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Taxation of shipping, inland waterways transport and air transport

Taxation of capital gains

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Taxation of shipping, inland waterways transport and air transport

Article 8 OECD Model
Paragraph 1

- Para. 1 **until** 2017 changes to the OECD Model ("OECD MTC")
  - Article 8(1): Exclusive right to tax profits from the operation of ships or aircraft in international traffic to the State in which the **Place of Effective Management (PoEM)** of the enterprise is situated

    → Alternative distributive rules: residence criterion or combination of PoEM and residence
- Para. 1 **after** 2017 OECD MTC Changes
  - Article 8(1): Exclusive right to tax profits from the operation of ships or aircraft in international traffic to the State in which **the enterprise is situated**

    → Alternative distributive rules:
    - PoEM criterion or
    - home harbour of the ship if PoEM is situated aboard a ship or
    - residence of the "*operator of the ship*" if there is no such home harbour

Article 8 OECD Model
Paragraph 2

- Para. 2 **until** 2017 OECD MTC Changes
  - Article 8(2): same distributive rule for operation of boats engaged in inland waterways transport

    → Article 8(2) applies also to inland waterways transport carried on between two points in the contracting State other than that of the effective management
- Para. 2 **after** 2017 OECD MTC Changes
  - Many States do not include this paragraph; accordingly, it has been eliminated
  - However OECD MTC Commentary para 15. provides for a possibility to use the same distributive rule of Article 8(1) for operation of boats engaged in inland waterways transport

    → In such a case it would apply also to inland waterways transport carried on between two points in the contracting State other than that of the enterprise

Article 8 OECD Model
Paragraph 3

- Article 8(3) **until** 2017 OECD MTC changes: if the PoEM is aboard a ship or a boat, it shall be deemed to be situated:
  - in the State of the home harbour; if this cannot be determined
  - in the State of which the operator is resident

    → Definition of home harbour to be interpreted in accordance with domestic law (generally it coincides with the harbour of registration)
- Article 8(3) **after** 2017 OECD MTC changes: eliminated in the text of the Article but kept as an alternative provision in the Commentary

Article 8 OECD Model
Paragraph 4

- Article 8(4) old OECD MTC **and** Article 8(2) OECD MTC after 2017 changes: the provision also applies to profits from the participation in a pool, a joint business or an international operating agency
- Taxes covered
  - Tonnage taxes
  - Special levies (e.g. passenger tax)

International traffic
Definition

- Article 3(1) lett. e) OECD MTC until 2017 changes:

  the term "international traffic" means any ***transport*** *by a* ***ship*** *or* ***aircraft*** *operated by an enterprise that has its* ***place of effective management*** *in a Contracting State,* ***except*** *when the ship or aircraft is* ***operated solely between places in the other Contracting State***

- Article 3(1) lett. e) OECD MTC after 2017 changes:

  the term "international traffic" means any transport by a ship or aircraft ~~operated by an enterprise that has its place of effective management in a Contracting State,~~ except when the ship or aircraft is operated solely between places in ~~the other~~ ***a*** *Contracting State* ***and the enterprise that operates the ship or aircraft is not an enterprise of that State***

Meaning of "Transport"

- The term "transport" is not defined in the OECD MTC → domestic law meaning applies
- Transport may apply to persons and goods, but also mail and livestock (some Treaties provide this expressly – e.g. India Brazil)
- What if the use of the ship/aircraft does not entail a "transport"?
  - Flying training, ferry flights, refitting

Meaning of "Ship"

- The term "ship" is not defined by the OECD MTC → domestic law meaning applies
- The meaning of ship is generally intended by maritime laws as any structure capable of navigation
- According Article 8 of the OECD MTC ships must be suitable for navigation and transportation
- Para. 17 of the OECD MTC Commentary after 2017 changes indicated that the "*the word "ship" (…) is intended to be given a wide meaning that covers any vessel used for water navigation*"
- "*The term ship would include all means of transport moving or moved on or under water, including, without limitation, submarines and hydrofoils*" (Kofler)

