



Exit Taxes in the Context of Double Tax Treaties: Is the Individual Emigrating from South Africa Protected Against Double Taxation?

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Abstract

For some countries, such as South Africa, a change of residence to another jurisdiction is a taxable event and may give rise to taxation of capital gains, based on a deemed disposal, even though there has not been an actual realisation of the capital gain. Such taxation is referred to as 'exit or departure tax' or 'exit charge'.

Double taxation of capital gains may arise when the former State of residence applies such an exit tax at the time when the taxpayer ceases to be a tax resident of that State, and when the new State of residence, thereafter, taxes the capital gain at the time of the actual disposal of the asset and realisation of the capital gain. A South African resident individual who emigrates, is therefore exposed to the risk of such double taxation. Double tax treaties following the OECD Model Convention aim at avoiding double taxation and provide distributive rules regarding capital gains in Article 13.

This study examines if double tax treaties protect the individual emigrating from South Africa against the application of South Africa's exit tax. Typical assets considered in the study are shares in a company, held as an investment. The analysis begins with an overview of the applicable rules of the South African Income Tax Act in respect of the capital gains tax levied when a South African resident individual emigrates and ceases to be a resident of South Africa. It then distinguishes between exit taxes in the strict sense (taxation of the accrued value at the time of emigration) and trailing taxes (extended tax jurisdiction, taxing the capital gains at the time of realisation after the emigration). The analysis then concentrates on four sub-questions, *i.e.* (i) whether Art. 13(5) of the OECD Model Convention (2017) applies to exit taxes, (ii) whether Art. 13(5) of the OECD Model precludes the application of an exit tax, (iii) to what extent double tax treaties are able to mitigate the risk of double taxation in the case of exit taxes, and (iv) whether the tax treaty network of South Africa provides any protection against double taxation caused by the application of the South African exit tax.

It was concluded that it is generally accepted, with the exception of a minority of authors, that the distributive rule of Art. 13(5) OECD Model includes capital gains arising from a deemed alienation and that that article does not preclude the former State of residence from applying its exit tax at the time when the person is still a resident of that State. However, Art. 13(5) OECD Model does preclude the application of trailing taxes after the person ceases to be a resident. In order to allow the application of trailing taxes, double tax treaties need to explicitly provide for this in a specific clause in the capital gains-article of the tax treaty. The exclusive allocation of taxing rights in art. 13(5) OECD Model in favour of the State of residence does not mitigate the risk of double taxation in the case of exit taxes in the strict sense. In order to avoid double taxation of that portion of the capital gain that already has been subjected to an exit tax in the strict sense, double tax treaties need to include a specific clause in the capital gains-article of the tax treaty, which obliges the new State of residence, when taxing the capital gain at the moment of realisation, to take into account the value that was subjected to the exit tax (step-up in the base cost). South Africa concluded only two treaties which provide for such a step-up in the base cost, one of which has not yet entered into force. This leaves the individual South African resident who emigrates, largely unprotected against double taxation of capital gains at a tax treaty level. It is recommended that South Africa include such specific clauses that provide for a step-up in the base cost in more tax treaties, especially in tax treaties with countries that do not already grant a step-up in terms of their domestic tax laws.

List of Abbreviations

BEPS	Base Erosion and Profit Shifting
CGT	Capital Gains Tax
DTC	Double Tax Convention
DTT	Double Tax Treaty
ECJ	European Court of Justice
EU	European Union
ITA	Income Tax Act 58 of 1962
OECD	Organisation for Economic Co-operation and Development
OECD Model	The OECD Model Convention
SA	Republic of South Africa
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
TAA	Tax Administration Act 28 of 2011

Chapter 1 - Introduction and Scope of the Analysis

1.1 Introduction - Context of the Issue

In this global and mobile day and age people relocate their residence from one country to another for various reasons. In past years, an increasing number of South African residents emigrated to other countries¹. Such change of residence has an impact on the tax status of the individual in the State of the original residence as well as in the State of the new residence. In residence-based tax systems, which is the norm in member states of the Organisation for Economic Co-operation and Development ('OECD') and which is the system applied in South Africa from the years of assessment commencing on or after 1 January 2001, a tax resident of a State is liable to tax in that State on his worldwide income and assets². In case of a change of residence to another jurisdiction ('emigration') the person ceases to be a tax resident of the former State of residence and is no longer liable to tax on his worldwide income in that State, which then becomes a State of source.

As capital gains are in principle taxed at the moment when they are realised, the former State of residence loses the possibility to tax the capital gains of movable assets held by an individual after his emigration. Therefore, in some countries the change of residence to another jurisdiction is a taxable event and may give rise to the taxation of capital gains, even though there has not been an actual realisation of the capital gain. Such taxation is referred to as exit or departure tax or exit charge.

Double taxation of capital gains may arise in the context of a change of residence of a taxpayer when the former State of residence taxes the unrealised increase in value of the asset based on a deemed disposal at the moment when the taxpayer ceases to be a tax resident of that State, and when the new State of residence, thereafter, taxes the capital gain at the actual disposal of the asset and the realisation of the capital gain. Several factors contribute to the risk of such double taxation, such as the differences in the domestic tax systems regarding capital gains, especially concerning the taxable event (deemed *versus* actual disposal), the moment when the exit tax charge arises (usually the day before the taxpayer ceases to be a tax resident) and the determination of the capital gain itself by the new State of residence (step-up in value of the base cost at the moment of immigration *versus* historical acquisition cost). Also, the realisation of a capital loss in the new State of residence has no impact on the exit tax paid in the former State of residence.

Even though the domestic tax law of some countries may contain provisions providing for a (unilateral) relief of double taxation of the capital gain, for example in that it only takes into account the gain accrued during the time that the taxpayer was a resident of that

¹ Newspapers regularly mention the increase in the numbers of South Africans emigrating. Here are some examples: <<https://www.businesslive.co.za/fm/features/cover-story/2018-08-16-wheres-everyone-going-behind-sas-skills-exodus/>>; <<https://businesstech.co.za/news/wealth/267845/4-real-facts-about-emigration-in-south-africa/>>

² Revenue Laws Amendment Act 59 of 2000, Government Gazette 21848, 6 December 2000.

country, the disparities between the different domestic tax systems means the risk of double taxation remains.

For South African income tax purposes the cessation of being a resident of South Africa, as a result of emigration, is a taxable event which triggers capital gains tax on the accrued value of the resident's world-wide assets. Not only does this exit tax cause a cash-flow problem as the exit tax is charged and payable at the moment of the emigration, but the emigrating individual risks being taxed a second time on the capital gains realised at the actual disposal of the asset in the new State of residence.

1.2 Scope of this Study

This study will examine whether double tax treaties preclude South Africa, as the former State of residence, from applying its exit tax and the extent to which double tax treaties provide any relief from the risk of double taxation of capital gains, in the event an exit tax has been levied by the former State of residence. These questions will be addressed from the perspective of an individual resident of South Africa, who changes his residence to another jurisdiction and who ceases to be a resident of South Africa.

Double tax treaties ('DTTs') following the OECD Model Convention ('OECD Model') aim at avoiding double taxation and provide for distributive rules regarding capital gains in Article 13³. Yet this article, in the Model Convention, does not address the consequences of a change of residence on the allocation of taxing rights nor does it remedy the double taxation issues in case the former State of residence applies an exit tax, which taxes the unrealised capital gains or capital appreciation which have accrued to the date the person ceases to be a resident.

This study will give an overview of the applicable rules of the South African Income Tax Act in respect of the capital gains tax, when a South African resident individual emigrates to another country and ceases to be a resident of South Africa.

The study will further examine exit taxes in the context of double tax treaties, more specifically exit taxes imposed on the increase in value of movable assets owned by an individual, which fall within the scope of Article 13(5) OECD Model – version 2017. Typical assets to be considered will be shares in a company, held as an investment.

The main research question is:

Do double tax treaties protect the individual, who is emigrating from South Africa, against the application of South Africa's exit tax and against double taxation of capital gains caused by the application of the South African exit tax?

The following sub-questions will be addressed:

- Does Art. 13(5) of the OECD Model apply to exit taxes?

³ As most of the South African Double Tax treaties and the treaties of other countries mentioned in this study follow the OECD Model Convention, the rules of the United Nations Model will therefore not be addressed.

- Does Art. 13(5) of the OECD Model preclude the application of an exit tax?
- To what extent are double tax treaties able to mitigate the risk of double taxation in case of exit taxes?
- Do the double tax treaties concluded by South Africa provide any protection against double taxation caused by the application of the South African exit tax?

Although the author briefly refers to loss situations, it is not dealt with in great detail. It is, however, noted that excessive taxes can result from such a situation.

This study will not address any issues related to foreign exchange control rules that apply in South Africa in case of a transfer of residence to another country.

1.3 Research Method

This study is based on a legal interpretive research approach and makes use of the doctrinal research method.

'Doctrinal research can be described (McKerchar: 2008) as a research methodology which provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments'⁴

The relevant applicable legislative rules and regulations, including bi-lateral tax treaties, and internal model conventions and commentaries, and case-law is analysed in the light of writings of experts in relevant books, journals, reports found in libraries, online-libraries and data-bases.

1.4 Structure of the Study

In order to achieve the stated objectives and answer the research question, the dissertation will be structured as follows:

Chapter 2 will examine the application of the South African exit tax in respect of privately held shares when a South African resident individual emigrates to another country.

Chapter 3 will examine the appropriate Article of the OECD Model Convention 2017, i.e. Article 13 (5). Generally, many of SA's treaties follow the OECD Model. Where relevant the corresponding article of a specific tax treaty will be analysed.

Chapter 4 will consider the double tax treaties concluded by South Africa, which contain a specific clause regarding capital gains, deviating from the OECD Model, addressing a

⁴ See Margaret McKerchar, 'Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation' (2008) 6 (1) *eJournal of Tax Research* 5, 18-19 <https://www.business.unsw.edu.au/research-site/publications-site/ejournaloftaxresearch-site/Documents/paper1_v6n1.pdf> : 'Doctrinal research is described as the traditional or 'black letter law' approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. It is typically a library- based undertaking, focused on reading and conducting intensive, scholarly analysis.'

change of residence. It will be examined to what extent these treaties mitigate the risk of double taxation caused by the application of the South African exit tax.

Chapter 5 will summarise the analysis and formulate a conclusion. It will furthermore contain some recommendations for South Africa to mitigate the risk of double taxation.

2 Chapter 2 - Exit Tax in South Africa

This chapter will give an overview of the rules and regulations concerning the capital gains taxation in South Africa when a resident individual transfers his residence to another country and on that occasion ceases to be a resident of South Africa. More specifically, the capital gains taxation will examine privately held shares in a company.

This study does not comment on any obligations nor issues that may arise in respect of the Exchange Control Regulations when a resident of South Africa emigrates to another country⁵.

2.1 Relevant Legal Framework

This section details the provisions regarding the taxable event, the timing of the tax charge, the tax assessment and the obligation for the payment of the tax due.

2.1.1 Taxable Event – Cessation of Being a Resident

South Africa has been applying a general capital gains tax with effect from 1 October 2001. This capital gains tax ('CGT') is governed by the Income Tax Act 58 of 1962 ('ITA') and by the Eighth Schedule to the ITA, Determination of taxable Capital Gains and Assessed Capital Losses, ('Eighth Schedule'). Since its introduction, some of the applicable rules have been amended⁶.

The capital gains tax forms a part of the normal income tax. Section 26A ITA includes the taxable capital gain in the normal income tax⁷. It applies to any assets of a South African resident, regardless of their situs in or outside South Africa (para 2 (a) Eighth Schedule), and to South African situs assets of a non-resident, i.e. immovable property situated in South Africa and any asset effectively connected with a permanent establishment of a non-resident in South Africa (para 2 (b) Eighth Schedule). Only the accrual of the value since the entry into force of the capital gains tax, i.e. 1 October 2001, is subject to the capital gains tax⁸.

The present study concerns shares in any company that are privately held by an individual who is a resident of South Africa and who is transferring his residence to another jurisdiction and therefore is ceasing to be a resident of South Africa. The capital

⁵ South African Reserve Bank, Exchange Control legislation
<<https://www.resbank.co.za/RegulationAndSupervision/FinancialSurveillanceAndExchangeControl/Legislation/Pages/default.aspx>>

⁶ An overview of the CGT legislation and its amendments is listed in section 1.2.6 of the Comprehensive Guide to Capital Gains Tax of the Legal Counsel of SARS: SARS, Legal Counsel, Income Tax, *Comprehensive Guide to Capital Gains Tax* (Issue 7), 9 October 2018, (accessed 23 November 2018) available:
<<https://www.sars.gov.za/AllDocs/OpsDocs/Guides/LAPD-CGT-G01%20-%20Comprehensive%20Guide%20to%20Capital%20Gains%20Tax.pdf>>

⁷ Section 26A ITA: "There shall be included in the taxable income of a person for a year of assessment the taxable capital gain of that person for that year of assessment, as determined in terms of the Eighth Schedule."

⁸ For assets acquired before 1 October 2001 a valuation date value of the asset on 1 October 2001 is to be determined according to paras 25-32 of the Eighth Schedule.

gains tax levied on the accrual of the value of an asset on the occasion of the transfer of residence to another jurisdiction is commonly referred to as 'exit tax' or 'exit charge'⁹.

Residence is defined in section 1(1) ITA. For natural persons there are two alternative criteria, the ordinarily residence test and residence based on physical presence.

Ceasing to be a resident of South Africa is a taxable event for income tax purposes. The ITA provides for a deeming provision in section 9H that treats the resident person as having disposed of each of his assets at market value on the date immediately before the day on which that person ceases to be a resident, and as having immediately reacquired them at the same value on the day on which he ceases to be a resident¹⁰. Depending on the nature of the assets such deemed disposal could trigger ordinary income or capital gains tax¹¹. In the context of this study the assets held, privately held shares, are of a capital nature, the (deemed) disposal of which would result in either a capital gain or a loss¹².

Regarding persons other than a company, i.e. individuals or trusts, section 9H (2) ITA states:

- (2) Subject to subsection (4), where a person (other than a company) that is a resident ceases during any year of assessment of that person to be a resident—*
- (a) that person must be treated as having—*
- (i) disposed of each of that person's assets to a person that is a resident on the date immediately before the day on which that person so ceases to be a resident for an amount received or accrued equal to the market value of the asset on that date; and*
 - (ii) reacquired each of those assets on the day on which that person so ceases to be a resident at an expenditure equal to the market value contemplated in subparagraph (i)¹³¹⁴*

Subsection (4) of section 9H ITA lists the assets to which this deeming provision of subsection (2) and of subsection (3) (in respect of companies) do not apply. These are mainly assets which remain of South African source and are taxable in the hands of a non-resident, such as immovable property situated in South Africa or any asset that is attributable to a permanent establishment of that person in South Africa¹⁵.

The tax on capital gains in general applies to assets as defined in paragraph 1 of the

⁹ See also further Chapter 3, point 3.1.

¹⁰ A similar deeming provision applies when a person commences to be a resident, paragraph 12(2) of the Eighth Schedule. The purpose is to determine the base cost of the assets of that person as they enter the CGT net to the effect that value accrued before becoming a resident is not subject to the CGT in SA.

¹¹ SARS, *Comprehensive Guide to Capital Gains Tax* (Issue 7), n 6, at 6.2.2A.

¹² This study will not address the distinction between revenue or capital. For a comment on that issue reference is made to Chapter 2 of the *Comprehensive Guide to Capital Gains Tax*, n 6.

¹³ Regarding companies, section 9H provides for a similar deemed disposal and reacquisition when a resident company ceases to be a resident or becomes a headquarter company (section 9H (3)(a) ITA) or when a controlled foreign company ceases to be a controlled foreign company (section 9H (3)(b) ITA).

¹⁴ Section 9H was introduced with effect from 1 April 2011. Before, this deeming provision was contained in paragraph 12 (2) of the Eighth Schedule.

¹⁵ The deeming provision of section 9H (2) and (3) ITA do also not apply in respect of certain restricted equity instruments obtained in the context of employment, such as a section 8B share within 5 years from the acquisition (broad-based employee share plan), a section 8C share or equity instrument that has not yet vested in a person and a section 8A option to acquire a share (section 9H (4) ITA).

Eighth Schedule,

“Asset’ includes –

(a) property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum; and

(b) a right or interest of whatever nature to or in such property;”

2.1.2 Timing of the Tax Charge, Assessment and Payment

This section will explain the timing of the tax charge, the assessment, the filing of the tax returns and the payment of the tax.

2.1.2.1 Timing of the Tax Charge

The taxable event of ceasing to be a resident triggers a deemed disposal of a person’s assets on the date immediately before the day on which the person ceases to be a resident (section 9H(2)(a) ITA). This is referred to as the time of disposition rule which was previously contained in para 13(1)(g)(i) of the Eighth Schedule¹⁶. The tax charge arises on the date so determined.

2.1.2.2 Year of Assessment

The timing of the tax charge while the person is still a resident is emphasised in section 9H(2)(b) ITA which provides that the ‘*year of assessment must be deemed to have ended on the date immediately before the day on which that person so ceases to be a resident*’.

This provision means that from the beginning of the year of assessment, which for individuals starts on 1 March, until the date immediately before the day on which the person ceases to be a resident, the taxpayer will be assessed as a resident.

The ‘succeeding year of assessment of that person must be deemed to have commenced on the day on which that person so ceases to be a resident’ (section 9H(2)(c) ITA). From this day on the person qualifies as a non-resident and is only liable to tax in respect of income and capital gains of a South African source, subject to the application of a double tax treaty.

