Taxing Indirect Transfer of Properties

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Taxing Capital Gain: General Rules in Tax Treaties

- Rule 1 – gains from alienation of the following properties (with very strong physical nexus) may be taxed in the country where they locate
  - Immovable property (as defined in Art. 6)
  - Other property forming part of business property of PE
  - (Equipment of international traffic)
- Rule 2 – gains from **"indirect transfer"** of 'Rule 1 property' (and its equivalent) may be taxed in the host country **<u>only in the specified limited circumstances</u>**
- Rule 3 – all other gains are taxable only in the country of residence

Indirect Transfer: Immovable Properties

- Indirect transfer covered:
  - Shares or interests in company, partnership or trust
  - At least 50% of the value of its property from immovable properties (as defined in Art.6)

- Exception: portfolio investment (as opposed to indirect holding of immovable property)
  - Traded on a recognized stock exchange
  - Small-scale holding (5% or less)

- Domestic law
  - Broadly similar structure (50% threshold, exception)
  - Variety of ‘vehicle’ (company, partnership, trust, etc.)

Indirect Transfer: Bulk Sale of Shares

- Japanese approach in the past
  - Consistency with domestic law
  - Anti-treaty shopping (avoidance of double non-taxation)
  - Reservation on Art.13 of the Model Convention

- Domestic law: bulk-sale of large holding considered tantamount to 'sale of business activity'
  - Large holding: 25% or more
  - Bulk sale: 5% or more

Indirect Transfer: Bulk Sale of Shares (cont'd)

- Withdrawal of the reservation (2010)
  - Risk of double taxation – global consistency
  - Possible impediment to inward FDI
  - Implications on corporate restructuring

- Further considerations
  - Indirect transfer of property vs. financial transaction
  - Location of property vs. residency of company
  - Not 'indirect transfer of PE business property' itself, but 'equivalent' transfer – how equivalent?
    - Alienation of business property of a resident sub of a foreign P
    - Indirect transfer of business property – threshold?

Indirect Transfer: Bailed-out Financial Institutions

- Japan reserves the right to tax gains from alienation of a Japanese financial institution's shares if:
  - The alienator acquired these shares from the Government of Japan (including the Deposit Insurance Corporation in this context);
  - Where GoJ had previously acquired the shares as part of the bail-out of the financial institution; and
  - The alienation is made within 5 years from the bail-out
- Extremely exceptional and historical:
  - Hard to discern from ordinary financial transaction
  - Rare bail-out approach – direct government acquisition
- Domestic law – taxable if qualified as 'bulk-sale'

Lessons

- Strong case for immovable property
- Political case for taxing gains derived from 'public funds' – may not be easy in practice
- Careful balancing needed in taxing gains from sales of shares
  - Encouraging FDI – securing taxation (on gains, on top of tax on income)
  - Risk of double taxation – avoidance of double non-taxation
  - Gains from business activities – gains from underlying properties
  - Implications on business restructuring