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# **Chapter 1**

## ***Improving the integrity of the foreign residents capital gains tax regime***

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### **Outline of chapter**

1.1 Schedule # amends the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that the foreign residents capital gains tax (CGT) regime operates as intended by preventing the double counting of certain assets under the Principal Asset Test.

### **Context of amendments**

#### **Australia's Foreign Resident CGT Regime**

1.2 Australia's foreign resident CGT regime was introduced in 2006, with the insertion of Division 855 into the ITAA 1997.

1.3 Consistent with international practice and Australia's international tax treaties, this regime promotes foreign investment in Australia. Subdivision 855-A operates to disregard a capital gain or capital loss made by a foreign resident provided the relevant CGT asset is not:

- a direct or indirect interest in Australian real property; or
- an asset used in carrying on a business through a permanent establishment in Australia.

1.4 The objects of the foreign resident CGT regime include ensuring that interests in an entity remain subject to Australia's capital gains tax laws if the entity's underlying value is principally derived from Australian real property. [*Section 855-5 ITAA 1997*]

1.5 This is achieved by ensuring that a capital gain realised by a foreign resident on an 'indirect Australian real property interest' (see section 855-25) cannot be disregarded .

1.6 An 'indirect Australian real property interest' includes a significant interest (generally a stake of 10 per cent or more) in an entity

whose underlying value is principally derived from ‘Australian real property’.

1.7 The Principal Asset Test in section 855-30 is used to determine whether an entity's underlying value is principally derived from Australian real property. The Principal Asset Test requires a comparison of the sum of the market values of the entity's taxable Australian real property (TARP) assets with the sum of the market values of its non-TARP assets.

1.8 A CGT asset is TARP if it is:

- real property situated in Australia (including a lease of land situated in Australia); or
- a mining, quarrying or prospecting right (to the extent that it is not real property), if the minerals, petroleum or quarry materials are situated in Australia.

*[Sections 855-20 and 855-25 of the ITAA 1997]*

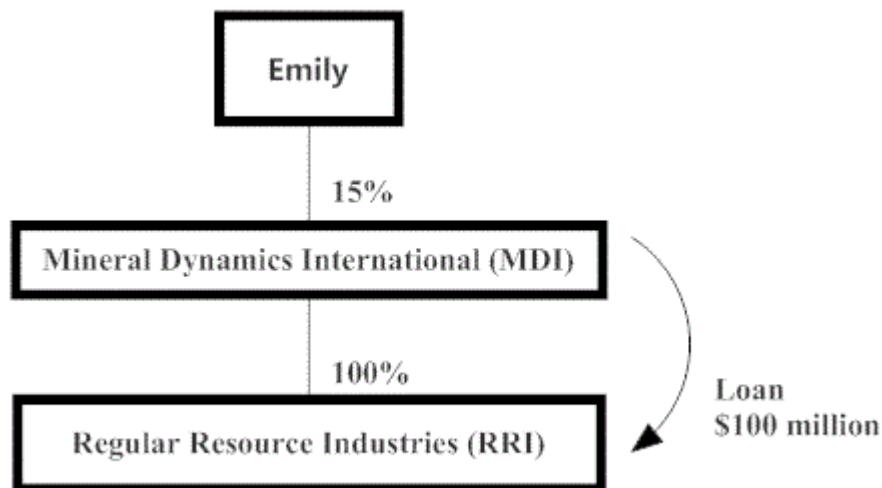
1.9 If the sum of the market values of the entity's assets that are TARP exceeds the sum of the market values of the assets that are non-TARP, any capital gain or capital loss is not disregarded and may be included in the assessable income of the foreign resident.

1.10 The Principal Asset Test applies to the assets of the entity in which the foreign resident had a direct interest (the **test entity**). Where an asset of the test entity is an interest in another entity the test may operate to also test the assets of those other entities. That is, the Principal Asset Test applies recursively to the assets of other entities in which the test entity has a significant interest, directly or indirectly, provided that the foreign resident has an indirect interest of at least 10% in that other entity.

