TR 2001/12 - Income tax and capital gains tax: capital gains in pre-CGT tax treaties

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Taxation Ruling
Income tax and capital gains tax: capital gains in pre-CGT tax treaties

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Preamble

The number, subject heading (the title), ***Class of person/arrangement, Date of effect*** *and* ***Ruling and explanation*** *parts of this document are a 'public ruling' for the purposes of Part IVAAA of the* ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling sets out the ATO's position on the extent and manner in which capital gains are dealt with in Australia's tax treaties negotiated before the enactment of the capital gains tax by the insertion of Part IIIA into the *Income Tax Assessment Act 1936* ('ITAA 1936').

2. This Ruling does not deal with the treatment of income gains from the alienation of property. Thus the one-off transaction with business characteristics held by the High Court to constitute a business profit in *Thiel v. FCT*[1] is not covered in this Ruling. It is also noted that in *FCT v. Lamesa Holdings BV*[2] the ATO did not take the view that the gains on the sale of the shares were of a capital nature. The ATO's view was based on the fact that the controlling minds behind Lamesa Holdings BV were in the business of acquiring companies, building them up and then selling them at a profit. On this basis the ATO considered the gain was of an income nature.

3. This Ruling assumes that certain receipts on the borderline of the income/capital gain distinction and assimilated to income under Australian law (discussed below) are treated as income in Australia's tax treaties. Apart from that observation, the Ruling does not deal with the question of what amounts to a capital gain for the purpose of a double tax treaty.

[1] 90 ATC 4717; (1990) 21 ATR 531.
[2] 97 ATC 4752;(1997) 36 ATR 589.

Ruling

4. Australia's right to tax gains taxable in Australia exclusively under the capital gains tax regime (that is, Part IIIA of the ITAA 1936, or Part 3-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997')) is not limited by pre-CGT treaties. This is because: (a) from Australia's perspective these treaties do not distribute taxing rights over capital gains; and (b) with the exception of the Australia/Austria DTA, under relevant *Taxes Covered* articles, Australia's tax on capital gains is not a tax to which pre-CGT treaties apply.

5. Pre-CGT treaties apply, however, to gains which at the time of signature of the relevant treaty were assessable under provisions other than the comprehensive capital gains regime. These treaties can apply, for instance, to income according to ordinary concepts arising on the alienation of property and certain borderline gains assimilated to income (for example, gains assessable under sections 25A, 26(a), 26AAA, 36, 47 or 59 of the ITAA 1936) which were taxable prior to the introduction of the comprehensive capital gains tax regime.

Definitions

Pre-CGT treaties and post-CGT treaties

6. The following tax treaties, which were negotiated before Australia introduced comprehensive taxation of capital gains, are referred to as 'pre-CGT treaties': United Kingdom (1967); Japan (1969); Singapore (1969); Germany (1972); New Zealand (1972); France (1976); Netherlands (1976); Belgium (1977); Philippines (1979); Canada (1980); Switzerland (1980); Malaysia (1981); Sweden (1981); Denmark (1981); Italy (1982); Korea (1982); Norway (1982); USA (1983); Ireland (1983); Malta (1984); Finland (1984); and Austria (1986).

7. Although the treaty with Austria was signed shortly after CGT legislation was assented to in 1986, the final text was negotiated in 1984. The signed text remained unchanged from the time of negotiation, so for the purposes of this Ruling it is a 'pre-CGT treaty'. Note also that amending Protocols – which include provisions dealing comprehensively with capital gains – have since been concluded with Singapore (1989) and Malaysia (1999), and a revised treaty containing a comprehensive capital gains provision has been concluded with New Zealand (1995). (Of course, over time the other pre-CGT treaties will be renegotiated.) A second Protocol to the

Netherlands treaty (1986) and a protocol to the French treaty (1989)[3] do not address alienation of property.

8. Treaties negotiated or amended to include a comprehensive capital gains provision after the Australia/Austria DTA are referred to as 'post-CGT treaties'.

Pre-OECD Treaties

9. An important category of pre-CGT treaties concerns those negotiated prior to Australia's membership of the OECD: United Kingdom (1967); Japan (1969); Singapore (1969); Germany (1972); and New Zealand (1972). These treaties contain some marked departures from the OECD Model. In this Ruling, to distinguish them from other pre-CGT treaties, these five treaties are referred to as 'pre-OECD treaties'.

Borderline gains

10. This ruling refers to 'borderline gains'. These are gains which are on the borderline of the income/capital distinction. Technically these gains may not be income according to ordinary concepts, but are included in the income tax base as assessable income. In the current law, such gains include: profit making undertakings or schemes; sale of trading stock as part of the sale of a total business; lump sum payments on termination of employment; return to work payments; realisation of traditional securities; certain foreign exchange gains; bounties and subsidies; compensation for loss of trading stock or profits; certain liquidator's distributions; depreciation recapture; and income received after death. Under past law which applied when various of the pre-CGT treaties were negotiated, 'borderline gains' included gains on property acquired for the purpose of profit-making by sale or purchased and sold within 12 months. In reality all these measures address borderline issues between income and capital such as income replacement, deduction recapture, clarifying the borderline or administrative rule of thumb solutions where the income/capital distinction is very fine or difficult to apply. Unless the context requires otherwise, 'income' when used in double tax treaties clearly requires a broader meaning than 'income according to ordinary concepts' - otherwise these borderline gains could be outside the scope of Australia's tax treaties.

11. Gains representing depreciation recapture and gains assessable under the former sections 26(a), 25A and 26AAA were specifically

[3] This Protocol was actually negotiated in December 1986. At that time Australia's Model post-CGT *Alienation of Property* Article had not been finalised. Accordingly negotiators agreed not to cover capital gains in that Protocol.

referred to in various negotiations as examples of income from the alienation of property. The ATO considers these to be the most obvious examples on the borderline of the income/capital distinction but some of the other cases described in the previous paragraph could also involve alienation of property and would be treated similarly.

Glossary

12. Other abbreviations and terms used in this Ruling are listed below:

1963 Draft Convention	*Draft Double Tax Convention on Income and Capital*, OECD, Paris. A commentary also accompanied the Draft Convention. Now replaced by the OECD Model (discussed below).
Agreements Act	*International Tax Agreements Act 1953*
ATO	Australian Taxation Office
CGT	capital gains tax
credit article	*Methods of Elimination of Double Taxation* Article. Australia generally uses the credit method to eliminate double taxation of items where, under the distributive rules, taxing rights are shared.
distributive rules	Tax treaty provisions where the Contracting States agree to limit their taxing rights are referred to as 'distributive rules' in this Ruling. In the OECD Model, these are the rules contained in Chapter III. In most Australian treaties they are in Articles 6 to 21.
DTA	Double Tax Agreement
DTC	Double Tax Convention
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
OECD Model	*Model Tax Convention on Income and on Capital*, OECD, Paris. This model (and Commentary) was originally published in 1977, effectively replacing the 1963 Draft Convention. It was revised in 1992 and periodically updated since then. The most recent update available at the time of issue of this ruling is the 29 April 2000 version.
residual article	*Income Not Expressly Mentioned* Article or *Other Income* Article. In the OECD Model this is found at Article 21. The first expression was used in the 1963 Draft Convention and the latter adopted in the 1977 OECD Model.
undefined terms provision	General rule of interpretation for terms not defined in tax treaties. In the OECD Model this is found at Article 3.2.
UN Manual	*Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries,* United Nations New York, 1979. Essentially, this was an 'unofficial' version

	published in advance of the UN Model.
UN Model	*United Nations Model Double Tax Convention Between Developed and Developing Countries* United Nations, New York, 1980.
Vienna Convention	*Vienna Convention on the Law of Treaties,* done at Vienna on 23 May 1969.
Australian Model	Australia's negotiating text used for negotiating agreements for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. This is an internal, unpublished document prepared by the ATO.

Date of effect

13. This Ruling will apply to years commencing both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). In practice the Commissioner's amendment power is generally limited to four years prior to the date of amendment unless there has been fraud or evasion. Uncertainty during the period on the application of the law will be taken into account, along with other relevant factors, when determining tax penalties.

Overview

Note: This Overview summarises the Explanations part of this Ruling

14. This Ruling responds to views expressed by some commentators that capital gains of treaty partner residents are relieved from liability to capital gains tax by the operation of Australia's pre-CGT tax treaties. Under these treaties they argue that, in certain circumstances, taxing rights over a non-resident's capital gains are allocated exclusively to the country of residence thereby eliminating liability to Australian tax.

Overview of ATO Position

15. While noting there are alternative arguments, the ATO adheres to the view that Australia's right to tax capital gains is not limited by pre-CGT treaties. It is the ATO's view that there was no agreement in Australia's pre-CGT treaties to cover capital gains (other than 'borderline gains') and that an application of the rules of treaty interpretation adopted internationally and by Australian courts

demonstrates this. Australia did not have a comprehensive CGT regime at the time the pre-CGT treaties were negotiated and such a regime was not in contemplation. While the treaties provide a mechanism for extension of treaty coverage to taxes not in existence at the time of signature, that extension is limited to similar taxes. The ATO considers that Australia's CGT is not a substantially similar tax. Even if this is not the case, the distributive rules of pre-CGT treaties do not limit domestic law taxing rights over capital gains.

16. Context is central to the ATO understanding of these treaty issues. For example, context is relevant to deciding whether under the *Taxes Covered* Article, CGT is substantially similar to the 'Australian income tax' existing when pre-CGT treaties were signed. Also the undefined terms provision may be used to enliven the meaning of key expressions such as 'income from alienation' and 'profits of an enterprise' by using the meaning under domestic tax law - so long as the treaty context permits.

17. The ATO position is based on an overall view of the context and language of pre-CGT treaties. It does not rest on any particular point but a number of indicators collectively demonstrate that capital gains were not covered in pre-CGT treaties (except Austria) and distributive rules in these treaties did not limit taxing rights over capital gains.

18. The ATO considers the context of these treaties shows that Australia attempted to limit the application of the *Alienation of Property* Article in all of Australia's pre-CGT treaties to income gains and did not intend that capital gains were to be covered by these treaties. These contextual factors include:

- Australia's 1976 reservation to the OECD Model retained the right to propose changes to the *Capital Gains* Article, because Australia did not levy a capital gains tax. The reservation was removed from the 1992 Model - the first Model published after CGT was introduced.

- Australian pre-CGT treaty practice compared to the prevailing OECD Model (see Table 1, columns 1 and 2 below) consistently reflects this reservation.

- Drafting changes to Australia's tax treaties made after the introduction of CGT (see Table 1, columns 2 and 3 below) also confirm an intention to not deal with capital gains in pre-CGT treaties.

- Comparing the pre-CGT treaties with the tax treaty policies of pre-CGT tax treaty partners reveals that in its negotiations Australia sought and obtained significant changes to the international models used by treaty partners. Most of Australia's pre-CGT treaty partners consistently followed the OECD Model and comprehensively dealt with all capital gains from the alienation of property. Departures from the OECD Model were clearly at Australia's behest - implying that the treaty partners would not interpret these Australian treaties like their other tax treaties. Furthermore, treaty partners had comprehensive CGT regimes in their domestic law and would be expected to seek to deal with capital gains. Pre-CGT treaties reflect compromises generally negotiated at Australia's insistence. While these changes reflect a consistent Australian position, treaty partners were able to agree to this position because it did not restrict their right to impose their own capital gains taxes and, because there was no Australian CGT, there was little prospect of double taxation occurring.

- Australia's economic and political interests favoured not dealing with capital gains in the pre-CGT treaties. CGT was a contentious domestic issue. Further, (as Australia's post-CGT treaty practice clearly shows) Australia's economic interests were not perceived to align with allocation of taxing rights under the OECD Model's *Capital Gains* Article. By not dealing with capital gains in pre-CGT treaties, Australia avoided referring to this contentious domestic issue while preserving its freedom of action to subsequently negotiate appropriate taxing rights over capital gains if a CGT was introduced.

Table 1: OECD Model *Capital Gains* Article compared with *Alienation of Property* Articles in Australia's Pre-CGT and Post-CGT treaties.[4]

1. OECD	***2. Pre-CGT***	***3. Post-CGT***
Heading		
Capital Gains	Alienation of Property[5]	Alienation of Property
Activities covered		
Comprehensively deals with capital gains.	No article in pre-OECD treaties. Later pre-CGT treaties did not deal with alienation of property comprehensively. Often only real property alienations covered.	Comprehensively deals with capital gains.
Characterisation		
(Capital) gains[6]	Generally expressed to deal only with *income* from alienation of property.	income, profits and gains.
Source rules in treaties (and Agreements Act) deal with		
No provision	income	income, profits and gains.
Entry into force provisions in treaties deal with		
Different approach	income	income, profits and gains.
Agreements Act 'force of law' provisions		
Not applicable	Give treaty force of law in relation to 'income'	General formula introduced: provisions of the treaty have force of law 'according to their tenor' (i.e., dealing with income, profits or gains)

19. The above observations are made independently of the evidence of the actual negotiations. Australia's records of

[4] This table identifies the trends in Australian treaty practice. There were some exceptions discussed later in the text, but generally Australia's treaty practice was very consistent.

[5] Because the article deals with income (pre and post CGT), the OECD heading (*Capital Gains*) is modified to *Alienation of Property*.

[6] The distributive rules of the OECD Model *Capital Gains* Article only refer to 'gains', but in the context of the heading and commentary they deal only with capital gains.

negotiations with pre-CGT treaty partners[7] support the position taken by the ATO. The records are not publicly available[8] but are mentioned to signal that the ATO considers the approach taken in interpreting pre-CGT treaties is consistent with Australia's international undertakings. The records may also be important when dealing with pre-CGT treaty partners.

20. Australia's pre-CGT practice was against a background in which Australia did not tax capital gains and the introduction of such a tax was unlikely. Thus there was little possibility of double taxation. The question is whether the parties intended pre-CGT treaties to deal with capital gains in the event Australia introduced such a tax.

21. On one view it might be inferred that Australia simply sought to remove references to capital gains for presentational purposes - possibly prompted by domestic political concerns. Such a view would require an assumption that the negotiators of the pre-CGT treaties agreed that, in the event that Australia subsequently introduced a CGT, the result, broadly, would be that taxing rights over capital gains would be allocated under the business profits rules, yielding a similar result to the OECD Model *Capital Gains* Article. It might also be argued that the chances of an Australian CGT being introduced were so remote that in practice it was only a minor matter for Australia to effectively cede many CGT taxing rights to the residence country.

22. The ATO view, however, is that these changes were intended to remove capital gains entirely from the scope of pre-CGT treaties. In so doing, both countries retained their freedom of action in relation to taxation of capital gains. In Australia's case, it would only be when a CGT was introduced that the domestic political processes would be able to give proper consideration to its cross-border application. In any event, because of Australia's strong disposition to preservation of source country taxing rights (evidenced by its reservations to the OECD Model and post-CGT treaty practice) Australia is very unlikely to have agreed to taxing rights over capital gains in pre-CGT treaties to be allocated similarly to the OECD Model *Capital Gains* Article - which has very restricted source country taxing rights. Australia's records of negotiations confirm Australia had intended not to deal with capital gains in pre-CGT treaties.

