Double tax treaties and the new regime for capital gains taxation of non-residents

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The Tax Laws Amendment (2006 Measures No 4) Act 2006 (Cth), part of which deals with non-resident capital gains tax (CGT), took effect from 12 December 2006, the date of Royal Assent of the Act. The new CGT provisions change the manner in which non-residents are taxed on capital gains in respect of certain CGT events happening to Australian property. The law previously taxed non-residents on capital gains made from CGT events happening in respect of CGT assets with the "necessary connection with Australia". Assets with the "necessary connection with Australia" were specifically listed in Div 136 of the Income Tax Assessment Act 1997 (Cth) and included assets such as land, interests in land, and shares and units in certain companies and trusts. This article examines the effect of Australia's Double Tax Agreements on the new legislation.

INTRODUCTION

The *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth) (the Act) has changed the classes of assets in respect of which non-residents can be taxed under the Australian capital gains tax (CGT) provisions and has broadly limited these assets to real property situated in Australia.

The purpose of this article is to examine the effect of Australia's Double Tax Agreements (DTAs) on the new legislation. First, the article will outline the structure of the new legislation and how it operates. It will then examine the class of "real property" assets actually taxed by the legislation and whether Australia's DTAs have any effect on the type of assets that are subject to tax.

The article will then discuss the interaction of Australia's DTAs with the new legislation, in particular, whether a non-resident can escape Australian taxation altogether by arguing that a gain from disposal of Australian real property is revenue, rather than capital in nature. In this respect, the article will explore whether taxation of pure capital gains under the new legislation could be avoided by arguing that they fall within the "Business Profits" article. The effect of pre-CGT treaties will also be briefly considered.

Finally, the new legislation's taxation of real property held indirectly through interposed entities will be examined – in particular, whether Australia has power under its DTAs to tax land-rich entities or whether any of the DTA provisions prevent the new legislation from taxing such gains.

THE NEW CGT LEGISLATION

The new legislation introduced Div 855 which will disregard capital gains and losses made by non-residents in respect of CGT events happening to CGT assets that are not "taxable Australian property".[1]

Taxable Australian property

Non-residents are therefore subject to CGT in respect of CGT events happening to "taxable Australian property", which is defined as the following:

- taxable Australian real property;
- a CGT asset that is an indirect Australian real property interest not covered by the last item in this list;

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[1] See *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-10(1).

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- a CGT asset used at any time in carrying on a business through a permanent establishment;[2]
- an option or right to acquire any of the above assets; and
- certain CGT assets in respect of which a capital gain or loss is disregarded when an entity ceases to be an Australian resident.

Taxable Australian real property

"Taxable Australian real property" (TARP) is defined as:

- real property situated in Australia; and
- a mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry materials are situated in Australia.[3]

A mining, quarrying or prospecting right is:

- an authority, licence, permit or right under an Australian law to mine, quarry or prospect for minerals, petroleum or quarry materials; or
- a lease of land that allows the lessee to mine, quarry or prospect for minerals, petroleum or quarry materials on the land; or
- an interest in such an authority, licence, permit, right or lease; or
- any rights that are in respect of buildings or other improvements that are on the land concerned or are used in connection with operations on it and are acquired with such an authority, licence, permit, right, lease or interest.[4]

Tracing through indirect holdings

The new legislation also applies where a CGT event happens in relation to a membership interest held by a non-resident and the relevant TARP assets are held indirectly through one or more interests. In this case, the legislation requires tracing through the interposed entities to the underlying TARP to determine whether the assets of the directly held entity consist principally of TARP.

A "membership interest" held by an entity in another entity at a time is an "indirect Australian real property interest" if at that time it satisfies two tests:

- the non-portfolio interest test at that time or throughout a 12-month period beginning no more than two years before the CGT event happened and ending no later than the relevant time; and
- the principal asset test at that time.[5]

An indirect Australian real property interest can only exist in respect of actual holdings and there will be no such interest where there is a mere right or option to acquire.[6]

"Membership interest" is defined as each interest or set of interests in an entity, or each right or set of rights in relation to an entity by virtue of which you are a member of the entity.[7] An entity can be a "member" (and therefore hold membership interests) of a partnership and trust, as well as a company.[8]

Non-portfolio test

An interest held in another entity satisfies the non-portfolio test at a time if the sum of the direct participation interests held by the holding entity and its associates is 10% or more.[9] "Direct participation interests" are defined broadly by reference to the controlled foreign company (CFC)

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[2] It should be noted that any capital gain or loss made in respect of such assets is reduced if the asset was only used in this way for part of the period from acquisition to when the CGT event happened (see *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-35).

[3] *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-20.

[4] *Income Tax Assessment Act 1997* (Cth), s 995-1.

[5] See *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-25.

[6] See *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-25(2).

[7] *Income Tax Assessment Act 1997* (Cth), s 960-135.

[8] See *Income Tax Assessment Act 1997* (Cth), s 960-130.

[9] *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 960-195.

provisions in Pt X of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) and include certain direct control rights that are held in companies, trusts and partnerships (eg the percentage of rights that a beneficiary holds in the income and corpus of a trust).

Principal asset test

A membership interest that an entity holds in another entity satisfies the principal asset test if the sum of the market values of the relevant entity's assets that are TARP exceeds the sum of the market value of the assets that are not TARP.[10]

In determining these market values, an asset of an entity that is a membership interest in another entity is treated as two assets: a TARP asset and a non-TARP asset.[11]

Where any holding entity in the structure has a non-portfolio interest in another entity, the TARP asset is treated as having a market value of nil. Similarly, if the ultimate holding entity has a total participation interest (ie the direct and indirect interests) in the relevant entity of less than 10%.[12] In any other case, the market value of the TARP of an entity is multiplied by the direct participation interest in that entity to determine the TARP market value of the membership interests in that entity.[13]

It should be noted that the principal asset test requires tracing through to the underlying Australian real property in all circumstances where an entity has a direct non-portfolio interest in another entity (this includes interposed entities). Accordingly, there is no condition for control before tracing is required.

"Real Property" – What assets does the legislation actually tax?

As discussed above, the legislation allows taxation of Australian real property which includes "real property" and certain other mining and exploration rights situated in Australia. The Explanatory Memorandum states that taxable Australian real property generally refers to real property *within the ordinary meaning of that term* that is situated with Australia.[14] The Explanatory Memorandum goes on to say that, consistent with Australian treaty practice, the meaning has been expanded to include certain mining, quarrying and prospecting rights.[15] Accordingly, there is an issue as to how the taxing rights imposed by the legislation are affected by Australia's DTAs, if at all.

Australia's DTAs are annexed to the *International Tax Agreements Act 1953* (Cth) (IAA 1953) and consequently form part of domestic law. Section 4 of the IAA 1953 incorporates the ITAA 1936 and ITAA 1997 and gives the IAA 1953 (including all the DTAs annexed to it) priority over any inconsistent provisions in the Assessment Acts or other Acts imposing Australian tax.[16] The Explanatory Memorandum to the new legislation reiterates the point that, in accordance with s 4 of the IAA 1953, where a tax treaty applies to a non-resident in respect of a CGT event, the definition of real property should be read in conjunction with the definition as stated in the treaty.[17]

Accordingly, where a DTA specifically defines real property, that meaning should prevail over the domestic law meaning for the purposes of the new legislation.[18]

There is an issue as to whether there is a difference between the ordinary domestic law meaning of "real property" and the meaning of "real property" under Australia's DTAs. If there is a difference,

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[10] *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-30(2).

[11] *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-30(3).

