# Exit Taxes and the OECD Model Convention

## Compatibility and Double Taxation Issues

It has been some time since discussions first began concerning the potential tax treaty override stemming from the imposition of exit or emigration taxes by states that have signed tax treaties following the OECD model convention. However, it seems that until now this issue has not been settled. As a consequence, states have been adopting different positions on the matter, which has led to an increasing risk of double taxation and double nontaxation of income.

The reasons for adopting an exit tax vary from state to state, but generally are based on the need to increase tax collection or thwart tax avoidance. However, an exit tax would only produce its desired effect if it is found to be compatible with the provisions of the extensive tax treaty network already in place.

The purpose of this article is to analyze whether the imposition of an exit tax by a contracting state could be interpreted as being in violation of its tax treaty obligations (always assuming that the concrete bilateral tax treaty follows the OECD model). Also, because not all states share the same views, this article proposes amendments to the OECD model convention to avoid the drawbacks currently arising from the imposition of exit taxes.

The impact that European Court of Justice decisions may have on exit taxes will not be addressed in this article.

## Exit Taxes

### Types

As can be deduced from the qualifying term “exit,” an exit tax is one that takes emigration and the consequent changing of tax residence status as a relevant component of its framework. Although the tax is generally assessed at the moment preceding the change of residence status (that is, prior to emigration), it is also used as a way to extend a state’s ability to tax after the change of tax residence status.

This article categorizes these types of taxes into “immediate exit taxes” and “capital gains taxes on former residents.”[1]

The immediate exit taxes can be defined as taxes that are levied on the appreciated value of the taxpayer’s properties immediately before emigration (that is, while the taxpayer is still a tax resident of the state imposing the tax).

The capital gains taxes on former residents, more commonly referred to as “trailing taxes,” can be defined as taxes that are levied on the effective and realized gains stemming from the alienation of properties carried out by a former resident taxpayer at some time following emigration. Usually, this extended tax liability expires after a minimum period of time following the change of tax residence status (generally 5 to 10 years) if no alienation is verified.

Even though both types of taxes are generally referred to as exit taxes, they are significantly different, at least from a legal perspective. While immediate exit taxes are levied on an unrealized gain and when the taxpayer is a tax resident solely of the taxing state, capital gains taxes on former residents are charged on the effective and realized gain, but at a moment when the taxpayer is also a tax resident of another state. These distinctions, particularly the one concerning the moment in which the tax is assessed, are important for purposes of (i) analyzing whether the imposition of such taxes may be viewed as incompatible with the OECD model convention and (ii) identifying the available measures to deal with the related issues derived from their imposition.

**Main Objectives**

Because most states apply the residence criterion as the connecting factor for subjecting a person’s income to worldwide taxation,[2] a simple change in tax residence may frustrate one state’s ability to tax.

Although losing the income that is generated and taxed on a continuous basis seems not to be an issue for the emigration state (also referred to as the “former state of residence”) as this is a consequence intrinsically associated with the adoption of the residence criterion, states that have introduced exit taxes in their tax system clearly intend to avoid the loss of the right to tax the income that has accumulated over time but has not been taxed, for policy reasons, on a continuous basis (for example, the appreciation in value of a property, which is generally taxed only on alienation or realization).

Considering that almost all states also use the source criterion as a connecting factor for taxing nonresidents who earn income originating from

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1 Both species can also be subdivided into limited and unlimited depending on whether they apply to all types of properties or only to specified properties (for example, substantial shareholdings).

2 The most notable exception is the United States, which applies the citizenship criterion as its main connecting factor for imposing taxation on a worldwide basis.

their territories, one could have the impression that by using both (i) the residence criterion to tax the worldwide income of residents and (ii) the source criterion to tax the income earned by nonresidents from sources within one's state territory, there would be no risk of losing tax revenue, even when there would be a change in the tax residence status of a taxpayer. This would be true, but for two situations: (i) the assets may be located outside of the states' territory, and (ii) tax treaty provisions may prevent source states from imposing taxes on nonresidents.

It is these drawbacks that the enactment of legislation providing for the levy of exit taxes intends to prevent. Thus, it may be argued that the main goal of an exit tax is to protect the tax revenue that would otherwise be collected had the taxpayer remained a tax resident of the former state of residence at the time of alienation.

## Imposition of Exit Taxes

**Which Types Are Covered?**

Although a different classification should not be impossible, it is likely that an exit tax is classified as a capital gains tax, especially because it generally applies to the *increase in value* of properties owned by a taxpayer immediately before or after emigration. Based on this, it is reasonable to assume that the provisions of article 13 OECD model (or its equivalent) should be taken into account when analyzing the effects of the application of a tax treaty on a contracting state's domestic exit tax legislation.

At first, it seems that article 13 OECD model would apply not only to immediate exit taxes, but also to capital gains taxes on former residents, since in both cases a capital gain arises (although more clearly in relation to the latter type of taxes). However, article 13 OECD model is the appropriate distributive rule to deal with only *capital gains taxes on former residents*. This is because, although according to the OECD commentaries article 13 OECD model applies "to all kinds of taxes levied by a contracting state on capital gains," its language as well as further paragraphs of the OECD commentaries indicate that it only applies to capital gains deriving from alienation transactions (something that only occurs in cases involving *capital gains taxes on former residents, not immediate exit taxes*). Article 13 OECD model is clear in this respect.

