PROPERTY COUNCIL of Australia

PROSPERITY | JOBS | STRONG COMMUNITIES

Submission on Foreign Resident CGT Withholding Regime

Treasury Exposure Draft and Explanatory Memorandum

7 August 2015

7 August 2015

General Manager
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Attention: Lucas Rutherford

By email: taxlawdesign@treasury.gov.au

Proposed foreign resident 10 per cent non-final withholding tax regime for purchases of certain taxable Australian property

Dear Lucas

Thank you for the opportunity to comment on the exposure draft for the *Tax and Superannuation Law Amendment (2015 Measures No.5) Bill 2015: Foreign resident capital gains withholding payments* (the ED) and the accompanying Explanatory Memorandum (the EM).

Consistent with our earlier submission in response to the October 2014 Treasury discussion paper and our subsequent discussions, industry is keen to ensure that the proposed regime does not result in unnecessary increased levels of compliance and administrative costs for property transactions.

We welcome the approach of the ED to incorporate measures such as:

- the vendor declaration, which will allow purchasers to rely on self-certifications from vendors as to their residency status;
- the ability to vary the rate of withholding, which will limit unnecessary withholding on transactions that do not give rise to Australian tax receipts, or where the tax payable will be less than 10% of the purchase price; and
- excluding on-market listed transactions, which recognises the impossibility of determining identity and residency of a counterparty in a listed environment.

However, given that a failure to withhold can give rise to penalties for the purchaser of up to 100% of the withholding tax amount, plus interest, it is critical that the proposed regime operates in a clear and practical manner in relation to the following threshold issues.

Vendor declarations

The ability of a purchaser to rely on a vendor declaration, and the ability of a vendor to provide a vendor declaration, will be paramount to ensuring amounts are not unnecessarily withheld.

The following amendments should be made to the vendor declaration provisions to ensure the safe harbour is workable and provides sufficient certainty for vendors and purchasers:

- Confirm in the legislation that a purchaser can request a vendor declaration, and include supporting commentary in the EM that a failure to provide a declaration when requested will constitute grounds for 'reasonable belief' that the vendor is a foreign resident and allow the purchaser to withhold; and

- Allow the following entities, which are not intended to be caught by the regime, to provide vendor declarations:
  - trustee of an Australian resident trust estate; and
  - entities that are exempt from tax such as charities and government bodies.

Custodians

The current ED forces purchasers to trace through Australian custodians to determine whether the custodian's client is a non-resident. This is not information that is readily available to the purchaser, and is inconsistent with existing withholding tax rules that impose the obligation on the Australian custodian.

The law should be amended to place the withholding obligation arising on the purchase of an asset from an Australian custodian holding the asset for a foreign resident on that custodian and not the purchaser.

Scope of withholding obligation

The withholding obligation is only intended to arise where there has been an acquisition of a CGT asset. The EM should clarify that withholding is not required in transactions such as an off-market buy-back of shares or units where shares or units are cancelled (and not acquired).

The legislation and EM should also provide greater clarity on how the regime applies (including worked examples on the Commissioner's variation power), where there is a scrip-for-scrip transaction that is not eligible for CGT rollover. Imposing withholding obligations on such a non-cash transaction could make the arrangement non-viable, which would adversely limit the capital management tools available to land-rich entities.

The earn-out rules should also be clarified to ensure that the withholding rules operate appropriately where an earn-out arrangement applies to the purchase of a commercial building. As currently drafted, such a purchase would not be caught by the earn-out rules resulting in additional complexity and uncertainty, and potential disputes between parties.

Variation of withholding rates

A simplified variation process should apply to purchases from foreign resident vendors who have an Australian tax file number (TFN) where the non-resident declares its TFN to the Commissioner. These vendors are not at 'high risk' of non-compliance as they are visible to the ATO.

In addition, a streamlined variation process should be available for sovereign wealth funds that apply for a tax ruling exempting them from Australian tax on their investment. The ATO should be able to provide a 0% withholding rate variation to the sovereign wealth fund at the same time the tax ruling is provided. This removes the need for the sovereign wealth fund to lodge a separate request for a variation, or face unnecessary withholding.

Our detailed submission on the above issues is set out in the Appendix.

