

EXPOSURE DRAFT

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FOREIGN RESIDENT CGT WITHHOLDING REGIME

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EXPLANATORY MATERIALS

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## **Glossary**

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The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
CGT	Capital gains tax
Commissioner	Commissioner of Taxation
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
TAA 1953	<i>Taxation Administration Act 1953</i>
TARP	Taxable Australian real property

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# **Chapter 1**

## **Foreign Resident CGT Withholding Regime**

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### **Outline of chapter**

1.1 The Exposure Draft introduces a new regime that imposes withholding obligations on the purchasers of certain Australian assets. The purpose of the regime is to assist in the collection of foreign residents' capital gains tax (CGT) liabilities.

### **Context of amendments**

1.2 Foreign residents are subject to CGT on any capital gains they make from the disposal of Australian assets. Voluntary compliance with these requirements, however, is extremely low and compliance action, by the Australian Taxation Office, is difficult to undertake.

### **Taxation of foreign residents' capital gains**

1.3 Australia's current foreign resident CGT regime was introduced in 2006, with the insertion of Division 855 into the *Income Tax Assessment Act 1997* (ITAA 1997). Consistent with international practice and Australia's international tax treaties, this regime promotes foreign investment in Australia. Subdivision 855-A operates to disregard a capital gain or capital loss made by a foreign resident unless the relevant CGT asset is taxable Australian property. Broadly, this includes:

- a direct or indirect interest in taxable Australian real property (TARP);
- an asset used in carrying on a business through a permanent establishment in Australia; or
- rights and options with respect to these assets.

#### ***Taxable Australian real property***

1.4 A CGT asset is TARP if, under section 855-20, it is:

- real property situated in Australia (including a lease of land situated in Australia); or
- a mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry materials are situated in Australia.

### ***Indirect Australian real property interests***

1.5 The objects of the foreign resident CGT regime (section 855-5) include ensuring that interests in an entity remain subject to Australia's capital gains tax laws if the entity's underlying value is principally derived from Australian real property.

1.6 This is achieved by ensuring that a capital gain made by a foreign resident on an 'indirect Australian real property interest' cannot be disregarded (see section 855-25).

1.7 An 'indirect Australian real property interest' includes a significant interest (an interest of 10 per cent or more) in an entity whose underlying value is principally derived from Australian real property.

1.8 The Principal Asset Test in section 855-30 is used to determine whether an entity's underlying value is principally derived from Australian real property. The Principal Asset Test requires a comparison of the sum of the market values of the entity's TARP assets with the sum of the market values of its non-TARP assets. The Principal Asset Test applies recursively to the assets of other entities in which the entity has a significant interest, directly or indirectly.

1.9 The Principal Asset Test is satisfied if the sum of the market values of the entity's assets that are TARP exceeds the sum of the market values of the assets that are non-TARP.

### ***Assets of Permanent Establishments***

1.10 A CGT asset is taxable Australian property if, at any time, it has been used in carrying on a business through a permanent establishment in Australia. The residency status of the entity that uses the CGT asset determines the way in which the term 'permanent establishment' is defined.

1.11 Where an entity is a resident in a country with which Australia has an international tax agreement that contains a permanent establishment article, the definition of permanent establishment in the agreement is used in determining whether the entity has a permanent establishment in Australia.

1.12 Where an entity is not a resident in a country with which Australia has an international tax agreement, the general definition of permanent establishment in subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) applies.

### **Compliance and collection**

1.13 Foreign residents are required to lodge tax returns if they have derived Australian assessable income, including a capital gain that is not disregarded under Division 855. Compliance with this obligation is very low in the case of foreign resident CGT liabilities. The Commissioner of Taxation (Commissioner) has a number of powers to assist in the collection of these liabilities; however, it is common for these to be ineffective.

1.14 Where the Commissioner is aware that a foreign resident has a tax liability, he may be able to issue an income tax assessment. The ability of the Commissioner to enforce an assessment against a foreign resident, however, will depend on the circumstances, particularly whether the taxpayer is present in Australia or has other investments in Australia.

1.15 Where the taxpayer has other investments, the Commissioner may seek a freezing order (*Mareva* injunction) against those assets, which can then be applied to the taxpayer's tax liability. However, a foreign resident will often not have other Australian assets to satisfy a tax liability.

1.16 The Commissioner may also issue a notice under section 255 of the ITAA 1936 to a person that is in control of a non-resident's money, requiring that person to pay the non-resident's tax. This mechanism is only effective where an assessment has been issued against the non-resident prior to the non-resident receiving the money. Such transactions can occur within days, limiting the Commissioner's ability to issue the necessary notice of assessment before the funds flow from Australia. The Commissioner is also unlikely to have immediate knowledge of the transaction.

### ***Withholding taxes***

1.17 Withholding taxes are amounts that a person withholds from a payment they make to another person and represent the (sometimes estimated) tax liability of the recipient. Withheld amounts are paid to the Commissioner. There is currently no specific withholding regime for capital gains and related property transactions.

1.18 A withholding tax may be final or non-final:

- A final withholding tax represents the final tax liability for the person receiving the withholding payment. Final withholding tax regimes exist for many revenue payments (for example dividends, interest payments and royalties) made to foreign residents.
- A non-final withholding tax is collected as an estimate of the recipient's final income tax liability. The recipient is still required to lodge an income tax return and pay any outstanding debit. They claim a credit for the amount of tax withheld in the income tax return at this time. Pay as you go withholding from salary and wages is an example of a non-final withholding tax.

1.19 The amendments in the Exposure Draft establish a non-final withholding regime.

1.20 A non-final withholding obligation may be imposed in one of two forms. In a traditional withholding regime, the withholding obligation arises with respect to a specific payment a person makes to another person. Two obligations are imposed:

- the obligation to withhold the amount from the payment; and
- the obligation to pay the withheld amount to the Commissioner.

1.21 The withholding payments specified in Division 12 in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953), including pay as you go withholding, are examples of this.

