

Tax Brief

21 October 2008

Capital Gains and Tax Treaties

For several years, the Australian Taxation Office ('ATO') has been engaged in a long and multi-faceted tax dispute with the Virgin group about the Australian tax consequences arising from the sale of shares in an Australian company by a non-resident shareholder.

One dispute – about the Commissioner's powers to collect the tax said to be owed – went to the High Court in late 2007 where the Commissioner's collection powers were upheld. The Federal Court has just ruled in the *Virgin Holdings SA* case [2008] FCA 1503 on the underlying substantive question – whether any Australian tax was in fact owed – and has held that the non-resident shareholder was not liable to Australian tax on the profit it made on the sale of the shares in its Australian subsidiary.

1. The dispute

The taxpayer, a Swiss resident company, sold shares of its Australian subsidiary in two tranches in November and December 2003, making a profit of about \$192m. It was agreed that this was a capital profit and so liable to tax (if at all) under the capital gains tax ('CGT') provisions which form part of the *Income Tax Assessment Act 1997*. There was no dispute about the fact that the CGT provisions as they were then drafted purported to apply.

2. Arguments and findings

The taxpayer argued that the profit arising on the sale of the shares was immune from Australian tax on two grounds. First, it claimed that the profit was immune from Australian tax on the basis of article 7 (business profits) of the double tax treaty between Australia and Switzerland. That is, the non-resident could not be taxed in Australia because the profit arising on the sale of the shares was a business profit within the scope of the article and thus immune from Australian tax unless the profit was attributable to a permanent establishment of the taxpayer in Australia. As both sides agreed that the taxpayer did not have a permanent establishment in Australia, the profit would be taxable only in Switzerland.

The second ground was that article 13 (alienation of property) of the treaty applied to the transaction, and this article also allocated to Switzerland the exclusive right to tax any profit made on the sale of the shares.

Greenwoods & Freehills

The ATO proposed three arguments in support of its tax assessment. First, it argued that the provisions of the double tax treaty were irrelevant to the dispute because the treaty entered force in 1981 and its effect did not extend to the CGT provisions which began operation only in 1985. It argued as an alternative that if the treaty did apply, neither article 7 nor article 13 operated in the way that the taxpayer asserted to limit Australia's power to tax a profit of a capital nature.

Justice Edmonds in the Federal Court found in favour of the taxpayer, holding that the treaty did extend to the CGT provisions of the *Income Tax Assessment Act 1997*, and that the provisions of the business profits article and the alienation of property article operated to deny Australia the ability to tax.

2.1 The meaning of “*Australian income tax*”

Article 2(1) of the treaty between Australia and Switzerland which sets out the “Taxes Covered” by the treaty provides that it applies to “the Australian income tax,” a slightly more truncated form of words for describing the taxes covered than is used in the OECD Model Convention. The term “the Australian income tax” was not defined in the treaty and so the judge, referring to article 3(2) which adopts domestic law meaning for undefined terms, concluded that the term took its meaning from the *Income Tax Assessment Act*.

This was a significant finding because the CGT provisions under which the profit was being assessed form part of the *Income Tax Assessment Act*, rather than being located in a separate Act, as is the case in the UK, for example. The judge noted that this Act, even in 1981, imposed tax on capital profits in a number of circumstances and so “the Australian income tax” which the treaty covered was already a tax that (albeit selectively) taxed profits of a capital nature. This interpretation effectively eliminated the ATO's argument which represented the CGT provisions as constituting a new and separate tax and not “Australian income tax.” The judge was fortified in his view because, if the transaction had been undertaken when the Swiss agreement entered into force, the profit would have been taxable under Australian law as it then stood as the shares had been bought and sold by the taxpayer within the previous 12 months. It would be odd, therefore, to conclude that the tax which could have been levied at the time the treaty was entered was covered by the treaty, but a new tax with a similar result was not!

Interestingly, the judge did not think that this issue was one which raised the question whether the operation of a treaty was ambulatory or static – that is, whether the term “the Australian income tax” should be read to mean different things as the domestic circumstances changed. The judge observed that, in his opinion, “the better and preferred approach should be ambulatory and not static,” but he concluded that it was not necessary to resolve the issue because even in 1981 the term “the Australian income tax” extended to tax on profits of a capital nature.

Greenwoods & Freehills

The first part of the judgment is thus of largely transitional importance – it has significance principally for ascertaining the scope of Australia’s pre-CGT treaties. The remainder of the judgment, however, has significance for a wider range of treaties as the issues raised by the ATO go to the interpretation of operative provisions found in both pre- and post-CGT tax treaties.

2.2 The meaning of “a substantially similar tax”

Article 2(2) of the treaty provided that it extended to “any identical or substantially similar taxes which are imposed ... in addition to, or in place of, the existing taxes ...”

