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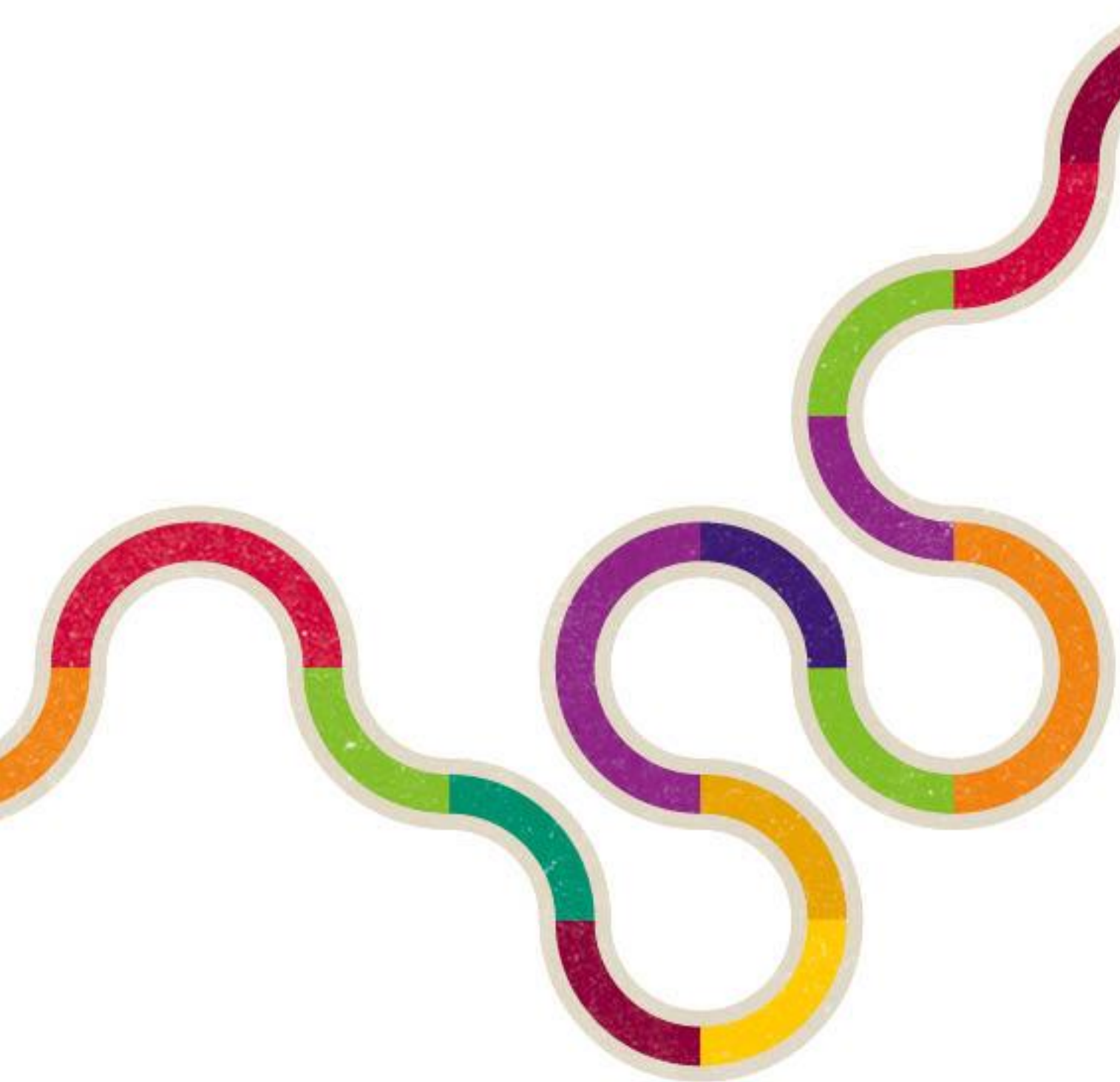
Property Settlement Risks – new 10% withholding tax affecting transfers of real property interests will impact on family lawyers



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*From 1 July 2016 it is presumed that the vendor of real property is a non-resident and the purchaser will be obliged to withhold 10% of the proceeds, register for withholding tax (WHT) and pay it to the Australian Taxation Office (ATO)**unless** a Clearance Certificate has been obtained prior to settlement.*

The *Tax and Superannuation Laws Amendment (2015 Measures No.6) Bill* 2015 received Royal Assent on 25 February 2016. Effective 1 July 2016 the legislation introduces a **new foreign capital gains withholding tax regime** which is designed to assist the Australian Taxation Office (ATO) in the collection of foreign investors' Australian tax liabilities arising from the sale of real property.