1.22 A second type of obligation exists for some purposes whereby only the obligation to pay an amount to the Commissioner arises. The person subject to the obligation is then entitled to withhold the amount from any payment to the person with the primary tax liability. The amendments concern the imposition of this type of withholding obligation.

1.23 Division 13 in Schedule 1 to the TAA 1953, which deals with the collection of tax with respect to alienated personal services income, is an example of this second approach. Further examples are contained in Division 14, which imposes obligations with respect to the provision of non-cash benefits and certain accruing gains.

1.24 Mechanisms for the payment of withheld amounts to the Commissioner, including the creation of offences and the imposition of penalties, are contained in Division 16. Division 18 provides that

recipients of withholding payment are generally entitled to a credit for the amount withheld or a refund. Credits are applied to the recipient's income tax liability once they have lodged their income tax return.

## **Summary of new law**

1.25 The Exposure Draft imposes a 10 per cent non-final withholding obligation on the purchasers of certain Australian assets where the purchaser has reason to believe the vendor is a foreign resident.

1.26 The obligation does not require withholding as such, but does require the purchaser to pay 10 per cent of the purchase price to the Commissioner. This amount may be withheld from the payment the purchaser makes to the vendor.

1.27 The obligation will apply to the acquisition of an asset that is:

- taxable Australian real property;
- an indirect Australian real property interest; or
- an option or right to acquire such property or interest.

## **Summary of exemptions**

1.28 To minimise the compliance costs that arise as a result of this obligation, no obligation is imposed in the following situations:

### ***Excluded transactions***

- Transactions involving residential property valued less than \$2.5 million
- An arrangement that is conducted through a stock exchange
- An arrangement that is already subject to an existing withholding obligation

### ***Vendor declarations provided to purchaser***

- Where the vendor has made a declaration that they are an Australian resident for income tax purposes

- Where the vendor has made a declaration that they will be carrying on a business through a permanent establishment located in Australia immediately after the transaction
- Where, if the CGT asset acquired is a membership interest, the vendor has made a declaration that the interest is not an indirect Australian real property interest

1.29 Note that the vendor declarations only exempt a specific vendor and withholding may still apply if the transaction involves multiple vendors.

### Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
A purchaser that acquires certain Australian assets from a vendor they have reason to believe is a foreign resident must pay 10 per cent of the purchase price to the Commissioner. The purchaser may withhold this amount from the vendor.	No equivalent

### Detailed explanation of new law

1.30 The withholding regime applies to purchasers that acquire certain taxable Australian property assets. When the purchaser acquires the asset, they must pay an amount, equal to 10 per cent of the total purchase price, to the Commissioner. The purchaser may withhold the amount from any amount owed to the vendor of the asset.

1.31 This differs from the majority of withholding rules in two respects.

1.32 Firstly, the obligation applies to the total purchase price for the asset acquired, rather than to a specific payment. This prevents multiple withholding obligations arising in relation to a single transaction that is completed through instalments.

1.33 Although there is no obligation to withhold as such, the obligation to pay the amount to the Commissioner is still described as a withholding obligation because the payment amount may be withheld from the vendor.

1.34 Secondly, the obligation is imposed on the purchaser of the property. Other withholding regimes that operate on a flow of funds basis may impose withholding obligations on intermediaries. Intermediaries, are not required to withhold under the amendments.

### Conditions for the obligation

1.35 Purchasers are only required to pay an amount to the Commissioner when the following conditions are satisfied:

- the asset acquired is a relevant Australian asset; *[Exposure Draft, item 1, paragraph 14-200(1)(c) in Schedule 1 to the TAA 1953]*
- the acquisition is not an excluded transaction; and *[Exposure Draft, item 1, subsection 14-200(1) in Schedule 1 to the TAA 1953]*
- any vendor of the property is a relevant foreign resident, who:
  - satisfies the knowledge condition – that is the purchaser has reason to believe the vendor is a foreign resident,
  - has not made a declaration that they are an Australian resident or that they are carrying on a business through an Australia permanent establishment, and
  - in the case where the property is membership interests, has not made a declaration that the membership interests are not indirect Australian real property interests.

*[Exposure Draft, item 1, paragraphs 14-200(1)(a) and (b) in Schedule 1 to the TAA 1953]*

### Relevant assets

1.36 The withholding obligation arises when a purchaser acquires an asset that is:

- taxable Australian real property;
- an indirect Australian real property interest; or
- an option or right to acquire such property or interest.

*[Exposure Draft, item 1, paragraph 14-200(1)(c) in Schedule 1 to the TAA 1953]*

1.37 These assets are detailed at paragraphs 1.4 to 1.9.

1.38 The amendments only apply to these assets. Other assets that are taxable Australian property are not subject to the amendments. For example, an asset, not being an asset listed in paragraph 1.36, that is used in carrying on a business through an Australian permanent establishment is not subject to the amendments.

1.39 The scope of the amendments reflects that the compliance burden of withholding in relation to these assets would be too high. In addition, foreign residents with a taxable presence in Australia represent a lower compliance risk.

1.40 Further assets and transactions are specifically excluded from the regime.

## **Excluded transactions**

### ***Residential property***

1.41 The amendments do not apply to residential property where the value of the real property is less than \$2.5 million. [*Exposure Draft, item 1, paragraph 14-215(a) in Schedule 1 to the TAA 1953*]

1.42 The purpose of this exclusion is to minimise compliance costs and ensure that the amendments are clearly inapplicable to most residential property sales conducted between Australian residents. This alleviates the need for purchasers to undertake the preliminary compliance obligation of determining the residency status of the vendor.

1.43 Residential property is subject to the exemption if it is property that contains ‘residential premises’. The term ‘residential premises’ is defined in section 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999* to mean a land or a building that is occupied, or is intended to be occupied, as a residence or for residential accommodation. GST Ruling 2012/5 provides further information on the interpretation of this provision.

1.44 Note that the Ruling refers to the apportionment of a property that is used as residential premises and for another purpose. There is no need to apply any apportionment in relation to the amendments. It is only necessary that the real property includes residential premises.