This wording regarding the deemed end of the year of assessment was added with effect from 8 May 2012 as a reaction of the legislature against the outcome in the judgement of the Supreme Court of Appeal (‘SCA’) in the *Tradehold*-case¹⁷. The Explanatory

¹⁶ Craig West and Jennifer Roeleveld, ‘Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?’ in Eric C.C.M. Kemmeren et al. (eds.), *Tax Treaty Case Law around the Globe 2012* (IBFD 2013) Online Books IBFD (accessed 2 August 2016), at 4.4.1.

¹⁷ SCA, 8 May 2012, *Commissioner for South African revenue Service v. Tradehold Ltd.*, Case No. 132/11 (2012) ZASCA 61, 2013 (4) SA 184 (SCA), 74 SATC 263. It has been commented on by Brian J. Arnold, ‘Tax Treaty Case Law News’ (2012) 7 *Bulletin for International Taxation* 481; Liezel G. Claassen, ‘The Exit Tax Consequences of the Migration of Companies from South Africa: Commissioner for the South African Revenue Service v. Tradehold Ltd’ (2013) 25 *South African Mercantile Law Journal* 387; Tracy Gutuza, ‘Dual residence and the provisio: Where was Tradehold resident?’ (2014) 26 (3) *South African Mercantile*

Memorandum to this amendment explicitly mentions that judgement and supports the proposed amendment by stating that *'it is clear from international precedent in this regard that treaty relief does not apply to a deemed disposal before cessation of residence. Treaty relief should apply only once a cross-border relationship exists (i.e. foreign residence status vis-à-vis a domestic event such as a domestic disposal). Unlike the South African exit charge, however, most exit charges also trigger a deemed cessation of tax year with a new tax year beginning once ex-residence status begins.'*¹⁸

The aim of this amendment was to align *'the exit charge with international norms and clarifies that a double taxation agreement does not exempt a person from capital gains tax the day before that person ceases to be a resident'*¹⁹.

The judgement of the Supreme Court of Appeal in the Tradehold-case caused uncertainty regarding the application of the exit tax in a case where a resident company ceased to be a resident of South Africa and became a resident in a country with which South Africa has concluded a double tax treaty, *i.e.* in Luxembourg. The court ruled in favour of the taxpayer; based on the double tax treaty between South Africa and Luxembourg, from the date of the relocation of the place of effective management to Luxembourg, that country had the exclusive taxing rights of capital gains from both actual or deemed alienation of property. Consequently, the South African Revenue Service ('SARS') was not entitled to apply the exit tax of para 12(2) of the Eighth Schedule.

2.1.2.3 The Tradehold-case

The facts of the Tradehold-case can briefly be summarised as follows. Tradehold Ltd was a company incorporated in South Africa. In the course of the year of assessment that ended on 28 February 2003, more specifically on 2 July 2002, it shifted its place of effective management to Luxembourg. On that date, a meeting of the board of directors of Tradehold was held in Luxembourg and it was resolved that all further board meetings would be held in that country²⁰. Notwithstanding the relocation of the seat of effective management to Luxembourg, Tradehold did not lose its 'resident'-status in South Africa and thus became a dual resident company. The resident-status changed on

Law Journal 543; Ernest Mazansky, 'South Africa's Exit Charge Overridden by the Luxembourg-South African Income and Capital Tax Treaty (1998)' (2012) 66 *Bulletin for International Taxation* 374; SARS, *Comprehensive Guide to Capital Gains Tax* (Issue 7), n 6, 110-112; Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16.

¹⁸ Explanatory Memorandum to the Tax Laws Amendment Bill, 2012, of 10 December 2012, point 5.4., III; Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.4.

¹⁹ Explanatory Memorandum to the Tax Laws Amendment Bill, 2012, of 10 December 2012, point 5.4., IV.

²⁰ See SCA, Tradehold, n 17, at 3. See more on the residence of a company and the 'place of effective management' from a South African perspective: Liezel G. Claassen, n 17, 387, 392-395 and SARS, *Income Tax Interpretation Note 6, Resident: place of effective management (persons other than natural persons)* (Issue 1) 26 March 2002 (accessed 24 November 2018) available

<<http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2018-12-Arc-12%20-%20IN6%20-%20Resident%20Place%20Effective%20Management.pdf>> Meanwhile a new issue of the Interpretation Note 6 has been released dated 3 November 2015, available

<[http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20\(companies\).pdf](http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20(companies).pdf)>

26 February 2003 when the amendment of the definition of 'resident' in section 1 ITA came into effect and the following wording was added to subparagraph (b) of the definition of 'resident':

'but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation'

The Commissioner for SARS had raised an additional assessment based on a taxable capital gain, which arose, according to the Commissioner, from a deemed disposal of all of 'Tradehold' assets (*in casu* the shares of its wholly owned subsidiary) in terms of para 12(1) of the Eighth Schedule, which at that time contained the exit charge before it was moved to section 9H of the ITA with effect from 1 April 2012. The Commissioner contended that the deemed disposal had occurred either on 2 July 2002 when the seat of the effective management was relocated to Luxembourg or on 26 February 2003 when it ceased to be a resident, and that it had given rise to a capital gain in the 2003 year of assessment²¹. It is not clear why the Commissioner did not pinpoint the exact date on which the deemed disposal took place and why he did not invoke the timing provision of the then applicable paragraph 13(1)(g)(i) of the Eighth Schedule which provided that the time of disposal in case of a person ceasing to be a resident is *'the date immediately before the day that the event occurs'*.

Tradehold from its side, invoked the Double Tax Agreement ('DTA')²² between South Africa and Luxembourg which had entered into effect on 1 January 2001 and contended that if there was a deemed disposal in the year of assessment 2003, then the resulting capital gain was not taxable in South Africa but in Luxembourg. In terms of the tie-breaker rule of Art. 4(3) of that DTA the place of residence of a company is deemed to be where its effective management is situated and this was Luxembourg from 2 July 2002 onwards²³. Further, in terms of Art. 13(4) of that DTA the taxing rights of capital gains are exclusively allocated to the State of residence, namely Luxembourg²⁴.

The Tax Court held in line with Tradehold's contention,

*'that in terms of Article 13(4) the relevant gain was taxable only in the Contracting State of which Appellant was a 'resident' as contemplated by the DTA and the relocation of its place of effective management caused Appellant to become a resident of Luxembourg in terms of Article 4(1)(a) of the DTA'*²⁵

The Tax Court rejected the Commissioner's argument that Art. 13(4) DTA referred to 'alienation of any property' and not to a deemed disposal of property as contemplated in para 12(a) of the Eighth Schedule, and held that Art. 13(4) of the DTA, also covered capital gains arising from a deemed disposal:

²¹ See SCA, Tradehold, n 17, at 4.

²² The terms 'Double Tax Agreement-DTA', 'Double Tax Convention -DTC' and 'Double Tax Treaty-DTT' are used interchangeably.

²³ See SCA, Tradehold, n 17, at 8.

²⁴ Art. 13 (4) of the South Africa-Luxembourg Double Tax Agreement reads: *'Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.'*

²⁵ Tax Court, 16 November 2010, Income Tax Case No 1848 (Tradehold v C: SARS), (2010) 73 SATC 170.

'(vi) That although Article 13(4) of the DTA referred to 'the alienation of any property' and not to a deemed disposal of property as contemplated by para 12(2)(a) of the Eighth Schedule, the taxable capital gain which arose on the deemed disposal of Appellant's assets did trigger the provisions of Article 13(4) of the DTA.

(vii) That there was no reason why a deemed disposal of property should not be treated as an alienation of property for purposes of Article 13(4) of the DTA and it would be absurd if a taxpayer were to be protected in terms of Article 13(4) from liability for tax resulting from a gain from an actual alienation of property, but not from a deemed alienation of property.²⁶

On appeal by the Commissioner for SARS, the same question was brought before the Supreme Court of Appeal which ruled in the same sense as the Tax Court, that Art. 13(4) of the DTA applies to capital gains that arise from both actual and deemed alienations and held,

'(iii) That the crisp question that fell to be determined was whether the term 'alienation' as used in the DTA included within its ambit gains arising from a deemed (as opposed to actual) disposal of assets and the term must be given a meaning that is congruent with the language of the DTA having regard to its object and purpose.

(iv) That Article 13 of the DTA was widely cast and included within its ambit capital gains derived from the alienation of all property; moreover, it was reasonable to suppose that the parties to the DTA were aware of the provisions of the Eighth Schedule and must have intended Article 13 to apply to capital gains of the kind provided in the Schedule and it was of significance that no distinction was drawn in Article 13(4) between capital gains that arose from actual or deemed alienations of property and there was no reason in principle why the parties to the DTA would have intended that Article 13 should apply only to taxes on actual capital gains resulting from actual alienations of property.²⁷

(v) That, having regard to the factors mentioned, the term 'alienation' as it is used in the DTA was not restricted to actual alienation and it is a neutral term having a broader meaning, comprehending both actual and deemed disposals of assets giving rise to taxable capital gains.

(vi) That, consequently, Article 13(4) of the DTA applied to capital gains that arose from both actual and deemed alienations or disposals of property and it followed therefore that from 2 July 2002, when Respondent relocated its seat of effective management to Luxembourg, the provisions of the DTA became applicable and that country had exclusive taxing rights in respect of all of Respondent's capital gains.

(vii) That the Tax Court was therefore correct in holding that the Commissioner had incorrectly included a taxable gain resulting from the deemed disposal of Respondent's investment in its income for the 2003 year of assessment.'

The SCA reasoned that the deeming provision is triggered under para 12 of the Eighth Schedule when a company ceases to be a resident or is treated as not being a resident as a result of the application of a double tax treaty²⁸. The SCA seems to have accepted that Tradehold's residence in South Africa only ceased on 26 February 2003²⁹ and, without explicitly stating it, the SCA seems to have considered this event to have caused the taxable event for the exit tax and not the shifting of the place of effective management to Luxembourg on 2 July 2002³⁰. The Court reasoned further that from 2 July 2002 Art.

²⁶ Tax Court, 16 November 2010, Income Tax Case No 1848 (Tradehold v C: SARS), 73 SATC 170.

²⁷ This finding is bizarre because the Eighth Schedule was introduced in 2001 *after* the double tax treaty between South Africa and Luxembourg was negotiated and concluded in 1998. See also E. Mazansky, 'South Africa's Exit Charge Overridden by the Luxembourg-South African Income and Capital Tax Treaty (1998)', n 17, 374, 375.

²⁸ See SCA, Tradehold, n 17, at 7.

²⁹ See SCA, Tradehold, n 17, at 3.

³⁰ Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.1.

13(4) of the DTA became applicable and that Luxembourg thus had the exclusive taxing rights in respect of all of Tradehold's capital gains (from both actual and deemed alienation or disposals of property)³¹.

The *Tradehold*-judgement of the SCA is of importance for two reasons: firstly, because of the question the Court addressed, namely whether Art. 13(4) of the Double Tax Treaty concluded between South Africa and Luxembourg also applies to capital gains arising from a deemed alienation of property, a question which the Court answered affirmatively; and secondly, because of the critical issue it did not address, namely the exact timing of the taxable event of the ceasing of being a resident combined with the timing of the tax charge on the date immediately before the day on which the company ceased to be a resident as provided in para 13(1)(g)(i) of the Eighth Schedule³². Further, the Court did also not address the crucial issue whether Art. 13(4) of the DTA precludes South Africa from applying its exit tax where a person transfers its residence from South Africa to a country with which South Africa has a tax treaty³³. In other words, the judgement did not rule on the question whether the exclusive allocation of taxing rights on capital gains in terms of the DTA precludes a contracting State from applying an exit tax on the date immediately before the date when the person ceases to be a resident. The relevance of this case in the context of double tax treaties will be further highlighted in Chapter 3.

The value as precedent of the *Tradehold*-case in the context of double tax treaties and exit tax must be treated with caution. The facts of this case were very specific and any future case needs to be appreciated having regard to its own specific facts³⁴. The outcome, which Arnold labelled as 'patently incorrect'³⁵, must be seen in the context of the definition of residence of a company in section 1 of the ITA of South Africa as it read at the time of the facts, which made it possible for the company to shift its place of effective management to another jurisdiction without losing its residence status in South Africa. It was accepted that *Tradehold* had become a dual resident and it seemed to be implicitly accepted that on that occasion the exit tax did not apply because the company did not cease to be a resident in terms of the ITA and so, according to the findings of the tax court and the SCA, the taxable event did not materialise at a moment when the company was still a resident. One can wonder why in the proceedings the Commissioner did not bring forward the deemed disposal when '*a resident who is as a result of the application of any agreement entered into by the Republic for the avoidance of double taxation treated as not being a resident*' in terms of para 12 (2)(a) of the Eighth Schedule as it read at the time when the facts of the case took place³⁶. Since it was common cause that the relocation of the place of effective management to Luxembourg took place on 2 July 2002 and the Court had accepted that *Tradehold*, based on the tie-breaker rule of Art. 4(3) of the DTA, was to be treated as a resident of Luxembourg (and conversely not

³¹ See SCA, *Tradehold*, n 17, at 26.

³² Liezel Claassen, n 17, 387, 395-396; Ernest Mazansky, 'South Africa's Exit Charge Overridden by the Luxembourg-South Africa Income and Capital Tax Treaty (1998)', n 17, 374, 375; Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.1.

³³ Brian J. Arnold, n 17, 481, 484.

³⁴ Liezel Claassen, n 17, 387, 401-402; Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.1.

³⁵ Brian J. Arnold, n 17, 481, 484.

³⁶ The question whether this would override the definition of 'resident' at that time in section 1 ITA in the context of exit tax is not clear.

as a resident of South Africa), this event could have triggered the exit tax in terms of para 12(2)(a) of the Eighth Schedule. The tax charge would then have arisen on the date immediately before that event, i.e. on 1 July 2002, when Tradehold still was a resident of South Africa (para 13(1)(g)(i) of the Eighth Schedule³⁷. Further, the loophole of dual residency was closed by the amendment of the definition of 'residence' with effect from 26 February 2003³⁸. And finally, the legislature added provisions to emphasise that the year of assessment must be deemed to have ended on the date immediately before the person ceases to be a resident (section 9H(2)(b) and (3)(b) ITA).

The addition of the deemed end of the year of assessment on the date immediately before the day when the person ceases to be a resident (section 9H(2)(b) and (3)(b) ITA) enforces the objective that the exit charge arises before the person ceases to be a resident and thus, when the person still is a resident³⁹.

2.1.2.4 Filing of Tax Returns, Assessment and Payment of the Tax

As mentioned in 2.1.2.2. the ceasing of being a resident during a year of assessment has the effect to end that year of assessment on the date immediately before the person ceases to be a resident (section 9H(2)(b) ITA). For this period commencing on the first day of that year of assessment, i.e. 1 March for individuals, and ending on the day preceding the date that the person ceases to be a resident the taxpayer will have to submit a return for normal tax as a resident (section 66(13)(a)(c) ITA).

The ITA does not provide for a specific timing to submit this return for normal tax, hence the normal rules apply and the return is due by the date prescribed by the Commissioner in the annual public notice in terms of section 66(1) ITA.

If the individual receives income from a South African source, then from the date on which he becomes a non-resident, he will have to submit a return for normal tax as a non-resident for the year of assessment commencing on that date and ending on the last day of the year of assessment, i.e. 28 February for individuals. The timing to submit this

³⁷ See Liezel Claassen, n 17, 395-396; Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.1.

³⁸ The definition of residence was amended by section 33 (1) of the Exchange Control Amnesty and Amendment of Taxation Laws Act No. 12 of 2003. The reason for the change was '*The current relationship between the definition of "resident" contained in the Income Tax Act and the definition of "resident" contained in agreements for the avoidance of double taxation is unclear. The Bill aligns the Income Tax Act, 1962, to agreements for the avoidance of double taxation so that both regimes operate in unified fashion. Any person exclusively deemed to be a resident of another country for purposes of one or more tax treaties (by virtue of tax treaty tie-breaker rules or otherwise) will not be a resident for purposes of the Income Tax Act, 1962, regardless of any other rules pertaining to the definition of resident contained therein. This proposal will come into operation on 26 February 2003.*', Explanatory Memorandum on the Exchange Control Amnesty and Amendment of Taxation Laws Bill, 2003, available <<http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2003-02%20-%20Explanatory%20Memorandum%20Exchange%20Control%20Amnesty%20Amendment%20Taxation%20Laws%20Bill%202003.pdf>> (accessed on 25 November 2018), 35.

³⁹ Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.4.; Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012, of 10 December 2012 available <<http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2012-01%20-%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202012.pdf>>

return is the general timing of section 66(1) ITA.

The amount of the tax liability of the normal tax will be assessed thereafter following the normal procedure in terms of section 91 of the Tax Administration Act 28 of 2011 ('TAA'). The notice of assessment will then state the amount of the assessment and the date for paying the amount assessed (section 96(1)(d) and (f) TAA).

However, the tax due on the capital gains in terms of the exit tax will have to be paid in advance by way of a provisional tax payment. The person emigrating qualifies as a provisional tax payer in terms of the definition of '*provisional taxpayer*' in para 1 of the Fourth Schedule to the ITA.

In terms of para 19(1)(a) of the Fourth Schedule every provisional taxpayer has to submit a return of an estimate of the total taxable income which will be derived by the taxpayer in respect of the year of assessment in respect of which the provisional tax is or may be payable by the taxpayer. This amount of the estimate includes the income tax due on the capital gains in terms of section 9H(2)(a) ITA.

