The anti-avoidance justification for taxing share sales raises numerous issues. First, taxing share sales because the real estate assets held by the target company have experienced appreciation creates the possibility of excessive taxation of such appreciation: the economic gain may be taxed at both the corporate and the shareholder levels.[15] If such excessive taxation is to be avoided, then potentially complex rules may have to be applied to ensure that gain that has been taxed at the shareholder level is not taxed again at the entity level (and vice versa).[16] No country that taxes foreigners on the disposition of companies that hold domestic real property, however, has systematically committed to mitigating such potential excessive taxation through their legal rules.[17]

Second, it is obvious that tax avoidance concerns arise not just in connection with real estate. Take, for example, an operating business the value of which has increased due to its improved prospects. It is rarely disputed that the disposition of a business run through a permanent establishment (PE) of a non-resident should be taxable in the country of the PE (paralleling the taxability of the business profits attributable to the PE). However, if a business is

[15] This rationale extends to the disposition of interest in other entities that are treated as legal persons, even if they are not subject to the corporate income tax.
[16] See David A. Weisbach, The Irreducible Complexity of Firm-Level Income Taxes: Theory and Doctrine in the Corporate Tax, 60 TAX L. REV. 215 (2007).
[17] See Wei Cui, Taxing Indirect Transfers: Improving an Instrument for Stemming Tax and Legal Base Erosion, 33 Va. Tax Rev. 649 (2014).

realized on a sale can be very different.[21] From the resident country's perspective, the amount of capital gain may depend on all kinds of expenses that should either be capitalized into the cost of the disposed asset or deducted from the income realized (thereby reducing the amount of capital gain), as well as on any depreciation or other allowance that have been given in respect of the investment (which may increase the amount of capital gain or trigger the recapture of income). This should not in itself cause alarm, if one remembers that the source of the difference is that the source country treats the capital gain as a form of passive investment income, subject to a simplified method of collection. [22]

1.4 Other special issues in delineating theope of capital gains taxation on foreigners

penalties on non-reporting transferors. However, if the chances of detection of taxable transactions are very low, the expected cost of a penalty for nonreporting may also be too low to be effective. If most taxpayers do not comply and the tax authority fails to detect most instances of noncompliance, imposing a heavy penalty on the few detected cases will also seem unfair.

Consider now transferee reporting. If the transferee is a nonresident as well, the failure of transferee reporting would be just as hard to detect as the failure of transferor reporting. A sanction imposed upon a transferee's failure to report would, in a way, be similar to increasing the penalties on a transferor's failure to report — in both cases, the aggregate penalties on nonreporting are increased. The difference is that the transferee usually has a lot less to lose by reporting, since it is not the party paying the tax. This may be sufficient to create compliance by transferees. Interestingly, however, no government seems to have instituted transferee reporting alone (without further requiring withholding) for taxing either direct or indirect transfers. This might be seen as pointing to the perceived magnitude of the collection problem: simply having information that some foreigner engaged in a taxable transaction is of little value; the government still has to do everything to collect the tax.

For certain types of property, such as real estate, shares in companies, and sometimes even ships and aircraft (because of regulatory requirements), the country in which they are located may operate ownership registration systems. The transfers of ownership will be recorded in such systems and tax authorities may require those who maintain the systems to report the transfers.[29] In addition, third parties in the transfers of financial claims, i.e. lessees, borrowers, and companies issuing shares, often receive notice of the transfers under either legal or

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foreign) to withhold on the capital gain realized on a transfer, when withholding is infeasible, the transferee or payor has not information reporting obligation.