[7] Files in relation to these negotiations are not comprehensive, with the fullest records existing for negotiations which occurred in Australia.

[8] Countries generally do not publicly release records of negotiations. The release of these records could have a negative impact on international relations and on the openness of future treaty negotiations. There are also sensitivities regarding the release of internal documents on deliberations of Government Policy. It is questionable whether these materials could be used in evidence (see for example IV Gzell, 'Treaty Protection from Capital Gains Tax', *Australian Tax Review*, (Vol 29: March 2000) 25, p. 28).

Alternative Views

23. A number of authors have written on this issue in recent years. Many have argued that pre-CGT treaties deal with capital gains. Clearly there are differences of emphasis between authors and differences between treaties. The following synthesises some of the key themes emerging from these commentaries.

24. The ATO does not agree with these arguments, often because they give insufficient weight to the context of these treaties as outlined above. The ATO response is provided in the detailed Explanation.

25. The alternative view often emphasises the requirement in Article 31 of the Vienna Convention that treaty language is to be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty and in the light of its object and purposes. As one of the purposes of tax treaties is to avoid double taxation such treaties should be interpreted liberally to achieve this purpose: a point enunciated by McHugh J in *Thiel*.[9]

Taxes Covered Article

26. In considering whether CGT is a tax to which a pre-CGT treaty applies, a key requirement is that the CGT be considered one of the taxes existing at the time of signature (usually by Australia as the 'Australian income tax') or that the tax be at least substantially similar to an existing tax. The alternative view argues that an ambulatory approach is to be applied to the meaning of 'Australian income tax' and that CGT is similar to the existing taxes.

27. The alternative view argues 'Australian income tax' effectively included a capital gains tax when most of the pre-CGT treaties were signed. Section 26AAA, for example, was always a 'pure' tax on capital gains. The CGT merely extends the range of transactions subject to the tax. Therefore CGT is an 'existing tax' or alternatively it is substantially similar to an existing tax and is therefore a tax to which pre-CGT treaties apply. The views of international tax authors and decisions of a foreign tribunal are quoted to support this view.

28. There is also an argument that if one country's list of existing taxes encompasses capital gains, then a tax on capital gains introduced by the other state will fall within the description of taxes covered by the treaty. Where the 'existing taxes' of a treaty partner include CGT, it is argued the treaty will cover CGT subsequently introduced by Australia. Views of international tax authors and decisions of foreign courts are cited to support this view.

[9] *Thiel v. FCT* 90 ATC 4717 at 4727; (1990) 21 ATR 531 at 542.

Business Profits Article

29. The central issue here is whether the expression 'profits of an enterprise' used in the *Business Profits* Article encompasses capital gains. This expression is not defined in tax treaties.

30. A principal argument advanced by commentators is that under subsection 3(2) of the Agreements Act, 'profits' is read as meaning a reference to any 'taxable income' from commercial activity. As taxable income includes net capital gains, capital gains are included within the meaning of 'profits' in this Article.

31. Furthermore, the undefined terms provision permits recourse to domestic tax law to give meaning to 'profits of an enterprise'. Several Australian cases dealing with taxation of dividends have found that 'profits' can include capital gains. The advocates of the alternative view have also identified several instances in post-CGT treaty practice where the term 'profits' appears to have been used interchangeably with 'gains'. It is therefore argued that the expression 'profits of an enterprise' can include capital gains.

Alienation of Property Article

32. The *Alienation of Property* Article in pre-CGT treaties generally deals with the income (and occasionally gains) from the alienation of property. The ATO considers that in this context the word 'income' does not embrace capital gains and where 'gains' are referred to, they relate only to revenue gains.

33. An alternative view is that 'income' and 'gains' should be read expansively to deal with capital gains. In particular it is argued that one of the distributive rules in this article deals with 'income from the alienation of capital assets' and that expression as a whole must be read as dealing with capital gains.

Residual Article

34. If a capital gain is not dealt with by the *Alienation of Property* or *Business Profits* Articles, the alternative view argues that potentially the residual article allocates taxing rights on a source basis.

35. To further demonstrate that the distributive articles of pre-CGT treaties are capable of covering capital gains reference is made to the residual article in the US treaty (1983) in particular. In general it is argued that the term 'income' should be interpreted as including 'capital gains', because in Australian treaty practice the terms 'income', 'profit' and 'gains' are used interchangeably. But in relation to the Australia/United States DTC, commentators refer to material produced by the United States as evidence of an

understanding by the US that capital gains may be dealt with in this article.

Pre-OECD Treaties

36. The pre-OECD treaties raise slightly different considerations because they do not have an *Alienation of Property* or residual article. The ATO and counter views are briefly discussed below.

37. The ATO considers the absence of an *Alienation of Property* Article strongly suggests that no agreement was reached to cover capital gains in these treaties. The United Kingdom and Japanese treaties do not have an OECD type *Business Profits* Article and instead define 'industrial and commercial profits'.[10] For a capital gain to come within this definition it is necessary to consider whether the capital gains can be considered as 'income' (United Kingdom) or 'profits' (Japan). The ATO considers that the context of these treaties, including relevant Explanatory Memoranda, does not permit such an interpretation. The alternative view argues that treaties must be interpreted liberally and the income/capital distinction is unjustified in these cases. Reference is also made to Australian tax case law where the expressions 'income' and 'profits' have been taken to include capital gains.

Explanations

The Issues

38. The analysis of this issue raises the following considerations:

- To what extent do pre-CGT treaties cover taxes on capital gains?
- Does the *Business Profits* Article deal with capital gains? That is, are capital gains included within the expression 'profits of an enterprise' or (in the case of earlier treaties) 'industrial and commercial profits'?
- Are capital gains dealt with by the *Alienation of Property* Article of pre-CGT treaties? Is a capital gain 'income' from the alienation of the types of property described in this article?
- Are capital gains dealt with by the residual article of pre-CGT treaties as income not dealt with in the other distributive rules?

[10] In the Australia/France DTA, the concept of industrial and commercial enterprise is retained in the definition of enterprise.

- Even if capital gains are not dealt with in the distributive rules, is there an obligation to give credit for source country taxation under the *Methods of Elimination of Double Taxation* Article of pre-CGT treaties?

39. The ATO argues that the context of pre-CGT treaties is relevant to the above issues. After a detailed analysis of the context of the pre-CGT treaties in relation to capital gains, this Explanation then examines each of the above issues in detail. For the purposes of this analysis, pre-CGT treaties have been examined within two broad categories:

- Pre-OECD treaties: that is the earliest pre-CGT treaties entered into before Australia joined the OECD (United Kingdom, Japan, Singapore, New Zealand and Germany). The last issue listed above (application of the credit rules) is particularly relevant to the pre-OECD treaties.
- Other pre-CGT treaties (which are examined first).

Context

40. For the purposes of Article 31 of the Vienna Convention, the context of a treaty includes, in addition to the text, any instrument which was made by one or more of the parties in connection with the conclusion of the treaty and accepted by the parties as an instrument in relation to the treaty. In *Thiel*[11], Dawson J was prepared to consider the OECD Model and Commentaries as part of this context, however he noted some doubts expressed in an article by Avery Jones and others on this point.[12]

41. Avery Jones agreed the 'Vienna Convention context' is too narrow for the purposes of the undefined terms provision. While it provides a starting point in determining the meaning of 'context' in the undefined terms provision, it is clear that it cannot be definitive. As the authors state:

> Applying the Vienna context definition to the expression 'unless the context otherwise requires' would make no sense because the Vienna context was not meant to be used in isolation from … other factors.[13]

42. The authors suggest a wider range of 'external' context is available in applying the undefined terms provision although exactly

[11] *Thiel v. FC of T* 90 ATC 4717 at 4723; (1990) 21 ATR 531 at 537.

[12] 'The Interpretation of Tax Treaties With Particular Reference to Article 3(2) of the OECD Model – II'(1984) *British Tax Review* 90, p. 92.

[13] *ibid*, p. 104.

how far the ambit of 'context' should extend is difficult to say.

43. In relation to statutory interpretation, the current view of the courts has been to consider context in its broadest sense. In *Consolidated Press Holdings Ltd & Anor v. FC of T*[14] Hill J stated:

> Although judicial views on the principles of construction of taxation statutes have differed over time (see cases referred to in the article 'A Judicial Perspective on Tax Law Reform' (1998) 72 *Australian Law Journal* 685), the modern view, at least generally, would seem to be that the task of construing a taxation statute, like the task of construing any other statute, requires the Court to ascertain the meaning of the words used in the context in which they appear and so as to give effect to the purpose of the legislature to be found in the language which it has used, but aided by extrinsic materials to which regard is directed to be had by virtue of s15AB of the *Acts Interpretation Act 1901*. Context is used in a broad sense to encompass such matters as the existing state of the law and the mischief, if any, which the legislature sought to remedy: *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 and see *FC of T v. Australia and New Zealand Savings Bank Ltd* (1998) 156 ALR 570 at 577.

44. More recently in *Chaudhri v. FCT* 2001 ATC 4214 at 4216; (2001) 47 ATR 126 at 128, the Full Federal Court (Hill, Drummond and Goldberg JJ) noted that:

> The guiding principle of statutory interpretation may be summed up as being the ascertaining of the meaning of the words which Parliament has used by reference to the context in which they appear, where 'context' has the wide meaning which extends to the legislative history, the Parliamentary intention and the mischief to which a particular provision has been directed as well as the narrower meaning which would dictate reading the words to be construed by reference to the immediately surrounding or otherwise related provisions.

45. Australia's domestic statutory interpretation rules focus particularly on the context of a legislative enactment, whereas the accepted international rules for treaty interpretation focus particularly on the context of a text finalised between negotiating countries. The two sets of interpretative rules are nevertheless broadly similar.[15]

46. Accordingly, the ATO considers treaty context should be taken in its broadest sense to have regard to the full fabric of matters that

[14] 98 ATC 5009 at 5017; (1998) 40 ATR 181 at 188.

[15] The relationship of the two sets of interpretative rules are discussed in more detail in TR 2001/13 (Treaty Interpretation) at paragraph 73 and following.

may be considered, including the historical and political matrix and the matters referred to in the Avery Jones discussion. In particular the following discussion has regard to:

- the practices and policies of Australia and the treaty partners in negotiating treaties at that time and subsequently;
- given the usual treaty object of avoidance of double taxation, the domestic taxation environments of the two countries when the treaty was negotiated; and
- the political, economic and diplomatic background to the treaty.

Australia's OECD Reservation [16]

47. Australia joined the OECD in 1971. In 1976 Australia entered reservations against the new OECD Model published in 1977 (the first since the 1963 Draft Convention). Among these was a reservation to the OECD's *Capital Gains* Article (Article 13):[17]

> Australia reserves the right to propose changes to reflect the fact that Australia does not levy a capital gains tax and that the terms 'movable property' and 'immovable property' are terms not used in Australian law.

48. By reserving the 'right to propose changes' to the OECD Model Australia clearly signalled it was not going to follow the OECD Model approach – which was to include a comprehensive article dealing with capital gains.

49. This reservation was withdrawn with the 1992 OECD Model revision - the first publication of an updated version of the OECD Model following the introduction of capital gains in Australia.

OECD Model and Australian Treaty Practices and Policies

50. Comparing Australia's pre-CGT treaties with prevailing international model treaties points to Australia's treaty practices and policies. Australia's tax treaties are broadly based on the prevailing OECD Model. However, Australia's treaties vary from the OECD standard in many respects. In particular, there are significant variations in relation to alienation of property (both before and after the introduction of CGT).

[16] Member Countries lodge reservations when they do not agree with the OECD Model or variations permitted by the commentaries and therefore wish to retain their freedom of action in negotiations.

[17] Refer to paragraph 33 of the 1977 OECD Model Commentary on Article 13 and the History in the current OECD Model Commentary.

51. The scheme of the OECD *Capital Gains* Article is described in the following table:

Table 2: Distributive rules - OECD Model *Capital Gains* Article

Para No	*Distributive rule*
1	State of situs may tax gains from immovable property.
2	State of permanent establishment or fixed base may tax gains from the alienation of moveable property forming the business property of a permanent establishment or fixed base.
3	State of effective management has exclusive taxing rights over gains from the alienation of ships and aircraft in international traffic.
4	Article 13(4) allocates taxing rights to the state of residence of the alienator of all property other than that referred to in Articles 13 (1) – (3). Effectively this means that taxing rights over capital gains from the alienation of business property which is not effectively connected with a permanent establishment or fixed base, and of non business capital gains (other than immovable property) are allocated to the state of residence.

52. The OECD Model allocates taxing rights to the source country only for alienation of immovable property (on the basis of *situs*) and permanent establishment property.

53. Consistent with an underlying philosophy of the OECD Model that trade between Member Countries as a whole would be in balance, taxing rights over the alienation of residual property are allocated to the residence country. Given Australia's position as a net capital importer and consequent disposition to protecting source country taxing rights (see discussion on the economic background below) the OECD Model would have been difficult to adopt without modification. Following Australia's membership of the OECD it was necessary to develop and defend a position on the OECD Model *Capital Gains* Article for negotiation with other Member Countries.[18]

54. Developing a treaty source country position in an environment in which Australia did not tax capital gains would have been a difficult abstract[19] exercise, potentially limiting the cross-border aspects of any future CGT regime. Australia's response was to reserve its position on the OECD *Capital Gains* Article. In

[18] When Australia joined the OECD, the prevailing OECD Model was the 1963 Draft Convention and in 1977 the OECD Model was published. There were no other relevant changes when pre-CGT treaties were negotiated.

[19] The United Nations Model where an 'alternative' *Capital Gains* article reserves taxing rights over residual gains to the country of source did not become available (as the UN Manual) until 1979. The UN Model Commentary, which also contains an alterative source based capital gains sweep-up, was officially published in 1980.

negotiations it then proposed modifications to that Article that effectively continued the previous policy of not dealing with capital gains in its tax treaties. Thus Australia preserved its right to negotiate appropriate distributive rules for capital gains in the event a comprehensive CGT was introduced.

55. Pre-CGT treaties consistently modified the OECD *Capital Gains* Article. The Australian Model Article 13 for 1980 (see Annexure A to this ruling) is reflected in pre-CGT treaty practice. This Model: (a) dealt with 'income' - not 'gains' as in the OECD Model; (b) changed the heading to '*Alienation of Property'*; and (c) dealt only with real property interests.

56. *Alienation of Property* Articles in most of Australia's pre-CGT treaties dealt only with 'income' from the alienation of property. By contrast the OECD Model deals with (capital) gains. Pre-CGT treaties were drafted deliberately to exclude capital gains. The use of 'income' demonstrates a consistent intention by Australia not to deal with capital gains as such in this article.[20]

57. Likewise, Australia consistently avoided using the OECD heading of '*Capital Gains*'. Where a specific article deals with alienation of property, Australia's pre-CGT treaties use the broader '*Alienation of Property*' as the title.[21] Again, this reflects the fact that distributive rules in the *Alienation of Property* Articles of Australia's pre-CGT treaties are generally expressed to apply only in relation to *income* from alienation of certain property. From the Australian perspective it would be inappropriate to use the OECD heading in pre-CGT treaties, because capital gains were not to be covered by the Article.

