



Law Council
OF AUSTRALIA

Business Law Section

Senior Adviser
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: ForeignResidentCGT@treasury.gov.au

10 June 2014

Dear Sir/Madam

**Improving the integrity of the foreign residents capital gains tax regime
Tax and Superannuation Laws Amendment (2014 Measures No. 3) Bill 2014**

- 1 The Taxation Committee of the Business Law Section of the Law Council of Australia (**the Committee**) welcomes the opportunity to comment on the exposure draft legislation released by the Government on 13 May 2014 concerning the proposed amendments to Division 855 of the *Income Tax Assessment Act 1997* (ITAA 97).
- 2 As an overarching comment in relation to the exposure draft legislation, the Committee would like to emphasise that the Commissioner already has two powerful weapons which can be used to address any perceived instances of abuse in the context of foreign residents and capital gains tax:
 - (a) the operation of the specific integrity provision in subsection 855-30(5) of the ITAA 1997 which prevents the injection of assets if done for the purpose of circumventing the principal asset test; and
 - (b) the general anti-avoidance rule contained in Part IVA of the *Income Tax Assessment Act 1936* which may be applied to cancel any tax benefit under all, or some part, of the relevant arrangement.
- 3 As a general statement of good tax policy, the Committee would rather the integrity issues, to the extent they do not involve legitimate commercial arrangements, be dealt with through the existing provisions noted above. The Committee's concern is that the loss to revenue attributable to the duplication of assets arising from legitimate commercial arrangements may not be sufficient to justify the introduction of yet another specific integrity provision and the additional compliance burden this will place on affected taxpayers.
- 4 The Committee is also concerned that the outcome under the proposed subsection 855-30(4A) could cause businesses impacted by the changes to make economic and financial decisions based on the artificial outcomes provided for under the amended Division 855. Such a result would be undesirable from a policy and business

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perspective. For example, the way in which the purchase of an asset from a relevant group entity is funded may have a fundamental impact on the outcome under Division 855.

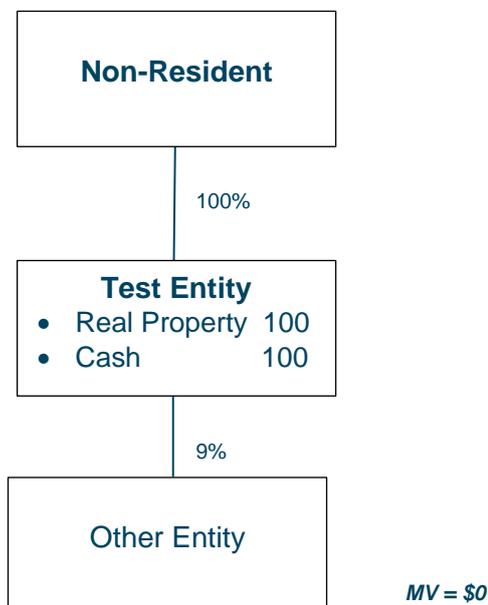
- 5 Putting the policy considerations aside, there are two particular issues with the exposure draft legislation which the Committee would like to raise for your consideration.

The creation of new assets and the tracing requirements

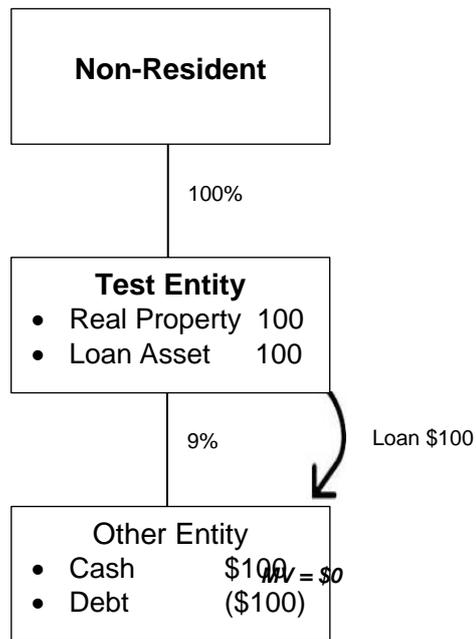
- 6 The proposed subsection 855-30(4A) simply refers in paragraph (b) to the creation of “the asset”.
- 7 In some circumstances there may be two assets created. If this is the case, which of the assets should be disregarded? Whilst labelling one of the assets as a ‘pre-existing asset’ may solve some confusion, the concept of a ‘new asset’ and its identification needs to be thought through when considered in the context of item 1 of the table in subsection 855-30(4).
- 8 Subsection 855-30(4) imposes tracing requirements and provides guidance on determining the market value of TAP and non-TAP assets in circumstances where the underlying assets are held through interposed entities.
- 9 Specifically, Item 2 of the table in subsection 855-30(4) provides that for underlying entities where the total participation interest of the holding entity exceeds 10% (and the direct holding requirements are satisfied), a portion of the underlying assets of that entity are directly included in calculating whether the test entity itself passes the principal asset test.
- 10 In circumstances where the holding entity has a less than 10% total participation interest in the underlying entity, Item 1 of the table in subsection 855-30(4) provides that the market value of the relevant membership interests (rather than gross underlying assets) will be included in the calculation and will be treated as a non-TAP asset. The differing treatment, based on the total participation interests, was designed to reflect that foreign residents with only portfolio participation interests will generally not have access to the necessary financial information to ascertain the market value of underlying assets.
- 11 Consider the following scenario:

