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SESSION 7B:

Non-residents and CGT – A refresher and an update

Presenter:

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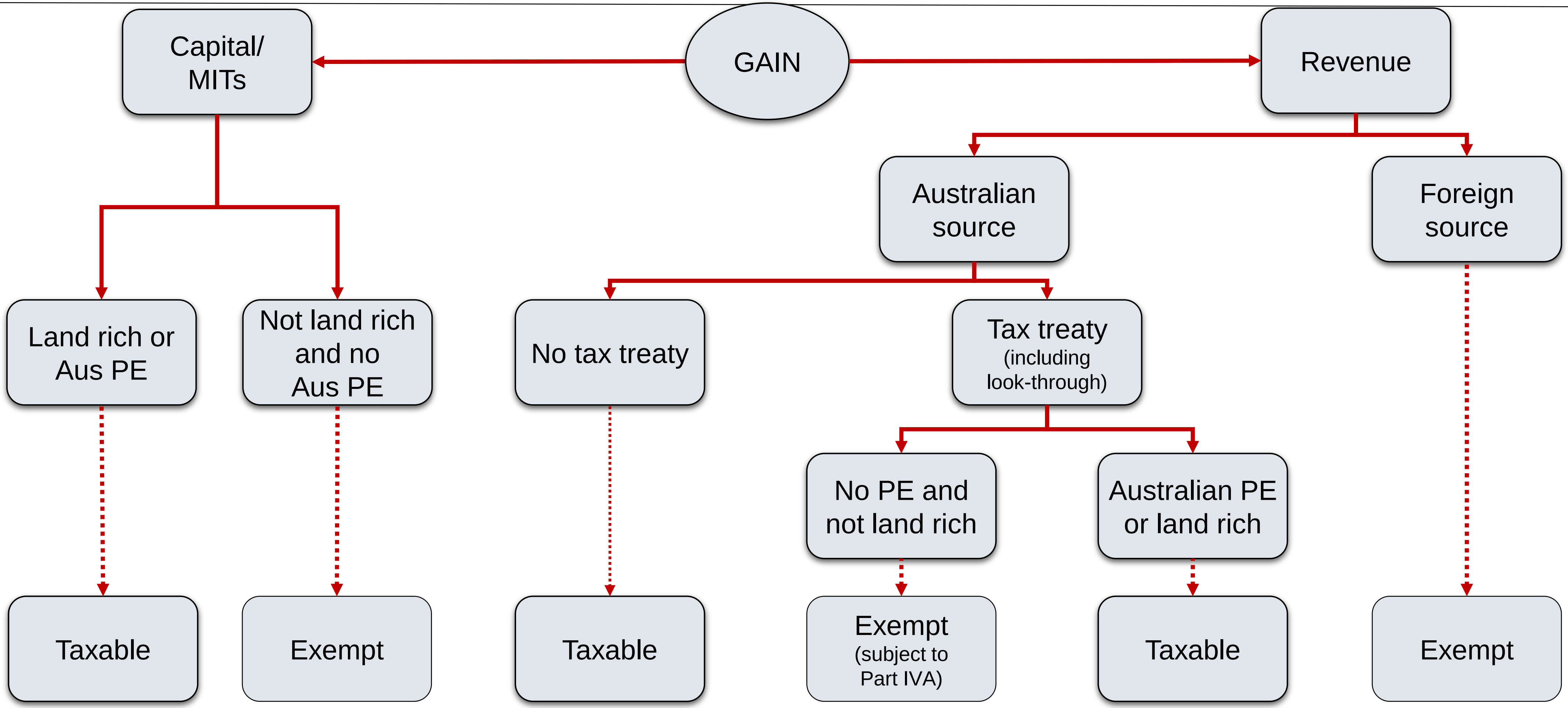
Introduction

- Key concepts + basic framework for non-residents
- Outcome in RCF and key takeaways
- Division 855 – key concepts and things to look out for
- Quirky issues including:
  - Cost base mismatches
  - Gains distributed from non-fixed trusts
  - Capital gains from non-resident trusts (TD 2017/23 + TD 2017/24)
  - Changing residency