58. Australia's pre-CGT Model *Alienation of Property* Article was less comprehensive than the OECD Model, applying only to real property interests. Annexure B to this ruling, which summarises Australia's pre-CGT treaties as negotiated, reflects this more restricted approach. *Alienation of Property* Articles usually had limited coverage, frequently only dealing with real property interests. Alienation of business property is dealt with in only 7[22] of the 17 pre-CGT treaties containing an *Alienation of Property* Article. Because these

[20] This is reflected in negotiation materials. It will be a matter for the courts to determine whether this intention has been carried through into the law.

[21] In fact, Australia is one of the few countries in the world to use this expression, suggesting it was developed by Australia. A review of Tax Analyst's *Worldwide Tax Treaties* October 2001 indicates that all New Zealand treaties containing an article dealing with gains use 'Alienation of Property' in the heading. The only other countries to use this term are Malta and Papua New Guinea. The US uses the title *Gains*.

[22] Belgium, Philippines, Switzerland, Sweden, Denmark, Norway and Ireland.

treaties did not include a residual provision (for example OECD Model Article 13.4) even where there are rules for alienation of business property, important areas outside the context of an enterprise (such as alienation of intellectual property) were not comprehensively dealt with.

Post-CGT: Changes to the Alienation of Property Article

59. Following the introduction of Australian CGT, a number of changes were made to Australian treaty practice in relation to the *Alienation of Property* Article:

- While the heading '*Alienation of Property*' was retained, the article now dealt with 'income, profits or gains' on the alienation of certain property (formerly 'income' only). Post-CGT treaties continue the *Alienation of Property* heading because they continue to deal with income, as well as profits and gains (whereas other countries use the OECD Model 'gains').
- The post-CGT treaty article is more comprehensive, always explicitly dealing with alienation of real property interests, business property, ships and aircraft.
- Post-CGT treaties are comprehensive with respect to capital gains, as a 'sweep up' provision reserving domestic law taxing rights to gains of a capital nature not dealt with elsewhere in the Article is also included. This provision is not found in the OECD Model, but is similar to the UN Model 'alternative' *Capital Gains* Article, as set out in the UN Model Commentary on Article 13 - *Capital Gains*[23]. (Income gains not dealt with in the article were likely to be dealt with as business profits or in the residual article.)

Post-CGT: other changes

60. In the following discussion the Australia/Korea DTC and the Australia/China DTA are referred to as representative of the 'pre' and 'post' CGT treaties respectively.

[23] 1980 UN Model Tax Convention, p. 150.

61. Source rules in Australia's tax treaties also changed to coincide with the introduction of CGT.[24] All the source rules in pre-CGT treaties deal only with 'income', but source rules for Australia's post-CGT treaties changed to also deal with 'profits and *gains*'. Compare the source rules in Article 23 of the Australia/Korea DTC which deal only with 'income', to the rules for the Australia/China DTA (Article 23.8 of that treaty and subsection 11S(2) of the Agreements Act) which deal with 'income, profits or gains'. The expression 'income, profits or gains' is used in the source rules in all post-CGT treaties and the Agreements Act - except for the Australia/Thailand DTA, where the source rule deals only with 'income'.

62. The *Entry into Force* articles in pre-CGT treaties also change terminology following the introduction of CGT - although the changeover was not as rigorous. Pre-CGT treaties, such as the Australia/Korea DTC, refer to entry into force in Australia of (a) withholding tax on *income* and (b) other Australian tax, in relation to *income*. The language in the Australia/China DTA is unchanged. However, the next concluded treaty (with Papua New Guinea) refers to other Australian tax 'in relation to income *or gains*'. The following two treaties (with Thailand and Sri Lanka) revert to the pre-CGT formulation. But the following treaty with Fiji refers to 'income, profits or gains' - a form of words used consistently in all Australia's later tax treaties. Regarding the China, Sri Lanka and Thailand treaties, the ATO still considers that given the context of these treaties, the Entry into Force article deals with capital gains.

63. Drafting changes to the 'force of law' provisions of the Agreements Act further underline the view that pre-CGT treaties were not considered to deal with capital gains. Australia's method of giving legislative effect to its tax treaties is by reproducing each treaty in its entirety as a schedule to the Agreements Act. Currently, sections 5 to 11ZJ of the Agreements Act give each of the schedules (i.e., the tax treaties) force of law in Australia. In the case of the Australia/Korea DTC the relevant provision is section 11L of the Agreements Act which, among other things, provides that the provisions of the treaty 'so far as those provisions affect Australian tax, have and shall be deemed to have had, the force of law'. Importantly, the section gives the treaty the force of law in relation to tax (other than withholding tax) 'in respect of *income*' only. The

[24] Source rules apply to all of Australia's tax treaties. Initially these were for the purposes of giving credit only, but subsequently the source rules applied for the purposes of Australian taxation generally. Source rules are now largely an Australian specialty, although other countries have used these treaty rules in the past. They are usually found in a *Source* Article included in the treaty, although in some early treaties (e.g., United Kingdom) they were included in the credit relief rules. In the German, Chinese, and Taipei treaties, they are found (to some extent) in the Agreements Act.

force of law provisions of the subsequent post-CGT treaty with China, reflect new coverage of capital gains by omitting the 'in respect of income' requirement.

64. Some commentators have suggested instances where they believe the words 'income' and 'gains' have been used interchangeably. This is addressed below in relation to the *Business Profits* Article.

Treaty Partners: treaty practice and domestic law

65. The Table at Annexure C to this ruling shows that Australia's treaty partners have generally followed the OECD Model consistently in contemporaneous treaties with other countries. By implication, the departures from the OECD Model in Australia's treaties were at the insistence of Australia.

66. In the case of the Australia/United States DTC (1983), the Australian negotiators substantially altered the then preferred US Model to exclude capital gains from the distributive rules. The US Treasury Department's draft *Model Income Tax Convention*, which was published in 1981,[25] contained a comprehensive *Gains* Article. This article is set out in column 2 of Annexure D to this ruling. The US Model reflected US domestic law – especially in relation to alienation of real property. The changes made during the course of negotiations to both the OECD Model and the US Model were significant. Article 13 of the Australia/United States DTC is at column 3 of Annexure D to this ruling. The willingness of the USA to extensively modify this Article, contrary to its treaty practice and Model position, supports a presumption that it was the intention of the negotiating parties to exclude capital gains from the coverage of the final text of that Article.

67. Many of Australia's pre-CGT treaty partners imposed a domestic capital gains tax. Australia did not. Yet Australia consistently limited the application of the *Alienation of Property* Article. For example, the United Kingdom had introduced a comprehensive capital gains tax regime in 1965, just before the negotiations with Australia commenced, but no article expressly dealt with capital gains. Canada had a comprehensive capital gains tax regime and would have been expected to deal with more than real property interests in its treaty with Australia. The United States had also long taxed capital gains, but Australia limited the treaty coverage of gains in that Convention to the extent of the United States *Foreign*

[25] See RL Doernberg and Kees van Raad, *The United States Model Income Tax Convention: Analysis, Commentary and Comparison*, Kluwer Law International 1997, p. 113. Note the 1977 US Model *Gains* Article also dealt comprehensively with capital gains.

Investment in Real Property Tax Act of 1980 and certain transport assets.

Political, economic and diplomatic background

68. Australia's economic interests did not favour dealing with capital gains in pre-CGT treaties. Australia had long held a strong disposition to the protection of source country taxing rights.[26]

69. The OECD Model assumes capital flows between Member countries are roughly equal and therefore allocates taxing rights over activities not clearly attributable to the source country to the country of residence. But Australia was a large net capital importer when the pre-CGT treaties were negotiated.[27] Had Australia adopted the OECD Model on capital gains, in the event that a capital gains tax was introduced there would be a significant revenue impact.

70. Without a fully developed Australian position on cross-border taxation of capital gains (which would have been politically difficult to develop - see below) and the lack of an international source country benchmark against which to negotiate the *Capital Gains* Article,[28] Australia preserved its freedom of action in the event a CGT was introduced, by generally excluding capital gains from treaty coverage.

71. Of course when pre-CGT treaties were negotiated, the absence of a comprehensive Australian CGT would have contributed to a perception for Australia's treaty partners that it was unnecessary to

[26] Australia's general preference for 'source-country' taxing rights was articulated in a March 1982 Australian Treasury Department document tendered in evidence at a hearing of the then *Parliamentary Joint Committee on Foreign Affairs and Defence: Sub-Committee on the Pacific Basin*, on 21 October 1982. The hearing examined the Australia/United States DTC. After noting the OECD Model assumes equal flows of income between countries and thus often divides taxing rights in favour of the residence country, the document contrasts the Australian position:

> 'The [residence] approach is not favoured by Australia which, being a net importer of capital and know-how, and having no substantial international shipping fleet of its own insists on retaining in its agreements as much of its primary taxing rights as it can, especially in relation to interest, dividends and royalties. Full adoption of the OECD approach by Australia would mean a substantial loss of revenue.'

As far back as 1919 Australia had advocated exclusive source taxation in relation to a Royal Commission into British income tax (see R Willis 'Great Britain's part in the Development of Double Tax Relief' *Bulletin* for IBFD (1965) Vol 19, 418). Refer also to Australia's extensive reservations and observations to the OECD Model.

[27] For example, in the 1968 parliamentary debates on the Australia/United Kingdom DTA, it was pointed out that combined US and UK investment in Australia was of the order of $5,000 million whereas Australian investment in these countries was only $100 million. See Australia, Senate, 1968 *Debates*, Vol 1 S 37, p. 738.

[28] The UN Model was not officially available until 1980, although a similar draft was in the 1979 UN Manual.

limit source country taxing rights over capital gains. Further any Australian objective to limit source country taxation of capital gains on the relatively small amount of outbound Australian investment at the time, would have been balanced against the fact that such provisions would effectively lock in the limits of the international aspects of any future capital gains tax regime.

72. It was also politically inexpedient to deal with this issue in tax treaties: capital gains taxation was a politically sensitive issue in this period.[29] For most of the time which pre-CGT treaties were negotiated (1967- 1984)[30] it would be expected that reference to capital gains in a treaty would have been, at least, unnecessary, and contentious for Australian Governments.

Context – Conclusion

73. Context has not been comprehensively addressed by many of those proposing an alternative view. On the other hand the ATO sees the context of these treaties as an important aspect of the analysis.

74. The ATO considers Australian treaty policy, driven by its economic interests had consistently emphasised source country taxing rights to a greater extent than the OECD Model. Post-CGT treaty practice in relation to capital gains on alienation of property clearly confirms this. However there were political sensitivities in dealing with this issue in pre-CGT treaties. Moreover, in the absence a domestic capital gains regime, identifying the potential cross-border limits of such a regime would have been a difficult and abstract exercise. Australia addressed this issue by not dealing with capital gains in its pre-CGT treaties: it removed capital gains entirely from the scope of pre-CGT treaties. In so doing Australia retained its freedom of action to levy a CGT if it was subsequently introduced. Australia's records of negotiations confirm Australia had intended not to deal with capital gains in pre-CGT treaties.

[29] Coalition Governments that held power for most of this period were opposed to the introduction of capital gains taxation. No tax treaties were concluded when the Labor Party, which advocated capital gains taxation, was in office for three years in the early 1970s. In 1974 the Asprey Committee recommended a capital gains tax, while cautioning against an early introduction of such measures. The Final Asprey Report recommended its introduction, but ultimately this was rejected by the Coalition, which had resumed office in 1975. Labor regained office in 1983 partly on a promise of no CGT in its first term. Following the December 1984 re-election of Labor, CGT was canvassed and the possibility of a CGT returned to the agenda with the 1985 Tax Summit.

[30] UK negotiations commenced in 1967 (see Governor-General's Speech *Senate* See Australia, Senate, 1968 *Debates*, Vol 1 S 33) and Austrian negotiations concluded in 1984.

Taxes Covered

75. The taxes to which a treaty applies are set out in the *Taxes Covered* Article (usually Article 2). This is intended to limit the application of the distributive rules of the treaty to the taxes described in the *Taxes Covered* Article.[31]

76. Like many countries Australia departs from the OECD Model, by deleting the opening two paragraphs of the OECD Model *Taxes Covered* Article which contain generalised descriptions of the taxes to be covered. A typical Australian *Taxes Covered* Article and the OECD Model equivalent are set out in columns 1 and 2 respectively of Annexure E to this ruling.

77. The *Taxes Covered* Article of pre-CGT treaties generally lists the 'existing taxes' to which the tax treaty applies in the opening paragraph. Australian taxes are listed as 'the Australian income tax' and most include a reference to the undistributed profits tax.[32] The second paragraph (the 'extension provision') extends the taxes covered to identical or substantially similar taxes.

ATO View

78. First, taxes on 'borderline gains' assimilated to income and taxed under Australian tax laws prevailing at the time of signature are 'existing taxes' for the purposes of the *Taxes Covered* Article of pre-CGT treaties. (Note that legislation relating to some borderline gains has been repealed – for example, sections 26(a), 25A - in relation to property acquired for the purpose of profit-making by sale - and 26AAA.)

79. Secondly, an important consequence flows from deleting the general descriptions of taxes covered in paragraphs 1 and 2 of the OECD Model *Taxes Covered* Article. Under the OECD approach, because of these general descriptions, all income and capital taxes are dealt with by the treaty and the distributive rules will apply to both groups of 'existing taxes' listed by the two countries. But where the two countries delete the OECD's paragraphs 1 and 2 and separately list the taxes covered, some distributive rules may be relevant for one

[31] There may be occasions where the terms of other articles clearly contemplate an application to taxes other than those listed in the *Taxes Covered* Article - see for example Article 26.1 of the OECD Model - but generally the taxes covered by the tax treaty are set out in this article.

[32] The UK, Japanese and German treaties refer to the Commonwealth income tax. The Austrian treaty refers to income tax imposed under the federal law of the Commonwealth of Australia, a formulation broadly followed in subsequent Agreements. The Swiss treaty refers to branch profits taxation and the Austrian DTA refers to the resource rent tax. The wording in all of Australia's treaties is designed to exclude sub-national taxes, consistently with Australia's reservation to Article 2 of the OECD Model.

country but not the other. This is starkly demonstrated in Article 21 of the Australia/Germany DTA, which allocates taxing rights over capital, but only Germany includes a capital tax in the list of capital taxes at Article 2. Clearly Article 21 of that treaty will apply only for German capital taxes and has no application to Australia.