## **Asset Duplication**

1.11 The Principal Asset Test only has regard to the market value of the assets of the relevant entities (it does not have regard to the liabilities or the source of the assets). Where the assets of multiple entities are assessed under the Principal Asset Test, and those entities have assets and liabilities arising out of transactions between themselves, this can affect the outcome of applying the Test in that the value of certain non-TARP assets can be effectively duplicated.

1.12 Transactions between these entities may create assets that lead to certain assets of the group effectively being valued multiple times, once in the hands of each entity. The issue is best illustrated by way of example.

**Example 1.1 Asset duplication under the current law**

Emily, a foreign resident, wishes to dispose of her 15 per cent interest in Mineral Dynamics International (MDI), a multinational investor in the global resources market.

MDI owns 100 per cent of the shares in Regular Resource Industries (RRI), a mining company with operations in Australia.

MDI also has \$100 million cash on hand (all examples in this Chapter use amounts denominated in Australian currency). RRI's only asset is a mining licence with a current market value of \$150 million.

If Emily were to sell her shares when these were MDI's only assets, the Principal Asset Test would be satisfied as the test entity, MDI, would have a TARP asset worth \$150 million (derived from the mining licence held by RRI) and a non-TARP asset worth \$100 million.

Before Emily sells her shares, MDI loans \$100 million to RRI on commercial terms. MDI thereby acquires a right to receive funds under the loan agreement. This right has a market value of \$100 million.

The same underlying store of economic value, the \$100 million, is effectively counted twice under the Principal Asset Test, once as a loan asset in the hands of MDI and again as cash in the hands of RRI.

As a result, the sum of the market values of MDI's non-TARP assets equals \$200 million (derived from the loan asset of MDI and the cash in the hands of RRI) and exceeds the value of the TARP asset (\$150 million derived from RRI's mining licence). The Principal

Asset Test is not satisfied. Therefore, any capital gain or capital loss that Emily would make on the disposal of her shares in MDI would be disregarded. The underlying value of MDI, however, has not changed.

1.13 Subsection 855-30(5) is an integrity rule that provides that the market value of an asset acquired with a purpose of failing the Principal Asset Test is disregarded. This integrity rule will not operate to prevent all instances of asset duplication, which may arise through legitimate commercial arrangements.

1.14 The treatment of inter-company loans under the Principal Asset Test is discussed in [ATO Interpretative Decision 2012/14](#). The potential for the Principal Asset Test to result in asset duplication is discussed in [Taxpayer Alert 2008/20](#).

### **Announced Changes to the Principal Asset Test**

1.15 On 14 May 2013, the previous Government announced amendments to the Principal Asset Test in the 2013-14 Budget. The amendments, as announced, would:

- value mining, quarrying or prospecting information and goodwill together with the mining rights to which they relate; and
- remove the ability to use transactions between members of the same consolidated group to create and duplicate assets.

1.16 On 4 November 2013, this Government announced that it would proceed with the changes to the Principal Asset Test.

#### ***The valuation of mining information and goodwill***

1.17 The previous Government's announcement of the valuation amendment appears to be a response to issues arising from the decision of the Federal Court in *Resource Capital Fund III LP v Commissioner of Taxation* [2013] FCA 363, which was handed down on 26 April 2013.

1.18 There are still matters before the courts in relation to this issue (see in particular the decision of the Full Federal Court in *Commissioner of Taxation v Resource Capital Fund III LP* [2014] FCAFC 37 (3 April 2014)). The Government has therefore decided to defer the enactment of the amendment and to assess whether it is required once the present litigation is finalised.

*The community's views are sought on this proposal through this Exposure Draft.*

***The scope of the anti-duplication amendment***

1.19 The amendments to address asset duplication, as announced by the previous Government, focused on interactions between members of a consolidated group or Multiple-Entry Consolidated (MEC) group.

1.20 However, the potential for assets to be effectively duplicated is not restricted to assets being created from transactions between members of a consolidated group; rather it arises from the operation of the Principal Asset Test itself.