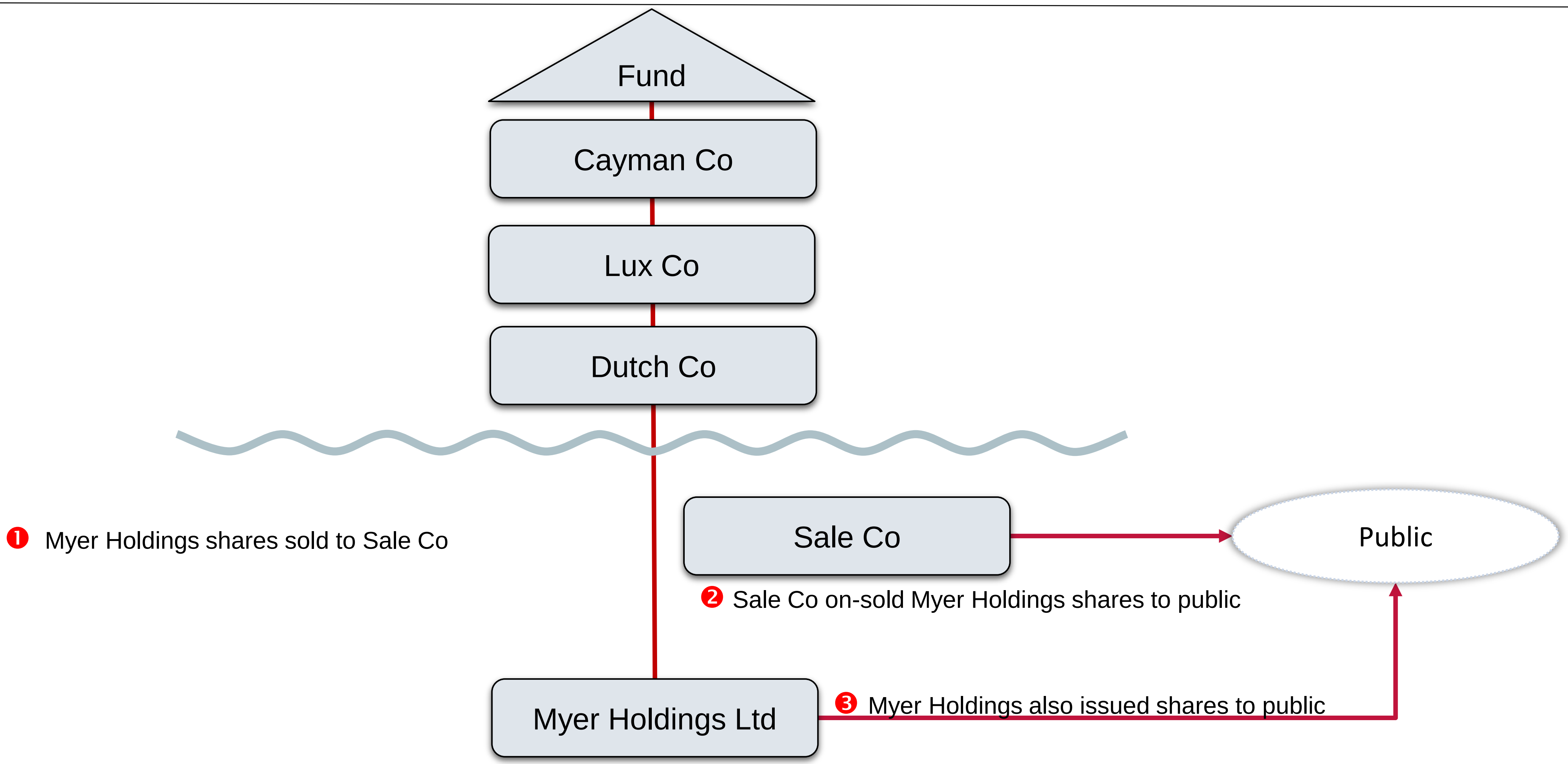
The key concepts for non-residents

Concept	Comments
Taxed on ordinary income/statutory income that has an <u>Australian source</u> (unless some other basis) (s.6-5/6-10)	Is this only relevant for revenue assets? (Discretionary trusts)
Division 855 meant to limits Australia's <u>domestic law</u> on the type of CGT assets subject to tax	Can have some impacts on residents via discretionary trusts
Don't forget the tax treaties	1. Entitlement to treaty benefits 2. Permanent establishment (Article 7) 3. Alienation of real property (Article 13)

