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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2006 MEASURES No. 4) BILL 2006

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello MP)

Table of contents

Glossary 1

General outline and financial impact 2

Chapter 1 Marriage breakdown roll-over.. 6

Chapter 2 Consolidation 19

Chapter 3 Simplified imputation system: imputation for New Zealand resident companies...............................22

Chapter 4 Capital gains tax and foreign residents 27

Index 63

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ATO	Australian Taxation Office
CGT	capital gains tax
Commissioner	Commissioner of Taxation
Family Law Act	*Family Law Act 1975*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
MEC group	multiple entry consolidated group
OECD	Organisation for Economic Co-operation and Development
OECD Model	*OECD Model Tax Convention on Income and on Capital*

General outline and financial impact

Marriage breakdown roll-over

Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to extend the marriage breakdown capital gains tax (CGT) roll-over to assets transferred to a spouse or former spouse because of:

- a binding financial agreement under the *Family Law Act 1975* (Family Law Act) or a corresponding written agreement that is binding because of a corresponding foreign law;
- an arbitral award under the Family Law Act or a corresponding arbitral award under a corresponding state, territory or foreign law; or
- a written agreement that is binding because of a state, territory or foreign law relating to de facto marriage breakdowns and that, because of such a law, cannot be overridden by an order of a court except to avoid injustice.

These amendments ensure that a capital gain or loss that would otherwise be made by an individual, a company or a trustee is deferred until the transferee spouse or former spouse disposes of the CGT asset.

These amendments also ensure that the CGT main residence exemption interacts more appropriately with the marriage breakdown roll-over by taking into account the way in which both the transferor and transferee spouses use the dwelling when determining the transferee spouse's eligibility for the main residence exemption.

Finally, these amendments ensure that marriage breakdown settlements do not give rise to CGT liabilities.

Date of effect: The amendments that relate to the marriage breakdown roll-over and the main residence exemption apply to CGT events that are trigger events for the purposes of Subdivision 126-A of the ITAA 1997 and that happen after the date of Royal Assent of this Bill.

The amendment that relates to marriage breakdown settlements applies to CGT events that happen after the date of Royal Assent of this Bill.

Proposal announced: This measure was announced in the then Minister for Revenue and Assistant Treasurer's Press Release No. 33 of 10 May 2005.

Financial impact: Minimal.

Compliance cost impact: Minimal.

Consolidation

Schedule 2 to this Bill amends the consolidation provisions in the *Income Tax (Transitional Provisions) Act 1997* to ensure that the integrity provision that requires certain roll-overs to be ignored for tax cost setting purposes does not apply to a consolidated group or multiple entry consolidated group that forms after a demerger, provided certain conditions are satisfied. These amendments also clarify the operation of the integrity provision.

Date of effect: This measure applies from 1 July 2002.

Proposal announced: This measure was announced in the then Minister for Revenue and Assistant Treasurer's Press Release No. 098 of 1 December 2005.

Financial impact: This measure will have these revenue implications:

2006-07	***2007-08***	***2008-09***	***2009-10***
–$20 million	–$5 million	–$5 million	–$5 million

Compliance cost impact: Negligible.

Simplified imputation system: imputation for New Zealand resident companies

Schedule 3 to this Bill amends the income tax law to ensure 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.

Date of effect: 1 April 2003.

Proposal announced: This measure has not previously been announced.

Financial impact: Nil.

Compliance cost impact: Negligible.

Capital gains tax and foreign residents

Schedule 4 to this Bill amends the income tax law to better target and strengthen Australia's capital gains tax (CGT) laws for foreign residents. This is achieved by narrowing the range of assets on which foreign residents will be subject to Australian CGT to Australian real property and the business assets (other than Australian real property) of a foreign resident's Australian permanent establishment. The integrity of the narrower CGT tax base is strengthened by including rules covering indirect holdings of Australian real property by foreign residents.

Date of effect: These amendments will apply to CGT events occurring on or after Royal Assent.

Proposal announced: This measure was announced in the Treasurer's Press Release No. 44 of 10 May 2005.

Financial impact: The cost to revenue of this measure is expected to be $50 million per annum in 2006-07. Thereafter, the cost is expected to be $65 million per annum.

Compliance cost impact: The CGT and foreign residents measure is unlikely to have a large impact on compliance costs overall. Although compliance costs may rise for those foreign investors with indirect holdings in Australian real property, compliance costs will likely decrease for a large number of other investors due to the narrowing of the assets on which foreign residents are subject to Australian CGT and the broadening of the non-portfolio interest requirement.

Summary of regulation impact statement

Regulation impact on business

Impact: The CGT and foreign residents measure in this Bill impacts on all foreign residents, be they individuals, companies, trusts or trustees of foreign trusts, holding interests in Australian assets or resident entities.

Narrowing the range of assets for foreign residents subject to Australian CGT, and expanding the non-portfolio (ie, 10 per cent or greater) interest

requirement means that many foreign residents who may have previously been subject to the Australian CGT will now fall outside the scope of the regime.

However, some foreign residents previously outside Australia's tax net will now come within the scope of Australia's CGT regime. Foreign residents affected are those holding non-portfolio interests in certain foreign entities.

Main points:

- This measure narrows the range of assets on which a foreign resident will be liable to Australian CGT to Australian real property and the business assets (other than Australian real property) of a foreign resident's Australian permanent establishment. This will further enhance Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's current broad foreign resident CGT tax base.

- To complement this change, the integrity of the CGT regime for foreign residents is strengthened by covering foreign residents' indirect holdings of Australian real property.

- Limiting the integrity measure to non-portfolio interests in entities where more than 50 per cent of the value of the assets of the entity is attributable to Australian real property will additionally carve out other foreign investors not investing in entities that are land rich.

Chapter 1
Marriage breakdown roll-over

Outline of chapter

1.1 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to extend the marriage breakdown capital gains tax (CGT) roll-over to assets transferred to a spouse or former spouse because of:

- a binding financial agreement under the *Family Law Act 1975* (Family Law Act) or a corresponding written agreement that is binding because of a corresponding foreign law;
- an arbitral award under the Family Law Act or a corresponding arbitral award under a corresponding state, territory or foreign law; or
- a written agreement that is binding because of a state, territory or foreign law relating to de facto marriage breakdowns and that, because of such a law, cannot be overridden by an order of a court except to avoid injustice.

1.2 These amendments ensure that a capital gain or capital loss that would otherwise be made is deferred until the transferee spouse or former spouse disposes of the CGT asset.

1.3 These amendments ensure that the CGT main residence exemption interacts more appropriately with the marriage breakdown roll-over by taking into account the way in which both the transferor and transferee spouses use the dwelling.

1.4 These amendments also ensure that marriage breakdown settlements do not give rise to CGT liabilities.

Context of amendments

1.5 In 2000, the Australian Government enacted new binding financial agreement provisions in the Family Law Act to encourage separating couples to settle their own financial affairs rather than involve the courts.

1.6 The binding financial agreement provisions allow financial agreements to be entered into before marriage, during marriage, or after the breakdown of a marriage. Financial agreements provide a capacity for spouses (and intending spouses) to decide themselves how financial matters should be dealt with if their marriage breaks down, without having to bear the expense of having such matters determined by courts in accordance with Part VIII of the Family Law Act.

1.7 Arbitral award provisions, inserted in the Family Law Act in 1991, allow property or financial disputes following the breakdown of a marriage to be arbitrated. Arbitration can be ordered by a court or can be privately arranged.

1.8 All Australian States and Territories except Victoria have provisions for written agreements for de facto marriage breakdowns that are similar to binding financial agreements under the Family Law Act. Western Australia also has arbitral awards for de facto marriage breakdowns corresponding to those under the Family Law Act.

1.9 Other countries may also have similar written agreements and arbitral awards relating to the breakdown of legal and de facto marriages.

1.10 Currently, the CGT roll-over on marriage breakdown is available where an asset is transferred to a spouse or former spouse because of:

- a court order or maintenance agreement under the Family Law Act or a corresponding foreign law; or
- a court order under a state, territory or foreign law relating to de facto marriage breakdowns.

1.11 The present lack of a similar CGT roll-over for binding financial agreements and arbitral awards inhibits their use. These amendments further encourage separating couples to settle their own affairs without involving the courts by removing potential CGT impediments.

1.12 The policy rationale for the CGT marriage breakdown roll-over (including as extended by these amendments) is that the transfer of assets occurs compulsorily or in the shadow of compulsion.

Summary of new law

1.13 Subdivision 126-A of the ITAA 1997 currently provides a CGT roll-over if a relevant CGT event happens because of a maintenance agreement made before 27 December 2000 or because of a court order.

1.14 The effect of the CGT roll-over is that:

- a capital gain or capital loss that would otherwise be made by the individual, company or trustee when the CGT asset is disposed of or created in another individual (the transferee spouse) is disregarded — the accrued capital gain or capital loss is deferred until the transferee spouse disposes of the CGT asset or creates the CGT asset in another entity; and
- for a disposal case, where the individual, company or trustee acquired an ownership interest in the dwelling before 20 September 1985, the transferee spouse is taken to have acquired it before that day.

1.15 These amendments extend the existing CGT roll-over to a relevant CGT event that happens because of:

- a binding financial agreement under the Family Law Act or a corresponding written agreement that is binding because of a corresponding foreign law;
- an arbitral award under the Family Law Act or a corresponding arbitral award under a corresponding state, territory or foreign law; or
- a written agreement that is binding because of a state, territory or foreign law relating to de facto marriage breakdowns and that, because of such a law, cannot be overridden by an order of a court except to avoid injustice.

1.16 These amendments also ensure that the CGT main residence exemption interacts more appropriately with the marriage breakdown roll-over by taking into account the way in which both the transferor and transferee spouses use the dwelling during their combined period of ownership when determining the transferee spouse's eligibility for the main residence exemption.

