Opinion piece

NEW FOREIGN RESIDENT CAPITAL GAINS WITHHOLDING TAX

by Gary Newton¹ and Henry Yuan²
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¹ Gary Newton, Partner and Accredited Specialist Property Law TressCox Lawyers, Chair of the Legal Practice Section’s Australian Property Law Group
² Henry Yuan, Paralegal, TressCox Lawyers
INTRODUCTION


Schedule 2 of this Bill introduces a new collection mechanism to support the operation of Australia’s foreign resident capital gains tax (CGT) regime that will apply to regulated contracts entered into on or after 1 July 2016.

The Australian Tax Office (ATO) has indicated that voluntary compliance with Australia’s foreign resident CGT regime has been poor. In the new regime, when a foreign resident disposes of certain taxable Australian property, the purchaser will be required to withhold and pay to the ATO 10 per cent of the proceeds from the sale. The purpose of the regime is to assist in the collection of foreign residents’ CGT liabilities.

However, there are concerns that the proposed tax measure will not just adversely affect purchasers, but vendors and the property market as well.

The proposed tax measure may impede the smooth operation of transactions and has the potential to disrupt the property market significantly. There is a concern that the proposed tax measure will give rise to additional significant compliance costs for all parties to a transaction. In addition, it may burden a purchaser with serious penalties when the liability to pay any CGT should be a matter for the vendor.

Who the withholding tax applies to

The withholding tax will apply to these types of taxable Australian property with a market value above $2M:

• real property situated in Australia – land, buildings, residential and commercial property;
• lease premiums paid for the grant of a lease over real property in Australia;
• mining, quarrying or prospecting rights, if the minerals, petroleum or quarry materials are situated in Australia;
• interests in Australian entities that predominantly have such assets (called indirect interests); and
• options or rights to acquire the above property or interest.

Specific exclusions

If the foreign resident vendor falls within one of these exclusion categories, there is no obligation to withhold the 10 per cent:

• taxable Australian Real Property (TARP) transactions with a market value under $2M, so if the market value is apparently $2M or more and the price is less than $2M the parties are not excluded;
• transactions conducted through a stock exchange;
• an arrangement that is already subject to an existing withholding obligation;
• a securities lending arrangement; and
• the foreign resident vendor is under external administration or in bankruptcy.
ONUS IS ON VENDOR TO ACQUIRE CLEARANCE CERTIFICATE

The ATO may certify that, based on the information supplied, there is nothing to suggest that an entity is or will be a foreign resident during a specific period. The purchaser is entitled to rely on the clearance certificate and would not be required to pay an amount to the ATO.

This means Australian resident vendors will be required to apply for a clearance certificate to ensure that no funds need to be withheld from the sale proceeds. The vendor may apply for a clearance certificate at any time. This can be before the property is listed for sale and is valid for 12 months.

If the vendor fails to provide the clearance certificate by settlement, the purchaser must withhold 10 per cent of the purchase price and pay this to the ATO on the day of settlement.

The ATO is implementing an ‘automated’ process in order to efficiently issue clearance certificates. This process would include:

- the vendor (or their agent) completing an online ‘clearance certificate application for Australian residents’ form;
- the information on the application being automatically cross-referenced against information held by the ATO to determine whether the vendor should be treated as an Australian tax resident for the purposes of the transaction; and
- the automatic issuance of a clearance certificate which removes the need for the purchaser to withhold the 10% from the sale proceeds.

The ATO expects that in straightforward cases the clearance certificates will be provided within days of being submitted. However, if there are data irregularities or exceptions, some manual processing may be required and the clearance certificate will be provided within 14-28 days.

Example 1

Louis purchases real estate in Melbourne from Lucas for $3M. Although Louis believes that Lucas is an Australian resident, unless Lucas provides Louis with a clearance certificate from the Commissioner/ATO, Lucas will be considered a relevant foreign resident. Louis would need to make a withholding payment to the ATO under the new Law.

Example 2

Jane plans to sell a piece of real estate in Sydney to John for $4M. Because Jane knows that she is a foreign resident at the time the transaction is entered into, she does not apply for a certificate from the ATO. In the absence of a certificate, Jane will be considered a relevant foreign resident for the purposes of the amendments. John is required to make a withholding payment to the ATO under the new law.

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3 From the Tax and Superannuation laws Amendment (2015 Measures no. 6) Bill 2015 Explanatory Memorandum, 53.
4 Ibid., 53.
Are you dealing with a relevant foreign resident?

