

AUSTRALIA'S DOUBLE TAX AGREEMENTS: GAINS FROM THE SALE OF SHARES BY NON-RESIDENTS

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In general terms, bilateral double tax agreements ("DTAs") between Australia and other foreign countries seek to resolve conflicts which may arise from the application of the domestic taxation laws of the two countries to the one transaction or event. This article details the various means by which Australia's DTAs deal with capital gains made from the disposal of Australian shares by non-residents. The article will illustrate that the inconsistency of approach of the various DTAs gives rise to complexity and uncertainty, which prompts the author to call for a comprehensive review of Australia's DTAs.

1. INTRODUCTION

A non-resident may seek to invest in Australia by acquiring shares in an Australian entity. Normal commercial practice may be to investigate the Australian taxation implications of its investment, including the treatment of gains or profits made from any subsequent disposal of the interest.

The scope of this article is specific, and only extends to capital gains made from the disposal of Australian shares by a non-resident. Other capital gains, such as those derived from the disposal of real property, are not considered.

2. CAPITAL GAINS TAX ("CGT")

In broad terms, Pt 3-1 of the *Income Tax Assessment Act 1997* (Cth) ("ITAA97") contains general provisions which deal with capital gains made by taxpayers, where capital assets are disposed of after 19 September 1985. A non-resident will only make a capital gain or loss if a "CGT event" happens to a "CGT asset" that has the necessary connection with Australia.¹ There are various categories of "CGT assets" which have the necessary connection with Australia including, amongst other things:

- shares or interests in shares in a resident private company; and
- a portfolio of shares of not less than 10 per cent of the issued share capital of a resident public company.²

A "CGT event" happens to a "CGT asset" where a non-resident disposes of Australian shares. A capital gain may arise, depending on the disposal proceeds.³ Assuming the non-resident is prima facie subject to CGT, the repatriation of the sales proceeds to the entity's country of residence may give rise to double taxation. Hence, a DTA may apply to determine taxing rights.

3. FOREIGN TAX CREDIT SYSTEM

The *Income Tax Assessment Act 1936* (Cth) ("ITAA36") contains a comprehensive foreign tax credit ("FTC") system, complemented by comparable provisions in foreign jurisdictions. In simple terms, this should allow most non-residents with interests in Australian companies to claim a credit for Australian tax paid. Usually the credit is limited to the amount of foreign tax payable in respect of the same gain.

* The views expressed in this article are those of the author and are not necessarily those of Ernst & Young.

¹ ITAA97, s 136-1.

² ITAA97, s 136-25.

³ ITAA97, s 104-5.

This article assumes that a non-resident is unable or unwilling to avail itself of relief through the application of the FTC system. The application of comparable FTC systems abroad is not considered.

4. DOUBLE TAX AGREEMENTS

Australia has negotiated and entered into various DTAs. Most of the agreements to which Australia is a party were negotiated and entered into prior to the introduction of CGT in Australia. The agreement between Australia and the United States for example, was agreed to in 1982 and generally became operative in years of income commencing on or after 1 December 1983.

When a non-resident triggers CGT upon the disposal of shares by it, a DTA may apply to determine taxing rights. The effect of the DTA will vary depending upon the actual DTA involved. Some DTAs do not consider gains of a capital nature at all. Some have limited application to certain types of capital gains. Others, particularly those entered into recently, allow Australia to tax certain capital gains.

Most DTAs do not specifically mention taxes on capital gains in their heading and in the Article describing the foreign taxes covered by the agreements. The DTAs with the United Kingdom and Ireland are the only ones that do so. In every DTA, the reference to Australian taxes covered is to "the Australian income tax", "the Commonwealth income tax" or similar wording.⁴

4.1 OECD Model Convention

As a member of the Organisation for Economic Co-operation and Development ("OECD"),

Australia negotiates DTAs with other OECD countries in accordance with the terms of the OECD Model Convention ("the OECD Convention"). As a general rule, bilateral agreements with non-OECD countries also tend to be consistent with the Convention, though some differences exist.

The commentary relating to the OECD Convention assists in the negotiation, application and interpretation of DTAs.⁵ It establishes categories of rules for different classes of income and capital. However, the OECD Convention does not explicitly mention capital gains made from the disposal of shares.

It is argued that the OECD Convention provides three principal ways of dealing with gains made from the sale of shares. First, many countries adopt a version of the Alienation of Property Article or Art 13(1) of the OECD Convention which refers to gains derived from the "alienation of immovable property". However, it does not cover the sale of shares in a company, even where the exclusive or main aim of the company is to hold immovable property.⁶

The second method the OECD Convention has been interpreted to provide relief to non-residents is the characterisation of profits from the sale of shares as "business profits", permitting the protection of the Business Profits Article or Art 7 of the OECD Convention. This Article may be interpreted to deal with the gains made from the alienation of shares. Where it applies, profits generally will be taxed in the country of residence of the non-resident, unless the non-resident carries on business through a permanent establishment ("PE") in Australia.