1.17 In addition, these amendments ensure that marriage breakdown settlements do not give rise to CGT liabilities.

Comparison of key features of new law and current law

New law	*Current law*
An automatic CGT roll-over applies to a relevant CGT event because of: • a court order under the Family Law Act or a corresponding foreign law; • a maintenance agreement approved by a court under section 87 of that Act or a corresponding agreement approved by a court under a corresponding foreign law; • a court order under a state, territory or foreign law relating to de facto marriage breakdowns; • a financial agreement made under the Family Law Act that is binding because of section 90G or a corresponding written agreement that is binding because of a corresponding foreign law; • an award made in an arbitration referred to in section 13H of that Act or a corresponding award made in an arbitration under a corresponding state, territory or foreign law; or • a written agreement that is binding because of a state, territory or foreign law relating to de facto marriage breakdowns and that, because of such a law, cannot be overridden by an order of a court except to avoid injustice.	An automatic CGT roll-over applies to a relevant CGT event because of: • a court order under the Family Law Act or a corresponding foreign law; • a maintenance agreement approved by a court under section 87 of that Act or a corresponding agreement approved by a court under a corresponding foreign law; or • a court order under a state, territory or foreign law relating to de facto marriage breakdowns. It does not extend to financial agreements, corresponding agreements or arbitral awards.
Where the transferor spouse acquired an ownership interest in a dwelling after 19 September 1985 and the marriage breakdown roll-over is	Where the transferor spouse acquired an ownership interest in a dwelling after 19 September 1985 and the marriage breakdown roll-over is

New law	*Current law*
available to the transferor spouse, the CGT main residence exemption rules take into account the way in which *both the transferor and transferee spouses* used the dwelling when determining the transferee spouse's eligibility for the main residence exemption.	available to the transferor spouse, the CGT main residence exemption rules take into account the way in which *only the transferee spouse* used the dwelling when determining the transferee spouse's eligibility for the main residence exemption.
Marriage breakdown settlements do not give rise to CGT liabilities.	Marriage breakdown settlements may technically give rise to CGT liabilities, as they result in the ending of an intangible asset.

Detailed explanation of new law

Marriage breakdown roll-over

1.18 Subdivision 126-A of the ITAA 1997 provides a CGT roll-over if a relevant CGT event happens involving an individual, a company or a trustee and the individual's spouse or former spouse because of:

- a court order under the Family Law Act or a corresponding foreign law;
- a maintenance agreement approved by a court under section 87 of that Act or a corresponding agreement approved by a court under a corresponding foreign law; or
- a court order under a state, territory or foreign law relating to de facto marriage breakdowns.

1.19 These amendments provide a CGT roll-over if a relevant CGT event happens involving an individual, a company or a trustee and the individual's spouse or former spouse because of something done under:

- a binding financial agreement under the Family Law Act or a corresponding written agreement that is binding because of a corresponding foreign law;
- an arbitral award under the Family Law Act or a corresponding arbitral award under a corresponding state territory or foreign law; or

- a written agreement that is binding because of a state, territory or foreign law relating to a de facto marriage breakdown and that, because of such a law, cannot be overridden by an order of a court except to avoid injustice.

[Schedule 1, items 3 and 7, paragraphs 126-5(1)(d) to (f) and 126-15(1)(d) to (1)(f)]

1.20 Under the income tax law, ***spouse*** includes a man and a woman who, although not legally married, live together on a genuine domestic basis as husband and wife. The CGT roll-over can only apply where the definition of spouse is met.

1.21 This amendment ensures that certain transfers of assets between spouses on the breakdown of a relationship does not give rise to a capital gain or capital loss. The roll-over is provided in these circumstances because the transfer of assets occurs compulsorily or in the shadow of compulsion.

Binding financial agreements and similar agreements

1.22 The Family Law Act allows financial agreements to be entered into before marriage (section 90B), during marriage (section 90C), or after the breakdown of a marriage (section 90D). Financial agreements provide a capacity for spouses (and intending spouses) to decide themselves how financial matters should be dealt with if their marriage breaks down, without having to bear the expense of having such matters determined by courts in accordance with Part VIII of the Family Law Act. Section 90G specifies the circumstances in which a financial agreement is binding on the parties to the agreement.

1.23 Property or financial disputes following the breakdown of a marriage can also be determined by arbitration (under section 13H of the Family Law Act).

1.24 The extended CGT roll-over is provided to transactions done under:

- a financial agreement that is binding on the parties to the agreement because of section 90G of the Family Law Act ***[Schedule 1, items 3 and 7, subparagraphs 126-5(1)(d)(i) and 126-15(1)(d)(i)]***; and

- an award made in an arbitration of a property or financial dispute under the Family Law Act ***[Schedule 1, items 3 and 7, subparagraphs 126-5(1)(e)(i) and 126-15(1)(e)(i)]***.

1.25 All Australian States and Territories except Victoria have laws for written agreements relating to de facto marriage breakdowns that are binding and cannot be overridden by an order of a court except to avoid injustice. Currently these are:

- a domestic relationship agreement or a termination agreement that complies with subsection 47(1) of the New South Wales *Property (Relationships) Act 1984*;
- a recognised agreement within the meaning of the Queensland *Property Law Act 1974*;
- a cohabitation agreement that is a certificated agreement within the meaning of the South Australian *De Facto Relationships Act 1986*;
- a personal relationship agreement or separation agreement that complies with subsection 62(1) of the Tasmanian *Relationships Act 2003*;
- a financial agreement that complies with subsection 205ZS(1) of the Western Australian *Family Court Act 1997*;
- a domestic relationship agreement or a termination agreement that complies with subsection 33(1) of the Australian Capital Territory's *Domestic Relationships Act 1994*; and
- a cohabitation agreement or a separation agreement that complies with subsection 45(2) of the Northern Territory's *De Facto Relationships Act*.

1.26 Western Australia also provides arbitral awards for de facto marriage breakdowns similar to those under the Commonwealth's Family Law Act. The extended CGT roll-over is provided to transactions done under such an award.

1.27 Other countries (including part of a foreign country, such as a state or province) may also have similar written agreements and arbitral awards relating to the breakdown of legal marriages and de facto relationships. The extended CGT roll-over is provided to transactions done under such agreements or awards. ***[Schedule 1, items 3 and 7, subparagraphs 126-5(1)(d)(ii) and (e)(ii), 126-15(1)(d)(ii) and 126-15(1)(e)(ii)]***

Conditions for the roll-over

1.28 The CGT roll-over will only apply to a financial agreement under the Family Law Act, a corresponding written agreement because of a corresponding foreign law or a written agreement relating to de facto marriage breakdowns if certain conditions are met. ***[Schedule 1, items 4 and 8, subsections 126-5(3A) and 126-15(5)]***

1.29 These conditions are:

- at the time of the trigger event, the spouses involved are separated and there is no reasonable likelihood of cohabitation being resumed; and
- the trigger event happened because of reasons directly connected with the marriage or de facto marriage breakdown.

[Schedule 1, item 9, subsection 126-25(1)]

1.30 The question of whether spouses have separated is to be determined in the same way as it is for the purposes of section 48 of the Family Law Act, as affected by sections 49 and 50 of that Act. ***[Schedule 1, item 9, subsection 126-25(2)]***

1.31 This does not introduce a requirement that the parties are separated for 12 months.

1.32 There may be situations where transfers would not be because of reasons directly connected with the breakdown of the marriage. This may be the case if, for example:

- the spouses had an agreement before the breakdown of the marriage or de facto marriage that the particular property was to be transferred between them for other reasons not directly related to the marriage breakdown; or
- the agreement provided for the transfer of non-specific property, the transfer does not occur for a considerable time (say, more than 12 months) after the agreement and factors are present that suggest the transfer was not directly connected to the marriage breakdown.

Consequences

1.33 The consequences of the marriage breakdown CGT roll-over are set out in existing subsections 126-5(5) to 126-5(7) for the disposal case and subsection 126-5(8) for the creation case. Where the relevant CGT event involves a company or trustee, additional consequences occur as set out in existing subsections 126-15(2) to 126-15(4). Broadly, the consequences of the marriage breakdown CGT roll-over are:

- a capital gain or capital loss that would otherwise be made by the individual, company or a trustee when the CGT asset is disposed of or created in another individual (transferee spouse) is disregarded — the accrued capital gain or capital loss is deferred until the transferee spouse disposes of the CGT asset or creates the CGT asset in another entity; and

- for a disposal case, where the individual, company or trustee acquired a CGT asset before 20 September 1985, the transferee spouse is taken to have acquired the asset before that day — that is, the pre-CGT status of the asset is preserved.

Main residence exemption

1.34 Where the transferor spouse acquired an ownership interest in a dwelling after 19 September 1985 and the marriage breakdown roll-over is available to the transferor spouse, the CGT main residence exemption rules take into account the way in which both the transferor and transferee spouses used the dwelling, during their combined period of ownership, when determining the transferee spouse's eligibility for the main residence exemption. ***[Schedule 1, items 2, 5 and 6, subsection 118-178(2), note 2 to subsection 126-5(5)]***

Example 1.1

Caroline (the transferor spouse) is the 100 per cent owner of a dwelling that she used only as a rental property for five years before transferring it to David (the transferee spouse). The transfer happens after the day of Royal Assent of this Bill and CGT roll-over applies. David uses the dwelling only as a main residence for five years before selling it.

David will be eligible for a 50 per cent main residence exemption having regard to how both Caroline and David used the dwelling.

Example 1.2

Peter (the transferor spouse) is the 100 per cent owner of a dwelling that he used as a rental property for three years then as a main residence for three years before transferring it to Susan (the transferee spouse). The transfer happens after the day of Royal Assent of this Bill and CGT roll-over applies. Susan uses the dwelling only as a rental property for six years before disposing of it.

Susan will be eligible for a 25 per cent main residence exemption having regard to how both Peter and Susan used the dwelling.

1.35 Where a dwelling that is used as a main residence from the time of purchase is later used to produce income and is transferred to the transferee spouse, the special rule for when a dwelling is first used to produce income applies (existing section 118-192 of the ITAA 1997) if that first income-producing use was after 20 August 1996. That is, the transferee spouse is taken to have acquired the ownership interest in the dwelling at the time it is first used to produce income for its market value at that time.

Example 1.3

George and Natalie are each 50 per cent owners of a dwelling that they used only as a rental property for two years before George transferred his 50 per cent interest to Natalie. The transfer happens after the day of Royal Assent of these amendments and CGT roll-over applies. Natalie uses the dwelling as her main residence for four years from the date of transfer until she sells it.

Natalie is entitled to a 66? per cent main residence exemption on the 50 per cent that she originally owned. She is entitled to a 66? per cent main residence exemption on the 50 per cent interest that was owned by George and transferred to her, having regard to how both Natalie and George used the dwelling.