Even if the language of article 13 OECD model by itself was not enough to confirm the need for an alienation transaction in order for its provisions to apply, this is corroborated by the OECD commentaries (paragraph 9 OECD commentaries on article 13).[3] Despite the close relationship between actual capital gains (derived from alienation transactions) and deemed capital gains (derived solely from capital appreciation), it can be deduced from the OECD commentaries that they are not both covered by the same distributive rule.

It would not have been necessary to make reference to other articles of the OECD model (for example, articles 6, 7, and 21) to deal with capital appreciation gains if they were already covered by article 13 OECD model. Albeit not the main subject of his article, Michael Lang[4] has raised the same concern:

Although one might argue about whether *it is convincing to deal with capital appreciation in article 13, since there is no "alienation"* it is clear from the Commentary that taxes on capital appreciation are considered to be taxes on income, not taxes on capital, and can therefore fall under one of the distributive rules applicable to income. [Emphasis added.]

Of course one can try to argue that since there is no definition of alienation in the OECD model convention, the state that would apply the treaty would be free to give its own interpretation for the term under the provisions of article 3.2 OECD model (for example, by deeming transactions such as the act of emigrating to equate to an alienation transaction). However, three arguments oppose this approach. First, the term "alienation" has been commonly and similarly interpreted as meaning a transaction by reason of which the title or ownership of a property is transferred. Second, the OECD commentaries, when clarifying the meaning of alienation, made it clear that such meaning matches its common adopted meaning. Third, *and most important*, this seems to be a situation in which the context of the OECD model convention requires a common interpretation of the term, particularly not to allow contracting states to freely bring other types of income under the scope of article 13 OECD model.

Therefore, even if article 3.2 OECD model is called into context, it would not allow that domestic legislations stretch the meaning of alienation to encompass situations in which there is not a transfer of ownership. On the contrary, article 3.2 reinforces the argument that states cannot artificially abuse their leeway in providing definitions to terms not defined by the OECD model convention.

Article 13 OECD model, as it currently stands, is not the appropriate distributive rule to deal with immediate exit taxes, but only with capital gains taxes on former residents, since only the latter type of taxes apply to (capital) gains derived from alienation transactions. Also, because of the lack of a rule

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[3] ''9. Where *capital appreciation and revaluation of business assets are taxed*, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the article or lay down special rules. *The provisions of the article as well as those of articles 6, 7, and 21 seem to be sufficient.*'' (Emphasis added.)

[4] Michael Lang, "'Taxes Covered' – What is 'Tax' according to article 2 of the OECD model?" 59 *Bulletin for International Fiscal Documentation* 6, (2005), pp. 216-223, at 219.

to deal with (capital) gains derived from capital appreciation, it is the general rules applicable to each type of income as provided for by the OECD model convention (that is, articles 6 to article 21, except article 13) that will come into play.

With this assumption in mind, the following section looks at the effects article 13 OECD model has solely on *capital gains taxes on former residents* (that is, trailing taxes) and how countries are dealing with that on a tax treaty level. The analysis of the compatibility of immediate exit taxes with the OECD model convention and its related consequences are more complicated and will be carried on in a separate section.

**The Effects of Article 13**

As mentioned before, capital gains taxes on former residents are taxes levied on the effective and realized (capital) gains derived by a person by the state where such person was formerly a tax resident. The tax is charged in a moment following emigration and generally when the person is also considered a tax resident of another state (that is, the new state of residence).

The main problem relating to the imposition of a capital gains tax on former residents by states, particularly to those that use residence as the connecting factor for imposing worldwide taxation, is that after emigration there will be not only one state claiming the status of state of residence, but, generally, two states *simultaneously*. This is really a problem to the former state of residence if (i) the property is not located within its tax jurisdiction (to which source taxation could be imposed) or (ii) it has signed a tax treaty based on the OECD model with the new state of residence of the emigrating person. If it is assumed that the emigrating person has not kept close connections with the former state of residence, the application of the OECD model "tie-breaker rules" (that is, article 4.2 for individuals and article 4.3 for companies) will attribute the status of state of residence exclusively to the state where the person moved after emigration. Therefore, the application of these provisions coupled with article 13.5 OECD model will result in an obstacle for the former state of residence to tax any capital gains derived after emigration.

As a result, it is possible to conclude that unless the former state of residence reserves its right to tax former tax residents under its tax treaties, it would not be able to apply its capital gains tax on former residents as it has previously intended, at least in situations involving a state with which it has signed a tax treaty identical to the OECD model and when no source/situs connection is available.

Unlike what will be discussed in relation to immediate exit taxes, we have not found any scholar or tax practitioner supporting the position that the imposition of a capital gains tax on former residents would be effective even in the absence of any changes to the OECD model convention. This lack of support may be viewed as the cause for many of the states that have adopted a capital gains tax on former residents to have reserved their right to tax former tax residents in their bilateral tax treaties. An example of a tax treaty provision addressing this issue is presented in the next section.