[12] *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-30(4).

[13] *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-30(4).

[14] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.28].

[15] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.28].

[16] However, the provision does not apply to the extent of any inconsistency with *Income Tax Assessment Act 1936* (Cth), s 160AO.

[17] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.29].

[18] This, of course, requires the non-resident to be a resident of the other Contracting State in respect of any particular DTA.

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the scope of the new legislation may change depending on whether the capital gain is made by a non-resident of a country with an Australian DTA or a non-resident of a country with which Australia has no DTA.

An alternative view is that the Explanatory Memorandum, when referring to definitions of real property in tax treaties, is referring to the role of DTAs in limiting domestic rights. One of the classic purposes of DTAs is to act as a "shield" against the exercise of taxing rights, rather than a "sword" to expand domestic taxing rights. Accordingly, it may be arguable that the definition of "real property" in DTAs should not expand the ordinary domestic law meaning of "real property" for the purposes of the new CGT legislation. If the common law domestic meaning of "real property" were expanded by Australia's DTAs, this would ostensibly expand the domestic law taxing rights, rather than limiting them in accordance with the classic purpose of DTAs.

However, by not defining "real property" in the new legislation, there may well be an intention to define it by reference to Australia's DTAs, where possible. Furthermore, the "source of income" article that exists in some of Australia's DTAs[19] deems certain income to be Australian-sourced where the DTA allocates Australia taxing rights in respect of that income. If this article could potentially deem income to be Australian-sourced where it otherwise would not be under domestic law, then it potentially gives Australia taxing rights over that income in respect of non-residents where they otherwise would not exist under domestic law. The income from real property and alienation of property articles are two of the articles covered by this deemed source article. Arguably, domestic legislation could expand the Australian tax base by reference to Australia's DTAs where those DTAs give expanded taxing rights to Australia in respect of "real property".

Domestic law meaning of "real property"

In Australian common law, "property" refers to the rights or interests in a thing rather than the thing itself. Accordingly, the term "real property" is concerned with particular rights. In *City Mutual Life Assurance Society v Smith*,[20] the court noted the historical distinction between "real" and "personal" property:

> the expressions real property, real estate, land, had in common (subject to any special context) a technical meaning in the law, and all denoted rights in property that could be recovered by real actions, long since abolished. These actions were applicable only to land, and only to such interests in land as carried seisin or the possession of freeholders.[21]

Accordingly, at common law, the technical meaning of "real property" is an interest in land equivalent to a freehold interest.[22] Fixtures that are annexed to the land become part of that land[23] and the value of these should, accordingly, be taken into account for the purpose of determining the value of TARP under the new legislation. Lesser interests or rights such as leasehold interests, licences, easements and profits a prendre therefore do not constitute "real property" within the ordinary meaning of that term because they are not freehold estates. The court in *FCT v Lamesa Holdings BV*[24] also confirmed that leasehold interests were treated as personal property for English common law purposes. As a consequence, a CGT event happening to a non-resident in respect of these interests and rights should not be caught by the new CGT legislation where there is no relevant DTA to modify the meaning of "real property".

The ordinary meaning of "real property" has been extended by statute in certain circumstances. For example, the GST legislation extends the meaning of real property in s 195-1 to include:

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[19] For example, Art 22 of the Polish Agreement.

[20] *City Mutual Life Assurance Society v Smith* (1932) 48 CLR 532.

[21] *City Mutual Life Assurance Society v Smith* (1932) 48 CLR 532 at 539. As this passage makes clear, "seisin" is essentially possession by an entity with a freehold estate in land.

[22] A freehold interest is an interest *almost* equivalent to absolute ownership which is of uncertain duration and includes estates fee simple, fee tail and life estates (see Bradbrook A, MacCallum S and Moore A, *Australian Real Property Law* (2nd ed, Lawbook Co., 1997).

[23] See eg *Belgrave Nominees Pty Ltd v Barlin-Scott Airconditioning (Aust) Pty Ltd* [1984] VR 947.

[24] *FCT v Lamesa Holdings BV* (1997) 77 FCR 597 at 606; 97 ATC 4752.

- *any* interest in or right over land (emphasis added); or
- a personal right to call for or be granted any interest in or right over land; or
- a license to occupy land or any other contractual right exercisable over or in relation to land.

Similarly, some of the State Real Property and Conveyancing Acts define property or real property to include *any* estate or interest in real property.[25]

Accordingly, if such an extended meaning of real property were adopted for the purposes of the new legislation, TARP would include all estates or interests and could then extend to leasehold interests and, if the GST definition were adopted, to licences as well.

However, as discussed above, the Explanatory Memorandum makes clear that the intention of the new legislation is that "real property" take its ordinary meaning, *not* the meaning as extended by certain statutes. Consequently, the domestic law meaning of "real property" should cover *only* freehold interests in land and should *not* extend to leasehold interests or other rights such as licences and easements.

As noted above, for the purposes of the legislation, the scope of TARP has been extended to include certain mining and exploration rights situated in Australia.

Meaning of "real property" under Australia's DTAs

Many of Australia's DTAs contain an alienation of property Article which gives Australia source taxing rights in respect of "real property" that is situated in Australia and alienated by a non-resident.

For example, in the Polish Agreement, "real property" is defined to have the meaning which it has under the laws of a particular Contracting State and includes:

- a lease of land and any other interest in or over land including a right to explore for mineral, oil or gas deposits or other natural resources, and a right to mine such deposits or resources; and
- a right to receive variable or fixed payments either as consideration for the exploitation of or the right to explore for or exploit, or in respect of the exploitation of, mineral, oil or gas deposits, quarries or other places of extraction or exploitation of natural resources.[26]

Many of Australia's DTAs adopt a definition of "real property" broadly equivalent to the above. Some other DTAs define real property to include a lease of land or any other *direct* interest in or over land and rights to exploit, or to explore for, natural resources.[27]

Mining rights

Some DTAs, however, do not specifically mention a right to explore or mine for natural resources and simply mention a right to receive payments in respect of these rights.[28] The new legislation gives Australia the power to tax non-residents on capital gains in relation to such rights. However, the alienation of property Article in these particular Australian DTAs does not appear to give taxing rights in relation to those mining rights unless they embody a right to receive payment in respect of exploitation or exploration of natural resources. In many DTAs, Australia reserves taxing rights in respect of "gains of a capital nature" from the alienation of property that is not "real property". Accordingly, Australia should have the power under Art 13 of many of its DTAs to tax non-residents on capital gains in respect of the alienation of exploration and mining rights, as required by the new legislation.

Leases

Many Australian DTAs extend the ordinary meaning of "real property" in domestic law by defining "real property" to include a lease of land and any other interest in or over land. This creates an anomalous treatment under the new legislation between situations where a CGT event happens in respect of a non-resident of a DTA country as opposed to a resident of a country with which Australia has no DTA.

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[25] See, eg the *Conveyancing Act 1919* (NSW); *Conveyancing and Law of Property Act 1884* (Qld).

[26] See Polish Agreement, s Art 6(2).

[27] See, eg the Korean Agreement.

[28] See, eg the Indian and Fijian Agreements.

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For example, consider a situation where a foreign resident of Hong Kong (HK resident) has a direct leasehold interest in land situated in Australia. As Australia has no DTA with Hong Kong, the ordinary domestic law meaning of "real property" applies in respect of the new CGT legislation. If the HK resident disposes of this leasehold interest, he or she should not be subject to Australian CGT under the new legislation because a leasehold interest does not constitute "real property" within the ordinary domestic law meaning of that term. However, if the foreign resident were Polish instead, they should be taxable because, in accordance with the Explanatory Memorandum to the new DTA, the treaty definition of "real property" should prevail over domestic law. Accordingly, unlike a HK resident, the Polish resident should be taxable on the disposal of the leasehold interest because leases over land are included within the Polish DTA definition of "real property".