80. In other words, distributive rules need not necessarily apply bilaterally. As discussed later, some provisions dealing with alienation of property were important for treaty partners particularly for presentational reasons, but from the Australian perspective were unnecessary.[33]

81. A third important point emerges from a comparison with the OECD Model. The deletion of OECD model paragraphs 2.1 and 2.2 and 'in particular' from paragraph 3 imply that some caution is to be exercised in applying the extension provision. Where OECD Model paragraphs 1 and 2 are present, OECD Model paragraph 3 is generally treated as a detailed but not necessarily complete list of taxes which only illustrate the general principles in paragraphs 1 and 2.[34] However, where only OECD paragraphs 3 and 4 are used (as paragraphs 1 and 2 in Australia's treaties) then OECD paragraph 3 (i.e., Australian Model paragraph 1) is interpreted as an exhaustive list. Countries may restrict the Article to OECD paragraphs 3 and 4 only, because they consider the treaty should exhaustively identify the taxes to be covered.

82. The OECD Model Commentary on the *Taxes Covered* Article confirms that OECD Members hold this view. Referring to the practice of Member countries which do not include OECD paragraphs 1 and 2 in their treaties the Commentary notes at paragraph 6.1:

> These countries prefer simply to list exhaustively the taxes in each country to which the Convention will apply, and clarify that the Convention will also apply to subsequent taxes that are similar to those listed.

83. Because taxes are exhaustively listed, new taxes (such as CGT) need to be very similar to the existing taxes before the extension paragraph makes the new tax one of the taxes covered. The OECD suggests that bilateral clarification of the application of new taxes will be required before new taxes are adopted in the treaty. This has not occurred in the case of Australian CGT.

84. The ATO considers the introduction of CGT fundamentally increased Australia's tax base and the context of the treaty suggests

[33] Even though certain listed taxes may have little impact on allocation of taxing rights, there are other reasons for listing the taxes, notably exchange of information.

[34] See OECD *Model Tax Convention on Income and on Capital* (Paris, 2000) (condensed version), Commentary on Article 2, at paragraph 6.1, p 59.

that there was no intention to cover capital gains taxation within the expression 'Australian income tax' in paragraph 1 or by extension. The overall context of pre-CGT treaties and additional caution (implicit in the omission of the OECD's paragraphs 1 and 2) to be applied in relation to extension provision requires that a tax on capital gains is not included in the *Taxes Covered* Article in pre-CGT treaties. The one exception to this is the Austrian treaty discussed below.

Alternative View – existing taxes include capital gains

85. The central expression in defining Australia's existing taxes is 'Australian income tax.' A counter view[35] suggests that an ambulatory approach should be adopted in interpreting tax treaties: an ambulatory approach is now embodied in OECD Model Article 3(2) ('undefined terms provision') and the views of international writers generally support this approach.[36] It is argued the undefined terms provision in tax treaties gives a domestic tax law meaning to undefined terms and that provision operates in an ambulatory way. Because net capital gains are now included in assessable income, it is argued that the expression 'Australian income tax' has evolved to cover capital gains.

86. As a matter of general principle the ATO agrees with the ambulatory approach in applying the undefined terms provision.[37] However, as the *Taxes Covered* Article has specific extension provision designed to accommodate changes in taxes covered, it is clearly inappropriate to use the undefined terms provision to accommodate the evolution of 'Australian income tax'. The extension provision has that role[38].

87. The fact that there is no specific reference to capital gains tax as existing taxes in post-CGT treaties (which clearly apply to capital gains) and similar expressions are used to describe Australian income

[35] IV Gzell, 'Treaty Protection from Capital Gains Tax', *Australian Tax Review,* (Vol 29: March 2000) 25, p. 27.

[36] Avery Jones and others, 'The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model - Part I (1984) *British Tax Review* 14 and Part II (1984) *British Tax Review* 90'.

[37] Note that Australia has (since the 1986 Austrian treaty) drafted the undefined terms provision to expressly reflect an ambulatory approach by specifying the relevant domestic laws are those 'from time to time in force'. It was not until 1995 that the OECD Model Article 3.2 changed to expressly incorporate an ambulatory approach in the text of that Article.

[38] It has been argued that the UK relies on the ambulatory meaning of 'income tax' to extend treaty coverage to changes in its tax law. This is apparently because of limitations in the UK's internal law which prevent reliance on the extension provision. This practice in the UK is not considered inconsistent with the ATO view. The ATO view is that the ambulatory meaning of the term 'Australian income tax' cannot extend treaty coverage to new taxes beyond those that would be covered by the extension provision.

tax in pre and post-CGT treaties is also regarded as evidence that pre-CGT treaties must extend to capital gains. The ATO response to this is that when pre-CGT treaties were signed, the only taxes which could be 'existing' taxes did not include a comprehensive CGT.

Alternative view - capital gains substantially similar to existing taxes

88. A technical analysis of aspects of sections 26(a), 25A and 26AAA,[39] indicates that at the time of signature, existing taxes may have extended to some gains which were not income according to ordinary concepts. One counter view is that the extension provision would also permit the taxes covered to extend to the CGT, because it is substantially similar to the one of the existing taxes, namely section 26AAA. In comparing section 26AAA with the CGT, what is needed is 'a comparison of the taxes concerned and not an analysis of underlying transaction'.[40] It is argued that section 26AAA taxes pure capital gains and the CGT regime merely extended the range of capital gains in the Australian income tax.

89. However there were many 'borderline gains' of this kind. While the ATO agrees these items may be included within the existing taxes, the question is whether CGT is identical or substantially similar to these provisions.

90. The *Taxes Covered* Article is designed to avoid the necessity of concluding a new treaty whenever the domestic tax laws of treaty partners are modified. The extension provision achieves this, although there are limits – new taxes must be at least substantially similar. The ATO considers the question of whether a tax is substantially similar is a matter of proportion, not requiring in this case an overly technical analysis of the capital/income distinction. Significantly Australia's international position (set out in its 1976 OECD Model reservation, discussed at paragraph 45) when most pre-CGT treaties were negotiated, was that 'Australia does not levy a capital gains tax'. This position was clearly not based on a technical approach to the issue. 'Borderline gains' such as those assessable under the former section 26AAA were not considered a CGT for tax treaty purposes.

91. Academic writings are said to confirm the counter view that where capital gains are normally dealt with in income tax laws, any new CGT will, for treaty purposes, be at least similar to income tax:

[39] Note that section 26AAA was introduced in 1973 so it could not be an 'existing tax' for tax treaties concluded before then (for example the UK, Japan and Germany).

[40] IV Gzell, (see footnote 35), p. 31.

> Taxation of capital gains is normally dealt with in income tax laws, although in some circumstances separate legislation is devoted to that subject (see national reports in LXIb CDFI 129ff (1976)). Consequently any new capital gains tax will for treaty purposes, normally have to be considered as being at least similar to income tax; the Danish *Landskatteret* ('Danish Tax Court') 26 ET 114 (1986): DTC *Denmark/France*, differs however. . .'[41]

92. In correspondence with the ATO, Professor Vogel clarified that the Danish case was cited to acknowledge that there are other views.

93. Authors[42] have also referred to the decision of *Gadsden v. MNR*.[43] In that case the Canadian Tax Review Board considered that the failure of the Canadian CGT to be mentioned in the *Taxes Covered* Article of the 1966 Canada/United Kingdom DTA did not prevent the subsequent introduction of a capital gains tax in 1972 from being picked up within the concept of 'income tax,' as Canada (similarly to Australia) taxes capital gains as part of its general income tax legislation. However, while the case may appear to be similar to the present issue, it can be distinguished. It is necessary to take into account the complete context and particularly in this case there were significant drafting differences between Australian treaty practice and the Canada/United Kingdom DTA. In this treaty a specific article was entitled *Capital Gains* and it comprehensively dealt with capital gains.

94. The subsequent decision of the Canadian Federal Court in *Gladden Estate v. The Queen*[44] found that capital gains on the deemed disposal of shares in a Canadian private company by a US resident were exempt under the 1942 Canada/United States DTC as 'sale or exchange' of capital assets. Again, in the Canada/United States treaty, there was a specific article (Article VIII) which comprehensively dealt with capital gains.

95. In both these Canadian treaties, Canada had agreed to comprehensively deal with capital gains notwithstanding that Canada did not have a capital gains tax at the time it entered the

[41] *Klaus Vogel on Double Taxation Conventions* (3rd ed Kluwer Law International, 1997), p 157.

[42] See for example, P Kennedy, 'CGT and Non-Residents; Part A: Protection Under Double Tax Agreements' (1993) *Taxation in Australia Red Edition* 27, p. 29.

[43] 83 DTC 127.

[44] 85 DTC 5188.

treaties. By contrast, the complete context at the time Australia was entering into its pre-CGT treaties was quite different.

96. A reference has also been made to Baker[45] who believes the United Kingdom Inland Revenue considers that where capital gains tax is introduced after a treaty was concluded capital gains taxes are drawn in by the extension for substantially similar taxes. The ATO notes that this statement is not definitive, nor is it confidently asserted. Further it is obvious, given departures from the OECD Model by many countries in relation to the *Taxes Covered* Article, that broad assertions, which do not take into account the context of each treaty, cannot be made in this area.

Alternative view - new tax substantially similar to the existing taxes of the other State

97. It has also been argued that if the list of taxes enumerated by a treaty partner in paragraph 1 of the *Taxes Covered* Article includes a capital gains tax, paragraph 2 of that Article will operate to include within the taxes covered, any substantially similar taxes levied by the other treaty partner. Thus, in the case of the Australia/United Kingdom DTA (where the United Kingdom lists 'the capital gains tax' in the list of taxes covered), Australia's subsequently introduced CGT could be a substantially similar tax.

98. This issue has been discussed mainly in the context of capital taxes, such as wealth taxes, which are often dealt with in double tax treaties of other countries. Vogel, Shannon, Doernberg and van Raad advocate this view in relation to capital taxes:

> The express enumeration of taxes is cumulative in this context. For example, if a tax on capital in the other contracting state is included in the express enumeration, a tax on capital introduced in the United States after the date of signature of the treaty would fall within the scope of the treaty provided it is substantially similar to the foreign tax. Similarly, taxes of the other contracting state imposed after the date of signature of the treaty that are substantially similar to enumerated United States taxes fall within the scope of the treaty.[46]

99. However, the ATO considers this cannot be the case in Australian pre-CGT treaties containing distributive rules over capital. For example, the Australia/Germany DTA does not contain a provision for 'entry into force' in relation to future Australian capital

[45] P Baker, *Double Tax Conventions and International Tax Law,* 2nd ed, Sweet and Maxwell, 1994, p. 113.

[46] Vogel, Shannon, Doernberg and van Raad: *United States Income Tax Treaties,* Kluwer Law International, 1995, Part 2 Commentary at p. 73.

taxes. If Australia was to subsequently introduce such a tax at the federal level there is no mechanism within the treaty for the treaty as a whole to take effect in relation to such taxes. Compare this also with Article 24(5) of the Australia/Norway DTC, which clearly does not accord with the view proposed by these authors, because Article 24(5) requires further negotiations if an Australian capital tax were to be introduced.

100. While these authors make this statement without citing supporting authority, support for this view is claimed[47]in a 1985 decision of the Paris Tribunal de Grande Instance (*Rohrmoser* No. 10669/84), concerning the France/Austria DTC (1959) and a 1992 decision of the Cour de Cassation (No 572 P) concerning the France/Switzerland DTC (1996) and capital taxes. Both cases dealt with the question of whether a French wealth tax introduced long after the conclusion of the relevant tax treaty was covered by that treaty, even though France had not included a wealth tax in its list of existing taxes. It was found that France's wealth tax was similar to the wealth taxes listed by Austria and Switzerland, and by applying the extension provision the subsequently introduced French wealth tax was covered by the treaty.

101. However, the ATO considers these cases are not relevant to the treatment of capital gains in Australian tax treaties. Both French treaties contained the equivalent of OECD Model Article 2.1, which specifically provided that those treaties would apply to taxes on capital. Furthermore those treaties both contain an article equivalent to the *Capital* Article in the OECD Model. By contrast, in relation to capital gains, Australia's pre-CGT treaties omit OECD Model Article 2.1 and do not contain a specific article allocating taxing rights over capital gains.

102. It needs to be remembered that Australian pre-CGT treaties exclude paragraphs 1 and 2 of the OECD Model (as does the US and Canada). The approach of such countries is to separately list their taxes. The natural meaning of the extension provision as applicable to these jurisdictions is that the extension provision applies separately.

Austria (1986)

103. Capital gains taxes are covered by Article 2 of the Australia/Austria DTA. Legislation enacting the Part IIIA of the ITAA 1936 was assented to on 24 June 1986 and the Australia/Austria DTA was signed on 8 July 1986. Therefore, Part IIIA was one of the existing taxes at the time of signature. While capital gains tax is now assessed under Parts 3-1 and 3-3 of the ITAA 1997 this is regarded as substantially similar to the capital gains tax existing at signature.

[47] IV Gzell, (see footnote 35), p. 33.

104. However, for the contextual reasons already discussed the ATO does not consider that the distributive rules of the treaty limit taxing rights over capital gains.

Italy (1982)

105. Australia has a consistent policy of not including OECD Model Articles 2.1 and 2.2 in its tax treaties. The Australia/Italy DTC is the only exception in all of Australia's tax treaties (pre or post CGT), and was clearly inserted at the insistence of Italy. Article 2.1 provides that 'the Convention shall apply only to taxes on income imposed on behalf of each Contracting State irrespective of the manner in which they are levied'. There are major changes from the OECD analogue, relating to sub-national taxes (see Australia's reservation to Article 2) and capital taxes. Importantly this provision is possibly more restrictive than the OECD Model, because it applies *only* to income taxes. Therefore, if, in the context of that Convention, income does not include capital gains, by the operation of Article 2.1, the Convention does not deal with such gains.

Business Profits Article

106. The *Business Profits* Article deals with business profits of an enterprise of one Contracting State, which carries on business in the other State. The key provision is Article 7.1, which in Australian pre-CGT treaties generally follows Article 7.1 of the OECD Model:

> The profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

107. Does the expression 'profits of an enterprise' encompass capital gains? Under the undefined terms provision, this expression can take the meaning it has under the domestic law, where the context permits.

ATO View – capital gains not 'profits of an enterprise'

108. In *Thiel* the High Court held that the word 'profits' could not be held to have a domestic law meaning. [48]

[48] *Thiel v FC of T* 90 ATC 4717 at 4719, (1990) 21 ATR 531 at 532, 533. Dawson and McHugh JJ came to similar conclusions.

109. Where a country distinguishes between income and capital gains, the *Business Profits* Article would not be expected to deal with capital gains. The OECD Model Commentary on Article 13 implies[49] that if the domestic law of a State taxes 'capital gains' such gains will not be dealt with in the *Business Profits* Article, but in the 'article on capital gains'. Relevantly, Australia's reservations on capital gains were made against OECD Model Article 13 - not the *Business Profits* Article. While the analogy with the OECD Model cannot directly be made (as the *Alienation of Property* articles in pre-CGT treaties differ from the OECD's *Capital Gains* Article) against this international benchmark and given Australia's recognition of the income/capital gain distinction, it would not be expected that the *Business Profits* Article would deal with capital gains.

110. Further the ATO considers that taking into account the context of Australia's pre-CGT treaties discussed in detail above, capital gains are outside the scope of pre-CGT treaties and 'profits of an enterprise' would not cover capital gains.