**Overcoming the Concurrent Residence Issue**

The most common tax treaty provision dealing with capital gains tax on former residents can be found in, for example, the Canadian tax treaties. Articles 13.7 and 13.8 of the Canada-Netherlands tax treaty signed in 1986, as amended by the 1997 protocol, may serve as an example:

> 13.7. Gains from the alienation of any property other than that referred to in paragraphs 1,2,3 and 4, shall be taxable only in the state of which the alienator is a resident.
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> 13.8. The provisions of paragraph 7 shall not affect the right of either of the states to levy, according to its law, a tax on gains from the alienation of any property derived by an individual who is a resident of the other state and has been a resident of the first-mentioned state at any time during the six years immediately preceding the alienation of the property.

By introducing such a provision, both contracting states reserve their right to tax gains from the alienation of any property derived by an individual who is no longer one of its tax residents, on the condition that the alienation takes place during the first six years following emigration. Further, by reserving their right to tax such gains, they automatically deal with the problem of double taxation. In other words, by making it clear in their tax treaty that the gains “may be taxed” in the former state of residence, the states create an automatic obligation for the new state of residence to avoid double taxation of income by applying the provisions of article 23 OECD model.

**Final Remarks**

As demonstrated above, the imposition of a capital gains tax on former residents does not, as a rule, effectively work in the absence of amendments to the OECD model convention, especially because of the provisions of article 13.5 OECD model. Since there is no indication by both the articles of the OECD model convention and the OECD commentaries that past residence status should be taken into consideration, only current residence status matters. Therefore, even though gains may have accrued when a person was a resident of a contracting state, the provisions of article 13.5 OECD model attribute the exclusive right to tax to the contracting state where the alienator is currently a resident.

As will be discussed below, this is not the case for immediate exit taxes, especially because there is no *concurrent* claim by two different states for the status of state of residence. We have pointed out that article 13 OECD model is not the appropriate distributive rule to cover the taxation of appreciated gains. However, the analysis of the compatibility of immediate exit taxes with the OECD model convention will be carried on taking into account the provisions of article 13 (especially article 13.5) because of the following reasons:

– most authors who addressed this compatibility issue have made their analysis taking into account the provisions of article 13.5 OECD model;
– there is not a problem to carry on such an analysis taking into account the provisions of article 13.5 OECD model, because what matters for determining the compatibility of immediate exit taxes with the OECD model is not a specific provision itself, but that some types of income, generally those to which immediate exit taxes apply, are subject to an exclusive regime of taxation;[5] and
– the analysis of article 13.5 OECD model is interesting insofar as it brings an additional element used by authors against the imposition of immediate exit taxes (the fact that only realized gains should be subject to taxation).

## The Immediate Exit Tax

### Overriding the OECD Model Convention

The main argument raised by authors who believe that the imposition of immediate exit taxes is incompatible with article 13.5 OECD model is that the provision reserves the exclusive right to tax to the state where the alienator is a resident. Because the alienation will take place at the moment when the person owning the property is a resident of the other contracting state (that is, the new state of residence), only this state would have the right to tax the gains derived. As a consequence, the taxation of the appreciated gains by the state where the owner of the property is a resident at the moment of emigration frustrates the exclusive right to tax attributed to the state where the owner will become a resident and would constitute an override of the tax treaty signed between the two involved states.

*The imposition of immediate exit taxes will likely not be interpreted as constituting a tax treaty override.*

However, the imposition of immediate exit taxes will likely not be interpreted as constituting a tax treaty override, even if introduced after the signing of a tax treaty. First, it is important to stress that the author does not follow the line of reasoning submitted by some other authors that immediate exit taxes are incompatible because at the moment they are imposed (for example, immediately before emigration) there is not a cross-border situation and,

[5] This means that the analysis of the compatibility of immediate exit taxes with the OECD model could be carried on by taking into account any one of the provisions granting an exclusive taxation right to the state of residence; for example, paragraph 1 of article 7 (when there is no permanent establishment involved), paragraph 5 of article 13, and paragraph 1 of article 21.

therefore, a tax treaty is not applicable. As provided by article 1 OECD model, the "convention shall apply to persons who are residents of one or both of the contracting states." Thus, it is enough that a person is a resident of the contracting state imposing the immediate exit tax to make all the tax treaties signed by this state applicable to him. Consequently, it is not technically correct to sustain that an immediate exit tax is compatible with the tax treaties signed by a contracting state because its tax treaties are not applicable when the tax is assessed or imposed. What is the reason then for arguing that they are not incompatible?

Taking into account that virtually all authors who concluded that immediate exit taxes are not in line with the OECD model underpin their view on the basis that their imposition would constitute a treaty override, this article states that it is important to refer to the conclusions drawn by the OECD on its report on the subject of treaty overrides.[6]

The term "treaty override", according to the OECD report, "refers to a situation where the domestic legislation of a state overrules provisions of either a single treaty or all treaties hitherto having had effect in that state.'' Two examples given by the Committee on Fiscal Affairs help to illustrate this assertion. The first example, although much too theoretical, illustrates a treaty override. It consists of a state enacting new legislation requiring its residents to withhold taxes on all interest or royalties paid abroad, notwithstanding its tax treaty obligations to ensure an exemption to such payments.

The second example is more elaborated and related to the subject under analysis. It depicts a situation when a state, which taxes capital gains derived from the sale of immovable property, decides unilaterally to enact legislation deeming the sale of shares in any real estate company as a sale of immovable property for the purpose of the application of its tax treaties. The objective of this state is clear-cut. It intends to avoid situations when taxpayers resident in another state make use of intermediary companies to acquire immovable property situated in that state and at the time of alienation take advantage of the provisions of article 13.5 OECD model to prevent the latter state from taxing the capital gain derived from the sale of the shares of the real estate company (no longer the sale of the immovable property).