The new legislation would appear to have a wider scope where a DTA exists. This creates a seemingly unfair outcome, since non-residents of Australian DTA countries would be subject to Australian CGT on a wider range of Australian assets than residents of non-treaty countries. Furthermore, if the same type of asset may be treated as TARP in some circumstances but not in others, the value of underlying TARP for the purposes of determining whether a company is land rich (and hence whether capital gains on sale are taxable to non-residents) will not always be the same.

Other interests in land

A further issue is whether inclusion of "any other interest in or over land" in the DTA definition of "real property" further extends the scope of the interests subject to CGT under the new legislation.

Article 3(2) of the *OECD Model Tax Convention on Income and on Capital* (OECD Model Convention) provides that any term not defined in the DTA shall, unless the context requires otherwise, have the meaning in domestic law of the relevant Contracting State.[29] A specific meaning in a treaty therefore takes priority and, if there is no such meaning, the meaning in domestic law is used unless the context requires a different interpretation. Accordingly, as "any other interest in or over land" is not defined, it should take its meaning under domestic law unless the context otherwise requires.

In *FCT v Lamesa Holdings*,[30] the court did say in relation to "direct interests in or over land"[31] that the kinds of direct interests which are concerned are interests in land analogous to leasehold interests.

Under Australian domestic law, profits a prendre[32] and easements[33] confer a proprietary interest.[34] Unlike a lease, these interests do not grant exclusive possession. The court in *Lamesa* still held that certain mining leases which were more akin to profits a prendre with a right of entry (as opposed to a lease giving exclusive possession) were direct interests in or over land.[35]

However, a mere licence to enter the land does not confer a proprietary interest and is a mere contractual right only enforceable between the parties to the contract. Accordingly, under domestic law, a licence does not give an interest in or over land. Licences should therefore not come within DTA definitions of "real property" and should not constitute an asset subject to CGT under the new legislation.

In contrast to Australia's DTAs, the OECD Model Tax Convention on Income and on Capital[36] refers to the alienation of "immovable property" rather than "real property". In some Australian DTAs,

[29] This article has been adopted in Australia's DTAs.

[30] *FCT v Lamesa Holdings BV* (1997) 77 FCR 597 at 606; 97 ATC 4752.

[31] As mentioned in Art 13 of the Netherlands Agreement.

[32] These are rights to take/exploit natural resources from the land that have a connection to the land (eg timber, minerals).

[33] An easement essentially gives an owner of one particular parcel of land rights in respect of another parcel of land which he or she does not own.

[34] See, eg the discussion in Bradbrook et al, n 22 at [1.27]-[1.38]

[35] *FCT v Lamesa Holdings BV* (1997) 77 FCR 597 at 606; 97 ATC 4752.

[36] See Organisation for Economic Co-operation and Development (OECD), *OECD Model Tax Convention on Income and on Capital*, Arts 6, 13.

the DTA refers to "real property" in respect of Australian taxing rights but "immovable property" in respect of the other Contracting State's taxing rights.[37] For example, in the Vietnamese Agreement, for Vietnam "immovable property" is broadly equivalent to the OECD Model Tax Convention meaning and includes "property accessory to immovable property" and "rights to which the provisions of general law in respect of landed property apply". This suggests that, for the purposes of the DTAs, "real property" is broadly equivalent to "immovable property".

It is unclear whether the OECD intended a licence to constitute a right which is immovable property. As a consequence of the *Thiel*[38] and *Lamesa* decisions, the Commentaries to the OECD Model Tax Convention form part of the "context" of Australia's DTAs and therefore can be used in their interpretation. The OECD Commentary to Art 13(2) states that "movable property" means all property other than "immovable property" and includes incorporeal property such as goodwill, licences etc.[39] Accordingly, it would appear that rights such as easements and profits a prendre would be taxable under the new legislation if a relevant DTA exists which extends "real property" to include interests in or over land. However, a licence should not be taxable under the new legislation.

Other CGT events – are they covered?

The new legislation goes further than a mere disposal of "real property" and also taxes non-residents on CGT events that happen in relation to real property. The Explanatory Memorandum states that for CGT events that do not specifically refer to CGT assets (eg D1 concerning creation of contractual rights) the relevant asset is the CGT asset to which the CGT event relates.[40] The Explanatory Memorandum gives several examples of this, including a grant of an easement which occurs in relation to land, a grant of a lease where the relevant asset is the land over which it was granted, and in relation to forfeited deposits where the relevant asset is the asset in respect of which the deposit was forfeited.[41]

Allocation of taxing rights

There is a question as to whether Australia has the power to tax such capital gains under its DTAs when they do not relate to the disposal of real property. As discussed above, Australia's DTAs generally give Australia power to tax capital gains on disposal of real property under an alienation of property article. For example, Art 13 of the Thai Agreement gives Australia the power to tax capital gains arising from alienation of real property situated in Australia and other property forming part of the business property of a permanent establishment which a non-resident enterprise has in Australia. A residual provision, Art 13(5), gives Australia the power to tax "gains of a capital nature" from the alienation of any other property.

The OECD Commentary states that "alienation of property" as used in Art 13 of the OECD Model Tax Convention covers capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift, and even the passing of property on death.[42] However, all of these examples of alienating assets appear to require an actual disposal of property. Similarly, in *Lamesa*, the court stated that the "word 'alienation' is apt to encompass sales, gifts, or exchanges, without the need for undue technicality".[43]

Consequently, Australian CGT events which do not involve an asset disposal do not appear to be covered by Art 13. Therefore, Art 13 of such DTAs would not appear to give Australia the power to tax, eg capital gains arising in respect of forfeited deposits in relation to land under the new legislation.

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[37] For example, the Vietnamese Agreement.

[38] *Thiel v FCT* (1990) 171 CLR 338; 90 ATC 4717

[39] OECD, *Commentaries on the Articles of the Model Tax Convention*, Commentary on Art 13 at [24].

[40] *Tax Laws Amendment (2006 Measures No 4) Bill* 2006 (Cth), Explanatory Memorandum at [4.20].

[41] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.20].

[42] OECD Commentaries, n 39, Commentary on Art 13 at [5].

[43] *FCT v Lamesa Holdings BV* (1997) 77 FCR 597 at 606; 97 ATC 4752.

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Other DTA articles

If another article does not allocate taxing rights to Australia in respect of such capital gains then the new legislation should be ineffective under DTAs with an alienation of property clause for these particular CGT events. Assuming that the relevant capital gains are not Business Profits,[44] then taxing rights over them should be allocated under the residual article of Australia's DTAs which deals with "other income". It should be noted that not all of Australia's DTAs contain an "other income" article and in such cases Australia should retain full taxing rights in respect of capital gains not covered by a specific DTA article.[45] Article 21 of the OECD Model Tax Convention deals with items of income that are not dealt with in other articles. Article 21(1) allocates taxing rights over such income exclusively to the State of residence. However, Australia has reserved its rights under this article to tax such income when it has an Australian source.[46]

For example, Art 21 of the Czech Agreement gives the sole right to tax other income to the State of residence. However, Australia has the right to tax items of "income" sourced in Australia. Capital gains may constitute "income" because they are taxed as statutory income as part of Australia's income tax law. If so, Australia would have the power under DTAs to tax capital gains that do not arise from alienation of property and so the new legislation would be effective in respect of such DTAs.[47]

It should be noted that it is unclear what is meant by an Australian source. As discussed previously, many Australian DTAs contain a "source of income" article which deems income, profits or gains to be Australian sourced where certain DTA articles give taxing rights to Australia in respect of such income. The "other income" article is one of the provisions covered by this deemed source article. Accordingly, income (such as capital gains) which Australia has the right to tax under the "other income" article would be deemed to have an Australian source. However, Australia only has the right to tax "other income" of non-residents which is sourced in Australia. This leads to somewhat of a logical dilemma, since both articles necessarily rely on the operation of each other.

