International Aspects of Capital Gains Taxation

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1.0 Introduction

This chapter considers the international tax issues arising in designing a capital gains tax (CGT). In other words, what are the key considerations of a CGT regime, in domestic and international law, particularly from the perspective of the taxation of gains relating to cross-border transactions?

This discussion looks at two broad areas in respect of CGT design issues in respect of the taxation of non-residents. The first area relates to the domestic design of the tax and focuses on whether a CGT should apply to all assets held by non-residents, or alternatively to some limited subset of those assets (including the possibility of it not applying at all).

The second area is how double tax agreements (DTAs) interact or change domestic CGT taxing rights. This area is intricately connected with the first issue because pre-existing and previously negotiated positions in a DTA network can influence domestic design decisions. DTAs limit the taxing rights of contracting states primarily to avoid or reduce double taxation. This normally occurs by relieving taxation in the source state. DTAs therefore change or alter domestic taxing rights.¹ This may involve an allocation of taxing rights from one jurisdiction to another by excluding the application of domestic tax law.² If domestic law purports to tax certain capital gains which are exempt from tax under a DTA then problems can arise.

In addition to the DTA network potentially influencing the scope of the taxation of capital gains, the following questions arise: How does an existing tax treaty network apply to a newly

¹ Vogel/Rust, in Reimer & Rust (eds), Klaus Vogel on Double Taxation Conventions, 4th edn (2015), Introduction at m.no 30, (page 23).
² Probably the most common example of this is the non-taxation of business profits in the source jurisdiction where the residence based enterprise does not carry on business in the source jurisdiction through a permanent establishment situated there. In the context of capital gains relief of double taxation under the DTA may occur through the non-taxation of a capital gain which has a source in one jurisdiction with the taxing rights being allocated to the residence jurisdiction.
introduced CGT? How do DTAs entered into prior to the introduction of a CGT apply to determine and allocate taxing rights? What are the current settings for allocating taxing rights within an existing DTA network? Should a country retain domestic taxing rights over both land and movable property gains sourced in its jurisdiction? In particular, what should a country’s policy be in respect of determining how to tax gains made on movable property? Should a country opt for the retention of source based taxing rights in respect of movable property situated within its jurisdiction, or adhere to the OECD Model Tax Convention on Income and Capital (OECD Model) which gives away these source based taxing rights in return for enhanced residence taxing rights?

Within any DTA network there exists a series of more detailed DTA related technical issues which relate to the scope of Article 13. For example, how does Article 13 relate to the taxation of land which is held as the inventory of a business taxpayer? Expressed another way if an enterprise sells land which is part of its trading stock should this be treated as business profits under Article 7 or as income under Article 13?

The questions above require consideration prior to determining how non-residents will be subject to a CGT. The approach taken in this chapter is to initially consider the issues in a wider context having regard to the OECD Model, and then in a more detailed way to consider the impact and consequences of introducing a CGT using New Zealand, as an example. As it happens, New Zealand is a particularly instructive case because (a) it is a member of the OECD, (b) it does not have a comprehensive CGT (that is, a tax on capital gains as such), but it does treat various classes of capital gains as ordinary income and taxes them accordingly, and (c) it has a network of DTAs that is fairly typical except that the inconsistency in the articles dealing with capital gains (generally Article 13, as in the OECD Model) provides a basis for examining the variety of difficulties that might arise.

The expectation is that the reader from any country will need to consider this broader picture before

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4 They are enhanced residency based taxing rights because they are, on the basis of reciprocal tax treatment, likely to increase residence taxation due to the non-taxation of foreign sourced capital gains.
examining their own jurisdiction’s framework and DTA network. It is likely that other jurisdictions face similar issues to those facing New Zealand.  

2.0 The domestic issues arising in respect of the design of the tax

One of the fundamental international tax issues that tax policy makers will confront is the question of how comprehensive a CGT is in respect of non-resident taxpayers. Simply put: should CGT apply to all assets owned by non-residents, only some assets (such as land or movable property held by a non-resident’s permanent establishment), or to no assets (that is, the CGT does not apply to non-residents at all)?

An example of a CGT regime which involved a reasonably comprehensive coverage of assets was that provided by the Australian CGT regime prior to changes made in 2006. Australian CGT previously applied to non-residents on the disposal of assets that had the ‘necessary connection with Australia’. The list of assets was comprehensive and included land, buildings, shares and various interests in connection with land situated in Australia, any asset which had been used by the taxpayer in carrying on business through a permanent establishment in Australia, shares in an Australian private company, an interest in an Australian resident trust, shares in an Australian resident public company (or units in a resident unit trust) where the individual and/or the individual’s associates had been beneficial owners of at least 10 per cent of the issued share capital of the company (or 10 per cent of the units), and any options or rights to acquire any of the assets mentioned above.

Sometimes the category of assets extends beyond a jurisdiction. China imposes tax on the sale of shares in Chinese companies, not only in respect of a direct transfer of shares in a Chinese company but also when there has been an indirect transfer of shares (that is, the sale of shares in an offshore holding company owning shares in the Chinese company).  

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5 This is likely because of the similar if not identical language in many DTAs.
6 See China’s Capital Gains Taxation of Non-residents and the Legitimate Use of Tax Treaties, Dongmei Qiu, Tax Notes International, Vol 60, No 8, 593 (November 2010).
More often CGT regimes focus, in the case of non-residents, only on particular classes of assets situated within the jurisdiction. The 2006 tax changes to the Australian CGT regime narrowed the expansive range of assets referred to above upon which a non-resident would be liable to Australian CGT. The current CGT regime now includes Australian land and business assets of a non-resident’s Australian based permanent establishment. Other regimes which focus on selected assets, usually land and shares in a company which owns land, include the United States,7 and South Africa.8

Sometimes CGT does not apply at all to non-residents. This was generally the position in the United Kingdom prior to April 2015. There were some exceptions to this policy, for instance recent UK residency and short-term non-residency status may make a recently migrated individual still subject to UK CGT. Assets held as part of a business in the UK continue to be subject to CGT.

However, in an Autumn Statement 2013 the UK government announced proposals to introduce a CGT on gains made by non-residents disposing of UK residential property with respect to dispositions made after April 2015 (and in respect of gains arising from that date).9

2.1 Arguments in favour of a CGT imposed on a comprehensive basis

2.1.1 Revenue and retention of source taxing rights

It seems a reasonable assumption that the more comprehensive a CGT is, the more revenue it will raise. As indicated above, many countries decide to impose CGT on non-residents on a different asset base which is normally less comprehensive than that imposed on residents (for

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7 According to Publication 519 (2013), U.S. Tax Guide for Aliens, US aliens (non-US residents) are subject to US tax only in respect of US sourced income which would include any gain on the sale of real property. The US, however, regards non-residents who derive capital gains on the sale of personal property situated in the US as non-residents deriving foreign sourced gains and these are not subject to US tax. The IRS website reads: 

‘Gain or loss from the sale or exchange of personal property generally has its source in the United States if the alien has a tax home in the United States. The key factor in determining if an individual is a U.S. resident for purposes of the sourcing of capital gains is whether the alien’s “tax home” has shifted to the United States. If an alien does not have a tax home in the United States, then the alien’s U.S. source capital gains would be treated as foreign-source and thus nontaxable.’

8 Likewise in South Africa the South African Revenue Service advises "A non-resident is only liable to CGT on immovable property in South Africa or assets of a “permanent establishment” (branch) in South Africa. Certain indirect interests in immovable property such as shares in a property company are deemed to be immovable property."

9 See the statement, extracted 20 October 2015, from the UK Government and HM Customs & Revenue at https://www.gov.uk/guidance/capital-gains-tax-for-non-residents-uk-residential-property.
example excluding shares in companies that do not invest in land). Some countries have different investment asset profiles than others in the sense that there may be greater investment in land rather than financial assets. Because of these two factors the extent to which certain assets are held by non-residents is significant in designing a tax that will raise revenue.