Ship and immovable property

- According Article 6(2) OECD MTC ships and aircraft shall never be regarded as immovable property, even if they are included in a ship registry
- Profits deriving from activities directly connected or ancillary to international transport fall under Article 8 even if they are related to immovable property
- **Example**: rental income received by an airline from leasing to a local company office and warehouse space otherwise used for handling its cargo in the other contracting State → fall under Article 8
  - 31 Mar. 2008, KLM Royal Dutch Airlines v. DCIT, Case No. 87/88 2002 (Delhi)
- However contra
  - *Cour administrative d'appel de Nancy* 10 Oct. 1991, Hoverlloyd Ltd. v. Ministre de l'Economie et des Finances, Case Nos. 89NC00529 and 89NC00531
  - Court of Federal Claims 4 Apr. 1967, Qantas Airways Ltd. v. United States (IRS), No. 118-89T

Domestic vs International traffic

Voyage in the State of the enterprise

State A (enterprise)

C D

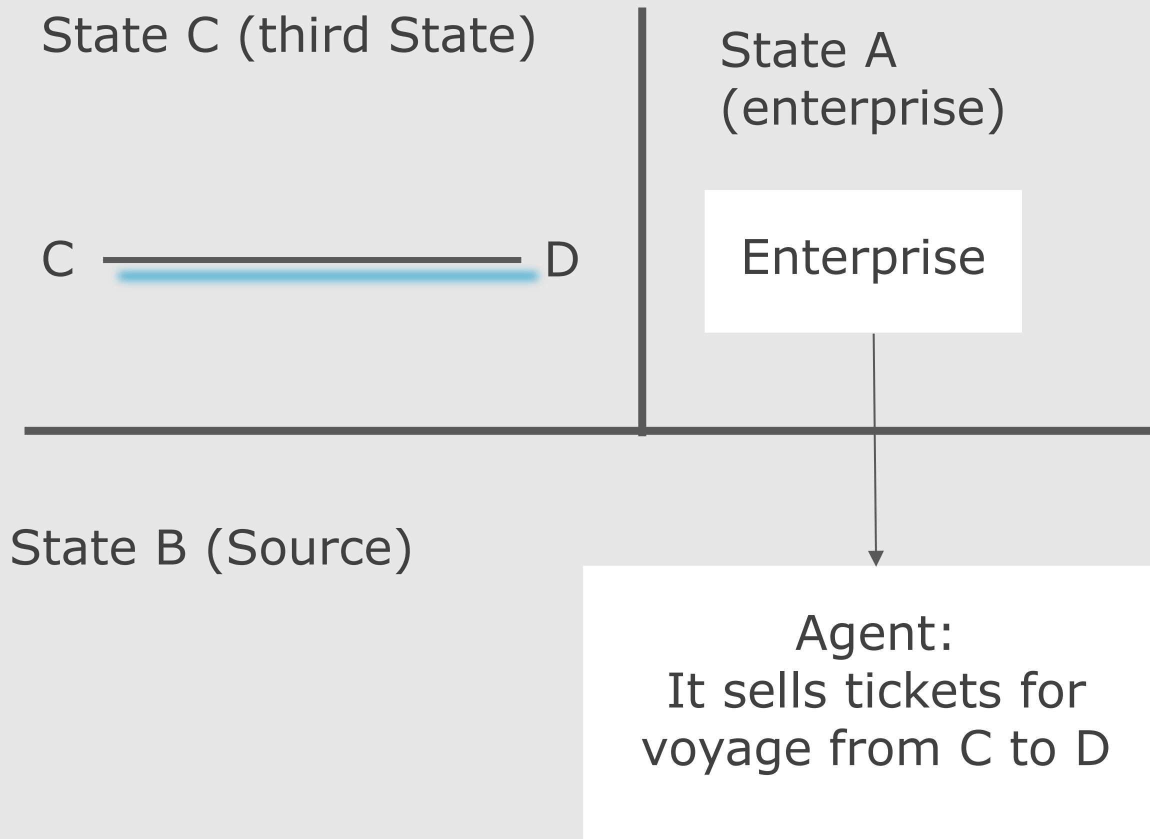
Enterprise

State B (Source)

Agent:
It sells tickets for voyage from C to D

- International traffic
- STATE A has exclusive right to tax profits from the ticket sale (Article 8 of A-B Treaty)

Voyage in a third State



- International traffic
- STATE A has exclusive right to tax profits from the ticket sale (Article 8 of A-B Treaty)

Voyage in the source State

State A
(enterprise)

Enterprise

State B (Source)