Arguably, a way can be found around this problem by looking at the meaning of source under domestic law. Foreign residents are only taxable in Australia on Australian-sourced statutory income (including capital gains) and other statutory income that is included within assessable income on a basis other than because it has an Australian source.[48]

"Australian source" is defined in the ITAA 1997 but the definition is unhelpful and does not give any indication as to when statutory income is sourced in Australia.[49] This article will not examine in detail whether a capital gain arising in relation to real property situated in Australia will always constitute Australian source income under domestic law.[50] An indirect disposition of Australian real property held through several foreign resident companies which are disposed of may not, for example, be Australian sourced under the common law where the contract is negotiated and entered into overseas. The reasoning in *Australian Machinery & Investment Co Ltd v DFCT*[51] may provide some support for this contention.

However, it is interesting to contemplate whether a non-resident capital gain under the new legislation will implicitly be Australian sourced under domestic law because it is taxable under s 6-10

[44] The taxation of such capital gains as business profits will be examined further below.

[45] For example, the Philippines Agreement does not contain an "other income" article.

[46] OECD Commentaries, n 39, Commentary on Art 21 at [13].

[47] If these non-alienation capital gains did not constitute other "income" and taxing rights were not allocated under any other article of the relevant DTA, then Australia would have an unlimited right to tax such gains and there would be no issues with having sufficient power under the new legislation.

[48] Section 6-10 of the *Income Tax Assessment Act 1997* (Cth) taxes non-residents on statutory income on this basis.

[49] See *Income Tax Assessment Act 1997* (Cth), s 995-1.

[50] For example, if a contract for sale of Australian property was entered into in a foreign country and a deposit was paid in that country to a foreign resident and the deposit was forfeited in that country.

[51] *Australian Machinery & Investment Co Ltd v DFCT* (1946) 8 ATD 81.

of the ITAA 1997 or whether any such gains are deemed taxable under s 6-10 on another basis besides being Australian sourced. There are several deemed source rules in the Australian income tax legislation which explicitly deem that particular types of income are Australian sourced. For example, s 6C of the ITAA 1936 deems all royalties paid to non-residents by residents or permanent establishments in Australia to have an Australian source. Arguably, because there are provisions within the Act that specifically deem certain types of income to have an Australian source, then taxable capital gains are not Australian sourced because there is no specific provision that *explicitly* deems them to be Australian sourced. If this is correct, then capital gains will constitute other statutory income which is included within assessable income on a basis other than because it has an Australian source. This is logical because the previous CGT provisions in Div 136 taxed non-residents on capital gains from assets that had the "necessary connection" with Australia – there was no mention of source. It would therefore appear that the "necessary connection" with Australia was the "other basis" upon which non-residents were previously taxed on capital gains.

It should also be noted that not all Australian CGT events are actually intended to constitute capital gains under the OECD Model Tax Convention. For example, the OECD Commentary to Art 13 states that if a shareholder sells shares to the issuing company in connection with the liquidation of that company or a reduction of its capital, any profit may be treated as a distribution of accumulated profits and not as a capital gain.[52] Such events could constitute taxable CGT events under the new legislation if they happened to land-rich companies; however, it would appear that if the OECD interpretation is adopted that they should be treated as dividends under Australia's DTAs (and thus capable of receiving treaty benefits), rather than capital gains taxable under the new legislation.

Application of the new legislation to capital gains that are also revenue gains

There is a question as to how the new CGT legislation will operate where a gain from the disposition of a direct or indirect interest in Australian "real property" is of a "revenue" nature under Australian domestic law. Ordinarily, such CGT gains are reduced to the extent that they are included within assessable income as revenue gains[53] and are taxable as ordinary income.[54]

Revenue gains under domestic law

The obvious example of revenue gains arising from the disposal of real property is where a taxpayer is actually carrying on a business of land development whereby land is purchased, developed and then sold to third parties. In such a case, the gains clearly arise directly from, and are a product of, the business being carried on and so are revenue in nature.[55]

Revenue gains can also arise from the disposal of real property where the disposal constitutes an isolated transaction, as opposed to a gain arising from a repeated series of transactions. In the *Myer Emporium case*[56] it was held that gains from an isolated transaction could constitute ordinary income where the taxpayer's intention in entering into the transaction was to make a profit or gain and the gain was made in carrying out a business operation or commercial transaction. It was not necessary that the gain arose from actually carrying on a business.

As mentioned, non-residents are ordinarily taxable on revenue gains as ordinary income where those gains have an Australian source. However, there is an issue as to whether Australia has *any* right to tax such revenue gains under Australia's DTAs even where the real property is situated in Australia.

Can one-off revenue gains fall under the business profits article?

The "business profits" article in Australia's DTAs allocates exclusive tax rights to an enterprise of a Contracting State, unless the enterprise carries on business in the other Contracting State through a

[52] OECD Commentaries, n 39, Commentary on Art 13 at [31].

[53] Under s 118-20 of the *Income Tax Assessment Act 1997* (Cth).

[54] Under s 6-5 of the *Income Tax Assessment Act 1997* (Cth).

[55] Land can even constitute trading stock of a business in certain circumstances. See, eg *FCT v St Hubert's Island Pty Ltd (in liq)* (1978) 138 CLR 210.

[56] *FCT v Myer Emporium Ltd* (1987) 163 CLR 199.

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permanent establishment in that State. Australia's DTAs typically allocate taxing rights in respect of the "profits of an enterprise". An "enterprise of a Contracting State" is generally defined as "an enterprise *carried on* by a resident of" that Contracting State.[57]

Accordingly, if revenue gains of a non-resident from the direct or indirect disposal of Australian real property are covered by the business profits Article, Australia will have no taxing rights over such gains. The new legislation will have no effect in this respect.[58]

Thiel v FCT[59] deals with the issue of whether revenue gains can fall within the business profits article where they do not involve the carrying on of a business but merely an isolated transaction. The case involved a Swiss resident carrying on business in Switzerland. This Swiss resident purchased units in an Australian unit trust which he converted later to shares and sold for a profit. The Australian Taxation Office (ATO) attempted to assess him on these profits. The taxpayer argued that his activities of buying the units and subsequently selling the shares were an "enterprise carried on by a resident of Switzerland" and, accordingly, the profits were only taxable in Switzerland under the business profits article of the Swiss-Australian DTA.

The ATO argued that the Swiss resident's activities did not amount to an "enterprise carried on" by a resident. One of the bases for this argument was that the activities involving the units and the shares amounted to an isolated transaction that could not constitute the carrying on of a business. Dawson J held that carrying on an enterprise does not require repetition or continuity. If it simply constitutes a single activity (as opposed to a business), the enterprise is carried on when the activity is undertaken.[60] Accordingly, isolated profit making activities can also constitute an "enterprise".[61] *Thiel's case* therefore held that an isolated transaction involving the alienation of property could constitute an "enterprise" of a non-resident. Gains arising from that transaction could be "profits of an enterprise" that fell within the business profits article, thus avoiding Australian tax.