Alternative Views

Subsection 3(2) of the Agreements Act

111. Subsection 3(2) of the Agreements Act which equates business profits to taxable income is frequently cited in support of the view that business profits include capital gains. It provides:

> For the purposes of this Act and the Assessment Act, a reference in an agreement to profits of an activity or business shall, in relation to Australian tax be read, where the context so permits, as a reference to taxable income derived from that activity or business.

112. It is argued that subsection 3(2) operates so the term 'profits' is to be read as meaning a reference to any 'taxable income' from commercial activity. Arguably, as taxable income includes net capital gains, this could mean that capital gains are included in the definition of 'profits' in the *Business Profits* Article.

[49] Paragraph 4 of the OECD Model Commentary on Article 13.

113. However, the subsection requires that the link between the term 'profits' and 'taxable income' can only be made where the context so permits.[50] The ATO does not consider the context of pre-CGT treaties permits the term 'profits' in the *Business Profits* Article, to be read as including capital gains - even though net capital gains are included in taxable income.

114. Furthermore, the ATO considers the purpose of subsection 3(2) of the Agreements Act is not to define the term *profits* as used in treaties. The legislative history and related explanatory material demonstrate this subsection is strictly a mechanism to implement a treaty term which is foreign to Australia's taxation laws within the technical language of Australia's domestic legislation[51] - rather than as an aid in defining a tax treaty term. Confirming this purpose subsection 3(2) is drafted to apply 'in relation to Australian tax' - not in relation to the agreement.

Profits of an enterprise include capital gains

115. Alternative views may also observe that the OECD Model Commentary states that the word 'profits' should be understood as having a broad meaning including all income derived in carrying on an enterprise.[52]

116. Against this background *FCT v. Slater Holdings Ltd (No 2)*,[53] *Kenneth A Summons Pty Ltd & Ors v. FCT*,[54] and *MacFarlane v. FCT*[55] may be cited as providing evidence that the term 'profits' is to be read as including capital gains. However the ATO notes that these cases deal with the meaning of profits in relation to dividend payments and address the interface between the taxation law and corporations law concepts. *Spanish Prospecting Company Ltd*,[56] might also be advanced as authority for the view that profits could apply to both income and capital gains, but again the context of this case, involving payments to creditors, differs from the treaty context. The ATO does not see these decisions as having application to this issue.

[50] This contextual requirement is also applied to subsection 3(2) in a forthcoming revision of Draft Taxation Ruling TR 95/D11, at paragraphs 4.76 and 4.79.
[51] For example, for the purposes of subsection 4(2) of the Agreements Act.
[52] See OECD Model, condensed version (see footnote 34) Commentary on Article 7, at paragraph 32, p. 104.
[53] 84 ATC 4883; (1984) 15 ATR 1299.
[54] 86 ATC 4979; (1986) 18 ATR 235.
[55] 86 ATC 4477; (1986) 17 ATR 808.
[56] (1911) 1 Ch 92.

Were the terms 'income', 'profits' or 'gains' used interchangeably?

117. Advocates of the alternative view also argue that the concepts of income, profits and gains have been used interchangeably in Australia's pre and post-CGT treaties. Gains includes capital gains. Therefore it is argued that profits of an enterprise should be read as including capital gains. Examples cited in support of this are:

- The credit article in both pre and post-CGT treaties gives credit, on the Australian side, only for taxes on 'income'. There is no mention of 'profits or gains' pre or post-CGT. Clearly credit is to be given for tax on capital gains in post-CGT treaties. For the credit rules to work post-CGT, the concept of 'income' must include 'gains'. Therefore in all Australian tax treaties the word 'income' can extend to 'gains'. (The technical aspects of this argument are questionable - see footnote.)[57]

- In post-CGT treaties the expression 'gain of a capital nature' is used in the residual rule in the *Alienation of Property* Article and other parts of the article refer to 'income, profits or gains'. It is argued that, because it is necessary to make the 'gains of a capital nature' qualification the earlier use of the word 'gain' cannot be used to contrast with 'income'.[58]

[57] Peter Kennedy, (see footnote 42) p 28; IV Gzell, (see footnote 35) p. 40. This argument overlooks an important aspect of the operation of the Australian part of the credit article. Australia's credit rules are always expressed to be subject to Australia's domestic foreign tax credit rules. These are largely found in Division 18, of Part I of the ITAA 1936, which was made law at the same time as capital gains legislation. Subsection 160AE(2) deems foreign sourced profits or gains of a capital nature to be income for the purposes of Division 18, so it was unnecessary to make any change to the post-CGT treaty language in the credit article.
Furthermore, post-CGT source rules changed to deem 'income, profits or gains' to be 'income' for the purposes of the treaty credit rules, so it was unnecessary to read 'income' to include 'gains'. There are only two isolated exceptions among the post-CGT tax treaties: the *Source of Income* Article in the Australia/Thailand DTA and the source of income rules for the Taipei Agreement in section 11ZF of the Agreements Act. These drafting changes are not significant against the background of the domestic rules in subsection 160AE(2).

[58] See Jason Chang, 'Application of the Business Profits Article to CGT', unpublished, Taxation Institute of Australia, February 1998, p. 24 and IV Gzell, (see footnote 35), p. 37.

- Some pre-CGT treaties deal with income from the alienation of capital assets. It is argued[59] that it is difficult to see how one could derive 'income' from capital assets unless 'income' encompassed capital gains.

118. The ATO agrees that the words 'income', 'profits' and 'gains' may be used interchangeably *within* a treaty.[60] The ATO considers that the meaning of these expressions in particular treaties is influenced by their context. Even if the first example was technically correct, in say a post-CGT treaty, given the context of that treaty it may possibly be the case that a reference to 'income' could include 'capital gains'. However for a pre-CGT treaty the context may well require that the word 'income' be read as not including capital gains.

119. As for the second example again the ATO accepts that the words 'income', 'profits' and 'gains' may be used interchangeably. However, the reason for the qualification in the sweep-up provision arises from the fact that the gains dealt with by articles in post-CGT treaties *do* have a wider coverage than in pre-CGT treaties. The sweep-up is only dealing with capital gains (and not income gains) and so it was necessary to describe that class of gains accordingly.

120. The third example is discussed in detail below. At this stage it is noted that from the Australian perspective depreciation recapture is an example of 'income from alienation of capital assets'.

Australia/ Netherlands (1976): Protocol Item 6(a)

121. In the Australia/Netherlands DTA, Item 6(a) of the First Protocol to that agreement provides:

> Where one of the States is entitled to tax the profits of an enterprise, that State may **treat as profits of an enterprise, profits from the alienation of capital assets of the enterprise**, not being profits that consist of income to which paragraph (1) of Article 13 applies. [Emphasis added]

122. Whether a Contracting State can tax the 'profits of an enterprise' is determined under the *Business Profits* Article. The Contracting State in which the enterprise or the person conducting the enterprise is resident always has a taxing right under the *Business Profits* Article over the profits of that enterprise. The other

[59] Peter Kennedy, (see footnote 42), p. 32.

[60] See for example Article 7.7 of the OECD Model which, when dealing with business *profits* (a net concept) refers in that context to items of *income* dealt elsewhere in the treaty. It is not uncommon for the OECD Model to use these expressions in an unfamiliar way.

Contracting State has a primary taxing right over such profits where the enterprise has a permanent establishment in that State.

123. It is sometimes argued[61] that this provision explicitly demonstrates that profits from the alienation of capital assets (which might be considered to encompass capital gains) fall naturally within the concept of 'profits of an enterprise'. On the other hand, the provision could equally be interpreted to the effect that without the provision 'profits of an enterprise' would not include profits from the alienation of capital assets. Furthermore, in *Lamesa*[62] the Federal Court commented that this treaty was concerned only with taxes on income, having no direct concern with capital gains.

124. In any event, the ATO does not consider that in this context 'profits' should be read as widely as meaning all 'capital gains' from the alienation of capital assets. The context of the treaty and the scope of the taxes covered under the treaty need to be taken into account. At the time the Netherlands treaty was concluded, sections 26(a), 26AAA and 59 of the ITAA 1936 potentially assessed gains on and recoupment of depreciation on certain alienations. Therefore the Protocol provision is dealing only with those 'borderline' classes of income assessable at the time the Protocol was concluded.

Alienation of Property Article

ATO View

125. Most of Australia's pre-CGT treaties only deal with 'income' from the alienation of property. The ATO considers this expression was carefully chosen to exclude capital gains. By contrast the OECD Model deals with (capital) gains. A number of pre-CGT treaties also mention 'gains' and the ATO considers that against the contextual backdrop of Australian pre-CGT treaty practice, this is a reference only to revenue gains - it does not extend to capital gains.

ATO view – 'Income from the alienation of property'

126. The use of 'income' demonstrates a consistent intention by Australia to deal with items that were income or assimilated to income and not to deal with capital gains as such in this article.

127. As noted earlier Australia consistently avoided using the OECD heading of '*Capital Gains*'. In pre-CGT treaties the broader expression '*Alienation of Property*' was used because the distributive rules of this article are generally expressed to apply only in relation to

[61] Jason Chang, (see footnote 58) p. 18.

[62] *FCT v. Lamesa Holdings BV* (1997) 97 ATC 4752 at 4755; (1997) 36 ATR 589 at 592.

income from alienation of certain property. By contrast the distributive rules of the OECD Model *Capital Gains* Article apply to (capital) gains arising from the alienation of all property.

ATO View - Why address income from alienation of property separately from the Business Profits Article?

128. The question arises as to why Australia agreed to a separate article on income from alienation of property if the business profits or residual article already dealt with such income?

129. Many treaty partners (especially OECD members) would have wished to have a *Capital Gains* Article similar to OECD Model. Australia could accommodate this objective (with some reluctance as the treaty practice shows) by referring only to *income* in an *Alienation of Property* Article. From the Australian perspective some alienations which were treated as income by Australian tax law (see for example sections 26(a), 26AAA and 59 of the ITAA 1936) would potentially be dealt with under this article. With the exception of alienation of real property discussed below, taxing rights would be the same as if these particular alienations had been dealt with under the *Business Profits* Article. For presentation reasons Australia could agree to *Alienation of Property* articles dealing with *income*.

130. For treaty partners, on the other hand, the 'presentational' integrity of using text similar to the OECD Model had been maintained. Furthermore, jurisdictions which do not strongly adhere to the income/capital distinction would have been accepting of the use of the word 'income' because from their perspective it could potentially embrace a wider class of gains from the alienation of property.[63]

131. Also there were advantages to Australia's source country interests in dealing with revenue gains on alienation of real property on the same basis as the OECD's *Capital Gains* Article.[64] Given the significance to the Australian economy of real property (as defined) there would have been a strong imperative to secure source country taxing rights over such alienations. Australia's drafting approach fulfilled this objective by expressly dealing with income from alienation of real property in this provision, because it better protects

[63] Recall the earlier discussion of the operation of the *Taxes Covered* Article in Australia's treaties which concluded that distributive rules in tax treaties do not always operate bilaterally. In other words, because the OECD Model paragraphs 2.1 and 2.2 are omitted, a distributive rule may apply to the taxes of one country and not the other – even though the distributive rule is drafted in bilateral form. Article 21 of the Australia/Germany DTA is a case in point.

[64] Initially Australia's preferred position was not to deal specifically with gains from the alienation of property. See for example the earliest pre-OECD treaties. However eventually Australia's opening position in treaty negotiations was to propose a provision dealing with income from real property and real property interests. (See Annexure A.)

source country taxing rights over real property than would the *Business Profits* Article.[65] Furthermore, this provision expands the meaning of real property and defines the *situs* of certain interests in land.

ATO view – 'gains' and 'profits' from the alienation of property

132. There are some isolated departures from usual Australian treaty practice at the time, regarding the use of the terms 'income or gains' is used. Clearly these changes were at the instigation of the treaty partner and give rise to an important question as to whether the term 'gains' means income gains or capital gains or both. The following table summarises these departures.

Table 3: References to 'gains' in distributive rules of *Alienation of Property* Articles in pre-CGT treaties

Expression	*Treaty partner*
'income or gains'	US, Canada and Malta use the phrase throughout the article, but effectively only real property interests are dealt with. The US also uses the expression for ships, aircraft and containers.
'income or gains'	Used in Irish DTA when dealing with alienation of real property interests, business property and ships and aircraft. Gains are defined in the case of Ireland to mean chargeable gains as defined by Irish tax law.
'income or gains'	Used in Norwegian DTC only when dealing with real property interests. (The Business Property clause refers to income.)
'gains'	Netherlands, Norway and Italy use the expression to relate to their unilateral treatment of certain shares.
'gains'	Norway also uses the expression in dealing with alienation of ships and aircraft.

133. The use of the word 'gain' was at the instigation of the treaty partner for the treaty partner's purposes. Significantly, except in the case of 'unilateral' provisions dealing with disposal of shares in subsidiaries (Netherlands, Norway and Italian treaties) and alienation of ships and aircraft in the Norwegian Convention (discussed below), the expression 'gains' is never used without also referring to 'income'. In the case of Ireland, gains are defined (at Article 14(2)(a)) only in relation to Ireland.

[65] See Canadian treaty practice which deals with alienations of real property similarly in the *Immovable Property* Article.

134. The ATO considers that for the contextual reasons discussed at the outset, from the Australian perspective 'gains' as used in these provisions does not refer to capital gains, but is confined to income gains, or gains assimilated to income - such as those assessable under section 26(a), 26AAA and 59 of the ITAA 1936. In particular it is noted that under the credit articles of pre-CGT treaties, Australia relieves double taxation only in respect of 'income'. Revenue gains readily fall within that description. However, if from the Australian perspective, 'gains' in the *Alienation of Property* Article had been intended to extend to 'capital gains' it would be expected that the credit article would have specifically referred to such gains. (Although the credit articles of post-CGT treaties refer only to 'income', post-CGT changes to the source rules and Australia's foreign tax credit rules had the effect of dealing with capital gains in the credit article – see footnote 57.)

135. Article 13(5) of the Australia/Norway DTA is the only case where the word 'gain' alone is used in a bilateral way. Norway was concerned to ensure that taxing rights over alienation of shipping was expressly dealt with. (Given Norway's extensive maritime interests this is not surprising.) From the Australian perspective, the gains were seen as dealing with depreciation recapture or section 26(a) type profits.

136. On one occasion (the Australia/Malaysia DTA) the relevant article, which deals only with real property interests, refers to 'income or profit'. For contextual reasons the ATO considers that profit does not extend to capital gains.

Alternative view – income (or gains) from the alienation of capital assets

137. The alternative view proceeds on a basis that the word income is used interchangeably with capital gains.[66] Other aspects of this issue are discussed in relation to the *Alienation of Property* Article.

138. Some pre-CGT treaties limit taxing rights over 'income' (and 'gains' in the case of the Australia/Ireland DTA) from the alienation of capital assets. The alternative view argues that it is difficult to see how income could be derived from the alienation of *capital* assets unless the term income included capital gains.