The final article which can be interpreted to provide protection from Australian CGT is the

⁴ P Kennedy, "CGT and Non-Residents; Part A: Protection Under Double Tax Agreements" (1993) 2(1) *Taxation in Australia Red Edition* 28.

⁵ OECD, *Commentary to OECD Model Convention*, Paris 1992, I-4.

⁶ *Ibid* C(13)-7.

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Other Income Article or Art 21 of the OECD Convention. This Article provides that "items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State", unless the income arises in connection with the carrying on of a business through a PE. The equivalent of Art 21 is replicated in most of Australia's DTAs. However, as detailed below, there is considerable uncertainty whether capital gains are caught.

It is clear that the OECD Convention does not specifically deal with the treatment of capital gains made from the alienation of shares. It provides little, if any guidance in this regard to OECD member countries. This article now refers to the various individual DTAs and attempts to ascertain how each deals with this issue.

4.2 Effect of DTAs

In the event of inconsistency between Australia's domestic tax laws and the provisions of a DTA, the latter prevails (subject to the application of the general anti-avoidance provisions contained within Pt IVA of the ITAA36).⁷ A DTA may overcome Australia's taxing rights arising from the provisions of the ITAA36 and ITAA97, including the CGT provisions.

4.3 Interpretation of DTAs

As there are obvious differences in wording, style and content⁸ between Australia's DTAs, it is important to determine the rules observed in interpreting them. The DTAs form part of Australia's domestic tax law through the application of the *International Tax Agreements Act 1953* (Cth)

("the ITA"). This legislation contains various definitions relevant to the various DTAs, including a definition of "profits", which will be examined in greater detail below.

The Full High Court decision of *Thiel v FC of T*⁹ is the main Australian authority dealing with the interpretation of DTAs. In *Thiel*, the Court dealt with the treaty between Switzerland and Australia which contained key terms such as "profits" and "enterprise".¹⁰ The treaty did not define these expressions. The Court was required to decide their meaning.

According to Mason CJ, Brennan and Gaudron JJ, the question of interpretation was to be "resolved by reference to the Agreement itself and any extrinsic materials which may properly be considered"¹¹ In their opinion, the meaning pursuant to Australian income tax law provided no assistance, as Australian courts had historically applied the particular terms in a different context. It was "safer to look to the context of the Agreement itself"¹².

The majority and McHugh J agreed that it is appropriate to refer to the OECD Convention and associated commentaries. Citing *Shipping Corporation of India Ltd v Gamlen Chemical Co. (A/Asia) Pty Ltd*¹³, McHugh J held that the Agreement was to be interpreted in accordance with the rules of interpretation recognised by international lawyers,¹⁴ as codified by the Vienna Convention on the Law of Treaties, even though Switzerland was not a party to this Convention

Article 31 of the Vienna Convention requires treaties to be interpreted in accordance with the ordinary meaning of terms "in their context and in the light of its object and purpose".¹⁵ Article 32

⁷ Section 4(2) of the *International Tax Agreement Act 1953* (Cth), which is the domestic legislation to which Australia's bilateral agreements are attached.

⁸ S Kontelj, "Capital Gains Tax and Non-Residents" (1995) 69(2) *Law Institute Journal* 135.

⁹ 90 ATC 4717 ("*Thiel*").

¹⁰ The DTA between Sweden and Australia, Art 7.

¹¹ *Thiel* 90 ATC 4717, 4719.

¹² *Ibid.*

¹³ (1980) 147 CLR 142, 159.

¹⁴ *Thiel* 90 ATC 4717, 4727.

¹⁵ *Ibid.*

provides that supplementary sources may be referred to, including the records of any negotiations preliminary to entering into treaties.

This general approach to the interpretation of DTAs has been subsequently followed by Einfeld J in *Lamesa Holdings BV v FC of T*¹⁶. In this case, the OECD Commentary was specifically referred to and the general context of the agreement was adhered to.

In *Lamesa*, Einfeld J considered whether the interpretation of the particular terms in the foreign language of the treaty partner country was relevant. Citing *Thiel*, he held that the "other language version of a DTA is admissible and both texts are equally authoritative".¹⁷ Einfeld J held that decisions of the Netherlands court system (the Hoge Raad) which considered the interpretation of the agreement between the Netherlands and Australia were "both admissible and persuasive".¹⁸

Generally, DTAs are treaties entered into between two countries for the avoidance of double taxation. In this context, it is argued that they should be interpreted in such a way to avoid double taxation.¹⁹ However, this general rule alone does not resolve the issue whether Australia's DTAs provide relief to non-residents disposing of shares in Australian companies. This issue is now examined.