Business profits and specific property articles

Revenue gains made by foreign residents on isolated property transactions that fall within the business profits article can fall outside Australia's DTA taxing rights where there is no Australian permanent establishment. This is arguably the outcome in DTAs where no specific alienation of property article exists.[62] However, the outcome is not so clear where a specific alienation of property article *does* exist in a DTA. For example, Art 7(6) of the Polish Agreement states that:

> Where profits include items of income which are dealt with separately in other Articles of this Agreement, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 13 of the Polish Agreement refers to "income or gains" derived from the alienation of real property which appears to encompass revenue gains. As such revenue gains are dealt with separately in Art 13, arguably, that article should take precedence over the business profits article. If this is the case, then Australia would still have the power to tax such gains even if they constituted "business profits".

Article 13(5) of the Polish Agreement also gives Australia power to tax "gains of a capital nature" of a non-resident from property alienation not dealt with under the other provisions of Art 13 (a "residual provision"). However, as the article refers to "gains of a capital nature", it should not include revenue gains.

It should be noted that Art 7(6) simply states that specific articles "shall not be affected" by the provisions of the business profits article. It does *not* say that those specific articles override the

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[57] See, eg Art 3(2) of the South African Agreement.

[58] Provided, of course, that the non-resident does not have a permanent establishment in Australia to which the gains are attributable.

[59] *Thiel v FCT* (1990) 171 CLR 338; 90 ATC 4717.

[60] *Thiel v FCT* (1990) 171 CLR 338 at 351 (Dawson J); 90 ATC 4717.

[61] *Thiel v FCT* (1990) 171 CLR 338 at 351 per Dawson J; 90 ATC 4717.

[62] See, eg the German and Japanese Agreements.

business profits article. The OECD Model Convention Commentary on Art 13 states that:

> The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such a 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.[63]

However, in *Thiel*, the business profits article applied to an alienation of property, even though there was an alienation of property article in the relevant Swiss DTA. Dawson J said that:

> This conclusion makes it apparent that the applicable article of the *Swiss Agreement* is Art 7 rather than Art 13. Having regard to the nature of the appellant's activity, it would clearly be inappropriate to regard his gain as being by way of income from the alienation of capital assets. Necessarily, the nature of the enterprise upon which the appellant was engaged did not involve the acquisition of capital assets.[64]

The relevant provision in *Thiels's case* was Art 13(3), which deals with income from the alienation of *capital assets* of an enterprise. The court's conclusion that the business profits article applied in preference to Art 13 was based on the fact that the relevant assets were revenue, rather than capital, in nature.

Therefore, where the relevant Art 13 provision is the one referring to "income or gains from the alienation of real property", rather than capital assets, Australia may still have taxing rights even where such income falls within the business profits article. This will depend on whether Art 13 should be treated as a specific article that has precedence over the business profits article. It may also depend on whether Australia retains taxing rights under Art 13 to "business profits", even though the taxing rights would be exclusively those of the State of residence under the business profits article where there was no Australian permanent establishment.

If the business profits article did take priority in these circumstances, a non-resident with no permanent establishment in Australia could escape Australian taxation on the sale of a direct or indirect holding of Australian real property. This is provided that the sale was made either in the course of carrying on a business or was entered into as an adventure in the nature of trade (ie a transaction of the type described in *Myer Emporium*).[65] The new CGT legislation is aimed at capital rather than revenue gains, however, non-residents could potentially fall outside the legislation (and the Australian tax net) by arguing that their Australian real property assets are revenue in nature.

A German resident, for example, could acquire Australian land or a land-rich company with the intention of making a profit from that asset. Under *Myer Emporium*, profit making only needs to be a significant purpose in acquiring and selling the relevant property, not the sole or dominant purpose.[66] On disposal, any revenue gains would not be taxable in Australia under the DTA. The ATO is also of the opinion that the relevant profit making intention in acquiring the property is an objective, rather than subjective, purpose.[67] This means that the German resident would be required to adduce evidence that objectively showed that the intention on acquisition was to make a profit.

Gains of a purely capital nature

Thiel's case confirmed that revenue gains from an isolated transaction that did not amount to carrying on a business could come within the business profits article. Dawson J stated that:

> the finding of the trial judge that the appellant "invested in the units with the clear purpose and intention of selling all of them and/or the shares into which they might be converted for profit" confirms that

[63] OECD Commentaries, n 39, Commentary on Art 13 at [5].

[64] *Thiel v FCT* (1990) 171 CLR 338 at 352 per Dawson J; 90 ATC 4717.

[65] Whether gains that are purely capital in nature can also potentially escape taxation under the business profits article will be discussed in greater detail below.

[66] Australian Taxation Office (ATO), *Income tax: Whether profits on isolated transactions are income*, Taxation Ruling TR 92/3 (1992) at [40].

[67] ATO, n 66, TR 92/3 at [38].

> what he did was *by way of an adventure of trade* and was of the requisite business character.[68]

He also regarded "business profits" as including "profits of a business nature or commercial character".[69] Furthermore, Dawson J distinguished a profit from a single transaction that amounts to a business profit from "something in the nature of a capital gain".[70] Accordingly, there is an issue as to whether "something in the nature of a capital gain" can fall within the business profits article.[71] In particular, the court's conclusion that an isolated transaction was covered by the business profits article was based on the transaction constituting an adventure in the nature of trade.

If an isolated transaction is not an adventure in the nature of a trade, there is an issue as to whether any resultant capital gains could still come within the business profits article. For example, an asset is purchased without an intention to make a profit on subsequent disposal and so the relevant gain does not constitute a revenue gain from an adventure in the nature of trade.

Section 3(2) of the IAA 1953 states that, for the purposes of the IAA 1953 and the Assessment Acts, a reference in an agreement to profits of an activity or business shall be read, where the context so permits, as a reference to taxable income derived from that activity or business. Accordingly, because gains of a capital nature are taxable income derived from an activity, arguably, they can be included within "profits" for the purposes of the business profits article.

ATO view

The ATO's view is that the business profits article does not deal with capital gains[72] because, although s 3(2) refers to profits being equivalent to taxable income, it also states "where the context permits". Accordingly, this prevents inclusion of capital gains within business "profits".

Enterprise

The business profits article also requires profits to be "*of* the enterprise". Similarly, under s 3(2) of the IAA 1953, taxable income must be "derived from that activity or business". Deutsch and Sharkey argue that profits must result from the enterprise being carried out. Pure capital gains from a mere realisation of an asset may not be covered because they do not arise from the actual enterprise being carried on, even though they belong to that enterprise.[73] Deutsch and Sharkey believe the business profits article requires profit to result *from* the enterprise's activity, not just have a nexus with a business.[74]

Can, then, gains from a sale of land-rich companies that are acquired with the intention of holding them as a long-term investment come within the business profits article? If Deutsch and Sharkey's view is correct, the business profits article would not cover such gains because they do not result *from* an enterprise and so are not profits "of" that enterprise.

Holding company

The outcome where a holding company acquires/forms subsidiaries for long-term investment purposes and subsequently disposes of a subsidiary rich in Australian land is questionable. Several cases have held that a company can carry on a business as a holding company.[75]

If a holding company sold a long-term investment, would this arise from the business of a holding company or would the sale simply have a nexus with that business? This question should probably

[68] *Thiel v FCT* (1990) 171 CLR 338 at 352 per Dawson J; 90 ATC 4717.