139. However, the ATO considers this overlooks the context in which these treaties were negotiated and particularly the fact that under section 59 of the ITAA 1936, 'income' could be derived from the alienation of capital assets (i.e., depreciation recapture). On this basis, Dawson J's comments in *Thiel*, can be reconciled with both

[66] See IV Gzell, (see footnote 35), p 40.

views. After concluding that the taxpayer's activities confirmed what he did was by way of an adventure in the nature of trade and had the requisite business character Dawson J states:[67]

> 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.

Residual Article

140. It has been argued that the 'residual income rules' in the *Income Not Expressly Mentioned* Article[68] apply to capital gains. This residual article provides a general rule relating to income not dealt with in the previous articles of the treaty. It deals both with (a) types of income not dealt with elsewhere, and (b) income arising in third states. Not all pre-CGT treaties contain this provision.

141. Article 21 of the Australia/Korean DTC (1982) is typical:

> (1) Items of income of a resident of a Contracting State which are not expressly mentioned in the foregoing Articles of this Convention shall be taxable only in that Contracting State.
>
> (2) However, if such income is derived by a resident of a Contracting States from sources in the other Contracting State, such income may also be taxed in the Contracting State in which it arises.
>
> (3) The provisions of paragraph (1) shall not apply to income derived by a resident of a Contracting State where the income is effectively connected with a permanent establishment or fixed base situated in the other Contracting State. In such a case, the provisions of Article 7 or Article 14, as the case may be, shall apply.

[67] *Thiel v FC of T* 90 ATC 4717 at 4724, (1990) 21 ATR 531 at 539.

[68] While this Article is entitled *Income Not Expressly Mentioned Article* in Australia's pre-CGT treaties, in 1976 the OECD Model was revised, changing the title to *Other Income*. Australia's recent tax treaties also use *Other Income*.

ATO view

142. The ATO considers, for the contextual reasons discussed at the outset, that it was not intended to deal with capital gains at all in pre-CGT treaties. Specifically it means that Australia did not intend the expression 'items of *income*' in the residual income rule to include capital gains.

Alternative view

143. An alternative view might be that the residual article in pre-CGT treaties which include such a provision was intended to act as a 'catch-all' provision and should be read widely - arguably to cover those capital gains not dealt with elsewhere in these pre-CGT treaties as 'items of income'.

144. Professor Vogel appears to take this view. In a discussion relevant to the Australia/Germany DTA (see later discussion on pre-OECD treaties) Professor Vogel observes that in the absence of an express capital gains rule, such gains could be dealt with by the residual article.[69]

145. Furthermore for similar reasons discussed in relation to business profits, it could be said that the terms 'income', 'profits' or 'gains' have been used interchangeably and on that basis income includes capital gains.

United States treaty (1983)

146. In the case of the Australia/United States DTC, the relevant USA authorities appear to agree with the approach taken by Professor Vogel that this Article is capable of dealing with capital gains. The US Treasury Technical Explanation of the DTC, for example, states that:

> . . . [g]ains with respect to other property are covered by Article 21 (Income Not Expressly Mentioned), which provides that gains effectively connected with a permanent establishment are taxable where the permanent establishment is located, in accordance with Article 7 (Business profits) and that other gains may be taxed by both the State of source of the gain and the State of residence of the owner. Double taxation is avoided under the

[69] Vogel, (see footnote 41), p 826.

provisions of Article 22 (Relief from Double Taxation).[70]

147. However, this was not the view adopted by Australia. The Explanatory Memorandum to the legislation which enacted the Australia/United States DTC,[71] did not make a similar observation.

148. It is interesting to note that US Letter Ruling LTR199918047 which deals with the treatment of gains from the sale of a foreign subsidiary, touches upon the US authorities' views on the treatment of gains on the sale of shares in an Australian subsidiary under the Australia/United States DTC.[72] Essentially the Letter Ruling implies that if the gain is dealt with by the residual article of the treaty, then in the particular circumstances outlined in the Letter Ruling, the source of the gain is in Australia.

149. While the US Technical Explanation is a relevant contextual consideration, against the background of the overall context of Australia's pre-CGT treaties and in the absence of any agreement on the Australian side to its content, less weight should be given to the Technical Explanation. Nevertheless, in accordance with Article 24 of the US DTC, the Australian competent authorities will undertake mutual agreement procedures with the United States, if necessary, to resolve particular cases, or possibly more generally.

Pre-OECD treaties: United Kingdom (1967), Japan (1969) and Germany (1972)

Background

150. Australia's earliest treaties with the United Kingdom (1946), United States (1953), Canada (1958), and New Zealand (1960) were strongly influenced by the 'Colonial Model' used by the British Empire and Commonwealth.[73] Elements of this Model can still be found in the drafting of the United Kingdom (1967); Japan (1969);

[70] Similar comments were made in the discussion of two of the relevant US Congressional report bodies, namely the Joint Committee on Taxation Explanation and the Senate Foreign Relations Committee Report.

[71] Australia, Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1983.

[72] Although the published Letter Ruling is 'sanitised' to protect the confidentiality of the applicant some references to tax treaty provisions are unique to the US treaty with Australia, suggesting it is dealing with the Australia/United States DTC.

[73] The Colonial Model was not published as such. The expression is used to refer to early UK treaty practice with colonies and other Commonwealth countries. JNewman, *United Kingdom Double Tax Treaties*, Butterworths (London 1979), p. 2: 'The United Kingdom did not follow the 1946 OECD (OEEC) [*sic*] model when concluding treaties in the late 1940s and 1950s with territories who were then colonies or members of the British Commonwealth'.

Singapore (1969); Germany (1972); and New Zealand (1972). All of these treaties have since been replaced except the United Kingdom (1967); Japan (1969); and Germany (1972). Australia's treaties concluded in the late 1960s and early 1970 were clearly moving closer to the OECD Model, but important aspects of the Colonial Model remain.

151. The Colonial Model defined a concept of 'industrial and commercial profits', (the analogue to the OECD's undefined expression 'profits of an enterprise'). This definition varies slightly from treaty to treaty. It generally excluded certain specific items which were often (but not always) expressly dealt with under other distributive rules. Following this practice, Australia's current treaties with the United Kingdom and Japan define 'industrial and commercial profits'.

152. Under the Colonial Model it was common to delete items from distributive rules if the source country retained taxing rights over the item.[74] There was no OECD *Capital Gains* Article - even though the United Kingdom and Japan were OECD members. (Likewise, these treaties omitted the prevailing OECD *Immovable Property*, *Capital*[75]and *Income Not Expressly Mentioned*[76] Articles.)

153. The Australia/Germany DTA, which was signed shortly after Australia joined the OECD but negotiated before Australia's membership, omits the OECD *Capital Gains* and residual articles. An abbreviated version of the OECD *Immovable Property* Article is included.

154. Obviously, issues relating to whether capital gains are dealt with by the *Capital Gains*/*Alienation of Property* and residual articles are not relevant to these treaties.

[74] It was not uncommon to exclude income from certain activities from treaty coverage in these times. For example, the Australia/United States DTC (1953) did not limit taxing rights over royalties other than cultural royalties, which enabled Australia to subsequently introduce a royalty withholding tax without much treaty restriction. Very often, credit relief in these treaties ensured that the residence country credit was to be given for items not dealt with in the treaty. But other contextual evidence (see later in the discussion) suggests it was not intended to deal generally with capital gains in the United Kingdom and Japanese treaties at all.

[75] It is not uncommon for states to delete this article from modern tax treaties. It is rarely included in Australia's treaties.

[76] A residual article was not included in Australian tax treaties until the early 1980s The Australia/Sweden DTA was the first Australian treaty to include such a provision.

'Industrial and commercial profits': United Kingdom (1967) and Japan (1969)[77]

United Kingdom (1967)

155. The Australia/United Kingdom DTA uses the expression 'industrial or commercial profits' which was defined in Article 5(7) to mean '*income* derived by an enterprise from the conduct of a trade or business, including income from the furnishing of services of employees or other personnel . . .' In this context does 'income' include 'capital gains'?[78]

156. Some commentators argue that since the title and preamble to the United Kingdom treaty is expressed to apply to capital gains and the taxes covered include UK capital gains tax, and there is no *Capital Gains* or residual article, then industrial or commercial profits should include capital gains. It is argued that income and gains are used interchangeably in pre-CGT treaties and should be given a broad interpretation.[79]

157. As was discussed above, the ATO considers that in the pre-CGT treaties, the term 'income' was used to specifically exclude capital gains taxation from the scope of pre-CGT treaties. The contextual support for this is especially strong in the case of the United Kingdom, because of the omission of an *Alienation of Property/Capital Gains* Article.[80]

158. Given the common legal backgrounds of Australia and the United Kingdom it is even more likely the term was carefully chosen, so as not to embrace capital gains. Evidence that the two territories adhered to the income/capital distinction in the treaty is in the title and preamble, which refer to both 'income and capital gains'. Consequently, the specific definition of the term 'industrial or commercial profits' to mean 'income' in this treaty is an express indication that the CGT is not intended to be dealt with as industrial and

[77] While Article 6 of the Australia/France DTA is headed 'Industrial or Commercial Profits' the OECD 'profits of an enterprise' approach is used. The German treaty follows the OECD approach also. These treaties were negotiated as Australia was moving into OECD membership.

[78] There is a preliminary requirement that the income be derived by an enterprise, and be from the conduct of a trade or business, which is beyond the scope of this Ruling.

[79] Jason Chang, (see footnote 58) at p. 34.

[80] The United Kingdom's Chartered Institute of Taxation appears to hold a similar view. (See Chartered Institute of Taxation, Press Release: 'Double taxation treaty network review 1988-99'.)

commercial profits. Also arguments relying on the application of subsection 3(2) of the Agreements Act are difficult to apply to this definition, because subsection 3(2) refers to 'profits' of an activity or business – not 'income'. There are other indicators concerning the application of the credit rules (discussed below) that confirm that it is not appropriate to regard capital gains as included in this definition.

Japan (1969)

159. The Australia/Japan DTA also uses the expression 'industrial or commercial profits', but defined it in Article 4(5) to mean '*profits* derived by an enterprise from the conduct of a trade or business [but excluding dividends, interest, royalties, shipping and aircraft income and personal services income]'. The ATO does not consider capital gains are included within the meaning of the word 'profits' for reasons similar to those mentioned in the earlier discussion in relation to 'profits of an enterprise' as used in post-OECD treaties.

Business profits: Germany (1972)

160. The Australia/Germany DTA uses an abbreviated OECD style *Business Profits* Article and the above discussion in relation to post-OECD applies similarly. For similar contextual reasons the ATO does not consider that capital gains are dealt with in this provision. In this case, the context is arguably more emphatic, because of the absence of a *Capital Gains*/*Alienation of Property* Article in the treaty. Significantly, the German author, Professor Vogel confirms no distributive rule applies to capital gains. He considers that 'taxation of capital gains . . . continues to lack a specific rule and the domestic law of the contracting States consequently applies in this respect without any restriction'.[81]

United Kingdom (1967): Does the credit article deal with capital gains?

161. It has been suggested that the credit article (Article 19) of the United Kingdom treaty could potentially deal with capital gains. However the ATO considers that for reasons set out in Australia's Explanatory Memorandum to the enacting legislation, the credit

[81] Vogel, (see footnote 41), at 826, 832 and 852.

article was designed to deal only with United Kingdom chargeable gains which were then assessable income in Australia (for example, under the former section 26(a) of the ITAA 1936).

162. It appears that the *Methods of Elimination of Double Taxation* Article (often referred to as the 'credit article') was designed to allocate taxing rights over income not expressly mentioned in the distributive rules of the treaty.[82] Article 19 of the 1967 Australia/United Kingdom DTA reads:

> (1) . . .
>
> (a) Australian tax payable under the laws of Australia and in accordance with this Agreement, whether directly or by deduction, on profits, income or chargeable gains from sources within Australia . . . shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the Australian tax is computed; and
> (b) . . .
>
> (2) (a) . . . United Kingdom tax payable under the laws of the United Kingdom and in accordance with this Agreement . . . whether directly or by deduction, on income derived by a resident of Australia from sources in the United Kingdom . . . shall be allowed as a credit against the Australian tax assessed by reference to the same income by reference to which the United Kingdom tax is payable.

163. For Article 19 to apply to an item of income, the only requirement is that the income (also profits or 'chargeable gains' in the case of the United Kingdom) is from sources[83] within the relevant territory. It is not strictly necessary to find a distributive rule specifically allocating profits to the country of source.[84]

164. A similar approach has been used in all Australian treaties since the 1946 United Kingdom treaty. The Explanatory Memorandums accompanying the enactment of this treaty and subsequent treaties (including the 1967 Australia/United Kingdom DTA) confirms it was commonly understood at that time that the

[82] As previously mentioned, many of Australia's pre-CGT treaties do not contain a residual Article, such as the *Income Not Expressly Mentioned* Article.

[83] The source of many items of income is described in Article 19(3).

[84] This contrasts with the drafting of the OECD Model which directly links the credit rule in Article 23B to the distributive rules allocating a taxing right to the source country. It does this by limiting the application of Article 23B to '*income . . . which may be taxed in the other Contracting State*'. This expression is only found in distributive rules allocating a source country taxing right.

credit rules were to deal with income not dealt with by the distributive rules.[85]

165. Article 19 of the 1967 United Kingdom treaty requires the country of residence to give credit for source country taxes on income not specifically dealt with in the distributive rules. For example, because real property income (other than rent effectively connected with a trade or business carried on through a permanent establishment) is not covered by the distributive rules, under Article 19 the residence country will credit source country taxation – a similar result if a standard *Real Property* Article was specifically included. Thus, it was unnecessary to include such a provision in the United Kingdom (and Japanese) treaties.

Dual Resident Article confirms credit rules deal with residual income

166. As drafted, the credit rule in Article 19 of the 1967 Australia/United Kingdom DTA does not, however, adequately distribute taxing rights if (say) real property income was derived from third countries. As the credit rule does not do this, the negotiators developed a unique *Dual Resident* Article that allocates taxing rights over the third country income of dual residents. In modern Australian treaties, some specific distributive rules (such as the *Business Profits* Article) deal with third country income with the residual article dealing with all other third country income. The *Dual Resident* Article is only used in Australian treaties where there is no residual article. Inclusion of this article confirms the Australian negotiators recognised the credit article was to deal with the balance of residual income not specifically mentioned in the distributive rules.

'in accordance with this Agreement'

167. Article 19 of the 1967 Australia/United Kingdom DTA includes a requirement contained in the prevailing OECD Model which first entered Australian tax treaty practice with the 1967 United Kingdom treaty. It requires that a credit must be provided by both the United Kingdom and Australia 'in accordance with this Agreement'. Strictly speaking, the text of the 1967 UK treaty does not prescribe the treatment of real property income or other residual income and it might be argued therefore that credit could not be required in such circumstances. But against the contextual background set out above, this qualification should be read more in keeping with the purpose of the provision as 'not contrary to this Agreement'.

[85] For example in the 1960 Australia/New Zealand DTA, music royalties were excluded from the definition of royalty, but the credit article (XIII) and the accompanying Explanatory Memorandum (at page 11) indicate that double taxation of such royalties was nevertheless to be eliminated by the credit article.

