

Tax alert

Special international report

Grant Thornton 

New legislation has removed **Capital Gains Tax (CGT)** on a range of **Australian assets** held by non-residents and has lifted a substantial restriction on foreign investment...

International reforms legislated to date

In recent times the Australian Government has modified Australia's taxation laws to enhance the attractiveness of Australia to foreign investors. The following measures had already been adopted:

- conduit foreign income regime - which allows untaxed foreign income derived by an Australian resident company to be distributed to a foreign shareholder free of any withholding taxes
- participation exemption - which allows for foreign dividend income exemptions, and a CGT exemption on the sale of shareholdings in foreign companies by an Australian company (to the extent that the foreign company has active business assets)
- Controlled Foreign Company (CFC) reforms - which primarily seek to reduce CFC compliance costs
- foreign income exemption for temporary residents - which remove tax-related disincentives for individuals who work in Australia on short term visas

New CGT rules

The new provisions that reform the CGT treatment of non-residents became operative from 12 December 2006.

Previously, Australian CGT applied to non-residents on the disposal of assets that were listed as having the "necessary connection to Australia". Under the new laws, Australian CGT will now only apply to non-residents on disposals of "taxable Australian property" which includes:

- Australian real property, including all real property in Australia and mining, quarrying and prospecting rights located in Australia

- an indirect real property interest
- a CGT asset that has been used at any time in carrying on a business through a permanent establishment in Australia; a reduction in the gain is made for the time the asset is not used in carrying on a business through a permanent establishment in Australia
- a right or option to acquire any of the above
- any CGT asset subject to a choice made by an individual under an election to treat the asset as being taxable Australian property upon ceasing to be an Australian resident

An "indirect real property interest" is a membership interest held in an entity where the majority of the underlying asset value of the entity (including through one or more interposed entities) is represented by Australian real property. The membership interest must be, or have been in twelve months of the last two years, a non-portfolio interest (i.e. an interest of 10% or more). Note, where the majority value test is satisfied, the new laws do not apportion the gain for that portion of the gain not related to Australian real property.

Extension of CGT in some cases

However, interests in non-Australian entities that directly or indirectly have the majority of their value represented by Australian real property (and that were previously not connected to Australia for CGT purposes) can now be considered to be "taxable Australian property" and be caught by Australian CGT.

Any asset that is now subject to Australian CGT (and was not previously) that was acquired before 10 May 2005 will receive a cost base step-up to their market value at that time.

Implication of the new rules

The new CGT rules effectively mean that shares held by non-residents in any Australian company that does not satisfy the Australian real property interest tests outlined above can be sold without an Australian CGT liability.

Currently, many foreign companies have multi-tiered holdings for their Australian subsidiary investments. This may have been effective in providing flexibility on exit or reorganisation, by avoiding a disposal of Australian company shares.

Now it is possible to structure Australian investments with a less complex holding structure. Furthermore, Australia can now be more effectively used as a jurisdiction from which to structure additional global operations, particularly for expansion in the

Asia-Pacific region.

Whether a business in Australia is established via a branch or a subsidiary becomes more important as it may be possible that an Australian subsidiary without significant Australian real property can now be ultimately sold free of any CGT, whereas the assets of an Australian branch may still be subject to CGT upon disposal.

Also, owing to the indirect interest provisions, care needs to be taken to ensure that any future restructuring of groups that have significant Australian real property interests are monitored to avoid unexpected Australian CGT on the transfer of foreign holding company shareholdings. It may be necessary to value current Australian asset holdings to determine what impact the new rules will have.

Examples

Individual investor

Mr Smith, a resident taxpayer of the United Kingdom, owns 35% of the shares in XYZ Pty Limited, an Australian incorporated private company. Mr Smith has owned all of his shares in XYZ since incorporation in 1992 and has never been an Australian resident taxpayer. XYZ does not directly or indirectly own real property in Australia and on 1 January 2007, Mr Smith sold all of his shares to an Australian private equity fund for a considerable gain.

Mr Smith does not incur an Australian CGT liability under the new laws.

Multinational investor

In July 2004, XYZ Corp, a US resident multi-national company, acquired 100% of the shares in Shelf Company Limited, a company incorporated in the Cayman Islands that has only one asset, being 100% of the shares in an Australian company called ABC.

ABC does not own any Australian real property. Shelf Company Limited incorporated ABC in August 1999, meanwhile XYZ paid \$500,000 for Shelf Company Limited.

XYZ now wishes to sell either Shelf Company Limited or ABC for \$1m. The buyer wishes to buy the shares in ABC.

Under the new CGT laws, XYZ will not incur an Australian CGT liability irrespective of whether ABC or Shelf Company Limited is sold. Previously, Shelf Company Limited would have been assessed to tax on any capital gain arising from the sale of ABC.

Indirect Australian real property interest

A Ltd, a company incorporated in the United Kingdom owns 100% of the shares in B Ltd, a company incorporated in the British Virgin Islands that only owns one asset, being 100% of the shares in C Pty Ltd, a company incorporated in Australia. The market value of the assets of C Pty Ltd can be apportioned as being 60% Australian real property and 40% other assets.

Working through the indirect Australian real property rules, not only will B Ltd be subject to Australian CGT upon the sale of C Ltd (which is no different from the old rules), but A Ltd will be subject to Australian CGT on the sale of B Ltd (which was not previously the case). If the above corporate structure had been in place prior to 10 May 2005, then the cost for Australian CGT purposes of the shares held in B Ltd by A Ltd will be deemed to be the market value of B Ltd as at 10 May 2005.

For further information please contact:

Adelaide

Malcolm Wight
T 08 8372 6666
F 08 8372 6677
E info@gttsa.com.au

Melbourne

Lisa Difford
T 03 9611 6611
F 03 9611 6666
E info@gtvic.com.au

Perth

Peter Fallon
T 08 9481 1448
F 08 9481 0152
E pfallon@gtwa.com.au

Brisbane

Peter Godber
T 07 3222 0200
F 07 3222 0444
E info@gtqld.com.au

Sydney

John Ross
T 02 8297 2400
F 02 9299 4445
E info@gtntsw.com.au

Grant Thornton

DISCLAIMER

This newsletter is general in nature and its brevity could lead to misrepresentation. No responsibility can be accepted for those who act on its content without first consulting us and obtaining specific advice.

Each office listed is a business operated independently of other firms and entities who use the trademark Grant Thornton. Grant Thornton is a trademark owned by Grant Thornton International and used under licence by independent firms and entities throughout the world. Liability limited by a scheme approved under Professional Standards Legislation.