Example 1.4

Harry (the transferor spouse) is the 100 per cent owner of a dwelling that he acquired for $100,000 in 1999 and used as a main residence for three years. In 2002, he decided to use the dwelling to produce income; it was valued at $150,000 at this time. He later transferred the dwelling to Anita (the transferee spouse). The transfer happens after the day of Royal Assent of this Bill and CGT roll-over applies.

Anita is taken to have acquired the ownership interest in the dwelling in 2002 for the market value at that time of $150,000.

1.36 The amendments do not prevent the operation of existing section 103-25 of the ITAA 1997 in relation to choices that may be available to the transferor spouse to treat a dwelling as their main residence under Subdivision 118-B during their ownership period — for example, under existing sections 118-145, 118-150 and 118-160.

1.37 Such choices are not required to be made by the transferor spouse where roll-over applies because the capital gain or capital loss is disregarded. However, there is nothing to prevent the transferor spouse making a choice — for example, as part of the negotiations with the transferee spouse and transferee spouse's advisers about the transfer of an ownership interest in a dwelling.

1.38 If there was a period when the transferor and transferee spouse had different main residences before they separated, they need to make a choice under section 118-170 to:

- treat one of the dwellings as the main residence of both of them for the period; or
- nominate the different dwellings as their main residences.

1.39 Relevant choices generally need to be made by the day the person lodges their income tax return for the income year in which the CGT event happens and are generally evidenced by the way the person prepares their return.

1.40 However, for the practical reasons of negotiating a property settlement, any choices the transferor spouse decides to make would generally be expected to be made before they transfer their ownership interest to the transferee spouse.

1.41 A signed statement could be provided by the transferor spouse to the transferee spouse in these circumstances as evidence of the making of a choice.

1.42 The Commissioner of Taxation has authority in appropriate cases to allow further time for a choice to be made after the time it is required to be made under the law.

1.43 Once a choice is made, it is binding and cannot be changed.

Example 1.5

At the time of negotiating their property settlement on the breakdown of their marriage in 2007, Calvin and Denise discuss with their advisers how to divide their joint assets.

In 1998, when she was single, Denise bought a townhouse which she lived in for three years. In 2001, Denise and Calvin rented a flat and started living together as husband and wife. At that time, Denise began renting out her townhouse. In 2003, after living together for two years in the flat, Denise and Calvin bought a house and moved in. Denise continued to rent out the townhouse.

In 2007, their relationship broke down. Denise and Calvin decided that Calvin would transfer his 50 per cent interest in the house to Denise (where she and their daughter would continue to live) and she would transfer the townhouse to Calvin (for him to live in) under a binding financial agreement.

Because the townhouse had been Denise's main residence, she could choose under section 118-145 to continue to treat it as such for up to six years of any period of absence.

In negotiating their binding financial agreement, Denise provided Calvin with a signed statement which indicated she had chosen to treat the townhouse as her main residence for the two years between the time she moved out and the time they bought the house together.

Calvin is taken to have acquired the townhouse for its market value in 2001 (under section 118-192) and will qualify for partial main residence exemption when he sells it. (The period from 1998 to 2001 is ignored from their combined period of ownership.)

The effect of Denise's choice is that the townhouse is exempt from CGT for the period between 2001 (when she moved out) and 2003 (when she and Calvin bought the house together). So when Calvin sells it, he will get exemption for the period from 2001 to 2003 and for the period he lived in it after the marriage broke down.

If Denise had not made the choice under section 118-145, Calvin would not get the exemption for the period from 2001 to 2003.

Marriage breakdown settlements

1.44 These amendments ensure a capital gain or capital loss that is made on a right ending (ie, on CGT event C2 happening to a right) is disregarded if certain conditions are met. This means that marriage breakdown settlements do not give rise to CGT liabilities.

1.45 The conditions are that:

- the capital gain or capital loss is made in relation to a right that directly relates to the breakdown of a marriage or de facto marriage;

- at the time of the trigger event, the spouses involved are separated and there is no reasonable likelihood of cohabitation being resumed; and

- the trigger event happened because of reasons directly connected with the marriage or de facto marriage breakdown.

[Schedule 1, item 1, subsection 118-75(1)]

1.46 There may be situations where transfers would not be because of reasons directly connected with the breakdown of the marriage. The question whether spouses have separated is to be determined in the same way as it is in the Family Law Act. ***[Schedule 1, item 1, subsection 118-75(2)]***

Application provisions

1.47 The amendments that relate to the marriage breakdown roll-over and the main residence exemption apply to CGT events that are trigger events for the purposes of Subdivision 126-A of the ITAA 1997 and that happen after the date of Royal Assent of this Bill.

1.48 The amendment that relates to marriage breakdown settlements applies to CGT events that happen after the date of Royal Assent of this Bill. ***[Schedule 1, item 10]***

Chapter 2
Consolidation

Outline of chapter

2.1 Schedule 2 to this Bill amends the consolidation provisions in the *Income Tax (Transitional Provisions) Act 1997* to ensure that the integrity provision that requires certain roll-overs to be ignored for tax cost setting purposes does not apply to a consolidated group or multiple entry consolidated group (MEC group) that forms after a demerger, provided certain conditions are satisfied. These amendments also clarify the operation of the integrity provision.

Context of amendments

2.2 When a group consolidates, the tax cost of a joining entity's assets are generally reset under Division 705 of the *Income Tax Assessment Act 1997* (ITAA 1997). However, as a transitional measure, the head company of the consolidated group could choose to retain the existing tax cost of assets held by some or all of the joining entities, provided certain requirements were satisfied (section 701-15 of the *Income Tax (Transitional Provisions) Act 1997*).

2.3 As the head company could apply the transitional measure on an entity by entity basis, opportunities arose for the tax cost of a joining entity's assets to be artificially increased by moving them between entities within the group prior to the group consolidating and claiming roll-over relief under Subdivision 126-B (capital gains tax (CGT) roll-over relief) or section 40-340 (balancing adjustment roll-over relief) of the ITAA 1997.

2.4 To prevent a head company from artificially increasing the tax cost of assets, section 701-35 of the *Income Tax (Transitional Provisions) Act 1997* requires a head company to ignore the effect of a roll-over under Subdivision 126-B or section 40-340 of the ITAA 1997 undertaken after 16 May 2002 and before the date the transitional group came into existence (which was generally 1 July 2004). Where section 701-35 applies, a head company is required to set the tax cost of a joining entity's assets as if the CGT event had not occurred.

2.5 The demerger provisions (Division 125 of the ITAA 1997) facilitate the demerging of entities by ensuring that tax considerations are not an impediment to restructuring a business. Prior to a demerger group undertaking a demerger, assets may be transferred between members of the group. Where this occurs, the affected entities may claim roll-over relief under Subdivision 126-B or section 40-340 of the ITAA 1997.

2.6 If this restructuring occurred after 16 May 2002 and a former member of the demerger group with a rolled-over asset subsequently became a member of a consolidation transitional group, the integrity rule in section 701-35 of the *Income Tax (Transitional Provisions) Act 1997* may apply to take away the benefits of the roll-over for consolidation tax cost setting purposes. It is inappropriate for the integrity rule to apply in these circumstances because the assets are transferred to facilitate the demerger rather than to artificially increase the tax cost of assets for consolidation purposes.

Summary of new law

2.7 The integrity provision that requires certain roll-overs to be ignored for consolidation tax cost setting purposes will not apply to a consolidated group or MEC group that forms after a demerger, provided that the company that received the rolled-over asset does not join the same consolidated group or MEC group as the company that transferred the asset.

2.8 These amendments also clarify the operation of the integrity provision.

Comparison of key features of new law and current law

New law	***Current law***
The integrity provision that requires certain roll-overs to be ignored for consolidation tax cost setting purposes will not apply to a consolidated group or MEC group that forms after a demerger, provided that the company that received the rolled-over asset does not join the same consolidated group or MEC group as the company that transferred the asset.	The integrity provision that requires certain roll-overs to be ignored for consolidation tax cost setting purposes will apply to a consolidated group or MEC group that forms after a demerger.

Detailed explanation of new law

2.9 In broad terms, section 701-35 of the *Income Tax (Transitional Provisions) Act 1997* will not apply where roll-over relief is claimed in respect of a restructure that happens to facilitate a demerger. That is, section 701-35 will not apply where:

- the act, transaction or event that gave rise to the CGT event for which there was a roll-over under Subdivision 126-B or section 40-340 of the ITAA 1997 happened before the demerger and in connection with the demerger;
- either the originating company or the recipient company ceased to be a member of the 'demerger group' (as defined in section 125-65 of the ITAA 1997) because of the demerger; and
- the recipient company and the originating company do not both join the same consolidation transitional group.

[Schedule 2, item 6, subsection 701-35(2A) of the Income Tax (Transitional Provisions) Act 1997]

2.10 Section 701-35 is intended to test whether the cost base or reduced cost base of an asset is different as a consequence of an act, transaction or event that gave rise to a CGT event that occurred prior to consolidation. In these circumstances, the effect of the act, transaction or event in relation to the CGT event is unwound for consolidation tax cost setting purposes.

2.11 These amendments modify the wording of section 701-35 to ensure that it operates as intended. ***[Schedule 2, items 1 to 5 and 7, subsections 701-35(1) and (3) of the Income Tax (Transitional Provisions) Act 1997]***

Application and transitional provisions

2.12 These amendments will apply from 1 July 2002, the commencement date of the consolidation regime. The amendments remove an unintended consequence and will be advantageous to taxpayers. ***[Schedule 2, item 8]***

Chapter 3
Simplified imputation system: imputation for New Zealand resident companies

Outline of chapter

3.1 Schedule 3 to this Bill amends the income tax law to ensure 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.

Context of amendments

3.2 Under the trans-Tasman imputation provisions in Division 220 of the *Income Tax Assessment Act 1997* (ITAA 1997), Australian franking credits flow through to an Australian shareholder who holds shares in a New Zealand company. The provisions apply only if the New Zealand company elects to maintain an Australian franking account reflecting Australian tax paid.

3.3 Generally, if a franked distribution is made from a New Zealand company to a shareholder that is an Australian company, the Australian company must include the distribution in its assessable income and is entitled to a tax offset. This causes a franking credit to arise in the Australian company's franking account (which can then be passed on to its shareholders).