[29] Note, however, that the mere transfer of legal ownership may not be sufficient to constitute an ownership change for income tax purposes under the tax laws of many countries.

contractual requirements. It may be possible to enlist such parties in reporting taxable transfers, even if they are not party to the transfer.[30]

Besides explicit sanctions, market dynamics may also create incentives to comply with reporting requirements. For example, when taxing capital gain, the source country generally needs to keep track of the tax cost or basis of the assets transferred. If the capital gain realized on a transfer has been subject to tax, the cost basis of the shares transferred should be stepped up for purposes of future source country taxation. Conversely, one can imagine a rule that provides that if a transfer has not been taxed (other than in a case where the capital gain on a transfer is positively exempted from tax, for example under an applicable treaty), then the basis of the transferred shares would, for the purpose of source country taxation, remain what it had been. That is, the transferee would not obtain a basis in the shares it acquires equal to the consideration it pays unless the acquisition has been taxed.[31] With such a rule in place, the failure to report a taxable transfer would result in the risk that the transferee, in the future when it acts as a transferor, would be taxed on gain that accrued to and was realized by previous owners. Of course, the future transfer itself will need to be reported or detected. Both the tax authority and the nonresident taxpayer may also have difficulty determining what the original basis was in the hands of previous owners.[32] Nonetheless, the risk of the conversion of a seller tax liability into a potential tax liability of the buyer (as a future seller) may well be unacceptable to many buyers.

[30] Such tactics have limits if third parties' contractual rights to notice vary widely in the market. On the other hand, a government requirement for third party reporting may induce changes in contractual terms, such that third parties will demand contractually (and receive) notice of transfers.

[31] This is different from the normal use of the concept of cost basis: the cost basis of an asset is normally determined in respect of a particular owner of the asset. However, this notion can be modified so as to keep track of the relationship of the asset to the taxing authority: which portion of the value of the asset has been subject to tax, in whoever's hands?

[32] That future transfer might also itself be exempt from tax (e.g., under treaty protection).

They would then either seek indemnity from the seller, or require, as a matter of contract, the seller to report the sale to the tax authorities and, in addition, to pay tax if required by law. [33]

2.2 Collection and Voluntary Compliance

From a collection and revenue protection perspective, transferee withholding is clearly a more powerful tool than transferee reporting. The U.S., Canada, and India each requires the transferee in a taxable direct (and, in the case of India and Canada, indirect) transfer to withhold from gross proceeds paid to the transferor, regardless of whether the transferee is domestic or foreign.[34] Each also makes the amount required to be withheld the personal tax liability of the transferee if it fails to withhold. Note that when the transferee is made personally liable for failing to withhold a tax that was in the first instance imposed on the transferor, one has merely made the implicit penalty of the no-basis-step-up treatment (which is possible even under transferor reporting) explicit.[35]

In countries with weak legal norms, a view may be held that the transferor's failure to pay tax on a transfer creates a de facto personal liability for the transferee anyway, since the tax authority could always "go after" the asset located in the country and therefore expropriate its value from the asset's present owner. Unless the transferee (new owner) is legally made liable for the tax that the transferor fails to pay, however, this kind of expropriation is against the rule of law (and is both unnecessary and unproductive for tax administration). Moreover, even when

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[33] Dynamics in the tax service market may also contribute to compliance. For further discussion, see Cui, supra note 17, at 680-1, 690-1, and 694. Because the penalties for non-reporting under China's policy of taxing indirect transfers of domestic company shares are very low, most compliance with that policy that has taken place in China since 2009 may have resulted from buyer and advisor monitoring.

[34] The U.S. rule, IRC Section 1445, requires withholding of 10% from gross proceeds. IRC § 1445 (2013); the

transferees are made liable for failures to withhold, it is important to observe legal distinctions.

taxable gain may make the contact of nonresidents with the source country less “one-shot” in character. Finally, it may be useful to focus on improving compliance among multinationals and foreign investors that deal with the source country on a repeated basis. A culture of compliance among such taxpayers (and their advisors) may be an important step towards creating a culture of compliance among nonresident taxpayers in general.