The basic framework



Revenue (1): 2009 - Myer sale

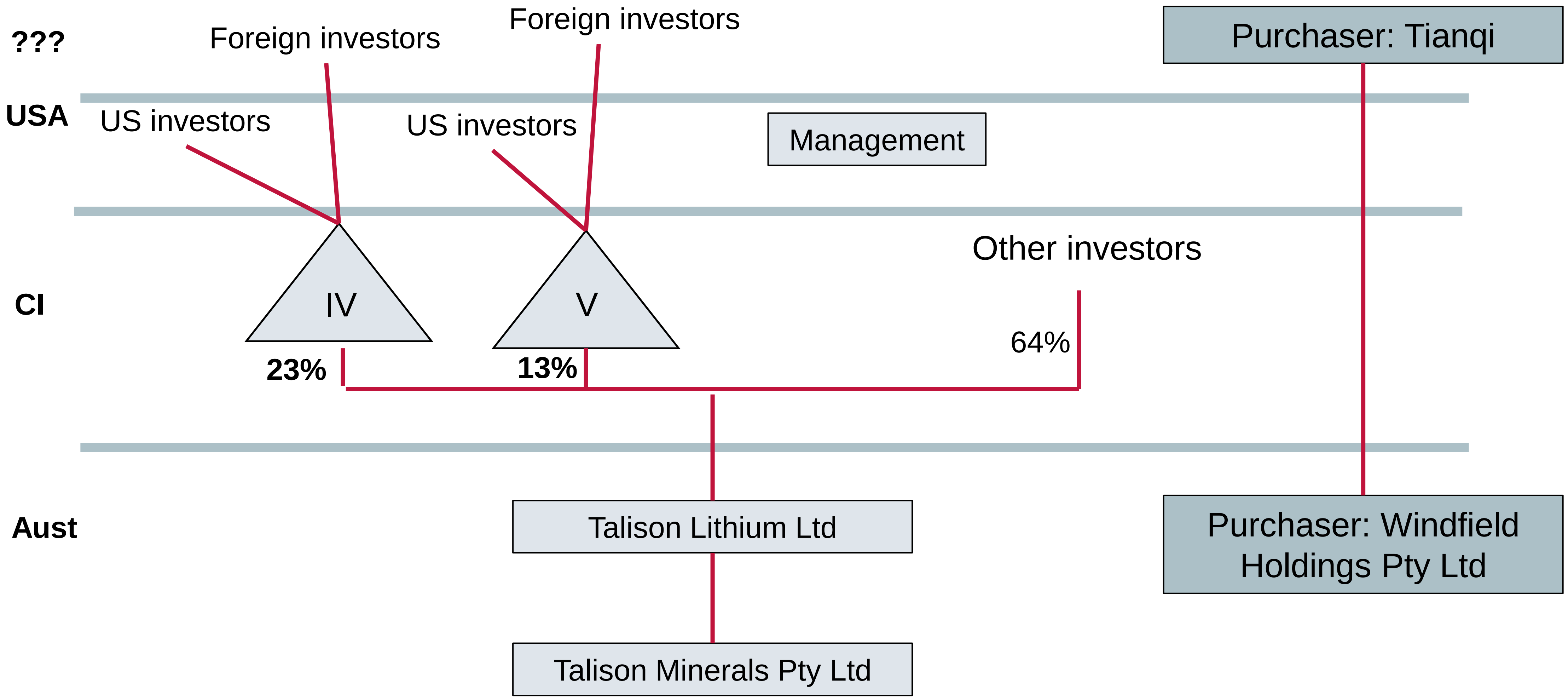


Revenue (2): ATO response to Myer

Issue	**ATO view**
Is the PE gain on revenue account?	Generally yes (TD 2010/21)
How do you determine source?	Don’t just look at where the contract is executed (TD 2011/24)
How does a treaty operate where LP in non-treaty country (Cayman Islands) but partners in a treaty country (US)?	Article 7 treaty benefits (PE) available provided (i) partner meets treaty requirements; (ii) LP treated as being fiscally transparent in home jurisdiction; and (iii) Article 13 does not apply to give or deny taxing rights to Australia (TD 2011/25).
Treaty shopping?	Part IVA can apply if no obvious commercial reason for the SPV to be in a treaty country (TD 2010/20)

Revenue: (3) – RCF litigation

- RCF IV (2006) and RCF V (2009)
  - formed in Caymans under Exempted Limited Partnership Law (1997)
  - not treated as a separate legal person / separate taxable entity under Caymans law
  - separate general partner for each fund (LLC formed under Caymans law)
  - each fund had management agreement with RCF Management LLC
  - RCF Management LLC set up local subsidiary RCF Management (Aust) to provide admin services for cost+ return
  - RCF IV had 77 limited partners of whom 73 were US residents
  - RCF V had 137 limited partners of whom 130 were US residents
- In 2007 RCF + other non-resident entities form Talison Minerals Pty Ltd to acquire lithium and tantalum assets from Sons of Gwalia
- Various reorganisations of assets / shares
- Shares listed on TSX and sold under Scheme of Arrangement to Tianqi. Deal starts in Dec 2012 and finalised in March 2013. At time of sale RCF IV holds 23% and RCF V holds 13% of Talison
- ATO issues assessments [6 days later!] in the names of the funds