1.45 Vacant land is not eligible for the exemption (see paragraph 47 of the Ruling).

### ***On-market transactions***

1.46 The amendments do not apply to ‘on-market transactions’ that are conducted on an approved stock exchange. *[Exposure Draft, item 1, paragraph 14-215(b) in Schedule 1 to the TAA 1953]*

1.47 ‘Approved stock exchange’ is defined in subsection 995-1(1) of the ITAA 1997 and approved stock exchanges are listed in Schedule 4 to the *Income Tax Assessment Regulations 1997*. The nature of these transactions makes it impossible for a purchaser to determine the identity and residency status of their counterparty.

1.48 The amendments will apply to listed securities where the sale is conducted off-market.

### ***Priority of other withholding obligations***

1.49 It is intended that the amendments apply as a withholding regime of last resort. As such, the amendments will not apply where another withholding obligation applies to the transaction. *[Exposure Draft, item 1, paragraph 14-215(c) in Schedule 1 to the TAA 1953]*

## **Relevant foreign resident vendors**

1.50 The obligation to pay an amount to the Commissioner only arises if the vendor is a relevant foreign resident. This concept incorporates the requirement that the purchaser has reasonable grounds to believe the vendor is a foreign resident. In addition, a vendor will not be a relevant foreign resident if they make one of three declarations (unless the purchaser knows the declaration to be false). *[Exposure Draft, item 1, paragraphs 14-200(1)(a) and (b), and section 14-210 in Schedule 1 to the TAA 1953]*

1.51 If the purchaser acquires property from multiple vendors, the obligation to pay an amount may arise if any of the vendors is a relevant foreign resident.

### ***The residency of the vendor***

1.52 The definition of resident of Australia is contained in subsection 6(1) of the ITAA 1936. A foreign resident is a person other than a resident (subsection 995(1) of the ITAA 1997).

1.53 An individual (natural person) is generally an Australian resident if they:

- are domiciled in Australia; or

- are present in Australia for at least 183 days of the income year,

unless they have a permanent place of abode outside Australia.

1.54 A company is a resident of Australia if it is incorporated in Australia, if it carries on a business in Australia and has either its central management and control in Australia, or its voting power is controlled by shareholders who are Australian residents.

1.55 Tax residency can be a complex legal and factual question. The purchaser will often have limited information about the vendors to be able to determine the question. To overcome this difficulty for purchasers, additional tests determine when purchasers have sufficient knowledge about a vendor that withholding becomes appropriate.

***The knowledge condition***

1.56 If a purchaser does not have reason to believe a vendor is a foreign resident, the knowledge condition ensures that the obligation to pay an amount to the Commissioner does not arise. This provides certainty to purchasers. Purchasers not comfortable applying the knowledge condition may instead seek a vendor declaration that confirms that a vendor is not a relevant foreign resident (see paragraphs 1.63 to 1.70).

1.57 The knowledge condition is satisfied where the purchaser has specific knowledge that a vendor is a foreign resident. For example, a purchaser will have specific knowledge where the vendor discloses that they are a foreign resident for income tax purposes. [*Exposure Draft, item 1, paragraph 14-210(1)(a) in Schedule 1 to the TAA 1953*]

1.58 The knowledge condition is satisfied where the purchaser reasonably believes a vendor is a foreign resident. For example, a purchaser may have a reasonable belief if the purchaser learns that the vendor is likely to be living overseas (although, even if correct, this is not determinative as to tax residency). [*Exposure Draft, item 1, paragraph 14-210(1)(b) in Schedule 1 to the TAA 1953*]

1.59 The knowledge condition is also satisfied where the purchaser has no reasonable grounds to believe that a vendor is an Australian resident and either:

- the vendor has an address outside Australia according to any record that is in the purchaser's possession, or is kept and maintained on the purchaser's behalf, about the acquisition;  
or

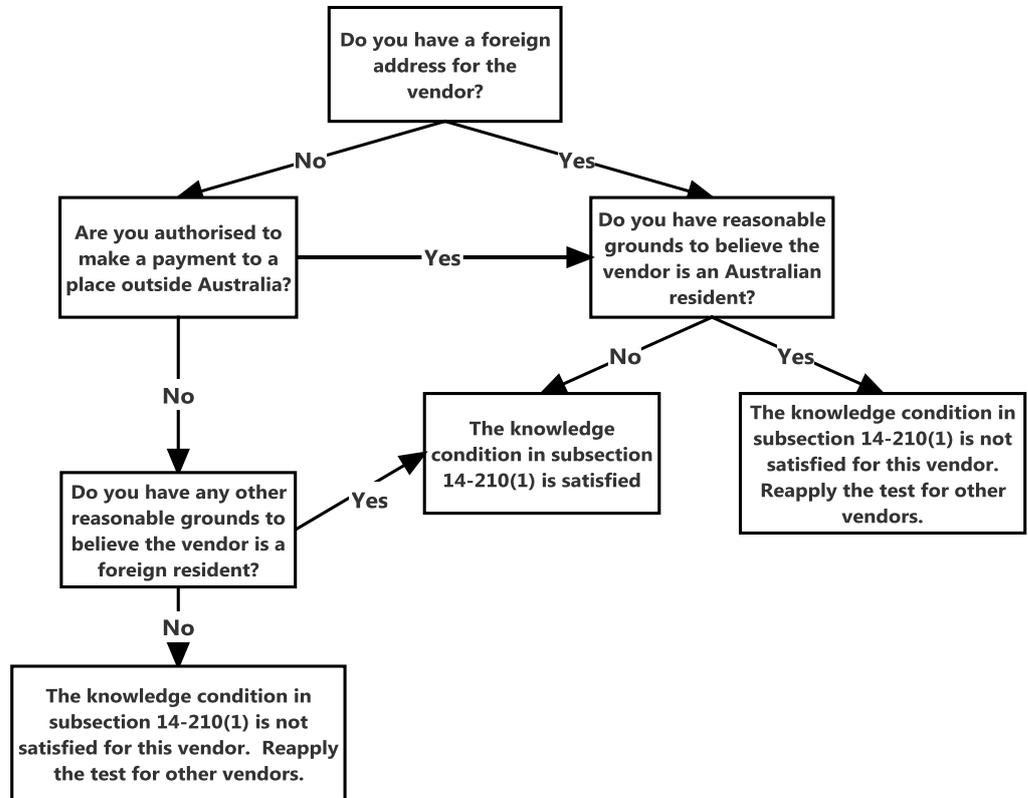
- the purchaser is authorised to provide a financial benefit (for example, make the payment) to a place outside Australia (whether to a vendor or to anyone else).