Take the situation in New Zealand as an example of a country which is a net capital importer.\(^\text{10}\) The fiscal revenue raising implications of introducing a CGT seem to be very hard to quantify and part of the reason for this is that part of the tax base which is owned by non-residents.\(^\text{11}\) Outside of land and assets owned by a foreign controlled permanent establishment the major New Zealand asset class is shares in New Zealand companies. Intuitively, given the relatively high foreign ownership of large New Zealand companies, forgoing CGT on gains made by foreign owners is likely to be significantly revenue adverse. The reason for this is that, unlike many other countries, the majority of New Zealand’s largest companies are overseas owned. Relatively few are listed on the domestic stock market. Of the largest 200 New Zealand companies, 102 are at least 50 per cent overseas owned and are not listed on the New Zealand stock exchange. Of the 48 companies listed on the New Zealand stock exchange, 14 are at least 50 per cent offshore owned.\(^\text{12}\) Overall, New Zealand-resident investors only owned 67 per cent of the New Zealand stock market in 2013.\(^\text{13}\)

Consequently, in this example of New Zealand, careful thought needs to be given about whether revenue on the sale of New Zealand companies should be excluded from the tax base. One


\(^{11}\) An example of how difficult it is to estimate revenue from is found in the various debates about introducing a CGT in New Zealand. The Treasury and New Zealand and Inland Revenue in their Background paper for Session 3 of the Victoria University of Wellington Tax Working Group entitled *The Taxation of Capital Gains* suggest a figure of $4.5 billion on an accrual basis excluding the family home, whilst on a realised basis it appears the figure is closer to $1.5 billion (again drawn from this report). Clearly such figures are somewhat nonsensical until the details of the tax are released and would also be very dependent on economic activity.

\(^{12}\) These comments are drawn from an analysis of the Deloitte/Management Top 200 New Zealand companies made by Brian Gaynor in his article in the New Zealand Herald entitled *Foreign Ownership Shortchanging Locals*, December 15, 2012.

\(^{13}\) Another Brian Gaynor article in the New Zealand Herald analysing sharemarket ownership figures compiled by Goldman Sachs. *New Zealanders Buy Back Their Sharemarket*, October 19, 2013 suggesting that the level of New Zealand ownership has increased from 65 per cent in 2012, 64 per cent in 2010 and 46 per cent in the mid-1990s.
reason for looking carefully at this is the growing awareness that emphasis on residence-based taxation, particularly of business profits earned through foreign direct investment, leads to “double non-taxation”.\textsuperscript{14} Rather prophetically, given recent OECD and G20 initiatives, Alex Easson as long ago as 1996 expressed concerns on this matter in reflecting on the difficulties associated with taxing international mobile capital: “In reality, the choice may be between source country taxation and no taxation at all.”\textsuperscript{15} Furthermore, Eassen noted that in many OECD countries, the majority of shares of listed companies are held by tax exempt entities such as pension funds or financial institutions that might be subject to special tax regimes (offering limited or no taxation).\textsuperscript{16}

That said, for reasons discussed shortly, many countries do not tax non-residents on gains made on the sale of personal property, and in particular shares in resident companies, where the income or gain could be said to have a source in their jurisdiction. This means that a country with a residence based tax system will maximise its revenue from a CGT on foreign shares owned by residents (outbound investment rather than inbound investment),\textsuperscript{17} but such an allocation of taxing rights is usually an obligation imposed under a DTA and not as a matter of domestic law policy.\textsuperscript{18}

2.1.2 Equality between residents and non-residents

As previously indicated the 2006 tax changes to the Australian CGT regime narrowed the range of assets on which a non-resident would be liable to Australian CGT. These taxable assets are now Australian land, and those business assets of a non-resident’s Australian based permanent establishment.

\textsuperscript{14} Currently the major focus of the OECD in its Base Erosion and Profit Shifting project. OECD (2013), \textit{Addressing Base Erosion and Profit Shifting}, OECD Publishing (http://dx.doi.org/10.1787/9789264192744-en).

\textsuperscript{15} Alex Easson, \textit{Fiscal Degradation and the Inter-National Allocation of Tax Jurisdiction} (1996) 5 EC Tax Rev. 5 at 112-3.


\textsuperscript{17} If the source country does not impose tax on the capital gain then the home country will not have to give a credit for that foreign tax and would be entitled to the full revenue tax benefit.

\textsuperscript{18} The reason for this is that the OECD \textit{Model Tax Convention on Income and Capital: Condensed Version} (9th ed, Paris, 15 July 2014), Article 13 (5) provides that gains from the alienation of any property that is not dealt with in earlier paragraphs of Article 13 is not subject to tax in the state of source and exclusively taxable where the seller is a resident.
Australian CGT previously applied to non-residents on a much more comprehensive basis which involved the disposal of assets that had the "necessary connection with Australia". Such assets included land, buildings, shares and various interests in connection with land situated in Australia, any asset which had been used by the taxpayer in carrying on business through a permanent establishment in Australia, shares in an Australian private company, an interest in an Australian resident trust, shares in an Australian resident public company (or units and a resident unit trust) where the individual and/or the individual’s associates have been beneficial owners of at least 10 per cent of the issued share capital of the company (or units), and any options or rights to acquire any of the assets mentioned above.

When Australia made this change it had to confront the issue of whether non-comprehensive CGT taxation could give foreigners a tax advantage that the residents of the country would not enjoy. Generally speaking, most countries’ tax systems apply relatively uniformly to residents and non-residents alike. When Australia decided in 2006 to modify its provisions relating to CGT, so as to narrow the range of assets on which a non-resident was subject to tax, political opposition made this point:

... what is at issue is a matter of equity and basic principle-namely that Australian law must not have the effect that Australians are treated less favourably than foreigners under our tax laws, or that non-Australians are given an unjustifiable competitive advantage over Australian citizens and residents.

With respect to non-residents, by limiting the range of assets that a CGT applies to, it is possible to see this as inequitable and potentially unfair when contrasted with the taxation of

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19 It is worth noting that the non-discrimination in the Model Convention (Article 24) requires consideration on this matter. A discrimination made on the basis of residency rather than nationality does not offend Article 24 (1) and provided CGT applies to a permanent establishment in the same or a similar way that it applies to a company resident in the source country then Article 24 (3) should not be able to be invoked.

20 The more likely allegation is that residents are favoured in comparison to non-residents, particularly in the areas of thin capitalisation, the ability to utilise imputation credits, and the ability to use foreign tax credits.

residents. Furthermore, such a tax preference can create an incentive for residents to structure their investments as non-residents.

2.2 Arguments in favour of a targeted range of assets (such as land and business assets owned by a permanent establishment)

2.2.1 Attracting foreign direct investment (FDI)

A principal reason given for the 2006 narrowing of the range of assets upon which a foreign resident would be liable to Australian CGT was “to further enhance Australia’s status as an attractive place of business and investment by addressing the deterrent effect for foreign investors of Australia’s current broad foreign resident CGT tax base”.22 The associated benefits in this reform were seen as greater certainty and generally lower compliance costs for investors.23

The approach taken in Australia was supported by work performed in the OECD. This suggested that “there is a growing consensus that taxation matters for FDI, but the extent to which it does so has been subject to debate, and different studies produce varying tax elasticities of FDI”.24 This working paper suggested, however, that focusing only on taxation in home and host countries and omitting broader policies, labour and product markets settings, could lead to a serious overestimation of the relevance of the tax policies.

The evidence to suggest that the absence of CGT on certain asset classes is important to attract foreign investment is not conclusive. In fact some studies suggest it is not an important consideration.25

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22 To real property and business assets of a foreign resident’s Australian permanent establishment contained in the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No. 4) Bill 2006 at paragraph 4.5.
23 Ibid, at paragraph 4.6.
2.2.2 Conforming with an international norm

Another justification given for the change in the Australian CGT regime was that it would align Australian law to that most commonly found in international practice. Such international CGT practice only taxes land situated in the source state, property connected with a permanent establishment based in the source state operated by a non-resident, and the shares of companies which own land in the source state. Given the changes made to the taxation of land held by non-residents in the United Kingdom so that CGT is now included on sales of residential land,\(^{26}\) then the position in that country, the US,\(^{27}\) South Africa,\(^{28}\) and Canada\(^{29}\) are broadly similar. As indicated, such countries also usually extend the definition of “taxable” property to include the shares of companies where a specified percentage (usually more than 50 per cent of the fair market value) of the share is attributable to real or immovable property, or natural resources, situated in that jurisdiction.