C D

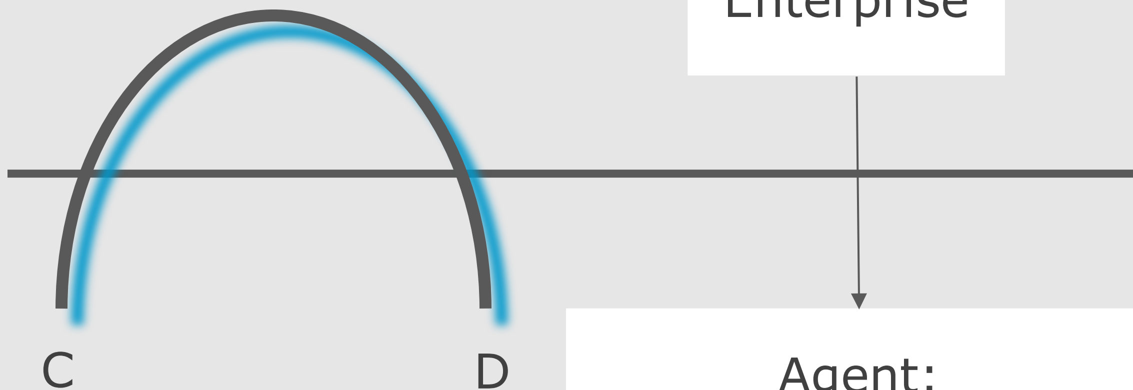
Agent:
It sells tickets for
voyage from C to D

- No international traffic
- STATE B has right to tax profits made by the P.E. that the enterprise has there (Article 7 of A-B Treaty)

Voyage in the source State

State A
(enterprise)

Enterprise



Agent:
It sells tickets for
voyage from C to D

State B (Source)

- No international traffic
- STATE B has right to tax profits made by the P.E. that the enterprise has there (Article 7 of A-B Treaty)

Voyage in the source State

- According to the definition provided by Article 3 of the OECD MTC, it is not international traffic a voyage operated solely between places in the other Contracting State → Article 7 OECD MTC

BUT

- If that transport – between places of the Other State - is part of a longer voyage where a stop in the State of the enterprise or in a third State occurs, then it is “international traffic” (Commentary of Article 3 – Para. 6.2) → Article 8 OECD MTC

Profits covered by Article 8

- Article 8 OECD MTC applies to profits that the enterprise derive from shipping, inland waterways transport or air transport
- If the enterprise is not exclusively engaged in those activities, Article 8 applies only to those profits

Taxation of capital gains

Definition of “capital gain”

- Generally defined as the **difference between the disposal proceeds and the acquisition cost** of certain assets, *e.g.* assets held by way of investment
  - → Capital gains may typically be contrasted with income from the sale of inventory in the course of a trade or business
  - → Qualification of a gain as a capital gain varies from country to country and is often strongly fact dependent
  - → Under US tax law a capital gain is a gain from the “sale or exchange” of a “capital asset”. Capital assets are defined by exclusion of assets specifically listed, such as inventory

Capital gains taxation and economic analysis

- Capital gains taxes exist under **various forms** and are levied at **various rates** in numerous countries. The US was the first country to introduce a capital gain tax
- Tax treatment of capital gains has been heavily influenced by economic theory and, in respect of capital gains on shares, by the effects of such taxation on the stock market
- Capital gains taxes have **two main effects** on the market economy

  → "Locked-in effect"

  → "Concentration effect"

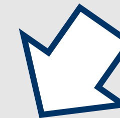
Capital gains taxation and economic analysis (cont.)

Locked-in effect

If gains are taxable and losses deductible, the owners of capital assets will tend to keep appreciated property and to liquidate depreciated property or, at best, will try to compensate losses and gains. This may give rise to a forced-out or mobilization effect

Concentration effect

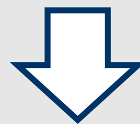
The capital gain tax is levied in one year on a gain representing the income of several years during which the property has gradually increased in value. In the case of a progressive tax, taxation will be higher than if it had taken place each year



The taxation of capital gains may have a destabilizing effect on the market → capital gains taxes are frequenlty levied at **reduced rates** (in particular in cases of long-term investments) and **deferred** if the amount resulting from the sale is reinvested

Capital gains taxation and economic analysis (cont.)