*[Exposure Draft, item 1, paragraph 14-210(1)(c) in Schedule 1 to the TAA 1953]*

1.60 This test will ensure that, where there are reasonable grounds to believe that the vendors are Australian residents, withholding will not be required, even if an amount is paid outside Australia, or a vendor has an address outside Australia. However, if there are no reasonable grounds to believe that the vendors are Australian residents, and the amount is to be paid outside Australia, or a vendor has a foreign address, the knowledge condition will be satisfied.

1.61 Whether or not there are reasonable grounds to believe that a vendor is or is not an Australian resident will be considered on an objective basis. The question is whether a reasonable person in the position of the purchaser would have thought that there were reasonable grounds to support the relevant belief.

**Diagram 1.1 The knowledge condition**



1.62 The Regulations may prescribe additional circumstances where the knowledge condition will be satisfied. *[Exposure Draft, item 1, paragraph 14-210(1)(d) in Schedule 1 to the TAA 1953]*

***Declarations as to residency***

1.63 Where the purchaser believes the vendor may be a foreign resident, they can request that the vendor make a declaration confirming their residency. The vendor will not be a relevant foreign resident where the vendor has made a declaration that they are an Australian resident (unless the purchaser knows the declaration to be false). *[Exposure Draft, item 1, subsection 14-210(2) and paragraph 14-220(1)(a) in Schedule 1 to the TAA 1953]*

1.64 It is envisaged that residents may use this declaration as a matter of course to establish their residency to a purchaser of property. The declaration may be inserted into sale agreements as a standard clause contractual warranty. A purchaser that receives a declaration is entitled to rely on it (unless they know it to be false) and no longer needs to consider

whether the reasonable grounds limbs of the knowledge condition are satisfied.

1.65 A purchaser will only know a declaration to be false if they have specific knowledge of the fact. That is, the purchaser must be a party to the fraud committed by the vendor or must have knowledge that the declaration is completely implausible. In all other circumstances, the declaration may be relied on. That a purchaser may have reasonable grounds to doubt the accuracy of a declaration does not, of itself, prevent the purchaser from relying on it.

1.66 A declaration is only effective in relation to the specific vendor. If an asset is acquired from multiple vendors, a purchaser may seek a declaration from each vendor.

### **Example 1.1 Determining the residency of the vendor**

Andrew enters into an off-market transaction to acquire all of the shares in a company. The majority of the company's investments are in real property holdings throughout Australia. The shares, therefore, constitute indirect Australian real property interests.

Andrew does not know the vendor of the shares. Under the terms of the sale contract, Andrew is to transfer the purchase price of the shares to an overseas bank account in the name of an associate of the vendor.

At this stage, the knowledge condition in subsection 14-210(1) is satisfied. Andrew notifies the vendor that he is required to withhold a portion of the purchase price unless the vendor can provide Andrew with further information about his residency (or an exemption).

The vendor provides Andrew with a declaration that states that the vendor is an Australian resident for income tax purposes. The knowledge condition is no longer satisfied because Andrew has a reasonable belief that the vendor is an Australian resident.

Even if Andrew could not verify the declaration to the extent necessary for him to have a reasonable belief in its accuracy, he could rely on it (provided he did not know it to be false) and no withholding obligation would arise.

### ***Declaration of Australian permanent establishment***

1.67 A foreign resident vendor will not be taken to be a relevant foreign resident where they make a declaration that they are carrying on a business through an Australian permanent establishment. *[Exposure Draft, item 1, subsection 14-210(2) and paragraph 14-220(1)(b) in Schedule 1 to the TAA 1953]*

1.68 The declaration must relate to the period immediately after the relevant transaction. That is, a declaration cannot be made when a foreign resident is selling its permanent establishment, as there would no longer be Australian assets to meet a tax liability.

1.69 The reference to ‘permanent establishment’ here is a reference to the general definition in subsection 6(1) of the ITAA 1936 only. It is not necessary to apply the provisions of any international tax agreements (see paragraph 1.11) because the test is not being used to determine Australia’s taxing rights.

1.70 A declaration may not be relied on if the purchaser knows it to be false.

***Declaration membership interest is not indirect Australian real property interest***

1.71 Another declaration can be made in the case of CGT assets that are membership interests (for example shares in a company). The vendor is likely to be in a better position than the purchaser to determine whether the membership interests satisfy the definition of an indirect Australian real property interest.

1.72 Membership interests that are not indirect Australian real property interests are not within the scope of the amendments. To support this, the amendments will not apply to a vendor where the purchaser relies on a declaration by the vendor that the interests are not indirect Australian real property interests. [*Exposure Draft, item 1, subsection 14-210(2) and subsection 14-220(2) in Schedule 1 to the TAA 1953*]

1.73 Before making a declaration, the foreign resident vendor must consider the level of their stake in the entity to which the interests relate. In addition, the vendor must consider whether the principal asset test is satisfied in relation to the entity. See paragraphs 1.5 to 1.9 for when membership interests are indirect Australian real property interests.

1.74 A purchaser may rely on the declaration even though the declaration may be inaccurate, unless the purchaser has specific knowledge that the declaration is false.

1.75 As with the other declarations, the declaration only goes to whether a specific vendor is a relevant foreign resident. Withholding may still be required if there are multiple vendors and another vendor is a relevant foreign resident.