Diagram 1

1. Is the interest taxable Australian Real Property (TARP) or a company title interest?

   - YES: Has the vendor provided a clearance certificate from the Commissioner to you?
     - YES: The vendor is not a relevant foreign resident for the purposes of the new law. No obligation to withhold payment.
     - NO: The vendor is a relevant foreign resident for the purposes of the new law. An obligation exists to withhold payment.
   - NO: Has the vendor provided a residency declaration that you do not know to be false?
     - YES: You are entitled to rely on a declaration that the vendor is not a foreign resident for the purposes of the new law.
     - NO: Apply the knowledge condition.

“KNOWLEDGE CONDITION” IS A REASONABLE GROUNDS TEST ON ACCEPTING THE VENDOR’S RESIDENCY

The knowledge condition is only relevant to acquisitions of indirect Australian real property interests and options and rights to acquire TARP or indirect Australian real property interests. It is not relevant to TARP and indirect interests that constitute company title interests, where the clearance certificate process applies.

Diagram 2 The Knowledge Condition

1. Do you know or have reasonable grounds to believe that the vendor is a foreign resident?

   - YES: The knowledge condition in subsection 14-210(1) is satisfied. An obligation exists to withhold payment.
   - NO: Do you have a foreign address for the vendor?
     - YES: Are you authorised to make a related payment to a place outside Australia?
     - NO: Do you have reasonable grounds to believe that the vendor is an Australian resident?
       - YES: Knowledge condition in subsection 14-210(1) is not satisfied. Reapply the test for other vendors.
       - NO: Knowledge condition in subsection 14-210(1) is satisfied. An obligation exists to withhold payment.
Example 3

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 vendors 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 intends to withhold a portion of the purchase price unless the vendor can provide Andrew with further information about his residency.

The vendor provides Andrew with a declaration that states that the vendor is an Australian resident for income tax purposes, which Andrew does not know to be false. The knowledge condition is no longer satisfied because Andrew has a declaration that the vendor is an Australian resident, that he is entitled to rely on.

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 and no payment obligation would arise.

Example 4

Victor is a foreign resident who is selling a commercial property with a cost base of $3M. Victor does not expect to be able to sell the property for $3M or more (i.e. he expects to make a capital loss on the sale).

Victor applies to the Commissioner/ATO for a variation. The ATO issues a variation notice to Victor stating that the amount payable to the ATO, 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 does not exceed $3M.

Paul later agrees to purchase the property from Victor for $2.9M. 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.

Purchasers’ obligations to the ATO and variation of withholding amounts

A purchaser must pay 10 per cent of the first element of the cost base for the CGT asset. This will usually be the total consideration they paid, or are required to pay, to acquire the CGT asset.

Both vendor or purchaser may apply to the ATO for a variation of the amount to be withheld. Reasons for a variation could include that:

- the foreign resident will not make a capital gain on the transaction
- the foreign resident will otherwise not have an income tax liability
- there are multiple vendors, only one of which is a foreign resident

A creditor of the vendor may have a security interest over an asset that is subject to the amendments. There may be situations in which the proceeds of the sale are insufficient to cover both the amount to be paid to the ATO and to discharge the debt the loan secures. Thus, a secured or unsecured creditor may apply to the ATO for a variation.

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7 Ibid. 57–58.
8 Ibid. 60.
Chris, a foreign resident, owns a commercial property located in Australia. Chris owes $3M 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 $2.9M net of costs. The proceeds are insufficient to pay the Commissioner and discharge Chris’ mortgage.

Chris would prefer that the ATO 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.

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

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

### EXERCISING OPTION TO BUY PROPERTY ATTRACTS SPECIAL RULE

Where a purchaser’s acquisition of property is the result of the exercise of an option, a special rule applies to avoid double counting. Where a purchaser is required to withhold, the amount to which the 10 per cent is applied is reduced by any payments the purchaser made for the option. It is also reduced by the market value of any property the purchaser gave to renew or extend the option.

### PENALTIES APPLY FOR FAILING TO WITHHOLD REQUIRED AMOUNT

The required amount must be paid to the ATO on or before the day 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. The penalty for failing to withhold is equal to the amount that was required to be withheld and paid.

Where an amount is withheld, the purchaser is required to complete a “Purchaser Remittance Form” and to provide the ATO with details of the vendor, purchaser and the asset acquired.

### TAX CHANGES ARE SWEEPING, BUT ARE THEY PROPORTIONATE?

This regime will have a significant impact on transactions, and in particular conveyancing. It will create a burden on vendors and purchasers alike to know all the rules and know all the exclusions.

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9 Ibid. 61.