5. ALIENATION OF PROPERTY ARTICLE

Most of Australia's DTAs contain an equivalent to Art 13 of the OECD Convention which refers to gains derived from the "alienation of immovable property". This is usually the only article specifically referring to capital gains.

Parts 5.1 to 5.4 (which follow) illustrate the different versions of Art 13 in Australia's DTAs. Some contain no equivalent of the article at all. Others can potentially apply but only within prescribed circumstances. More recent DTAs show a clear intention to determine taxing rights regarding capital gains from the disposal of shares.

5.1 No Equivalent

There is no equivalent to Art 13 in the UK, Japan and Germany DTAs.²⁰ Each of these agreements were negotiated and entered into prior to the introduction of CGT in Australia. Profits made by a UK resident, for example, from the disposal of shares in an Australian entity are likely to be subject to CGT. Any relief from double taxation must be obtained from the other articles of each DTA.²¹

5.2 No Protection

DTAs entered into between Australia and the US, Canada, the Netherlands, France, Malaysia, Italy, Korea, Malta, Finland and Austria generally provide that income or gains derived by a non-resident from the alienation or disposal of real property situated in Australia may be taxed in Australia. Gains made by a non-resident from the disposal of shares in an Australian company, the assets of which consist wholly or principally of real property²² or gains made from the alienation of a direct interest in or over land²³ may be similarly taxed in Australia.

These agreements do not provide protection, as they merely state that the income or gains may be taxed in the country where the taxpayer is not a resident. This does not eliminate the potential for double taxation. The equivalent article to Art 23 of

¹⁶ 97 ATC 4229 (*Lamesa*).

¹⁷ *Ibid* 4237.

¹⁸ *Ibid* 4238.

¹⁹ Kontelj, above n 8.

²⁰ Before 29 March 1995, the New Zealand DTA did not contain an article dealing with gains from the disposal of real property.

²¹ For example, the "industrial or commercial profits" Article of the DTA between the United Kingdom and Australia.

²² See eg, Art 13(2)(b)(ii) of the DTA between the US and Australia.

²³ See eg, Art 13 of the DTA between Canada and Australia.

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the OECD Convention would, in broad terms, allow relief by exemption or credit methods (which will not be discussed in the context of this article).

Some agreements deal with "income"²⁴ from the alienation of real property. Others apply to "income or gains"²⁵ or "income or profits".²⁶ As real property is generally regarded as a capital asset,²⁷ it is difficult to see how one could derive income from the disposal of real property, unless the term "income" encompasses capital gains.²⁸ The reference to "income" should include capital gains by virtue of the context of the agreements themselves.

The agreements do not apply to all types of capital gains. Where the entity in which the shares are sold is not land-rich, this article may not apply.

5.3 Limited Protection

The equivalent to Art 13 in Australia's DTAs with Belgium, the Philippines, Switzerland, Sweden, Denmark, Ireland and Norway are presented in slightly differently terms. Broadly, these agreements provide (with some exceptions), in the case of an enterprise, for taxation only by the state of residence of the enterprise.²⁹

For instance, Art 13(3) of the treaty between Australia and Belgium provides that "income from the alienation of capital assets of an enterprise of a Contracting State shall be taxable only in that Contracting State, but, where those assets form part of the business property of a permanent establishment situated in the other Contracting State, such income may be taxed in that other State".

Again, these agreements are not exactly the same. The agreements between Australia and Belgium, the Philippines, Sweden and Denmark refer only to "income" from the alienation of real property. Other DTAs refer to "income or gains".³⁰ As discussed above, the better view is that the term "income" in the context of Art 13, contemplates capital gains and is not restricted only to income according to ordinary concepts.

5.4 Recent DTAs

Australia's DTAs entered into or re-negotiated since 1987³¹ have an equivalent to Art 13 which specifically provides the Australian authorities with the right to tax capital gains. The agreement with New Zealand provides that:

Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of any property other than that to which any of the preceding paragraphs of this Article apply.³²

Australia is likely to retain taxing rights over all Australian capital gains made by a New Zealand resident, with limited exceptions (such as those applying to gains derived from the alienation of ships or aircraft operated in international traffic).³³ However, such a provision might not extend to some disposals caught by the application of the ITAA97, such as the disposal of a revenue asset (not being trading stock) of a non-resident.³⁴

²⁴ The DTAs between Australia and the Netherlands, France, Italy, Korea, Finland and Austria.

²⁵ The DTAs between Australia and the US, Canada and Malta.

²⁶ The DTA between Australia and Malaysia.

²⁷ Real property may be characterised as a revenue asset of a taxpayer where, for instance, the taxpayer carries on a business of trading in real property.

²⁸ Kennedy, above n 4, 32.

²⁹ Ibid 27.

³⁰ The DTAs between Australia and Switzerland, Ireland and Norway.