Nevertheless, context shows capital gains not generally covered

168. Accordingly, it might be argued that capital gains, which are not dealt with by the distributive rules, are dealt with in Article 19 of the 1967 Australia/United Kingdom DTA. If a United Kingdom resident makes an Australian-sourced capital gain, it might be argued that Article 19(1)(a) provides an unrestricted source country taxing right, and requires the United Kingdom to allow a credit in respect of such ‘chargeable gains’.

169. However, the language of Article 19(1)(a) and 19(2)(a) and the accompanying Explanatory Memorandum suggests that at the time of conclusion of the treaty, it was intended that only ‘chargeable gains’ that were also treated as assessable income by Australia when the treaty was concluded (e.g., under the former section 26(a) of the ITAA 1936) would come within the ambit of Article 19. First, under paragraph 19(1)(a), the UK was to provide credit for Australian tax on ‘profits, income or chargeable gains’. On the other hand, Australia was to provide credit only in respect of ‘income’.[86] There is no reference to ‘capital gains’ in the Australian credit rules.

170. Secondly, the relevant Explanatory Memorandum confirms the Australian Government considered the provision would only apply to income or gains assimilated to income. It was to apply only for the purpose of giving credit for United Kingdom capital gains taxes in relation to receipts that would be treated as *income* by Australia. The Explanatory Memorandum says:

> As the agreement is drafted, it will in practice have little effect in relation to the taxes imposed on capital gains by the United Kingdom. The principal effect will be in relation to article 19 [the credit article]- see notes on that provision. On the Australian side, the Agreement applies only to income tax imposed by the Commonwealth, the withholding tax on dividends and interest being within the description ‘income tax’.[87]

again, at p. 52:

[86] Consider the following example. Assume a UK resident sold property acquired for the purpose of profit making by sale. There is a gain on disposal and the source of the gain is Australia. Assume that the profit is not income according to ordinary concepts. In 1967 Australia would probably have taxed the profit as part of assessable income under the former paragraph 26(a) of the ITAA 1936. The UK could have taxed its resident on a ‘chargeable gain’. Under the *Credit* Article - Article 19(1)(a) - because the gain was Australian sourced, the United Kingdom would be obliged to credit any Australian ‘section 26(a)’ tax against its capital gains tax. And vice versa under Article 19(2)(a), if the facts are reversed.

[87] Australia, Explanatory Memorandum, Income Tax (International Agreements) Bill 1968, Income Tax Assessment Bill 1968 pp. 28, 29.

> A credit for Australian income tax would be allowable against United Kingdom capital gains tax in any case in which a particular gain is treated as income in Australia (for example, profits from the sale of Australian real estate purchased for purposes of resale at a profit) but for United Kingdom tax purposes is treated as a capital gain and charged to capital gains tax.

171. Accordingly the ATO does not consider that the treaty generally covers capital gains. Note this is consistent with the ATO's view of the operation of all pre-CGT treaties regarding capital gains.

Japan (1969): credit article

172. The same principles apply in interpreting the Australia/Japan DTA. There is a clear structural relationship between the United Kingdom treaty and the Japanese treaty concluded two years later. The Explanatory Memorandum to the Income Tax (International Treaties) Bill 1969 confirms the common approach of this treaty with the United Kingdom and other earlier treaties:

> In common with the Singapore Agreement, the agreement with Japan is broadly along the lines of the treaties negotiated with the United Kingdom, the United States, Canada and New Zealand.[88]

German (1972) and subsequent treaties

173. Technically it is also arguable that the credit rules in the German treaty are capable of dealing with all residual income although the accompanying explanatory material does not supply the contextual support for this interpretation. While technically the same may be true of all subsequent treaties as they all use a similar credit rule, for the contextual reasons discussed earlier, the ATO does not consider that the credit rules in the German and later pre-CGT treaties generally deal with capital gains.

Title: United Kingdom (1967) and Ireland (1983)

174. A related issue is the title and preamble to the Australia/United Kingdom DTA which specifically directs that their purpose is the avoidance of double taxation and the prevention of fiscal evasion in respect of 'income and *capital gains*'(emphasis added). The same issues arise with the Australia/Ireland DTA.

[88] Australia, Explanatory Memorandum, Income Tax (International Agreements) Bill 1969, p. 18.

175. The Federal Court in the *Lamesa* case may have been referring to this aspect of the Australia/United Kingdom DTA when it said:

> [u]nlike more recent treaties, the [Netherlands] Agreement is concerned only with taxes on income. It has no direct concern with capital gains: *cf* the double tax agreement between the United Kingdom and Australia which refers specifically both to taxes on income and capital gains.[89]

176. However, notwithstanding the reference to capital gains in the title and the preamble, the ATO considers that this reference does not imply that these treaties generally deal with capital gains.

177. It is a United Kingdom speciality, found in its treaties generally, to include 'capital gains' in the title and preamble to deal with the specific description of taxes covered and the nature of the its capital gains tax rules. The United Kingdom may refer to capital gains because for individuals it imposes a separate tax on capital gains. As explained, there are arrangements in the credit rules to cover those items which, at the time, were included in assessable income in Australia but would be chargeable gains in the United Kingdom. For this reason, and consistently with the United Kingdom's treaty practice, there is a reference to capital gains in the title and preamble.

178. There is no similar explanation in the Explanatory Memorandum for the Australia/Ireland DTA, but the similar construction of the credit rule and also the definition of the credit article in that treaty, coupled with a definition of chargeable gains only for Irish purposes suggests similar reasoning can be applied to the Australia/Ireland DTA.

Treaty partner response

179. Australia's pre-CGT treaty partners were invited to comment on the draft taxation ruling but only Norway has formally raised a view contrary to the ATO position. Norway has agreed its view may be publicly stated, subject to the qualification that its view is of a general and preliminary nature.

180. Norway's preliminary position is that taxes on capital gains are covered by its treaty with Australia. Reasons given for adopting this position are similar to the alternative arguments discussed previously in the Ruling. Further consultation may be required if cases of capital

[89] *FCT v. Lamesa Holdings BV* (1997) 97 ATC 4752 at 4755; (1997) 36 ATR 589 at 592.

gains taxation arise that are considered not to be in accordance with the treaty.

Detailed contents list

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19 December 2001

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Subject references:
- alienation of property
- business profits
- capital gains
- Colonial Model
- credit article
- double tax agreements
- income not expressly mentioned
- OECD Model
- other income
- source rules/dual resident article
- tax treaties
- taxes covered
- UN Model
- undefined terms
- US Letter Ruling LTR199918047

Legislative references:
- ITAA 1936 Div 18, Part 1
- ITAA 1936 25A
- ITAA 1936 26(a)
- ITAA 1936 26AAA
- ITAA 1936 36
- ITAA 1936 47
- ITAA 1936 59
- ITAA 1936 160AE(2)
- ITAA 1936 Part IIIA
- ITAA 1997 3-1
- ITAA 1997 3-3
- Agreements Act 1953 3(2)
- Agreements Act 1953 11S(2)
- Agreements Act 1953 4(2)
- Agreements Act 1953 5ZJ
- Agreements Act 1953 6ZJ
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- Agreements Act 1953 8ZJ
- Agreements Act 1953 9ZJ
- Agreements Act 1953 10ZJ
- Agreements Act 1953 11L
- Agreements Act 1953 11ZF
- Agreements Act 1953 11ZJ
- Acts Interpretation Act 1901 15AB

Case references:
- CIC Insurance Ltd v. Bankstown Football Club Ltd (1997) 187 CLR 384
- Chaudhri v. FCT 2001 ATC 4214; (2001) 47 ATR 126

- Consolidated Press Holdings Ltd & Anor v. FC of T 98 ATC 5009, (1998) 40 ATR 181;
- FCT v. Lamesa Holdings BV (1997) 97 ATC 4752; (1997) 36 ATR 589;
- FCT v. Slater Holdings Ltd (No 2), 84 ATC 4883; (1984) 15 ATR 1299;
- FC of T v. Australia and New Zealand Savings Bank Ltd (1998) 156 ALR 570
- Gadsden v. MNR 83 DTC 127;
- Gladden Estate v. The Queen 85 DTC 5188;
- Kenneth A Summons Pty Ltd & Ors v. FCT 86 ATC 4979, (1986) 18 ATR 235;
- Landskatteret (‘Danish Tax Court’) 26 ET 114 (1986);
- MacFarlane v. FCT 86 ATC 4477, (1986) 17 ATR 808;
- Rohrmoser No. 10669/84;
- Spanish Prospecting Company Ltd, (1911) 1 Ch 92;
- Thiel v. FC of T 90 ATC 4717, (1990) 21 ATR 531.

ATO references:
NO: T2000/012770; T2001/019309
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Annexure A

Australian Model 1980

Article 13
Alienation of Property

1) Income from the alienation of real property may be taxed in the Contracting State in which that property is situated.

2) For the purposes of the Article –

a) the term 'real property' shall include –

(i) a lease of land or any other direct interest in or over land;

(ii) rights to exploit, or to explore for, natural resources; and

(iii) shares or comparable interests in a company, the assets of which consist wholly or principally of direct 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;

b) real property shall be deemed to be situated –

(i) where it consists of direct interests in or over land – in the Contracting State in which the land is situated;

(ii) where it consists of rights of exploit, or to explore for, natural resources – in the Contracting State in which the natural resources are situated or exploration may take place; and

(iii) where it consists of shares or comparable interests in a company, the assets of which consist wholly or principally of direct 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 – in the Contracting State in which the assets or the principle assets of the company are situated.

Annexure B

Comparison of Australia's pre-CGT `treaties` *to OECD Model 'Capital Gains' Article*

Treaty	TITLE	OECD 13(1)	OECD 13(2)	OECD 13(3
UK ('66)	X	X	X	X
Japan ('69)	X	X	X	X
Singapore ('69)	X	X	X	X
Germany ('72)	X	X	X	X
NZ ('72)	X	X	X	X
France ('76)	'Alienation of Property'	Yes, 'income' is covered	X	X
Netherlands ('76)	'Alienation of Property'	Yes, 'income' is covered	X	X
Belgium ('77)	'Alienation of Property'	Yes, 'income' is covered	Yes, 'income' is covered	X
Philippines ('79)	'Alienation of Property'	Yes, 'income' is covered	Yes, 'income' is covered	X
Canada ('80)	'Alienation of Property'	Yes, 'income' or 'gains' are covered	X	X
Switzerland ('80)	'Alienation of Property'	Yes, 'income' and 'gains' are covered	Yes, 'income' covered	X
Malaysia ('81)	'Alienation of Land'	Yes, 'income' and 'profits' are covered	X	X
Sweden ('81)	'Alienation of Property'	Yes, 'income' is covered	Yes, 'income' is covered	X
Denmark ('81)	'Alienation of Property'	Yes, 'income' is covered	Yes, 'income' is covered	X
Italy ('82)	'Alienation of Property'	Yes, 'income' is covered	X	X
Korea ('82)	'Alienation of Property'	Yes, 'income' is covered	X	Yes, 'incom is covered
Norway ('82)	'Alienation of Property'	Yes, 'income' is covered	Similar, income covered	Similar, gai covered
USA ('83)	'Alienation of Property'	Yes, 'income' and 'gains' are covered	X	Yes, 'incom and 'gains' a covered
Ireland ('83)	'Alienation of Property'	Yes, 'income' and 'gains' are covered	Yes, 'income' and 'gains' are covered	Yes, 'incom and 'gains' a covered

Malta (‘84)	‘Alienation of Property’	Yes, ‘income’ and ‘gains’ are covered	X	X	X
Finland (’84)	‘Alienation of Property’	Yes, ‘income’ is covered	X	X	X
Austria (’86)	‘Alienation of Property’	Yes, ‘income’ is covered	X	X	X

(#) The paragraph differs considerably from the residual provision of the OECD Model. Unlike the OECD Model, the paragraph is limited to alienations of business property. Moreover, with the exception of the Irish DTA, the paragraph refers to ‘income’ from the alienation of capital assets and not to ‘gains’ as in the residual provision of the OECD Model. As discussed in the Ruling, it is considered by the ATO that the reference to ‘income or gains’ in the Irish treaty is to gains assimilated with income and not to all capital gains.

Annexure C

OECD Capital Gains Article: Treaty partner practice

The charts on the following pages broadly describe the treaty practice of Australia’s tax treaty partners in relation to the OECD Model Article 13.

Along the top of the chart the names of treaty partners are listed. This axis also lists numbers representing four paragraphs of the OECD Model Article 13. The key to these paragraphs is as follows:

1	alienation of real property provision
2	alienation of business assets provision
3	alienation of shipping and aircraft assets provision
4	residual capital gains provision

The vertical axis lists treaties negotiated by each of Australia’s treaty partners indicated on the top of the chart. A range of treaties negotiated immediately before and after their Australian treaty is listed. For each treaty partner their respective treaty partners and the year of conclusion of these treaties is listed.

Grey shading represents treaty paragraphs analogous to the OECD model. Diagonal shading represents cases without an analogue, but a residual provision achieves a similar effect to the OECD Model. Eg 1: The United Kingdom’s 1966 treaty with Australia does not contain an equivalent of the OECD Model Art 13. Eg 2: 1966 UK/New Zealand DTA has no OECD Art 13.1, but a residual provision (see OECD Art 13.4) gives similar taxing rights. Black shading represents a residual provision but which is limited to alienations of business property.

While we consider that the tables represent an accurate reflection of the treaties listed, the content of these particular treaties should be verified by examining the text of those treaties.