The scope of the new legislation goes beyond the sale of direct interests in real property and it appears that the effect of these provisions may have unintended consequences. Caution will be required when drafting *Family Law Act* Orders and financial agreements that directly or indirectly affect interests in real property.

Transactions affected

1 Where the following assets have a value of $2million or more, withholding is required unless a Clearance Certificate (or valid exemption) is provided:

- Taxable Australian Real Property which includes:
  - real property in Australia such as land and buildings, both residential and commercial
  - mining, quarrying or prospecting rights
  - lease premiums paid for the grant of a lease over real property in Australia
- Indirect Australian real property interests that provide a company title interest

2 The following assets could require withholding to be deducted. There is no minimum threshold for these assets :

- Indirect Australian real property interests (which are holdings of 10% or more in any entity whose assets are predominantly Australian real property ie more than 50% of total market value of the asset)

3 Transactions involving the option or right to acquire any of the assets classes in 1 and 2 above, will also attract the withholding obligations.

For the assets referred to in 2 above, where the transferee has reasonable grounds to believe the transferor is an Australian Resident there will be no obligation to withhold the tax.

However, where uncertainty exists a Vendor Declaration should be obtained from the transferor.

Vendor declarations

There are two types of vendor declaration:

- Residency declaration (confirming Australian resident)
- Not an indirect Australian real property interest declaration (confirming the sale represents less than a 10% interest in the entity or the companies' assets are not predominantly Australian real property)

Vendor declarations are valid for a 6 month period from the date of signing. It will therefore be imperative to ensure declarations are still valid at the date of settlement.

There is no specified format for the declarations. However the ATO will provide template examples on its website prior to 1 July 2016. Penalties will be imposed for false and misleading declarations.

Excluded transactions

The new withholding regime will not apply to:

- Real property transactions valued at under $2 million
- On-market transactions in relation to shares, units or membership interests listed on an approved stock exchange

- Transactions subject to another withholding obligation
- Securities lending arrangements
- Transactions where the vendor is in administration or transactions arising from the administration of a bankrupt estate, a debt agreement or a personal insolvency agreement

As mentioned, these provisions appear to have a broad impact, being triggered on a change in ownership regardless of whether taxation is payable on such a change and including where transfers are eligible for roll-over relief under the *Income Tax Assessment Act.*

Therefore any Orders made or financial agreements entered into under the *Family Law Act* providing for the transfer of real property (with a value greater than $2million) or an equity interest (share or units) in an entity predominately holding real property assets (regardless of the value of the real property or the equity interest) will be subject to the new withholding tax regime

Example scenarios

Example One:

The Husband and Wife are both Australian taxation residents and, as part of their property settlement, agree to transfer a property on Sydney's North Shore valued at $3.5M, from the Husband to the Wife. The property was held 100% by the Husband.

The property has a value greater than $2million, so regardless of the fact that the Husband and Wife are Australian taxation residents, if a Clearance Certificate is not obtained by the Husband (notional Vendor) from the ATO prior to the transfer then the Wife (notional Purchaser) would be obligated to remit $350,000 to the ATO as withholding tax on the Husband's behalf.

The Wife would be required to remit the withholding tax notwithstanding that such a transfer would obtain roll-over relief and no taxation would otherwise be payable by the Husband on such a transfer.

A less clear situation arises where the property is held jointly by the Husband and Wife.

In such circumstances, using the above example and assuming the Husband and Wife each hold a 50% interest, the value of the interest being transferred would be $1.75million (50% of $3.5million) and therefore less than the $2million threshold.