In addition, we note that:

- the application of the proposed regime is not limited to purchases of assets where there is or may be a capital gain or loss to the vendor on the disposal of that asset. Rather, the rules may apply to the purchase of any asset that is relevant taxable Australian property which may include the purchase of a vendor's land and buildings held by them as a revenue asset or as trading stock. The Bill should be amended to delete the words "capital gains" and this should be made clearer in the EM;

- the design of the proposed Commissioner's variation power rules relies heavily on the ATO engaging with relevant parties to the transaction in a timely manner and the ATO then speedily and efficiently making a decision on those variation requests. We look forward to engaging separately with the ATO to consult on the development of their forms setting out the information needed for them to decide on whether to exercise that power as well as consulting on the possible making of variations on a class basis; and

- while a taxpayer is required to make a withholding payment to the Commissioner at the time they become the owner of the CGT asset (generally the settlement date), it is not clear at what point in time the taxpayer is required to make other determinations, for example, whether the vendor is a foreign resident or whether the asset is an excluded asset. We understand that the settlement date should be the relevant date for all of the determinations. This is not currently clear in the ED. In addition, we consider the date of contract to be the more relevant date in certain circumstances. For example, a property that is acquired for just under $2.5 million should be an excluded asset notwithstanding the fact its market value may rise above $2.5 million by settlement.

We are keen to meet and talk through our industry recommendations at your earliest convenience.

Please let us know when you would be available and in the meantime, if you have any queries, please contact Belinda Ngo (02 9033 1929) or myself.

Yours sincerely

Andrew Mihno
Executive Director – International and Capital Markets

Submission

1. Vendor declarations and reasonable grounds' residency test

A purchaser is only required to withhold where they have reasonable grounds to believe the vendor is a foreign resident. A failure to withhold can give rise to penalties of up to 100% of the withholding tax amount, plus interest. As such, it is critical that the legislation and supporting EM provide practical guidance concerning the application of the "reasonable grounds" residency rules of subsection 14-210(1).

Paragraph 1.56 of the EM states that "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 taxpayers."

However, the later discussion concerning "reasonable belief" at paragraph 1.59 states that the condition is satisfied "where the purchaser has no reasonable grounds to believe that a vendor is an Australian resident" and the purchaser has an overseas address for the vendor or an authority to make a payment overseas for the vendor.

This seems to indicate that a purchaser may have a broader obligation to investigate the residency status of the vendor.

The test is stated to be "whether a reasonable person in the position of the purchaser would have thought that there were reasonable grounds to support the relevant belief". A purchaser who does not turn his mind to this issue risks failing the test if it is subsequently shown that the vendor was in fact a non-resident. This could give rise to penalties of up to 100% of the withholding tax amount.

As such, it is expected that in practice, most purchasers will act conservatively and require vendors to provide a residency declaration as part of the sale process.

The ED and EM should be amended as follows to provide required greater certainty for purchasers:

- Make it clear in the legislation that a purchaser can request a declaration from a vendor – currently, section 14-220 provides that entities "may" give a written declaration. This section should also provide that "you may request" such a declaration.

- Greater guidance in the EM on what constitutes grounds for reasonable belief, including how to apply paragraph 14-210(1)(b) in circumstances where a purchaser asks for a residency declaration from the vendor, and the vendor refuses to provide it within the required timeframe. This should be grounds for the purchaser to "reasonably believe" that the vendor is a foreign resident, and therefore to withhold.

2. Vendor declarations by Australian resident trusts

A purchaser may rely on a declaration made by a vendor that they are an Australian resident, to treat them as not being a relevant foreign resident, unless the purchaser knows the declaration to be false (subsection 14-210(2) and paragraph 14-220(1)(a)).

Based on the existing ED drafting, Australian resident trusts would not be able to make a vendor declaration, and could potentially be subject to unnecessary withholding.

The definition of Australian resident for the *Tax Administration Act* is the section 995 *Income Tax Assessment Act 1997* (ITAA 1997) definition. This picks up the definition of resident of Australia in section 6 of the *Income Tax Assessment Act 1936* (ITAA 1936). Residency of trusts is not covered by the section 6 ITAA 1936 definition of 'resident'.

The ED and EM should clearly address how the residency declaration provision applies where the vendor is a trust.

If the trustee entity (the legal owner of the asset) is an Australian resident company or resident individual it should follow under the current drafting that the Australian residency requirements are met.

However, we are concerned this outcome might by challenged by the ATO on the view that it is the trust estate and its beneficiaries that are the relevant taxpayer that the measures are targeted at and not the trustee.

The treatment of trusts is not clearly explained in the EM, although paragraph 1.122 states:

> *"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.**" (emphasis added)*

Although example 1.9 concludes that no withholding obligation arises with respect to that purchase, we are concerned that the example refers only to a custodian relationship. It should be the case that a resident trust estate, including a custodian, should be excluded from withholding tax and be able to make the residency declaration.

This can be made clear in the EM by including an example of a listed property trust that has section 98 liability, and confirming that such a trust would not be subject to withholding, and can make the residency declaration if requested to do so by a purchaser.

The measures should specifically refer to resident trust estates for completeness and to remove this uncertainty.

A "resident trust estate" is defined in subsection 95(2) of the ITAA 1936:

> *For the purposes of this Division, a trust estate shall be taken to be a resident trust estate in relation to a year of income if:*
> *(a) a trustee of the trust estate was a resident at any time during the year of income; or*

(b) the central management and control of the trust estate was in Australia at any time during the year of income.