**Summary of new law**

1.21 Schedule # amends the law to prevent the double counting of certain non-TARP assets that can distort the application of the Principal Asset Test.

1.22 Where the assets of two or more entities are included in the Principal Asset Test, the market value of new non-TARP assets arising from transactions between those entities will be disregarded for the purposes of the Principal Asset Test.

1.23 These amendments are broader than those announced by the previous Government. In particular, the scope of the amendments is not restricted to entities that are members of the same consolidated group or MEC group.

**Comparison of key features of new law and current law**

<i>New law</i>	<i>Current law</i>
<p>Where the assets of two or more entities are included in the Principal Asset Test, the market value of new non-TARP assets arising from an arrangement involving those entities will be disregarded.</p> <p>In particular, certain assets that relate to liabilities located elsewhere in the corporate group will not be counted because they do not represent the group’s underlying economic value.</p>	<p>The application of the Principal Asset Test can be distorted by transactions between certain related entities that create new non-TARP assets, for example loan assets. These agreements can result in double counting of the same market value under the Principal Assets Test.</p> <p>This can result in situations where the Principal Asset Test is not satisfied even though the underlying value of the relevant entity is principally derived from Australian real property.</p>

## Detailed explanation of new law

1.1 Schedule # amends section 855-30 of the ITAA 1997 to prevent double counting of non-TARP assets when applying the Principal Asset Test. [Schedule #, item 1, subsection 855-30(4A)]

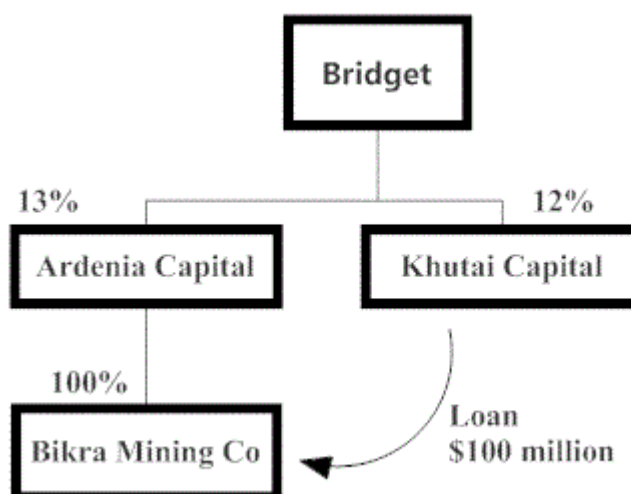
### The entities to which the amendments apply

1.2 The amendments apply to any assets arising from transactions between entities that have their assets valued for the purposes of the Principal Asset Test as a result of a CGT event occurring to a foreign resident. [Schedule #, item 1, paragraph 855-30(4A)(a)]

1.3 The amendments can apply to all entities within an economic structure regardless of whether the entities are members of the same consolidated group or MEC group for tax purposes.

1.4 In applying the Principal Asset Test, arrangements involving related parties and group members that result in the creation of new assets will not be affected if the assets of only one of the parties to the arrangement are taken into account in applying the Test. See the following example involving multiple chains of ownership.

#### Example 1.2 Groups with multiple chains of ownership



Bridget, a foreign resident, has interests in two investment firms. One of the firms, Ardenia Capital finances an Australian mining company, Bikra Mining Co, through the purchase of shares. The other, Khutai Capital, makes an investment by way of a loan agreement with Bikra.



If Bridget disposed of her interest in Khutai Capital, the amendments would not apply to the loan asset created in the hands of Khutai Capital. This is because the assets of Bikra are not taken into account for the purposes of applying the Principal Asset Test in relation to Bridget's disposal of the membership interests in Khutai Capital.

Similarly, if Bridget were to dispose of her interest in Ardenia Capital, the amendments would not apply to the cash asset in the hands of Bikra because Khutai Capital's loan asset is not assessed under the Principal Asset Test on Bridget's disposal of the membership interests in Ardenia Capital.