3.4 The current law does not operate as intended if the franked distribution made from the New Zealand company is:

- non-assessable non-exempt income of the Australian company because it is paid out of attributed income;
- non-assessable non-exempt income of the Australian company because it is a non-portfolio dividend; or
- non-assessable non-exempt income of the Australian company because it is paid out of attributed foreign investment fund income.

3.5 In these circumstances, because the distribution is non-assessable non-exempt income, a franking credit does not arise in the Australian company's franking account (even though the New Zealand company has paid Australian tax and attached franking credits to the relevant distribution).

Summary of new law

3.6 A franking credit will arise in the franking account of an Australian company that receives a franked distribution from a New Zealand company that has elected into the Australian imputation system where:

- the distribution is non-assessable non-exempt income of the Australian company because it is paid out of attributed income;
- the distribution is non-assessable non-exempt income of the Australian company because it is a non-portfolio dividend; or
- the distribution is non-assessable non-exempt income of the Australian company because it is paid out of attributed foreign investment fund income.

Comparison of key features of new law and current law

New law	*Current law*
A franking credit will arise in the franking account of an Australian company that receives a franked distribution from a New Zealand company that has elected into the Australian imputation system where: • the distribution is non-assessable non-exempt income of the Australian company because it is paid out of attributed income; • the distribution is non-assessable non-exempt income of the Australian company because it is a non-portfolio dividend; or • the distribution is non-assessable non-exempt income of the Australian company because it is paid out of attributed foreign investment fund income.	A franking credit does not arise in the franking account of an Australian company that receives a franked distribution from a New Zealand company that has elected into the Australian imputation system where: • the distribution is non-assessable non-exempt income of the Australian company because it is paid out of attributed income; • the distribution is non-assessable non-exempt income of the Australian company because it is a non-portfolio dividend; or • the distribution is non-assessable non-exempt income of the Australian company because it is paid out of attributed foreign investment fund income.

Detailed explanation of new law

Franking credit arises for an Australian company

3.7 Section 220-350 will apply if a New Zealand company that has elected into the Australian imputation system makes a franked distribution to an Australian company where:

- the distribution is paid out of attributed income (and is therefore wholly or partly non-assessable non-exempt income under section 23AI of the *Income Tax Assessment Act 1936* (ITAA 1936));
- the distribution is a non-portfolio dividend (and is therefore non-assessable non-exempt income under section 23AJ of the ITAA 1936); or
- the distribution is paid out of attributed foreign investment fund income (and is therefore wholly or partly non-assessable non-exempt income under section 23AK of the ITAA 1936).

[Schedule 3, item 1, subsection 220-350(1)]

3.8 In these circumstances, a franking credit will arise in the Australian company's franking account on the day that the distribution is made. ***[Schedule 3, item 1, subsection 220-350(2)]***

3.9 If only part of the distribution is non-assessable non-exempt income, then a franking credit in relation to the distribution will arise under section 220-350 in relation to the part of the distribution that is non-assessable non-exempt income. Another franking credit will arise in respect of the remaining part of the distribution under item 3 in the table in subsection 205-15(1) due to the operation of subsection 207-90(2).

3.10 The amount of the franking credit that arises in the Australian company's franking account is:

- if the whole of the distribution is non-assessable non-exempt income, the amount of the franking credit attached to the distribution by the New Zealand company; or
- if only part of the distribution is non-assessable non-exempt income, so much of the amount of the franking credit attached to the distribution by the New Zealand company that is attributable to the non-assessable non-exempt part of the distribution.

[Schedule 3, item 1, subsection 220-350(3)]

Example 3.1

A New Zealand company that has elected into the Australian imputation system makes a distribution of $700 to an Australian company and attaches $300 of franking credits to that distribution.

The whole of the distribution is a non-portfolio dividend and is therefore non-assessable non-exempt income of the Australian company under section 23AJ of the ITAA 1936.

Section 220-350 will apply so that a franking credit of $300 will arise in the Australian company's franking account on the day that the distribution is made.

Example 3.2

A New Zealand company that has elected into the Australian imputation system makes a distribution of $700 to an Australian company and attaches $300 of franking credits to that distribution.

$420 of the distribution is paid out of attributed foreign investment fund income and is therefore non-assessable non-exempt income of the Australian company under section 23AK of the ITAA 1936.

Section 220-350 will apply so that a franking credit of $180 (ie, $300 $\times$ $420/$700) will arise in the Australian company's franking account on the day that the distribution is made. An additional franking credit of $120 will arise under item 3 in the table in subsection 205-15(1).

Australian company's conduit foreign income reduced

3.11 Under Division 802 of the ITAA 1997 an Australian company is able to make an unfranked distribution to its foreign owners free of dividend withholding tax to the extent that the distribution is declared to be conduit foreign income.

3.12 The amount of the Australian company's conduit foreign income is reduced by the franked part of a distribution (paragraph 802-30(4)(c)). Therefore, if a franking credit arises in the franking account of an Australian company under section 220-350, the company's conduit foreign income will be reduced by the franked part of a distribution.

3.13 The conduit foreign income provisions in Division 802 commenced, broadly, from 1 July 2005. Those provisions replaced the foreign dividend account provisions in Division 11A of Part III of the ITAA 1936. As section 220-350 of the ITAA 1997 applies from 1 April 2003, a consequential amendment is made to the former foreign dividend account provisions so that, if a franking credit arises in the franking account of an Australian company under section 220-350, the company's foreign dividend account will be debited by the franked part of the distribution. ***[Schedule 3, items 3 and 4, paragraphs 128TB(1)(e) and (3)(e) of the ITAA 1936]***

Application and transitional provisions

3.14 The amendments will apply from 1 April 2003 (ie, from the commencement of the trans-Tasman imputation measures). These amendments will ensure that the income tax law operates as intended and will benefit affected taxpayers. ***[Schedule 3, items 2 and 5]***

Chapter 4
Capital gains tax and foreign residents

Outline of chapter

4.1 Schedule 4 to this Bill inserts Division 855 and Subdivision 960-GP into the *Income Tax Assessment Act 1997* (ITAA 1997). This Schedule also repeals Division 136 of the ITAA 1997 and makes changes to various provisions of the *Income Tax Assessment Act 1936* (ITAA 1936). The changes narrow the range of assets on which a foreign resident will be liable to Australian capital gains tax (CGT) to Australian real property and the business assets (other than Australian real property) of a foreign resident's Australian permanent establishment. To complement this change, the integrity of the CGT regime is strengthened by including foreign resident indirect holdings of Australian real property. This ensures that capital gains and capital losses on a foreign resident's indirect, as well as direct, interests in the targeted assets are subject to Australia's CGT regime.

4.2 This chapter explains:

- the type of assets on which a foreign resident may be liable to Australian CGT; and
- the circumstances that must exist before an interest held by a foreign resident in those assets will come within Australia's CGT regime.

4.3 All legislative references are to the ITAA 1997 unless otherwise stated.

Context of amendments

4.4 This measure implements the Government's decision to reform the CGT treatment of foreign residents. The decision was announced in the Treasurer's Press Release No. 44 of 10 May 2005.

4.5 The CGT and foreign residents measure will further enhance Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's current broad foreign resident CGT tax base.

4.6 More generally, the amendments will encourage investment in Australia by aligning Australian law more consistently with international practice. This results in greater certainty and generally lower compliance costs for investors.

4.7 The amendments also align Australia's domestic law with the approach adopted in Australia's tax treaties. By aligning our law with Australia's treaty practice, Australia's approach to capital gains becomes more consistent. There will also be additional benefits from enabling Australia's tax treaties to be further aligned to the Organisation for Economic Co-operation and Development (OECD) standards. By bringing Australia more in line with international practice, this will relieve the pressure to compromise other aspects of Australia's preferred tax treaty practice. This will result in more favourable tax treaty outcomes for Australia.

4.8 The reforms better target and strengthen the application of CGT to foreign residents. This is achieved firstly by narrowing the range of assets on which a foreign resident is subject to Australian CGT to Australian real property, and the business assets of an Australian permanent establishment of a foreign resident (other than real property assets, which are covered under the real property rules). This aligns Australia's law more closely with OECD practice.

4.9 Secondly, the integrity of this narrower CGT tax base for foreign residents will be strengthened by applying CGT to non-portfolio interests in interposed entities, including foreign interposed entities, where more than 50 per cent of the value of the interposed entities' assets is attributable, whether directly, or indirectly through one or more other interposed entities, to Australian real property. This is consistent with Australia's tax treaty practice and the *OECD Model Tax Convention on Income and on Capital* (OECD Model).

4.10 The integrity part of the measure ensures foreign investors cannot avoid Australian CGT consequences by holding their Australian assets through interposed entities. For example, 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.

4.11 The Government's decision to narrow the range of assets on which a foreign resident will be subject to CGT to Australian real property and the business assets of a permanent establishment removes the need to consider providing CGT conduit taxation relief for foreign residents to the extent that the gain from the disposal of an interest in an Australian entity has an underlying foreign source. Consideration of such a regime was announced on 13 May 2003 by the Government in its response to the Board of Taxation's recommendations on the *Review of International Taxation Arrangements*. The proposed amendments represent a more comprehensive and consistent reform of Australia's foreign resident CGT regime.

Summary of new law

4.12 This measure makes two changes to the CGT regime as it applies to foreign residents:

- narrows the range of assets which may be subject to Australian CGT to Australian real property directly held by a foreign resident and any CGT asset (other than Australian real property) used by the foreign resident at any time in carrying on a business through a permanent establishment in Australia; and
- strengthens the application of CGT to foreign residents in Australia's domestic law by applying CGT to non-portfolio interests in interposed entities (including foreign interposed entities), where more than 50 per cent of the value of the interposed entities' assets is attributable, whether directly, or indirectly through one or more other interposed entities, to Australian real property.

Rights or options in relation to these assets will also be covered.

