CHAPTER 1

Background

1.1 The Tax Laws Amendment (2006 Measures No. 4) Bill 2006 was introduced into the House of Representatives on 22 June 2006 by the Parliamentary Secretary to the Treasurer, the Hon. Chris Pearce, MP.

1.2 On 16 August 2006, on the recommendation of the Selection of Bills Committee, the Senate referred the provisions of the Bill to the Economics Legislation Committee for inquiry. The Committee was initially asked to report by 31 August 2006 and an interim report was presented on 31 August 2006 and tabled on 4 September 2006. Subsequently, the Committee's reporting deadline was extended to 4 October 2006.

Conduct of the inquiry

1.3 The Committee invited witnesses to attend a public hearing on 4 September 2006. The hearing was held at Parliament House in Canberra. Witnesses who presented evidence at the hearing are listed at Appendix 2.

1.4 The Committee received 5 submissions (including 1 supplementary submission) to its inquiry which are listed at Appendix 1.

1.5 The Hansard transcript of the Committee's hearing is tabled with this report. These documents, plus the Committee's report, are also available on the Committee's website at http://www.aph.gov.au/Senate/commitee/economics_ctte/tlab_3/index.htm

1.6 The Committee thanks those who participated in the inquiry.

Provisions of the Bill

1.7 The provisions of the Bill provide the following amendments:

- Schedule 1 – extending the existing Capital Gains Tax (CGT) rollover relief as it applies to marriage breakdowns so that the CGT rollover applies to the main residence exemption and marriage breakdown settlements do not result in CGT liabilities;
- Schedule 2 – improving the interaction between the consolidation rules and the demerger rules by removing the integrity measure from where a consolidated group or multiple entry consolidated group forms after a demerger, provided that specified conditions are satisfied;
- Schedule 3 – further enhancing the simplified imputation system by ensuring that franking credits are available to an Australian company which receives a franked distribution that is non-assessable non-exempt income from a New Zealand company that has elected into the Australian imputation system; and

- Schedule 4 – narrowing the range of assets subject to the Australian CGT regime as it applies to foreign residents and strengthening the application of CGT to foreign residents by applying CGT to non-portfolio interests in interposed entities under certain conditions.[1]

1.8 The Selection of Bills Committee (Report No. 8 of 2006) identified Schedule 4 of the Bill as the principal area for consideration and inquiry by the Committee. However, the Committee also made limited inquiries into Schedule 1 of the Bill at its public hearing in Canberra. This report examines only matters relating to Schedule 4.

Schedule 4 – Capital gains tax and foreign residents

1.9 Schedule 4 will amend Division 855 and Subdivision 960-GP of the *Income Tax Assessment Act 1997* and repeals Division 136 of this Act. It also includes amendments to some provisions within the *Income Tax Assessment Act 1936*.

1.10 The amendments contained in Schedule 4 are part of further reforms targeting disincentives in the CGT regime which may be deterring foreign investors from investing in Australia. Reforms to the international taxation system were originally flagged in 1999 following the *Review of Business Taxation*.

1.11 The consultation paper *Review of International Taxation Arrangements* (RITA), released by the Department of Treasury in 2002, reported the outcomes of the Government's review into international taxation which included a number of issues in relation to CGT and non-residents. Subsequently, the Board of Taxation released its publication *Internal Taxation – A Report to the Treasurer,* examining the matters raised in RITA and providing recommendations. On 13 May 2003 the Australian Government responded to the Board of Taxation's report, announcing that it would consider the recommendations[2] and on 10 May 2005 the Government announced that it would implement a suite of reforms to the treatment of CGT for foreign residents.[3]

1.12 The current package will deliver significant benefits to foreign investors holding shares in Australian companies and interests in certain trusts because these interests will not attract CGT. This will more closely align Australia's CGT laws with standards of the Organisation for Economic Co-operation and Development (OECD). The Hon. Peter Dutton, MP described the reforms as 'enhanc[ing] Australia's status as an attractive place for business and investment' by removing the disincentives to foreign investors that currently exist within the taxation system.[4]

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1 Explanatory Memorandum, pp 7, 21, 25, 33.