2.2.3 The practicalities of tax administration

There is a real challenge for tax administrations to discover the presence of a taxable gain in circumstances where the non-resident vendor has not returned it. A share register can disclose the residence of a shareholder with respect to a direct share disposal but it is much more difficult to identify an indirect sale (where the disposal takes place at a holding company level). In addition to identification of the presence of the gain it is similarly hard to enforce the payment of the tax in an indirect sale situation when the vendors are located in another jurisdiction and the assets (including settlement proceeds) are all offshore.

2.2.4 Current DTA obligations

One of the important issues in this debate of how comprehensively CGT regimes apply to categories of assets is the extent to which a country has existing DTA arrangements which already

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\(^{26}\) The UK government introduced a CGT on gains made by non-residents disposing of UK residential property after 5 April 2015.

\(^{27}\) Internal Revenue Service Publication 519 (2013), U.S. Tax Guide for Aliens.


\(^{29}\) Canadian Revenue Authority, Non-Residence and Income Tax, T4058(E) Rev. 13.
provide for the allocation of taxing rights. Let us assume that a country’s current DTAs apply to a newly introduced CGT.\textsuperscript{30} Equally, a country may decide to change key features of an existing CGT regime. Unless the country decides to embark on a complete renegotiation of its DTA network, then existing DTAs already allocate some of the country’s taxing rights. In order to discuss this it is necessary to explain the position generally under the OECD model. Then, by way of example, we consider the approach taken in New Zealand’s DTA network in order to understand how pre-existing DTAs can affect new taxes.

**Gains on the disposal of immovable property or land (Article 13 (1))**

The source state taxation provided for in Article 6 of the Model Convention (which focuses on income derived from the *use* of immovable or land rather than gains on its disposal) is retained in respect of any gains made on the alienation of immovable or land. Article 13 (1) proceeds on the basis that “gains derived by a resident of a Contracting State from the alienation of immovable/real property referred to in Article 6 and situated in the other Contracting State may be taxed by that other State”. Accordingly, Article 13 (1) follows the pattern of Article 6 in having a resident of one state dispose of property situated in the other.\textsuperscript{31}

The introduction of a CGT into a country that consistently uses Article 13 (1) means that the tax on gains made on the sale of land will be largely unaffected by existing treaty obligations. As an example, turning to the New Zealand DTA network, the result of using the OECD Model Article 13 (1) is that if gains from the sale of land\textsuperscript{32} situated in New Zealand are taxable in New Zealand under domestic law then the DTA preserves that taxing right. The New Zealand DTA network is very

\textsuperscript{30} This issue is discussed subsequently at 3.1.
\textsuperscript{31} Accordingly, it does not apply where the alienator is a resident in the state where the property is disposed of (or a dual resident) nor where the property is located in a third state. There is a close correlation between paragraphs (1) and (4) so that if shares in an interposed company holding immovable property were disposed of the gain is sometimes treated in the same way as if the gain was generated by the sale of directly held immovable property.
\textsuperscript{32} The terms ‘immovable’ and ‘real’ property are used interchangeably in New Zealand’s DTA network but unfortunately the distinction between real and personal property does not exactly match the distinction between immovable and movable property. This issue is discussed in greater detail in C Elliffe, *International Cross-Border Taxation in New Zealand* (2015) Thomson Reuters, ch 4.9, at 484-488.
consistent with this outcome and only two old treaties do not have the equivalent to the OECD Model Article 13 (1) but the effect is the same.\textsuperscript{33} New Zealand therefore retains, broadly, the right to tax gains made from the sale of immovable/land.\textsuperscript{34} However, whilst the statement is true on a general basis, there is significant variation in the New Zealand DTAs with respect to Article 13 (1). This is because the terms used in the opening words of Article 13 (1) (such as ‘gains’ or ‘income or gains’) affect the scope of the Article. This problem is discussed in greater detail, subsequently, at paragraph 3.2.\textsuperscript{35}

Gains on the disposal of movable or personal property which is part of the business property of a PE

Gains made from the disposal or alienation of movable or personal property which forms part of a business property of a PE which an enterprise of a contracting state has in the other (source) state may be taxed in the source state. Under the OECD Model Article 13 (2) it is clear that the outright sale of the whole of the PE (or more accurately the gains made in respect of the sale of assets of the PE) may also be taxed in the source state.\textsuperscript{36}

Exactly what property forms part of the business property of a permanent establishment may be somewhat of a debateable point in different jurisdictions? In many countries care should be taken in the assessment of what is business property of a permanent establishment.\textsuperscript{37} The OECD

\textsuperscript{33} These are the Fiji/New Zealand DTA (1977) and the Malaysia/New Zealand DTA (1976). Both of these treaties have neither Article 6 nor Article 13 but proceed instead with a definition of "industrial or commercial profits" which excludes income or profits from the sale or other disposition of land. This exclusion means that domestic taxing rights are preserved and that the equivalent to Article 7 (normally business profits but under this older treaty model industrial or commercial profits) does not apply to limit New Zealand sourced taxation to only that where the non-resident has a PE in New Zealand.

\textsuperscript{34} Assuming, of course, such gains are subject to New Zealand tax which may not be the case in respect of the sale of certain landholdings.

\textsuperscript{35}The consequence of using terms such as "gains" or "income or gains" in Article 13 (1) may give rise to the interpretation that some of New Zealand’s DTAs (those that use simply the term "gains" and there are eight DTAs that do so) do not apply to give New Zealand taxing rights in respect of income (as opposed to capital gains) arising on the sale of real estate acquired with the intention of disposal or where the sale of land as part of the business of dealing in or developing land unless the enterprise concerned has a permanent establishment in New Zealand.

\textsuperscript{36} The OECD Commentary describes “movable property” as all property other than immovable property (dealt with in paragraph (1) and defined in Article 6) see the OECD Model Convention (2010), Commentary on Article 13, paragraph 24.

\textsuperscript{37}See in particular paragraph 27.1. of the OECD Commentary.
Commentary on Article 13 refers to the Committee of Fiscal Affairs’ report Attribution of Profits to Permanent Establishments and the concept that economic ownership of the property is allocated to the permanent establishment in accordance with the discussion in that report. New Zealand, along with Chile, Greece, Mexico, Turkey and Portugal, disagreed with the approach taken in Part I of the 2010 Attribution of Profits to Permanent Establishments Report and has made a Reservation to Article 7 saying that it reserves the right to use the previous version of Article 7. New Zealand has also made a Reservation to paragraphs (3) and (5) of Article 13 but is silent in respect of Article 13 (2).

Thus, as an example of the operation of Article 13 (2), New Zealand will be able to tax the gain provided the movable property forms part of the business property of a permanent establishment in that country. In the event that the movable property is not part of the business property of a permanent establishment then Article 7 may apply which will allocate New Zealand’s taxing rights away from a New Zealand sourced gain to the country of residence of the foreign enterprise.

Gains from the alienation of ships and aircraft operated in international traffic

The OECD Model contains a provision that deals with gains from the alienation of ships and aircraft operated in international traffic (and personal property pertaining to the operation of such ships and aircraft). This allocates the taxing right exclusively to the Contracting State where the place of effective management of the enterprise is situated (or where the enterprise is resident) effectively allocating taxing rights to the country of residence.

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38 See in particular paragraph 27.1.
39 Case law suggests that isolated transactions may well be business profits: Thiel v Federal Commissioner of Taxation (1990) 94 ALR 647, (1990) 171 CLR 338. Even if they are not business profits per se but are assessable under Part C of the Income Tax Act 2007 (NZ) (because the property was acquired for the purpose of resale) New Zealand will still have a taxing right under Article 13 (2) if the gain was made in respect of business assets which form part of the business property of the permanent establishment.
40 Article 7 provides that business profits (say a one-off transaction of shares acquired for the purpose of resale) with no New Zealand permanent establishment will be only taxed in the taxpayer’s country of residence.
41 OECD Model, art 13(3).
Gains from the alienation of shares in property rich companies

Gains from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State can be taxed in that State. This is an important provision because it allows for the taxation of gains from the sale of such shares in circumstances where the underlying sale of the immovable property would be subject to tax in the state of source (such gains being covered by Article 13 (1)).