SCENARIO A

Before:



After



12 In the circumstances illustrated by the above example, proposed subsection 855-30(4A) would apply as:

- the parties to the arrangement are the first entity and the other entity (as those terms are defined in subsection 855-30(3)); and
- the effect of the arrangement was to create an asset of one of those two parties.

13 The asset in question that is created cannot be the membership interests in the Other Entity, as they existed prior to the arrangement. However, a loan asset has been created in the hands of the Test Entity. That the loan asset should be treated as a newly created asset is consistent with the approach taken in the draft explanatory memorandum¹.

14 If a strict interpretation of the proposed section was applied to the above example, the result would be that the principal asset test would be passed:

TARP assets

- Real property \$100

NON-TARP assets

- Loan (disregarded) \$0
- MV of interests in Other Entity \$0

¹ *ibid* at Example 1.3.

15 Such an outcome cannot be intended as there is no duplication occurring and, in fact, the draft explanatory memorandum recognises this issue²:

1.5 The amendments will also only apply to entities in which the foreign resident has a sufficient interest. Table item 2 of subsection 855-30(4) only applies to entities in which the foreign resident has a total participation interest of at least 10 per cent and where the entity with the direct interest has at least a 10 per cent interest.

1.6 The amendments do not apply in this case because the Principal Asset test assesses the net market value of the interest (and includes this in the value of the non-TARP assets).

16 ,It is not clear that the proposed drafting of subsection 855-30(4A) achieves the outcome targeted in paragraphs 1.5 and 1.6 of the draft explanatory memorandum.

Provision of services

17 Another anomaly with the current proposed drafting of subsection 855-30(4A) might arise in circumstances where there is an arrangement pursuant to which one related company provides services that result in the creation of an asset in the second related company. For example, this could arise where one group company provides research and development services to a second group company which results in the creation of valuable intellectual property in the second entity.

18 Such a scenario would seem to be caught by the proposed subsection 855-30(4A) even though there is no duplication of an existing asset. No duplication arises in one sense because there is no corresponding liability connected with the asset. The duplication in the examples provided in the draft explanatory memorandum arise in circumstances where the new asset created is offset by a corresponding liability in another group entity. The broad effect of the offsetting liability is that there is no additional value created in the test entity.

Possible solutions

19 There are a range of possible solutions to the issues identified above. Solutions which may be considered include (but are not limited to):

(a) Disregarding the value of a newly created asset in the hands of the First Entity only in circumstances where the corresponding asset is not disregarded as a newly created asset in the hands of the Other Entity. An ordering rule might be required if this approach is taken.

(b) Ensuring that the market value of an asset should not be disregarded in circumstances where Item 1 of the table in subsection 855-30(4) applies to membership interests in the Other Entity.

(c) Ensuring that the market value of a newly created asset is:

² *ibid* at Paragraphs 1.5 and 1.6.

- (i) only disregarded where there is a corresponding liability created in one of the "related" entities; and
- (ii) is only disregarded to the extent of the % of "relatedness" between the two entities (total participation interest of the holding company could be used as a measure).

- 20 Of these solutions, option (c) is perhaps the one with the most merit, although potentially attracts the highest level of added complexity and therefore compliance burden.
- 21 The rationale for option (c) is that true duplication of assets only occurs where a new asset is created and the overall value of the membership interests in the test entity has not changed because there a corresponding liability created elsewhere. That is, a second asset has been created (and will be relevant to the principal asset test) but without an accretion in value in the test entity.
- 22 To further balance the compliance burden (and associated costs), a safe harbour level should be introduced such that arrangements between entities in circumstances where the holding company has a less than (for example) 20% total participation interest in "the other entity" are not affected by the anti-duplication measures. In these circumstances the risk to revenue arising from genuine commercial transactions resulting in asset duplication (where the existing integrity provisions might not apply) would be minimal.

If you have any questions, in the first instance please contact the Committee Chair, Mark Friezer, on (02) 9353 4129.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'John-ISK', with a long horizontal stroke extending to the right.

John Keeves
Chairman, Business Law Section