2.3 The organization of tax administration

The occurrence of taxable transfers of domestic assets among non-residents can be erratic, which makes it hard to decide to assign dedicated tax administration personnel to collect tax on such transfers. However, non-reporting non-residents—whether they are transferors or transferees—are like domestic taxpayers who do not file tax returns: special efforts have to be made to detect them and bring them into compliance. It is not clear that the tax authority in any country has developed well-articulated strategies for dealing with this predicament. In many OECD countries, where both tax administration and the study of tax administration are generally more developed than elsewhere, the scope of capital gains taxation for non-residents tend to be limited. They therefore offer limited expertise insofar as taxing non-residents’ capital gains is concerned. In the United States, for example, an IRS publication from 2010 states that a study of the collection of FIRPTA tax was only “planned” and data was “not yet available”.[37] Moreover, the “planned” study was only based on returns filed by transferees who have withheld tax from the gross proceeds of sales of U.S. real estate interest (including shares of U.S. companies that

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transferor self-reporting of sale of U.S. real property interests, and there is no sign of any data on audits (if any) of transferors and transferees. In fact, the United States did not attempt to measure nonresident taxpayer compliance until 2008, and even the new attempt to do so is designed only for individual taxpayers.[39]

For developing countries that aim to preserve their tax base consisting of income belonging to non-residents to a greater extent than OECD countries, effective tax administration strategies have to be developed indigenously. One possible approach is to centralize tax administration in this area so as to allow specialization and the economy of scale: the number of taxable transactions as well the revenue outcome will diminish if averaged over too many tax administrators, whereas a small number of specialized tax administrators may be able to deal with a relatively large number of taxable transactions because of the one-shot nature of the taxpayers involved.[40]

3. Article 13 of the UN Model Convenle6a11-cs)(1)6(3)23TJ [illegible]

Article 13 acknowledges that "[most] members from developing countries advocated the right of the source country to levy a tax in situations in which the OECD reserves that right to the country of residence."[44]

Movable property part of a PE. Article 13(2) gives the source country taxing right on gains from the alienation of movable property forming part of the business property of a PE (or pertaining to a fixed base available for the purpose of performing independent personal services). The UN Commentary explicitly notes that "the term 'movable property' means all property other than immovable property…It includes also incorporeal property, such as goodwill, licenses, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment [or fixed base] is situated."[48] This is an important observation, because tangible movable properties—such as machines and equipment—tend to experience depreciation and thus has limited potential for capital gain. It is instead the intangible components of a business, including contracts with customers, employment contracts with skilled personnel, brand names, know-how (whether patented or not), etc. that give rise to capital gains on the sale of a business.

This broad definition of movable property under Article 13(2), however, raises a difficult interpretive issue: is moveable property that does not form part of the business property of a PE of a non-resident thereby carved out from the scope of taxation under Article 13? Consider the vulture fund that has sold a portfolio of non-performing loans at a handor-2(e2(a)4(x)-10(a)g(n.)-10(I)12(s)-10(

If this is right, and if under the same treaty, interest on loans (and rent or royalty from leases, licenses, and other agreements and covered by the Royalties article) remain taxable in the source country, a sharp inconsistency between the treatments of income and of gain from the same asset would result.

As discussed below, this difficulty is not necessarily resolved even the contracting states agree to retain residual taxing right for the source state over gains not otherwise enumerated in Article 13.

Entities holding immovable property directly or indirectly. Article 13(4) in the UN Model provides taxing right over "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" to that State. Clause (b) of the paragraph defines "principally" in relation to ownership of immovable property to mean that "the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate." The UN Commentary notes that the provision

> "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. In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the

Article 13 of the OECD Model adopted a similar carve-out. An obvious reason is that there are important types of companies the value of which derive predominantly from real property, e.g. hotel and resort operators, operators of shopping malls and even of restaurants and cinemas, and, of course, companies that extract natural resources. The appreciation in the value of the shares of such companies is likely to reflect the appreciation of the underlying real property, and it is not at all obvious why the source country should give up taxing right over such shares. This carve-out can also be regarded as a special case in the inconsistent treatment between PEs and subsidiaries of non-residents, mentioned in Section 1.2 above and further discussed next.