Article 13 (4) provides as follows:

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.42

The inclusion of Article 13 (4) means that it is not open to a non-resident to incorporate a property-holding company and dispose of their investment through the sale of the shares in that entity in a tax-free manner if the domestic jurisdiction taxes shares in property rich companies.

If a country decides to introduce a CGT then the approach taken with respect to Article 13 (4) becomes critical. This is because the absence of Article 13 (4) in a treaty network can significantly undermine the taxation of non-residents in respect of gains from the sale of shares in property rich companies; and that, in turn, undermines the taxation of non-residents in respect of gains derived from the sale of immovable property.

For whatever reason, New Zealand has not consistently included Article 13 (4) in its DTAs and thus there is the potential for significantly different tax outcomes for vendors of shares resident in different jurisdictions in respect of gains made on New Zealand property rich companies. It is therefore an interesting case study because this has previously never been an important issue for New Zealand tax policy makers. New Zealand has as yet resisted the introduction of a comprehensive

CGT; that is, there is no tax on capital gains as such, but some classes of capital gains are treated as income and taxed accordingly (for example gains made on the sale of land acquired for the purpose of sale). Accordingly, the allocation of taxing rights under Article 13 was seen as an academic point.

The theoretical problem of taxing gains on the sale of land can no longer be said to something that would be addressed in the future. This is because the New Zealand Government announced in the 2015 Budget that it would introduce a bright-line test to tax any gain on the sale of residential property where the property was acquired on or after 1 October 2015 and sold within two years of acquisition. Suddenly, the issue of whether property-rich companies could be used to circumvent this bright-line test became a critical issue which required legislative action. Included within the draft legislation is an anti-avoidance provision which deems a sale of shares in a property-rich company to be a disposition by the company of the residential property to the shareholder and resale by that shareholder back to the company. This has the effect of crystallising a deemed gain on the sale of residential property by the shareholder with the effect that the gain arises from the deemed sale of the land itself rather than from the sale of the shares.

The deemed sale of the residential property by the shareholder (which is in substitution for the real transaction which is a sale in the property-rich company) can be seen as a response to the problem that a significant number of New Zealand’s DTAs allocate the right to tax the shares of property-rich companies to the country of residence of the company rather than to the country where the land is situated. The effect of the deeming transaction circumvents the treaty obligations and arguably is an example of domestic law overriding the DTA network.

So what exactly is the position under the New Zealand DTA network? To give some indication of the scale of the problem, Appendix A (at the end of this chapter) shows which of New Zealand’s

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43 Income Tax Act 2007 (NZ) ss CB 6 – CB 23B.
44 This legislation is contained in the Taxation (Bright-line Test for Residential Land) Act 2015.
46 This is defined as a company which owns residential land and these assets represent 50% or more of the market value of the assets of the company (section GB 52 (1)).
DTAs allow the source country to tax gains made on disposals of property rich shares, and which do not. We now seek to explain what this means for those of New Zealand DTAs that incorporate Article 13 (4). Also, what are the consequences if the New Zealand DTAs have not?

**DTAs that have Article 13 (4)**

It is probably a fair conclusion to say that in the majority of cases, prior to the introduction of a CGT, New Zealand will seek to impose tax more often on the sale of land held by a company than upon the sale of the company’s shares.47

What this means though is that New Zealand reserves the right to apply its share sale taxation rules where the relevant DTA contains Article 13 (4). This is the large majority of countries with which New Zealand has a DTA.48 The point to note, referred to above, is that there may be a mismatch between the taxation of a gain made on a sale of the underlying assets of the company and a gain made on the sale of the shares of that company. If, however, a gain on the sale of the land-rich company shares were to be subject to New Zealand’s domestic tax under the design of the CGT then 75 per cent of the country’s DTAs would reinforce that taxing right. In other words, if the domestic CGT imposes tax on personal property (including shares in companies of course) then the large majority of New Zealand’s DTAs will preserve that taxing right in respect of the sale of shares in property-rich companies.

**DTAs that do not have an equivalent to Article 13 (4)**

47 The reason for this is that the relevant taxing legislation (subpart CB of the Income Tax Act 2007) has a wider net to capture gains which arise from the direct sale of real property than for gains derived from the sale of shares. For example, it is often said that New Zealand’s land sale provisions are quasi-capital gains tax, taxing builders, developers, sub-dividers (and in all these cases their associates) and situations involving a significant increase in land due to changes in zoning and resource management. The same cannot be said for the sale of shares. Gains made on sales of shares are only taxable where the shares are held on some form of revenue account, which means they will have been acquired for the purpose of resale, as part of the profit-making undertaking or scheme, or as part of the business of the holder. Given the lack of symmetry, it is possible for a non-resident to sell shares and to suffer no tax under New Zealand domestic law even when a gain made on a sale of the underlying property would have been subject to tax.

48 The majority of which are the more recently negotiated DTAs comprising about 75 per cent of the New Zealand DTA network.
The answer, if DTAs do not have a paragraph (4), is that the tax position will default to Article 13 (5) of the OECD Model. This is because paragraph (5) is the default position if the preceding paragraphs (that is, paragraphs 1 to 4 of article 13) do not deal with the issue. For example, paragraph (4) of the German/New Zealand DTA provides as follows:

Income or gains from the alienation of any property, other than that referred to in paragraphs 1 to 3, shall be taxable only in the Contracting State of which the alienator is a resident. 49

This means that a German resident holding shares in a New Zealand land-rich company will only be subject to tax in Germany, and not New Zealand, on a gain on their disposal. New Zealand has surrendered its taxing rights in return for increased residency taxing rights in respect of New Zealanders holding shares in land-rich companies where property is situated in Germany. Consequently, New Zealand CGT will not be able to be imposed on shares in land rich New Zealand companies held by German residents. 50

New Zealand has nine DTAs where there is no equivalent to Article 13 (4). 51

The alienation of property not dealt with under the other paragraphs

Article 13 (5) operates as a default provision and it deals with gains from the alienation of property which are not dealt with in any of the preceding paragraphs of Article 13. The OECD Model provides that such gains are taxable only in the state of which the alienator is a resident. The country which is the source of the gain has allocated its taxing right to the country of residence.

New Zealand has entered a reservation in respect of paragraph 5 of Article 13. 52 Given that New Zealand is one of the few countries in the OECD without a CGT, it is difficult to see the reason

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49 This is identical to the OECD Model paragraph (5) except for the reference to the preceding number of paragraphs.
50 Depending on the design of New Zealand’s CGT this raises important issues with respect to treaty shopping and future DTA negotiations.
51 These are Belgium, Denmark, Germany, Indonesia, Korea, Netherlands, Philippines, Switzerland, and the United Arab Emirates.
52 Also in respect of paragraph 3 to Article 13.
Whatever the reason for the reservation, the table in Appendix B illustrates quite graphically that New Zealand has not consistently followed the OECD Model.

**DTAs which provide for taxation of other gains in the state of residence**

The countries which have DTAs with New Zealand that are listed on the right-hand side of the table in Appendix B follow the OECD model and allocate taxing rights for other gains to the country of residence. For these countries, Article 13 (5) would apply to deny New Zealand a taxing right under a CGT where a gain has been made by a non-resident (naturally this is not a gain of a kind previously dealt with under any of the other paragraphs of Article 13 nor being a gain which is a business profit made by a New Zealand permanent establishment of a non-resident enterprise).