The OECD report stresses that this type of legislation is in contravention with a state's tax treaty obligations even if the overriding measure is clearly designed to put an end to the improper use of its tax treaties.[7]

Despite what one could have expected, the analysis of the OECD report does not provide a straightforward answer as to whether the imposition of immediate exit taxes constitutes a treaty override, especially because the

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6 OECD Committee on Fiscal Affairs Report on Tax Treaty Overrides, 1989.

7 It is questionable that this conclusion is still valid today in light of the significant changes introduced in 2003 to article 1 of the OECD commentaries, "Improper use of the convention".

examples above do not cover situations involving immediate exit taxes. Further, it is not an easy task to find out if the conclusion reached by the OECD for the case described above can be analogically applied to the case of immediate exit taxes.

However, a closer analysis of the second example given by the OECD on its report on tax treaty overrides may be a good starting point for trying to solve the issue. According to the conclusions drawn by the OECD, it would not be possible for a contracting state, in order to escape from the application of article 13.5 OECD model, to change its domestic tax legislation and provide that gains derived from the sale of shares of "real property companies'' be considered as gains derived from the sale of immovable property. Thus, the question is why the changing of the domestic legislation of a contracting state to impose an immediate exit tax should be treated differently from the changing in the domestic legislation depicted by the second example of the OECD report on tax treaty overrides, particularly considering that the new law imposing an exit tax is, to some extent, also enacted to escape from the application of article 13.5 OECD model.

The decisive factor is that in the example given by the OECD report, the enactment of the new legislation by one contracting state immediately affects persons that are residents of the other contracting state, that is, persons who can claim the application of article 13.5 before the enactment of the new legislation. In other words, the sole enactment of the new legislation is sufficient to convert an exclusive right to tax attributed to the state of residence into a shared right with the state of source. As a result, the state of residence is no longer granted the exclusive right to tax the income derived from the sale of shares. On the other hand, as far as immediate exit taxes are concerned, the enactment of the new legislation only affects persons who are still residents of the state levying the tax. There is not an immediate change in the allocation of taxing rights (for example, persons who are residents of the other state will not be subject to an immediate exit tax). No state is being deprived of its right to tax.

Hence, even if one tries to apply article 13.5 OECD model (or article 7 or article 21), the exclusive right to tax would still be of the state imposing the immediate exit tax. The fact that the person will become a tax resident of a new state does not affect his residence status at the moment the immediate exit tax is assessed. The only way for a person to claim that he is a tax resident of the new state for purposes of applying a tax treaty is by arguing that future events should have to be taken into consideration when the immediate exit tax is enacted, but this is something that has no legal basis and would be too far-reaching.

Consequently, there is no basis for submitting that the enactment of an immediate exit tax constitutes a tax treaty override, even on the basis that this would be against the allocation of taxing rights defined by treaty negotiators at the time a tax treaty was concluded. The fact that a state has decided to tax the appreciated gains derived by its residents immediately before emigration cannot be seen as a breach of its tax treaty obligations; otherwise, the same conclusion should be reached if the state simply had decided to use the accrual system of taxation for taxing capital gains. Depriving a state from choosing its method of taxation is not something that is within the scope of the OECD model convention. This is explicit in the OECD commentaries[8] when it states, “It is left to the domestic law of each contracting state to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed”. The emigration is just the moment used to determine the amount of gain subject to tax, as it could have been the last day of each month.

**Taxing Unrealized Gains**

Another argument used by some authors to reject the imposition of immediate exit taxes is that article 13 OECD model forbids that unrealized gains be subject to taxation. Some authors try to build an argument on using the term “alienation” to sustain that only transactions that result in an alienation of property could be subject to tax, as if article 13 OECD model would impose a restriction on states that intend to tax capital gains that are not derived from alienation transactions.

There is nothing in article 13 OECD model that would impede a contracting state from taxing unrealized gains or gains that do not derive from an alienation transaction. On the contrary, the OECD commentaries[9] elucidate that there are generally three moments when capital gains are taxed: (i) when an alienation of a property takes place, (ii) when there is a realization of the property, and (iii) when there is a capital appreciation of property.

As previously mentioned, the function of article 13 OECD model is to regulate the attribution of taxing rights between two contracting states when there is a (capital) gain or loss derived from an alienation transaction, and not to impose restrictions when there is not. In order for article 13 to be construed as prohibiting a contracting state from taxing gains that are not derived from an alienation transaction, its language should have been structured differently; for example, like the language in article 7.1 OECD model. In article 7.1a threshold is established (that is, the permanent establishment threshold), and it is only after this threshold is met that the contracting state in which the business of a resident of the other contracting state is carried on acquires taxation rights. There is not a limit or prohibition in article 13 OECD model.

Consequently, it is also without basis that some authors use the realization or even the alienation requirement as a condition for (capital) gains to be subject to taxation under article 13 OECD model.

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8 Para. 2, OECD commentaries on article 13.

9 Paras. 6, 7 and 9, first sentence, OECD commentaries on article 13.

**Double Taxation Potential**

A real problem deriving from the imposition of an immediate exit tax, which has been taken as contrary to the main object and purpose of a tax treaty, is the great risk of the occurrence of double taxation of income.