Since the year of assessment is deemed to end on the date immediately before the day that the person ceases to be a resident (section 9H(2)(b) ITA), a year end provisional tax payment needs to be made in terms of para 21(1)(b) of the Fourth Schedule. The amount of the total estimated liability for the normal tax for that year needs to be paid '*not later than the last day of the year of assessment in question*'. This means that the amount of the exit charge needs to be paid the latest on the day immediately before the individual ceases to be a resident.

Late payment of the provisional tax is subject to a penalty of 10% of the amount paid late (para 27 of the fourth Schedule). The late submission of the provisional tax return later than four months after the last day of the year of assessment, will be deemed to be a nil return (para 19(6) of the Fourth Schedule) and is subject to an underestimation penalty of 20% in terms of para 20 of the Fourth Schedule.

The exit charge is thus immediately payable before the day on which the individual ceases to be a resident. There is no possibility for deferral of the payment until the moment of actual disposal of the asset. The capital gains tax is also definitively assessed in the original assessment in terms of section 91 TAA, subject to additional assessment in terms of section 92 TAA, and a later decrease in value after the emigration or an ultimate realisation of a capital loss has no influence on the exit tax as determined at the moment of the transfer of residence.

2.2 Issues Concerning the Exit Tax

From the above, it is evident that the deemed disposal of assets upon emigration and the immediate taxing of the corresponding capital gains, together with the obligation to immediately pay, create a cash-flow problem since the assets have not been actually disposed of. In some cases, this cash-flow problem can be prohibitive and influence the decision whether or not to emigrate or force a person to actually dispose of assets in order to be able to pay the exit tax.

Since the exit tax is definitively assessed and paid, there is no relief in case of the realisation of a later capital loss or a later smaller capital gain.

In sum, this means that emigration from South Africa may impose a high financial burden on the taxpayer which may be punitive in some cases. This financial burden is even bigger if the new State of residence does not grant a step-up in value at the moment of the immigration and when the previously taxed capital appreciation is subjected to capital gains taxation a second time at the moment of the actual realisation.

The following chapters will analyse whether double tax treaties preclude the application of an exit tax by the former State of residence, and extent to which double tax treaties are able to prevent the risk of double taxation. The double tax treaties concluded by South Africa will be evaluated in terms of this analysis.

3 Chapter 3 - Double Tax Treaties – Capital Gains – Change of Residence

This chapter will examine to which extent Double Tax Treaties ('DTT' and 'DTTs') address the situation and prevent the double taxation of capital gains when the change of residence gives rise to taxation of an (un)realised capital gain in the State of emigration. As already mentioned above, the taxation of unrealised increases in value of assets by the State of emigration (also referred to as 'former State of residence') and the subsequent taxation of the realised capital gains by the State of immigration (also referred to as 'new State of residence') may give rise to (at least partial) double taxation of the capital gain or to excessive taxation in case of the realisation of a loss.

As most double tax treaties of South Africa follow the OECD Model, this chapter will comment mainly on the OECD Model and selected DTTs. Unless stated otherwise, reference is made to the current version of the OECD Model Convention of 21 November 2017.

The main purpose of a double tax treaty is to prevent and eliminate double taxation⁴⁰. To this end, double tax treaties provide for a set of rules '*which settle to what extent each of the two Contracting States may tax income and capital and how international juridical double taxation is to be eliminated.*'⁴¹ Double tax treaties also address the risk of excessive taxation⁴². One of the controversies regarding the allocation of taxing power on capital gains is whether or not exit taxes, levied because and at the time of or after a change of residence to another jurisdiction, are compatible with Art. 13(5) OECD Model and whether they are covered by that article⁴³.

⁴⁰ The OECD Commentary (2017) on Art. 1, para 54 states: '*54. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. As confirmed in the preamble of the Convention, it is also a part of the purposes of tax conventions to prevent tax avoidance and evasion.*'

⁴¹ The OECD Commentary (2017), Introduction, para 17. Contracting States mutually agree to limit the application of their domestic tax law in cases when the tax treaty '*reserves taxation for the other Contracting State either entirely or partially*', Klaus Vogel and Alexander Rust, 'Introduction' in Ekkehart Reimer and Alexander Rust (eds), *Klaus Vogel on Double Taxation Conventions* (4th edn, Kluwer Law International 2015), n° 52. Such limitation '*may consist of the waiver of a tax claim of a Contracting State in favour of the other Contracting State or in the grant of a credit against its tax for taxes paid in the other Contracting State*', *ibidem*, n° 54. In the same sense, Michael Lang states that double tax treaties have a limiting effect on the domestic tax laws of the Contracting States, who have the original jurisdiction to tax, yet in accordance with international law, Michael Lang, 'The Effects of DTCs' in *Introduction to the Law of Double Taxation Conventions (Second Revised Edition)* (IBFD 2013), Online Books IBFD (accessed 11 June 2018), n° 39-45. Klaus Vogel rejects the idea that double tax treaties allocate jurisdiction to tax or attribute a right to tax, Klaus Vogel and Alexander Rust, 'Introduction', n° 51, with further references to further literature on this topic.

⁴² Such excessive taxation is usually mentioned in the context of the application of high withholding taxes in the source state. To the extent that withholding taxes '*levied in the State of source exceed the amount of tax normally levied on profits in the State of residence, such taxes may have a detrimental effect on cross-border trade and investment.*', OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Introduction, para 15.4. The exit tax levied by the State of emigration might exceed the tax normally levied on capital gains in case of the actual realisation of a smaller capital gain, or in case of the realisation of a loss. This would result in excessive taxation, that could be relieved under a tax treaty.

⁴³ See Brian J. Arnold, n 17, 481, 484; Bruno Carramaschi, 'Exit taxes and the OECD model convention: compatibility and double taxation issues' (2008) 49 *Tax Notes International* 283; Luc De Broe, 'Hard Times for Emigration Taxes in the EC' in *A Tax Globalist: Essays in honour of Maarten J. Ellis* (IBFD 2005), Online

After first defining exit taxes and distinguishing between exit taxes in the strict sense and trailing taxes, the following sections will analyse the allocation principles under Art. 13 (5) OECD Model applicable to the so-called 'other assets'. They will also examine whether that article covers capital gains arising from a deemed alienation such as is the case for exit taxes.

Further, the influence of timing aspects related to the application of Art. 13(5) OECD Model in case of a change of residence will be examined.

For the study of exit taxes in the context of double tax treaties, the relationship between domestic specific anti-avoidance rules and tax treaties is relevant. Therefore, the revised OECD Commentary on Art. 1 (2017) will be considered.

This chapter will also comment on the method of double taxation relief provided for in the OECD Model and on the recent trend of double tax treaties to include a specific clause on exit taxes in the capital gains-article.

3.1 Exit Taxes in the Strict Sense and Trailing Taxes

In order to examine the impact of DTTs on exit taxes, it is necessary to have a better understanding of the different types of exit taxes.

In principle, the taxation of individuals of capital gains of privately held movable assets, such as shares of a company, in their State of residence usually is linked to the realisation of the gain and no income or deduction or gain or loss is recognized until cash or equivalent is received or paid⁴⁴. One of the possible reasons for this is the correlation between the obligation to pay and the ability to pay⁴⁵.

Books IBFD (accessed 5 January 2017); Luc De Broe, 'Chapter 5 – The Relevance of Residence under EC Tax Law' in Guglielmo Maisto (ed.), *Residence of Individuals under Tax Treaties and EC Law* (IBFD 2010), Online Books IBFD (accessed 2 August 2017); Luc De Broe and Katrien Willocqué, 'Exit Taxes on Substantial Shareholdings and Pension Claims: The Dutch Supreme Court's Interpretation of Arts. 13, 15 and 18 of the OECD Model', in Philip Baker and Cathrine Bobbett (eds.), *Tax Polymath. A Life in International taxation. Essays in honour of John F. Avery Jones*, (IBFD 2010) 227; Eric C.C.M. Kemmeren, 'Chapter 28: Netherlands: Exit Taxation of a Substantial Shareholder: Tax Treaty Override?' in Eric Kemmeren et al. (eds.), *Tax Treaty Case Law around the Globe 2016* (IBFD 2017) Online books IBFD (accessed 31 January 2017); Michael Lang, 'Allocation rules' in *Introduction to the Law of Double Taxation Conventions (Second Revised Edition)* (IBFD 2013), Online Books IBFD (accessed 11 June 2018); Ekkehart Reimer, 'Article 13' in Ekkehart Reimer and Rust (eds.), *Klaus Vogel on Double Taxation Conventions* (4th edn, Kluwer Law International 2015); Josef Schuch and Erik Pinetz, 'The Definition of Dividends, Interest, Royalties and Capital Gains' in Michael Lang et al. (eds.) *The OECD-Model-Convention and its Update 2014* (IBFD 2015) Online Books IBFD (accessed 23 May 2018); Stefano Simontacchi, *Taxation of Capital Gains and the OECD Model Convention with Special Regard to Immovable Property* (Kluwer Law International 2007); Maria Teresa Soler Roch, 'Chapter 27 Exit Tax: A Fair Balance?' in Heike Jochum et al. (eds.), *Practical Problems in European and International Tax Law: Essays in Honour of Manfred Mössner* (IBFD 2016) Online Books IBFD (accessed 4 January 2017).

⁴⁴ Sanford H. Goldberg et al., 'Taxation Caused By or After a Change of Residence (Part 1)' (2000) 21 *Tax Notes International* 643, 643.

⁴⁵ Maria Teresa Soler Roch, n 43, at 27.2.1; Sanford H. Goldberg et al., n 44, 643, 643. Another reason is the difficulty of assessing and taxing the increase in value on an annual basis, which would also require to accept the carry-back of losses. Such a system would be very complex, burdensome and expensive.

In the case of a change of residence of an individual, the individual ceases to be a tax resident of a State ('former State of residence' or 'State of emigration') and becomes a resident of another State ('new State of residence' or 'State of immigration'). By ceasing to be a tax resident, who is taxable on his worldwide income, the individual remains only taxable in the former State of residence on income from a source in that State. In case of emigration, the former State of residence may therefore lose its ability to tax the individual on the increase in value of the movable asset accrued during the time when the individual was a resident in that State. This is one of the reasons why certain jurisdictions impose a tax on the accrued increase in value of assets in the case of an individual changing his residence to another jurisdiction⁴⁶. Such a tax is commonly referred to as an 'exit tax', 'departure tax' or an 'exit charge'. The wording 'transfer of residence to another jurisdiction or country', 'change of residence' and 'emigration' will be used interchangeably.

There are several variations in the domestic laws of different countries for taxing capital gains in the event of a change of residence of a taxpayer. Sometimes extended payment terms are permitted. *'A trailing tax is a tax imposed on non-residents (...) after emigration, that extends beyond the scope of the tax applicable to ordinary non-residents, but is limited to gains on assets situated or deemed situated in the country of former residence. It is imposed at a later date, usually the year of actual disposition, on assets owned on the date of the change of residence'*⁴⁷.

Generally, exit taxes in the broad sense can be divided in two major categories, firstly, exit taxes in the strict sense and secondly, the so-called 'trailing taxes'⁴⁸. The main differences between these two categories is the timing when the tax charge is imposed, at the time of or after the emigration, and whether unrealised or realised gains are taxed.

The term 'exit tax in the strict sense' refers to an immediate tax on unrealised appreciation of assets on departure from the State of residence⁴⁹. The location of the assets is usually irrelevant, save the application of a tax treaty in respect to specific assets. In the case of exit taxes in the strict sense the tax charge relates to an accrued value and is as such disconnected from the moment of actual realisation of the capital gain at the actual disposal. Sometimes the actual collection of the tax may be deferred till the moment of the actual realisation or to a similar event⁵⁰. The taxable value is determined based on the value of the asset at the time of the emigration, often, such as is the case in South Africa (see Chapter 2), the day before the individual ceases to be a resident. A later increase or decrease in value is not relevant, nor has it an influence on the amount subjected to the exit tax in the strict sense.

Some jurisdictions apply so-called 'trailing taxes'. The term 'trailing taxes' refers to a tax imposed on a former resident after the emigration, on assets that he held at the moment

⁴⁶ Other reasons for imposing an exit tax may be to prevent the avoidance of capital gains tax, see Luc De Broe, 'Hard Times for Emigration Taxes in the EC', n 43, at 1.2; Eric C.C.M. Kemmeren, n 43, at 28.4.1; Maria Teresa Soler Roch, n 43, at 27.2.1.

⁴⁷ Sanford H. Goldberg et al., n 44, 643, 648.

⁴⁸ When the term 'exit tax' is used, it refers to exit taxes in the broad sense, which includes exit taxes in the strict sense and trailing taxes.

⁴⁹ Sanford H. Goldberg et al., n 44, 643, 645; Bruno Carramaschi, n 43.

⁵⁰ Without being exhaustive, this is *inter alia* the case in Canada, France and Netherlands.

of the emigration. In such cases, the taxing jurisdiction of the former state of residence is extended. Sometimes provisions in domestic law may extend a State's taxing jurisdiction for a certain period of time – often 5 or 10 years - in respect of residents who emigrate from the jurisdiction. Such extended claim to the taxing jurisdiction is '*usually limited to capital gains realized in respect of assets that cannot be taxed in the state on a situs basis*'.⁵¹ This is a different situation from the exit tax in the strict sense, on accrued capital gains upon change of residence to another jurisdiction, as the extended taxing jurisdiction is not based on the residence principle (the person has left the jurisdiction and is no longer a resident there) and aims at taxing capital gains upon realisation of the asset at a certain moment in time within a fixed period of time after emigration⁵². The taxable gain is determined based on the value of the asset at the time of actual realisation.

The capital gains tax applicable in South Africa in case of emigration of a South African resident is (for the applicable assets) of the type of an exit tax in the strict sense⁵³.

3.2 Art. 13 (5) OECD Model Convention

The allocation of the taxing right of capital gains is dealt with in Article 13 OECD Model. The article contains different allocation rules depending on the nature of the assets concerned.

The residual rule for the allocation is found in Art. 13(5) OECD Model (in the version 2003 and following) and allocates the taxing rights of capital gains to the State of which the alienator is a resident, for other assets than those addressed in the previous paragraphs, *i.e.* gains from an immovable property (Art. 13(1)), movable property forming part of a business property of a PE (Art. 13(2)), gains from the alienation of ships or aircraft operated in international traffic and of movable property pertaining to the operation of such ships or aircraft (Art.13(3)), gains from shares or comparable interests, such as interests in a partnership or trust, that derive more than 50 per cent of

⁵¹ Joanna Wheeler, *Time in Tax Treaties - Global Tax Treaty Commentaries*, Global Tax Treaty Commentaries IBFD (2017), accessed 24 May 2018, at 5.2.1.2.: '*The extended claim to taxing jurisdiction is usually limited to capital gains realized in respect of assets that cannot be taxed in the state on a situs basis. Without such a rule, the state would lose its ability to tax the gain when the person ceases to be resident, even though a large part of the gain may have accrued during the period when the person was resident. Such rules generally apply for a fixed period, commonly 5 or 10 years. That fixed period generally starts when the person ceases to be resident under domestic law or, if the person is also resident in another state, when the outcome of the residence tiebreaker provision changes and shifts the person's residence for the purposes of that tax treaty to the other state. Exceptions to the extended jurisdictional claim often apply to persons who were resident for less than a stated fixed period and/or only temporarily.*' See also Giorgio Beretta, 'Mobility of Individuals after BEPS: The Persistent Conflict between Jurisdictions' (2018) 7 *Bulletin for International Taxation* 72, at 3.1.; Sanford H. Goldberg et al., n 44, 643, 648.

⁵² Joanna Wheeler, n 51, *ibidem*.

⁵³ The exclusion of immovable property from the exit tax in South Africa (see 2.1) is based on the source principle: income and capital gains from immovable property remain taxable in the State of situs even in the hands of non-residents. South Africa keeps its taxing power as the State of source, even after a person ceases to be a resident and has become a non-resident. The deferral of capital gains taxation until the actual disposal of the immovable property is, therefore, not a form of trailing tax. A trailing tax extends the source principle for assets over which the former State of residence otherwise would lose its taxing power, *i.e.* for movable assets that are subject to the principle of residence-based taxation. At a treaty level, the source-based taxation of capital gains of immovable property is reflected in the specific allocation rule of Art. 13(1) OECD Model.

their value directly or indirectly from immovable property (Art. 13 (4)⁵⁴)⁵⁵.

For the ease of phrasing, the specific allocation rules of Art. 13(1) to 13(4) OECD Model will be referred to as 'specific allocation rules' and Art. 13(5) as the 'residual allocation to the residence state' or the 'residual allocation rule'.

The situation of a change in residence and the risk of double taxation of capital gains caused as a consequence thereof, are not explicitly addressed by Article 13 of the Model Convention⁵⁶.

The following sections will analyse the principles of Art. 13(5) OECD Model and examine their impact on exit taxes in the strict sense as well as on trailing taxes.

3.2.1 Exclusive Allocation of the Taxing Right to the Residence State for 'Other Assets'

Art. 13(5) OECD Model allocates the taxing rights of capital gains of 'other assets' exclusively to the State of Residence of the alienator⁵⁷:

"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."

The exclusive allocation to the state of residence of the alienator means that the other State must exempt the income from its tax⁵⁸.