It is unclear to the Writers whether the ATO considers the value of interest or the value of the property as a whole when assessing whether the foreign capital gains withholding tax regime will apply.

Until the ATO provides clarity around such circumstances it is our view that caution should be exercised and a Clearance Certificate should be obtained where the total value of the property exceeds the threshold regardless of the extent of the interest that is to be transferred.

Finally, regardless of the issue identified with respect to the threshold we do hold the view that withholding tax in such an example if found to be applicable would only apply to the value of the interest being transferred, which in the revised example above would be $1.75million, resulting in withholding tax of $175,000.

Example Two:
The Husband and Wife are both Australian taxation residents and members of a self-managed superannuation fund. The Fund has a direct interest in real property, as well as investments in various listed and unlisted companies and unit trusts.

As part of their property settlement the parties split part of the Husband's superannuation to the Wife, and roll out the Wife's superannuation benefit to a new Fund established by the Wife.

In giving effect to the settlement, the following assets are rolled out:

- An apartment on the Gold Coast valued at $2.5 million.
- Shares in listed companies worth $500,000

- Units in a unit trust established by the parties' accountant that is engaged in property development. The parties' superannuation fund holds 15% of the issued units worth $500,000, and the other unit-holders are other clients of the accountant.

The withholding tax regime would have the following impact on the above:

- A Clearance Certificate would be required to be obtained by the Trustee of original superannuation fund and provided to the Trustee of the Wife's new superannuation fund as otherwise the transfer of the Gold Coast apartment would be subject to withholding as it is valued at an amount greater than $2 million.

- The shares in listed companies worth $500,000 would not be subject to the new provisions as they are transactions in relation to shares, units or membership interests listed on an approved stock exchange, and therefore exempted.

- The transfer of the units in the unlisted property development unit trust would not be subject to the new provisions notwithstanding it is an indirect Australian real property interest, as the Trustee of the Wife's new superannuation fund would have reasonable grounds to believe the transferor was an Australian resident.

Example Three:
The Husband is Chinese national and holds property in Australia and China. The Wife is an Australian resident. The Parties while married lived in Australia but since separation (2 years ago) the Husband has returned to China and now rarely returns to Australia.

All the parties' assets are held by the Husband or entities under his control.

Settlement of the parties' property proceedings requires a transfer from the Husband and entities that he controls of the following:

- Australian bank accounts holding $100,000 in cash

- The former matrimonial home valued at $3 million

Assuming the Husband is not an Australian taxation resident, the transfer of the former matrimonial home to the Wife will be subject to the withholding tax regime.

The transfer of the former matrimonial home would be subject to the capital gains tax rollover provisions, and therefore no income tax would be payable by the Husband on the transfer of the property to the Wife. Regardless, the Wife (as notional purchaser) would be required to remit $300,000 to the Australian Taxation office unless a variation or exemption is applied for by the Husband.

While the Wife will be out of pocket by the $300,000 withholding tax she is required to remit to the ATO, the Husband will be able to obtain a refund of the amount remitted upon lodgement of his Australian tax return for the year in which the transfer occurred (subject to having no other Australian income).

Conclusion

The above examples should highlight that regardless of the taxation residency of the parties, where advisors are drafting property settlement agreements involving any of the asset classes discussed, there is much to consider before any transfers are progressed. Are Clearance Certificates required? If not eligible, does the Vendor have grounds for an exemption or rate variation application, or in the case of equity interests can a residency declaration be made? Or do the relevant shares or units represent less than a 10% interest in the entity?

If not picked up, clients could face having to remit an unexpected amount to the ATO on behalf of their former spouse, with the added insult that the former spouse could receive a windfall payment when that amount is ultimately refunded to them on lodgement of a return.

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How it will be administered

Clearance certificates can be obtained by application to the ATO and will verify that the vendor is a resident. The certificate will be valid for 12 months and must be provided by the vendor in respect of transactions involving all taxable Australian real property and company title interests. The Clearance Certificate aims to provide certainty to purchasers regarding their withholding obligations.

