
Chapter 1

Technical Correction to Australia's Foreign Resident CGT Regime

Outline of chapter

1.1 This Exposure Draft makes a technical correction to Australia's foreign resident capital gains tax (CGT) regime. Specifically, a correction is made to the meaning of 'permanent establishment' in section 855-15 of the *Income Tax Assessment Act 1997* (ITAA 1997).

1.2 The correction will ensure that foreign residents are subject to CGT in relation to CGT assets that they have used in carrying on a business through a permanent establishment located in Australia.

Context of amendments

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

1.4 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.

1.5 Section 844-15 of the ITAA 1997 provides that the term 'permanent establishment' has the same meaning as it does in section 23AH of the *Income Tax Assessment Act 1936* (ITAA 1936).

1.6 The use of that definition was intended to apply any applicable treaty definition for permanent establishment. Alternatively, if no applicable treaty definition existed, the default meaning of permanent establishment in subsection 6(1) of the ITAA 1936 would apply.

1.7 Section 23AH, however, deals with outbound investment. The section 23AH definition applies in relation to 'listed or unlisted countries', which, by definition, are countries other than Australia. A strict application of this definition in the context of Division 855 precludes a CGT asset from ever being taxable Australian property. This outcome is clearly unintended as it would mean that part of the definition of taxable Australian property has no operation.

Summary of new law

1.8 A technical amendment is made to Division 855 to ensure that, in determining whether an asset is 'taxable Australian property', the test in respect of CGT assets that are used in carrying on a business through a permanent establishment in Australia applies appropriately.

1.9 This change replaces the reference to a permanent establishment within the meaning of section 23AH of the ITAA 1936 with specific tests. Consistent with section 23AH, these tests take into account an entity's status as a resident of a country with which Australia has an international tax agreement in determining whether it has a permanent establishment in Australia.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
For the purposes of a foreign resident, a permanent establishment in Australia will have its meaning under any relevant tax treaty or, if no treaty exists, the default statutory definition.	The meaning of permanent establishment in section 855-15 of the ITAA 1997 relies on the definition of the term in section 23AH of the ITAA 1936, which does not apply to Australian permanent establishments.

Detailed explanation of new law

1.1 This Exposure Draft makes a technical correction to the definition of taxable Australian property. A CGT asset is taxable Australian property if it is used at any time in carrying on a business through a permanent establishment in Australia.

1.2 To ensure the definition of taxable Australian property applies as originally intended, these amendments replace the reference to the section 23AH definition of permanent establishment with an equivalent test that

applies in respect of Australian permanent establishments. Consistent with the section 23AH definition, this new test applies any applicable treaty definition of permanent establishment.

1.3 In determining whether a CGT asset is taxable Australian property of a kind that is used in carrying on a business through a permanent establishment in Australia, the residency status of the entity that uses the CGT asset determines the way in which the permanent establishment is defined.

1.4 Where an entity is a resident in a country with which Australia has an international tax agreement that contains a permanent establishment article, the definition of permanent establishment in the agreement is used in determining whether the entity has a permanent establishment in Australia. *[Schedule #, items 1 and 3, subparagraph 855-15(a)(i), cell at table item 3, column headed 'Description' and subsection 855-35(1)]*

1.5 An international tax agreement is defined in subsection 995-1(1) as an agreement within the meaning of, and given the force of law by, the *International Tax Agreements Act 1953*. To ensure that this aspect of the test is appropriately targeted, these amendments also introduce a definition of 'permanent establishment article'.

1.6 A permanent establishment article is defined as Article 5 of the UK convention, or a corresponding agreement of another international tax agreement. *[Schedule #, items 2 and 4, section 855-16 and subsection 995-1(1)]*

1.7 Article 5 of the UK convention sets out the definition of permanent establishment for the purposes of that convention. An article in another agreement that has the same effect for the purposes of that agreement is also a permanent establishment article. This approach to defining permanent establishment articles is consistent with the definitions of associated enterprises article, business profits article, and residence article, which each refer to the corresponding article in the UK Convention.

1.8 Where an entity is not a resident in a country with which Australia has an international tax agreement, the general definition of permanent establishment in subsection 995-1(1) is used in determining whether the entity has a permanent establishment in Australia (this definition refers to the definition in subsection 6(1) of the ITAA 1936). *[Schedule #, item 1, subparagraph 855-15(a)(ii), cell at table item 3, column headed 'Description']*

1.9 These amendments apply only to the way in which a permanent establishment is defined, and do not otherwise affect the test for whether a CGT asset is taxable Australian property.

Application and transitional provisions

1.10 The amendments in this Exposure Draft apply from the commencement of Division 855. [*Schedule #, item 5*]

1.11 These changes are of a technical nature and do not affect any other aspect of the definition of taxable Australian property. They do not negatively affect any taxpayer because the scope of the definition of taxable Australian property aligns with the intention of the original provisions.

1.12 Division 855 was introduced in the *Tax Laws Amendment (2006 Measures No. 4) Act 2006* and applies to CGT events that happen on or after 12 December 2006 (being the commencement of item 112 of Schedule 4 of that Act).

1.13 Applying the amendments to Division 855 made by this Schedule from the commencement of Division 855 ensures the references to an Australian permanent establishment in the Division apply as originally intended.