The most common example of Article 13 (5) applying to deny New Zealand taxing rights is likely to be a gain made on a share in a company under new CGT rules or under existing income tax law where the share was acquired as part of a profit-making undertaking or scheme or for the purpose of disposing of it. It is however a debatable point as to whether a one off gain would be caught as a business profit to which Article 7 applies although the majority of court decisions, and the Commentary itself suggests that the term “business profits” should be read widely and include one-off transactions. In any event, provided the alienator does not have a permanent

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53 A country with a CGT that wished to retain its CGT source taxing rights would be the more likely candidate to make a reservation in respect of paragraph 5.  
54 Gains not dealt with under any of the preceding paragraphs in Article 13.  
56 Paragraph 59, Commentary on Article 7 of the OECD Model Tax Convention on Income and Capital, Paris, Eighth Edition, July 2010 (this is the Commentary on the old version of Article 7 which is the relevant one for New Zealand given its reservation to the new Article 7 and its non-adoption in New Zealand’s DTAs).  
57 Various cases have expanded on the issue of whether profits from isolated or one-off investment activities are included within Article 7. In *Minister of National Revenue v Tara Exploration and Development Co limited* (1972) 28 DLR (3d) 135, the Supreme Court of Canada held that an Irish resident company with no permanent establishment in Canada which bought and sold shares in three Canadian mining companies had carried out an adventure in the nature of trade which brought it within the business profits article of the Canada/Ireland DTA. In *Thiel v Federal Commissioner of Taxation* (1990) 94 ALR 647, (1990) 171 CLR 338, a Swiss resident purchased six units in an Australian private unit trust with the understanding that these units would convert into shares which were part of a public offering. This conversion occurred enabling the taxpayer to make a substantial gain from the sale of shares. The Australian Commissioner assessed the taxpayer and the taxpayer challenged this assessment on the grounds that the acquisition of the units and the sale of the shares constituted “an enterprise carried on by a resident of Switzerland” under the Australia/Switzerland DTA. His argument was that under the DTA these business profits were only taxable in Switzerland because there was no permanent
establishment in New Zealand, the result under Article 13 (5) and Article 7 would be the same and New Zealand would not have the right to tax the gain.

**DTAs which provide for taxation of other gains in the state of source**

As the table in Appendix B indicates a considerable number of New Zealand DTAs preserve source country taxing rights in respect of gains of a capital nature.\(^{58}\) An example of such a provision is found in recently re-negotiated Canada/New Zealand DTA as follows:

> Nothing in this Convention affects the application of the laws of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of any property other than that to which any of the preceding paragraphs of this Article apply.\(^ {59}\)

New Zealand does not steadfastly follow the OECD Model Article 13 (5) but instead appears to have accepted the negotiating position of its DTA treaty partners. This can be understood from the perspective of a country that has not been troubled by the presence of a CGT but the future may mean that treaty provisions previously regarded as unimportant could have real revenue consequences.

**Summary of conclusions in respect of New Zealand’s current DTA obligations**

As previously explained, in examining the New Zealand DTA network we have an example of a jurisdiction which has negotiated taxing rights in respect of a CGT when such a tax does not currently

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\(^{58}\) These are the countries on the left-hand side of the table.

\(^{59}\) Canada/New Zealand DTA (2012), Article 13 (5).
exist in that country. What has been created is incoherent in the sense that there is substantial inconsistency in retaining source taxing rights in some situations whilst surrendering them in others. The lesson is that a DTA network can endure beyond current tax policy settings. The diversity of treatment under the various paragraphs of Article 13 vividly illustrates the operation of these taxing rights. What then do we learn from this study and how can this be applied in future in countries contemplating reforming their existing CGT or introducing a CGT where currently there is no such tax?

New Zealand’s current DTA network would thus set the following parameters within which a CGT would have to operate.

1. Domestic taxation of gains made on disposals of land would not be constrained by the DTA network.
2. Domestic taxation of gains made on the disposal of movable property (shares and other business assets) where they are part of the business property of a permanent establishment of a non-resident taxpayer would not be constrained by the DTA network.
3. Nine of New Zealand’s DTAs would appear to preclude New Zealand from taxing a gain made on the sale of shares in a company, even where the company’s assets included (or consisted wholly of) land situated in New Zealand. New Zealand’s other DTAs would permit the taxation of such gains.
4. Domestic taxation of New Zealand movable property which is not part of the business property of a permanent establishment is constrained in respect of 20 DTAs (that is, New Zealand does not have taxing rights in respect of the alienation of movable property unconnected with a permanent establishment).\[61\]

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60 Belgium, Denmark, Germany, Indonesia, Korea, Netherlands, Philippines, Switzerland, and the United Arab Emirates.
61 Australia, Austria, Belgium, Denmark, Finland, France, Germany, India, Indonesia, Ireland, Italy, Japan, Korea, Netherlands, Philippines, Spain, Switzerland, United Arab Emirates, United Kingdom, United States of America.
In terms of New Zealand tax policy, if CGT were to be imposed on gains made on disposals of land\textsuperscript{62} and gains made on disposals of business assets of a New Zealand permanent establishment of a foreign enterprise, then there is no DTA constraint. However, international experience suggests that to impose CGT on gains made on disposals of movable property whilst not imposing it on indirect holdings (companies which own land) is problematic. Clearly the problem area is the use of companies to own land and the subsequent disposal of shares rather than the underlying land. In such circumstances the potential for treaty shopping and erosion to the CGT base could be substantial.

Consideration may be given to renegotiating the nine DTAs that do not contain the equivalent to Article 13 (4) or whether it is possible to design domestic law which legitimately overrides these treaty obligations particularly in situations where the treaty is being used abusively. The careful drafting of the anti-abuse provisions relating to the newly introduced bright line tax on residential property in New Zealand is a clear example of the consequences arising from DTAs that do not have Article 13 (4).\textsuperscript{63}

If the decision was made to impose CGT on a wider asset base than that referred to in the two paragraphs above then other more significant issues arise in terms of the 20 DTAs that allocate taxing rights to the residence countries in respect of Article 13 (5). This is an immediate problem but over time changes could be made in respect of those 20 DTAs. That should not be taken lightly: it would be a major task to renegotiate on a timely basis these DTAs.

The UN Model Commentary on Article 13 states that ‘most members from developing countries advocated the rights of the source country to levy a tax in situations in which the OECD reserves that

\textsuperscript{62} Real property could be expanded to include gains on other exploitation of natural resources. For instance in Australia, the term real property includes a mining, quarrying or prospecting right where the minerals, petroleum or quarry materials are situated in Australia. In the case of Canada, taxable Canadian property includes resource property and timber resources.

\textsuperscript{63} New Section GB 52 which has been introduced by the Taxation (Bright-line Test for Residential Land) Act 2015 referred to in the discussion at footnote 43 to 44 above.
right to the country of residence.\textsuperscript{64} The OECD Model allocates taxing rights to the country of
residence primarily in the default Article 13 (5) which deals with movable/personal property not
being part of the business property of a permanent establishment.

New Zealand, of course, is a member of the OECD. But it has, possibly because New Zealand
might want to introduce a CGT in the future, reserved its position in respect of paragraph 5. New
Zealand may therefore freely depart from the OECD Model in respect of Article 13 (5) and elect
source based taxation in respect of capital profits. There is certainly no need for a capital importing
country like New Zealand to be shy about protecting a source basis of taxation. There are already
many instances where New Zealand departs from the OECD Model in order to achieve that
outcome.\textsuperscript{65}

2.2.5 Conclusions on domestic CGT design with respect to non-residents

Should CGT in respect of non-residents apply to locally sourced gains on all assets owned or
some reduced range of assets? On balance, despite the valid concerns of inequality to residents and
loss of revenue, there seems to be greater rationale for limiting the scope of CGT to the asset
categories of land, shares in companies that primarily own land, and business assets held by a
permanent establishment of the foreign enterprise.

In the case of New Zealand, as an example of a country which has recently considered, and
rejected, a comprehensive CGT,\textsuperscript{66} it seems on balance that the limitation of the scope of CGT to
reduced asset categories make sense. The principal reasons for taking this approach are as follows:

\textsuperscript{64} United Nations Model Double Taxation Convention between Developed and Developing Countries (2011),

\textsuperscript{65} Good examples of these are the approaches taken in New Zealand DTAs with respect to the width of the
definition and rate of tax on royalty income in Article 12, the deeming of permanent establishments in Article 5
in circumstances where natural resources and the use of substantial equipment occur as well as "service"
permanent establishments.