Substantial participation in a company. The Commentary on the UN Model Convention Article 13 notes that "some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State." It then claims that "for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12 month period preceding the alienation, held, directly or indirectly, a substantial participation.[53] This position is reflected in paragraph 5 of Article 13 of the UN model, where the percentage deemed to constitute substantial participation is to be established through bilateral negotiations. Paragraph 5 allows that the substantial holding (which leads to taxability) may be "indirect", partly as an anti-avoidance device.[54]

Under the OECD Model Convention, the alienation of shares of companies other than those holding domestic real property assets is not taxable in the country of residence of the companies. As discussed in Section 1.2, this produces differential treatment between PEs and

subsidiaries, and seems to ignore the anti-avoidance argument for taxing both asset and share sales.[55] Article 13(5) of the UN Model can be viewed as constituting an improvement in this regard. What is less clear, especially in view of the analysis of enforcement and compliance in Section 2 above, is why administrative considerations dictate a percentage ownership approach to having a threshold for taxing the alienation of shares. For example, if it is the burden of filing a tax return by the non-resident that is at issue, a monetary amount (i.e. exclusion of small gains) seems to be more appropriate.

The Commentary on the UN Model Convention also points out arguments against taxing listed shares (that it is "costly", and that "developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares".[56]) It goes on to suggest language for carving out traded shares from the scope of taxation under paragraph 5. The cost of taxing exchange-traded shares and the policy of boosting domestic stock markets, however, seem to be issues better addressed through domestic law. There seems to be little need or justification for negotiating reciprocal agreement one by one with treaty partners.

Residual taxing power. Article 13(6) of the UN Model Article, like 13(5) of the OECD Model, gives the residence state exclusive taxing rights over assets not covered by the preceding paragraphs of the article. However, as mentioned, the UN Commentary has noted the preferences of developing countries to retain taxing power over assets not specifically enumerated. Such preferences are also reflected in the treaty practice of many countries—and not just developing ones.[57] This is not surprising, insofar as the previous paragraphs of Article 13 do not capture all

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[55] See Weisbach, supra note 16.
[56] UN Com3.003 Tw 06(a)6(e(r)5n(e)-t)7-17(y)20(t)-2le hrr6,(r)33(a)-6()-10(i5(e)-4(2s)-1(o(e)- m (Tc 0 Tw 11.566 08.518)Tj EI

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important elements of the capital gains tax base for the source country (recall the discussion at the beginning of Section 1), and insofar ceding such residual taxing rights would create disparate treatment between income and game from the same asset.

The way in which residual taxing power can be preserved until Article 13, however, remains a problematic issue. The UN Commentary on Article 13 proposes the language: "Gains from the alienation of any property *other than those gains* mentioned in paragraphs 1, 2, 3 and 4 may be taxed in the Contracting State in which they arise according to the law of that State" (emphasis added). The question can be raised as to what constitutes gain "mentioned" in a previous paragraph. Consider the gain from the alienation of shares that fall below the ownership threshold set by the contracting state in a provision similar to Article 13(5) of the UN Model. Article 13(5) only says that the gain realized on the alienation of shares above the threshold is taxable in the source state. Is gain realized on the alienation of shares below the threshold thereby "mentioned"? If one takes the position that it is not, then the residual taxing power paragraph essentially erases the line drawn in Section 13(5): it is almost as though Section 13(5) is deleted in its entirety.[58] Read this way, the approach to drafting in Article 13 would strike many readers as unusual (and unnatural), and even source country tax authorities may have refrained from "reading away" distinctions made in the previous paragraphs of Article 13 if residual taxing power is reserved under Article 13(6).[59]

2003), Argentina, Brazil, China (the tax treaties with Australia, Canada, the Czech Republic, Germany, Hungary, India, Japan, Malaysia, the Netherlands, New Zealand, Nigeria and Thailand), India (the tax treaties with Canada and the United States) and Turkey (the tax treaties with Canada, Italy, Singapore and Spain). Jinyan Li and Francesco Avella, Article 13 : Capital Gains - Global Tax Treaty Commentaries (IBFD 2014), section 3.1.6.2 ("Other cases dealt with by domestic law").

[58] A similar question can be raised about the 50%-of-assets threshold for real property holding entities in Article 13(4).