- **Relief of the concentration effect** → the longer the duration of possession, the stronger the concentration effect justifying a decrease of the tax rate upon realization of the gain
- **Capital effect** → the vendor who realizes a gain and is taxed will come back into the market only with an amount decreased by the tax



If a country wants to favour investments in capital assets to stimulate growth, it will **exempt capital gains** either totally or under condition of reinvestment

Capital gains on shares realized by companies

Capital gains on shares

- With reference to **shares of companies**, the capital gain is generally the reflection of:
  - Reserves existing in the company the shares of which are sold; or
  - Capitalization of future income that will be distributed under the form of dividends
- Particularly on the occasion of takeover bids, the capital gain may exceed the above elements by reason of
  - Synergies which will be found between companies; or
  - Other related elements such as the increase of market share

Capital gains on shares
Participation exemption

- In most countries, dividends and capital gains are subject to the same regime → they are eligible for the **participation exemption** ("PEX") in the hands of corporate shareholders

  → Regime primarily intended to mitigate double economic taxation of income in the corporate sphere

- The PEX is a **tax relief** accorded to a company in respect of distributions received from and capital gains realized on certain shareholdings in a company
- The relief generally takes the form of an **exemption from tax** but may sometimes take other forms, such as a deduction from taxable income equal in amount to the benefited income

Capital gains on shares
Participation exemption (cont.)

- In some States (*e.g.* Italy and France) the consistency between taxation of gains and taxation of dividends makes it such that gains are **subject to a 95% exemption**

  → Intended to reflect the non-deductibility of costs related to an asset (the shares) that derives exempt income

Capital gains on shares
PEX conditions

- Most PEX regimes provide for **conditions** either regarding the entity whose shares are being disposed of and/or the corporate shareholder
- These conditions try to cope with a variety of **goals**:
  - Avoid the application of the exemption when the gain reflects the ordinary trading course of the business of the corporate shareholder
  - Avoid the application of the exemption to transfer enveloped passive assets
  - Make sure the exempted gain is the result of an effectively taxed income
  - Prevent abusive application of the exemption targeting the "exempted gain" characterization as opposed to other classes of income

Capital gains on shares
PEX conditions – Fixed assets

- Some domestic legislation (e.g. Italy, France) require the share to have been shown as **fixed assets** in the balance sheet of the corporate shareholder for accounting purposes

  → *Objective*: document the non-trading nature of the holding

  → *Shortcoming*: accounting rules look at the intention of the shareholder so that the balance sheet representation is open to great discretion

- Most legislations providing for the accounting condition of the shares being entered as fixed asset also provide for anti-abuse rules that permit the tax authorities to disregard balance sheet representation

Capital gains on shares
PEX conditions – Shareholder's activity

- Some countries (e.g. the Netherlands) focus on the **activities conducted by the corporate shareholder** to establish whether or not the holding reflects a long-term investment

  → *Shortcoming*: pointing to the corporate shareholder requires factual review which may be less friendly to non-resident taxpayers and also to the tax authorities of the source country

Capital gains on shares
PEX conditions – Investee's activity

- Another condition frequently adopted in PEX regimes is the **nature of the business of the investee company**

  → *Objective*: prevent the application of the regime to mere transfers of assets that are enveloped in a company without any business activity (e.g. gains on shares of passive real estate companies are excluded from exemption in Italy)

- The borderline between business and passive investment is difficult to draw in a legislative provision and might sometimes result in a restrictive interpretation and consequent denial of the releif

Capital gains on shares
PEX conditions – Minimum holding

- The **minimum holding** condition may be reflected either in absolute terms (*e.g.* Luxembourg, which requires a minimun acquisition cost of Euro 1.2 million) or as a percentage of voting rights or share capital owned by the corporate shareholder (*e.g.* 5% of share capital in the Netherlands and 10% of share capital in Luxembourg)

  → *Objective*: reflect the non-trading nature of the holding on the assumption that a material investment or the holding of significant voting rights or capital expresses the long-term nature of the investment

Capital gains on shares
PEX conditions – Holding period

- The **holding period** condition may be found, for example, in Belgium, France, Italy and Luxembourg and may vary from 1 (Belgium, Italy and Luxembourg) to 2 years (France)
  - → *Objective*: ensure that shares have not been held for trading
  - → *Shortcoming*: there might be situations in which the failure to meet the holding period condition does not reflect an abusive transaction. It is unreasonable that the corporate shareholder cannot rebut the presumption and obtain the PEX regime