³¹ The DTAs between Australia and China, PNG, Thailand, Sri Lanka, Fiji, Hungary, Kiribati, India, Poland, Indonesia, Vietnam, Spain, the Czech Republic, Taipei, Singapore and New Zealand.

³² Article 13(5) of the DTA between Australia and New Zealand.

³³ Article 13(4) of the DTA between Australia and New Zealand.

³⁴ Kennedy, above n 4, 28.

6. BUSINESS PROFITS ARTICLE

Most DTAs between Australia and its treaty partners contain a provision similar to the following:

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated in that other State. If the enterprise carries on business in that manner, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that PE.³⁵

Some agreements vary slightly from this typical version of Art 7 of the OECD Convention. For instance, the DTA with the United Kingdom applies to "industrial or commercial profits" (defined as income derived from the conduct of a trade or business) of an industrial or commercial enterprise. The Japanese agreement is similar to the UK agreement, although "industrial or commercial profit" is defined as "profits" derived from the conduct of a trade or business. The DTA between Australia and Malaysia refers to "income or profits of an enterprise" and the US DTA mentions the "business profits" of an enterprise.

The use of varying terms, such as "business profits" and "industrial or commercial profits", means that each DTA should be interpreted separately on its own terms. However, it is worth investigating whether there is scope to argue that the respective Business Profits Articles apply to determine taxing rights in relation to capital gains.

6.1 Business Profits

In the absence of a PE in Australia, Art 7 may provide relief from Australian CGT where capital

gains are characterised as "business profits". Whether capital gains can be so characterised is not a settled area of domestic or international law. The difficulty in interpreting the Business Profits Article of the various DTAs was heralded by commentators from the time CGT was first introduced in Australia.³⁶

The term "business profits" is not defined and is often only used in the heading to the Article itself. This is true for many agreements, where the Article itself refers only to "profits of an enterprise".³⁷

The OECD Commentary provides little assistance, although the intention does appear to be to interpret the term "business profits" pursuant to the domestic laws of each treaty partner. The OECD Commentary provides that:

...no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied.³⁸

The ITA is the domestic legislation which gives force to the various DTAs entered into between Australia and foreign jurisdictions. Subsection 3(2) of the ITA provides that any references 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". Taxable income, for Australian tax purposes, is the amount upon which income tax is payable after deduction of allowable expenses and exempt income. This would encompass, under Australian law, any capital gains derived pursuant to Pt 3-1 of the ITAA97.

Treaty protection from taxation of gains from the disposal of shares is supported by the decision

³⁵ Article 7(1) of the DTA between Australia and New Zealand.

³⁶ A Blaikie, "International Aspects" (1987) 21(11) *Taxation in Australia* 750.

³⁷ See eg, the DTAs between Australia and Canada, New Zealand and the Netherlands.

³⁸ OECD, above n 5, C(13)-2.

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of the High Court in *Thiel*.³⁹ In this case, a Swiss resident purchased units in a private unit trust in anticipation of significant gains that could be made from an imminent public offering. The units were converted into shares, which were immediately sold.

The Commissioner of Taxation assessed the taxpayer on the profit made, pursuant to s 26AAA of the ITAA36.⁴⁰ The taxpayer challenged the assessment and claimed that the acquisition of units and sale of shares constituted an "enterprise carried on by a resident of Switzerland", and pursuant to Art 7 of the DTA between Australia and Switzerland, the profits were taxable only in Switzerland.

At first instance, the primary judge⁴¹ held that the transactions entered into by the taxpayer were an isolated speculative activity which did not form part of the taxpayer's existing Swiss business activities of importing and selling earthmoving equipment. Accordingly, the profit was not protected by the Business Profits Article which contemplated ongoing business operations, and a business plan or venture involving repetition or system. The taxpayer's appeal to the Full Federal Court⁴² was dismissed for similar reasons.

The taxpayer successfully appealed to the High Court. The primary focus of the Court was whether the activities of the taxpayer amounted to an "enterprise carried on". The meaning of this term is discussed subsequently in this article.

The Court also considered the implications of the heading to the Article, "Business Profits". The majority of the Court⁴³ held that once "an activity is held to constitute an enterprise, the heading ...

imports no additional limitation".⁴⁴ Dawson J added:

Article 7 is headed "Business Profits" and, as that heading indicates, it deals with business profits. But once it is recognised that "enterprise" includes an isolated activity as well as a business, business profits cannot be confined to profits (or taxable income) derived from the carrying on of a business but must embrace any profit of a business nature or commercial character. Profit from a single transaction may amount to a business profit rather than something in the nature of a capital gain even if it does not involve the carrying on of a business.⁴⁵

On the other hand, McHugh J held that the heading to Art 7 must be taken into account, and hence the profits of the enterprise had to be "profits from an adventure in the nature of trade".⁴⁶

Ian Gzell QC⁴⁷ points out there is not a great deal of difference between the majority approach and that of McHugh J. The majority were prepared to hold that an isolated transaction constituted an enterprise, provided the isolated transaction was entered into for a business or commercial purpose. Accordingly, the heading of the Article would import no additional restriction. McHugh J, on the other hand, held that an isolated transaction could amount to an enterprise, provided it satisfied the requirements imposed by the heading and could be described as an adventure in the nature of trade. Both views appear to arrive at the same conclusion.