[59] An alternative interpretation is that what is reserved is taxing right over types of property not referred in a previous paragraph. This interpretation is made explicit in some treaties. For example: "Gains derived by a resident of a Contracting State from the alienation of *any property other than that* referred to in paragraphs 1 through 5 and arising in the other Contracting State may be taxed in that other Contracting State." (emphasis added) Thus shares of resident companies are a type of property already covered by Article 13(5), and the alienation of shares below the

4. Preventing Non-Residents' Avoidance of the Tax on Capital Gains

Section 2 identified detection of taxable transfers and enforcement against delinquent taxpayers as the main challenges for administering the tax on non-residents' capital gains. These are the types of challenges more frequently discussed in connection with tax evasion, but for non-residents and for taxing capital gains, the line between tax avoidance and tax evasion is especially blurry: it takes little effort for the taxpayer to hide the relevant taxable transactions and to dodge enforcement (efforts the undertaking of which normally distinguishes the tax evader). This may be one reason why tactics for avoiding the tax on capital gains are generally fairly crude. Another reason is that, as discussed in Sections 1 and 3, both domestic laws of various countries and tax treaties may sometimes give the impression that ceding source country taxing right over capital gains (e.g. from company shares and from the transfer of other financial claims or intangibles) is normal. But once such concessions are made, taxpayers can be expected to exploit them.

4.1 Treaty Shopping

One obvious strategy for avoiding capital gains tax is setting up holding companies that otherwise serve little or no business purpose in jurisdictions with treaties that contain favorable provisions on the taxation of capital gains. Even for countries that generally take the position of taxing transfers of shares of domestic companies (whether all transfers or transfers of substantial

threshold would not be taxable even under Article 13(6). The question is then what is a "type of property" previously referred to. For example, does Article 13(2) refer to all movable property, or only movable property used in a business, or, even more narrowly, only movable property used in a business conducted by a PE? As discussed above, the reading of Article 13(2) as referring to all movable property would make the class of "property other than that referred to" in a previous paragraph nearly empty. On the other hand, reading it as referring to "movable property used in a business conducted by a PE" would mean that erasing the distinctions drawn in (and therefore the point of) that paragraph.

ownership, per Article 13(5) of the UN Model), some of their treaties may exempt such transfers. Still fewer treaties may exempt the transfer of shares of real estate holding companies (contrary to Article 13(4) of the UN Model).[60] And a developing country may not always be able to negotiate the retention of residual tax rights under Article 13(6).

Since a separate chapter in this volume deals with the abuse of treaties, there is no need to dwell on the issue here. Just one comment is worth making in connection with Article 13. Unlike some of the other distributive articles in tax treaties (regarding e.g. interest, dividend, royalties, and increasingly frequently, other income), which generally deploy the concept of beneficial owner as a way of preventing treaty abuse, the capital gains article generally does not refer to beneficial owners. This by no means implies that a more permissive attitude towards treaty shopping is intended with respect to capital gains. Instead, it merely reflects the fact that the drafting of the article uniformly refers to capital gains "derived by" residents of a contracting state, and never employs the phrase "paid to". And it is this latter phrase that led to the (perceived) need to stress the qualification of the payee as a beneficial owner in the other distributive articles.[61]

4.2 Indirect Transfers[62]

whether the holding entity (or entities) is (are) domestic or foreign. This is why Article 13(4) of the UN Model permits the country where immovable properties are located to tax foreigners on

resident companies.[66] While the background to these policy developments may be very diverse,[67] what is likely common among them is that there are active offshore markets for trading investments into these jurisdictions, making tax avoidance through indirect transfers a natural strategy.