2 The Hon. Peter Costello, MP, Treasurer, 'Review of International Taxation Arrangements', Press Release 032, 13 May 2003.

3 The Hon. Peter Costello, MP, Treasurer, 'International Tax Reforms', Press Release 044, 10 May 2005.

4 The Hon. Peter Dutton, MP, Minister for Revenue and the Assistant Treasurer, 'Government Introduces Further Improvements to the Tax System', Press Release 039, 22 June 2006.

1.13 As outlined in the Explanatory Memorandum, Schedule 4 contains two key changes to the CGT regime for non-residents:

- reducing the categories of taxable Australian assets held by a foreign resident which attract CGT from nine categories to five; and
- applying CGT to non-portfolio interests held by foreign residents in interposed entities under certain conditions, thereby introducing an additional integrity measure into the taxation system.[5]

1.14 The measures contained within Schedule 4 also apply to rights or options in relation to assets. The changes are applicable to all foreign residents (individuals, companies, trusts or trustees of foreign trusts, holding interests in Australian assets or resident entities).[6]

1.15 Key issues examined below in relation to Schedule 4 are: the narrowing of the tax base; the reduction in the categories of assets attracting CGT; and, the proposed integrity measure.

Narrowing of the tax base

1.16 The cost to revenue of the CGT reforms for foreign residents is expected to be $50 million per annum in 2006-07 and $65 million per annum thereafter. This is because a reduction in the range of taxable assets to essentially land-rich assets will mean that some foreign investors will no longer be required to pay CGT when engaging in certain transactions. This exemption appears to form the basis of the expected loss to Government revenue per annum.[7]

1.17 The Explanatory Memorandum outlined a number of measures that are likely to counter-balance the negative impact on revenue including:

- longer term economic benefits because Australia will become a more attractive regional hub for business and investment;
- a further reduction in constraints on foreign investment into and out of Australia; and
- decreased risks to revenue from the introduction of the integrity measure by targeting foreign residents who may be using alternative structures to change their Australian tax obligations.[8]

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5 Explanatory Memorandum, p. 33.

6 Explanatory Memorandum, p. 5.

7 For an outline of the costs to revenue of these reforms, see Explanatory Memorandum, p. 65. However, a breakdown of the costs to revenue of $50 million for 2006-07 and $65 million per annum thereafter has not been provided in the Explanatory Memorandum.

8 Explanatory Memorandum, p. 68.

1.18 In terms of compliance costs, it is anticipated that the new provisions are unlikely to have a significant impact. The impact on compliance costs are anticipated as:

- an increase for foreign investors with indirect holdings in taxable Australian real property;
- a decrease for foreign investors as a result of the narrowing of the assets which will attract Australian CGT and the broadening of the non-portfolio interest requirement; and
- nil effect on Australian taxpayers as the proposed provisions only apply to foreign residents.[9]

Narrowing the range of taxable assets

1.19 Under the current CGT base a foreign resident makes a capital gain or loss whenever a CGT event occurs for any asset that has a 'necessary connection with Australia' including:

- land and buildings located in Australia;
- shares or units in Australian resident companies or trusts;
- a 10% or greater shareholding in an Australian public company;
- a 10% or greater unitholding in an Australian unit trust;
- business assets of an Australian permanent resident; and
- an option or right to acquire one of the above.

1.20 Broadly, the new categories to be introduced restrict the range of taxable assets to Australian real property assets and interests, notably:

- taxable Australian real property assets, including interests in Australian real property regardless of whether the interest is held directly or indirectly; and
- CGT assets used by non-residents in carrying on a business through a permanent establishment in Australia.

1.21 The interpretation of taxable Australian real property also extends to include a mining, quarrying or prospecting right (to the extent that right is not real property), if the minerals, petroleum or quarry materials are situated in Australia.

1.22 This amendment removes the requirement for introducing a CGT conduit regime, as described in Recommendation 3.10(1) of RITA, and 'extended it to all capital gains tax except for the land-rich entities'.[10]

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9 Explanatory Memorandum, p. 5.