4.13 This measure will apply to relevant CGT events that occur on or after the date of Royal Assent of this Bill.

Comparison of key features of new law and current law

New Law	***Current Law***
A capital gain or capital loss that a foreign resident makes from a CGT event is disregarded for Australian tax purposes unless the event relates to an asset that is 'taxable Australian property'. Broadly, 'taxable Australian property' includes direct or indirect interests in Australian real property and the business assets of an Australian permanent establishment.	A foreign resident makes a capital gain or a capital loss if a CGT event occurs in relation to an asset that is an 'asset having the necessary connection with Australia'. Broadly, 'assets having the necessary connection with Australia' include land and buildings situated in Australia, shares or units in Australian resident companies or trusts, and the business assets of an Australian permanent establishment.
Disposals by foreign residents of non-portfolio interests in Australian entities where the value of the entity's assets is principally derived from Australian real property will be subject to Australian CGT.	Disposals by foreign residents of interests (excluding portfolio interests in public companies or unit trusts) in Australian resident entities only are subject to Australian CGT.
Disposals by foreign residents of non-portfolio interests in foreign entities where the value of the entity's assets is principally derived from Australian real property will be subject to Australian CGT.	No equivalent.
A capital gain or loss arising from a CGT event occurring in relation to an interest in an interposed entity is subject to Australian CGT if the interest in the entity passes both the principal asset test and the non-portfolio test.	No equivalent.

Detailed explanation of new law

What does this measure do?

4.14 As a result of this measure, the current range of assets on which foreign residents are subject to Australian CGT will be narrowed to certain interests in Australian real property assets, and the business assets of Australian branches of a foreign resident. Real property assets of a permanent establishment are included as part of taxable Australian real property assets.

4.15 This measure also introduces an integrity rule designed to ensure that Australia maintains its source country taxing rights over this narrower range of assets. This is achieved by making certain interests subject to Australian CGT where more than 50 per cent of the value of the interposed entities' assets is attributable, whether directly, or indirectly, through one or more other interposed entities, to Australian real property. ***[Schedule 4, item 2, sections 855-5 and 855-25]***

Who will this measure affect?

4.16 This measure affects all foreign residents who have either investments that derive their value from Australian real property, or are the business assets of an Australian permanent establishment of the foreign resident. As a consequence of this measure, foreign residents will be subject to Australia's CGT regime only where they make a capital gain or a capital loss as a result of a CGT event happening in relation to a CGT asset that is 'taxable Australian property'.

4.17 This measure also amends provisions that apply to taxpayers who cease to be, or become, Australian residents for tax purposes. This ensures that the policy intent of those provisions is maintained.

When does a foreign resident disregard a capital gain or capital loss?

4.18 A capital gain or capital loss from a CGT event is disregarded if made by a foreign resident, or the trustee of a foreign trust for CGT purposes (just before the CGT event happens), in relation to a CGT asset that is not taxable Australian property. ***[Schedule 4, item 2, subsection 855-10(1)]***

4.19 In relation to the business assets of an Australian permanent establishment, capital gains or capital losses from a CGT event may be reduced if the asset was not used in carrying on a business through the permanent establishment for part of a period (the period being from when the asset was acquired to when the CGT event happened). This provision replaces the repealed section 136-30. ***[Schedule 4, item 2, section 855-35]***

Which CGT events are relevant?

4.20 For a capital gain or capital loss to be disregarded, the CGT event must happen in relation to a CGT asset that is not taxable Australian property. A list of all relevant CGT events can be found in Division 104. In the case of a disposal of a CGT asset (CGT event A1) the CGT asset being disposed of is the one to which the CGT event happens. However, not all CGT events specifically refer to a CGT asset (eg, CGT event D1 dealing with the creation of contractual or other rights). In these cases,

the intention of the words 'in relation to a CGT asset' is that the relevant asset is the CGT asset to which the CGT event relates. The following are examples of how to determine the relevant CGT asset for particular CGT events. ***[Schedule 4, item 2, subsection 855-10(2)]***

Example 4.1

> The relevant asset in relation to the granting of an option (CGT event D2) or a lease (CGT events F1 to F4) is the asset over which the option or lease was granted.

Example 4.2

> The relevant asset in relation to the forfeiture of a deposit (CGT event H1) is the asset over which the deposit was forfeited.

Example 4.3

> The relevant asset in relation to the creation of contractual rights or other legal or equitable rights (CGT event D1) is the asset over which the contractual right was created.
>
> For example, where an easement over land in Australia is granted, the land is the subject of the creation of the rights in the easement. Therefore, the CGT event happens in relation to the land. Where a contract is entered into with the purchaser of a manufacturing business not to operate a similar business in the same town, the contract is entered into in relation to the conduct of the business, not in relation to the land that the business may own and is located on. The CGT event does not happen in relation to the land.

4.21 Applying Australian CGT only where the CGT event relates to taxable Australian property may affect the taxation consequences for foreign residents that have previously applied a roll-over under Subdivision 126-B (companies in the same wholly-owned group). The application of the rule in subsection 855-10(1) means CGT event J1 (where a company ceases to be a member of a wholly-owned group) will only apply to roll-over assets (that were the subject of a roll-over prior to the date of Royal Assent of this Bill) if the roll-over asset is taxable Australian property at the time of CGT event J1. If the roll-over under Subdivision 126-B occurs after the date of Royal Assent of this Bill then CGT event J1 applies consistent with existing practice as the roll-over asset is required to be taxable Australian property both before and after the original CGT event for which a roll-over is obtained. ***[Schedule 4, item 2, paragraph 855-10(1)(b)]***

What is taxable Australian property?

4.22 A foreign resident is subject to Australian CGT if the relevant asset in relation to a CGT event is taxable Australian property. With one exception, an asset can only be taxable Australian property if it consists of an interest in either real property or the business assets of an Australian permanent establishment of a foreign resident. Applying Australian CGT to foreign residents only on these assets means Australia is more closely aligned with accepted international practice.

4.23 The five items listed in section 855-15 as CGT assets that are taxable Australian property replace the current nine categories of assets that are collectively referred to as assets 'having the necessary connection with Australia'. This reflects the intent of this measure, in keeping with international practice, to narrow the range of assets on which foreign residents will be subject to Australian CGT, and to strengthen this narrower CGT tax base.

4.24 The circumstances in which an interest in real property or in the business assets of an Australian permanent establishment of a foreign resident will be taxable Australian property are set out in the first four items in the table in section 855-15. These items relate to circumstances where the foreign resident's CGT asset is:

- taxable Australian real property (see paragraphs 4.28 and 4.29);
- an indirect Australian real property interest (see paragraphs 4.30 and 4.31);
- a business asset of an Australian permanent establishment; or
- an option or a right over the above items.

[Schedule 4, item 2, section 855-15]

4.25 The only circumstance where a CGT asset may not meet the above requirements but is treated as taxable Australian property is where the taxpayer, on ceasing to be an Australian resident, makes an election under subsection 104-165(2) to disregard the capital gain or loss that would otherwise have resulted from CGT event I1 happening. CGT assets covered by CGT event I1 include all assets that are not taxable Australian property and any indirect Australian real property interests (see paragraph 4.104). Where a taxpayer makes this election, subsection 104-165(3) deems those assets that were the subject of the

election to be taxable Australian property. These assets are item 5 in the table in section 855-15. ***[Schedule 4, item 2, section 855-15]***

4.26 There are rules to ensure that CGT assets cannot be covered under more than one category of taxable Australian property. The business assets of an Australian permanent establishment do not include CGT assets that are also covered under item 1, 2 or 5 in that table. Similarly, if a CGT asset comes within both item 2 and item 5, then that asset is considered to be taxable Australian property as a result of item 5.

4.27 A similar tiebreaker is not required between a CGT asset that is an indirect Australian real property interest (item 2) and an option or a right to acquire that asset (item 4). An indirect interest in Australian real property can only occur where an actual holding exists, as opposed to a right or an option. Rights and options are specifically excluded from participation interests by subsection 855-25(2). This section modifies the application of sections 350 and 351 of the ITAA 1936 for the purposes of this measure by excluding 'entitled to acquire'.

What is taxable Australian real property?

4.28 Taxable Australian real property generally refers to real property, within the ordinary meaning of that term, that is situated in Australia ***[Schedule 4, item 2, paragraph 855-20(a)].*** Consistent with Australia's tax treaty practice, this meaning has been expanded to include a mining, quarrying or prospecting right (to the extent that the right is not real property), where the minerals, petroleum or quarry materials are situated in Australia ***[Schedule 4, item 2, paragraph 855-20(b)].*** Although where held directly, disposals of taxable Australian real property that are depreciating assets may be disregarded if section 118-24 applies.

4.29 Where an Australian tax treaty applies to a foreign resident in relation to a CGT event, in accordance with existing practice, the definition of real property should be read in conjunction with the definition as stated in the treaty. This outcome results from the application of section 4 of the *International Tax Agreements Act 1953*.

What is an indirect real property interest?

4.30 An indirect Australian real property interest concept has been introduced to strengthen Australia's foreign resident CGT tax 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. There are certain conditions to be met in applying the indirect Australian real property interest concept that are intended to reduce compliance costs for foreign residents, while maintaining

consistency with Australia's taxing rights under tax treaty practice. This lessens the distorting effect that differing CGT consequences can have on business structures chosen to invest into Australia.

4.31 An indirect Australian real property interest will only exist where a foreign resident has a membership interest in an entity and that interest passes two tests:

- the non-portfolio interest test (see paragraphs 4.32 to 4.38); and
- the principal asset test (see paragraph 4.39 to 4.58).

[Schedule 4, item 2, subsection 855-25(1)]

What is the non-portfolio interest test?

4.32 Under the tax treaty framework, Australia has a source country taxing right over the whole of a capital gain or capital loss made on Australian real property, including interests in entities whose assets consist principally of Australian real property, whether held directly or indirectly through a chain of interposed entities.