\textsuperscript{66} The introduction of a bright line test on residential property bought and sold within two years is effectively a
short-term capital gains tax.
• The existing DTA network already prevents the taxation of movable property at source in New Zealand for 20 of New Zealand’s major trading partners. The most significant category of movable property will be shares in New Zealand companies.67

• Where most of the value of the assets of a company is in land then gains made on the sale of the company’s shares should also be subject to CGT; otherwise the potential avoidance is too easily achieved and too significant.68 This will mean it would be necessary for New Zealand to renegotiate nine of its DTAs or to consider other ways to prevent these treaties being used in a way that will undermine the imposition of CGT.

• Limiting the comprehensiveness of the CGT (to gains made on disposals of land and shares in land-holding companies) has been rationalised in other jurisdictions on the grounds of attracting and retaining foreign direct investment and adhering to an international norm consistent with the OECD Model.

• The impracticality of imposing (and collecting) tax on non-residents disposing of personal property.

3.0 Tax treaty issues arising from the introduction of a capital gains tax

The extent to which DTAs are already intricately involved in influencing domestic CGT policies is indicated above. Some other issues arise in respect of DTAs which require consideration. Again, the approach taken is to consider how these issues would arise and be dealt with under the New Zealand DTA network. This is likely to be illustrative of issues which would also arise under other jurisdictions’ DTAs.

67 Consideration could also be given to the taxation of a substantial holding on New Zealand listed stock exchanges such as the approach under the Canadian CGT where a shareholder (or associates of the shareholder) owned 25 per cent or more of the listed company then that constitutes taxable Canadian property.

68 Further, it would be important to consider integrity measures similar to those introduced by Australia in 2006. Under those provisions gains made on disposals of shares in a foreign (non-Australian) company investing in Australian real property are subject to Australian CGT. The Australian rules apply to any non-portfolio (greater than 10 per cent holdings) share in any interposed company (including foreign companies) where 50 per cent of the value of the interposed entity is attributable, whether directly, or indirectly through one or more other interposed entities, to Australian real property.
3.1 Do treaties concluded prior to the introduction of CGT apply to the newly introduced CGT?

The general position

Should it be assumed that existing DTAs apply in respect of a newly introduced CGT? In the case of New Zealand, Article 2 of many of the country’s DTAs specify “the income tax” as the sole “existing tax” to which the DTA applies. For many years the Australian Tax Office ran an argument that pre-CGT DTAs (those DTAs concluded prior to the introduction of Australian CGT) had no effect, and in particular, no restriction, on the Australian taxation of capital gains made by residents in those DTA countries.69

This position now seems to have been resolved in Australia with the courts concluding that the approach of the ATO was incorrect. An example of this litigation was the Australian Federal Court of Appeal in Virgin Holdings SA v Commissioner of Taxation.70

Capital gains tax is not a separate tax in Australia but it is part of "the income tax" imposed under the Federal law of Australia. It is therefore a tax to which the DTA applies under Article 2. Case law has held that even if a capital gains tax were introduced subsequent to the conclusion of a DTA it may still be regarded as a tax to which the DTA would apply. This is either because it falls within the term "Australian Income Tax" or, alternatively, because the DTA is expressed under Article 2 (2) as applying to "substantially similar taxes" imposed under the laws of Australia. In Virgin Holdings SA Edmonds J’s view was that the term "the Australian income tax" in Article 2(1)(a) accommodated and encompassed, at the time of the conclusion of the Swiss agreement prior to the introduction of a formal capital gains tax, the taxation of capital gains:

69 It does seem strange to have the tax authority arguing that a DTA does not apply but a principal purpose of a DTA is to allocate taxing rights and in this instance the DTA reduces source taxation by allocating taxing rights to the residence country. One of the ATO’s arguments was that Australia had reserved its position on Article 2 stating that they “… reserve their position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital”. New Zealand has no such general reservation.
It is true, that at the time, capital gains were not taxed on the comprehensive basis that came with the introduction of Pt III A into the ITAA 1936, but the income tax assessed under the Act accommodated and encompassed the assessment of capital gains as income, the assessment of capital receipts as income and the assessment of notional amounts as income just as much as it accommodated and encompassed the assessment of income according to ordinary concepts. 71

Virgin Holdings’ position in the case was supported by the views expressed by Klaus Vogel and other commentators that capital gains tax ‘... will, for treaty purposes normally have to be considered as being at least similar to income tax’.72 Reference was also made to the Irish High Court case of Kinsella where Kelly J had considered a similar problem in the context of the Ireland/Italy DTA. In that case Ireland had, like Australia, introduced a CGT after the Ireland/Italy DTA came into force. In the Irish High Court, Kelly J took the view:

CGT is, in my view, a substantially similar tax to the Italian taxes listed in article 2.3 and of course specifically covered in article 12. I do not however rest my decision upon that proposition. Rather do I take the view that CGT is a substantially similar tax to the Irish taxes which are mentioned in article 2.3. I do so for the following reasons. As I’ve already pointed out CGT is a tax on gains or profits rather than a tax on capital wealth. ... True it is that capital gains are taxed in a different way from other forms of income but the tax legislation regards the two as being very closely related. 73

In a similar way, in Virgin Holdings Edmonds J decided that, even if CGT was not within the term ‘the Australian income tax’, (and he had already concluded that it was), he would have held that a tax on capital gains was ‘substantially similar’ to ‘the Australian income tax’.

71 Virgin Holdings SA v Commissioner of Taxation [2008] FCA 1503, 11 ITLR 335, at paragraph 44.

72 Vogel et al, Klaus Vogel on Double Taxation Conventions (3rd edn, 1997) (Kluwer Law International) at 157. The current (fourth edition) suggests that the question of whether a tax is “similar” has to be decided against the background of the entire tax system. It then goes on to note the decisions referred to above and record that “the Federal Court of Australia and the High Court of Ireland hold the view that a newly invented capital gains tax is an income tax.” This is found at in Reimer & Rust (eds), Klaus Vogel on Double Taxation Conventions, 4th edn (2015), Volume 1, page 167, [m.no 65].

73 Kinsella v Revenue Commissioners [2007] IEHC 250, 10 ITLR 63, 75 to 77.
The issue may arise in the future in New Zealand (and in other countries) as to whether the taxation of capital gains under a capital gains tax is a ‘substantially similar tax’ to income tax. It is submitted that the same, or a similar, approach would be applied in New Zealand (and other countries) even where the only reference is to ‘income tax’. This outcome may be more likely if as a matter of implementation capital gains were regarded as ordinary income under the taxing statute (as is the position in Australia and South Africa) rather than imposing a separate capital gains charge (as in the United Kingdom).

While generally the New Zealand DTA network would apply to a newly introduced CGT there may be some specific DTAs which require closer examination.

**Specific agreements that make it clear that the DTA does not apply to capital gains**

Sometimes it will be made abundantly clear in the DTA that there is no limitation on the taxation of capital gains. An example of this is found in the Australian/ New Zealand DTA of 1995 which replaced the pre-capital gains tax treaty. That 1995 treaty contained the following paragraph in Article 13 (5):

Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of any property other than that to which any of the preceding paragraphs of this Article apply.

Consequently for New Zealand residents investing in Australia, the decision in *Virgin Holdings* was of relatively little consequence. Similarly, the current 2010 DTA clearly applies to capital gains and even extends Australia’s taxing rights in respect of such gains for six years after leaving Australian residence.

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75 Double Taxation Relief (Australia) Order 1972.

76 Double Taxation Relief (Australia) Order 1995, which is now being replaced by the 2010 convention.

77 See Article 13 (5) of the Australian/ New Zealand DTA (2010).

78 See Article 13 (7) of the Australian/ New Zealand DTA (2010).
Some DTAs already expressly include such items relating to capital profits and follow the OECD Model. For instance the Hong Kong/New Zealand DTA (2011) applies to ‘taxes on gains from the alienation of movable or immovable property... as well as taxes on capital appreciation’.79

Specific agreements without an alienation of property article (Fiji and Malaysia)

Are capital profits included in the definition of industrial and commercial profits?