Based on article 13.5 OECD model, it is the contracting state where the alienator is a resident at the time of the alienation (that is, the new state of residence) that will have the exclusive right to tax the gain derived from the effective alienation of the property. Therefore, if this state does not take into account, under its domestic legislation, the immediate exit tax already assessed and paid on the appreciated gain of the same property when applying its capital gains tax, double taxation will certainly arise. The following example can clarify the issue:

Imagine a taxpayer resident in country A that owns shares of a company also resident in country A. The shares were acquired in year 1 for €100. In year 2, when the fair market value of the shares is €150, the taxpayer emigrates from country A to country B (assume that this country does not provide for any form of relief for the taxation in country A). If country A applies an immediate exit tax, it will tax the difference between the fair market value of the shares and their cost of acquisition (€50) right before emigration. However, if in year 3, when the fair market value of the shares is still €150, the taxpayer decides to effectively sell the shares, there is a great chance that country B will tax the same gain that was previously taxed by country A (if the domestic legislation of country B so provides), even if a tax treaty following the OECD model has been signed by the involved countries. This is because country B would have a legitimate right to tax the above-mentioned capital gain under the provisions of article 13.5 of the A-B tax treaty, since it is the state where, at the moment of the alienation of the shares, the alienator is a resident.

**Double Nontaxation Potential**

However, the lack of the levy of an immediate exit tax can also give rise to double nontaxation of income. For this to occur, it is only necessary that the state where the person owning the property is a resident does not impose taxes on capital gains. Some European countries (such as the Netherlands and Belgium) that apply the participation exemption regime do not generally tax capital gains.

Also, cases of double nontaxation are not only a consequence of fortune. There are several cases when the decisive criterion to select the jurisdiction to fix residence is the tax treatment available for capital gains, together with climate, security, and economic conditions as the other relevant criteria. Therefore, the cases of double nontaxation of capital gains are augmented by the possibility of a person choosing beforehand to which state he wants to emigrate.

Another important factor that should be taken into consideration is even if the new state of residence imposes capital gains taxation, double taxation will only arise if it takes the original cost of acquisition of the property as the parameter to assess the taxable capital gain. If, however, the new state of residence has an immigration step-up mechanism, whereby the person gets a step-up in basis of the property at the time of immigration based on a market valuation (as in the Netherlands and Canada) or applies the ordinary credit method even for immediate exit tax (as in the United Kingdom), only the additional gain accrued after immigration would be subject to tax.

**Final Remarks**

Some authors question the underlying source of double taxation and put forward the query as to whether the cause of double taxation is (i) the levy of the immediate exit tax by the former state of residence or (ii) the lack of a rebasing or a method to relieve double taxation by the new state of residence.[10]

The examples provided above illustrate and confirm that the combination of article 13.5 OECD model (or articles 7 or 21 OECD model) and the lack of imposition of immediate exit taxes may lead to double non-taxation of income, while the combination of the levy of immediate exit taxes and the lack of appropriate relief for taxation of appreciated gains may lead to double taxation of income. Unlike the previous sections, where there was room for a debate, there is no divergence of opinion regarding the high risk of occurrence of double taxation or double nontaxation of income if the current scenario remains unaltered.

The OECD identified this issue when it addressed the problem of multiple residence taxation verified in cases of employee stock option plans. The similarities of the risks of double taxation resulting from the taxation of appreciated gains in the event of emigration and the risks of multiple taxation of gains earned by employees with stock options were described by the OECD in its report on cross-border issues related to employee stock options[11] as follows:

> 37. While the preceding comments have focused primarily on residence-source issues, situations where the benefits from employee stock-options are subject to tax in more than one state do not arise only, and maybe not primarily, because of the source and residence taxation of stock-options. Where an employee who is a resident of one state is taxed as a non-resident in another state, article 23 provides relief from any double taxation. *However, an employee might reside in different countries at the time an option is granted, the time it vests, the time it is exercised and the*

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[10] J.W.J. de Kort, "Levy upon Emigration of a Substantial Participation Holder: An Infringement of Article 13 of the OECD Model Convention?" 31 *Intertax* 3 (2003), pp. 102-106, at p. 105.

[11] OECD Committee on Fiscal Affairs report, "Cross-border income tax issues arising from employee stock-option plans", June 16, 2004.

*time the shares acquired with the option are sold.* All of these countries may claim the right to tax as *states of residence* and if each of them has a system that taxes the benefit from the stock-option at the time the taxpayer is a resident of that country, there will be multiple residence taxation. *While article 23 deals with residence-source double taxation, it does not provide relief for all cases of residence-residence double taxation. The risks of multiple residence taxation may be compounded in the case of countries that have a "departure tax" on capital gains*, that is countries that deem capital gains to be realised when a person ceases to be a resident or that maintain, through their tax conventions, a right to tax capital gains of former residents. [Emphasis added.]

As a result of this report, the OECD decided to amend the OECD commentaries on article 23[12] to try to solve, at least partially, the risk of double or multiple taxation of gains derived from employee stock option plans. The idea behind the OECD commentaries is to transform a conflict of residence-residence *nonconcurrent* taxation (which is not solved by the OECD model convention) into a regular conflict of source-residence taxation. However, the drawback of the solution envisaged by the OECD, which is even recognized in the OECD commentaries, is that it does not satisfactorily solve the problem when there is a triangular situation. In this case, the OECD commentaries suggest that the two states claiming taxation as state of residence use the mutual agreement procedure to solve the issue. The OECD commentaries go further to propose that a possible basis for solving the issue would be for the competent authorities of the two states to agree that each state should provide relief regarding the residence-based tax that was levied by the other state on the part of the benefit that relates to the period during which the employee was a resident of that other state.