This should be incorporated into the residency declaration process. As it is intended that transactions with resident trust estates should not be subject to the proposed withholding rules notwithstanding whether such trusts have any foreign resident beneficiaries as confirmed by paragraph 1.122 above, such trusts should be able to make the residency declaration.

To deny resident trusts the ability to make such a declaration will significantly increase the costs of compliance and could result in extensive unnecessary withholding of amounts.

Example 1.11 indicates that a withholding obligation arises where a foreign beneficiary is absolutely entitled to an asset against a custodian and the purchaser has reasonable grounds to believe that he is acquiring the asset from a non-resident. This implies that a purchaser could have knowledge of the entitlement status of the beneficiary and also the residency status of the beneficiary. This appears to be an unlikely scenario and places an unnecessary burden on purchasers in this situation.

To resolve this issue, the withholding obligation should be imposed on the custodian (refer discussion below).

3. Vendor declarations by charities and government vendors

It is common for REITs to acquire land and buildings from tax exempt entities including charities, for example from the Freemasons and also churches.

Such entities will not have a tax obligation in respect of their disposal of assets and should not be subject to the withholding regime. The EM confirms that a variation could apply where the income from such a transaction is exempt to the vendor. Tax exempt vendors should also be able to make the residency declaration.

We are concerned that a charity might have difficulty providing a declaration that they are an Australian resident. Although some charities would operate through companies and meet paragraph (b) of the definition of resident, potentially some charities are not incorporated and they would need to undertake additional work to obtain comfort that they could make this declaration.

A government body may also have difficulties in providing a residency declaration including for example the Crown or a Federal or State entity.

To assist the operation of the provisions the vendor declarations should be expanded to exclude withholding in such circumstances where a declaration of residency might not be able to be made.

This might be implemented by including an additional exemption where a vendor declaration is made that the vendor entity or any gain from the transaction is exempt from tax. For illustration purposes this could be similar to the following:

> ***Declaration that exempt from income tax***
> *14-220(3) An entity may give you a written declaration, about a transaction that acquires a CGT asset, to the effect that the *ordinary income and *statutory income from the transaction is exempt from income tax.*

4. Withholding obligation should sit with the vendor custodian

The ED should be amended to place the withholding obligation arising on the purchase of an asset from an Australian custodian holding the asset for a foreign resident on that custodian and not on the purchaser.

It is the Australian custodian that will have the relevant information to determine if their client is an Australian or foreign resident. The purchaser of the asset from that custodian may have difficulty in determining how the asset is held by the custodian (ie whether it is held on an absolute entitlement basis) and the residency of the ultimate beneficiary of that asset. The purchaser should be able to accept a residency declaration in respect of that transaction from the custodian.

Withholding by the Australian custodian would also mirror the requirements under existing withholding tax regimes and will assist understanding and implementation of the new law as well as minimise compliance costs and unnecessary withholding of tax and the resulting need for refund requests.

5. Scope of withholding and off-market buy-backs

The ED should be amended or alternatively the EM should be expanded to address the application of the rules to acquisitions of assets involving off-market buy backs.

Certain transactions, such as an off-market buy back of shares or units, may not result in a taxpayer acquiring or disposing of a CGT Asset. The EM should confirm that no withholding obligation arises in these circumstances.

6. Scope of withholding and non cash components

Currently, the EM provides some examples of circumstances where a variation can be expected to be made by the Commissioner. One example is where a CGT rollover applies, such as in an eligible scrip for scrip transaction.

However, there will be transactions where there is a non-cash component, such as a scrip for scrip transaction, where CGT rollover is not available. In these circumstances, a purchaser will not have access to cash from the transaction to meet its withholding obligation. This may make transactions of this type uneconomic where they involve a non-resident vendor who cannot obtain a variation from the Commissioner.

Where the replacement asset is itself a Division 855 asset, the transaction should not be subject to a withholding obligation. In any event, the disclosure of the transaction to the Commissioner in the variation process should provide the non-resident with a process to mitigate any compliance concerns.

If it is expected that the Commissioner's variation power will need to be utilised to deal with the non cash transaction scenario then this should be set out in the EM to assist parties to the transactions to identify that an application should be made and to also support that these are circumstances in which the variation power might be exercised.

7. Scope of withholding and deferred payment rule

In ordinary circumstances, the amount of withholding is required to be calculated and paid at the time of settlement. However, where the transaction involves an earn-out arrangement, the proposed section 14-205 requires withholding on any deferred payments made under the earn-out.