This allocation of taxing power to the residence state is seen as consistent with the economic allegiance theory "*in that the residence state is where capital is accumulated and consumed and legal rights are enforceable.*"⁵⁹. This theory was brought forward by four

⁵⁴ Paragraph 4 of Article 13 OECD Model was introduced in the 2003 OECD Model of 28 January 2003; for a history of Article 13 see Hans Pijl, 'Capital Gains: The History of the Principle of Symmetry, the Internal Order of Article 13 and the Dynamic Interpretation of the Changes in the 2010 Commentary on "Forming Part" and "Effectively Connected"' (2013) *World Tax Journal* 3. In the 2017 OECD Model of 21 November 2017 the scope of Art. 13(4) has been broadened and also similar interests in partnerships and trusts are included. Paragraph 4 reads now as follows: '*Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.*'

⁵⁵ Ekkehart Reimer, n 43, n° 33; Simontacchi observes a disagreement on the interpretation of the scope of Art. 13(5) as a 'catch-all' provision. Does it cover all possible gains not dealt with in the other paragraphs of Art. 13 or only to gains from other property than dealt with in the other paragraphs? Since the 2003 version of the OECD Commentary, Art. 13(5) is the residual article for gains not covered in Art. 13(1), for example for gains of immovable property in the residence State or in a third state – para 22 of the Commentary on Art. 13(1) (version 2003 and following), Stefano Simontacchi, 'Ch 9 Capital gains (Article 13 OECD Model Convention)', n 43, 129, 173-174.

⁵⁶ Luc De Broe, 'The Tax Treatment of Transfer of Residence by Individuals', General Report IFA Congress Oslo 2002 *The tax treatment of transfer of residence by individuals* (IFA Cahiers 2002 87b) 19, 23 ; Sanford H. Goldberg et al., n 44, 643, 643; Joanna Wheeler, n 51, at 1.1.

⁵⁷ See also OECD Commentary on Art. 13, para 20.

⁵⁸ Klaus Vogel and Alexander Rust, 'Introduction', n 42, n° 63.

⁵⁹ Jinyan Li and Francesco Avella, *Article 13: Capital Gains - Global Tax Treaty Commentaries*, Global Tax Treaty Commentaries IBFD (2017), accessed 23 May 2018, at 1.1.2.1.

economists in a theoretical report on double taxation for The Financial Committee of the League of Nations, the predecessor of the OECD, in the 'Report on Double Taxation to the financial Committee' in 1923⁶⁰. The principles of this report formed a benchmark of the model conventions to avoid double taxation drafted by the League of Nations⁶¹. The theory of economic allegiance was identified as an appropriate basis on which taxation should be levied in a situation, where various jurisdictions might exercise their power of taxation⁶². In order to allocate the taxing rights between the state of residence and the state of origin or situs, *i.e.* of source, according to this theory, it is necessary '*to ascertain where the true economic interests of the individual are located, and, as a consequence, where the elements that constitute this economic allegiance have to be identified.*'⁶³. In that respect, the four economists investigated where wealth is really produced, *i.e.* where it really comes into existence, where it is owned and where it is disposed of. The four elements identified as constituting the true meaning of economic allegiance are origin, situs, enforceability and domicile⁶⁴. Even though the Report did not deal with the taxation of capital gains, at the later introduction of the articles on capital gains its principles also applied to capital gains as the allocation of taxing rights over capital gains "*was always consistent with what was provided for in the articles dealing with income from property and capital represented by that property, which were directly influenced by the 1923 Report*"⁶⁵.

The residence of the alienator for treaty purposes is determined under the application of the domestic law of the contracting states (Art. 4(1) OECD Model)⁶⁶. If an individual qualifies as a resident under the domestic laws of both contracting States, the residence for the treaty application is determined by applying the tie-breaker rules *cfr.* Art. 4(2) OECD Model.

For the application of Art. 13(5) OECD Model the current residence is the determining factor, *i.e.* the residence at the moment of the alienation. The former residence is irrelevant⁶⁷. The implication of the timing of determining the residence for the application of the treaty in the context of exit taxes will further be discussed in section 3.3.

The taxable gain is determined under the domestic laws of the state of residence at the time of the taxable event⁶⁸. Para 3 of the Commentary on Art. 13 specifies that,

⁶⁰ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 4.

⁶¹ See Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 5.

⁶² See Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 7.

⁶³ See Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 8 with reference to the report.

⁶⁴ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 8-9.

⁶⁵ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 21.

⁶⁶ Emely Fett, 'Chapter 11: Residence under Tax Treaties with Third States' in *Triangular Cases - The Application of Bilateral Income Tax Treaties in Multilateral Situations* (IBFD 2014) Online Books IBFD (accessed 26 January 2016), at point 11.1.; Belema R. Obuoforibo, *Article 4: Resident - Global Tax Treaty Commentaries*, Global Tax Treaty Commentaries IBFD (2017), accessed 23 May 2018, at point 1.1.2.2.

⁶⁷ Sanford H. Goldberg et al., n 44, 643, 653

⁶⁸ Josef Schuch and Erik Pinetz, n 43, at V.; see also OECD Commentary on Art. 13, para 3.

"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 Article can in no way be construed as giving a State the right to tax capital gains if such right is not provided for in its domestic law."

The computation of the capital gain is also left to the domestic law applicable⁶⁹.

The exclusive allocation of the taxing right to the State of residence at the time of the alienation applies to the entire gain. A specific paragraph 3.1. was inserted in the Commentary on Art. 13 in the 2014 version, which confirms this principle:

*' (...) where the Article allows a Contracting State to tax a capital gain, this right applies to the entire gain and not only to the part thereof that has accrued after the entry into force of a treaty (subject to contrary provisions that could be agreed to during bilateral negotiations), even in the case of a new treaty that replaces a previous one that did not allow such taxation.'*⁷⁰

This assertion is seen as a mere clarification of the existing legal situation⁷¹.

According to Schuch and Pinetz exit taxes levied by the State of emigration are an effective way for that State to prevent a loss of tax revenue due to a change in taxing rights from one contracting state to the other. These authors find exit taxation fully compatible with Art. 13 OECD Model, *'as the levy of the tax does not concern assets over which the other contracting state has taxation rights'*⁷². They state that *'without a deviation from the OECD Model, the emigration state is fully competent to levy an exit tax on the assets falling outside its possible scope of taxation, while the immigration state is fully competent to tax the alienation under its domestic law without being limited by the tax treaty'*⁷³.

However, such a unilateral application of an exit tax creates the risk for double taxation if the State of immigration does not take into account the exit tax levied by the State of emigration.

3.2.2 Meaning of the Term 'Alienation'

It can be questioned whether the term 'alienation' is limited to the transactions where an actual transfer of ownership takes place or whether other taxable events like a deemed disposal are also covered by that term.

The taxable event covered by article 13 of the Model Convention is the 'alienation' of an asset. The term 'alienation', however, is not defined in the OECD Model.

For any term not defined in the treaty, Art. 3(2) OECD Model (2017) says that such term shall, unless the context of the treaty requires otherwise, have the meaning that it has at that time under the law of the State (that is applying the treaty) for the purposes of the taxes to which the treaty applies, with a prevalence of the meaning under the applicable tax laws of that state. In the 2017 version of the OECD Model the wording has been amended and the wording *'or the competent authorities agree to a different meaning*

⁶⁹ OECD Commentary on Art. 13, para 12.

⁷⁰ OECD Commentary on Art. 13, para 3.1.

⁷¹ Josef Schuch and Erik Pinetz, n 43, at V.

⁷² Josef Schuch and Erik Pinetz, n 43, at V.

⁷³ Josef Schuch and Erik Pinetz, n 43, at VI.

pursuant to the provisions of Article 25” was added in order “*to remove any doubt that in a case where a mutual agreement reached under Article 25 indicates that the competent authorities have agreed on a common meaning of an undefined term, the domestic law meaning of that term would not be applicable, as is the case when a term is defined in the Convention or when the context requires a meaning that is different from the domestic law meaning.*”⁷⁴ This means that the domestic law meaning of a term has to be set aside not only when the context of the treaty requires otherwise but also in case the competent authorities of the contracting States pursuant to a mutual agreement procedure as meant in Art. 25 OECD Model have agreed to apply a different meaning. The amended Art. 3(2) OECD Model (2017) reads as follows:

‘2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.’ (Art. 3(2) OECD Model (2017))

Therefore, for the meaning of the term ‘alienation’ in Art. 13(5) reference is made to its meaning in the domestic tax law of the contracting State, unless the treaty context requires otherwise or in case a different meaning has been agreed by the competent authorities of the contracting states in a mutual agreement procedure in application of Art. 25 OECD Model.

The scope of Art. 13 is greatly influenced by the meaning of the term ‘alienation’⁷⁵. The ordinary meaning of the term seems to require a transfer of property from one person to another⁷⁶. This appears however to be a too limited a meaning for the application of Art. 13 OECD Model.

The history of the terminology used to describe the events giving rise to capital gains and of the use of the term ‘alienation’, is found to constitute a significant portion of the context of Art. 13 and should therefore play a major role in the interpretation of such a term⁷⁷. Simontacchi concludes from that history and context that *‘it follows that the term “alienation” must be interpreted in a broad way so as to affect the scope of the provision as little as possible’*⁷⁸.

The Commentary on Art. 13 supports a broad scope of the article and of the meaning of the term ‘alienation’.

Para 5 of the Commentary on Art. 13 states that the article does not give a detailed definition of the term ‘capital gains’ *‘for the reasons previously mentioned’*, thereby

⁷⁴ OECD Commentary on Art. 13, para 13.2.

⁷⁵ Stefano Simontacchi, ‘Chapter 9 Capital gains (Article 13 OECD Model Convention)’, in Michael Lang (ed.), *Source versus Residence* (Kluwer Law International 2008) 129, 143.

⁷⁶ Stefano Simontacchi, ‘Chapter 9 Capital gains (Article 13 OECD Model Convention)’, n 75, 129,143.

⁷⁷ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 182.

⁷⁸ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 182; See also Ekkehart Reimer, n 43, n° 162 with reference to Austrian scholars Lang and Toifl who seem to adhere the position that alienation requires a change of ownership.

referring to the diversity of capital gains taxation in various jurisdictions⁷⁹. Para 5 of the Commentary on Article 13 mentions further:

‘The words “alienation of property” are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.’ (emphasis added)⁸⁰.

The use of the words ‘in particular’ means that this enumeration is not exhaustive and that the term ‘alienation of property’ is broader than ‘sale or exchange of property’.

The Commentary on Art. 13 also explains that Art. 13 is not limited to realised capital gains:

‘6. Most States taxing capital gains do so when an alienation of capital assets takes place. Some of them, however, tax only so-called realised capital gains. (...) Whether or not there is a realisation has to be determined according to the applicable domestic tax law.’⁸¹

‘7. As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation’⁸²

The Commentary gives some examples of ‘increment taxes’, i.e. taxes of capital appreciation without any alienation or revaluation⁸³. The Commentary states that such ‘increment taxes’ qualify as taxes covered by Art. 2 OECD Model. Hence the realisation of a gain is not required for it to be within the ambit of Art. 13.

The purpose of Art. 13 is clearly to cover all the possible capital gains definitions used in the various jurisdictions. Therefore the term ‘alienation’ must be interpreted broadly enough to include all such cases⁸⁴. As to the application of Art. 3(2) OECD Model, the Commentary does not provide for clear guidelines as to what extent the recourse to domestic law is or is not allowed⁸⁵. Whereas it seems to be clear from the history and from the purpose of Art. 13 that the term ‘alienation’ has a treaty meaning, recourse to domestic law may be necessary and appropriate in cases where that meaning is too vague to include difficult cases where there is no transfer of rights relating to a property, such as is the case with taxation of capital gains derived from a deemed alienation⁸⁶. Also Reimer adheres to a similar approach in that the ‘core’ of the term ‘alienation’ has to be interpreted autonomously under the Model Convention, ‘*while a flexible periphery is open to follow the*

⁷⁹ See OECD Commentary on Art. 13, paras 5 and 3.

⁸⁰ OECD Commentary on Art. 13, para 5: “(...) capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.”

⁸¹ OECD Commentary on art. 13, para 6.

⁸² OECD Commentary on art. 13, para 7.

⁸³ OECD Commentary on art. 13, para 8.

⁸⁴ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 183.

⁸⁵ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 184.

⁸⁶ Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention with Special Regard to Immovable Property*, n 43, 184.

*meaning the term has under the domestic law of one of the Contracting States*⁸⁷. In application of Art. 3(2) OECD Model, ‘*surrogates for alienation*’, such as a taxpayer moving to a foreign country, is also subject to Art. 13(5) OECD Model, in so far the domestic law makes it subject to the same legal consequences as the alienation of the property⁸⁸.

Several authors are of the opinion that the term ‘alienation’ in Art. 13 OECD Model is limited to cases where an actual transfer of ownership takes place⁸⁹. Lang refers to the context of the convention, from which ‘*it is inferred that an alienation is the transfer of the ownership of the asset. The question whether certain dealings are regarded as alienations has to be determined exclusively in the context of the treaty. Transactions in one of the two contracting states, which are merely put on par with alienations by means of domestic legislation, are therefore not necessarily alienations in the sense of a tax treaty.*’⁹⁰ If the appreciation in value is taxed, such tax would fall under the distributive rule regarding the income from the particular asset⁹¹.

According to Kemmeren, Art. 13 OECD Model would only cover ‘increment taxes’, i.e. taxes on established capital appreciation without alienation, in relation to business assets, and not capital appreciation from privately held shares⁹². Kemmeren commented on a ruling of the Dutch Supreme Court regarding the Dutch exit tax on substantial shareholdings in a case where a Dutch resident (individual) emigrated to Switzerland⁹³. Kemmeren argues that, based on its legislative history, the Dutch exit tax cannot be characterised as an increment tax and that it was conceived as an anti-avoidance rule to discourage tax-driven emigration from the Netherlands. It is true that the OECD Commentary only mentions ‘increment taxes’ in relation to business assets⁹⁴.

De Broe is of the opinion that Art. 13(5) OECD Model allocates the taxing right of capital gains to the State of residence at the moment of the actual alienation. As a consequence, a contracting State has relinquished its power of taxation to the State where the taxpayer resides when he actually disposes of the assets and realises the gains⁹⁵.

De Broe and Kemmeren take the position that the introduction of an exit tax in the strict sense after entering into a tax treaty would be a unilateral breach by that State of its commitments under its tax treaties (treaty override), which would not be in accordance with the application and interpretation in good faith of the terms of Art. 13(5) OECD Model under the Arts. 26-27 and 31 VCTL⁹⁶. De Broe contends that, if a contracting State

⁸⁷ Ekkehart Reimer, n 43, n° 9-11.

⁸⁸ Ekkehart Reimer, n 43, n° 15 and 18.

⁸⁹ Michael Lang, n 43, n° 313; Bruno Carramaschi, n 43, 3 and Eric C.C.M. Kemmeren, n 43, at 28.4.2 (eleventh argument to substantiate treaty override); Luc De Broe, ‘Chapter 5 –The Relevance of Residence under EC Tax Law’ n 43, at 5.2.3.1.; Maria Teresa Soler Roch, n 43, at 27.2.2.

⁹⁰ Michael Lang, n 43, n° 313.

⁹¹ Michael Lang, n 43, n° 313; Bruno Carramaschi, n 43, 3-4.

⁹² Eric C.C.M. Kemmeren, n 43, at 28.4.2. Kemmeren comments on the ruling of the Netherlands Supreme Court (Hoge Raad) of 16 January 2015, no. 13/05247, Tax Treaty Case Law IBFD. The case concerned the application of the Dutch exit tax when an individual, resident of the Netherlands, emigrated to Switzerland.

⁹³ Netherlands Supreme Court (Hoge Raad) of 16 January 2015, no. 13/05247, Tax Treaty Case Law IBFD.

⁹⁴ OECD Commentary on Art. 13, paras 6-9.

⁹⁵ Luc De Broe, ‘Chapter 5 –The Relevance of Residence under EC Tax Law’ n 43, at 5.2.3.1.

⁹⁶ Luc De Broe, ‘Chapter 5 –The Relevance of Residence under EC Tax Law’ n 43, at 5.2.3.1; Eric C.C.M. Kemmeren, n 43, at 28.4.2. Kemmeren points out at the diverging case law of the Netherlands Supreme

wishes to preserve its right to levy an exit tax when entering into a DTT, it needs to do so in the tax treaty⁹⁷. Other authors are of the opinion that the introduction of an exit tax does not imply a treaty override, because the tax charge arises at the moment before there is a cross-border situation⁹⁸.

For the reasons mentioned above and the clear broad scope of Art. 13(5) OECD Model, the author does not concur with these authors that the references to increment taxes in relation to business assets in the Commentary would support the position that an exit tax in the strict sense would not be covered by Art. 13(5) OECD Model.

Under South African domestic law, the term 'disposal' includes also the cases of 'deemed disposal' as defined in section 9H(2)(a)(i) ITA. As mentioned in Chapter 2, the event of ceasing to be a resident or the emigration of a taxpayer is regarded as a deemed disposal and deemed reacquisition. Because of the broad meaning of the term 'alienation' in Art. 13(5) OECD Model, such deemed disposal is included in that term and should for that reason fall within the ambit of the allocation rule of Art. 13(5).