Although nothing was mentioned in the new OECD commentaries in relation to the risk of double taxation arising from the levy of immediate exit taxes, the reasoning in them could be applied to such cases. However, two problems could be raised in this respect: first, the reasoning applied by the OECD to stock option gains does not smoothly derive from the language of the OECD model; and second, even if this could be taken as unquestionable, nothing was mentioned regarding the cases when immediate exit taxes are levied. This may be why states have already tried to deal with this problem in their bilateral tax treaties.

It is imperative that a solution be developed to reduce the risk of double taxation of income, particularly in light of (i) the current trend followed by states of introducing immediate exit taxes as part of their tax system and (ii) the increasing global mobility of taxpayers.

[12] Paras. 4.1-4.3, OECD commentaries on article 23.

## Conclusion and Recommendations

### Important Principles

It was demonstrated above that because a state decides to levy an immediate exit tax on the appreciated gains embedded in properties owned by its tax residents and elects the moment immediately before emigration of its tax residents to assess the amount of tax due does not characterize *per se* a breach of its tax treaty obligations. However, this right to tax is not unrestricted and will not be used to frustrate the right of other states to exercise their concurrent right to tax. For example, if a contracting state decides to levy an immediate exit tax on properties that the other contracting states has the primary right to tax, such taxation should take into consideration the tax that would have been levied by the other state had this latter state also considered the emigration/immigration as a taxable event. In other words, the levy of the immediate exit tax must be carried out in compliance with the same allocation of taxing rights and methods to relieve double taxation already established by the OECD model convention. This is in line with the rule in article 23 OECD model that a state will provide relief for double taxation if one of its residents derives income that, in accordance with the provisions of the convention, “may be taxed” in the other state.[13]

These concepts are fundamental for the designing of the appropriate method to relieve double taxation as far as immediate exit taxes are concerned. Nevertheless, a policy decision will be made before a conclusion on the appropriate method is achieved, and this will depend on the answer to the following question: Is double taxation a result of the levy of immediate exit taxes by the former state of residence or a consequence of the lack of relief to be given by the new state of residence? This question is political. It cannot be solved by simply applying methods of interpretation to both the OECD model convention and the OECD commentaries.

However, there are aspects that may put more weight on one side of the argument. One could argue, for instance, that it is reasonable to pick the lack of a method to relieve double taxation in the new state of residence as the cause for double taxation when the property is situated in the state levying the immediate exit tax. However, one can argue that if the property is situated in the new state of residence it is then the levy of the immediate exit tax, without regard to the primary right to tax of the state of situs, the cause for double taxation. The most difficult situation is verified when the property is situated neither in the former nor in the new state of residence, but in a third state (that is, a triangular situation). Because there is no correct answer, it seems suitable to apply logic similar to that used by the OECD

[13] According to paragraph 32.8 OECD commentaries on article 23, “such relief must be provided regardless of when the tax is levied by the state of source. The state of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the state of source taxes it in an earlier or later year”.

regarding the taxation of gains derived by employees from stock options. According to this logic, both states would have the right to tax the appreciated or realized gain, but limited to the extent of the value accumulated during the period when the owner was a resident of that state. Look at the following example:

Assume a person resident in state A owns shares of a company situated in state C, the cost of acquisition of which is €100. Imagine that this person decides to emigrate to state B, that state A levies an immediate exit tax, and that the market value of the shares just before emigration is €150. Finally, assume that two years after emigration, when the person is already a tax resident of state B (and no longer a resident of state A), the shares are alienated for €180 and that state B taxes capital gains as part of its taxation system.

If the states involved in this example had signed tax treaties among themselves identical to the OECD model, but which had been adapted to comply with the principles and concepts delineated above, the consequences of the above-described events would be as follows:

- On emigration, state A would have the right to tax the appreciated gain embedded in the shares up to the moment of emigration (€50), based on articles 7 or 21 of both the tax treaties signed with states B and C.[14]
- On alienation of the shares, state B would have the exclusive right to tax the total gains derived from the alienation transaction (€80), based on article 13.5 of both the tax treaties signed with states A and C.
- State B would have to exempt the appreciated gain of €50 or give a credit for the immediate exit tax levied on such gain in state A, as this gain corresponds to the part of the total gain derived while the person was still a resident of state A. The exemption or credit would be based on article 23 of the A-B tax treaty.