The earn-out provisions have yet to be finalised, but based on the exposure draft legislation 'CGT treatment of earnout rights' (the CGT ED), a "look-through earnout right" includes a requirement that the asset is an active asset just before the CGT event. An active asset is referenced back to the CGT small business concessions and excludes an asset primarily used to derive rent.

Therefore, unless the CGT ED is amended, earnout arrangements in respect of most commercial buildings would not qualify as a "look-through earn-out right" and hence would not be subject to section 14-205 or to the relevant treatment under those proposed CGT rules.

Earn out arrangements can apply to commercial building sales where, for example, the purchase is subject to remediation taking place in relation to the building, and part of the purchase price is retained until the remediation is completed. Another common example is where a commercial building under development is sold, and the purchase price has a deferred component based on let floor area to be achieved by the developer.

It appears to follow that the cost base of the CGT asset "just after the acquisition" will include the value of any ineligible look through earnout right relating to the CGT asset and as a result 10% withholding will be required on that amount at the time of settlement (i.e. when the purchaser becomes the owner of the asset).

This outcome will result in a purchaser withholding obligation mismatch to the timing of the subsequent payment of the additional amount to the vendor as well as the likely mismatch of the payment required on the value of the right at settlement and that which would be required had the payment been calculated on the amount ultimately paid to the vendor, without any apparent adjustment mechanism.

This will result in undesirable additional complexity and uncertainty for the operation of the proposals and with dealings between the parties, potentially resulting in disputes.

The exclusion of commercial buildings from the deferred withholding obligation treatment would seem to be an inadvertent outcome and should be rectified by ignoring the active asset requirement of the proposed look-through earnout right rules for the purpose of the withholding rules.

The deferred payment rule should also be extended to apply to other deferred consideration arrangements that do not qualify as earn-out arrangements but could be included in cost base, to match the timing of those subsequent payments to the obligation to pay the amount to the Commissioner. Such deferrals could include retention amounts for remediation costs or construction contracts.

An adjustment will be required to subsection 14-200(3) to exclude the value of any look through earnout right and other deferred withholding obligations covered by the expanded section 14-205 from the amount upon which the 10% payment is required to be made on the day the purchaser becomes the CGT asset's owner.

8. Simplified variations for foreign resident vendors with TFNs

A simplified process should be available for the variation of the amount of withholding tax payable in respect of purchases from foreign resident vendors who have an Australian tax file number (TFN) but who are not carrying on a business in Australia. Importantly, such vendors are not at 'high risk' of non-compliance as they are visible to the ATO.

For example, a foreign resident investing in a commercial building solely for the purpose of collecting rent will not be considered to be carrying on a business in Australia (and therefore, will not be able to make a vendor declaration), but may have a TFN and therefore an Australian tax presence.

A foreign resident vendor should be able to make a variation application under section 14-225 by declaring its TFN to the Commissioner and also the expected tax liability from the transaction. The variation should be taken to be granted unless the Commissioner determines otherwise and notifies the applicant within 21 days of receiving that application.

This simplified variation process would provide more certainty and further reduce the administration and compliance burden on the ATO and on arm's length purchasers and vendors in conventional transactions.

The examples provided in the EM at paragraph 1.80 do not cover this situation, that is where a non-resident taxpayer has a TFN and can provide details about the quantum of its tax liability. The examples assume a variation to Nil. In practice, many non-residents in this situation (ie who are subject to the provisions but have a tax liability less than 10% of the proceeds) could be expected to apply for a TFN and disclose their tax liability details thus increasing compliance. This may well be a more commercially acceptable outcome to waiting to claim a credit on lodgement of a tax return.

9. Streamlined variations for sovereign wealth funds

Currently, sovereign wealth funds can apply for an ATO ruling to confirm they are not subject to tax on their investment(s) into Australia. These entities would therefore not be subject to tax on disposal of their investments from Australia.

However, these exempt sovereign wealth funds could inadvertently be caught up by the proposed withholding regime as they will have foreign resident indicia.

Such funds would not be able to provide a "residency declaration", and instead, would need to apply for a variation of withholding rate at the time of any potential sale of their investments.

The administrative process could be significantly streamlined by allowing the ATO to provide a clearance certificate (or 0% withholding rate variation) to the sovereign wealth fund at the same time as the tax ruling on their status. The sovereign wealth fund could then furnish this certificate / rate variation at the time of sale as evidence that withholding is not required. Such an approach would remove duplication of time and effort, both for the sovereign wealth fund investor and the ATO.

Contacts

Andrew Mihno

Executive Director – International & Capital Markets

Property Council of Australia

Phone: 02 9033 1944

Mobile: 0406 454 549

Email: amihno@propertycouncil.com.au

Belinda Ngo

Deputy Executive Director – International & Capital Markets

Property Council of Australia

Phone: 02 9033 1929

Mobile: 0400 356 140

Email: bngo@propertycouncil.com.au