???
USA
CI
Aust
Foreign investors
Foreign investors
Purchaser: Tianqi
US investors
US investors
Management
Other investors
IV
V
23%
13%
64%
Talison Lithium Ltd
Talison Minerals Pty Ltd
Purchaser: Windfield Holdings Pty Ltd

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RCF – What was the outcome

Issue	Outcome
Who is the relevant taxpayer?	The Limited Partners (not the Limited Partnership) Unexpected
Revenue or capital gain?	Revenue (consistent with ATO Myer response)
Source?	Australia (consistent with ATO Myer response)
Treaty benefits?	Yes, for the US partners so Australia can only tax if either (i) PE in Australia or (ii) Talison Australian land rich
Can Australia tax the gain?	No, no PE/entities not Australian land rich (down to valuation) (Finding of fact)
What next?	Watch this space: ATO has appealed

RCF – unresolved Div 855 issues

Issue	Comments
Why was Div 855 a focus of the judgement given finding that assets held on revenue account?	Seems to have applied Div 855 as a proxy for the Treaty/*Lamesa* s.3(2A) requirements Treaty test in Article 13: *shares or comparable interests in a company, the assets of which consist wholly or principally of real property in Australia*
How do you determine the 10% non-portfolio interest test?	At the LP level (passed) or at the partner level (likely not passed, unless associates)
Is the Division 855 valuation test manageable?	Government waxes and wanes on whether legislative amendment required

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Division 855 – an overview

- Introduced in 2006
- Stated purpose:
  - Align domestic law with Australian treaty practice by narrowing range of CGT assets held by non-residents to Australian real property assets and business assets of Australian PE of non-residents
  - Strengthen integrity by ensuring use of interposed entities not enough to escape Australian CGT
- A withholding regime to actually collect the tax was introduced 10 years later…
- Capital gain or loss is disregarded (rather than reduced to nil)

Division 855 - Key concepts

Concept	Comments
Who can benefit from Div 855?	▪ Foreign resident ▪ Foreign resident with an Australian PE (apportionment for number of days asset not used in Australia) ▪ Trustee of a foreign trust (impact on resident beneficiaries…) ▪ Non-resident beneficiaries of fixed trusts (impact where discretionary trusts…)
What CGT events are covered?	All CGT events. Modified so that for the following events, CGT event taken to occur to the specified asset: ▪ D1 (creating contractual rights) – assets that is the subject of the rights; ▪ D2 (granting an option) - asset the subject to the option; ▪ F1 (granting a lease) asset subject to the lease

Division 855 - Key concepts

Concept	Comments
What CGT assets are subject to CGT?	1. “Taxable Australian real property”: ▪ Real property situated in Australia (including a lease of such land) ▪ Mining quarrying or prospecting rights situated in Australia 2. “Indirect Australian real property interests”: 10% direct or indirect ownership stake in an Australian land rich entity 3. A CGT asset used in carrying on a business through an Australian PE 4. An option to acquire a CGT asset covered by the above? 5. A CGT asset deemed to be TARP because an individual on ceasing to be an Australian tax resident made a CGT event I1 election

TARP

- Amendment in 2009 to put beyond doubt that real property includes a lease
- The new non-resident CGT withholding regime deems all vendors of TARP to be a non-resident unless a clearance certificate is given