UK					JAPAN					NETH.					SWITZ					CANADA					MAL'SIA					USA				
	1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4
SWE 60	▒				FRA 64	▒	▒	▒	▒	SPA 71	▒	▒	▒	▒	MAL 74	▒	▒	▒	▒	PRK 78	▒	▒	▒	▒	SWZ 74	▒	▒	▒	▒	JAM 80	▒	▒	▒	▒
ISR 62	▒				FRG 66	▒	▒	▒	▒	INO 73	▒	▒	▨	▒	SIN 75	▒	▒	▒	▒	ROM 78	▒	▒	▒	▒	FRN 75	▒	▒	▒	▒	DEN 80	▒	▒	▒	▒
FRG 64	▒				NOR 67	▒	▒	▒	▒	FRA 73	▨	▒	▒	▒	ITA 76	▒	▒	▒	▒	UK 78	▒	▒	▒	▒	CAN 76	▒	▒	▨	▒	EGY 80	▒	▒	▨	▒
TRI 66					BRA 67	▒	▒	▒	▒	ISR 73	▒	▒	▒	▒	CAN 76	▒	▒	▒	▒	INO 79	▒	▒	▒	▒	IND 76					CAN 80	▒	▒	▨	▒
CAN 66	▒	▒	▒	▒	SRI 67	▒	▨	▨	▒	CZK 74	▒	▒	▒	▒	UK 77	▒	▒	▒	▒	BAR 80	▒	▒	▒	▒	NZ 76					BAN 80	▒	▒	▒	
NZ 66	▨	▒	▒	▒	EGY 68	▒	▒	▒	▒	THA 75	▒	▒	▒	▒	BEL 78	▒	▒	▒	▒	NZ 80	▒	▒	▒		FRG 77	▒	▒	▒	▒	ARG 81	▒	▒	▒	▒
SIN 66	▒				BEL 68	▒	▒	▒	▒	SUR 75	▒	▒	▒	▒	PRK 80	▒	▒	▒	▒	US 80	▒	▒	▒	▒	POL 77	▨	▒	▒	▒	NZ 82	▒	▒	▒	▒
AUS 67					AUS 69					AUS 76	▒				AUS 80	▒	▒		▨	AUS 80	▒				AUS 81					AUS 83	▒		▒	
BEL 67	▨	▒	▒	▒	ITA 69	▒	▒	▒	▒	MAL 77	▒	▒	▒	▒	NZ 80	▒	▒	▒	▒	FRG 81	▒	▒	▒	▒	KOR 82	▒	▒	▒	▒	ITA 84	▒	▒	▒	▒
LUX 67	▒	▒	▨	▒	UK 69	▒	▒	▒	▒	MOR 77	▒	▒	▒	▒	HUN 81	▒	▒	▒	▒	BAN 82	▒	▒	▒	▒	PAK 82	▒	▒	▒	▒	PRC 84	▒	▒	▒	▒
NET 67	▨	▒	▒	▒	KOR 70	▒				ZAM 77	▒	▒	▒	▒	SRI 83	▒	▒	▒	▒	CAM 82	▒				PHL 82	▒	▒	▒	▒	BAR 84	▒	▒	▒	▒
POR 68	▒	▒	▒	▒	MAL 70					PRK 78	▒	▒	▒	▒	GRC 83	▒	▒	▒	▒	SRI 82	▒	▒	▒	▒	ROM 82	▒	▒	▒	▒	SRI 85	▒	▒	▒	▒
SWA 68					ZAM 70	▒	▒	▒	▒	ROM 79	▒	▒	▒	▒	EGY 87	▒	▒	▒	▒	TUN 83	▒	▒	▒	▒	THD 82	▒	▒	▒	▒	TUN 85	▒	▒	▒	▒
SAF 68	▨	▒	▒	▒	NET 70	▒	▒	▒	▒	POL 79	▒	▒	▒	▒	NOR 87	▒	▒	▒	▒	EGY 83	▒	▒	▒	▒	BAN 83	▒	▒	▒	▒	NET 86	▒	▒	▒	▒
FRA 68	▒	▒	▒	▒	SIN 71					NZ 80	▒	▒	▒	▒	ICE 88	▒	▒	▒	▒	IVO 83	▒	▒	▒	▒	FIN 84	▒				INO 88	▒	▒	▨	▒
AUT 69	▒	▒	▒	▒	SWZ 71	▒	▒	▒	▒	UK 80	▒	▒	▒	▒	INO 88	▒	▒	▒	▒	KEN 83	▒	▒	▒	▒	ITA 84	▒	▒	▒	▒	FRG 89	▒	▒	▒	▒
FIN 69	▒	▒	▒	▒	FIN 72	▒	▒	▒	▒	GRC 81	▒	▒	▒	▒	PRC 90	▒	▒	▒	▒	SWE 83	▒	▒	▒	▒	PRK 85	▒	▒	▒	▒	FIN 89	▒	▒	▒	▒

SING					GERMANY					FRA					BELGIUM					PHIL					SWEDEN					DANISH					IRE				
	1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4
					LUX58				▒	SWI66	▒	▒			LUX70	▒	▒	▒	▒						USA39					POR72					AST66	▒	▒	▒	▒
					FRA59	▒				USA67	▒	▒		▒	NET70	▒	▒	▒	▒						AUT59					SWI73	▒	▒	▒	▒	SWI66	▒	▒	▒	▒
					IRE62				▒	UK68	▒	▒	▒	▒	AST71	▒	▒	▒							GRE61					BRA74	▒	▒	▒		CAN66				
					UK64				▒	POR71	▒	▒	▒	▒	BRA72	▒	▒	▒		USA76		▒	▒	▒	SWI65					POL76	▒	▒	▒	▒	FRA68				
					GRC66				▒	BRA71	▒	▒	▒		IND74	▒	▒	▒	▒	UK76	▒	▒	▒	▒	BRA75					HUN78	▒	▒	▒	▒	NET69	▒	▒	▒	▒
					JAP66	▒	▒	▒	▒	NET73	▒	▒	▒	▒	CAN75	▒	▒	▒	▒	FRA76	▒	▒	▒	▒	POL75					USA80					BEL70	▒	▒	▒	▒
					SPA66	▒	▒	▨	▒	SPA73	▒	▒	▒	▒	SLO75	▒	▒	▒	▒	CAN76					SPA76					UK80	▒	▒	▒	▒	ITA71	▒	▒	▒	▒
					BEL67	▨	▨		▒	SLO73	▒	▒	▒	▒	CZC75	▒	▒	▒	▒	BEL76	▒	▒	▒	▒	SLO79					NZ80	▒	▒	▒	▒	LUX72	▒	▒	▒	▒
SWE68				▒	ICE71	▒	▒		▒	CZC73	▒	▒	▒	▒	FIN76	▒	▒	▒	▒	SIN77	▒	▒	▒	▒	CZC79					LUX80	▒	▒	▒	▒	JAP74	▒	▒	▒	▒
MAL68					SWI71	▒	▒		▒	CAN75	▒	▒	▒	▒	POL76	▒	▒	▒	▒	FIN78	▒	▒	▒	▒	ITA80	▒	▒	▒	▒	ITA80	▒	▒	▒	▒	UK76	▒	▒	▒	▒
AUS69					AUS72					AUS76	▒				AUS77	▒	▒		■	AUS79	▒	▒		■	AUS81	▒	▒		■	AUS81	▒	▒		■	AUS83	▒	▒	▒	■
ISR71					POL72				▒	NZL79	▒	▒	▒	▒	SWI78	▒	▒	▒	▒	ITA80	▒	▒	▒	▒	HUN81	▒	▒	▒	▒	CZC82	▒	▒	▒	▒	NZ86	▒	▒	▒	▒
NET71				▒	BRA75	▒	▒	▒	▒	NOR80	▒	▒	▒	▒	NZL81	▒	▒	▒	▒	JAP80					UKR81	▒	▒	▒	▒	SLO82	▒	▒	▒	▒	SWE86	▒	▒	▒	▒
BEL72	▒	▒	▒	▒	HUN77	▒	▒		▒	HUN80	▒	▒	▒	▒	HUN82	▒	▒	▒	▒	NZ80					RUS81					PRC86	▒	▒	▒	▒	FIN92	▒	▒	▒	▒
GER72	▒	▒	▒	▒	NZL78	▒	▒	▒		PRC84	▒	▒	▒	▒	ITA83	▒	▒	▒	▒						JAP83	▒	▒	▒		RUS86	▒	▒		▒	POR93				
NZ73					FIN79	▒	▒		▒	RUS85	▒	▒		▒	PRC85	▒	▒	▒	▒	AUT81	▒	▒	▒	▒	LUX83					UKR86	▒	▒	▒	▒	DEN93	▒	▒	▒	▒
FRA74	▒	▒	▒	▒	POR80	▒	▒	▒	▒	UKR85					UK87	▒	▒	▒	▒	INDO81					UK83					GRE89	▒	▒		▒	RUS94	▒	▒	▒	▒
SWI75	▒	▒	▒	▒	CZC80	▒	▒			TUR87	▒	▒	▒	▒	TUR87	▒	▒	▒	▒	MAL82	▒	▒	▒	▒	CAN83	▒	▒	▒		NOR89	▒	▒	▒	▒	SPA94	▒	▒	▒	▒
THA75	▒	▒	▒	▒	SLO80	▒	▒			ITA89	▒	▒	▒	▒	NOR88	▒	▒	▒	▒	BRA83	▒	▒	▒	▒	PRC86					SWE89	▒	▒	▒	▒					
CAN76	▒	▒	▒	▒	RUS81	▒	▒	▒	▒	SWE90	▒	▒	▒	▒	SWE91	▒	▒	▒	▒	GER83	▒	▒	▒	▒	IRE86	▒	▒	▒	▒	FIN89	▒	▒	▒	▒					

ITALY					KOREA					NORWAY					MALTA					FINLAND					AUSTRIA				
	1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4		1	2	3	4
NZ79	░	░	░	░	UK77	░	░	░	░	IRE69	░	░	░	░	GER74					SLO75	░	░	░	░	CAN76	░	░		░
DEN82	░	░	░	░	BEL77	░	░	░	░	POR70	░	░	░	░	BEL74	░	░	░	░	BEL76	░	░	░	░	SLO78	░	░	░	░
SWE80	░	░	░	░	DEN77	░	░	░	░	TUR71	░	░	░	░	DEN75	░	░	░	░	POL77	░	░	░	░	CZC78	░	░	░	░
POR80	░	░	░	░	CAN78	░	░	░	░	POL77	░	░	░	░	FIN75					HUN78	░	░	░	░	ARG79	░	░	░	░
SLO81	░	░	░	░	NET78	░	░	░	░	SLO79	░	░	░	░	PAK75	░	░	░	░	GER79	░	░	░	░	RUS81	░			
CZC81	░	░	░	░	FIN79	░	░	░	░	CZC79	░	░	░	░	NOR75	░	░	░	░	GRE80	░	░	░	░	UKR81	░	░	░	░
FIN81	░	░	░	░	FRA79	░	░	░	░	UKR80	░	░	░	░	NET77	░	░	░	░	ITA81	░	░	░	░	ITA81	░	░	░	░
AUT81	░	░	░	░	SWI80	░	░	░	░	RUC80	░	░	░	░	FRA77					NZ82	░	░	░	░	PHI81	░	░	░	░
LUX81	░	░	░	░	SWE81	░	░	░	░	BRA80					AUT78	░	░	░	░	LUX82	░	░	░	░	BUL83	░	░	░	░
MEX81	░	░	░	░	NZ81	░	░	░	░	HUN80	░	░	░	░	ITA81	░	░	░	░	IND83	░	░	░		KOR85	░	░	░	░
AUS82	░			▨	AUS82	░		░		AUS82	░	░	░	■	AUS84	░				AUS84	░				AUS86	░		░	
BEL83	░	░	░	░	NOR82	░	░	░	░	LUX83					BUL86					PRC86	░	░	░	░	INDO86	░	░	░	░
USA84	░	░	░	░	TUR83	░	░	░	░	UK85	░	░	░	░	CAN86	░	░	░	░	RUS87	░	░		░	MAL89	░	░	░	░
RUS85	░	░	░	░	LUX84					ITA85	░	░	░	░	HUN91					UKR87	░	░	░	░	CYP90	░	░	░	░
UKR85	░	░	░	░	AUS85	░	░	░	░	PRC86					PRC93	░	░	░	░	SWE89	░	░	░	░	PRC91	░	░	░	░
NOR85	░	░	░	░	IND85					IND86	░	░	░	░	CYP93	░	░	░	░	NOR89	░	░	░	░	FRA93	░	░	░	░
POL85	░	░	░	░	ITA89	░	░	░	░	SWI87	░	░	░	░	IND94	░	░	░	░	ICE89	░	░	░	░	NOR95	░	░		░
PRC86	░	░	░	░	BRA89	░	░	░		GRE88					POL94	░	░	░	░	DEN89	░	░	░	░	STH96	░	░	░	░
GRE87					HUN89	░	░	░	░	BEL88	░	░	░	░	UK94	░	░	░	░	USA89	░	░	░	░	USA96	░	░	░	░
UK88	░	░	░	░	IRE90	░	░	░	░	FIN89	░	░	░	░	LUX94	░	░	░	░	CAN90	░	░	░	░	UK93	░	░	░	░
FRA89	░	░	░	░	POL91	░	░	░	░	DEN89	░	░	░	░	SWE95	░	░	░	░	SWI91	░	░	░	░					

Annexure D

Comparison OECD Model, US Model, Australia-US DTC

1. OECD Model	2. US 1981 Model	3. Australia-US Convention
Capital Gains (1)Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State. (2) Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State. (3) Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.	*Gains* (1) Gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 (*Income from Real Property (Immovable Property)* and situated in the other Contracting State may be taxed in that other State. (2) Gains from the alienation of (a) shares of the stock of a company (whether or not a resident of a Contracting State) the property of which consists principally of real property situated in a Contracting State; or (b) an interest in a partnership, trust, or estate (whether or not a resident of a Contracting State) to the extent attributable to real property situated in a Contracting State may be taxed in that State. For the purposes of this paragraph the term "real property" includes the shares of a company referred to in subparagraph a) or an interest in a partnership, trust or estate referred to in subparagraph b). (3) Gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or which are attributable to a fixed base available to a resident of a Contracting State in the other Contracting State for the purposes of performing independent personal services, and gains	*Alienation of Property* (1) Income or gains derived by a resident of one of the Contracting States from the alienation or disposition of real property situated in the other Contracting State may be taxed in that other State. (2) For the purposes of this Article: (a) the term 'real property situated in the other Contracting State', where the United States is that other Contracting State, includes a United States real property interest, and real property referred to in Article 6 which is situated in the United States; and (b) the term 'real property', in the case of Australia, shall have the meaning which it has under the laws in force from time to time in Australia and, without limiting the foregoing, includes: (i) real property referred to in Article 6; (ii) shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia; and (iii) an interest in a partnership, trust or estate of a deceased individual, the assets of which consist wholly or principally of real property situated in Australia. (3) Income or gains derived by an enterprise of one

(4) Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.	from the alienation of such permanent establishment (alone or with the whole of the enterprise) or such fixed base, may be taxed in that other State. (4) Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft, or containers operated in international traffic shall be taxable only in that State. (5) Gains described in Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12. (6) Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident**.**	of the Contracting States from the alienation of ships, aircraft or containers operated or used by it in international traffic shall, except to the extent to which that enterprise has been allowed depreciation in the other contracting State in respect of those ships, aircraft or containers, be taxable only in that State, and income described in subparagraph (4)(c) of Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12. (4) For the purposes of this Article, real property consisting of shares in a company referred to in subparagraph (2)(b)(ii), and interests in a partnership, trust or estate referred to in subparagraph (2)(b)(iii), shall be deemed to be situated in Australia.

Annexure E

Taxes Covered Article. Comparison of the Australia-US Convention and OECD Model Convention

Australia-US Convention	OECD Model
No equivalent	1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
No equivalent	2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
(1) The existing taxes to which this Convention shall apply are:	3. The existing taxes to which the Convention shall apply are in particular:
(a) in the United States: the Federal income taxes imposed by the Internal Revenue Code, but excluding the accumulated earnings tax and the personal holding company tax; and	a) (in State A): .... b) (in State B): ....
(b) in Australia: the Australian income tax, including the additional tax upon the undistributed amount of the distributable income of a private company.	
(2) This Convention shall also apply to any identical or substantially similar taxes which are imposed by either Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes. At the end of each calender year, the competent authority of each Contracting State shall notify the competent authority of the other Contracting State of any substantial changes which have been made during that year in the laws of his State relating to the taxes to which this Convention applies or in the official interpretation of those laws or of this Convention.	4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.