There is authority that the holding of shares in a subsidiary is the business of a company and that any

³⁹ 90 ATC 4717 ("*Thiel*").

⁴⁰ Section 26AAA of the ITAA36 provided that profits arising from certain disposals of property within 12 months of acquisition were included in the assessable income of the taxpayer. The provision included certain capital gains within the Australian tax base.

⁴¹ 88 ATC 4094 (per Franklyn J).

⁴² 89 ATC 4015 (per Sheppard, Lee and Northrop JJ).

⁴³ Mason CJ, Brennan and Gaudron JJ.

⁴⁴ *Thiel* 90 ATC 4717, 4720.

⁴⁵ *Ibid* 4724.

⁴⁶ *Ibid* 4729.

⁴⁷ I Gzell QC, "Double Talk: Emerging Trends in Tax Treaties", *Taxation Institute of Australia (NSW Intensive Seminar)*, October 1992, 71.

gainful use to which the company puts its assets constitutes the carrying on of a business.⁴⁸ This is explored in greater detail in part 6.4 of this article.

6.2 Industrial or Commercial Profits

It is unclear whether the principles espoused in *Thiel* can be extrapolated to other DTAs, which adopt different terminology to that of the Swiss agreement.⁴⁹

Do the words "industrial or commercial profits"⁵⁰ in the DTAs between Australia and the United Kingdom and Japan respectively import an additional restriction? What is the effect of the definition of "enterprise" in the agreement with France, which requires that the enterprise be "industrial or commercial"?⁵¹

Support for the view that the UK and Japanese agreements may be interpreted similarly to the Swiss agreement is contained within a Note of the Italian General Directorate of Taxes⁵² which considered the application of Art 4(1) of the DTA between the Netherlands and Italy. The Article reads as follows:

Profits derived by a person resident in one of the two States from the exercise of any industrial, agricultural, mining, commercial or other similar activity shall not be taxable in the other State unless the person concerned carries on his activity in that other State through a PE situated therein.

The Italian revenue authority ruled, in respect of a company resident in the Netherlands which owned 15% of the shares of an Italian company, being its only activity, that because the Netherlands company was a holding company, the gain was

deemed to represent business income with the requisite industrial or commercial flavour.

Whether this would be the result in relation to the similarly worded UK and Japanese agreements is not certain. This is primarily because the issue has not been judicially tested in Australia and because the Italian ruling was decided against the background of Italian tax law, under which all activities of companies were deemed to be business activities.⁵³

Nevertheless, applying the majority decision in *Thiel*, provided that the alienation of shares in an Australian subsidiary by a non-resident is entered into for business or commercial purposes, the non-resident could be seen to derive industrial or commercial profits from an industrial or commercial enterprise. Reference should be made to s 66(1) of the *Finance Act 1988* (UK),⁵⁴ which provides that subject to certain exceptions, a company incorporated in the UK is to be regarded as a resident of the UK for the purpose of various taxing statutes. Of one of the exceptions to the general rule, the UK Inland Revenue have stated:

The exceptions from the incorporation test in Sch 7 depend in part on the company carrying on business at a specified time or during a relevant period. The question whether a company carries on business is one fact to be decided according to the particular circumstances of the company. Detailed guidance is not practicable but the Revenue take the view that "business" has a wider meaning than "trade"; it can include transactions, such as the purchase of stock, carried on for the purposes of a trade about to be commenced and the holding of investments including shares in a subsidiary company. Such a holding could consist of a

⁴⁸ Ibid 76.

⁴⁹ I Farmer and S Beasley, "Treaty Protection for Capital Gains After ATO Clarification" (1995) 7(4) *The CCH Journal of Australian Taxation* 59.

⁵⁰ Article 5(1) of the DTA between Australia and the United Kingdom.

⁵¹ Article 2(1)(f) of the DTA between Australia and France.

⁵² Note of the Directorate of Taxes, Div. IX (No. 9/360), per Edwardes-Ker, *The International Tax Treaties Service*, In Depth Publishing Ltd, Article 7, at p. 16.

⁵³ Kennedy, above n 4, 32.

⁵⁴ Gzell QC, above n 47, 76.

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single investment from which no income was derived.

Pursuant to this view, the mere holding of shares in a subsidiary company could constitute a "business" for UK revenue purposes. The views of domestic taxing authorities are relevant and accordingly, the subsequent sale of the investment could be viewed as having been entered into for business or commercial purposes.