Indirect Australian real property interest

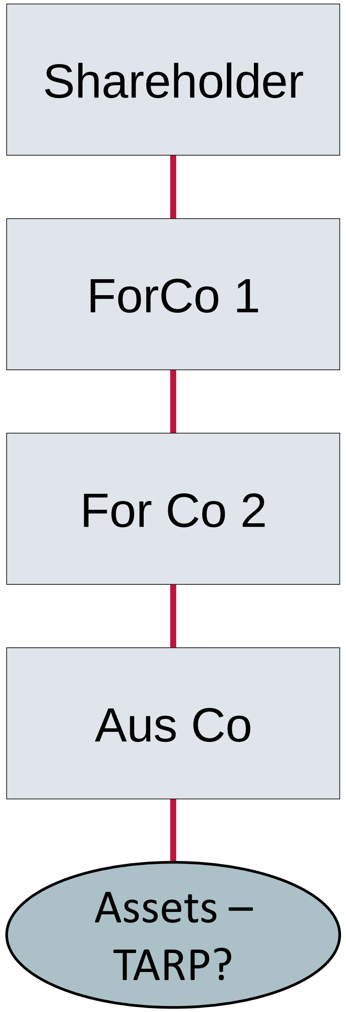
Concept	Comments
Non-portfolio interest test	▪ Need to directly hold 10% or more of the "membership interests" in entity either at time of CGT event or throughout a 12 month period in 24 months prior to CGT event ▪ Tested on an associate inclusive basis ▪ Membership interest a share in a company, unit in a unit trust ▪ Therefore, a share that is a debt interest (such as a RPS) under Div 974 is not caught. Nor is a non-share equity interest.

Principal asset test

Concept	Comments
Principal asset test	▪ The “test entity” (ie shares in company triggering the CGT event) passes the principal asset test if market value of its assets that are TARP exceed the sum of the non-TARP assets ▪ Tracing rules where multiple subsidiaries ▪ Integrity rule ensures market value of any asset acquired for a non-incidental purpose of ensuring principal asset test <u>not</u> satisfied is ignored ▪ Two amendments to overcome technical issues: 1. 2014: Ensure assets not duplicated to avoid principal asset test being satisfied (s.855-30(3A)) 2. 2018: Principal asset test to be done on associate inclusive basis

Principal asset test

If shares in ForCo 1 sold, “look-through approach” to determine if value of ForCo1 attributable to TARP



Principal asset test: anti duplication

Pre-amendment calculation:

TARP:	$150
Non-TARP:	$200 ($100 cash + $100 loan)
TOTAL	$350

MDI shares are not TAP

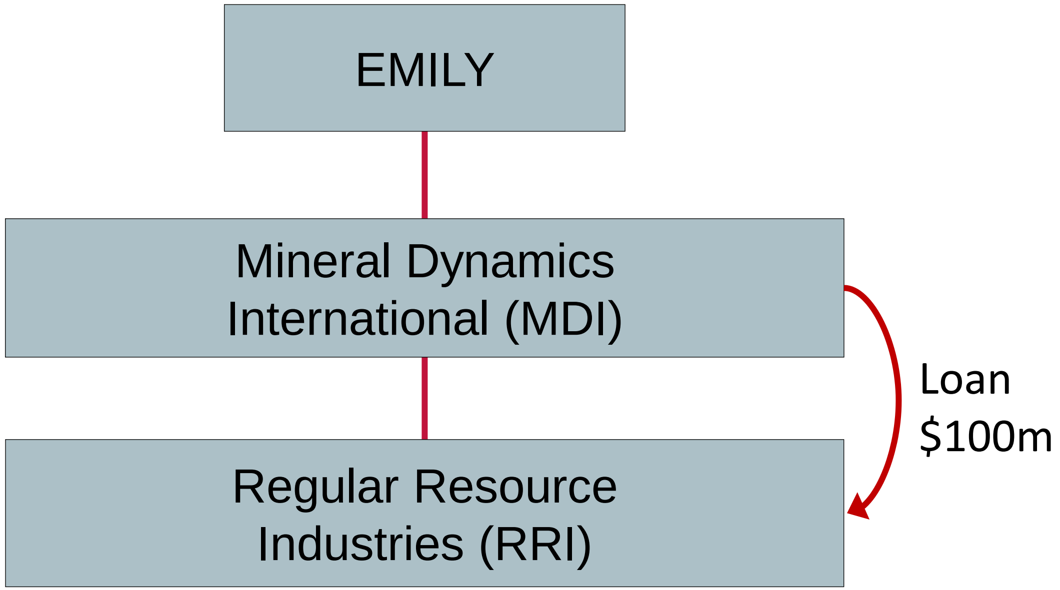
Post-amendment calculation:

TARP:	$150
Non-TARP:	$100 (cash in RRI)
TOTAL	$250

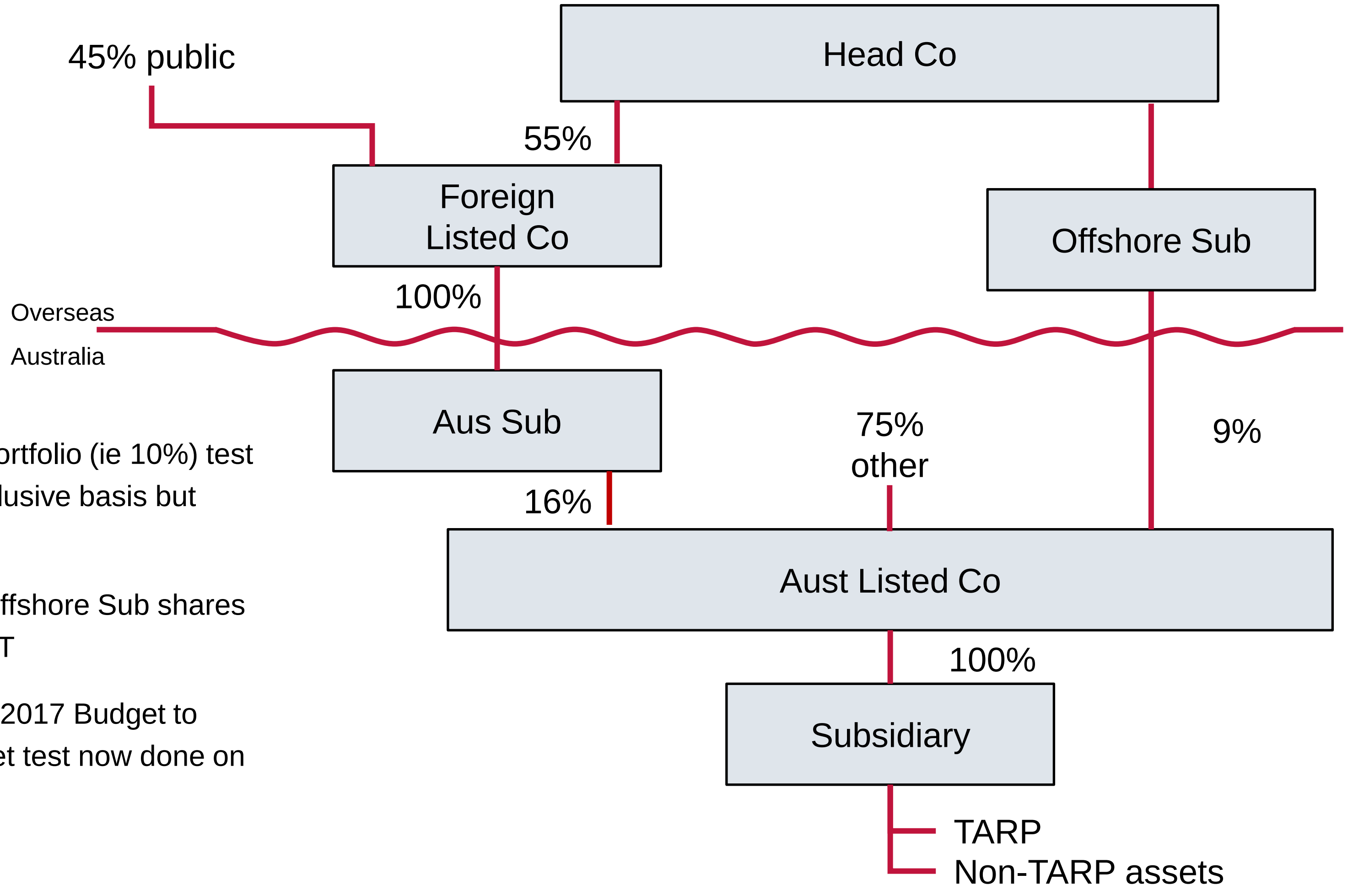
MDI shares are TAP

Assume:

- RRI has interest in land of $150m;
- MDI has $100m cash
- MDI loans $100m to RRI



Principal asset test: associate inclusive



HeadCo total interest in Aus Listed Co is 17.8% (being 16% x 55% + 9%)

- Under current law, non-portfolio (ie 10%) test done on an associate inclusive basis but principal asset test is not.
- Thus, HeadCo can sell Offshore Sub shares and not be subject to CGT
- Proposed amendment in 2017 Budget to ensure that principal asset test now done on associate inclusive basis

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Assets used in an Australian PE

CGT asset used in carrying on a business through a permanent establishment in Australia:

1. Technical amendment in 2014 to ensure correct definition used. Had previously referred to the s.23AH definition (which defines a PE in relation to a "listed or unlisted country" – clearly not Australia)
2. For a fixed trust, non-residents only taxed when trust sells a TARP asset. One assumes that the trust is not taken to hold all of its assets in carrying on a business through an Australian PE…otherwise s.855-40 exemption doesn't work