In this context, the judgement of the Supreme Court of Appeal of South Africa in the Tradehold-case needs to be mentioned⁹⁹. The SCA held that the term 'alienation of property' of the DTA between South Africa and Luxembourg was '*widely cast*' and was '*not restricted to actual alienation and it is a neutral term having a broader meaning, comprehending both actual and deemed disposals of assets giving rise to capital gains*'¹⁰⁰. The reason for this finding, namely the reference to the intention of the parties to the DTA, is surprising, as the provisions regarding the exit charge in the Eighth Schedule were only introduced with effect from 1 October 2001, long after the negotiation of the DTA by the parties since the tax treaty between South Africa and Luxembourg was concluded on 23 November 1998. Equally surprising was the outcome of the judgement in that the Court held that Luxembourg had the exclusive taxing powers of the capital gains and that this prevented South Africa from applying its exit tax, without considering the time of disposition rule which considers the deemed disposal to have taken place on the date immediately before the change of residence, and without pinpointing the exact date of the taxable event that triggered the deemed disposal. There is no indication in the reasoning of the Court that this judgement supports the doctrine that an exit tax adopted after a double tax treaty came into effect would be a forbidden treaty override of the allocation of taxing powers. As already mentioned in 2.1.2.3. the Court did not address the question whether the treaty precludes a contracting state from levying an exit charge at a moment before the change of residence. Additionally, the judgement needs to be considered in the specific context of the unique facts of the case and the particularity of the definition of

Court (Hoge Raad), where the Supreme Court seems to accept a deeming provision in relation to capital gains of shares as in line with the allocation of taxing powers of the DTT whereas it held that a deeming provision in relation to pensions was contrary to the allocation of taxing powers to the other contracting State. It would be interesting to analyse the reasons of these diverging outcomes and to compare the exit charges on capital gains with the ones on pension interests, yet such analysis would exceed the purpose of this paper.

⁹⁷ Luc De Broe, 'Chapter 5 – The Relevance of Residence under EC Tax Law' n 43, at 5.2.3.1.

⁹⁸ Brian J. Arnold, n 17, 481, 484; Bruno Carramaschi, n 43, 6-7; Maria Teresa Soler Roch, n 43, at 27.2.2., contends that exit taxes are not a case of treaty override *inter alia* because the concept of capital gains in Art. 13 OECD Model does not include deemed capital gains.

⁹⁹ See the facts of this case supra 2.1.2.3.

¹⁰⁰ SCA, Tradehold, n 17.

'resident' in the South African ITA applicable to companies at the time of the facts of the case. Moreover, the South African rules and regulations regarding the definition of residence have been amended and the timing of the tax charge has been more explicitly defined in order to emphasise that the exit charge arises at a moment when the person is still a resident.

The analysis of the meaning of the term 'alienation' leads to the conclusion that, based on the broad meaning of the term 'alienation', Art. 13(5) OECD Model does not prevent and allows South Africa, as the State of residence, to levy a capital gains tax on its resident taxpayers under the deeming provision read together with the time of disposal rule of section 9H(2)(a) ITA (for a person other than a company) and section 9H(3)(a) ITA (for a company which ceases to be a resident).

Yet, the meaning of the term 'alienation' is not apt to prevent the risk of double taxation, as Art. 13(5) allows the new State of residence equally to tax the capital gains at the time of the actual disposal of the asset and of the actual realisation of the gain, which is another taxable event covered by the meaning of the term 'alienation'. The actual disposal and the deemed disposal are two different taxable events falling within the ambit of Art. 13(5) OECD Model, occurring at different points in time. Hence the timing of the application of the treaty needs to be further examined (see 3.3.).

3.3 Timing Aspects Related to the Application of the Double Tax Treaty in Case of Change of Residence

Where the broad scope of Art. 13(5) OECD Model also includes a capital gains tax on a deemed disposal in case of a change of residence to another jurisdiction (see 3.2.2.), the timing aspects are crucial for the application of Art. 13(5) OECD Model in the event of a change of residence of the taxpayer to another jurisdiction. Both, the timing of the application of the double tax treaty and the timing aspects of the allocation of the taxing right need to be determined.

As Wheeler states in the Global Tax Treaty Commentaries, the role of time in the allocation of taxing rights does not get a great deal of attention in the OECD Model and the UN Model¹⁰¹. The distributive articles of the OECD Model do not state explicitly what is to be regarded as a taxable event for treaty purposes, although they do use various terms to indicate the connection between income and a person, that is required in order for the tax treaty to apply, and some of these terms could also be taken as an indication of the timing. The use of the term capital gains 'derived by' a person in Art. 13(5) OECD Model seem to suggest such indication of timing¹⁰².

Timing aspects relate to the determination of the taxable event that gives rise to the application of the double tax treaty, of the state of residence at that moment and to the allocation of the taxing right over the gain in case of a change of residence during the time when the gain accrued. The following sections will reflect on these aspects.

¹⁰¹ Joanna Wheeler, n 51, at 1 Introduction.

¹⁰² Joanna Wheeler, n 51, at 3.2.2.

3.3.1 Application of Art. 13(5) OECD Model when the Tax Charge Arises under Domestic Law

The timing of a taxable event is not regulated by a tax treaty. It is, rather, domestic law that determines when a tax charge is imposed. All that a tax treaty generally does is to express an agreement between the two states that, in certain cases, a tax charge does not apply or is limited¹⁰³.

The timing of the taxable event linked to the term ‘alienation’ of Art. 13(5) OECD Model follows domestic law; the OECD Model uses the term ‘alienation’ and applies the domestic law approach at a specific moment when a realisation or deemed realisation occurs¹⁰⁴.

This understanding of the determination of the timing of a tax charge under domestic law is supported by the Commentary on the OECD Model. The 2014 Commentary on Art. 1 OECD Model stated in general that the basic domestic rules for determining which facts give rise to a tax liability are not addressed by tax treaties and are not affected by them¹⁰⁵. Even though this passage referred to the characterisation of income and to the determination of the taxpayer under domestic law, it implicitly includes a reference to the timing of the tax charge as the timing of a taxable event is a similarly fundamental aspect of a tax charge¹⁰⁶. Further, para 3 of the Commentary on Art. 13 (2017) explicitly refers to domestic law for the determination of whether and how capital gains are taxed. This includes the determination of which facts give rise to a tax liability and the manner of imposing a tax charge. Ultimately, 2015 Final Report of Action 6, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, of the OECD/G20 Base Erosion and Profit Shifting Project (‘BEPS Action 6’) states explicitly that ‘*The provisions of tax treaties do not govern when income is realised for domestic tax purposes*’¹⁰⁷. Even though this statement was made in the context of exit taxes in the broad sense, it is thought to reflect a general principle¹⁰⁸.

Art. 13 OECD Model applies to taxes levied at a specific moment in time, e.g. when a change of circumstances occurs, even though the tax charges relate to a period of time, as the capital gain accrued over time¹⁰⁹. The Final Report on BEPS Action 6 also mentions that in a number of States, ‘*liability to tax on some types of income that have accrued for the benefit of a resident (whether an individual or a legal person) is triggered in the event that the resident ceases to be a resident of that State*’¹¹⁰. The OECD Model does not explicitly take account of a change in circumstances that are relevant to the distribution of taxing

¹⁰³ Joanna Wheeler, n 51, at 3.2.3.

¹⁰⁴ Joanna Wheeler, n 51, at 4.3.2.2.

¹⁰⁵ OECD Commentary on Art. 1 (2014), para 22.1. This paragraph which referred to the relationship between domestic anti-abuse rules and the treaty provisions has been deleted in the 2017 version of the Commentary since a whole new set of paragraphs is inserted in the Commentary regarding the anti-abuse provisions in domestic law and treaty benefits (see the new paras 57-80 of the OECD Commentary on Art. 1 (2017)).

¹⁰⁶ Joanna Wheeler, n 51, at 3.2.3.1.

¹⁰⁷ OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015) accessed 18 December 2016, available at <http://dx.doi.org/10.1787/9789264241695-en>

¹⁰⁸ Joanna Wheeler, n 51, at 3.2.3.1.

¹⁰⁹ Joanna Wheeler, n 51, at 4.8.3.

¹¹⁰ BEPS Action 6, Final Report, n 107, at 65.

rights¹¹¹.

Mismatches may arise regarding a different timing of the tax charge and of the taxable amount according to the domestic law of the contracting states¹¹². Such a mismatch may occur when the term ‘alienation’ refers to two different taxable events in the two contracting states: the one state levies a capital gains tax at an event that is regarded as a deemed disposal, such as when a taxpayer ceases to be a resident for tax purposes, while the other contracting state may apply a capital gains tax when the asset is actually disposed of and the capital gain is realised. This mismatch in timing of taxable events holds the risk of double taxation where the relevant person becomes a resident of another State which seeks to tax the same income at a different time¹¹³. In 3.5. the method to prevent the double taxation will be analysed.

3.3.2 The State of Residence when the Tax Charge Arises

Under Art. 13(5) OECD Model, the taxing right is allocated exclusively to the State of residence at the moment when the tax charge arises. The residence at that moment is then determined under the domestic tax law of that State¹¹⁴.

According to Art. 4(1) OECD Model (2017) the residence is determined under the domestic law of the Contracting State and requires that the person is liable to tax on a comprehensive basis¹¹⁵:

‘For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, (...). This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.’

For a trailing tax, the taxable event is the actual alienation within a confined period of time after the emigration, at a moment when the taxpayer has become a resident of the other contracting State. In the light of Art. 13(5) OECD Model the exclusive taxing right of the capital gains is allocated to the State of residence at that moment, thus to the State of immigration. This means that, unless a specific DTT deviates from Art. 13(5) OECD Model the application of the trailing tax by the former State of residence is contrary to that article of the OECD Model¹¹⁶. Art. 13(5) OECD Model does not provide for a basis for the former State of residence to exercise its extended taxing jurisdiction or to tax accrued gains after the taxpayer ceased to be a resident¹¹⁷.

The BEPS Action 6, Final Report, states in respect of exit taxes in the strict sense that the tax liability to such taxes usually arises *‘when a person is still a resident of the State that applies such taxes and does not extend to income accruing after the cessation of*

¹¹¹ Joanna Wheeler, n 51, at 4.3.1.

¹¹² Joanna Wheeler, n 51, at 3.2.4.1.

¹¹³ BEPS Action 6, Final Report, n 107, at 66.

¹¹⁴ The Commentary refers to the domestic law for the way how the gains from the alienation of property are taxed, see OECD Commentary on Art. 13, para 3.

¹¹⁵ Jinyan Li and Francesco Avella, n 59, at 2.1.1.2. Residence and change of residence.

¹¹⁶ Ekkehart Reimer, n 43, n° 163.

¹¹⁷ Joanna Wheeler, n 51, at 5.2.1.2.

residence'¹¹⁸. To that extent 'nothing in the Convention, and in particular in Articles 13 (...), prevents the application of that form of taxation'¹¹⁹. The Final Report continues, 'Thus, tax treaties do not prevent the application of domestic tax rules according to which a person is considered (...) to have alienated property for capital gain tax purposes, immediately before ceasing to be a resident.'¹²⁰

The State of emigration will usually be the State of residence at the time of the taxable event, as the taxable event which is assimilated to an 'alienation' is deemed to have taken place immediately before the taxpayer ceases to be a resident of that State. The State of emigration is therefore, as State of residence, entitled to levy the exit tax.

This view has been shared by the Netherlands Supreme Court (Hoge Raad) in its ruling of 16 January 2015. The Court held that the emigrating substantial shareholder cannot claim a right in respect of that gain under a tax treaty with the immigration country to which a resident of that country is entitled, because of the fact that under national law, the benefit is deemed to be realised at the moment immediately before ceasing domestic tax liability, i.e. the resident tax liability in the Netherlands¹²¹. In previous judgements the Hoge Raad also ruled that the Dutch exit tax on substantial shareholdings is not contrary to the treaty provisions regarding capital gains on shares (cfr. Art.13(5) OECD Model) because the tax is levied just before the emigration and the treaty is not applicable at that moment, and the OECD Commentary on Art. 13 OECD Model does not preclude a contracting state to include a deemed alienation of shares in the term 'alienation'¹²².

The Canadian Federal Court of Appeal ruled similarly in the *Holbrook R. Davis v Her Majesty The Queen* – case concerning the application of the Canadian exit charge when a Canadian resident individual transferred his residence to the United States. According to Canadian domestic law provisions the individual was deemed to have disposed of his property immediately before ceasing to be a resident. The Court held that the tax treaty did not apply because the capital gains were deemed to have been made while he was a resident in Canada and not after he became a resident of the United States¹²³.

As already mentioned in 2.1.3., the South African Supreme Court in the Tradehold-Case did not address the issue of the timing of the deemed disposal¹²⁴. One can only assume possible reasonings regarding the exact timing of the tax charge either at the moment when the company shifted its place of effective management to Luxembourg or when it ceased to be a resident by effect of the amended definition of resident¹²⁵.

¹¹⁸ BEPS Action 6, Final Report, n 107, at 66.

¹¹⁹ BEPS Action 6, ibidem.

¹²⁰ BEPS Action 6, ibidem.

¹²¹ Hoge Raad 16 January 2015, no. 13/05247, BNB 2015/64; for an extensive commentary of this case see Eric C.C.M. Kemmeren, n 43.

¹²² Luc De Broe, 'Chapter 5 –The Relevance of Residence under EC Tax Law' n 43, at 5.2.1.3.1. with reference to Hoge Raad, 20 February 2009, Nos. 42.699, 42.701, 42.702 and 07/12134; Hoge Raad 20 February 2009, nos. 07/12314; 42.701 and 43.760, Tax treaty Case Law IBFD.

¹²³ *Holbrook R Davis v Her Majesty The Queen* 80 DTC 6056 (1980), [1980] 2 FC 250, 1980 FC LEXIS 465, as mentioned in SARS, *Comprehensive Guide to Capital Gains Tax* (Issue 7), n 6, p. 112.

¹²⁴ SCA, Tradehold, n 17.

¹²⁵ Craig West and Jennifer Roeleveld, 'Chapter 4: South Africa: Transfer of Seat and Exit Taxation: Treaty Override?', n 16, at 4.4.1. and 4.4.2.

In a case concerning an exit tax on pensions the Brussels Court of Appeal took a different position in its judgement of 17 October 2002¹²⁶. The domestic tax provision provided that a pension payment to an individual who emigrates from Belgium before the actual payment, is deemed to have taken place on the day before the taxpayer ceases to be a tax resident of Belgium. The Court of Appeal had to answer the question whether this deeming provision was in breach of the double tax treaty between Belgium and France, which allocated the exclusive taxing rights on other income to the state of residence, *in casu* France (Art. 18 DTT Belgium-France). The Brussels Court of Appeal had ruled in favour of the taxpayer based on the reasoning that the Belgian domestic tax provision in question, dating from after the DTT was concluded, was in breach of the provisions of the treaty which allocated the exclusive taxing powers to the state of residence. The Tax authorities contended that the taxpayer was not entitled to invoke the treaty because the pension was not actually taxed in France as the state of residence at the moment of the actual payment of the pension. This argument was rejected by the Court of Appeal. In a similar case, the Belgian Supreme Court rejected this contention of the Tax Authorities and held that the allocation of exclusive taxing powers to one contracting state does not allow the other state to tax the income if the first state does not actually tax the income, unless the treaty provides for that possibility¹²⁷. In later Administrative guidance, which is still in force, the Belgian Tax Authorities confirmed that the deeming provision regarding the payment of pensions does not apply to a taxpayer who emigrates to a country with which Belgium has concluded a double tax treaty that allocates the exclusive taxing power on pensions to the state of residence¹²⁸.

Even though the deeming provision of the exit charge on pensions is similar to the exit charge on capital gains, the Courts seem to apply a different standard regarding treaty override and conformity with the double tax treaty¹²⁹. This difference is even more apparent in the case law of the Netherlands Supreme Court, where the deeming provision regarding the exit tax on substantial shareholdings is found to be in line with the allocation of exclusive taxing powers to the state of residence (see the cases mentioned above), even if the exit tax was introduced after the entry into effect of the double tax treaty, whereas the similar deeming provision regarding accrued pension rights is held to be in breach of the obligation to apply a treaty in good faith¹³⁰. The question whether or not such different outcome is justified, exceeds the scope of this study. It is submitted that caution is required when contemplating the value of precedent of cases regarding exit

¹²⁶ Court of Appeal Brussel, 17 October 2002, Tax Treaty Case Law IBFD Online.

¹²⁷ Belgian Supreme Court (Hof van Cassatie), 5 December 2003, F.02.0042.F, Tax Treaty Case law IBFD; see also Luc De Broe, 'Hard Times for Emigration Taxes in the EC', n 43, at 5.1.

¹²⁸ The taxpayer then is required to provide a proof of residence in the other contracting state. Circulaire AOIF 19/2007 of 12 July 2007. The domestic tax rule regarding the exit tax on pensions has been found contrary to EU law (European Court of Justice, C-522/04 *European Commission v. Belgium*, 5 July 2007, ECLI:EU:C:2007:405) and therefore only applies in case of emigration to a non-EER country (without DTT).

¹²⁹ Belgium does not apply an exit charge on capital gains to individuals who emigrate, which explains the absence of case law on that topic.

¹³⁰ See Luc De Broe and Katrien Willoqué, *Exit Taxes on Substantial Shareholding and Pension Claims: The Dutch Supreme Court's Interpretation of Arts. 13, 15 and 18 of the OECD Model, in Tax Polymath. A Life in International Tax. Essays in Honour of John F. Avery Jones* (Ph. Baker and C. Bobbett eds.), (2010 IBFD), 233-234 and 245, with reference to Netherlands Supreme Court (Hoge Raad) 19 June 2009, nos. 43.978, 08/02288 and 07/13267. See also Eric C.C.M. Kemmeren, n 43, at 28.4.2. with reference to the same judgements of the Netherlands Supreme Court and additionally referring to Hoge Raad 5 September 2003, no. 37.657 and Hoge Raad 15 April 2011, no 10/00990.

charges on pension rights in the context of cases regarding exit tax on capital gains in respect of shares.

