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20 August 2024

Dear Sir/Madam,

Strengthening the foreign resident capital gains tax regime

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 173,000 members in over 100 countries and regions. We make this submission in response to The Treasury's consultation paper **Strengthening the foreign resident capital gains tax regime** (Consultation Paper) released on 23 July 2024, on behalf of our members and in the broader public interest.

The proposed expansion of the capital gains tax (CGT) base for foreign residents as set out in the Consultation Paper significantly broadens the scope of assets, many of which are currently not subject to tax in Australia, that could potentially be caught under the new proposals. At a broader policy level, the inclusion of assets and projects related to the energy transition under the new CGT proposals potentially conflicts with Australia's clean energy transition ambitions. Such projects could be classified as assets with a close economic connection to Australian land or natural resources and be taxed under the proposed expansion of the CGT base. This classification could discourage foreign investment in the renewable sector.

Without transitional rules or grandfathering provisions, existing foreign investors may face unexpected tax liabilities on assets that were not factored in at the time of investment. This, coupled with a relatively low $20 million threshold that applies before a reporting obligation arises to the Australian Taxation Office (ATO), means there is a need for clear legislative and administrative guidance and practical examples by the time the law is enacted. A post implementation review (for example, after three to five years) should also be conducted to assess the effectiveness and compliance costs of the new CGT proposals.

Please refer to the Appendix for our responses and recommendations

If you have any queries, please contact Jenny Wong, Tax Policy Lead on jenny.wong@cpaaustralia.com.au or Bill Leung, Tax Technical Advisor on bill.leung@cpaaustralia.com.au.

Yours sincerely,

Ram Subramanian
Interim Head of Policy and Advocacy

Appendix

Detailed discussion

At the outset, we outline our key concerns with the proposed integrity measure in relation to foreign resident CGT as announced by the Government in the 2024-25 Budget. The first relates to the absence of transitional or grandfathering provisions; the second relates to the expanded scope of the type of assets caught under the new proposals; and the third, relates to the expanded testing period in applying the principal asset test.

Transitional rule/grandfathering provisions

The proposed changes to the CGT regime for foreign residents will have significant implications and yet no transitional rules or grandfathering provisions are proposed in the Consultation Paper. Foreign residents who have invested, or are considering investing, into Australian assets may be faced with an Australian tax liability on disposal of their investment which may not have been factored in at the time of the investment.

The lack of transitional or grandfathering provisions appears inequitable and inconsistent with CGT legislation introduced in the past, which typically includes some form of transitional rule. The government should consider implementing a transitional rule for assets that become taxable Australian property (TAP) or taxable Australian real property (TARP). Certain assets will be classified as TARP from 1 July 2025. If historical gains are fully taxed, this could incentivise taxpayers to dispose of these assets before the deadline to refresh cost bases. A precedent exists in Section 855-25(3) of the *Income Tax Assessment Act 1997* (ITAA 1997), which provides a market value cost base for assets that became taxable in 2005 but were not previously taxable under the former Division 136 of the ITAA 1997. Implementing a similar rule would also align with Subdivision 855-B, which offers a market value cost base for assets that first enter the Australian tax net when the owner becomes an Australian resident.

The proposals should not affect foreign residents who invested in Australia on the basis of the law as it stood prior to the announcement. We recommend that a transitional rule should apply to existing assets (eg refreshing the cost base of assets held pre-announcement) held by foreign residents that are not currently subject to CGT but which may be subject to Australian tax under the proposals outlined in the Consultation Paper.

Expanded scope of assets subject to CGT

The 2024-25 Budget measure seeks to broaden the CGT base for foreign residents to ensure that assets with a close economic connection to Australian land and/or natural resources are captured within the tax law.

The objective of strengthening the integrity of CGT on foreign residents investing in Australian land is understandable; however, it could present a conflict when applied to investments in renewable or clean energy projects. These projects, although important for Australia's clean energy transition, potentially are being classified as assets with a close economic connection to Australian land or natural resources. This classification could discourage foreign investment in the renewable sector, which potentially relies heavily on international capital. A post implementation review should be taken on the expanded scope of the new CGT proposals affects the level of investment in clean energy projects.

Other specific issues we would like to make on the expanded scope of assets caught under the proposals:

- It is unclear whether the proposed law will be designed such that the scope of assets caught under the proposals will be determined based on principle based drafting or general principles or alternatively, whether a list of assets will be included in the law. To provide taxpayers certainty and clarity on what assets are in scope under the proposals, we recommend the legislation to be drafted by including a list of assets rather than a general principle.

- The inclusion of licences to use land situated in Australia is extremely broad. The general inclusion of licences and agreements for lease may apply to investments in entities with statutory licences granted by Government agencies. We recommend that the scope of assets caught under the proposals be limited to leases only or alternatively, include a specific list to identify those licences that should be included in the proposals, for example, exploration licenses. Agreements that give a service provider a licence to enter land should not be covered. For example, this would include a development agreement that provides the development entity a licence to carry out construction works on land.