This is yet to be tested in the Australian courts of law. Until that time, the position cannot be certain.

6.3 Income or Profits

The equivalent to Art 7 of the OECD Convention in the DTA between Australia and Malaysia is yet another variation of the Business Profits Article. It refers to "income or profits" of an enterprise.

The use of the term "income or profits" appears to contemplate a broad application of the Article. It may be easier to argue that a capital gain derived by a Malaysian entity from the disposal of shares in an Australian company, falls within the definition of "income or profits" and in the absence of a PE of the non-resident in Australia, Malaysia should retain the right to tax the gain.

6.4 Enterprise Carried On

To qualify for relief pursuant to the equivalent of Art 7 of the OECD Convention, the activity giving rise to the profits must amount to "an enterprise". The majority of the High Court in *Thiel* were satisfied that the taxpayer's activities, albeit of an isolated nature, constituted an enterprise.

As observed by Dawson J in *Thiel*⁵⁵, the definition of "enterprise" in the DTA between Australia and Switzerland (which replicates the equivalent in the OECD Convention) does not appear to immediately clarify what would amount to "an enterprise". "Enterprise" is defined to mean "an enterprise carried on by a resident of Australia or an enterprise carried on by a resident of Switzerland, as the context requires".⁵⁶

The Court considered whether the term "carried on" referred only to a business with elements of continuity or repetition. In broad terms, the Court held that the words "carried on" did not impose this requirement and referred to the commentary accompanying the OECD Convention, which stated:

The question whether an activity is performed within the framework of an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States.⁵⁷

Accordingly, both an isolated venture or activity, as well as a framework within which activities are conducted, could constitute an "enterprise carried on", provided the activity or activities are entered into for business or commercial purposes.

Some commentators⁵⁸ suggest that the mere disposal of Australian shares by a non-resident company does not amount to an enterprise. In contrast, there is authority that the holding of shares may constitute the carrying on of a business by the holding company, and the realisation of that capital asset is a part of the company's business, as it amounts to the gainful use to which the company puts its assets.⁵⁹

⁵⁵ *Thiel* 90 ATC 4717, 4723.

⁵⁶ Article 3(1)(f) of the DTA between Australia and Switzerland.

⁵⁷ OECD, above n 5, C(3)-2.

⁵⁸ Kennedy, above n 4, 31.

⁵⁹ *Smith v Anderson* (1880) 15 ChD 247; *Ruhamah Property Co Ltd v FC of T* (1928) 41 CLR 148; *Carapark Holdings Ltd v FC of T* (1966-1967) 115 CLR 653; *London Australia Investment Co Ltd v FC of T* (1976-1977) 138 CLR 106; *American Leaf Co v Director-General* [1979] AC 676; *FC of T v Total Holdings (Australia) Pty Ltd* 79 ATC 4279.

The disposition of shares may be within the ordinary course of business, where for example, there is a history of disposals by the holding company⁶⁰ or the disposition itself constitutes an enterprise, albeit an isolated activity. At all times, the gain must be "commercial" and in the nature of business, for protection to apply.

6.5 Recent Case Law

In 1997, the Federal Court handed down its decision of *Lamesa*⁶¹. The Court was not required to directly consider the application of Art 7 of the DTA between Australia and the Netherlands. However, it is interesting to note that at the hearing, the Commissioner conceded that, as the non-resident company did not carry on business in Australia through a PE, Art 7 prevented the taxation of the income, unless another article of the treaty applied.

The facts of *Lamesa* are complex. Aware that a certain Australian company ("Arimco") was the subject of a takeover bid at an undervalued price, a US entity acquired the share capital of an Australian entity ("ARL"). ARL then acquired the shares in ARM. The US entity purchased the share capital of a company incorporated in the Netherlands ("Lamesa") and the ARL shares were transferred to Lamesa. ARM then made a successful takeover bid for Arimco. Subsequently, ARL was listed and Lamesa disposed of its interest in ARL for a substantial profit.

The Commissioner assessed Lamesa pursuant to s 25(1)(b) of the ITAA36, which provided that the assessable income of a non-resident includes income derived directly or indirectly from Australian sources. Lamesa claimed that the profits were excluded from Australian tax by virtue of Art 7 of the DTA. The Commissioner conceded

that Art 7 would provide relief to Lamesa, provided that Art 13 of the DTA did not apply.

This article does not examine this decision in detail. Suffice to say that the Commissioner accepted that the Business Profits Article could apply in this instance. Einfeld J observed that it was "common ground that Lamesa has the protection of Article 7".⁶²

Accordingly, the decision bolsters the argument that a gain made from the disposal, by a non-resident, of shares in an Australian entity can be protected by the Business Profits Article. This is despite the fact that the taxpayer was assessed pursuant to the income provisions and not the CGT provisions of Australian tax law.