10 Mr Mark Hadassin, Institute of Chartered Accountants in Australia, *Committee Hansard,* 14 September 2006, p. 3.

Submissions and other commentary

1.23 All submissions, as well as commentary on the Bill from legal firms which did not provide submissions to the inquiry, supported the narrowing of the categories of assets attracting CGT. While this inquiry attracted limited submissions, it has been the subject of considerable commentary in legal newsletters and the press.

1.24 The Institute of Chartered Accountants in Australia stated their support for the proposed provisions, describing some of the benefits as:

> …streamline[ing] and simplify[ing] the operation of the law. The revised rules focuses Australia's CGT regime on a more limited range of assets which promotes efficiency and will reduce business compliance costs.[11]

1.25 In the publication 'Legal Update', Corrs, Chambers and Westgarth commented that the current categories of assets attracting CGT by foreign investors is too wide and inconsistent with international practice.[12] The Taxation Institute of Australia submitted that the changes align Australia's taxation system with that of our key trading partners, namely, the United States of America and Canada and remove unnecessary complexity in the taxation system by:

- concentrating on the major enforceable gains rather than making an ambit claim for tax which is rarely collected; and
- mirroring Australia's current jurisdiction claim under tax treaties.[13]

1.26 Under the proposed changes foreign investments in sectors that are traditionally not land-rich (such as retail, financial services or information technology sectors) will avoid CGT. However, mining, real estate and infrastructure sectors will continue to attract the CGT. KPMG partner, Mr David Watkins was reported in the Australian Financial Review as saying that:

> Other developed countries like the United Kingdom typically only are interested in applying capital gains tax to non-residents investing in land and building. The fact that [Australia] had a longer list, including shares in companies, made us uncompetitive.[14]

1.27 Others have suggested that the narrowing of the asset categories will increase the incentives for foreign entities to invest in Australia and may potentially lead to a wave of merger and acquisition activity.[15] As an example, a recent media report

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11 The Institute of Chartered Accountants in Australia, *Submission 2,* p. 2.

12 Corrs, Chambers and Westgarth Lawyers, 'Capital Gains Tax and Foreign Residents', Legal Update, 30 June 2006.

13 Taxation Institute of Australia, *Submission 3,* p. 1.

14 Elizabeth Kazi, 'CGT change to spur mergers', *Australian Financial Review,* 23 June 2006, p. 15.

15 KPMG, 'Capital gains tax changes a catalyst for M&A wave', Media Release, 22 June 2006.

speculated that the changes to the CGT regime will reap an 'enormous capital gains tax advantage' to foreign investors bidding in the sale of Coles Myer because the entity is not land-rich, leasing most of its retail outlets.[16] Furthermore, the report commented that 'any foreign group has a significant advantage over an Australian group' as the disposal of shares by foreign investors would not attract CGT.

1.28 In a media release, KPMG said that the prospect of reforms to the CGT regime is already resulting in foreign investors reviewing their strategies for investing in Australia and is expected to increase transactions in the market.[17] In the publication 'Legal Update', Minter Ellison described some of the key outcomes that could be expected from the new CGT regime including:

- increased activity by non-residents in Australian unlisted companies and unit trusts, and in interests of 10% or more in Australian listed companies, where the underlying assets do not comprise predominantly Australian real property;
- [that] Australia will become a more desirable holding company location;
- [that] non-residents will be more likely to structure the carrying on of a business in Australia via an Australian subsidiary entity rather than an Australian branch; and
- an increase in Australian investment by non-residents.[18]

1.29 The main beneficiaries of the changes to non-resident CGT were described by the Institute of Chartered Accountant in Australia in evidence to the Committee as both pension and superannuation funds and foreign multinationals establishing regional headquarters in Australia.[19] The Investment and Financial Services Association Ltd commented:

> Historically, there are number of reasons why the flow of funds from non-resident investors into Australia has been relatively low. In this regard, any significant enhancement to the international tax regime, such as the proposed changes to capital gains tax and non-residents, are a step in the right direction.[20]

Additional integrity measure

1.30 The Bill proposes the introduction of an integrity measure to ensure that foreign investors do not avoid Australian CGT by holding their assets in interposed

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16 Simon Evans, 'CGT windfall for overseas Coles bidders', *Australian Financial Review,* 28 August 2006, p. 10.