Options

- Are options over unissued shares (such as a rights issue) caught by Div 855?
- Can be relevant for rights issues and application of non-resident CGT withholding
- Position appears to be no – shares need to be issued

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Trusts – cost base mismatch

Outcomes – Aus Trust

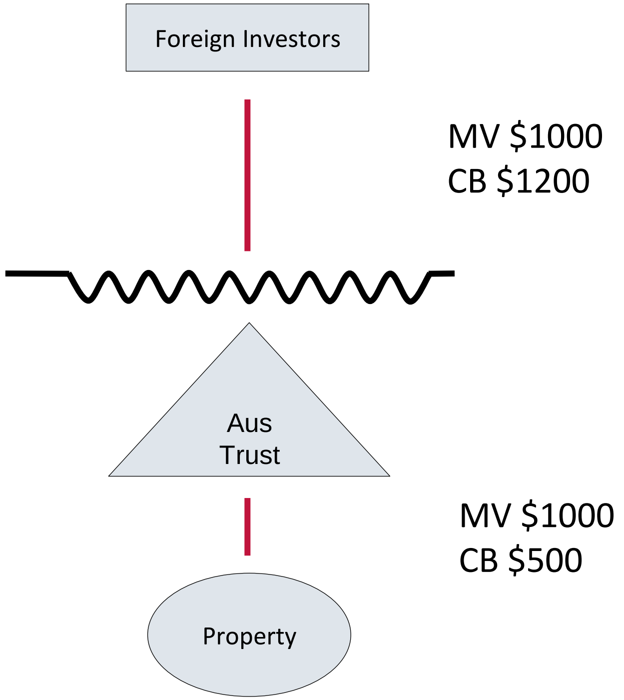
The outcome for Aus Trust should be as follows:

- Net income of trust is $250 (after application of CGT discount)
- Distribution of $1,000 made to investors comprising:
  - Net capital gain - $250
  - CGT discount - $250
  - Tax deferred - $500
- Non-final withholding tax (s.98) of 30% on gross capital gain ($500) distributed to investors – WHT $150
- Units in Aus Trust are then redeemed for nil consideration (given trust no longer has cash)

Outcomes - Investors

The outcome for investors should be as follows:

- Assessable on gross gain distributed from Aus Trust ($500)
- The capital loss on redemption of the units of $700 is a non-TAP capital loss and cannot be offset against capital gain distributed from Aus Trust ($500)
- Investor pays $150 tax despite making $200 economic loss.



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Trusts – non-resident beneficiaries

Section 855-40 provides:

(2) A *capital gain you make in respect of your interest in a *fixed trust is disregarded if:
(a) you are a foreign resident when you make the gain; and
(b) the gain is attributable to a *CGT event happening to a *CGT asset of a trust (the ***CGT event trust***) that is:
(i) the *fixed trust; or
(ii) another fixed trust in which that trust has an interest (directly, or indirectly through a *chain of trusts, each trust in which is a fixed trust); and
(c) either:
(i) the asset is not *taxable Australian property for the CGT event trust at the time of the CGT event; or
(ii) the asset is an interest in a fixed trust and the conditions in subsections (5), (6), (7) and (8) are satisfied.

So non-residents beneficiaries of an Australian fixed trust may be ok

But what about Australian discretionary trust?

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Trusts – non-resident beneficiary

From ATO Discussion Paper:

- Oz Trust is a resident discretionary Trust
- Oz Trust holds shares in land rich Australian company (Land Co) and a non-land rich Australian company (Other Co)
- Shares sold via contract executed in UK (so no Australian source) for $100,000 ($70k for Land Co; $30k for Other Co)
- Entire $100,000 distributed to a non-resident beneficiary
- Given no Australian source, is any amount subject to tax? Is just the $70,000 subject to tax given it is referable to TARP and the $30k does not have an Australian source?