The ATO apparently directed most of its effort to its proposition that the CGT provisions were not “substantially similar” to the taxes covered in article 2(1). Given the judge’s conclusion on the scope of the taxes covered, this line of argument became irrelevant. However, no doubt with a view to a possible appeal from his decision, the judge expressed his view if the CGT provisions were not part of “the Australian income tax,” then he was “of the firm view that [they were] substantially similar to ‘the Australian income tax’ ...” He found support for this conclusion in the views of Klaus Vogel and the 2007 decision of the Irish High Court in *Kinsella* [2007] IEHC 250.

2.3 Operation of the business profits article

Having concluded that the treaty applied to these taxing provisions, the next issue concerned the proper interpretation of article 7.

The parties agreed that the non-resident seller constituted an “enterprise,” and that it did not conduct its activities in Australia through a permanent establishment located here.

The ATO argued, however, that the operation of article 7 was limited to circumscribing tax on the revenue profits of an enterprise; it did not purport to address tax that might be imposed on the capital profits of an enterprise. The argument was that this limitation on the operation of article 7 should be inferred because of the existence of article 13, a specific provision which was directed exclusively to tax imposed on capital profits arising from the alienation of property.

The judge disagreed. He found the argument unconvincing because the ATO argued that article 13 did not actually apply to the transaction. Hence the ATO was arguing that article 7 should be read as subject to an implied limitation, the limitation arose from the existence of article 13, but article 13 did not actually operate! In other words, the limitation on the scope of article 7 was said to arise by implication from the existence of another but inoperative provision.

The judge held, based largely on comments by the High Court in the earlier decision in *Thiel*, that article 7 extended to restrict Australia’s ability to impose tax on profits of a capital nature.

Greenwoods & Freehills

2.4 Alienation of property article

The final issue concerned the proper interpretation of article 13(3) of the treaty. This article deals with the taxation of gains from “the alienation of property.”

The ATO argued that this provision applied to the transaction, but it contained no restriction on the right of Australia to tax the capital profit made on the sale of the shares. The relevant part of article 13(3) allocated the exclusive right to tax “income from the alienation of capital assets of an enterprise of one of the Contracting States” to the home State of the enterprise, in this case Switzerland.

As this argument was not fully explored before the Court, and was regarded by the judge as irrelevant in light of his earlier conclusions, he addressed only a few comments to this issue. First, he observed that the word “income” in the phrase “income from the alienation of capital assets of an enterprise” could not simply be referring to income according to ordinary concepts. If it were referring just to income gains, the provision would rarely apply – the alienation of “capital assets of an enterprise” will typically give rise to capital profits, not income under ordinary concepts. Hence, he wondered whether the reference to “income from the alienation of capital assets” should be read as extending to a gain which “is assimilated to income” which is exactly how he considered the CGT provisions work.

He concluded, therefore, that article 13 would apply to allocate exclusively to Switzerland the right to tax a capital profit (that is added to income) arising on the sale by a Swiss enterprise of a capital asset if the business profits article did not.

3. Observations

The underlying issue – whether the operation of Australia’s pre-1985 tax treaties extends to the CGT provisions – has been a contentious topic in the profession for many years, but it has taken over 20 years for it to be agitated before a Court. Having comprehensively lost the case, the ATO seems likely to appeal – at least the judge recognised “the reality that these proceedings are unlikely to stop with my judgment.”

In the meantime, in accordance with its usual practice, the ATO will presumably follow its current Ruling TR 2001/11 which formed the main basis of its argument in the case, unless the forceful terms in which the decision is expressed produce a change of heart.

Both Australian domestic law and treaty practice have moved on considerably since the Swiss and similar treaties so the outcome of the case will be largely limited to the so-called pre-CGT treaties. After the CGT was enacted, Australia changed its treaty policy to ensure that Australian domestic CGT law was unaffected by treaties through inclusion of a provision that typically reads, “nothing in this agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature ...”. After the considerable narrowing of the application of the CGT to non-residents in 2006, treaty policy changed again to entrench the new domestic law approach in our treaties. The relevant provision now reads (in the recent Japan treaty), “gains from the alienation of any property other than that referred to in the preceding paragraphs of this article [which

Greenwoods & Freehills

largely reflect the 2006 law] shall be taxable only in the Contracting State of which the alienator is a resident.”

The 2006 changes also mean the result in the case applies only for CGT arising from events occurring before 12 December 2006. For CGT events occurring on or after this date, Australia would not seek to tax a person in a similar position to the taxpayer (unless the company being sold was “land-rich”) and so any limitation under a tax treaty becomes irrelevant. Nonetheless, there have been a number of significant comparable assessments for CGT which will turn on the ultimate outcome of this or a similar case.

For further information, please contact

Sydney

Ernest Chang

61 2 9225 5965

ernest.chang@gf.com.au

Andrew Mills

61 2 9225 5966

andrew.mills@gf.com.au

Melbourne

Richard Shaddick

61 3 9288 1412

richard.shaddick@gf.com.au

Adrian O’Shannessy

61 3 9288 1723

adrian.o'shannessy@gf.com.au

www.gf.com.au

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

Liability limited by a scheme approved under Professional Standards Legislation