Capital gains on shares
PEX – Selected Countries overview

Tax Feature	Belgium	Denmark	France	Ireland	Italy	Luxembourg	Netherlands	Portugal	Spain	Switzerland
Dividends										
Participation Exemption	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes
Minimum holding	10% or acquisition price (value) of at least EUR 2.5 million	10%	5%	N/A	No	10% or acquisition cost of at least EUR 1.2 million	5%	10%	5% or acquisition cost of more than EUR 20 million	10 % or CHF 1 million
Holding period	1 year	No	2 years	N/A	No	12 months or commitment to hold for 12 months	No	12 months	1 year which can be met after dividends are paid/received	No
Capital gains										
Participation Exemption	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Minimum holding	12 months. If realized before the end of the 12-month holding period: 25%	10%	5%	5%	No	10% or acquisition cost of at least EUR 6 million	5%	10%	5% or acquisition cost of more than EUR 20 million, the latter applying only to qualifying ETVEs	10% as of January 2011
Holding period	12 months. If realized before the end of the 12-month holding period: 25%	No	2 years	12 months	12 months	12 months or commitment to hold for 12 months	No	12 months	1 year by the date of transfer of shares	1 year

Article 13 OECD Model and UN Model

Article 13 OECD Model 2014
Overview

- Article 13 of the 2014 OECD MTC regulates capital gains
- Prerequisite for the application: **existence of an “alienation”**

  → From the context of the OECD MTC, it is inferred that an alienation is the transfer of the ownership of the asset

- The question whether certain dealings are regarded as “alienations” has to be determined exclusively **in the context of the treaty**

  → Transactions in one of the two contracting States, which are merely put on par with the alienations by means of domestic legislation, are not necessarily alienations in the sense of a tax treaty

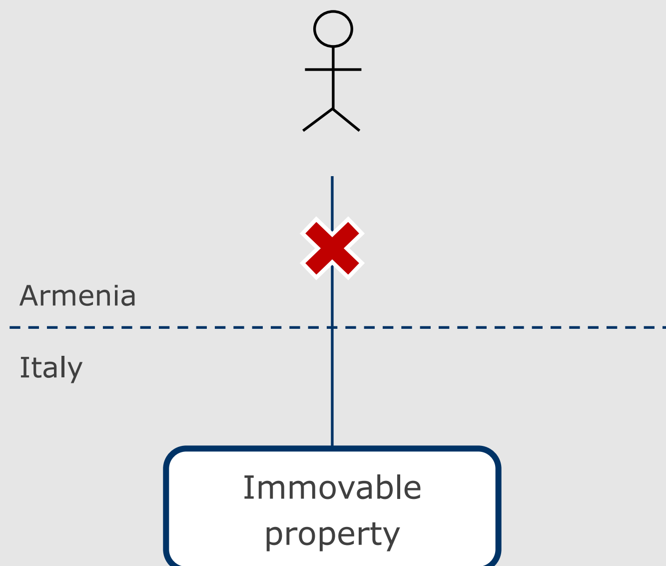
Article 13 OECD Model 2014
Example

- A resident of the Netherlands holds a 100% share in a Dutch company. In the year X1 he moves to Belgium and in the year X2 he sells all the shares to a bank, provided that it liquidated the company ("liquidation clause")
- Under Dutch domestic law, the income arising from such alienation of shares constitutes "income from capital". The question was whether the Netherlands had a taxing right under Art. 13(5) of the Belgium-Netherlands DTC, which provides for a source tax of 20%
- The Dutch tax administration argued that Art. 13(5) did not apply because in domestic terms this income was not regarded as a capital gain. However, the Netherlands Supreme Court ruled that regardless of the classification of the income under domestic law, Art. 13 did also include the sale of shares with a liquidation clause, because **the term capital gains has an independent meaning in the treaty**

Article 13(1) OECD Model 2014
Immovable property

- Article 13(1) OECD MTC deals with the **alienation of immovable property**. In accordance with Article 6 OECD MTC, the taxing rights are allocated to the State in which the property is situated
  - → Whether the residence State can also assert taxing rights depends on Article 23 OECD MTC
  - → The concept of "immovable property" is defined in Article 6 OECD MTC. The rule only applies if the immovable property is situated in one contracting State and the recepient of the capital gain is resident in the other contracting State
  - → If the alienated immovable property is situated in the residence State of the alienator or in a third State, Article 13(1) OECD MTC does not apply

Article 13(1) OECD Model 2014
Example



- A person resident in Armenia owns Italian immovable property and sells it
- Under Article 13(1) of the Armenia-Italy DTC, the situs State (*i.e.* Italy) may tax the gain arising from the alienation
- Article 24 of the Armenia-Italy DTC (Article 23 OECD MTC) provides that Armenia has to deduct from the taxes payable therein the taxes paid in Italy on such gain (credit method)