## The amount to pay to the Commissioner

1.76 A purchaser must pay, to the Commissioner, 10 per cent of the total consideration they paid, or are required to pay, to acquire the CGT asset. This is reflected in the first element of the CGT asset's cost base (see subsection 110-25(2) of the ITAA 1997). [*Exposure Draft, item 1, subsection 14-200(3) in Schedule 1 to the TAA 1953*]

1.77 The amount includes 10 per cent of the market value of any property provided to acquire the CGT asset.

### *Multiple purchasers*

1.78 When working out the amount to pay to the Commissioner, it is important to correctly identify the CGT asset acquired. This is particularly the case where multiple purchasers each purchase interests in a property.

### **Example 1.2 Joint purchase of property**

John and Jane purchase a residential property for \$3 million from a vendor they know is a foreign resident. They acquire title to the property as joint tenants.

Under section 108-7 of the ITAA 1997, John and Jane are each taken to have acquired the property as tenants in common in equal shares.

The CGT asset that John has acquired is a 50 per cent interest in the property. The cost base of the asset is \$1.5 million (assuming no incidental expenses). John must pay \$150,000 to the Commissioner. Jane must pay the same amount to the Commissioner.

Between them, John and Jane are entitled to withhold \$300,000 from the amount they pay to the vendor.

Note that the purchase is not entitled to the residential premises exemption because the property, as a whole, has a value of \$3 million.

### *Variation of withholding amounts*

1.79 The Commissioner may vary a payable amount, in relation to either a particular case or class of cases. The variation may include a variation to nil. [*Exposure Draft, item 1, section 14-225 in Schedule 1 to the TAA 1953*]

1.80 A foreign resident or a purchaser may apply to the Commissioner for a variation of the amount. Reasons for a variation could include that:

- the foreign resident will not make a capital gain on the transaction (for example because they will make a capital loss or a CGT roll-over applies);
- the income from the transaction is exempt (for example because of a double tax agreement);
- the foreign resident will otherwise not have an income tax liability (for example because of carried-forward capital losses or tax losses); or
- there are multiple vendors, only one of which is a foreign resident.

1.81 The Commissioner may issue a variation (other than a class variation) to the applicant. However, the variation is only effective if it is provided to the purchaser. *[Exposure Draft, item 1, subsections 14-225(2) and (3) in Schedule 1 to the TAA 1953]*

### **Example 1.3 Applying for and receiving a variation**

Victor is a foreign resident who is selling a commercial property with a cost base of \$1 million. Victor expects to make a capital loss on the sale (assuming the purchase price is less than \$1 million).

Victor applies to the Commissioner for a variation. The Commissioner issues a variation notice to Victor stating that the amount payable, to the Commissioner, by a purchaser of Victor's property is reduced to nil. The variation is subject to the condition that the purchase price for the property not exceed \$1 million.

Later, Paul agrees to purchase the property from Victor for \$900,000. Victor provides a copy of the variation notice to Paul. The variation takes effect and Paul's liability to the Commissioner is reduced to nil.

1.82 Either party may object to a variation (other than a class variation) or the Commissioner's decision not to issue a variation. *[Exposure Draft, item 21, section 20-80 in Schedule 1 to the TAA 1953]*

1.83 A variation made in a particular case is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. An amendment is made to assist readers in this respect but is not intended to alter the operation of the law. *[Exposure Draft, item 1, subsection 14-225(4) in Schedule 1 to the TAA 1953]*

1.84 A variation applying to a class of amounts is a legislative instrument. *[Exposure Draft, item 1, subsection 14-225(5) in Schedule 1 to the TAA 1953]*

### ***Variation for sale of secured property***

1.85 A creditor of the vendor may have a security interest (for example, a mortgage) over an asset that is subject to the amendments. There may be situations where the proceeds of the sale are insufficient to cover both the amount to be paid to the Commissioner and to discharge the debt the loan secures.

1.86 The Commissioner does not have any priority over secured creditors in relation to the recovery of tax-related liabilities. It is not the intention of these amendments to undermine the security of creditors in the event of a vendor's default. The Commissioner must consider this intention when deciding whether to vary a withholding amount. *[Exposure Draft, item 1, subsection 14-225(1) in Schedule 1 to the TAA 1953]*

1.87 To support this power, a secured creditor may apply to the Commissioner for a variation where they are exercising a power, in relation to the security, to recover the debt (for example a power of sale). *[Exposure Draft, item 1, subsection 14-225(3) in Schedule 1 to the TAA 1953]*

### **Example 1.4 Power of sale**

Chris, a foreign resident, owns a commercial property located in Australia. Chris owes \$1 million to a bank, which is secured by a mortgage over the commercial property.

Chris' business has been performing poorly and he has missed a number of repayments on the loan. The bank decides to exercise its power of sale.

The property is sold for \$950,000 net of costs. The proceeds are insufficient to pay the Commissioner and discharge Chris' mortgage.

Chris would prefer that the Commissioner is paid in preference to the bank because he would be entitled to a credit for this amount. Therefore, he does not apply for a variation (even though one may be available if he made a capital loss).

The bank is entitled to apply for a variation and does so. The Commissioner considers the circumstances and concludes that requiring an amount to be paid to the Commissioner would prevent the bank from recovering the debt from its secured interest.

The Commissioner issues a notice to the bank that varies the amount to nil. The bank provides a copy of the notice to the purchaser. The purchaser is relieved of any obligation to pay an amount to the Commissioner.

1.88 It will not be necessary for the Commissioner to exercise this discretion other than in situations where the secured creditor is in a position to exercise a recovery power, or such a position is likely to arise.

### **Example 1.5 Other secured creditors**

Daniel, a foreign resident, owns commercial property located in Australia. Daniel owes \$950,000 to a bank, which is secured by a mortgage over the property. Daniel has been meeting all of his obligations under the loan and there is nothing to suggest Daniel will have difficulty continuing to meet his obligations.

Daniel enters into a contract to sell the property for \$1 million. The purchaser knows that Daniel is a foreign resident and will be required to pay \$100,000 to the Commissioner when the property settles. In these circumstances, there will be insufficient sale proceeds available at settlement to discharge the mortgage.

Daniel (rather than the bank) is entitled to apply for a variation. However, on the available information, Daniel would not be entitled to a variation. If he wishes to dispose of the property, he will need to make other commercial arrangements acceptable to the bank (because the bank has the power to prevent the sale). This is likely to require him to provide an additional \$50,000 to the bank or to refinance his obligations in some way.