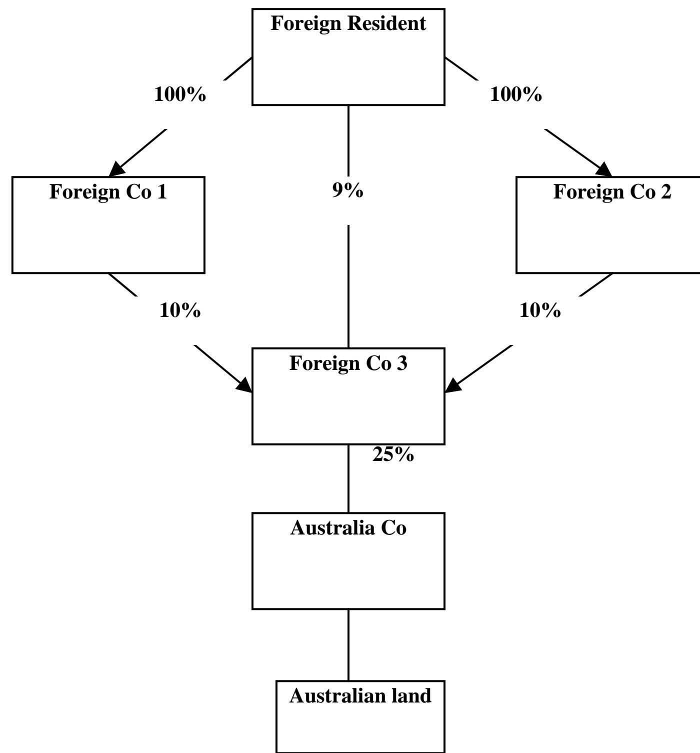
4.33 The non-portfolio interest test excludes membership interests of less than 10 per cent from being indirect Australian real property interests.

What does the non-portfolio interest test involve?

4.34 The non-portfolio interest test is consistent with the approach taken under the existing law whereby foreign residents with a 10 per cent or greater interest in a public company or unit trust are subject to Australian CGT.

4.35 A membership interest held by an entity (the holding entity) in another entity (the test entity) passes the non-portfolio test if the sum of the direct participation interests (paragraphs 4.45 to 4.50) held by the holding entity and its associates in the test entity is 10 per cent or more ***[Schedule 4, item 12, section 960-195].*** An associate takes the meaning under section 318 of the ITAA 1936, consistent with the existing use of the term in Australia's current CGT regime for foreign residents.

Example 4.4



> Foreign Resident directly holds a 9 per cent interest in Foreign Co 3. Foreign Resident's associates (Foreign Co 1 and Foreign Co 2) each hold a 10 per cent direct participation interest (see paragraphs 4.45 to 4.50). For the purposes of the non-portfolio test, Foreign Resident holds an associate-inclusive direct participation interest in Foreign Co 3 greater than 10 per cent.

4.36 The non-portfolio test for the purposes of the indirect Australian real property interest criteria is satisfied if the interest passes the test either:

- at that time (generally the time of the CGT event); or
- throughout a 12 month period that began no earlier than 24 months before that time and ended no later than that time.

[Schedule 4, item 2, paragraph 855-25(1)(a)]

4.37 The latter criteria has been included as an integrity measure and is designed to counter staggered sell downs. For example, if within the last year a foreign investor had a 100 per cent interest in an entity, and sold 91 per cent of that interest, then the remaining 9 per cent interest in

the entity would pass the non-portfolio test if sold within the relevant 24 month period. ***[Schedule 4, item 2, subparagraph 855-25(1)(a)(ii)]***

4.38 The two year period is shorter than the equivalent requirement used in the current regime where a foreign resident is liable to Australian CGT if they, together with any associates, held a non-portfolio interest in a publicly-listed company or unit trust at any time during the previous five years. This is consistent with the period applicable for the participation exemption for capital gains or capital losses in foreign active companies in Subdivision 768-G.

What is the principal asset test?

4.39 A membership interest must also pass the principal asset test to be an indirect Australian real property interest. ***[Schedule 4, item 2, paragraph 855-25(1)(b)]***

4.40 The principal asset test establishes the circumstances where a sufficient connection between a membership interest in an entity and underlying Australian real property exists.

4.41 A principal asset condition, whereby chains of entities are looked through to the underlying assets held by those entities, is consistent with more recent Australian tax treaties and the OECD Model provisions covering the *Alienation of real property*.

4.42 A membership interest held by a foreign resident (holding entity) in another entity (test entity) passes the principal asset test if more than 50 per cent of the value of the test entity's assets is attributable to taxable Australian real property. Paragraphs 4.59 to 4.78 discuss the operation of the principal asset test.

4.43 The concepts of a 'direct participation interest', 'indirect participation interest' and 'total participation interest' are used to determine whether a sufficient connection exists between a membership interest being tested under the principal asset test, and the underlying Australian real property.

4.44 These concepts are consistent with the calculations performed for determining the reduction in capital gains and capital losses arising from CGT events in relation to certain voting interests in active foreign companies (see Subdivision 768-G).

What is a direct participation interest?

4.45 A ***direct participation interest*** is the total interest that an entity directly holds in another entity. ***[Schedule 4, item 12, section 960-190]***

4.46 The level of participation interest is measured by reference to several factors. ***[Schedule 4, item 12, items 1 to 3 in the table in section 960-190]***

4.47 If the entity is a company within the meaning of Part X of the ITAA 1936, the direct participation interest in the company is a direct control interest within the meaning of section 350 of the ITAA 1936, excluding entitlements to acquire (already covered by the definition of 'taxable Australian property' in section 855-15, item 4) and subsections 350(6) and (7) of the ITAA 1936. ***[Schedule 4, items 2 and 12, paragraph 855-25(2)(a), item 1 in the table in section 960-190, subsection 960-190(2)]***

4.48 In applying the concept of a direct control interest in a company, any debt interest (eg, non-equity shares) are ignored.

4.49 If the entity is a trust within the meaning of Part X of the ITAA 1936, the direct participation interest in the trust is a direct control interest within the meaning of section 351 of the ITAA 1936, excluding entitlements to acquire (already covered by the definition of 'taxable Australian property' in section 855-15, item 4) and subsections 351(3) and (4) of the ITAA 1936. ***[Schedule 4, items 2 and 12, paragraph 855-25(2)(b), item 1 in the table in section 960-190, subsection 960-190(2)]***

4.50 Equivalent rules apply for partnerships, as if the partnership were a company. The assumptions for this purpose are based on section 820-865 of the thin capitalisation rules. ***[Schedule 4, item 12, item 3 in the table in section 960-190, subsection 960-190(3)]***

What is an indirect participation interest?

4.51 An ***indirect participation interest*** is the participation interest held by an entity in another entity through intermediate entities.

4.52 An entity's indirect participation interest in another entity is calculated by multiplying the following:

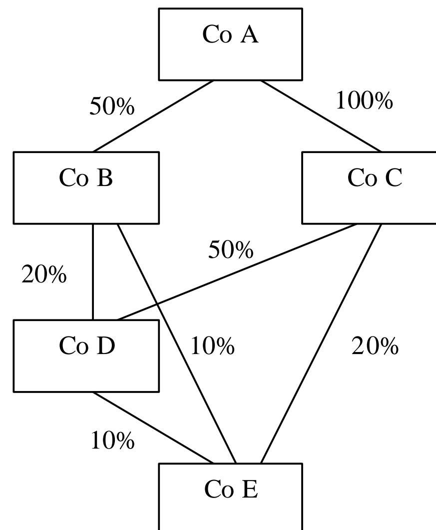
- the entity's direct participation interest in another entity (the 'intermediate entity') at that time;
- by the sum of:
  - the intermediate entity's direct participation interest (if any) in the interposed entity at that time; and
  - the intermediate entity's indirect participation interest (if any) in the interposed entity at that time (as worked out under one or more other applications of this section).

[Schedule 4, item 12, subsection 960-185(1)]

4.53 If the entity's indirect participation interest in the other entity is held through more than one chain of intermediaries, then the result of the calculation above for each separate chain is added together to determine the company's indirect participation interest. ***[Schedule 4, item 12, subsection 960-185(2)]***

4.54 In other words, where the entity has a direct participation interest in more than one intermediary entity, each of which may have a direct or indirect participation interest in the other entity, then the entity's indirect participation interest is to be worked out by tracing through each of those intermediary entities.

Example 4.5



The total participation interest that Co A has in Co E is the sum of Co A's direct and indirect participation interests in Co E. As Co A does not have any direct participation interest (DPI) in Co E, only its indirect participation interest (IPI) in Co E is relevant.

The indirect participation interest that Co A has in Co E is the sum of the indirect participation interest through Co B and the indirect participation interest through Co C.

The indirect participation interest that Co A has in Co E is:

$$\begin{aligned} IPI_{AE} &= \left[DPI_{AB} \times \left(DPI_{BE} + IPI_{BE}\right)\right] + \left[DPI_{AC} \times \left(DPI_{CE} + IPI_{CE}\right)\right] \\ &= \left[50\% \times \left(10\% + 2\%\right)\right] + \left[100\% \times \left(20\% + 5\%\right)\right] \\ &= 31\% \end{aligned}$$

The calculations of 'direct participation interest', 'indirect participation interest' and 'total participation interest' are used for the non-portfolio interest test and the principal asset test.

What is the total participation interest?

4.55 The 'total participation interest' concept is used for the purpose of the principal asset test. ***[Schedule 4, item 2, subsection 855-30(4)]***

4.56 An entity's total participation interest at a particular time in another entity is the sum of:

- the entity's direct participation interest in the other entity at that time; and
- the entity's indirect participation interest in the other entity at that time.

[Schedule 4, item 12, section 960-180]

4.57 The purpose of the total participation interest is twofold. Firstly, a foreign resident with a total participation interest of 10 per cent or more in underlying taxable Australian real property is placed in a situation closer to that of a foreign resident directly owning an interest of 10 per cent or more in taxable Australian property. This ensures that there is sufficient connection between the interest held by the foreign resident and the underlying taxable Australian real property.

4.58 Secondly, it ensures that only foreign residents with access to the necessary financial information come within this measure. This requirement becomes more important as the value of underlying assets is calculated for entities further down the chain of interposed entities, where it may be quite difficult to get access to sufficient information to be able to perform the calculation.

How does the principal asset test operate?

General

4.59 The principal asset test to used to determine when an entity's underlying value is principally derived from Australian real property

[Schedule 4, item 2, subsection 855-30(1)]. A membership interest held by a foreign resident (holding entity) in another entity (test entity) passes the principal asset test if the sum of market values of the test entity's assets that are taxable Australian real property exceeds the market value of the test entity's assets that are not attributable to taxable Australian real property ***[Schedule 4, item 2, subsection 855-30(2)].***

4.60 In order to determine whether the principal asset test is satisfied, the assets of the test entity are examined to determine to what extent the value of those assets is taxable Australian real property held directly, or attributable to taxable Australian real property through membership interests held in other entities. The assets of the test entity may comprise one, or a combination of:

- direct holdings of taxable Australian real property;
- direct holdings of non-taxable Australian real property; or
- assets that are membership interests in other entities.