This same reasoning works when the appreciated gain stems from a property in which the right to tax must be shared by the state of residence and the state of source/situs. Take the same example described above, but instead of assuming that the person owns shares of a company, assume that

[14] One could argue that article 10 of the A-C treaty could apply in this case, since the income subject to tax derives from the appreciation in value of shares and this could be assimilated to dividends. However, the author believes that article 10 OECD model is not applicable to this situation since there is no payment or distribution being made by the company to its shareholder (as is required by article 10.1 OECD model). Also, it is not because the individual has moved from one contracting state to the other (for example, from A to B) that the contracting state where the company is situated will lose the right to tax the dividends under article 10 OECD model at the moment they are effectively paid to a resident of the other contracting state. Finally, even considering that the new state of residence (state B) will be obliged to provide relief for the immediate exit tax paid in the former state of residence (state A) and to the tax paid in the state where the company is situated (state C) when the dividends are distributed, this result is not different than the one that would have been verified if a resident of state B had effectively bought the shares from a resident of state A (unless state B would not provide for a step-up in basis of the acquired shares).

he owns an immovable property situated in state C. Further, assume that state C taxes only realized capital gains. If the states involved were again to follow the principles and concepts delineated above, including that the primary right to tax of the source/situs state should be respected by the state imposing the immediate exit tax, the following consequences would arise:

– State A would have the right to tax the appreciated gain embedded in the immovable property up to the moment of emigration (€50). However, because the primary right to tax the income deriving from immovable property is of state C (based on article 6 of the A-C tax treaty), state A would have to exempt the appreciated gain from tax or give a credit against its own immediate exit tax for the tax that would have been levied by state C. Further, by applying article 7 or 21 of the A-B tax treaty, state A would prevent state B from any right to tax the appreciated gain.

– On alienation of the immovable property, state B would apply the same reasoning applied by state A and would tax the actual capital gain (€80). However, it would have to exempt the income or give a credit for the capital gains tax effectively charged by state C (based on articles 13.1 and 23 of the B-C tax treaty).

– State B would also be obliged to exempt the part of the gain that derived until the moment the person was a resident of state A or give a credit for the immediate exit tax levied on such gain (that is, the appreciated gain of €50). The exemption or credit would be based on article 23 of the A-B tax treaty.

If we assume that state A taxes appreciated gains at a rate of 20 per cent, that state B taxes actual capital gains at a rate of 30 per cent, that state C taxes actual capital gains at a rate of 10 per cent, and for the sake of simplicity, that all states apply the ordinary tax credit method to avoid double taxation, the numerical result of this last example would be the following:

– State A would tax the appreciated gain at a rate of 20 per cent: €50 x 20% = €10. However, state A would have to give a credit for the tax that would have been levied by state C: €50 x 10% = €5. Therefore, state A would collect €5 in taxes.

– State B would tax the actual capital gain at a rate of 30 per cent: €80 x 30% = €24. However, state B would have to give a credit for the tax that was effectively levied by state C: €80 x 10% = €8. Also, state B would have to give a credit for the immediate exit tax levied by state A (€5). There fore, state B would collect €11 in taxes (€24 - €8 - €5).

With these concepts in mind we propose amendments to the OECD model convention and OECD commentaries. The proposed language has the principal purpose of making it clear that the taxation of appreciated gains is not incompatible with the OECD model convention and that double taxation is prevented. The amendments will also address the situations when capital gains taxes on former residents are levied. Obviously, the proposed changes are general and may be restricted or tailored by the states during tax treaty negotiations.

Because of the close relationship between appreciated gains and actual gains and in order to keep a consistent tax treatment for both types of gains, the appropriate article to be amended is article 13 OECD model.

Article 23 OECD model would also be amended to accommodate the obligation of the new state of residence to provide relief for the immediate exit tax already levied in the former state of residence, even considering that the new state of residence would have an exclusive right to tax the gains derived from the alienation of the property. Finally, the author adopted the ordinary credit method to relieve juridical double taxation, as opposed to the exemption method,[15] because not all states effectively impose exit taxes and if the exemption method is used, double nontaxation of income could arise.[16] Further, amendments to the OECD commentaries on article 13 OECD model and to article 23 OECD model were suggested with the sole purpose of clarifying the concepts described above.

The author acknowledges, however, that the adoption of the proposed changes to article 13 OECD model and article 23 A and 23 B OECD model must be accompanied by a thorough review and adaptation of all the relevant OECD commentaries, especially those addressing the amended articles. This adaptation process is outside of the scope of this article, especially because it is not essential for the comprehension of the proposed changes.

**Proposed Language — Article 13**

Two new paragraphs will be added to article 13 OECD model. Paragraphs 6 and 7 will be worded as follows, with the new proposed language in italics:

> Article 13
>
> Capital Gains
>
> 5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, and 4, shall be taxable only in the contracting state of which the alienator is a resident.
>
> *6. The provisions of paragraph 5 shall not affect the right of either of the states to levy, according to its law, a tax on gains from the alienation of any property derived by a person who is a resident of the other state and has been a resident of the first-mentioned state at any time during the five years immediately preceding the alienation of the property.*

15 The author also preferred to use the ordinary credit method instead of the step-up mechanism because it is more commonly applied and consequently has been tested for a longer period of time.

16 If, due to administrative reasons, a state decides to keep the exemption method as its preferred method to avoid double taxation, it will not be opposed.

*7. The provisions of the preceding paragraphs shall not affect the right of either of the states to levy, according to its law, a tax on gains from the appreciation in value of any property derived by a person who is a resident of that state. Such taxation shall be carried out following the same attribution of taxing rights referred to in paragraphs 1, 2, 3, 4, and 5.*

**Proposed Amendments**

*Inclusion of a new section: the "paragraph 6" section and inclusion of paragraph 33.*

33. Paragraph 6 is an exception to paragraph 5. It allows the state where a person was formerly a resident to levy a tax on the gains derived by such person from the alienation of any property, even considering that the person is no longer a resident of that state when the alienation of the property is carried out. However, this tax can only be imposed if the alienation of the property takes place not later than five years after the person has lost the condition of a resident of the state imposing the tax. After this period has elapsed, the provision of paragraph 5 becomes applicable and only the state where the person is currently a resident may subject the gains to tax.