1.89 The outcome in Example 1.5 may be different if Daniel could point to circumstances that meant it was likely that he would soon default on his loan obligations. It is not the intention to draw a distinction between an ordinary sale and a sale by a mortgagee where the impetus for the sale is the same – the unsustainable financial position of the mortgagor. However, provided the mortgagor has other viable options to discharge the mortgage without a variation to the withholding amount, a variation is not required to protect the security of the mortgagee.

### **Transactions involving look-through earnout rights**

*The amendments with respect to look-through earnout rights depend on the amendments proposed in the exposure draft – providing ‘look-through’ CGT treatment to earnout arrangements.*

1.90 An earnout arrangement is an arrangement where, as part of the sale of a business or the assets of a business, the vendor and purchaser agree that subsequent financial benefits may be provided, based on the future performance of the business or the related business in which the assets are used. In a standard earnout arrangement, the buyer agrees to pay the seller additional amounts if certain performance thresholds are met within a particular time.

1.91 A look-through earnout right is a right to future financial benefits, and unascertainable at the time the right is created (section 118-565 of the ITAA 1997). The right must be created under an earnout arrangement involving the disposal of a CGT asset that is an active asset of the vendor, and the financial benefits under the right must be contingent on and reasonably related to the future economic performance of the asset (or a related business).

1.92 Vendors must include financial benefits received under look-through earnout rights in determining the capital proceeds of the disposal of the underlying asset.

1.93 Because the amount is unascertainable at the time the right is created, the amount will be added to the capital proceeds of the underlying asset after the withholding tax is calculated and paid. Therefore, an additional rule is necessary to ensure a portion of the financial benefit payment is paid to the Commissioner.

1.94 If the original transaction required a purchaser to pay an amount to the Commissioner, the purchaser must also pay an amount to the Commissioner with respect to financial benefits provided under look-through earnout rights. [*Exposure Draft, item 1, subsection 14-205(1) in Schedule 1 to the TAA 1953*]

1.95 The purchaser must pay 10 per cent of the financial benefit to the Commissioner. The Commissioner may vary the required amount (see paragraphs 1.79 to 1.89). [*Exposure Draft, item 1, subsection 14-205(3) in Schedule 1 to the TAA 1953*]

### **Example 1.6 Look-through earnout rights**

Patrick acquires commercial property from a vendor he knows to be a foreign resident. The purchase price for the premises is \$1 million.

Because the parties are uncertain as to the value of the premises, Patrick also agrees to pay, to the vendor, a future amount calculated on the profits that Patrick is able to generate from the premises. The right to receive this payment is, in the hands of the vendor, a look-through earnout right.

Patrick withholds \$100,000 from the purchase price and pays this amount the Commissioner.

Two years later, Patrick's business has been very successful. He is required to pay \$50,000 to the vendor under the terms of the sale contract. Patrick is required to pay \$5,000 to the Commissioner and may withhold this amount from the payment to the foreign resident vendor.

1.96 Generally, if the purchaser was required to withhold with respect to the original transaction, financial benefits will be subject to these additional rules. However, the latter obligation may be relieved where there is a change in circumstances relating to the residency of the person ultimately receiving the financial benefit.

1.97 This may arise because the residency of the original foreign resident changes. Alternatively, the financial benefit may be directed towards a person who was not a part of the original transaction. In either case, the question, of whether the person receiving the benefit is a relevant foreign resident, is reassessed at the time the financial benefit is provided or received.

### **Example 1.7 Look-through earnout rights and changes in circumstance**

Further to Example 1.6, assume that, before the payment of the \$50,000, the vendor provided Patrick with a declaration that the vendor was now an Australian resident for income tax purposes. Patrick is not required to pay any amount to the Commissioner.

### **Requirements when paying the amount**

#### ***When to pay an amount***

1.98 The required amount must be paid to the Commissioner on the day the obligation to pay the amount arises.

1.99 When a purchaser acquires property, the obligation arises when the purchaser becomes the owner of the property. This is to be distinguished from the time the purchaser is taken to have acquired the asset for CGT purposes (generally backdated to the date the purchaser entered into the purchase contract). [*Exposure Draft, item 1, subsection 14-200(2) in Schedule 1 to the TAA 1953*]

### **Example 1.8 When to pay an amount when acquiring property**

Ben is acquiring a residential property for \$3 million. Ben knows that the vendor of the property is a foreign resident and that the acquisition is subject to a withholding obligation.

Ben enters into a contract for the purchase of the property on 1 August 2016 and pays a \$150,000 deposit. The contract is settled on 1 October 2016 when Ben is required to pay the balance of \$2.85 million to the vendor and receives a transfer of title to the property.

Ben withholds \$300,000 from the settlement amount (paying \$2.55 million to the vendor). Ben must pay the \$300,000 to the Commissioner on the same day, 1 October 2016.

1.100 For financial benefits provided under a look-through earnout right, the obligation arises when the purchaser provides the financial benefit to the vendor. The amount must be paid to the Commissioner on the day the financial benefit is provided. *[Exposure Draft, item 1, subsection 14-205(2) in Schedule 1 to the TAA 1953]*

***Form of payment***

1.101 Payments to the Commissioner must be made through an electronic payment method approved by the Commissioner (for example Electronic Funds Transfer or BPAY). This is required through an amendment that applies section 16-85 in Schedule 1 to the TAA 1953 to the payments. *[Exposure Draft, item 14, subsections 16-70(3) and (4) in Schedule 1 to the TAA 1953]*

1.102 The Commissioner may allow alternative means of payment in some circumstances.

***Notification to the Commissioner***

1.103 A purchaser paying an amount to the Commissioner must notify the Commissioner (section 16-150 in Schedule 1 to the TAA 1953). The notification must be in the approved form and will be used to collect information necessary for the amount to be credited to the appropriate foreign resident taxpayer.