3.3.3 No Time Apportionment or Compartmentalisation

The question of time apportionment or compartmentalisation arises *'when a new tax treaty becomes applicable or when there is a change in the factual situation of the taxpayer, both resulting in a shift in the allocation of taxing powers of the tax treaty states involved'*¹³¹. The taxation of a capital gain takes place at a specific moment in time, whereas the gain accrued over a period of time. During this period of time the taxpayer might transfer his residence to another jurisdiction. Such change in the factual situation has its implications in the applicable tax treaty. As mentioned, under 3.2.1. the allocation of taxing rights under Art. 13 OECD Model applies to the entire gain, as determined under the domestic laws of the State of residence at the moment of the 'alienation' in the sense of Art. 13(5) OECD Model. Wheeler states that, in case of a change of treaty residence during the accrual period of the gain, it is unlikely that any apportionment is required in respect of capital gains, even though they may accrue over many years¹³².

The change of residence has an immediate effect on the allocation of the taxing rights under Art. 13(5) OECD Model and does not require any apportionment¹³³. This is supported by para 3.1 of the Commentary on Art. 13 (from the 2014 version onwards). Even though this paragraph comments on the effect of the entry into force of a new treaty, *'it provides strong support for the argument that tax treaties do not require a time apportionment of a capital gain to take account of a material change in circumstances during the accrual period of the gain'*¹³⁴.

In other words, there is no basis in Art. 13(5) OECD Model, that the State of residence must apply an apportionment of the taxing rights under which the profits are taxable in the state where the respective increase in value has accrued. Art. 13(5) OECD Model allocates that taxing right to the State of residence without taking the past into account¹³⁵. Art. 13 OECD Model does not provide for a compartmentalisation of the gain.

As suggested by quoted para 3.1. of the Commentary on Art. 13, contracting States may include deviations from the OECD Model in a specific DTT and provide for an apportionment of the income generated by the alienation of an asset (see 3.6). Through the apportionment of the gain in the DTT the double taxation of the gain can be prevented. In absence of such a deviation from the OECD Model, the allocation under art. 13 applies in its entirety in favour of the contracting State to which this article allocates the taxing rights at the time when the tax is levied¹³⁶. In 3.6 and 4.1 deviations from the OECD Model which provide for an apportionment of the taxable gain between the contracting states in case of a change of residence will be further examined.

However, compartmentalisation of the taxable gain may be granted under domestic tax

¹³¹ Daniël Smit, 'Timing Issues under Double Tax Treaties: The Dutch Approach' (2016) 44 (1) *Intertax* 29.

¹³² Joanna Wheeler, n 51, at 5.3.3.1.

¹³³ Joanna Wheeler, n 51, at 5.3.5.2.1.; Jinyan Li and Francesco Avella, n 59, at 2.1.7.

¹³⁴ Joanna Wheeler, n 51, at 4.3.3.

¹³⁵ Josef Schuch and Erik Pinetz, n 43, at V.

¹³⁶ Josef Schuch and Erik Pinetz, n 43, at V.

rules. This is for example the case when the country of entry, in case of a change of residence, grants a so-called 'step-up' in the base cost¹³⁷.

South Africa applies such compartmentalisation under domestic law in that a step-up in the base cost is granted at the time of the immigration to South Africa (Para 12 (1) and (2)(a)(i) of the Eighth Schedule). Assets owned by a taxpayer at the moment when he becomes a tax resident in South Africa are deemed to be disposed of and immediately reacquired the day that he commences to be a resident and this value is taken into account as the base cost for the later determination of the taxable capital gain.

In the European Union the European Court of Justice ('ECJ') recognised the principle of territoriality combined with a temporal element related to the period of the residence of the taxpayer as a legitimate justification for a Member State to levy an exit tax in the strict sense on accrued increases in value. This finding of the ECJ, however is based on an erroneous understanding of the temporal element in the application of the distributive rule of Art. 13(5) OECD Model. The ECJ is saying to base its findings on the Opinion of the Advocate General Kokott developed in the N-case in respect of the principle of territoriality¹³⁸. Yet, this understanding was erroneous because it is not as such supported by that Opinion. Even though the AG referred to the principle of territoriality in Art. 13(5) OECD Model which allocates the taxing powers on capital gains to the state where the alienator is a resident, the AG did not as a matter of principle attach a temporal element to it. The AG only observed that in the particular case of the tax treaty between the Netherlands and the United Kingdom the capital gains-article seemed to diverge from that principle laid down in Art. 13(5) OECD Model and that the Netherlands had added a temporal component to the principle of territoriality in its domestic law provisions, '*namely residence within the territory during the period in which the taxable profit arises*'. The AG found that the '*provisions concerning tax on emigration may none the less be seen as consonant with the principle of territoriality*'¹³⁹. The author concurs with De Broe in his criticism that there is no support in Art. 13(5) OECD Model for a territorial taxation on a temporal basis¹⁴⁰.

As a technical solution in the paradigm of the residence-based taxation of capital gains of shares and the application of an exit tax on the increases in value in case of a change of residence of the taxpayer to another jurisdiction, Kemmeren suggests a residence-based compartmentalisation of such capital gains, which would make exit taxes superfluous if the system would be included in tax treaties¹⁴¹. Yet, as a fundamental solution to the issue of competing tax jurisdiction of capital gains on shares, Kemmeren advocates an origin-based allocation of taxing powers to the state in which the value has been added. In the context of capital gains on shares, the principle of origin points to the state where the company carries out or has carried out its substantial entrepreneurial activities to tax the capital gains realized upon alienation of the shares. Under such system, the transfer of residence of the company's shareholder becomes irrelevant¹⁴². This debate touches the

¹³⁷ Sanford H. Goldberg et al., n 44, 643, 650; Daniël Smit, n 131, 37.

¹³⁸ ECJ, C-470/04, N, 7 September 2006, EU:C:2006:525, n°46; Opinion of the Advocate- General Kokott, 30 March 2006, in C-470/04, N, n°94.

¹³⁹ Opinion of the Advocate- General Kokott, 30 March 2006, in C-470/04, N, n°95-97

¹⁴⁰ Luc De Broe, 'Chapter 5 – The Relevance of Residence under EC Tax Law' n 43, at 5.2.1.3.2.

¹⁴¹ Eric C.C.M. Kemmeren, n 43, at 28.5.

¹⁴² E.C.C.M. Kemmeren, n 43, 28.5 and 28.6.

question of the nexus of capital gains with the residence or the source state, which exceeds the scope of this paper.

3.4 Exit Tax as a Domestic SAAR and Denial of the Treaty Benefit of Art. 13(5) OECD Model in Case of Abuse?

The latest version of the OECD Model of 2017 and of the Commentary implement some provisions and comments as drafted in the 2015 Final Report of BEPS Action 6¹⁴³. These recent evolutions shed a different light on the debate whether or not exit taxes are compatible with tax treaties and support the viewpoint in favour of the compatibility of exit taxes in the strict sense.

In respect of the circumvention of domestic tax law provisions facilitated by tax treaty benefits the Final Report of BEPS Action 6 drafted a revision of the section of the Commentary on 'Improper use of the Convention' where the interaction between domestic anti-abuse rules and tax treaties is 'better' articulated¹⁴⁴.

The Final Report of BEPS Action 6 explicitly mentions departure and exit taxes (in the strict sense) as examples of domestic anti-abuse rules which prevent the granting of treaty benefits in inappropriate situations¹⁴⁵. Indeed, the benefits of a double tax treaty might be sought by a person in order to circumvent the application of a domestic tax provision. A person might seek to circumvent the capital gains taxation by transferring his residence to another State which does not tax capital gains or which taxes capital gains at a lower rate. The benefit of the exclusive allocation of taxing power under Art. 13(5) OECD Model facilitates such avoidance of the domestic capital gains tax regime of the State of emigration. The adoption of anti-abuse rules in tax treaties is not sufficient to address such tax avoidance strategies that seek to circumvent provisions of domestic tax laws, so the BEPS Action 6 Final Report states. *'These must be addressed through domestic anti-abuse rules, including through rules that will result from the work on other parts of the Action Plan'*. The Final Report suggest changes to the Commentary of the OECD Model which will clarify that treaties do not prevent the application of domestic anti-abuse rules, such as departure or exit taxes¹⁴⁶.

One of these amendments of the Commentary is found in para 56 of the Commentary on Art. 1 OECD Model (2017), which mentions as an example of 'Improper Use of the Convention' the situation where an individual transfers his residence to the other

¹⁴³ BEPS Action 6, Final Report, n 107, n° 15-16 identifies two categories where the granting of treaty benefits would be inappropriate. The first category are cases where a person tries to circumvent limitations provided by the treaty itself. In the cases of the second category a person tries to circumvent the provisions of domestic tax law using treaty benefits.

¹⁴⁴ BEPS Action 6, Final Report, n 107, n° 59 and integrated in the amended in the 2017 version of the Commentary on Art. 1, paras 54-80. Luc De Broe and Joris Luts, 'BEPS Action 6: Tax Treaty Abuse' (2015) 43 (2) *Intertax* 122, 135-136, n° 36 and 37. These authors doubt whether the proposed change to the Commentary on the relationship between tax treaties and domestic anti-avoidance rules are providing more clarification and expect it to add more uncertainty on the matter.

¹⁴⁵ BEPS Action 6, Final Report, n 107, n° 65-67.

¹⁴⁶ BEPS Action 6: Executive Summary, 10 and BEPS Action 6, Final Report, n 107, n° 54. For a critical review of the proposed clarifications see Luc De Broe and Joris Luts, n 144, 122, 135-137 and 139-142, especially at n° 51.

contracting state in order to make use of the application of Art. 13(5) of the OECD Model and to avoid the capital gains tax in his former state of residence:

'56. (...) Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.'

Such cases need to be addressed primarily by domestic law anti-abuse provisions¹⁴⁷. Exit taxes are an example of such defensive measures found in domestic tax law provisions and are usually considered to be specific anti-abuse rules ('SAARs')¹⁴⁸.

Where the application of domestic anti-abuse rules produces conflicting results with the application of tax treaty provisions, the tax treaty provisions are intended to prevail¹⁴⁹. The revised Commentary then explains that *'such conflicts will often be avoided and each case must be analysed based on its own circumstances'*¹⁵⁰.

The revised Commentary also explains in para 73 of Commentary on Art. 1 OECD Model (2017), that one of the solutions to the conflict between the domestic rule and the tax treaty is that the application of specific anti-abuse provisions found in the domestic law may influence the treaty application¹⁵¹. The Commentary states that where the meaning of terms that are not defined by the treaty, are to be interpreted according to their meaning in the domestic laws according to Art. 3(2) OECD Model, this includes the application of domestic SAARs. *'In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting result'*¹⁵². Already under the previous Commentary of 2014 the application of domestic SAAR was not seen as contrary to the application of the double tax treaty (para 9.2 of the Commentary on Art. 1 (2014)).

This supports the view that the meaning of the word 'alienation' of art. 13(5) OECD Model includes the extended definition of 'alienation' provided for in domestic tax law, such as the deemed disposal upon emigration in section 9H ITA in South Africa.

¹⁴⁷ BEPS Action 6, Final Report, n 107, n° 16.

¹⁴⁸ Giorgio Beretta, n 51, at 4 and footnote 71.

¹⁴⁹ OECD Commentary on Art. 1(3) (2017), para 70.

¹⁵⁰ OECD Commentary on Art. 1(3) (2017), para 71.

¹⁵¹ *"73. Second, many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person (see paragraph 1 of Article 4), the determination of what is immovable property (see paragraph 2 of Article 6) and the determination of when income from corporate rights might be treated as a dividend (see paragraph 3 of Article 10). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results. This would be the case, for example, if a domestic law provision treats the profits realised by a shareholder when a company redeems some of its shares as dividends: although such a redemption could be considered to constitute an alienation for the purposes of paragraph 5 of Article 13, paragraph 28 of the Commentary on Article 10 recognises that such profits will constitute dividends for the purposes of Article 10 if the profits are treated as dividends under domestic law."* (emphasis added)

¹⁵² *ibidem*.

More in general, the Final Report emphasizes that the '*main objective of the work aimed at preventing the granting of treaty benefits with respect to transactions is to ensure that treaties do not prevent the application of specific domestic law provisions that would prevent these transactions. Granting the benefits of these treaty provisions in such cases would be inappropriate to the extent that the result would be the avoidance of domestic tax. Such cases include situations where it is argued that (...) Article 13(5) prevents the application of exit or departure taxes (...)*'¹⁵³.

This all supports the position that domestic tax rules providing for an exit tax in the strict sense are not contrary to Art. 13(5) OECD Model when such tax is imposed when the person is still a resident of the state of emigration and the tax does not extend to income accruing after the transfer of residence¹⁵⁴. With reference to the established case law of the European Court of Justice regarding exit taxes De Broe and Luts state that exit taxes on accrued capital gains have become more accepted, in particular in the EU, whereas De Broe '*has always been very critical to the enactment of exit taxes by States subsequent to their tax treaties that follow Articles 13, 18, and 21 OECD Model in particular where they do not undertake any effort (either unilaterally or through an amendment of their treaties) to prevent the resulting double taxation.*'¹⁵⁵

Beretta suggests that the application of an exit tax in the strict sense is problematic as it might constitute a breach of the allocation rules of the tax treaty¹⁵⁶. In his view, the application of an exit tax can only be justified if and to the extent that it is intended to address abusive schemes. The issue then is to distinguish between *bona fide* emigration and emigration that is solely aimed at obtaining inappropriate treaty benefits. The Commentaries do not give any guidance to that end. This reasoning, however, is based on the premise that exit taxes in the strict sense constitute a treaty override and are in breach of the obligation to interpret tax treaties in good faith in terms of Art 31 VCLT¹⁵⁷. Moreover, the lack of distinction between *bona fide* emigration and tax driven emigration also exists at a domestic law level as exit taxes often apply regardless of the reason of a change of residence to another jurisdiction. Therefore, the author does not concur with Beretta regarding this remark.

Further, the Commentary accepts that the application of a tax treaty provision is denied under judicial doctrines or principles applicable to the interpretation of the treaty and describes the example of a sham transfer of residence to another State in order to benefit from the distributive rule of Art. 13(5) OECD Model and to avoid the application of the capital gains tax in the State of emigration¹⁵⁸.

¹⁵³ BEPS Action 6, Final Report, n 107, n° 54.

¹⁵⁴ See also Luc De Broe and Joris Luts, n 144, 122, 140, n° 50.

¹⁵⁵ Luc De Broe and Joris Luts, n 144, 122, 141, n° 52, with reference Luc De Broe, 'The Tax Treatment of Transfer of Residence by Individuals', General Report IFA Congress Oslo 2002, 19, 65–68; Luc De Broe and Katrien Willoqué, n 128, 227, 243–248. De Broe and Luts still find that the exit taxes on pensions remain problematic both from the perspective of EU law or treaty law.

¹⁵⁶ Giorgio Beretta, n 51, at 4.

¹⁵⁷ See above 3.2.2. and Luc De Broe, 'The Tax Treatment of Transfer of Residence by Individuals', n 56, 19, 65–68; Luc De Broe and Katrien Willoqué, n 128, 227, 243–248; Eric C.C.M. Kemmeren, n 43, at 28.4.2.

¹⁵⁸ Para 75 Commentary on Art. 1(3) (2017): "*75. Fourth, the application of tax treaty provisions may be denied under **judicial doctrines or principles applicable to the interpretation of the treaty** (see paragraph 78 below). In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both a proper interpretation of the treaty and as result of the application of domestic specific anti-abuse rules. **Assume, for example**, that the domestic law of State A provides for the taxation of gains*

The facts of this example are however very specific and relate to a situation in absence of the existence of any domestic exit tax rule. The example confirms that, in principle, the treaty benefit of Art. 13(5) must be granted in case of a change of residence by the taxpayer. This means that the principle of exclusive power of taxation to the residence State must, in principle, be honoured by the contracting States, since tax (treaty) abuse requires substantiating circumstances in each specific case. In case of *bona fide* emigration the taxpayer should benefit fully from the treaty protection.

It needs to be emphasised that the denial of treaty benefits based on judicial doctrines or domestic specific or general anti-abuse rules can only be justified if and to the extent that such denial is intended to address abusive schemes. The Commentary does not provide for any suggestion on how to distinguish between a *bona fide* change of residence and one that aims at obtaining inappropriate treaty benefits¹⁵⁹. In the context of the European Union, tax abuse in the EU context cannot be assumed¹⁶⁰. In the context of anti-abuse provisions in the tax treaty itself, the Commentary explicitly warns that abuse should not be lightly assumed:

*'61. It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. That principle applies independently from the provisions of paragraph 9 of Article 29, which merely confirm it.'*¹⁶¹

In the light of judicial doctrines or domestic general anti-abuse rules para 80 of the Commentary on Art. 1 (2017) confirms that

*"Whilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation **as long as there is no clear evidence that the treaties are being abused.**"* (emphasis added)

In the absence of abusive purpose in the relocation of the individual, which is to be examined on a case-by-case basis, and in the absence of an exit tax in the strict sense, the allocation of taxing power to the State of residence of Art. 13(5) OECD Model should have

*derived from the alienation of shares of a domestic company in which the alienator holds more than 25 per cent of the capital if that alienator was a resident of State A for at least seven of the 10 years preceding the alienation. In year 2, an individual who was a resident of State A for the previous 10 years becomes a resident of State B. Shortly after becoming a resident of State B, the individual sells the totality of the shares of a small company that he previously established in State A. The facts reveal, however, that all the elements of the sale were finalised in year 1, that an interest-free "loan" corresponding to the sale price was made by the purchaser to the seller at that time, that the purchaser cancelled the loan when the shares were sold to the purchaser in year 2 and that the purchaser exercised de facto control of the company from year 1. **Although the gain from the sale of the shares might otherwise fall under paragraph 5 of Article 13 of the State A-State B treaty, the circumstances of the transfer of the shares are such that the alienation in year 2 constitutes a sham within the meaning given to that term by the courts of State A. In that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting paragraph 5 of Article 13 of the State A- State B treaty, which will allow State A to tax the relevant gain under its domestic law rule.**"* (emphasis added)

¹⁵⁹ Giorgio Beretta, n 51, at 4.