17 KPMG, 'Capital gains tax changes a catalyst for M&A wave', Media Release, 22 June 2006.

18 Minter Ellison Lawyers, 'Australian Capital Gains Tax and foreign residents', Legal Update, 20 July 2006.

19 Mr Mark Hadassin, Institute of Chartered Accountants in Australia, *Committee Hansard,* 14 September 2006, pp 2–3.

20 Investment and Financial Services Association Ltd, *Submission 4,* pp 1–2.

entities. The Explanatory Memorandum explained that this measure will strengthen Australia's CGT base:

> This ensures that the disposal of an interest in Australian real property is subject to Australian CGT regardless of whether the interest is held directly or indirectly.[21]

1.31 The following example illustrated this point:

> …the foreign resident may establish a foreign company that then invests in the Australian assets. But for special rules, the sale of that company by the foreign resident would not be subject to Australian CGT consequences, whereas the direct sale of the Australian assets would. This overcomes a tax anomaly that would otherwise arise between foreign residents who invest directly in Australia versus those who invest indirectly.[22]

1.32 The additional integrity measure would apply to the disposal of non-portfolio interests in interposed entities (including foreign entities) where more than 50 per cent of the value of such an interest is derived from taxable Australian real property. An indirect Australian real property interest will be established to exist where the foreign resident has a membership interest in an entity which passes both the non-portfolio interest test and a principal asset test. This aligns with Recommendation 3.6 of RITA 'as it applies to protect the narrower CGT tax base for foreign residents.'[23]

Introducing and enforcing the integrity measure

1.33 The Board of Taxation did not support implementation of Recommendation 3.6 of RITA:

> The Board recommended against proceeding with the Review of Business taxation proposal to apply capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets'.[24]

1.34 The Institute of Chartered Accountants in Australia commented:

> We note that the Board recommended that Australia would gain little from CGT expansion measures to tax non-residents disposing of equity interests in foreign entities…This recommendation was driven, at least in part, by an appreciation that the revenue to be collected would be outweighed by the inefficiency of and discouragement for foreign investment in Australia.[25]

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21 Explanatory Memorandum, p. 38.

22 Explanatory Memorandum, p. 32.

23 Explanatory Memorandum, p. 61.

24 See publication: Board of Taxation, 'Review of International Taxation Arrangements. A Report to the Treasurer', February 2003, p. 94.

25 The Institute of Chartered Accountants in Australia, *Submission 2,* p. 5

1.35 In responding to the Board's recommendation, the Government had previously explained that:

> A non resident holding Australian assets through a non resident company can dispose of that company, avoiding Australian tax on any capital gain - even though the gain relates to Australian assets. The Review of Business Taxation recommended addressing this issue but its implementation was deferred pending a review of tax treaty policy by this review.
>
> As the Board proposed giving up relevant capital gains taxing rights (Recommendation 3.11(2)) in tax treaty negotiations it did not support this measure proceeding. It also noted the possible adverse effect upon foreign investors' perception of Australia as a place to invest, and perceived administration concerns.
>
> However, as the Government has decided to continue taxing these capital gains, it may be appropriate to reinforce Australia's ability to tax non residents disposing of Australian assets. Accordingly, in consultation with the business community, the Government will give further consideration to the Review of Business Taxation recommendation, recognising that any proposal will need to address concerns regarding a possible adverse effect upon foreign investors' perception of Australia as a place to invest, administration and compliance issues.[26]

1.36 The Explanatory Memorandum noted that the inclusion of this integrity measure in Australian taxation law is consistent with Australia's tax treaty practice and the *OECD Model Tax Convention on Income and on Capital*.[27]

1.37 Concern has been expressed about the inclusion of the concept of 'indirect Australian real property interests' into the categories of assets. Difficulties in enforcing this provision were flagged in a *Taxation in Australia* article by Mr Peter Norman:

> The expectation that a non-resident will simply file a tax return and pay the tax due on its disposition of an interest in an interposed foreign company that is an 'indirect real property interest' may be somewhat optimistic.[28]

1.38 In addition, Mr Norman said that whilst the Bill confines the application of this provision to interposed entities holding Australian real property, 'the status quo of relying on the non-resident to file a tax return remains'.[29]

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26 The Hon. Peter Costello, MP, Treasurer, 'Review of International Taxation Arrangements', Press Release 032, 13 May 2003.