1.104 No obligation is imposed to provide annual reports to the Commissioner under section 16-153.

1.105 The approved form may require the purchaser to quote the vendor's tax file number if the vendor has provided one. Amendments are made to allow purchasers to collect tax file numbers from foreign residents (where they have them) and provide them to the Commissioner. This will assist the Commissioner to match withholding payments to specific foreign residents. *[Exposure Draft, items 2 and 9 to 11, paragraph 202(s) of the ITAA 1936, and paragraphs 8WA(1AA)(b), 8WB(1A)(a) and 8WB(1A)(b) of the TAA 1953]*

***Requirement to register***

1.106 A purchaser paying an amount to the Commissioner must apply to register as a withholder (section 16-140 in Schedule 1 to the TAA 1953).

1.107 Withholders completing the one approved form when paying withheld amounts to the Commissioner will comply with both sections 16-140 and 16-150.

### **Withholding tax credits**

1.108 A purchaser required to pay an amount to the Commissioner is entitled to withhold the amount from the foreign resident (section 16-20 in Schedule 1 to the TAA 1953).

1.109 The foreign resident vendor will be entitled to a credit for the amount paid to the Commissioner (Division 18 in Schedule 1 to the TAA 1953). The entitlement to a credit arises when the Commissioner makes an income tax assessment (or determines that no income tax is payable) for the income year. The vendor must lodge an income tax return to claim the credit.

1.110 The main crediting provision would be section 18-15, with section 18-20 applying where the recipient is a partnership and section 18-25 applying to trustees.

1.111 Amendments are made to the definitions of ‘amount required to be withheld’, ‘amount withheld’ and ‘withholding payment’ to ensure that Division 18 applies correctly to amounts paid to the Commissioner.  
*[Exposure Draft, items 5 to 8, subsection 995(1) of the ITAA 1997]*

1.112 The availability of a credit to a foreign resident is contingent on the purchaser paying the amount to the Commissioner. A credit does not arise merely because an amount has been withheld from a payment made to the foreign resident that the withholder was required to pay to the Commissioner. See sections 18-15 and 18-20, and paragraph (b) of the amended definition of ‘amount withheld’.

1.113 Part IIB of the TAA 1953 (about Running Balance Accounts) sets out how the Commissioner must treat a credit. These generic rules will apply to credits for amounts withheld under the new withholding regime.

### ***Refund of amounts withheld in error***

1.114 Subdivision 18-B provides for withholders or the Commissioner to refund withheld amounts, or amounts paid to the Commissioner, where there has been an error.

1.115 The Commissioner may refund an amount paid under the amendments (per section 18-70). A person receiving a withholding payment under the amendments, however, may not claim a refund from

the purchaser (per section 18-65). *[Exposure Draft, items 18 and 19, subparagraph 18-65(1)(a)(ii) and paragraph 18-65(6)(c) in Schedule 1 to the TAA 1953]*

## **Penalties and offences**

1.116 The existing administrative penalties, specified in sections 16-30 and 16-35 in Schedule 1 to the TAA 1953, for failures to withhold will apply for the new withholding provisions. No amendment is required. This is because sections 16-30 and 16-35 impose a penalty where there is a failure to pay an amount as required by Division 14, and the new obligations created by these amendments are inserted into Division 14.

1.117 The general interest charge will apply to amounts that are not paid to the Commissioner by the required date. *[Exposure Draft, item 14 and 15, section 16-80, and subsections 16-70(3) and (4) in Schedule 1 to the TAA 1953]*

1.118 Division 268 in Schedule 1 to the TAA 1953 sets out provisions for the recovery of unpaid withholding amounts and allows the Commissioner to make an estimate of a person's withholding liability. Division 269 imposes penalties on directors of companies that fail to meet their withholding obligations. Division 298 sets out the machinery provisions for the collection and remission of penalties, and the imposition of interest on unpaid penalties.

1.119 The offence provision of section 20-35 will also apply to the new withholding obligations. Section 20-35 makes it an offence to claim, falsely, a credit owing to a person who has received a withholding payment.

1.120 Administrative penalties apply to making a false or misleading statement. These penalties also apply to statements made to purchasers in declarations made under the amendments (see subsection 285-75(4)).

## **Application of the regime to particular transactions**

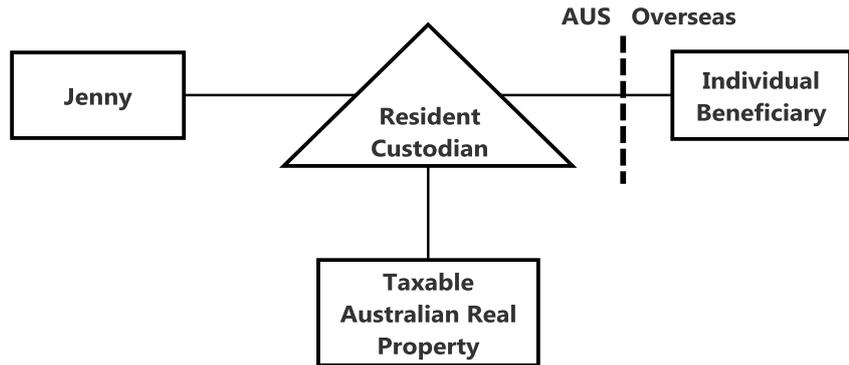
1.121 This section details how the components of the regime operate together in particular transactions. This section also discusses interactions with other areas of the law.

### ***Transactions involving trusts***

1.122 The trustees of trusts are subject to income tax assessments when a foreign resident beneficiary has a present entitlement to a share of the net income of the trust (section 98 of the ITAA 1936). The amendments do not apply where an Australian resident trustee will have a section 98 liability.

1.123 Many foreign residents will hold their investments in Australia via an Australian trust, including a custodian service provider.