[69] *Thiel v FCT* (1990) 171 CLR 338 at 351 per Dawson J; 90 ATC 4717. McHugh J (at 361) also referred to the relevant profits in that case being earned "from an adventure in the nature of trade".

[70] *Thiel v FCT* (1990) 171 CLR 338 at 351 per Dawson J; 90 ATC 4717.

[71] This issue has been raised in Deutsch R and Sharkey N, "Australia's Capital Gains Tax and Double Taxation Agreements" (2002) (Jun) *Bulletin – Tax Treaty Monitor* 228.

[72] See ATO, *Income tax and capital gains tax: Capital gains in pre-CGT tax treaties*, Taxation Ruling TR 2001/12 (2001).

[73] Deutsch and Sharkey, n 71 at 231.

[74] Deutsch and Sharkey, n 71 at 232.

[75] See, eg *Spassked Pty Ltd v Commissioner of Taxation* (2003) 136 FCR 441; [2003] FCAFC 282.

turn on whether the business of a holding company is simply managing the underlying subsidiaries, receiving dividends from them and performing administrative functions on their behalf or whether it also includes selling the subsidiaries even where they are a long-term investment. A consideration of the activities falling within the "business of a holding company" is beyond the scope of this article. However, if it did include administering the sale of subsidiaries held for long-term investment, then prima facie any resultant profit would be profits from that enterprise and so would be profits *of* the enterprise falling within the business profits article.

If Art 7 did apply to gains of a capital nature that were not revenue gains (or applied to gains made by a holding company carrying out the "business of a holding company"), then there is an issue whether Australia would have taxing rights under its DTAs to apply the new legislation (in the situation where no permanent establishment existed in Australia). The relevant issue, as discussed above, is whether the alienation of property article, being a specific article, has precedence over the business profits article.[76] If Art 13 did take precedence, then Australia would still have the right to tax any such gains despite them also constituting business profits.[77]

Capital gains not from alienation

This article has previously considered the application of the new legislation to capital gains that arise in relation to real property (eg forfeited deposits) rather than from the disposal of real property. As discussed above, Art 13 deals only with the *alienation* of real and other property and does not cover these other types of capital gain. Accordingly, if another type of capital gain arises that falls within the business profits article[78], then Australia should have no taxing rights over that gain and the new legislation would be inapplicable.

Effect of pre-CGT treaties

The status of particular treaties as "pre-CGT"[79] could affect the above analysis. The ATO's view is that pre-CGT treaties do not apply to CGT because the taxes covered article of such treaties does not specifically list CGT as a covered tax and it is not identical or substantially similar to an income tax.[80] Consequently, Australia retains full taxing rights in respect of capital gains under pre-CGT treaties. This article will not consider in detail the validity of the ATO's view. The alternative view is that CGT is covered by these treaties because Australian CGT is not a separate tax and net capital gains form part of assessable income and are taxed under Australia's income tax.[81] Accordingly, CGT should come within the existing list of covered taxes in pre-CGT treaties or constitute an identical or substantially similar tax.[82]

The ATO's alternate position is that, even if CGT is covered by pre-CGT treaties, Australia's power to tax capital gains is not limited because pre-CGT treaties do not distribute taxing rights over capital gains (in particular, the business profits, alienation of property and "other income" articles).[83]

[76] This article in many of Australia's DTAs defines "real property" to include also certain land-rich entities and hence alienation of interests in such entities would be covered by this article in those circumstances. The application of Arts 7 and 13 in respect of indirect holdings of real property by non-residents will be discussed in greater detail below. It should be noted that Art 13, in many of Australia's DTAs, covers both "income or gains" and, accordingly, both revenue and capital gains would appear to be covered.

[77] Of course, this would not apply for DTAs without a specific Art 13.

[78] Either because it also constitutes an adventure in the nature of a trade or because pure capital gains *can* actually be covered by the article.

[79] That is, enacted before the capital gains tax legislation was introduced in Australia.

[80] ATO, n 72, TR 2001/12.

[81] See Deutsch and Sharkey, n 71 at 229; Gzell I, "Treaty Protection from Capital Gains Tax" 2000 29 AT Rev 25.

[82] This view is premised upon an ambulatory approach applying in this respect. See Deutsch and Sharkey, n 71 at 229.

[83] ATO, n 72, TR 2001/12 at [4]. In particular, the ATO believes that because the alienation of property and "other income" articles refer to "income" and not gains, capital gains are not covered. The alternative argument is that "income" does include

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If the ATO's view is *not* correct, treaty protection in respect of pre-CGT treaties should be available in respect of the new CGT legislation. The ATO accepts that revenue gains can still receive treaty protection under the business profits article.[84]

Indirect holdings of real property

The new CGT legislation also applies where a non-resident disposes of an indirect interest in Australian real property through one or more interposed entities. The Explanatory Memorandum to the new CGT legislation states that the legislation is consistent with Australian and OECD treaty practice by applying CGT on disposal of interposed entities by non-residents where more than 50% of the value of the interposed entity is derived from Australian real property.[85] The Explanatory Memorandum goes on to say that Australia has DTA source country taxing rights in respect of capital gains/losses from interests in entities whose assets consist principally of Australian real property, even where held indirectly through a chain of entities.[86] This article will now examine whether Australia's DTAs do in fact allocate taxing rights to Australia in respect of indirect disposals of Australian real property.

Companies

No specific power to tax land-rich companies

Several Australian DTAs do not have a specific article which allocates taxing rights over interests in land-rich companies. In particular, the Japanese and German Agreements do not contain a specific alienation of property article. Accordingly, where eg a Japanese resident disposes of a company whose value is principally derived from Australian real property, Australia should have no power under the new legislation to tax any resultant revenue or capital gain if it falls within the business profits article.[87]

The Japanese and German Agreements do not contain an "other income" article that follows the model "other income" articles in Australia's modern DTAs. If a modern "other income" article did exist in DTAs without a specific alienation of income article, then, similar to other such articles in Australia's DTAs, it would tax non-residents on capital gains with an Australian source. Accordingly, if the relevant capital gains did not fall within the business profits article, Australia would retain taxing jurisdiction over them under the "other income" article.

Specific taxing power

Many Australian DTAs, such as the Irish Agreement, include within the definition of real property "shares or comparable interests in a company the assets of which consist wholly or principally of interests in or over land in one of the Contracting States or of rights to exploit, or to explore for, natural resources in one of the Contracting States". Accordingly, Australia has the power to tax "income or gains" from the alienation of interests in such land-rich companies under Art 13 of those DTAs. These DTAs give the new legislation power to tax such gains.

However, the situation is not so clear where shares are alienated in a company which is land rich but holds the land indirectly through several interposed companies. This situation was dealt with in *Lamesa* which involved a Dutch company that held interests in Australian real property via three interposed Australian companies. The Dutch company disposed of the first Australian company and the ATO sought to tax the profits.

The taxpayer argued that the business profits article of the Netherlands-Australia DTA prevented the ATO from taxing the profits and that the alienation of property article (Art 13), did not apply.

capital gains if the relevant income tax includes capital gains, which Australia's income tax does include (see Deutsch and Sharkey, n 71 at 230). The ATO is also of the view that the "profits of an enterprise" covered by the business profits article does not include capital gains.

[84] ATO, n 72, TR 2001/12 at [5].

[85] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.9].

[86] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.32].

[87] Of course, this is subject to the ATO's views on pre-CGT treaties and the argument that pure capital gains cannot come within the business profits article.