27 Explanatory Memorandum, p. 32.

28 Peter Norman, 'Capital gains tax reforms for non-residents', *Taxation in Australia,* issue 41, no. 2, August 2006, p. 84.

29 Peter Norman, 'Capital gains tax reforms for non-residents', *Taxation in Australia,* issue 41, no. 2, August 2006, p. 84.

1.39 In 'Legal Update', Corrs, Chambers and Westgarth Lawyers also reported that applying indirect Australia real property interests as an asset category 'raises interesting enforcement issues' but noted that it will be the subject of amendments included in the International Tax Agreements Amendment (No. 1) Bill 2006.[30]

1.40 KPMG has argued that the introduction of the this concept will mean that some foreign investors will now be liable to pay CGT whereas they had previously been exempt:

> As a result, a foreign company selling shares in another foreign company may find themselves exposed to Australian tax.[31]

Transitional measures

1.41 The lack of transitional measures for introducing the provisions of Schedule 4 was the foremost concern presented in evidence to the inquiry.[32] The Institute of Chartered Accountants in Australia argued:

> The CGT expansion measure has no transitional measures, which means that Australia has effectively subjected to Australian CGT a large range of foreign investors selling their interests in foreign companies which ultimately have Australian assets. Those investors, newly taxable, are potentially taxable on unrealised gains accrued over past decades.[33]

1.42 Furthermore, the Institute commented:

> This expansion has been handled in an inequitable manner, from a transitional viewpoint, as it creates new CGT exposures for foreign residents previously not exposed to Australian CGT, in circumstances not resulting from any tax avoidance activity, including for example because:
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> - foreign residents subject to the measures are not given any enhanced cost base at the commencement of the new rules; and
> - the rules may potentially subject to Australian taxation foreign residents' underlying gains on non-Australian assets and non-Australian real property assets.[34]

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30 Corrs, Chambers and Westgarth Lawyers, 'Capital Gains Tax and Foreign Residents', Legal Update, 30 June 2006.

31 KPMG, 'Capital gains tax changes a catalyst for M&A wave', Media Release, 22 June 2006.

32 See for example, Mr Ali Noroozi, Institute of Chartered Accountants in Australia, *Committee Hansard,* 14 September 2006, p. 2; Mr David Rynne, Minerals Council of Australia, *Committee Hansard*, 14 September 2006, p.9.

33 The Institute of Chartered Accountants in Australia, *Submission 2,* p. 5.

34 The Institute of Chartered Accountants in Australia, *Submission 2,* p. 5; The Minerals Council of Australia, The Australian Petroleum Production and Exploration Association Ltd and The Corporate Tax Association, *Submission 1,* p. 3.

1.43 Similar concerns were also expressed in a joint submission by the Minerals Council of Australia, Australian Petroleum Production and Exploration Association Ltd and Corporate Tax Association. To address these matters it was recommended that either a market value cost base be introduced, or that interests acquired prior to the Royal Assent of the Bill be excluded from the CGT base.[35]

1.44 However, at the inquiry's public hearing, the Institute told the Committee that the absence of transitional measures in the Bill will be addressed by the Government in an amendment to be 'introduce[d] into Parliament shortly I believe'.[36] This point was reiterated by Minerals Council of Australia representative, Mr David Rynne, who said:

> It was formally brought to our attention only yesterday that the government will proceed with an amendment that will address this principal concern—that is, non-resident entities will obtain a 10 May 2005 market value cost base. This was our foremost concern, and this amendment is very much welcomed by the joint submission parties.[37]

1.45 Mr John Nagle from the Department of the Treasury provided further information to the Committee on the nature of the proposed amendments:

> There are two amendments in the legislation…The first one is what we call resetting the cost of these assets being brought into Australia's tax base for the first time. The second one we consider a consequential amendment that removes an inappropriate demerger provision that was picked up only after consultations had ceased on the measure and industry came to us with a live case that showed there was a need to make another consequential amendment to a demerger provision.[38]

1.46 The Committee notes that the financial impact of implementing either of these measures would be an additional cost to revenue, over and above the $50 million per annum in 2006-07 and $65 million per annum detailed in the Explanatory Memorandum.