Indicative ATO view that entire $100k assessed to trustee under s.98 <u>even</u> if no Australian source

Trusts – non-resident beneficiary

Pre 2011	2011 "interim" trust streaming changes
Div 115-C included an additional capital gain in a non-resident's assessable income if that non-resident had been assessed under s.98A, which would require the capital gain to have an Australian source. Beneficiary got a corresponding deduction for the extra capital gain	Capital gains now taken out of Division 6 and the beneficiary derives the capital gain directly for tax purposes. Importantly, Div 115-C no longer refers back to the "source" requirement in s.98A
For the trustee, s.98 assessments only apply if the capital gain has an Australian source. Per ATO ID 2003/676: *The fundamental issue to be resolved is whether any capital gain made by the trustee in respect of the shares, is sourced in Australia.* *The capital gains tax provisions do not contain any provision that expressly determines the source of a capital gain, or net capital gain, for the purposes of Division 6 of Part III of the ITAA 1936. The 'taxable Australia property' tests in section 855-15 of the Income Tax Assessment Act 1997 (ITAA 1997) are not relevant for this purpose.* *…* *Accordingly, as the source of the capital gain is outside Australia, the trustee is not assessable under subsection 98(4) of the ITAA 1936 on any resulting net capital gain from the vesting of the trust and registration of the shares in the names of the non-resident beneficiaries.*	For the trustee, s.115-220 provides: *(1) This section applies if* *(a) you are the trustee of the trust estate; and* *(b) on the assumption that there is a share of the income of the trust to which a beneficiary of the trust is presently entitled, you would be liable to be assessed (and pay tax) under s.98* *(2) For each *capital gain of the trust estate, increase the amount (the **assessable amount**) in respect of which you are actually liable to be assessed (and pay tax) under section 98 of the Income Tax Assessment Act 1936 in relation to the trust estate in respect of the beneficiary by [certain amounts]*

Trusts – resident beneficiary

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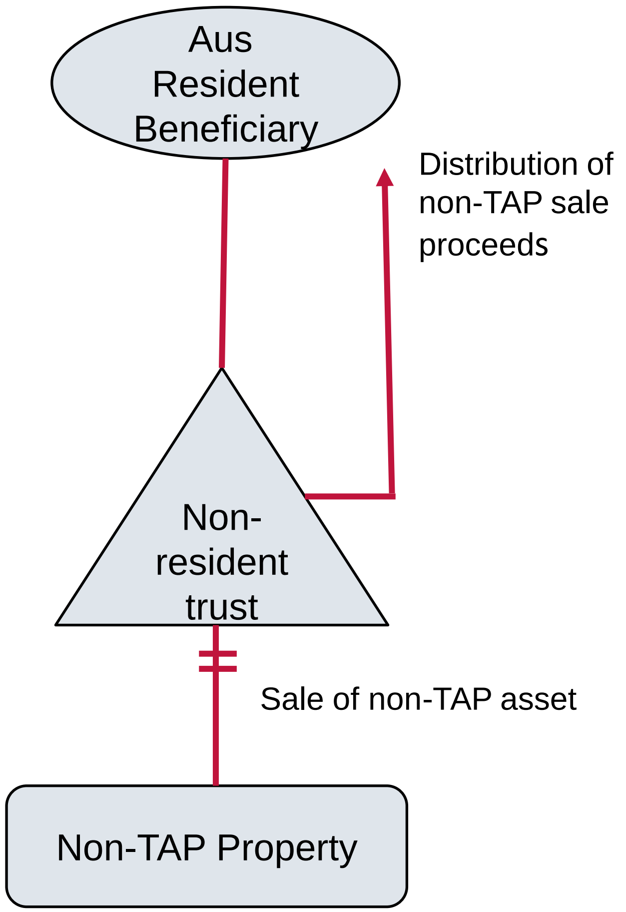

Issue	Comments
Does Div 855 apply?	Yes – s.855-10 overrides the residency assumption in s.95 (TD 2017/23)
Does s.99B apply to the distribution	Yes (TD 2017/24)
What about the CGT discount?	No – the hypothetical taxpayer in s.99B(2) is a resident only. Has no characteristics that would engage the discount (individual/trustee) TD 2017/24

So different outcome for a resident individual beneficiary between investing directly or via a trust (no discount, can't use capital losses).

Same paranoia of Australian corporates accessing the CGT discount driving 2018 Budget trust changes

Changing residency

Becoming a resident	Ceasing to be a resident
Post CGT non-TARP assets are generally taken to have been acquired for market value at the time the individual/company becomes an Australian resident Note: CFCs are subject to different provisions and need to consider s.457	A resident will generally be taken to have disposed of their post CGT non-TAP assets for market value at the time they cease to be a resident (I1/I2) Different considerations apply to Div 40 assets etc Budget changes to main residence exemption causing angst
	An individual can make an election to defer the capital gain – assets taken to be TAP going forward Note: UK treaty may allow subsequent disposal of the TAP asset to also be ignored in Australia

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