"Real property", in Art 13, was defined to include shares or comparable interests in a company whose assets consisted wholly or principally of a lease of land or any other direct interest in or over land or rights to exploit or explore for natural resources.

The taxpayer argued that the profits were not from alienation of real property because the first interposed entity's assets were not direct interests in real property because it only held property via two other interposed companies. The court held that the Swiss Agreement dealt only with the situation where shares were alienated in a company holding a direct interest in land. The alienation of shares in a company which held Australian real property indirectly through several tiers of companies was not an alienation of real property and so Art 13 did not apply. The gains were of a revenue nature and fell under the business profits article and so Australia had no taxing rights.

Domestic law

Section 3A of the IAA 1953 was introduced in an attempt to deal with the *Lamesa* problem. Section 3A applies if a DTA has an article dealing with the alienation of interests in companies or other entities whose assets consist wholly or principally of real property.[88] Section 3A(2) extends the relevant provision in the DTA to alienations/dispositions of *any* interests in companies or other entities, the value of whose assets is wholly or principally attributable, whether directly or indirectly through one or more interposed companies or other entities, to such real property or interests.

As this provision has been included in the same Act that gives DTAs the force of domestic law, it would appear that this Act overrides the *Lamesa* decision in this respect. It is, however, questionable, whether this is in accordance with the treaties themselves; there could be an argument under international law that s 3A has no application in respect of particular treaties with provisions similar to the Netherlands Agreement.

Under Art 3(3) of Australia's DTAs, any undefined term takes its meaning under domestic law "unless the context otherwise requires". Although there is a definition of "real property" in DTAs,[89] there is no further definition of the actual items included within real property, such as the item relating to shares in a land-rich company. Prima facie, the IAA 1953 s 3A definition should be incorporated into such DTAs to effectively override the *Lamesa* decision.

However, domestic law meanings should only be adopted, "unless the context otherwise requires". The court in *Lamesa* endorsed the principles of treaty interpretation outlined by McHugh J in *Teoh's case*,[90] including the principles that the actual text of a treaty should take primacy when interpreting the treaty and that the context, object and purpose of the treaty should also be considered. The conclusion in *Lamesa* was based on the actual language and policy intent/context of the DTA, *not* on domestic law interpretations as to the meaning of the items included within the DTA "real property" definition. Arguably, therefore, the interpretation given by the court in *Lamesa* should not be affected by the domestic law present in s 3A.

If s 3A does not override DTAs in international law, the applicability of the new CGT legislation to disposals of land-rich companies which hold real property indirectly should be examined. If pure capital gains could fall within the business profits article and the non-resident did not have an Australian permanent establishment, then the new legislation could be of no effect in respect of such gains. Otherwise, such gains may fall within the "other income" article of Australia's DTAs.[91] As outlined previously, such gains are generally taxable in the country of residence unless they are sourced in the other State.

[88] Specifically, the section applies if a DTA makes provision in relation to income, profits or gains from the alienation or disposition of shares or comparable interests in companies or of interests in other entities, whose assets consist wholly or principally of real property within the meaning of the DTA or other interests in relation to land and the Act gave that article in the DTA the force of law.

[89] For example, the Swiss and Irish Agreements.

[90] *Applicant A v Minister for Immigration and Ethnic Affairs* (1997) 190 CLR 225; 71 ALJR 381.

[91] This is, of course, provided that pure capital gains can constitute "income" and assumes that the relevant DTA does not have a "sweep up" provision in its Art 13.

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Suppose, for example, that an Irish resident owns 100% of an Irish resident company, which owns an Australian company whose sole asset is Australian land via two Dutch companies. Assume that the Irish resident disposes of the Irish company and the resultant gain is purely of a capital nature. If the gain is not a business profit, Ireland will retain sole taxing rights as the State of residence unless the gain has an Australian source.

Australian source

If "source" is determined by reference to domestic law, will a gain on sale of a foreign resident company by a foreign resident (where the contract for sale is executed overseas) be Australian sourced? If it could be argued that, under Australian domestic common law, such a gain was not Australian sourced, then Australia would have no DTA taxing rights under its "other income" DTA articles over such gains in respect of the new CGT legislation.[92]

As discussed previously, non-residents can be taxable on statutory income, such as capital gains, both where they have an Australian source and where the legislation taxes them on another basis besides having an Australian source. Accordingly, it may be implicit in the new legislation that *all* gains taxed under that legislation are intended to have an Australian source. Alternatively, capital gains (such as those described above on the sale of a non-resident company) which could possibly be non-Australian sourced may be taxable to non-residents under the ITAA 1997 on "some basis other than having an Australian source".[93] If this were the case, such gains would only be taxable in the State of residence under the "other income" DTA article and, accordingly, the new legislation may not have effect in *some* situations as outlined above where a foreign resident disposed of a foreign company.

Article 13 residual provisions

Some of Australia's DTAs contain a "residual" provision within Art 13 that gives Australia taxing rights in respect of "gains of a capital nature" from the alienation of property other than gains to which other provisions of Art 13 apply. If capital gains from the alienation of shares are not covered by the other provisions of Art 13 because land is held indirectly by the company, then this residual provision may give Australia taxing rights over the gains anyway.

An alternative argument is that, in such circumstances, the other provisions of Art 13 *do* in fact apply because they cover the field and are exhaustive in respect of allocating taxing rights to source states for alienations of interests in land-rich companies. The argument would be that, even where the other provisions of Art 13 did not allocate taxing rights to a source State from alienation of shares in companies with indirect interests in land, they implicitly apply in this situation to allocate taxing rights to the State of residence (ie by mutual exclusion the allocation of taxing rights to source State from alienation of shares with direct holdings of land excludes the allocation of taxing rights over shares with indirect land holdings to that source State). If this argument were valid, the "residual" provision would not apply because the other provisions of Art 13 would apply to deal with such capital gains from indirect land holdings.

The Art 13 "residual" provision in several of Australia's DTAs contains limited residual capital gains taxing rights. For example, the Belgian Agreement in Art 13(3) states that "income from the alienation of capital assets of an enterprise of a Contracting State shall be taxable only in that Contracting State" except where the enterprise has a permanent establishment in the other State. This is subject to Art 13(1) which permits a source State to tax "income from the alienation of real property". In the Belgian Agreement, "real property" is defined to include shares in a company where the assets consist wholly or principally of direct interests in or over land. Putting aside s 3A of the IAA 1953, in accordance with *Lamesa*, this means that shares which have an interest in land through several tiers of interposed entities are not "real property" under the Belgian Agreement. Accordingly, an alienation of such shares by a Belgian resident should fall within the Art 13(3) residual provision, rather than the "alienation of real property" provision. Based on this argument, such capital gains

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[92] See, eg *Australian Machinery and Investment Co v DFCT* (1946) 180 CLR 9; cf *Thorp Nominees v FCT* (1987) 18 ATR 489.

[93] As outlined in the *Income Tax Assessment Act 1997* (Cth), s 6-10.

should only be taxable in the country of residence (ie Belgium) and Australia would have no taxing rights under the DTA.[94] If this line of reasoning is correct, then the new CGT legislation should not be effective, from a DTA perspective, in respect of capital gains of this type for DTAs which have a similar Art 13 to the Belgian Agreement.

New DTAs dealing with the Lamesa problem and recently renegotiated DTAs

To deal with the issues created by the *Lamesa* decision, DTAs negotiated after the decision commonly have an alienation of property clause which refers to shares being real property where their value is principally derived from real property held both directly and indirectly.[95] Accordingly, such a clause ensures that shares in a land-rich company can constitute real property even where the underlying real property assets are held through several tiers of interposed entities.