Two of the NZ DTAs remaining from the mid-70s do not have an alienation of property article. Such provisions may also be lacking in the older treaties of other jurisdictions. Neither the Fijian nor the Malaysian DTAs with New Zealand has the equivalent to Article 13 but, instead, both refer to "industrial or commercial profits of an enterprise" which is defined in the general definition section as “profits derived by an enterprise of a Contracting State from the carrying on of a trade or business”.

In *Thiel*80 the High Court of Australia considered the meaning of ‘business profits’.81 The majority (Mason CJ, Brennan, and Gaudron JJ) held that this one-off transaction fell within Article 7 confirming that it was both an activity that constituted an enterprise and the resultant gain was also ‘the profits’ of such an enterprise:82

Dawson J considered that the meaning of profits in Article 7 could relate to an isolated transaction but distinguished this from the traditional view of a capital gain:

But once it is recognised that “enterprise” includes an isolated activity as well as a business, business profits cannot be confined to profits (or taxable income) derived from the carrying on of a business but must embrace any profit of a business nature or commercial character. *Profit from a single*

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79 Article 2 (2) of the Hong Kong/New Zealand DTA (2011).
81 Industrial and commercial profits are similar to business profits although according to Philip Baker the term "business profits" appears to be wider than industrial or commercial profits (see Philip Baker *Double Taxation Conventions*, (2013) A7B.07.)
82 *Thiel v Federal Commissioner of Taxation* (11010) 94 ALR 647, (11010) 171 CLR 338, 98 ATC 4717 at 4720.
transaction may amount to a business profit rather than something in the nature of a capital gain even if it does not involve the carrying on of a business. (Emphasis added).  

John Marney\(^4\) suggests that based on the approach in *Thiel* a court may distinguish between profits taxed on a one-off transaction which are subject to CGT but which are not in the nature of business profits *per se*. He suggests that in these circumstances the Fijian and Malaysian DTAs would have no application to capital gains. The domestic New Zealand law, including a newly introduced CGT, would be fully applicable to residents of Fiji and Malaysia who derived a capital gain in New Zealand without the DTA allocating (or more importantly reducing) taxing rights. This conclusion can only be reached in circumstances where the gains could not be regarded as the industrial and commercial profits of an enterprise.\(^5\)

Specific agreements that have an alienation of property article which refers exclusively to ‘income’ rather than ‘income or gains’ (Sweden and Spain)

As part of the remarkable diversity of treatment of gains made from the alienation of property the New Zealand DTA network has some unusual features which may be found in other jurisdictions. In contrast to most of New Zealand’s DTAs that refer to either ‘income, profits or gains’ or ‘income or gains’ those with Sweden (1980) and Spain (2006) refer exclusively to ‘income’. Is it intended that ‘income’ be interpreted to include capital gains? This seems unlikely as under normal principles of domestic interpretation this would not occur in a common law country\(^7\) as the two concepts are mutually exclusive. The question is whether the term income, used in a DTA, should have a broader contextual meaning. This seems to be stretching the plain words of the Article

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\(^{83}\) *Thiel v Federal Commissioner of Taxation* (11010) 94 ALR 647, (11010) 171 CLR 338, 98 ATC 4717 at 4724.


\(^{85}\) In which case Article 7 would determine they would only be taxed in New Zealand if there was a permanent establishment there. As the decision in *Thiel* shows it is quite possible for a one-off transaction to be regarded as industrial and commercial profits.

\(^{86}\) See also paragraph 3.2 subsequent.

\(^{87}\) As ‘income’ is an undefined term, Article 3 (2) would normally require that the term take the tax related domestic law definition of the country seeking to interpret it (normally this is the source country), unless the context otherwise requires.
notwithstanding the normal role of Article 13 in the OECD Model which is to deal with the taxation of capital gains. The better view is that Article 13 in both the Swedish and Spanish DTAs does not apply to transactions subject to a capital gains tax.\textsuperscript{88} The implication is that a domestic CGT would apply to capital gains without Article 13 affecting the allocation of taxing rights. In other words where Article 13 normally limits source taxing rights on capital gains\textsuperscript{89} this will not apply where the DTA simply uses the term “income” in Article 13.

3.2 The scope of Article 13 (1): ‘gains’ versus ‘income or gains’ versus ‘income, profits or gains’

One important issue which requires consideration is the relationship between Article 7 and Article 13 in any country’s DTA network. The OECD Model Article 13 simply refers to ‘gains’ from the alienation of various forms of property. The heading of Article 13 refers to ‘capital gains’. The OECD Commentary recognises the widespread divergence in approach from different countries including the non-taxation of capital gains, targeted taxation of particular forms of capital gains (sometimes as income) and more comprehensive taxation.\textsuperscript{90}

\textit{Taxing business profits involving land: does Article 13 apply?}

Article 7(4) of the OECD Model states that ‘where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article’. This paragraph is consistently applied in the New Zealand DTA network. Articles 13(1) and (4) give New Zealand, as a source country, the right to tax profits on the sale or disposal of land, or shares in New Zealand land-rich companies. One would normally expect that New Zealand would wish to retain the right to tax gains on the alienation of land.\textsuperscript{91}


\textsuperscript{89} Such as the taxation of personal property under Article 13 (5) of the OECD Model.

\textsuperscript{90} OECD Commentary (2014) on Article 13 at paragraphs 1 and 2.

\textsuperscript{91} This is consistent with the right to tax income from the use of real property contained in Article 6.
However, some forms of alienation of land are currently subject to tax as ordinary income under the New Zealand statute. One-off transactions where property is acquired with the purpose or intention of resale or by people with a particular status (builders or developers for example) derive income which is subject to tax under domestic law in New Zealand. In other circumstances the sale of land as part of a business will generate income.

The question is does New Zealand always retain a taxing right on New Zealand sourced income and gains through the application of Article 13, or does Article 13 not apply in some cases, leaving certain business profits to be taxed under Article 7? Put another way, can an enterprise sell land or, more likely, shares in an asset rich company and derive business profits to which Article 7 applies. If this occurs, then in the absence of a permanent establishment in New Zealand, New Zealand will lose its source taxing rights in respect of the disposition of land.

Used in its OECD format the term ‘gains’ focuses on capital gains which in a common law jurisdiction can be regarded as fundamentally different from income. The OECD Commentary proceeds on the basis that there should not be a difference between the taxation of a capital gain or a business profit: the right to tax the gain from the alienation of a business asset should be given to the state that has the right to tax business profits. Although the OECD Model uses the term ‘gains’ exclusively, that is not the preferred scope for New Zealand treaty negotiators. This is for a very good reason: there is significant risk in losing source New Zealand taxing rights when the term ‘gains’ is used alone.

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92 Sections CB 6-14 of the Income Tax Act 2007 (New Zealand) as an example.
93 In normal circumstances this land used as part of a business would be regarded as trading stock. However, under the New Zealand Income Tax Act 2007 land cannot be trading stock (section EB 2 (3)). This is a modification to the standard trading stock rules, the effect of which is to defer a deduction for the cost of the land held on revenue account until the time when the land is sold, rather than calculating the cost of goods sold under traditional trading profit accounting rules (which effectively give a deduction for the opening stock and any purchases whilst adding back the value of trading stock on hand at the end of the income year).
New Zealand’s DTA network uses a variety of terms to identify the scope of Article 13. In this it is not alone, as Rick Krever describes this as a common attribute of Article 13 for many countries:

Article 13 stands out not only in terms of its diversity in practice from country to country but also in respect of any one country’s treaties—the norm is for a country to have different-sometimes greatly different-versions of the article in almost all its treaties.95

*The different approaches in the New Zealand DTA network*

These are as follows.

- **Income, profits or gains**: These terms are used in seven of New Zealand’s DTAs.96

  This is the most comprehensive basis used in the New Zealand treaty network. It is difficult to see that any form of income or capital gain would be excluded from the scope of Article 13.