If Bridget were to sell both interests contemporaneously, she had significant control over the affairs of each entity, and both entities had significant TARP assets, it may be necessary to consider whether the loan asset was acquired for a purpose that satisfy the condition in subsection 855-30(5). The present amendments, however, would not apply.

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 these interests (and includes this in the value of the non-TARP assets). [*Subsection 855-30(4), table item 1*]

### **The arrangements to which the amendments apply**

1.7 The amendments only apply to arrangements that result in the creation of new non-TARP assets. [*Schedule #, item 1, paragraph 855-30(4A)(b)*]

1.8 The amendments apply where a new asset is created, for example, a financial asset or a new interest in a pre-existing asset of another entity. The amendments ensure that, where a new asset is created and its market value is derived from a liability owed by another relevant entity, the market value of the new asset is disregarded.

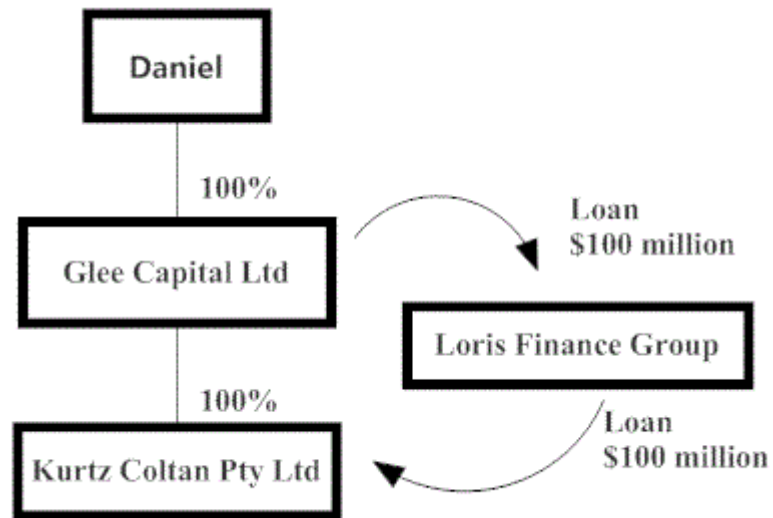
### **Example 1.3**

Further to Example 1.1, the amendments would apply to disregard the loan asset in the hands of MDI for the purposes of the Principal Asset Test.

The underlying and pre-existing cash asset will continue to be valued. The Principal Asset Test will assess it in the hands of its current owner, RRI.

1.9 The amendments also apply to arrangements that involve third parties, provided at least two of the parties to the arrangement meet the conditions outlined above.

**Example 1.4 Arrangements involving third parties**



Daniel, a foreign resident, is disposing of his interest in Glee Capital Ltd.

Glee Capital’s assets consist of its interest in its wholly-owned subsidiary, Kurtz Coltan Pty Ltd, and a \$100 million loan asset.

The loan asset arose from an arrangement whereby Glee Capital lent funds to an unrelated third party, Loris Finance Group, which on lent the funds to Kurtz Coltan Pty Ltd.

The amendment will apply to ensure that the loan asset in the hands of Glee Capital is disregarded for the purposes of applying the Principal Asset Test in relation to Daniel’s disposal of the membership interests.

1.10 The amendments will not apply to a transaction involving the simple transfer of pre-existing assets between relevant entities. Where no new asset is created, no potential for duplication arises.

**Application and transitional provisions**

1.11 Where the entities involved in the creation of the new non-TARP asset are members of the same tax consolidated group, or MEC

Group, the amendments will apply to CGT events that occur after 7.30pm on 14 May 2013 (Budget Night); and

1.12 For all other entities, the amendments will apply to CGT events occurring on or after the day on which this exposure draft is released for public consultation. [*Schedule #, item 2*]

1.13 The application dates reflect the dates on which it was announced that the amendments would apply to particular entities.

1.14 The retrospectivity of these amendments to the date of their announcement is warranted as the amendments correct a defect in the operation of the Principal Asset Test that would otherwise prevent it from operating as intended. The amendments also ensure greater integrity for Australia's foreign resident CGT regime.