Australia is currently renegotiating several of its DTAs[96] and this provides an opportunity to ensure that Australia has sufficient taxing power under its DTAs to give effect to the new CGT legislation. For example, Australia recently renegotiated its DTA with Norway and a new Treaty was signed on 8 August 2006. The previous Treaty did not have a specific capital gains tax article. One of the aims of the new Treaty was to align the capital gains tax treatment more closely with OECD practice.[97] In this respect, the Treaty was aimed at preserving Australia's taxing rights over Australian assets with a physical connection with Australia, including mining rights and other interests related to Australian real property.

Furthermore, the alienation of property article allocates taxing rights to a State in respect of certain interests in companies where more than 50% of the value is derived directly or indirectly from real property situated in that State.[98] The above provisions therefore give taxing power to Australia to enact the new non-resident CGT legislation[99] in respect of real property held directly and indirectly through other companies.[100]

Trusts and partnerships

CGT events happening to membership interests in land-rich trusts and partnerships are covered by the new CGT legislation,[101] as are events happening where property is held indirectly through several tiers of interposed entities, including trusts and partnerships.[102]

The Explanatory Memorandum states that the principal asset test approach is consistent with Australia's treaty practice whereby source country taxing rights are provided over gains derived from the alienation of interests in entities where the value of the entity's assets (even where held indirectly through a chain of interposed entities) are principally attributable to real property in the source country. The Explanatory Memorandum contends that this is consistent with the OECD Model

[94] Once again, it is assumed that pure capital gains can constitute "income".

[95] See, eg the Argentine Agreement.

[96] For example, the Korean Agreement.

[97] Minister for Revenue and Assistant Treasurer, *Australia-Norway Sign Revised Tax Treaty*, Media release No 62, (2006).

[98] See the Norway Agreement, Art 13(4).

[99] In respect of Norwegian residents.

[100] Article 13(5) of the Norwegian Agreement is a residual provision that allocates taxing rights in respect of the alienation of any property not otherwise dealt with in the article. It is interesting to note that this provision follows the OECD Model Convention and allocates residual taxing rights solely to the State of residence. This differs from other Australian DTAs in which Australian reserves residual taxing rights in this respect. This change is likely to be due to the fact that the new CGT legislation taxes non-residents on a narrower class of assets being only real property.

[101] See the definitions of "membership interest" and "member" in the *Income Tax Assessment Act 1997* (Cth), ss 960-130, 960-135.

[102] There are also special provisions that apply for capital gains made by a non-resident in respect of an interest in a fixed trust (see *Tax Laws Amendment (2006 Measures No 4) Act 2006* (Cth), s 855-40.

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Convention Article on alienation of property which gives a source country taxing rights where greater than 50% of the value of an interest is derived from real property in the source country.[103]

As discussed above, Australia's DTAs generally include "shares or comparable interests in a company" which is land rich within the meaning of "real property", however, trusts and partnerships are often not mentioned. The Commentary to the OECD Model Convention[104] outlines that States are free to alter the model Art 13 so that other types of interests besides shares (eg interests in partnerships or trusts), the value of which are derived from immovable property, are also covered by the Art.[105]

On this basis, it would appear that interests in partnerships and trusts need to be specifically mentioned within the definition of "real property" in order to be covered by the "alienation of real property" provision in Art 13. This is supported by the fact that some Australian DTAs *have* specifically mentioned interests in trusts and partnerships within the definition of real property.[106]

The alternative argument is that, because the definition of "real property" in Australia's DTAs states that it shall "*include*" shares in a land-rich company, its meaning could also include interests in trusts and partnerships if these interests were included within the meaning of "real property" at domestic law. In *City Mutual Life*,[107] Dixon J defined "real property" to mean both "estates of freehold legal or equitable". Accordingly, an equitable interest in land consisting of a trust could potentially constitute "real property" under domestic law. It is less clear whether land held through several trusts would constitute an equitable interest in the freehold.

As discussed above, Australian domestic law contains an override in s 3A which extends the "real property" alienation clause to alienations of any interests in companies or in *any other entities*.[108] This overrides any contrary position in the relevant treaty for Australian domestic law purposes.

Although, a taxpayer may be able to mount an objection on international law principles, and based on the relevant treaty, that interests in trusts and partnerships are not covered by the "alienation of real property" provisions. For those DTAs which give residual taxing rights in respect of the alienation of capital assets to the State of residence,[109] treaty protection may therefore be available under Art 13 against the taxation of disposals of land-rich trust and partnership interests under the new legislation.

CONCLUSION

The *Tax Laws Amendment (2006 Measures No 4) Act 2006* has changed the manner in which non-residents are subjected to Australian CGT. Taxation of non-resident capital gains is now, broadly, limited to real property and certain mining rights situated in Australia. The legislation also taxes non-residents on capital gains in respect of Australian real property held indirectly through interposed entities.

This article has examined the interaction of the new non-resident CGT regime with Australia's DTAs. Firstly, it submitted that the range of assets that are taxable under the new legislation can change depending on whether the relevant taxpayer is a resident of a country with which Australia has a DTA. This stems from the different meaning that "real property" has under domestic law and Australia's DTAs. The Explanatory Memorandum to the new legislation may support the argument that the ordinary meaning of "real property" can be altered by a DTA for the purposes of determining

[103] *Tax Laws Amendment (2006 Measures No 4) Bill 2006* (Cth), Explanatory Memorandum at [4.77].

[104] Article 13 of the OECD Model Convention also includes "shares or comparable interests in a company" within the meaning of "immovable property".

[105] OECD Commentaries, n 39, Commentary on Art 13 at [28.5].

[106] See, eg Art 13(2) of the Argentine Agreement.

[107] *City Mutual Life Assurance Society v Smith* (1938) 48 CLR 532.

[108] Indirect holdings of real property through multiple tiers of interposed entities are also included.

[109] For example, the Belgian Agreement. It should be noted that this is a pre-CGT treaty and the ATO's view is that even if capital gains tax is covered by such treaties then the treaty articles still do not allocate taxing rights over capital gains to either Contracting State.

which assets are subject to non-resident CGT. However, there is an alternative argument that the Explanatory Memorandum is referring to a limitation of domestic law taxing rights by Australia's DTAs, rather than an expansion of domestic law taxation by DTAs extending the common law meaning of "real property".

Non-residents with no Australian permanent establishment who successfully argued that gains from real property were revenue in nature, could avoid tax under the new legislation under the business profits article. Australia may, however, still retain taxing rights over such gains where they are covered by a specific alienation of real property article. A similar argument could be maintained in respect of pure capital gains, although it would have less chance of success in that case. The new legislation covers all types of capital gains related to Australian real property, not just those from alienation of property. Consequently, where these "other" capital gains are covered by the business profits article, Australia may not have taxing rights over these gains in respect of the new legislation.

The new legislation also taxes non-residents on capital gains in respect of membership interests in entities (including foreign resident entities) which hold land directly and through interposed entities. Australia may not have the power to tax such capital gains under the alienation of property article in some Australian DTAs, which means that the new legislation may not have effect in this respect. However, there is conflict between the domestic law and these treaties which makes the outcome uncertain. A similar argument exists in respect of entities other than companies (ie partnerships and trusts).

The new non-resident CGT legislation purports to tax non-residents on all capital gains in respect of Australian real property, including property held indirectly through interposed entities (including foreign entities). However, Australia's DTAs may not give Australia the right to tax gains in respect of real property in all situations covered by the non-resident CGT legislation.

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