- The Consultation Paper states that it is not proposed to extend the jurisdiction to tax foreign residents on capital gains from the disposal of livestock and equipment used in agriculture and forestry, except to the extent that these assets are installed on land, or are used in carrying on a business through a permanent establishment in Australia.

  We submit that further clarity is required on which assets have a "close economic connection to Australian land and/or natural resources" as the concept is not always clear. For example, are all disposals of biological assets as defined in International Accounting Standard **IAS 41 Agriculture** excluded from the proposed measure?

Principal asset test - expansion of testing period

The proposals in the Consultation Paper involves changing the principal asset test (PAT) for deciding whether a company or trust is 'land-rich' from a point-in-time test (… '[the] membership interest … passes the principal asset test … *at that time*') to a period test: 'if the underlying entity derives more than 50 per cent of its market value from TARP at the time of testing or *at any time during* the preceding 365 days …'.

There are a few practical issues this proposal raises:

- Obtaining information for each day of the 365-day period to apply this test is likely to be difficult in practice, especially for minority investors. There is also the potential for valuation disputes. This issue is exacerbated as the proposed measure will apply to CGT events commencing on or after 1 July 2025, which in the absence of a transitional provision includes a CGT asset held well before that date. In addition, as noted above, given we have no precise definition of the broader definition of TARP at present, there is a degree of retrospectivity by imposing a look-back rule where taxpayer have to consider the TARP status of an asset at a time held prior to 1 July 2025.

- There is a risk under this proposal that transactions may now be taxed where there is no integrity risk. For example:

  - There could be scenarios where land has been disposed of by the Australian entity and taxed and the shares/units in the entity is sold within 12 months and taxed again merely because the entity being disposed of held real property in the past 365-day period.

- Another scenario could include the disposal of land by an eligible tier-1 company in a multiple entry consolidated (MEC) group, which gives rise to a tax liability for the MEC group, and the vendor entity is later sold by a non-resident. In this example there is no disposal of Australian real property which remains in the tax net.

To alleviate the above concerns, we make the following recommendations:

- The law needs to be drafted to allow a degree of reasonableness when applying a 365-day testing period. Section 152-40(3A) of the ITAA 1997 is an example of this with a note to the subsection saying that the test need not be applied on a day-to-day basis. A rule as set out in subsection 152-40(3B) could also be adopted under these proposals to allow for temporary failures, for example one day out of 365 days.

- A transitional rule needs to be included in applying the 365-day PAT rule. For the first income year of the rule, a transitional rule be adopted that does not include the expanded categories of TARP within the 365-day PAT testing. If the new rules apply to CGT events entered into on 1 July 2025, for the sale of shares/units, this could cover assets that are TARP from the date of the announcement of these changes.

- The ATO should provide practical and cost-effective valuation and compliance guidance to assist taxpayers to determine and monitor valuations of their investments over the 365-day test period as proposed in the Consultation Paper. Consideration should also be given to whether certain administrative shortcuts in valuing certain assets are appropriate.

Specific Responses to Questions raised in the Consultation Paper

1. *We are interested in views on the appropriateness of the policy principle for continuing to exclude economic interests, and whether there would be any unintended consequences from changing the treatment of economic interests in TARP, to ensure they are taxed equivalently in Division 855 of the ITAA 1997 with membership interests in TARP.*

The Consultation Paper on page 11 proposes the introduction of an integrity rule to include total return swaps. However, without clear evidence of tax arbitrage practices, the rationale for introducing a specific integrity rule remains uncertain and should be reassessed after a post-implementation review of the proposed changes to Division 855 is conducted. Reassessing the need for a specific integrity rule at a later date also reduces the complexity of the current proposals and ensures any future integrity provisions are clear and appropriately targeted.

If an integrity rule is proposed, we submit it should be limited to transactions that are economically equivalent to the sale/disposal of the asset where there is a clear purpose that such arrangements were entered into to avoid CGT. The introduction of an integrity rule should not be a general rule that treats any economic right related to land as taxable Australian real property (for example, as in the case of the Victorian Duties economic entitlement rules—where acquiring an economic entitlement is treated as obtaining an ownership interest in the land, making it subject to duty). In addition, development agreements, which may provide for a sharing in the proceeds of sale of land being developed, should not be caught within the proposed integrity rule. Other examples include rights to performance fees by a fund manager or commissions by a sales agent. These rights should remain outside the scope of taxable Australian real property.

2. *Are there other consequences of the proposed reforms that raise similar behavioural concerns? Do you consider that additional integrity rules are required to address them, or that the existing general anti-avoidance rules, and other specific integrity rules, provide sufficient protection?*

It is unclear at this stage if the proposed reforms will raise behavioural concerns. We recommend a post-implementation review of the proposed changes to Division 855 should be conducted (for example, after five years) to identify if integrity measures are needed to address specific concerns.