¹⁶⁰ See ECJ C-9/02, *de Lasteyrie du Saillant*, 11 March 2004, EU:C:2004:138, at 51.

¹⁶¹ OECD Commentary on Art. 1 (2017), para 61.

its full effect.

One might wonder whether the Final Report on BEPS Action 6 and the Commentary regarding the interaction between treaties and domestic anti-abuse rules also apply to trailing taxes. A trailing tax is an alternative way for a State to protect its tax base in case of emigration of a taxpayer followed by the realisation of a capital gain. As such, it has the character of a domestic specific anti-abuse provision, which targets the actual realisation of the capital gain within a limited period of time after the person has ceased to be a resident of the State of emigration.

Even though trailing taxes may be conceived as specific anti-abuse rules, the same reasoning as for the exit taxes in the strict sense cannot be transposed to trailing taxes. Where the BEPS Action 6 Final Report does not see any conflict between the exit tax (in the strict sense) and Art. 13(5) OECD Model, such conflict does exist in the case of trailing taxes (see 3.1.). In such case, the Commentary states that the application of the treaty should prevail under public international law and that such conflicts will often be avoided and each case must be analysed based on its circumstances¹⁶². One solution to resolve that conflict, is to specifically allow the application of a specific domestic anti-abuse rule in a tax treaty¹⁶³. The Commentary mentions the conflict of the trailing tax with Art. 13(5) and states that *'in such a case, to the extent that paragraph 5 of Article 13 would prevent the taxation of that individual by State A upon the alienation of the property, the Convention would prevent the application of that domestic rule unless the benefits of paragraph 5 of Article 13 could be denied, in that specific case, under paragraph 9 of Article 29 or the principles in paragraphs 60 and 61 above'*¹⁶⁴.

Paras 60 and 61 of Art. 1 (2017) refer to the principle that States do not have to grant the benefits of a tax treaty *'where arrangements that constitute abuse of the provisions of the convention have been entered into'* and that such abusive transactions should not be lightly assumed. This means that the State of emigration must substantiate, on a case-by-case basis, that the emigration was tax driven and that there is clear evidence of abuse of the treaty, as mentioned in paras 61 and 80 of the Commentary on Art. 1 (2017), in order to deny the protection of Art. 13(5) OECD Model in the face of a domestic trailing tax to apply in a treaty situation.

Based on the interaction between SAARs and tax treaties as explained by the Commentary (2017) it now seems clear, that on the one hand, Art. 13(5) OECD Model does not prevent the former State of residence from levying an exit tax and (in the strict sense) that exit taxes in the strict sense are not contrary to the OECD Model. On the other hand, the application of trailing taxes is contrary to Art. 13(5) OECD Model and the benefit of the treaty may only be denied if the State applying the trailing tax is able to substantiate that the transfer of residence constitutes an abuse of that treaty benefit.

3.5 Method of Double Taxation Relief

In general, Article 13 of the OECD Model does not contain any specific measures to

¹⁶² OECD Commentary on Art. 1 (2017), paras 70 and 71.

¹⁶³ OECD Commentary on Art. 1 (2017), para 72.

¹⁶⁴ OECD Commentary on Art. 1 (2017), para 74.

prevent double taxation of capital gains¹⁶⁵. However, the exclusive allocation of the taxing power to the State of residence of the alienator of Art. 13(5) OECD Model leaves no room for the other State to tax. But in the context of exit taxes, the problem of potential double taxation of the capital gains in case the State of emigration imposes an exit tax in the strict sense, is a result of the taxpayer being a resident of two different States at different times and of these States levying tax on different taxable events¹⁶⁶. This conflict is also referred to as residence-residence conflict, which leaves the double taxation unrelieved¹⁶⁷. Each State applies, fully in line with the allocation of the taxing powers under Art. 13(5) OECD Model, its domestic law provisions at a different moment in time and each State taxes a different taxable event (taxation of the accrued appreciation in value *versus* taxation of a realised capital gain), yet the tax base may overlap and the gain risks to be taxed twice.

Except for the cases where a particular double tax treaty explicitly addresses the exit tax in the strict sense, the new country of residence is not hindered by the tax treaty to tax the capital appreciation accrued before the immigration of the taxpayer a second time at the time of realisation¹⁶⁸. As mentioned above in 3.1., Art. 13(5) OECD Model does hinder the former State of residence to exercise an extended tax liability at the moment of realisation of the asset, as the new State of residence of the alienator has the exclusive taxing power over the gains derived from the alienation of the assets.

The general methods for the elimination of double taxation under article 23 of the OECD Model may however be inadequate in the case of exit tax¹⁶⁹.

In case a double tax treaty provides for a specific provision in Art. 13 which addresses the distribution of the power of taxation in case the State of emigration applies an exit tax in the strict sense or a trailing tax, the taxing power of capital gains are shared and the general method of prevention of double taxation under Art. 23 OECD Model applies. In case of a trailing tax the State of residence at the time of the actual disposal will usually grant a tax credit for the tax levied in the former State of residence.

The Final Report of BEPS Action 6 recognises the problem of potential double taxation caused by exit taxes, '*where the taxpayer becomes a resident of another State which seeks to tax the same income at a different time, e.g. (...) when assets are sold to third parties*' and such problem is '*the result of that person being a resident of two States at different times and of these States levying tax upon the realisation of different events*'¹⁷⁰.

With reference to the approach suggested by para 4.3. of the Commentary on Art. 23 (version 2014 at the time of the Final Report on BEPS Action 6) the Final report on BEPS Action 6 suggests that a possible basis for resolving double taxation situations arising from the application of departure taxes would be for the competent authorities of the two States involved to agree, through the mutual agreement procedure of Art. 25(3) OECD

¹⁶⁵ Jinyan Li and Francesco Avella, n 59, at 1.1.2.7.

¹⁶⁶ The OECD/G20 BEPS Project addresses the issue in the Action 6-2015 Final Report in the context of the interaction between treaties and domestic anti-abuse provisions, BEPS Action 6, Final Report, n 107, n° 65-66.

¹⁶⁷ Mario Tenore, 'Timing Issues Related to Changes in Treaty Residence or Source' (2006) 34 (3) *Intertax* 132, 132

¹⁶⁸ see Sanford H. Goldberg et al., n 44, 643, 653; Josef Schuch and Erik Pinetz, n 43, at V.

¹⁶⁹ Jinyan Li and Francesco Avella, n 59, at 1.1.2.7.

¹⁷⁰ BEPS Action 6, Final Report, n 107, at 66.

Model, that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of income that accrued while the person was a resident of that State¹⁷¹. Inspiration for this approach was found in a similar example, where two States of residence tax the benefit arising from an employee stock-option at different times, which is addressed in para 4.1 to 4.3 of the Commentary on Article 23 A and 23 B¹⁷². The Final Report concludes, *'This would mean that the new State of residence would provide relief for the departure tax levied by the previous State of residence on income that accrued whilst the person was a resident of that other State, except to the extent that the new State of residence would have had source taxation rights at the time that income was taxed (i.e. as a result of paragraphs 2 or 4 of Article 13). States wishing to provide expressly for that result in their tax treaties are free to include provisions to that effect'*¹⁷³.

It needs to be mentioned that, some countries provide for unilateral relief from double taxation of the capital gain based on domestic tax rules¹⁷⁴. This is particularly the case when the State of immigration grants a step-up in acquisition cost for the value of the assets at the time when the taxpayer becomes a tax resident of that state. Such step-up eliminates the risk of taxing a (part of the) capital gain a second time when the asset is disposed of.

A different problem may arise, if at the ultimate disposal of the asset a capital loss is realised or a smaller capital gain: there is no obligation for the State of emigration which levied an exit tax on an unrealised gain, to revise its tax and to take a decrease in value into account that occurred after the taxpayer ceased to be a tax resident of the State of emigration. The issue of a post-emigration decrease in value is a topic of debate in the case-law of the European Court of Justice¹⁷⁵.

3.6 Recent Trend to Include a Clause on Exit Taxes in Double Tax Treaties

From the analysis of Art. 13(5) OECD Model regarding exit taxes in the strict sense and trailing taxes, it follows that the risk of double taxation in the case of an exit tax in the strict sense is not dealt with under the Model Convention and that the former State of residence is unable to levy a trailing tax once the taxpayer has become a tax resident of the other contracting State. Whereas the OECD Model applies a rather static approach regarding timing issues in the distributive rules, in recent years, there is *'a growing awareness of the need to deal explicitly in tax treaties with the possibility of changes in the factual situations to which they apply'*¹⁷⁶. The OECD Commentary does not object that the Contracting States include a specific clause in Art. 13 in order to explicitly address the

¹⁷¹ BEPS Action 6, Final Report, n 107, at 67.

¹⁷² BEPS Action 6, Final report, n 107, at 66.

¹⁷³ BEPS Action 6, Final Report, n 107, at 67.

¹⁷⁴ Such is the case in South Africa, para 12(1) and (2)(a) of the Eighth Schedule.

¹⁷⁵ The ECJ, in its ruling in the *N*-case, considered the failure to take post-emigration decreases in value into account, as one of the aspects that made the Netherlands exit tax, as in place at that time, disproportionate to the objective pursued by the Netherlands exit tax, ECJ C-470/04, *N*, 7 September 2006, n 135, at 54 and 55. But in the *National Grid Indus*-case, the ECJ, the ECJ held the freedom of establishment did not require the Member States to take post-emigration losses into account, ECJ C-371/10, *National Grid Indus*, 29 November 2011, EU:C:2011:785, at 56.

¹⁷⁶ Joanna Wheeler, n 51, at 3.3.1.

allocation of taxing powers in case of a change of residence¹⁷⁷.

There is a recent trend in the tax treaty practice to deviate from Art. 13(5) OECD Model and to include a provision in Article 13 regarding the apportionment of the taxing rights of capital gains in case one of the contracting States applies an exit tax in the strict sense on the unrealised gains or to allow the former state of residence to levy a trailing tax.

Several countries have included a specific provision in the capital gains article of their treaties to address the allocation of taxing powers of capital gains in case of a change of residence of the taxpayer¹⁷⁸. Special attention will be given to the specific exit tax provisions in the tax treaties concluded by South Africa (see Chapter 4).

Regarding the application of a trailing tax which entails an extended tax liability, the taxing rights between the State of emigration and the State of immigration are shared between the two contracting States ('may be taxed' in the former State of residence). The double taxation is then prevented according to Art. 23A or Art. 23B OECD Model, which then obliges the State of residence at the moment of the realisation of the gain, to grant a tax credit for the trailing tax paid in the former state of residence.

In the event, the State of emigration applies an exit tax on the unrealised increase in value, when the taxpayer ceases to be a resident of that State, a specific clause in Art. 13 may prevent the double taxation of the same gain by the State of immigration, in that the latter State has to grant a step-up in the base cost when it taxes the capital gain at the moment of realisation.

Further, there is no uniformity in the scope of these specific clauses. They generally only apply to individuals who change their residence from the one contracting State to the other. Often the scope is limited to a certain category of assets and to the alienation within a limited period of time after the taxpayer ceased to be a resident in the State of emigration. Sometimes it divides the taxable base of the capital gain between the State of original residence and the State of the new residence (step-up). Often it is required that the taxpayer was a resident of the former State of residence for a substantial period of time (often three or five years). The reason for this is to spare short-term residents from such trailing taxes or exit taxes.

Several countries formulated reservations on Art. 13 in the sense that they reserve the right to tax the alienation of shares or substantial shareholdings in companies which are

¹⁷⁷ OECD Commentary on Art. 13, para 3.1.: *'Also, where the Article allows a Contracting State to tax a capital gain, this right applies to the entire gain and not only to the part thereof that has accrued after the entry into force of a treaty (subject to contrary provisions that could be agreed to during bilateral negotiations), even in the case of a new treaty that replaces a previous one that did not allow such taxation.'* (emphasis added).

¹⁷⁸ see also Ekkehart Reimer, n 43, n° 165 with reference to tax treaties of Germany with respectively Austria, Canada, Denmark, Finland, Italy, Norway, Sweden and Switzerland; Josef Schuch and Erik Pinetz, n 43, at V. with reference to several tax treaties of Austria with respectively Germany, Switzerland, Poland and Sweden; Maria Teresa Soler Roch, n 43, at 27.2.2. with reference to tax treaties signed by Spain with respectively Canada, Germany, Norway and Sweden; Luc De Broe, 'The Tax Treatment of Transfer of Residence by Individuals', n 56, 19, 51, 65 and 68; Marisa Baltromejus, 'Recent Developments in German Tax Treaty Policy' (2016) *European Taxation* 176, 178.

residents of that country¹⁷⁹. Depending on the domestic tax law such taxation may also occur in case of emigration. Sweden made a reservation regarding the right to tax gains from the alienation of property by an individual who was a resident of Sweden at any time during the ten years preceding such alienation¹⁸⁰. The USA reserved its right to include a rule providing for an increase in the basis of property of an individual the value of which was taxed under an exit tax regime¹⁸¹.

It is worth noting that the limitation in time of the application of specific provisions in tax treaties regarding trailing taxes suggests that after the lapse of the specified time the former State of residence does not see the need to preserve its taxing right over the gains accrued to certain assets before the moment of emigration of the individual. One of the reasons could be that the former state of residence accepts the exclusive allocation of taxing rights to the new State of residence because after the lapse of time the nexus between the increase in value and the residence fades. Another explanation could be that the trailing tax was aimed at preventing tax driven short-term emigration in order to circumvent the application of the capital gains tax followed by a quick re-immigration (also referred to as 'round-tripping') and that after the lapse of a certain period of time the tax-avoidance purpose of the emigration is found less likely¹⁸². It would however exceed the scope of the present study to elaborate on this aspect of nexus of the gain with the source or the residence.

3.7 Conclusion

The analysis of Art. 13(5) OECD Model in the context of exit taxes, shows that it is generally accepted, with the exception of a few authors, that the term 'alienation' includes deemed alienations.

As to the timing of the application of Art. 13(5) OECD Model in case of a change of residence, it is the State of residence at the moment when the tax charge arises, that has the power to tax capital gains. The moment when the tax charge arises, is determined in terms of the domestic tax laws of the former State of residence and is usually the date immediately before the day when the person ceases to be a resident. A minority of authors submit that the introduction of an exit tax after a double tax treaty has been concluded which follows the wording of Art. 13(5) OECD Model, is contrary to the application of the tax treaty in good faith and qualifies as prohibited treaty override.

This results in the exclusive allocation of taxing powers to impose exit taxes in the strict sense in favour of the former State of residence. This also means that Art. 13(5) OECD Model precludes the former State of residence to apply trailing taxes.

The allocation of taxing powers of Art. 13(5) OECD Model applies to the entire gain and allows the new State of residence to tax the entire capital gain at the moment of the actual disposal. There is no obligation under that article to apply a time apportionment

¹⁷⁹ Paras 33 and following of the Commentary on Art. 13 (2017)

¹⁸⁰ Para 34 of the Commentary on Art. 13 (2017).

¹⁸¹ Para 37 of the Commentary on Art. 13 (2017).

¹⁸² Luc De Broe, 'The Tax Treatment of Transfer of Residence by Individuals', n 56, 19, 68; Luc De Broe, 'Hard Times for Emigration Taxes in the EC', n 43, at section 3.

of the gain.

The Final Report of BEPS Action 6 recommends countries to introduce exit taxes in their domestic laws in order to prevent the circumvention of the domestic capital gains taxation, through the use of treaty benefits (exclusive taxing right of capital gains of the State of residence). So, exit taxes are considered to be a domestic SAAR. The revised Commentary on the OECD Model (2017) explicitly accepts the application of domestic SAAR in a cross-border context.

The OECD Model does not provide any double taxation relief after the application of an exit tax in the strict sense. Such relief requires the insertion of a specific clause in the capital gains-article which obliges the new State of residence to take into account the value which was subjected to the exit tax in the strict sense. It is noted that several countries, such as South Africa itself, grant a step-up in value of assets when a person becomes a resident and so, already provide for unilateral double taxation relief based on their domestic law provisions.

A recent trend can be identified whereby countries include specific clauses in the capital gains-article that address the change of residence.

The following chapter examines the specific provisions in the double tax treaties of South Africa which deviate from the OECD Model and which address the taxation of capital gains in case of a change of residence.

4 Chapter 4 - Specific Clauses Regarding Capital Gains that Address a Change of Residence – The South African Double Tax Treaties

Most South African tax treaties contain an article regarding capital gains along the lines of Art. 13(5) OECD Model (2003 and later). As mentioned earlier in Chapter 3.2.1., the residual rule allocates the taxing rights of capital gains exclusively to the State of which the alienator is a resident. However, several of South Africa's tax treaties deviate from this residual rule for the specific situation of capital gains in case of a change of residence from the one to the other contracting State. This chapter analyses the clauses found in those tax treaties of South Africa and comments on the impact on the exit tax levied by South Africa in terms of section 9H ITA when a taxpayer ceases to be a resident of South Africa.

4.1 Variations of the Exit Tax Clauses

An overview of the variations of all the specific exit tax clauses in the tax treaties of South Africa is given in a chart – Appendix 1.