7. OTHER INCOME ARTICLE

Assuming that capital gains of the nature in question are not dealt with under the Business Profits or another specific Article, the final avenue for relief from Australian taxation available to a non-resident upon the disposal of Australian shares is the equivalent articles to Art 21 of the OECD Convention.

7.1 OECD Reservation

Australia has recorded an important reservation in relation to Art 21 of the OECD Convention, as follows:

Australia, Canada, Mexico, New Zealand and Portugal reserve their positions on this Article and would wish to maintain the right to tax income arising from sources in their own country.⁶³

⁶⁰ Farmer et al, above n 49, 59.

⁶¹ *Lamesa* 97 ATC 4229.

⁶² Ibid 4233.

⁶³ OECD, above n 5, C(21)-5.

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In most of its DTAs, Australia has successfully included a provision to preserve its right to tax "income", otherwise not covered by an agreement, where it is derived from Australian sources. The term "source" is not defined, and is discussed at length below.

7.2 No Equivalent

The bilateral tax agreements between Australia and the United Kingdom, Japan, Germany, the Netherlands, France, Belgium, the Philippines, Switzerland, Malaysia and Italy do not contain an equivalent to Art 21 of the OECD Convention.

McHugh J in *Thiel* thought it "significant" that the Swiss agreement did not contain an equivalent to Art 21,⁶⁴ for reasons which he did not elaborate. In any event, he held that the Swiss taxpayer was still entitled to relief from Australian tax.

Consequently, a resident of these foreign jurisdictions which disposes of Australian shares must rely on other articles of the DTAs for relief from double taxation.

7.3 "Income"

The remainder of Australia's DTAs contain a provision equivalent to Art 21 of the OECD Convention. All apply expressly to "income" not otherwise dealt with in the agreements.

There is considerable conjecture whether the term "income" includes capital gains made from the disposal of shares. There is a view that the term "income" refers to income according to ordinary concepts, and does not include capital gains.⁶⁵ However, it is submitted that the better view is that capital gains are included within the ambit of the term "income".

Many of the DTAs entered into by Australia describe the agreement as a convention to avoid double taxation and to prevent fiscal evasion with respect to taxes on "income". Most of these agreements go ahead to deal with gains from the disposal of real property, which are thus implicitly included within the description of taxes on "income".

The commentary accompanying the OECD Convention describes Arts 6 to 21 as establishing rules "with regard to different classes of income".⁶⁶ The commentary thus refers to the articles relating to "business profits", "capital gains" and "other income" as constituting different classes of "income". This runs contrary to the argument that "income" refers only to income according to ordinary concepts.

That capital gains are included within the concept of "income" for the purposes of Art 21 of the OECD Convention is the view held by the US authorities. The US Treasury Department Technical Explanation of the US Treaty observes (as reported by Gzell QC):⁶⁷

Gains with respect to any other property are covered by Article 21 (Income Not Expressly Mentioned), which provides that gains effectively connected with a PE are taxable where the PE 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 provisions of Article 22 (Relief from Double Taxation).

Gzell QC also notes the view expressed in the Report of the Senate Foreign Relations Committee that gains from the alienation of property not covered by Art 13, are subject to the general rule of Art 21:

⁶⁴ *Thiel* 90 ATC 4717, 4728.

⁶⁵ R Gibson, "The New Canada-Australia Income Tax Convention" (1981) September/October *Canadian Tax Journal* 688.

⁶⁶ OECD, above n 5, I-6.

⁶⁷ Gzell QC, above n 47, 75.

The proposed Double Taxation Agreement would generally allow the source country to tax capital gains of residents of the other country. In this respect, the proposed Double Taxation Agreement differs from the US model, which generally allows such source country taxation only in limited circumstances (see discussion under Article 13 (Alienation of Property)).

These views would be admissible in a court of law, provided they are interpreted as recommendation as opposed to mere statement.⁶⁸ The Court of Appeal in New Zealand has admitted such expressions.⁶⁹ In support, Art 32 of the Vienna Convention provides that records of negotiations preliminary to entering into a treaty may be referred to.

For the reasons stated above, the better view is that capital gains are included within the ambit of the term "income", for the purposes of the application of the equivalent articles to Art 21 of the OECD Convention. Where the Business Profits or Alienation of Property Articles do not apply to the disposal of shares, Art 21 should apply to determine the taxing rights of the Contracting States.

7.4 Source

In most cases, the source of the gain is central to determining taxing rights, when applying Art 21 or its equivalent. The term "source" is not defined in any of the agreements. Australia has very limited statutory source rules. The source of gains from the disposal of shares is determined pursuant to established rules of the common law.