**Example 1.9 Purchase from Australian trustee**



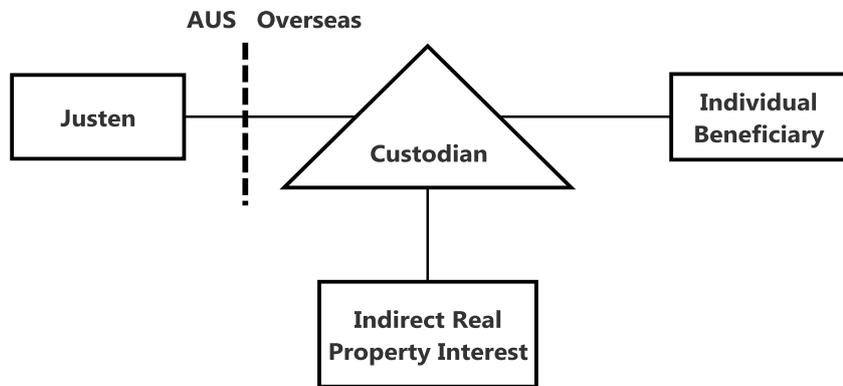
Jenny acquires taxable Australian real property. The vendor of the property, the person with legal title, is an Australian resident that holds the property on trust for a foreign resident.

No withholding obligation arises with respect to the purchase. However, if there is a capital gain on the sale, the custodian may be assessed under subsection 98(3) of the ITAA 1936.

The foreign resident beneficiary is assessed under subsection 98A(1) but is entitled to a credit for the tax paid by the custodian (subsection 98A(2)).

See also subsection 98(4) and section 98B for situations where the beneficiary is another trust.

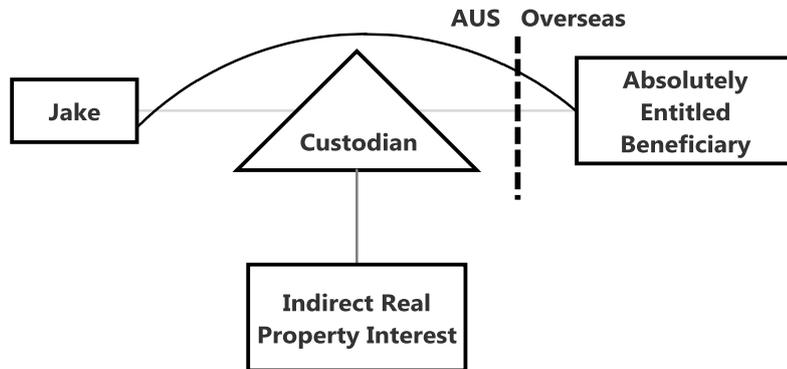
**Example 1.10 Purchase from foreign resident trustee**



In an off-market transaction, Justen acquires shares that are an indirect Australian real property interest. The vendor of the property, the person with legal title, is a foreign resident custodian.

Justen knows that the custodian is a foreign resident. Justen pays 10 per cent of the purchase price to the Commissioner. The custodian will be entitled to a withholding tax credit under section 18-25 in Schedule 1 to the TAA 1953.

**Example 1.11 Purchase from absolutely entitled beneficiary**



In an off-market transaction, Jake acquires shares that are an indirect Australian real property interest.

Under the general law, the legal owner of the property is a custodian. However, the beneficiary is absolutely entitled to the assets of the trust, including the shares. For CGT purposes, the beneficiary, and not the custodian, is taken to be the owner of the asset. The sale of the asset, by the custodian, is taken to have been done by the beneficiary

(section 106-50 of the ITAA 1997). The beneficiary is therefore the vendor for withholding purposes.

If Jake has reasonable grounds to believe he is acquiring the shares from a foreign resident, he must pay 10 per cent of the purchase price to the Commissioner. The absolutely entitled beneficiary would then be entitled to a credit for this amount under section 18-15 in Schedule 1 to the TAA 1953.

### ***Foreclosures***

1.124 A foreclosure is an uncommon situation in Australia where a secured creditor assumes ownership of a secured asset. It is generally a remedy of last resort for the creditor and is generally only available where the creditor has attempted to exercise a power of sale.

1.125 The amendments apply to a foreclosing creditor in the same way they apply to a purchaser of an asset.

### **Example 1.12 Foreclosures**

Rick, a foreign resident, owns a commercial property. Rick has a loan with a bank, which is secured by a mortgage over the property.

Rick is in default on his repayment obligations. The bank attempts to exercise its power of sale to recover the debt. The property is offered for sale in a public auction but the auction fails to receive a bid sufficient to discharge the mortgage and cover the bank's expenses.

The bank seeks, and is granted, an order for foreclosure. This results in the bank acquiring legal title to the property from Rick. As the bank has acquired title, the bank is the purchaser for the purposes of these amendments and would be subject to the withholding obligation.

The bank is entitled to apply for a variation to the withholding amount. In considering the application, the Commissioner will take into account the policy intention that these amendments do not prevent the bank from realising the value of its security. See paragraphs 1.85 to 1.89.

As the market value of the property is less than Rick's debt, the Commissioner considers that any withholding obligation would further diminish the value of the bank's security. The Commissioner, therefore, varies the withholding amount to nil.

## Consequential amendments

1.126 The new withholding obligation is added to lists of withholding obligations and tax-related liabilities. *[Exposure Draft, items 12, 13 and 22, subsections 10-5(2) and 250-10(2) in Schedule 1 to the TAA 1953]*

1.127 Various references to Division 14 are updated to reflect that the Division contains multiple obligations. *[Exposure Draft, items 16, 17 and 20, paragraphs 16-140(1)(b), 16-143(2)(b) and 16-150(b), and subparagraph 18-70(1)(a)(ii) in Schedule 1 to the TAA 1953]*

1.128 Notes are added to Division 855 of the ITAA 1997 (about the capital gains tax obligations of foreign residents) cross-referencing the new withholding obligation. *[Exposure Draft, items 3 and 4, notes to section 855-15 of the ITAA 1997]*

## Application provisions

1.129 The amendments apply to CGT assets acquired on or after 1 July 2016. *[Exposure Draft, item 23]*

1.130 A purchaser is generally taken to have acquired an asset on the date they entered into the contract to acquire it (see Division 109 of the ITAA 1997). Therefore, the amendments will not apply to transfers that occur under a contract entered into prior to 1 July 2016.