The scope of these clauses differs from treaty to treaty. However, one can distinguish two main categories of clauses. On the one hand, there is the category of specific provisions allowing the former State of residence to levy its trailing taxes and to tax its former

resident on capital gains realised after they have ceased to be a resident of that State. This is the case in the tax treaties with Botswana, Canada, Ireland, Italy¹⁸³, Netherlands, Norway, Sweden, UK and Zimbabwe. On the other hand, there is the category of clauses addressing the exit taxes in the strict sense, levied on the unrealised appreciation in value and providing for the obligation of the State of residence at the time of realisation of the gain, to take the valuation at the time of the exit tax into account and to allow a step-up in the base cost. Such clauses appear in only two tax treaties, namely in the tax treaty with Denmark and the new tax treaty with Germany. The latter, however, is not yet in force.

It may come across as striking that nine tax treaties contain a clause regarding the preservation of the right to apply trailing taxes and only two tax treaties provide for a provision that address the exit taxes in the strict sense. As mentioned in Chapter 2, South Africa applies an exit tax in the strict sense since 1 October 2001. For treaties concluded before that date, there was no reason for South Africa to include a provision regarding the relief of potential double taxation (step-up) in outbound situations. For treaties concluded since the introduction of the exit tax in South Africa, South Africa might not have felt the need to explicitly include a provision in its tax treaties regarding its exit tax in the strict sense, since the risk of double taxation after the taxpayer ceases to be a resident of South Africa, is mainly a concern of the emigrating taxpayer and not so much of the South African Treasury. In applying the exit charge, South Africa had its share of the taxation of the increase in value for the period of time that the taxpayer was a resident. The other contracting State might not feel the incentive either to include a provision regarding the apportionment of the taxing powers in case an exit tax in the strict sense is levied, because the other contracting State would, in so doing, agree to limit its taxing power of the capital gain at actual disposal and to share it with the former State of residence. In case the other contracting State already grants a step-up in the base cost at the time of the immigration, then the need to include a specific provision in the tax treaty is not strictly necessary. Only if the new State of residence does not grant a step-up in cost basis under its domestic law, then the inclusion of a specific exit tax provision in the tax treaty would be beneficial for the taxpayer who wants to transfer his residence out of South Africa to the other contracting State.

For the inclusion of a clause to preserve the right to apply a trailing tax, the other contracting State must have been the requesting party. In that case, South Africa as the inbound country, agrees to grant a tax credit for the trailing tax paid to the other contracting State, which potentially results in a reduction of its own capital gains tax if the other Contracting State also imposes its trailing tax on the post-emigration increase in value of the asset. One might wonder why South Africa seems to rather readily agree to grant a tax credit and thereby to potentially reduce its own tax base for its capital gains tax. One reason for this could be that, in an inbound situation, South Africa does not actually lose a taxable base because under its domestic law, since 1 October 2001, a step-up in the base cost is granted at the moment of immigration (para 12 (1) and (2)(a) of the Eighth Schedule). This is only true if the other contracting State does not subject the post-

¹⁸³ Art. 13(5) DTT RSA-Italy allows the State of emigration to tax the capital gains from the alienation of any property up until five years after the change of residence of the individual, provided the individual 'is not subject to tax on those gains in the other Contracting State'. The DTT with Mexico contains a similar clause, yet restricted to participations held together with all persons who are related to the recipient, at any time during twelve months preceding the alienation, of at least 25 per cent in the capital of that company. The tax charge is then limited to 20 per cent of the taxable gains.

emigration increase in value to its trailing tax. Before 1 October 2001, South Africa did not apply a general capital gains tax and the gains from the alienation of shares would not have been taxable under domestic tax law anyway¹⁸⁴.

As mentioned, the specific provisions vary in their scope. A further distinction in the clauses can be identified based on the type of assets concerned. Some clauses regard any property owned by the individual before the change of residence. This is the case in the tax treaties with Canada, Italy, Ireland and the UK. Others regard only shares (or similar corporate rights) of any company, which is the case in the tax treaty with Denmark, or shares of a company resident in the state of emigration, which is the case in the tax treaties with Botswana, Germany (new treaty), Netherlands ¹⁸⁵, Norway, Sweden and Zimbabwe¹⁸⁶. In case of trailing taxes, the tax treaties set a time limit for the taxing power of the emigrating state in case of disposal after the emigration.

Whereas all the specific exit tax provisions mentioned in this section apply to individuals only, the tax treaties of the category of exit taxes in the strict sense, *i.e.* the tax treaty with Denmark and the new treaty with Germany, require for the individual to have been a resident of the State of emigration for a minimum period of time of five years in order for the apportionment of the taxing power to apply. In these cases, the tax treaty does not prescribe any time limitations to the moment of disposal and realisation of the capital gain.

4.2 Evaluation of the Impact of these Specific Treaty Clauses that Address a Change of Residence for the Individual Emigrating from South Africa

From the perspective of an individual, resident of South Africa, who is transferring his residence to another jurisdiction, the implications of the specific clauses in tax treaties regarding capital gains in case of the change may be limited in practice.

None of these clauses prevent South Africa from applying its exit tax in the strict sense when an individual ceases to be a resident.

The clauses in respect of the application of trailing taxes are only relevant for an individual emigrating from a State which applies a trailing tax based on its domestic tax laws. To date the South African Income Tax Act does not apply a system of extended tax liability (trailing tax). The tax treaties of South Africa allowing the application of such extended tax liability by the other contracting state, are irrelevant for the protection

¹⁸⁴ This applies to shares held as an investment. However, capital gains from shares held as a commodity would have been dealt with under normal tax.

¹⁸⁵ 5% participation, directly or indirectly, together with spouse or any relations by blood or marriage in the direct line.

¹⁸⁶ The double tax treaties of South Africa with respectively China (People's Republic), Ethiopia, India and Indonesia, address the allocation of taxing powers in case of the alienation of shares or similar rights in a company (not a 'real estate company'), which is a resident of the other Contracting State, yet regardless of a change of residence of the shareholder. These clauses are also not limited to shares held by an individual. The clause in the treaties with China and Saudi Arabia require a substantial participation of 25%. Such clauses allow in those cases for a source-based taxation in connection with a company that is a resident of that State. In the double tax treaties with Ethiopia, India and Indonesia no minimum participation is required.

against double taxation of capital gains for individuals emigrating from South Africa.

Only two tax treaties, one of which is not yet in force, i.e. respectively the tax treaty with Denmark and the new tax treaty with Germany, concern the application of an exit tax in the strict sense and double taxation. These clauses provide an effective protection against the possible double taxation of the same capital gain, yet only in respect of limited type of assets, i.e. any shares held by the individual before he became a resident of the other contracting State (DTT SA-Denmark) or shares in a company resident in the State of emigration (new DTT SA-Germany). When a South African resident emigrates to Denmark and is subjected to the South Africa exit tax, at a later actual disposal of shares, Art. 13(6) of the DTT SA-Denmark grants the individual the possibility to elect to apply a step-up in the base cost for those shares at the value for the capital appreciation which has already been taxed by South Africa¹⁸⁷. Art. 13(6) of the new tax treaty with Germany obliges Germany not to include the appreciation of capital that was subjected to the South African exit tax in the determination of the subsequent appreciation of capital¹⁸⁸. In other words, the tax treaty obliges Germany to exempt the capital appreciation which already has been subjected to the South African exit tax. When the individual emigrates to Germany, this provision will only provide protection from double taxation in respect of the capital appreciation of shares in a company resident in South Africa.

The scope of the treaty protection and prevention of double taxation of capital gains in the case of emigration to Denmark or Germany, only relates to a limited type of assets, i.e. shares (Denmark) or shares in a company resident in South Africa (Germany). The respective tax treaties do not prevent the double taxation of capital gains of other movable property¹⁸⁹.

Protection against the risk of double taxation of the capital gains, is absent in the case of emigration to any country other than Denmark (or Germany, once the new tax treaty has come into force).

Tax treaties containing a specific provision regarding capital gains in case of a change of residence, do not have any influence on the timing of the payment of the exit tax. The immediate collection of the exit tax on the accrued value at the moment of emigration creates a cash-flow problem. In case of a trailing tax, the moment of ceasing to be a tax resident would not be a taxable event. From the emigrating taxpayer's perspective this is a more desirable situation than an exit tax which requires the immediate payment of the tax. Such immediate payment may cause a high financial burden on the taxpayer.

¹⁸⁷ Art. 13(6) of the DTT SA-Denmark reads: '6. Where an individual who was a resident of a Contracting State for a period of five years or more was, on becoming a resident of the other Contracting State, subjected to tax by the first-mentioned State on the appreciation in the value of the shares held by him, such individual may for the purposes of determining the gain derived by him on the subsequent disposal of such shares elect that the shares shall be deemed to have been acquired by him at a price equal to the value of the shares which was taken into account by the first-mentioned State in the determination of the said appreciation.'

¹⁸⁸ Art. 13(6) of the new DTT SA-Germany reads: '6. Where an individual was a resident of a Contracting State for a period of 5 years or more and has become a resident of the other Contracting State, paragraph 5 shall not prevent the first-mentioned State from taxing under its domestic law the capital appreciation of shares in a company resident in the first-mentioned State for the period of residency of that individual in the first-mentioned State. In such case, the appreciation of capital taxed in the first-mentioned State shall not be included in the determination of the subsequent appreciation of capital by the other State.'

¹⁸⁹ Such other movable property could be art, jewellery, precious stones, gold bullion, bonds and other debt-instruments, intangible assets such as copyright, a patent, a trademark et

It would be in the interest of South African resident individuals, that South Africa includes specific provisions in Art. 13 in more of its tax treaties, especially in those with countries that do not provide for a step-up in the base cost under their domestic tax law. Yet, this may not be a priority for the South African Treasury, which has little to gain from such specific provisions.

Since the Final Report of BEPS Action 6 suggests that the problem of double taxation be resolved under the mutual agreement procedure, it might nonetheless be in the interest of South Africa to include an apportionment of the taxing right between the consecutive resident states, even if it were to avoid mutual agreement procedures.

For all these reasons, it is the opinion of the author that in reality, these specific clauses in the tax treaties of South Africa have a rather limited impact on the protection of the South African taxpayer who transfers his residence to another jurisdiction, against the risk of double taxation.

5 Chapter 5 - Conclusion

This study examines whether double tax treaties preclude South Africa, as the former State of residence, from applying its exit tax and the extent to which double tax treaties provide any relief from the risk of double taxation of capital gains, in the event an exit tax has been levied by the former State of residence.

The present analysis of Art. 13(5) OECD Model (2017) in the context of exit taxes allows to draw the following conclusions.

The outcome of the debate about the compatibility of exit taxes with Art. 13(5) OECD Model tends to support the compatibility of exit taxes in the strict sense with tax treaties. With the exception of a minority of authors, it is generally accepted that the term 'alienation' in Art. 13(5) OECD Model has a wide meaning and includes capital gains arising from a deemed alienation.

The distributive rule of Art. 13(5) OECD Model applies at the moment when the tax charge arises. The tax charge of exit taxes in the strict sense usually arises prior to the moment when the person ceases to be a resident. As a consequence, the taxing powers of capital gains, including the case of exit taxes, are exclusively allocated to the State of residence at the time when the tax charge arises.

A minority of authors are of the opinion that the introduction of an exit tax after a double tax treaty has been concluded, is contrary to the application of the tax treaty in good faith and consists of prohibited treaty-override.

Besides the traditional arguments *pro* compatibility of exit taxes with double tax treaties, based on the wide meaning of the term 'alienation' and the timing of the tax charge, the Final Report of BEPS Action 6 and the change of the OECD Commentary on Article 1 (2017) regarding the relationship between domestic anti-abuse rules and the tax treaty leave little doubt about the compatibility of exit taxes in the strict sense with Art. 13(5) OECD Model. In any case, neither the Final report of BEPS Action 6 nor the revised OECD Commentary on Art. 1, comment on the issue of potential treaty override, when exit taxes are introduced while a tax treaty following Art. 13(5) OECD Model is in place.

In order to avoid the double taxation of the portion of the capital gain that already has been subjected to an exit tax, more and more tax treaties include a specific clause in Art. 13, that obliges the new State of residence to take into account the value that was subject to an exit tax when taxing the capital gain at the moment of realisation.

It is widely accepted, and it is the position of the OECD/G20, that Art. 13(5) OECD Model does not prevent a contracting State from levying an exit tax in the strict sense, on unrealised increases in value while the taxpayer still is a resident of that State, based on a deeming provision in the domestic tax law. The reason for this can be found in the timing when the tax charge arises. In the case of an exit tax in the strict sense the tax charge usually arises at the moment when the taxpayer is still a resident of that State. As a consequence, the State of emigration, as the State of residence at the time of the deemed disposal, has the exclusive power of taxation regarding such gains under the

distributive rule of Art. 13(5) OECD Model.

Art. 13(5) OECD Model does not resolve the problem of possible double taxation of the capital gain in the event the former state of residence levied an exit tax in the strict sense and the new state of residence taxes the capital gain at the moment of the realisation. Contracting states may however include a provision in their double tax treaties, which apportions the taxable gain between the two States. Such specific provision may stipulate that the new State of residence must take the value considered for the levying of the exit tax into account when taxing the realised capital gain, and so must grant a step-up in the base cost. Alternatively, the new State of residence could grant a tax credit relief in its domestic law of the exit tax paid in the former State of residence.

However, Art. 13(5) OECD Model does prevent the former state of residence from levying a trailing tax and thus, to exercise an extended taxing jurisdiction when the taxpayer has become a tax resident of the other contracting state. In order to preserve such extended taxing jurisdiction, the tax treaty needs to provide for a specific allocation rule.

From the analysis of exit taxes in the context of the OECD Model it follows that the double tax treaties concluded by South Africa following Art. 13(5) OECD Model do not preclude South Africa from applying its exit tax, that is of the type of an exit tax in the strict sense, which occurs on the date immediately before the day on which the individual ceases to be a resident.

Only two double tax treaties of South Africa contain a specific clause dealing with a change of residence and prevent potential double taxation through the granting of such a step-up in the base cost (the DTT with Denmark and the new DTT with Germany, the latter not yet being in force). The scope of these specific clauses is limited to shares, in the tax treaty with Denmark, and to shares in a company resident in South Africa, in the new tax treaty with Germany. Other movable assets are not protected against the risk of double taxation.

Nine double tax treaties concluded by South Africa allow for the application of trailing taxes. Since South Africa is applying an exit tax in the strict sense, at the time when the individual ceases to be a resident, these specific clauses in these tax treaties do not serve the individual who is emigrating from South Africa.

In sum, this means that the individual resident of South Africa who is emigrating, is largely left unprotected against double taxation of capital gains, at a tax treaty level. The individual needs to rely exclusively on the domestic tax laws of the new State of residence for the value of the assets that were already subjected to the South African capital gains tax, to be taken into account for the capital gains taxation at the actual disposal of the asset.

It is recommended that South Africa include specific clauses that provide for a step-up in the base cost in more double tax treaties, especially in tax treaties with countries that do not already grant a step-up in terms of their domestic tax laws. Even though this might not be a priority for the South African Treasury, which has little to gain from including

such specific clauses, it might nonetheless be in the interest of South Africa to include an apportionment of the taxing right between the consecutive resident states, even if it were to avoid mutual agreement procedures.

Other issues related to the application of the South African exit tax could be the subject of further research. One of the issues regards the question whether post-emigration decreases in value or the actual disposal resulting in a capital loss, need to be taken into account by the former State of residence that levied an exit tax. Another remaining serious issue is whether the financial burden of the immediate payment of the South African exit tax is confiscatory or a forbidden deprivation of property.

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7 APPENDIX 1 - Double Tax Treaties of South Africa with Specific Exit Tax Clauses

Double Tax Treaties of South Africa that Address a Change of Residence in the Allocation of Taxing Power of Capital Gains

Other Contracting State	Date of the Treaty	Treaty Article	Person - Alienator	Type of Assets (Any Property, Shares, Shares in Company Resident in State of Emigration, Substantial Shareholdings)	Time Limit for Alienation	Exclusive/Shared Power of Taxation (E/S)/Step-up	Type of Exit Tax: Exit Tax Senu Stricto/Trailing Tax (ETss/TT)	Other
Botswana	7/08/2003	Art. 13(5)	Individual	Shares Res Co	10 years	S	TT	
Canada	27/11/1997	Art. 13(6)	Individual	Any Property	6 years	S	TT	
Ireland	7/10/1997	Art. 13(6)	Individual	Any Property	3 years	S	TT	
Italy	16/11/1995	Art. 13(5)	Individual	Any Property	5 years	S	TT	provided no taxation in new state of residence
Netherlands	10/10/2005	Art. 13(5)	Individual	Shares Res Co 5%	10 years	S	TT	
Norway	12/02/1996	Art. 13(4)	Individual	Shares Res Co	5 years	S	TT	
Sweden	24/05/1995	Art. 13(5)	Individual	Shares Res Co	10 years	S	TT	
United Kingdom	4/07/2002	Art. 13(6)	Individual	Any Property	6 years	S	TT	
Zimbabwe	4/08/2015	Art. 13(5)	Individual	Shares Res Co	10 years	S	TT	
Denmark	11/11/1996	Art. 13(6)	Individual - 5 years or more resident State of Emigration	Shares	none	E+Step-up (optional)	ETss	
Germany (new DTT - not in force)	9/09/2008	Art. 13(6)	Individual - 5 years or more resident State of Emigration	Shares Res Co	none	E+Step-up	ETss	