4.61 Taxable Australian real property and non-taxable Australian real property assets that are not membership interest in other entities are valued at market value. ***[Schedule 4, item 2, subsection 855-30(2)]***

4.62 Where an asset of an entity is a membership interest in another entity, that asset is treated as two assets — taxable Australian real property and non-taxable Australian real property, which are valued at market value. This applies only if the other entity is tested — if not tested, the membership interest is treated as non-taxable Australian real property (see paragraph 4.67). ***[Schedule 4, item 2, subsections 855-30(3) and (4)]***

4.63 An integrity rule ensures that the value of assets acquired for a purpose (other than an incidental purpose) that includes ensuring that the principal asset test would not be passed are to be disregarded for the purposes of the principal asset calculation (see paragraphs 4.84 to 4.86). ***[Schedule 4, item 2, subsection 855-30(5)]***

Details

How are assets held directly treated?

4.64 Taxable Australian real property and non-taxable Australian real property assets directly held by the test entity are valued at market value ***[Schedule 4, item 2, subsection 855-30(2)].*** Note, however, special rules apply to assets that are membership interests. Paragraphs 4.79 to 4.86 discuss market valuation requirements.

How are membership interests treated?

4.65 Where an asset of the first entity includes a membership interest in another entity, that asset is treated as if it were instead the following two assets:

- an asset that is taxable Australian real property; and
- an asset that is not taxable Australian real property.

[Schedule 4, item 2, subsection 855-30(3)]

4.66 Once the membership interest is treated as if it were instead two separate assets, the next step is to determine the market value of the taxable Australian real property asset and non-taxable Australian real property asset components. ***[Schedule 4, item 2, subsection 855-30(4)]***

4.67 Where the first entity holds a direct participation interest in the other entity of less than 10 per cent, or the holding entity (the entity applying the principal asset test) holds a total participation interest in the other entity of less than 10 per cent, then the value of the taxable Australian real property asset is zero and the value of the non-taxable Australian real property asset is equal to the market value of the membership interest. ***[Schedule 4, item 2, item 1 in the table in subsection 855-30(4)]***

4.68 Effectively, this means that there is no requirement to trace through such membership interests as the value of the membership interest for the purposes of the principal asset test has been determined as a non-taxable Australian real property asset.

4.69 On the other hand, where the first entity holds a direct participation interest in the other entity of at least 10 per cent *and* the holding entity holds a total participation interest in the other entity of at least 10 per cent, there are sufficient interests held in the other entity to trace through the other entity. The market value of the taxable Australian real property and non-taxable Australian real property assets is based on the market values of the assets of the other entity. ***[Schedule 4, item 2, item 2 in the table in subsection 855-30(4)]***

4.70 The value of the membership interest that an entity (first entity) holds in another entity (the other entity) that is taxable Australian real property is calculated by *multiplying* the sum of the values of the assets of the other entity that are taxable Australian real property *by* the first entity's direct participation interest in the other entity. Where the assets of the other entity include membership interests in a third entity, those membership interests will also be treated as two separate assets (taxable

Australian real property and non-taxable Australian real property assets). Separate valuation rules apply to those assets depending on the interest levels held in that third entity. ***[Schedule 4, item 2, item 2 in the table in subsection 855-30(4)]***

4.71 Similarly, the value of the membership interest that an entity (first entity) holds in another entity (the other entity) that is not taxable Australian real property is calculated by *multiplying* the sum of the values of the assets of the other entity that are not taxable Australian real property *by* the first entity's direct participation interest in the other entity. Where the assets of the other entity include membership interests in a third entity, those membership interests will also be treated as two separate assets (taxable Australian real property and non-taxable Australian real property assets). Separate valuation rules apply to those assets depending on the interest levels held in that third entity. ***[Schedule 4, item 2, item 2 in the table in subsection 855-30(4)]***

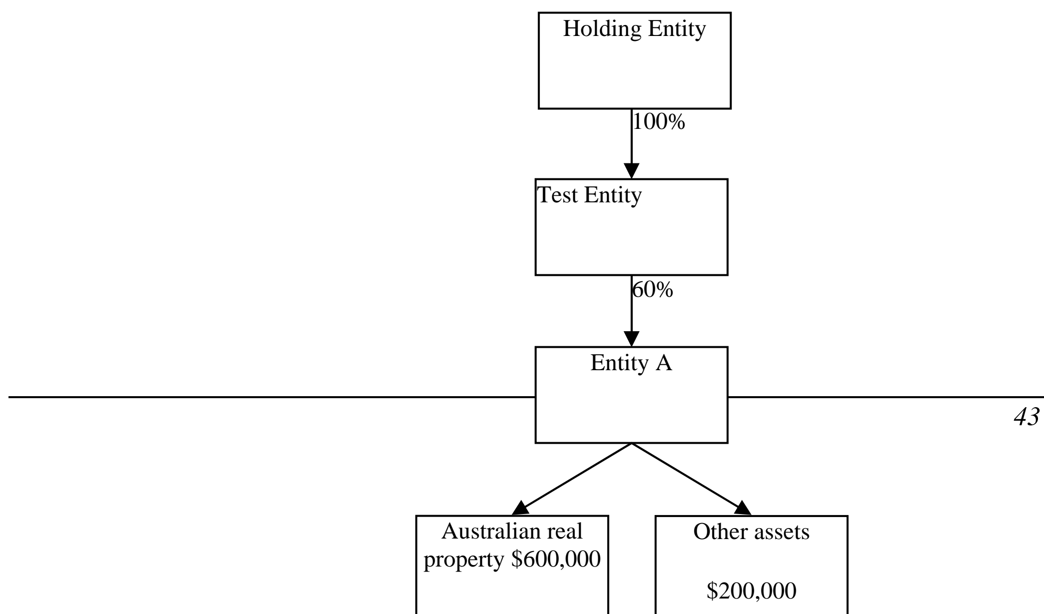
4.72 Therefore, in practice, the calculations would be performed from the lowest level in a chain of entities where it has been identified that there are no assets that are membership interests to look through. The value of the assets from the lowest entity level would then be brought up to each higher tier entity through the membership interests in that chain of entities, and so on until the test entity level is reached.

Totalling assets directly held and assets held through membership interests

4.73 The total value of the taxable Australian assets and non-taxable Australian assets held by the test entity are then compared to determine if more than 50 per cent of the value of the test entity's assets is attributable to taxable Australian real property, held directly by the test entity, or indirectly through membership interests in other entities.

4.74 Example 4.6 illustrates this approach.

Example 4.6: Disposal of Test Entity



- DPI_{HT} is the direct participation interest (DPI) of Holding Entity in Test Entity;
- DPI_{TA} is the direct participation interest of Test Entity in Entity A;
- TARP is taxable Australian real property;
- Non-TARP is non-taxable Australian real property;
- Test Entity holds no assets other than a membership interest in Entity A;
- Entity A has liabilities of $100,000.

Principal asset test

Test Entity's direct participation interest in Entity A is 60%. Holding Entity's total participation interest in Entity A is also 60% ($DPI_{HT} \times DPI_{TA} = 100\% \times 60\%$).

As item 2 in the table in subsection 855-30(4) applies, the value of the asset that is the membership interest in Entity A (DPI_{TA}) is calculated as TARP and non-TARP assets.

$$\begin{aligned} DPI_{TA}\ \text{TARP} &= 60\% \times \$600,000 \\ &= \$360,000 \\ DPI_{TA}\ \text{non-TARP} &= 60\% \times \$200,000 \\ &= \$120,000 \\ \text{Test Entity assets that are TARP} &= \$360,000 / (\$360,000 + \$120,000) \\ &= 75\% \end{aligned}$$

Holding Entity's membership interest in Test Entity passes the principal asset test since more than 50 per cent of the value of Test Entity's assets is attributable to taxable Australian real property.

4.75 The condition of a direct participation interest of less than 10 per cent is consistent with the non-portfolio test applied to the membership interest held by the holding entity in the test entity. If a foreign resident disposed of a membership interest in another entity of less than 10 per cent, that interest would not come within this measure. In

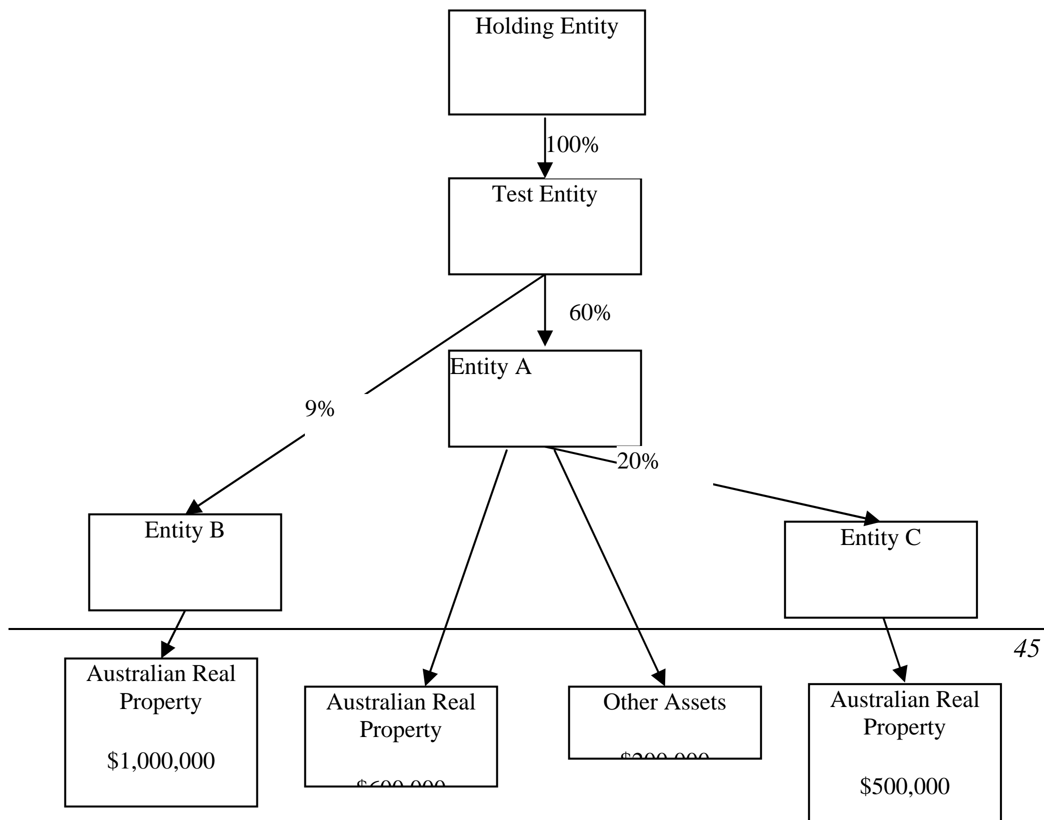
such cases it is therefore appropriate that the membership interest is not required to be looked through further, and is valued for the purposes of the principal asset test as a non-taxable Australian real property asset. ***[Schedule 4, item 2, item 1 in the table in subsection 855-30(4)]***