Article 13(2) OECD Model 2014
Movable property forming part of a PE

- Capital gains from the **alienation of movable property** forming part of the **business property of a PE** situated in the other contracting State may be taxed in the PE State

→ The residence State's right to tax depends on Article 23 OECD MTC

→ The assets covered under Article 13(2) OECD MTC can be determined by reference to Article 7 OECD MTC

Article 13(3) OECD Model 2014
Ships and aircraft

- Article 13(3) OECD MTC deals with capital gains from the **alienation of ships or aircraft** operated in international traffic, as well as capital gains from the **alienation of boats engaged in inland waterways transport** and from movable property pertaining to the operation of such ships, aircraft or boats

  → 2014 OECD MTC assigns the right to tax to the State in which the PoEM of the enterprise is situated

  → 2017 changes to OECD MTC: right to tax to the State in which the enterprise is situated (see slide 3)

Article 13(4) OECD Model 2014
Shares in immovable property 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 <u>may be taxed in that State</u>

  → Whether the residence State can also tax will depend on Article 23 OECD MTC

- The 2017 Draft OECD MTC subtitutes Article 13(4) with the following:

  "*Gains derived by a resident of a Contracting State from the alienation of shares* ***or comparable interests, such as interests in a partnership or trust****, may be taxed in the other Contracting State if,* ***at any time during the 365 days preceding the alienation****, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property,* ***as defined in Article 6****, situated in that other State*"

Article 13(4) UN Model 2011
Shares in immovable property companies

- Article 13(4) of the 2011 United Nations Model Double Taxation Convention (UN Model) encompasses not only shares but also **interest in partnerships, trusts or estates**, as long as the property of the same consist "principally" of immovable property situated in a contracting State
  - → The term "principally" also means a 50 per cent threshold, as in the OECD MTC
  - → Entities whose property consists principally of immovable property <u>used by them in their business activities</u> are excluded from the provision, unless they are immovable property management companies, partnerships, trusts or estates

Article 13(5) OECD Model 2014
Blanket clause

- The alienation of **any asset** not covered by Article 13(1) to Article 13(4) OECD MTC falls under Article 13(5)
- The right to tax these capital gains is exclusively assigned to the residence State of the recepient → not necessary to make reference to Article 23 OECD MTC

  → Assets covered by Article 13(5) may include participations not covered by Article 13(4), receivables, know-how and patents, insofar as these assets are not attributable to a PE in a State other than the residence State of the recipent. Moreover, this rule covers PE assets if the PE is situated in a third country or in the residence State of the alienator

Article 13(5) OECD Model 2014
Example

- A resident of Austria with an apartment in Switzerland owns jewellery. When this person sells the jewellery, the blanket clause of Article 13(3) of the Austria-Switzerland DTC provides that the residence State of the alienator has the right to tax
- Under the Austrian domestic law, the gains may or may not be taxed, depending on how long the person owned the jewellery. If the jewellery is sold during the so-called "speculation period", the person must pay income tax in Austria. If, however, the sale takes place outside the "speculation period", the sale is not taxable
- Therefore, even though the treaty allocates the taxing right to Austria, it is possible that no tax will be imposed under the Austrian domestic law. **The treaty does not give rise to an independent right to tax**

Article 13(5) UN Model 2001
Other shares

- Numerous OECD Member countries included in their DTCs a provision similar to Article 13(5) of the 2001 UN Model: *Capital gains from the* ***alienation of shares other than those in immovable property companies****, representing a certain percentage of the share in a company which is a resident of a contracting State, <u>may be taxed in that State</u>*
  - → Assumption that such a shareholder can control the dividend policy of the company and is in a position to transform dividens, generally subject to withholding tax in the source State, into capital gains, which, under the OECD MTC, are taxable only in the residence State of the alienator
  - → Percentage of the minimum shareholding to be established through bilater negotiations

Article 13(5) UN Model 2011
Other shares (cont.)

- In the 2011 update of the UN Model Article 13(5) has been changed by the introduction of a **period and participation requirement:** *Capital gains from the alienation of shares of a company resident in a contracting State, other than those in immovable property companies, may be taxed in that State provided that the alienator* ***at any time during a 12-month period after the alienation holds directly or indirectly a certain percentage*** *of the capital of the company*

  → The minimum participation in the capital is left to bilateral negotiations