The current approaches to taxing indirect transfers illustrate a well-known dichotomy in legal design for anti-avoidance, namely the use of specific anti-avoidance rules (SAARs) and general anti-avoidance rules (GAARs). The crucial distinction is that under a SAAR, the content of the legal rule applicable to the relevant circumstances is specified ahead of time, so that it is clear what the outcome of applying the rule will be. By contrast, GAARs tend to be statements of principle, and how the legal standard is applied can only be known after the fact. India's policy illustrates the SAAR approach. The 2012 amendment of the Income Tax Act of India provided that "any share or interest in a company or entity registered or incorporated outside India shall be deemed to be … situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India." Therefore, the transfer of such shares would result

authorized to "recharacterize an equity transfer according to its business substance, and disregard the existence of the offshore holding company which is used for tax planning purposes." That is, only a tax authority can determine the taxability of an indirect transfer, and such determination is to be made explicitly on the basis of a finding of tax avoidance motives. The statutory basis of this determination has been attributed the GAAR in China's Enterprise Income Tax Law.[70]

Using the GAAR to deal with potentially abusive indirect transfers has turned out to be unsatisfactory in China in many respects, for the fundamental reason that indirect transfers of shares of Chinese companies occur too often. Many of the entities used in offshore structures for investing into China neither serve substantial functions nor display bona-fide, operational business purpose. In this context, the determination that many of the holding companies serve no genuine business purpose, or that whatever business purpose they serve pales in comparison to the potential tax savings though indirect transfers, can be made in a much more routine fashion than case-by-case examinations permit. There are reports of a backlog of indirect transfer cases across China, in which foreign entities have reported indirect transfers already carried out, are

These phenomena are consistent with the theory that, when a type of transaction which the law wishes to regulate occurs often, it is socially more efficient to spell out the content of law ahead of time, thus minimizing the costs for regulated subjects, legal advisors, and enforcement personnel of interpreting the law.[71] Thus SAARs are likely to be a superior way of dealing with the majority of indirect transfers, while a GAAR should be reserved for the relatively rare cases that are not properly dealt with by SAARs.

However, the existing SAARs adopted by various countries for taxing indirect transfers—in Australia, Japan, and Canada for real property holding companies, and in India for all companies that hold sufficient assets in India—suffer from some obvious problems. An important aspect of this approach for taxing indirect transfers is that transfers of shares of foreign entities by nonresidents are treated as giving rise to items of *per se* taxable income: any capital gain on such transfer is explicitly stipulated to have a domestic source. Take Canada for an example. If Foreign Company *A* derives more than 50% of the fair market value of its shares directly or indirectly from real or immovable property situated in Canada, then the shares of *A* constitutes "taxable Canadian property," and any capital gain realized on the disposition of shares of *A* is deemed to arise in Canada. Suppose now that *A* is wholly owned by another foreign company, *B*, and *B* has no assets other than *A*'s shares. The shares of *B* would also constitute "taxable Canadian property". Any capital gain realized on the disposition of *B* shares is therefore also taxable income in Canada, and is legally distinct from the capital gain that has accrued to or been realized on *A* shares. If the capital gain on the disposition of the shares of *A* (by *B*) has been taxed in Canada, that does not prevent the capital gain realized on the disposition of the shares of *B* (by *B*'s shareholder) from being taxed in Canada (or vice versa).

Interestingly, neither Canada, Australia, Japan, nor the Commentaries on the OECD and UN Model Tax Conventions, has addressed this problem of multiple taxation arising from the taxation of indirect transfers of real estate. Nor do they (or the United States, in its law taxing the transfer of U.S. companies that hold U.S. real property) deal with an issue of proportionality: if the shares of holding Company derive only 50% of their fair market value from domestic assets, under most of the existing SAARs, *all* of the capital gain realized on the sale of the shares is taxable in the country of the location of the underlying assets. Although the recent Shome Report in India recommends that any gain realized on a taxable indirect transfer should be taxed only in proportion to the value of the Indian assets relative to the entity's global assets, this is still different from taxing the gain on the transfer only to the extent attributable to gain realized on the underlying Indian assets.[72]

Are governments justified in their indifference about these problems? One view is that the decision of how many layers of intermediate companies are interposed between the domestic asset and ultimate investors is in the control of the taxpayers, as are decisions to make dispositions at different levels. If governments are wary of convoluted and opaque offshore

structures, but by non-compliance and evasion. If a government wants to maintain the credibility of its anti-avoidance regime without committing indefinite resources to enforcement, it should try to maximize voluntary compliance. Rationalizing the rules for taxing indirect transfers — including by mitigating the multiple taxation of the same economic gain — seems to be one strategy for increasing voluntary compliance.