  Under these DTAs New Zealand would retain the right to source taxation in respect of trading gains from the sale of inventory of land, and gains taxed as either income under specific targeted income tax provisions as well as capital gains under a newly introduced CGT.97 This is the terminology used in the recent Australia/New Zealand DTA (2010) which is referred to in the National Interest Analysis in the Report of the Finance and Expenditure Committee of the New Zealand Parliament as follows:

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96 Australia, Chile, Japan, South Africa, Taiwan, Thailand, and United Arab Emirates.

97 This is why Krever says in his chapter "Tax Treaties and the Taxation of Non-residents' Capital Gains" (see FN 92) at page 220:

  To ensure that Article 13 applies to both trading gains on the sale of inventory ("ordinary income" in these jurisdictions) and gains realised on the disposal of real property that is not inventory (capital gains), common law jurisdictions might replace the term "gains" used in the OECD model treaty with the phrase "income, profits or gains" from the disposal of real property.
Specific rules apply to the taxation of income, **profits or gains derived from the sale of property**. In the case of real property the profits are taxable where the property is situated (Article 13 refers).\(^98\)

- **Income or gains**: Because this is by far the most commonly used term (it is used in twenty of New Zealand’s DTAs) this is arguably the most important category.\(^99\) It seems clear that a broad meaning should be given to the words income and gains.\(^100\) Marney takes the view that the reference to ‘income’ should be seen in the context of the wider policy of protecting source taxation often found in New Zealand DTAs (due to its net capital importer status) and that all income (including business profits from the sale of land held on revenue account) should be within the scope of Article 13 (1).\(^101\) It seems strongly arguable that this is correct both for this reason and for the additional reason: if both Article 7 and Article 13 (1) apply, then it is clear that Article 13 will have preference because of the effect of Article 7 (4). In this instance, profits made on the sale of real estate inventory are income and can be dealt with under Article 13. The normal heading for Article 13 ‘alienation of property’ is neutral

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\(^99\) Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, India, Indonesia, Ireland, Italy, Korea, Netherlands, Norway, Papua New Guinea, Philippines, Switzerland, United Kingdom, United States, and Vietnam.

\(^100\) The interpretation of DTAs in New Zealand was considered by the Court of Appeal in *Commissioner of Inland Revenue v United Dominions Trust Ltd* (1973) 1 NZTC 61, 028 and the President of the Court of Appeal, McCarthy P, discussed the interrelationship between the principles to be applied in an interpretation of international agreements and the position under New Zealand domestic law. He concluded that having regard to the provisions of the Acts Interpretation Act 1924: Counsel were in concert that New Zealand Courts should take this broad approach and that this was really not in any material sense different from that enjoined on us, when interpreting domestic law, by the provisions of the Acts Interpretation Act 1924. So I shall proceed from that agreed starting point: we are not to adopt a narrow interpretation but to interpret having regard to the broad intentions of the framers as they emerge from the text.

The New Zealand Courts will therefore construe the language in a double tax convention upon ‘broad principles of general acceptance’ per Richardson J, *Commissioner of Inland Revenue v JF P Energy Inc* [1990] 3 NZLR 536 at 538. As the Court of Appeal recognised in the *United Dominions Trust* case, this approach is consistent with the rules of public international law on interpretation of treaties and specifically with the Vienna Convention on the Law of Treaties.

and supports the view that income from the alienation of property includes gains from the realisation of trading stock.\textsuperscript{102}

- **Gains:** The solitary term “gains” is used in Article 13 of eight of New Zealand’s DTAs.\textsuperscript{103}

As discussed briefly above, the use of this term follows the OECD Model which uses the heading “capital gains” in the title to the Article. Krever takes the view that it is at least ‘a plausible basis’ for taxpayers to argue that the word ‘gains’ is intended to mean (only) capital gains. This results in the consequences of non-taxation on New Zealand sourced ‘income’ (using that term in a technical sense which excludes capital gains) in respect of profits from the disposal of land inventory, so ‘a door is opened for avoiding local taxation’.\textsuperscript{104} The problem is that an interpretation can be taken which suggests that only capital gains are subject to Article 13 and that income, and particularly business income from the sale of real estate inventory, is outside the scope of Article 13.

This is why the OECD Commentary states:

The right to tax gains from the alienation of the business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply.\textsuperscript{105}

\textsuperscript{102} Under this interpretation Article 13 is not limited to the income arising from the sale of non-business assets and capital assets.

\textsuperscript{103} Austria, China, Czech Republic, Mexico, Poland, Russian Federation, Singapore, and Turkey.


\textsuperscript{105} OECD Commentary (2010) on Article 13 at paragraph 4.
Gains will be characterised under New Zealand domestic legislation as income or capital gains. There is thus a real concern that in the case of these eight countries the following tax consequences arise:106

If the gain is income under the statute then;

- Where profits are made on the sale of real estate arising from the disposal of land acquired with the intention of disposal or the sale of land as part of the business of dealing in or developing land, then Article 13 (1) does not apply but Article 7 does. As a result New Zealand would only be able to have a taxing right in respect of this type of income if there is a permanent establishment in New Zealand.

If capital gains then;

- New Zealand would be able to apply Article 13(1) to the taxation of a newly introduced CGT.

Careful drafting of the way in which capital gains are incorporated into domestic legislation is important in respect of this issue. It may be desirable that capital gains are incorporated within the definition of income under New Zealand domestic law but they should perhaps be defined in a way which makes clear that they are ‘gains’ deemed to be income.

- Income: As previously indicated the term ‘income’ is used in two of New Zealand’s DTAs.107 This is therefore a clear departure from the OECD Model. It would seem that the negotiators to these DTAs intended only income determined under the New Zealand domestic law to be dealt with within the scope of Article 13. Capital gains in contrast would be outside the scope of Article 13, and also outside the scope of the DTA. This would mean New Zealand would

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107 Spain and Sweden.
retain full domestic CGT taxing rights without any further restriction or allocation under the relevant DTAs.

In conclusion, for the reasons given above, New Zealand treaty negotiators should prefer ‘income, profits or gains’ in establishing the scope of Article 13 in determining its relationship with Article 7.

4.0 Conclusion
It is no simple matter to introduce or reform a new CGT regime when there is a diverse and extensive DTA network which has been negotiated without the presence of a comprehensive CGT. The New Zealand DTA network illustrates that, in the absence of a CGT, treaty negotiators have inconsistently used a variety of terms such as ‘gains’, ‘income and gains’, and ‘income profits or gains’ to define the scope of Article 13. The applicability of Article 13 to certain transactions will depend on which of these three variations have been used in the DTA.

Furthermore, as another example of the possible incoherence that can exist when DTAs are negotiated without affecting existing taxing rights, the New Zealand DTA network has quite a few DTAs that exclude the modern OECD version of Article 13(4). This means that under those DTAs, in theory, the sale of shares in land-rich companies would normally be taxed, not in the source country, but only in the country of the residence of the vendor. The recent introduction of a bright line test which taxes gains made on the sale of residential property bought and sold within two years has necessitated the introduction of an anti-avoidance rule which effectively overrides some of New Zealand’s DTAs.

Lastly, in the absence of a CGT regime a country may be indifferent as to whether it retains source taxing rights in respect of gains made on disposals of personal property under Article 13(5). This is the New Zealand experience with roughly half of the DTA network retaining source taxing rights while the other half allocates those taxing rights to the country of residence. When such taxing rights are allocated to the country of residence and there is no equivalent to Article 13(4) then the opportunity exists to structure investment, even in land, using entities based in favourable DTA
jurisdictions. Such transactions create opportunities for classic treaty shopping arrangements. In the absence of domestic law overriding such DTA obligations, either through specific provisions or the application of the general anti-avoidance rule, then a substantial treaty renegotiation is required.

### Appendix A

**Article 13 (4)**

<table>
<thead>
<tr>
<th>(4) Gains from shares deriving &gt; 50% value from immovable property taxable at source</th>
<th>Gains from shares deriving &gt; 50% value from immovable property taxable in State of residence</th>
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</thead>
<tbody>
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<td>Australia</td>
<td>Belgium</td>
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<td>Denmark</td>
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### Appendix B

#### Article 13 (5)

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<th>Other gains taxable at source</th>
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