The determination of the source of income is to be ascertained as a practical, hard matter of fact, dependent upon all the relevant circumstances.⁷⁰ There are no presumptions of source and each

factual situation is addressed on a case by case basis. Income may be derived from a number of sources, requiring an exercise of apportionment where this so.

There is only one Australian authority dealing specifically with the issue of source of profits from the disposal of shares. In *Australian Machinery and Investment Co Ltd v DFC of T*⁷¹, an Australian company purchased mining leases, which were transferred to newly incorporated companies in consideration for shares in the companies. Whilst visiting England, the power of attorney for the Australian company disposed of shares in the new entities to several English companies, in exchange for shares in those English companies. The Australian company then disposed of the English shares, some sales being made in England and some in Australia.

Regarding the disposal of the Australian shares, Latham CJ and Williams J held that the profit was derived partly from sources in Australia and from England.⁷² However, the Full High Court did not determine the proper apportionment between the sources.

Dixon J (with whom McTiernan J agreed) considered there was insufficient information to determine the source of the gains made from the disposal of the English shares. Williams J held that the taxpayer acquired shares in English companies on English registers and that the profits from the sales in England were derived exclusively from an English source. However, the source of the gain made from the disposal of the English shares in Australia, was both Australian and English.

Notwithstanding the diversity of approaches in this case, it is apparent that the situs of the shares and the location of sale were factors of significance in determining the source of gains made from the sale of shares.⁷³

⁶⁸ Ibid 75.

⁶⁹ *Commissioner of Inland Revenue v JFP Energy Incorporated* (1990) 12 NZTC 7176.

⁷⁰ See eg, *Thorpe Nominees Pty Limited v FC of T* 88 ATC 4886.

⁷¹ (1946) 8 ATD 81 ("*Australian Machinery*").

⁷² Ibid 90.

⁷³ Blaikie, above n 36, 744.

There is a suggestion by Williams J in *French v FC of T*⁷⁴ that where the sale of shares would have been assessable pursuant to the former s 26(a) of the ITAA36, that greater emphasis should be given to the place where the transactions are carried out rather than the location of the property itself. This view could be similarly applied to the sale of shares subject to CGT.

In *Australian Machinery*, Starke J also observed that where the "essence of the business" is entering into contracts with a view to profit, it is "the locality where such contracts are habitually made which is the source of the profit".⁷⁵

Accordingly, the determination of the source of gains made from the disposal of shares is an unsettled area of law. Each case is to be decided on its merits. However, the following factors should be considered in ascertaining questions of source:

- location of the preliminary and final negotiations relating to the proposed sale;
- source of the funds used to invest in the shares;
- location of the share register and share certificates of the company;
- jurisdiction where the documentation effecting the sale is drafted and executed;
- location where the profits made from the sale are presented and subsequently utilised; and
- location of the professional advisers used in relation to the acquisition and disposal.

If most of the aspects of a transaction involving the disposal of shares in an Australian subsidiary are conducted or executed outside Australia, it should be strongly arguable that the source of any profits made is outside Australia. Accordingly, where the equivalent to Art 21 of the OECD Convention applies, the ex-Australian source of the profits should deny Australia taxing rights in relation to the gain.

⁷⁴ *French v FC of T* (1957) 98 CLR 398.

⁷⁵ (1946) 8 ATD 81, 95-96.

⁷⁶ T Flahvin, "Non-residents, Capital Gains Tax and the Double Tax Agreements" (1991) 3(1) *The CCH Journal of Australian Taxation* 48.

⁷⁷ Gzell QC, above n 47, 73.

⁷⁸ These are objectives specifically recognised by the OECD in the Commentary to the OECD Model Convention, I-2.

8. CONCLUSION

In summary, the considerable differences in wording and style between the various DTAs leads to uncertainty in the application of the law to gains derived from the disposal by a non-resident of shares held in an Australian company. This uncertainty is likely to persist until such time as the Australian courts, legislature or Taxation Office clarify the position to be adopted. This is particularly so in relation to the older bilateral tax agreements, which it is submitted, are completely incompatible with the more recently enacted CGT provisions.⁷⁶

Indeed, it is disappointing that the High Court in *Thiel* did not discuss the interaction of Art 7, Art 13 and Art 21 of the OECD Convention.⁷⁷ Were this so, the relative roles of these Articles may have been clarified.

The OECD itself should be concerned to promote harmonisation and constant revision of the DTAs entered into by OECD member countries.⁷⁸ This need should prompt review of DTAs and further clarification by the OECD.

Uncertainty regarding the application of DTAs does little to promote foreign investment in Australia. Few non-resident investors could be confident about the taxation implications of disposing of their Australian share investments. This may promote a reluctance to invest in Australian companies in the first place.

It is submitted that Australia's DTAs need to be aligned more closely with the Australian tax system which since 20 September 1985, has taxed certain capital gains made by taxpayers.

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