Notably, China's policy for taxing indirect transfers, though problematic in adopting an approach of case-by-case determination, inadvertently suggests a solution to the problems characterizing the existing SAARs. In China, indirect transfers become taxable only after they have been determined by tax authorities to be, in economic substance, direct transfers. The layers of offshore holding companies, instead of creating separately and distinctly taxable assets under Chinese law, must be disregarded. This implies[74] that if the shares of a Chinese company are treated as having been disposed of indirectly through the transfer of an offshore entity, the fact that the indirect transfer has been subject to tax should be reflected by adjusting the tax cost or basis for the Chinese company's shares.[75] This eliminates the possibility of taxing the same economic gain multiple times as a result of multiple layers of indirect transfers. Moreover, the tax on an indirect transfer would always necessarily be proportional. The source country will only get to tax any gain represented by the excess of (1) the portion of the purchase price paid on the indirect transfer that is allocable to the shares of the target company in the source country

[74] Not all Chinese tax policymakers, administrators or advisors have grasped these implications. Since the adoption of 698, parties have been more focused on *when* indirect transfers are taxable and not *how*.

[75] For example, suppose that Foreign Investor S forms an offshore company P with equity capital of 200. P in turn contributes 200 of equity capital to Chinese company Q. When the value of Q shares grows from the initial value of 200 to 250, S sells the shares of P for 250 to buyer B. If China decides to disregard the existence of P to tax S on the sale, and S is liable for tax on the gain of 50, then the tax basis or cost of Q shares in the hands of P, and of B, should each be adjusted to 250. If either P disposes Q shares now for 250, or B disposes of P shares for 250, there should be no further tax for either P or B.

tax" and rely on a treaty provision to preserve the taxing rights of the former residence state and prevent double taxation.

Exit taxes (also referred to as "departure taxes") are taxes that countries levy immediately before a person ceases to be a resident. Under an exit tax, assets owned by an emigrant are deemed to be alienated at market value and reacquired at a cost equal to that value. For instance, under the Australian domestic law exit tax rules, a person ceasing to be resident is deemed to dispose of assets other than taxable Australian assets, on which non-residents are taxed, at market value. Individuals may elect not to be taxed on exit in which event taxation is deferred until actual disposition, but, rather, at the cost of tax on the full capital gain, including gains accruing after ceasing to be a resident. Similarly, Australia deems a person who becomes a resident to acquire assets other than taxable Australian assets at market value on becoming a resident. Canadian rules are largely similar to the Australian ones.

However, in the absence of coordination between the treaty states, a problem regarding the potential double taxation of the accrued gain may arise. This occurs when the property is actually alienated and the current residence state taxes the entire gain, computed by reference to the historical cost basis, which includes the gain that has been subject to the exit tax in the former residence state. Countries with exit taxes, such as Australia, Canada, the Netherlands, South Africa and the United States, may include special provisions in their tax treaties to resolve the problem of double taxation. This is usually realized by allowing the taxpayer to use a tax cost for the asset in the new residence state equal to its market value at the time of the change in residence.

Trailing taxes are taxes levied after a change of residence over assets that would normally not otherwise be taxed in the hands of a non-resident, but are usually taxed under domestic law if

alienated within a given period following the change of residence (generally 5 to 10 years). A country may have both a trailing tax and an exit tax if a taxpayer has an election to be subject to the exit tax or remain liable to tax for the full gain realized on actual alienation following the change of residence.

Trailing taxes create two problems. First, the former residence state's taxing right is, in the absence of a special provision, denied by article 13 of the OECD Model if the former residence state has no jurisdiction to tax particular gains under a tax treaty as a source state. Countries with only a trailing tax may preserve the operation of the tax for a given period. Second, many tax treaties that permit the former residence state to impose a trailing tax do not require the new residence state to make a corresponding adjustment to the cost base.