In straightforward cases where the ATO has all the required information, it is expected that Clearance Certificates will be provided within 1–14 days. A non-resident or temporary resident cannot obtain an ATO certificate; therefore, the purchaser will be required to withhold 10%.

Where a Clearance Certificate is not provided by the time of settlement, the purchaser must register and withhold 10% of the proceeds, then make payment of this amount to the ATO on settlement. A Purchaser Payment Notification form is required to be lodged with the ATO to obtain the details required to make the payment. The penalty for a purchaser failing to withhold is equal to the amount that was required to be withheld and paid.

In the event that withholding tax has been paid to the ATO, the foreign vendor will need to lodge an Australian tax return for the relevant year to make a claim for the withheld funds. The 10% WHT credit will be offset against any applicable tax payable by the non-resident and if the withholding tax is greater than the tax that would be assessed, the excess will be refunded. at the time of assessment.

Vendor variations

Where a vendor is not eligible to obtain a Clearance Certificate because of their residency status, they can apply to the ATO for a variation to the 10% withholding rate in certain circumstances.

A variation may be granted where the vendor can show that they will not make a capital gain on the disposal (either through a capital loss outcome or eligibility for CGT rollover) or there are carried forward losses available to negate any tax liability. Other circumstances where the ATO may consider a variation include where a vendor has a mortgage security on the property and deduction of the 10% of the proceeds would mean a shortfall of funds to discharge the security; or where there are multiple vendors and only one is a non-resident.

An application for variation will be required in the approved form by the vendor. The ATO has indicated these will take up to 28 days to process. The ATO will issue a notice of variation stating the revised amount to be withheld (or none) and the notice should be supplied to the purchaser prior to settlement.

What to consider when drafting *Family Law Act* orders or financial agreements with direct or indirect interests in real property assets

- The taxation residency of the parties involved - noting that tax residency is different to immigration residency and that a party could be Australian born or hold Australian permanent residency, but still not be a resident for taxation purposes

- Ensure that an ATO Clearance Certificate has been applied for and remains current well in advance of the transfer date for any proposed 'disposals'

- Confirm receipt of an ATO Clearance Certificate for any 'acquirers' prior to settlement.

- Consider building in Residency Declarations as part of the order or agreement.

- Where the transferor party is not an Australian resident, ensure a variation application is made to the ATO, as most transfers between parties to the marriage or relationship that would be contemplated in family law circumstances, won't give arise to a taxation consequence.

- Where a payment of withholding tax cannot be avoided, ensure allowance for the payment is contemplated in determining the division of assets of the Parties.

Issues to watch for

As discussed earlier the scope of the provisions appears to be wider than expected, with the following scenarios presenting potential unintended consequences and therefore caution is required in planning for these:

- The transfer of partial interests in real property where the total value of the property is $2million or greater but the interest being transferred is less than $2million.

- Where a trustee is disposing of property, there could be delays with obtaining a Clearance Certificate if there are non-resident beneficiaries of a trust

- When a change of Trustee involves the transfer of property held in trust, a Clearance Certificate may be required by the exiting Trustee

- The $2million threshold will not apply to transfers of securities; there is no minimum threshold (ie: shares and units)

- The ATO has advised that if a Trustee is selling land, the Clearance Certificate must be in the name of the Trustee (same for Superannuation Funds)

- Withholding may be required even when there is no CGT consequences (for example on the transfer of a real property interest as part of a property settlements)

- New standard contracts will be issued by the relevant real estate and law bodies to incorporate the changes

- The ATO will release its automated application for Clearance Certificates in late June, 2016

The ATO has advised it is developing a number of Law Companion Guidelines on specific issues relating to the new regime. It is hoped that the ATO provides further clarity on some of the broader consequences so practitioners can get certainty around these various scenarios and plan their processes accordingly.

Prepared by Grant Thornton Australia for the Family Law Section of the Law Council of Australia.

Sian Sinclair | Partner – Tax
Global Industry Leader - Real Estate & Construction
Grant Thornton

Joseph Box | Partner – Financial Advisory
National Head of Forensic Consulting
Grant Thornton