*Inclusion of a new section: the "paragraph 7" section and inclusion of paragraphs 34 and 35.*

34. By providing that the provisions of the preceding paragraphs shall not affect the right of either of the states to levy, according to its law, a tax on gains from the appreciation in value of any property derived by a person who is a resident of that state, paragraph 7 makes clear that the taxation of "capital appreciation" is not in disagreement with the provisions of the convention. This paragraph addresses, for example, the situations when contracting states levy a tax on the accrued gains derived by persons who cease to be their residents, even if the gains were not yet realized (the so-called exit or departure taxes).

35. The paragraph, however, restricts the right of the state to levy this tax to the period during which the person deriving the appreciation gains is still a resident of that state (the postponement or deferral of the effective collection of the tax is not relevant and does not affect the right of that state to impose taxation). Accordingly, it is not possible for that state to tax gains derived from the appreciation in value of a property that accrued after the person has become a resident of the other state. This is why the verb indicating the residence status is in the present tense (that is, "is a resident"). The only exception to this rule is if the property is situated in the state imposing the tax, since in this case the prior right to tax the referred property belongs to such state. Therefore, solely in this situation, the state is allowed to tax not only the appreciation in value

accrued until the person becomes a resident of the other state, but also the effective and entire gain derived from the alienation of the property.

**Proposed Language — Article 23**

Article 23 A and B shall be amended as follows, with the new proposed language in italics:

Article 23 A. Exemption Method

2. When a resident of a contracting state derives items of income which, in accordance with the provisions of articles 10, 11, *and paragraph 6 of article 13, may be taxed in the other contracting state, or in accordance with the provisions of paragraph 7 of article 13 has been taxed in the other contracting state*, the first-mentioned state shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other state. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other state.

Article 23 B. Credit Method

1. When a resident of a contracting state derives income or owns capital which, in accordance with the provisions of this convention, may be taxed in the other contracting state, *or in accordance with the provisions of paragraph 7 of article 13 has been taxed in the other contracting state*, the first-mentioned state shall allow:

a. as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other state;

**Proposed Amendments**

*Amendments to the paragraphs of "The Scope of the Articles" section and inclusion of new paragraphs 4.4 and 4.5.*

4.4 Another example of a case not solved by article 4 is when countries have a departure or exit tax levied on capital appreciated gains, that is, when countries deem capital gains to be realized or when countries tax gains derived from the appreciation in value of properties when a person ceases to be its resident, even if the gains have not yet been realized.

4.5 This problem, however, has been particularly dealt with in paragraph 7 of article 13 and in paragraph 2 of article 23 A and paragraph 1 of article 23 B. In these situations, the state claiming full liability to tax the gains derived from the alienation of any property must give a credit for the tax that has been levied in the other state on the same gain, even considering that at that point in time and under some circumstances, the exclusive right to tax is conferred to the first-mentioned state.

*Inclusion of new paragraph 48.1 to the "paragraph 2"section of article 23 A (exemption method).*

> 48.1 Paragraph 2 also provides for two other exceptions to the application of the exemption method. The state of residence shall apply the credit method for items of income that may be taxed in the other contracting state under the provisions of paragraphs 6 and 7 of article 13. These are not cases of conflict of residence-source taxation, but special cases when the other contracting state by having been the state of residence may still tax some types of income derived by a person who is currently a resident of the first-mentioned state and the cases when the other contracting state have subjected the person to a tax on the appreciation in value of his properties while the person was one of its residents.

*Amendments to the paragraphs of "paragraph 1" section of article 23 B, with the new proposed language in italics.*

> 57. Article 23 B, based on the credit principle, follows the ordinary credit method: the state of residence (R) allows, as a deduction from its own tax on the income or capital of its resident, an amount equal to the tax paid in the other state E (or S or the state where the person was formerly a resident in the cases provided for in paragraphs 6 and 7 of article 13) on the income derived from or subject to tax in, or on capital owned in, that other state, but the deduction is restricted to the appropriate proportion of its own tax.

**Final Remarks**

Any time the OECD model convention is amended, it takes years until the current tax treaties are renegotiated and the amendments are finally adopted. However, the proposed amendments are the only effective solution to deal with the problems created by the increasing number of states that are adopting exit taxes as part of their tax system. A suggestion to make the renegotiation process less burdensome was given by the panel members of the joint IFA/OECD Seminar (Seminar F: The OECD Model Convention — 2002 and Beyond) at the 2002 IFA Congress in Oslo, and could be considered for this case. It consisted of states adopting single-issue protocols on topics agreed to by Working Party 1 without raising other treaty issues. According to the panelists, if all OECD countries adopted this procedure, most cases would quickly be covered by the proposed amendments.[17] Therefore, it is a matter for the Working Party 1 to give its view on these proposed amendments.

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[17] Catherine Bobbett and John F. Avery Jones, "Tax Treaty Issues relating to Cross-Border Employee Stock Options", 57 *Bulletin for International Fiscal Documentation* 1 (2003), pp. 4-8, at p. 7.

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