Pro-rated assessment of real property holdings

1.47 The Institute of Chartered Accountants in Australia and the joint submission from the Minerals Council of Australia, Australian Petroleum Production and Exploration Association Ltd and Corporate Tax Association described a further alleged deficiency with the Bill as that the assessment of CGT for companies with substantial real property holdings is not pro-rated. Mr Noroozi illustrated this concern:

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35 The Institute of Chartered Accountants in Australia, *Submission 2,* p. 5.

36 Mr Ali Noroozi, Institute of Chartered Accountants in Australia, *Committee Hansard,* 14 September 2006, p. 2.

37 Mr David Rynne, Minerals Council of Australia, *Committee Hansard*, 14 September 2006, p. 9.

38 Mr John Nagle, Analyst, International Tax and Treaties Division, Department of the Treasury, *Committee Hansard,* 14 September 2006, p. 13.

> Let us say that a non-resident has shares in an Australian company whose assets are 60 per cent Australian real property. In that scenario if the foreign resident sells the shares in that Australian company then they have to pay tax on 100 per cent of the value of those shares as opposed to the 60 per cent that is referable to Australian real property.[39]

1.48 The joint submission outlined the impact of the assessment of CGT not being pro-rated, including that the use of Australia as a regional headquarters would be discouraged under certain circumstances.[40] The submission argued that taxable CGT gains or losses on Australian real property need to be more precisely focussed by specifying that only a proportion of the gain on the sale of interests in a resident or non-resident entity that is land-rich should be subject to CGT, equal to the Australian land-rich proportion. To address the problem, the submission proposed:

> …all that would be needed would be the introduction of provisions somewhat similar to subsections 768-505(2) and 768-505(4) which similarly pro-rate a total CGT gain or loss in the context of the participation exemption provisions of subdivision 768-G (albeit while only applying in the context of the range 50% to 100%).[41]

1.49 Representatives from the Institute of Chartered Accountants in Australia stated that any action to address this concern should not delay the passage of the Bill, commenting:

> …we would not want to delay this measure any further because of this one issue that we have. So we fully support the immediate passage of this through parliament.[42]

Other concerns

1.50 The joint submission by the Minerals Council of Australia, Australian Petroleum Production and Exploration Association Ltd and Corporate Tax Association also outlined a number of other amendments for inclusion in the Bill, including:

- addressing impediments to upstream corporate restructures by:
  - amending the CGT event J1 anomalies; and
  - dealing with other CGT restructuring impediments.

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39 Mr Ali Noroozi, Institute of Chartered Accountants in Australia, *Committee Hansard,* 14 September 2006, p. 2.

40 The Minerals Council of Australia, The Australian Petroleum Production and Exploration Association Ltd and The Corporate Tax Association, *Submission 1a,* pp 5–6.

41 The Minerals Council of Australia, The Australian Petroleum Production and Exploration Association Ltd and The Corporate Tax Association, *Submission 1a,* p. 6.

42 Mr Ali Noroozi, Institute of Chartered Accountants in Australia, *Committee Hansard,* 14 September 2006, p. 2.

- allowing taxpayers to choose to utilise book values in all 'indirect Australian real property interest' calculations;
- introducing a mechanism to avoid potential double taxation exposures where an Australian tax impost against the proposed changes to the CGT regime is not creditable against the equivalent gain taxed in a foreign jurisdiction; and
- allowing grouping access to CGT losses and tax losses of wholly-owned companies.[43]

Committee's view

1.51 The Committee considers that the Bill adequately addresses anomalies in Australia's international taxation system as it relates to the treatment of CGT and non-residents. The Committee is convinced that the amendments to the taxation system will reap important benefits to the Australian economy and to the people of Australia.

Recommendation

The Committee recommends that the Senate pass the Bill.

Senator George Brandis
Chair

43 The Minerals Council of Australia, The Australian Petroleum Production and Exploration Association Ltd and The Corporate Tax Association, *Submission 1,* pp 3–4.