It should be noted that where specific integrity concerns were identified concerning the current Division 855, the ATO used provisions under the existing provisions to address these concerns. These integrity measures include the general anti-avoidance rules under Part IVA of the ITAA 1936, the transfer pricing provisions in Division 13 of the *Income Tax Assessment Act 1936* (ITAA 1936) and Division 815 of the ITAA 1997, and the tax promoter penalty provisions in Division 290 of Schedule 1 of the *Taxation Administration Act 1953*, which has since been expanded in scope and penalties of the promoter penalty provisions following the introduction of *Treasury Laws Amendment (Tax Accountability and Fairness) Bill 2023* which is now law.[1]

3. *Treasury is interested in views on the appropriateness of the $20 million threshold, and whether there may be any unintended consequences, noting the considerations outlined above.*

The 2024 Budget proposal announced a requirement that a foreign resident vendor disposing of membership interests exceeding $20 million in value must notify the ATO of a vendor declaration they make to the purchaser that the sale is “not an indirect Australian real property interest”.

In that case, the vendor must notify the ATO of the transaction in the approved form prior to the CGT event or settlement (whichever is earlier). The ATO then has a period (the Consultation Paper suggests 28 days, 45 days or 60 days) during which to review the proposed transaction.

The requirement of all non-residents holding membership interests exceeding $20m to apply to the ATO to obtain pre-sale clearance from the ATO at least a month in advance seems impractical. There will be many cases where the company is clearly not land rich or the non-resident holds a less than 10% interest in the company.

[1] For example, see TA 2008/20 – Foreign residents exploiting asset valuations to avoid capital gains tax

In addition, the vendor declaration regime is also separate to any processes governed by Australia's Foreign Investment Review Board (FIRB). While the FIRB process will necessarily involve consideration of tax issues, the $20 million threshold proposed here differs from the criteria that must be met under FIRB.

We submit that the $20 million threshold is too low. We recommend for consistency, consideration should be given to the monetary thresholds under FIRB for various types of assets before the new notification requirements to the ATO are triggered. The proposals should also allow the Commissioner of Taxation to provide exemptions for certain classes of assets that are considered as lower investment risk to reduce regulatory burden for foreign investors to have to notify the ATO for each investment.

4. *Similarly, we are interested in views on the appropriate timeframe with which foreign resident vendors will be required to notify the ATO in advance of a transaction (i.e., the set review period), noting the policy intent, as outlined above.*

We make the following observations:

- A shorter 28-day time period would be more commercially acceptable but the risk of the ATO not being able to properly investigate arises, potentially leading to a direction to withhold instead. The Consultation Paper noted that these transactions would be planned well in advance so the time period should not be an issue. Whilst this may be the case for larger transactions, this may not be the case for transactions around the $20 million mark.

- There could be transactions where parties may not know until close to signing whether or not a sale will in fact go ahead and details of the final consideration. In such cases, the relevant parties may not be in a position to approach the ATO with certainty within the relevant time frame.

- The Consultation Paper does not explicitly prohibit the vendor from completing the transaction during the period and clarity is required on this issue.

- Clarity is also needed on the consequence of a foreign resident providing a declaration to the buyer but not having had it approved by the ATO.

5. *What information should the purchaser be required to consider, and when, in determining whether a declaration is false (and if so, to withhold)? We also welcome views on whether not knowing the declaration to be false at the time the declaration is given to the purchaser remains the appropriate threshold, in light of the new ATO notification process?*

We believe the only way for the declaration mechanism to work is if the approved form for the notification is extensive and detailed, somewhat akin to a private ruling request. If ATO involvement is required, the purchaser should be absolved of any risk for failing to withhold (in the absence of fraud).

6. *Are the current administrative penalties for the failure to lodge an approved form and for providing a false and misleading vendor declaration sufficient for ensuring compliance with the new requirements? If not, what is an appropriate level? This question should be considered in the context of the threshold identified at question 3 above.*

No response to this question at this stage.

7. *How can the approach to this new process assist the purchaser in complying with their obligations, including clarity on when to withhold?*

We understand that there is no change for vendors with a transaction that is in respect of an indirect Australian real property interest (IARPI). They are subject to CGT and therefore foreign resident capital gains withholding by the purchaser.

However, we highlight that for vendors where declarations are made that a transaction is in respect of non-IARPI and not subject to CGT, they are subject to potential ATO scrutiny under the proposal, particularly in light of the proposed lower transaction threshold of $20 million.

As noted above, there will be many cases where the company is clearly not land rich or the foreign resident holds a less than 10% interest in the company.

The proposals should focus on relieving taxpayers and the ATO from unnecessary compliance burdens associated with low-risk transactions. To achieve this, the Commissioner of Taxation should be empowered to grant exemptions for specific asset classes that are considered lower investment risks, thereby reducing the regulatory burden on foreign investors by eliminating the need for them to notify the ATO for each investment.