4.76 Similarly, the condition that the foreign resident (holding entity) who is the subject of this measure must have a total participation interest in an entity of 10 per cent or more recognises that there are sufficient interests held in the other entity to trace through the other entity. Also, a foreign resident is placed in a situation similar to that of either owning Australian real property directly or indirectly as, in either case, an interest of less than 10 per cent does not come within this measure. ***[Schedule 4, item 2, item 1 in the table in subsection 855-30(4)]***

4.77 This approach is consistent with Australia's treaty practice whereby source country taxing rights are provided over gains derived from the alienation of interests in entities where the value of the entity's assets, whether they are held directly or indirectly (including through chains of interposed entities) are principally attributable to real property in the source country. This is also consistent with the *Alienation of property* Article in the OECD Model, which provides that a country may exert a source country taxing right where more than 50 per cent of the value of an interest is derived directly or indirectly from real property in that country.

4.78 Example 4.7 is a comprehensive example where the effect of direct and total participation interest on the principal asset test is illustrated.

Example 4.7: Disposal of Test Entity



- DPI_{HT} is the direct participation interest of Holding Entity in Test Entity;
- DPI_{TA} is the direct participation interest of Test Entity in Entity A;
- TARP is taxable Australian real property;
- Non-TARP is non-taxable Australian real property;
- DPI_{TB} is the direct participation interest of Test Entity in Entity B;
- DPI_{AC} is the direct participation interest of Entity A in Entity C;
- TPI_{HT} is the total participation interest of Holding Entity in Test Entity;
- TPI_{HB} is the total participation interest of Holding Entity in Entity B;
- TPI_{HC} is the total participation interest of Holding Entity in Entity C;
- Test Entity holds no assets other than membership interests in Entity A and Entity B;
- Entity A holds an asset that is a membership interest in Entity C, as well as Australian real property ($600,000) and non-real property assets ($200,000);
- Entity B holds Australian real property with a market value of $1,000,000, and has liabilities of $100,000.

Principal asset test

The membership interest held by Test Entity in Entity A is a DPI of 60%. The TPI_{HA} is also:

60% ($DPI_{HT} \times DPI_{TA} = 100\% \times 60\%$)

The membership interest held by Test Entity in Entity B is a DPI of 9%. The TPI_{HB} is also:

9% ($DPI_{HT} \times DPI_{TB} = 100\% \times 9\%$)

The membership interest held by Entity A in Entity C is a DPI of 20%. The TPI_{HC} is:

12% ($DPI_{HT} \times DPI_{TA} \times DPI_{AC} = 100\% \times 60\% \times 20\%$)

Item 1 in the table in subsection 855-30(4) applies to the membership interest held by Test Entity in Entity B. The membership interest is

treated as only a non-taxable Australian real property asset equal to the market value of the membership interest. Entity B has net assets of $900,000, so Test Entity's membership interest in Entity B has a market value of $81,000 ($DPI_{TB} \times$ $900,000)

As item 2 in the table in subsection 855-30(4) applies for membership interests DPI_{TA} and DPI_{AC}, the value of the assets that are the membership interests in Entity A (DPI_{TA}) and Entity C (DPI_{AC}) are calculated as taxable Australian real property and non-taxable Australian real property assets.

<u>For Entity A</u>

Membership interest in Entity C = TARP and non-TARP assets:

$$\begin{aligned} \text{TARP} &= DPI_{AC} \times \$500,000 \\ &= 20\% \times \$500,000 \\ &= \$100,000 \end{aligned}$$

$$\begin{aligned} \text{non-TARP} &= DPI_{AC} \times \$0 \\ &= \$0 \end{aligned}$$

Entity A's assets that are TARP = $700,000 ($100,000 + $600,000)

<u>For Test Entity</u>

Membership interest in Entity B = non-TARP asset = $81,000

Membership interest in Entity A = TARP and non-taxable Australian real property assets

$$\begin{aligned} \text{TARP} &= DPI_{TA} \times \$700,000 \\ &= 60\% \times \$700,000 \\ &= \$420,000 \end{aligned}$$

$$\begin{aligned} \text{non-TARP} &= DPI_{TA} \times \$200,000 \\ &= 60\% \times \$200,000 \\ &= \$120,000 \end{aligned}$$

$$\text{Test Entity assets that are TARP} = \$420,000$$

$$\text{Test Entity assets that are non-TARP} = \$201,000\ (\$81,000 + \$120,000)$$

Holding Entity's membership interest in Test Entity passes the principal asset test since more then 50 per cent of the value of Test Entity's assets is attributable to taxable Australian real property.

How should assets be valued?

4.79 Assets should be measured at fair market value. The 'market value' is the amount that a willing purchaser, acting at arm's length to the seller, would pay for the asset.

4.80 There may be situations where market valuations cannot be obtained due to lack of access to information or insufficient control to demand the production of market valuation.

4.81 It would be expected that an entity would do all it can to arrive at a market valuation. If an entity is not required to prepare financial statements or it has not prepared financial statements then a market valuation would be required.

4.82 When a taxpayer cannot get access to information, or the taxpayer does not have sufficient control to demand that a market valuation be undertaken, the taxpayer may use the value in the audited accounts of the entity only when the asset value is determined under the revaluation method (ie, the fair value of the asset). These accounts would be expected to be prepared in accordance with the Australian equivalents to the International Accounting Standards. Asset values determined under the cost method do not represent an accurate value for the real property and may result in distortions in the calculation of whether the principal asset test is met.

4.83 Where an entity, the subject of the principal asset test, has no assets that are membership interests to look through, it may not be necessary to value each of its assets. Rather, the market value of the total assets as a whole might be ascertained by reference to the market price of shares in an entity. In the simple case where the total market value of all the shares in a company is $300, and the company has $100 of liabilities, the market value of the total assets of the entity will then be $300 (market value of the entity) plus $100 (liabilities). If the market value of taxable Australian real property assets of the entity is $50, then the value of non-taxable Australian real property assets of the entity would be the balance of $350.

What assets are included in the calculation?

4.84 An integrity measure has been included to ensure that the assets of the entities being tested are not inappropriately inflated by the injection of liquid assets at the testing time. In working out whether the value of the interest being tested is derived from taxable Australian real property, the market value of any asset acquired by an entity is disregarded if the acquisition was done for a purpose, other than an incidental purpose, that

includes ensuring that the principal asset test was not passed. ***[Schedule 4, item 2, subsection 855-30(5)]***

4.85 If total assets are inflated by injecting assets that are not taxable Australian real property, taxable Australian real property will represent a smaller proportion of total assets. It is therefore necessary to ensure that the assets being tested for the purposes of the principal asset test are representative of the assets held prior to the testing time.

4.86 The integrity rule excludes the injected assets from being non-taxable Australian real property assets for the purposes of the test. The non-taxable Australian real property assets will consequently be taken to be those that existed before the injection took place. For example, assets injected through a business restructure, intra-corporate loans or other such method will be excluded if the restructuring, loan or other action was taken for a purpose of ensuring that the principal asset test was not passed. ***[Schedule 4, item 2, subsection 855-30(5)]***

How will roll-overs operate?

Roll-overs under Subdivision 126-B

4.87 Roll-overs of taxable Australian property between an Australian resident and a foreign resident or between two foreign residents will continue to be available as a result of amendments made by this measure.

Scrip for scrip roll-overs

4.88 Scrip for scrip roll-overs will generally be permitted if the replacement interest is itself taxable Australian property. This replaces the existing requirement that the replacement entity is an Australian resident or a resident trust for CGT purposes. Whether or not a subsequent capital gain or capital loss that arises in relation to that replacement interest can be disregarded for Australian tax purposes is determined by applying the general principal in subsection 855-10(1) to the CGT events occurring in relation to that asset. ***[Schedule 4, item 59, subsection 124-795(1)]***

Roll-overs to a company

4.89 In certain circumstances where the roll-over involves the disposal or creation of an asset by an individual, trust or partners to a wholly-owned company, there is an existing requirement that each asset must be taxable Australian property at the time of the trigger event. This requirement applies to roll-overs mentioned in Division 122, except those from a resident individual, trust, or partners to a resident wholly-owned company. Similarly, there will also be a requirement in Subdivision

124-N (dealing with trust restructures) that where the transferee is a foreign resident, the roll-over will only be available if the CGT asset is taxable Australian property just after it is disposed of to the transferee under the trust restructure. This replaces the existing requirement that the transferee company be an Australian resident, ensuring only those assets that are taxable Australian property in the hands of the transferee can be rolled-over. ***[Schedule 4, item 64, subsection 124-875(6)]***

4.90 For roll-overs under Division 122 that must satisfy the existing requirement that each asset must be taxable Australian property at the time of the trigger event, a further condition must now also be satisfied. This additional condition is that the interest in the recipient company received as a result of the roll-over must also be taxable Australian property just after that time. ***[Schedule 4, items 41 to 44, subsections 122-25(6) and (7), subsections 122-135(6) and (7)]***

4.91 The additional condition is an integrity provision that prevents the immediate disposal of interests in the company without there being any Australian CGT consequences. However, being an indirect real property interest, whether any subsequent disposal of that interest is subject to Australian CGT will depend on whether the interest in the company at the time of the CGT event passes the principal asset test (and the non-portfolio test) at that time.

4.92 The conditions permitting roll-overs from a resident individual, trust, or partners to a resident wholly-owned company remain unaffected by these amendments as they are not limited by the status of the assets being transferred. ***[Schedule 4, item 41, paragraph 122-25(6)(a)]***

General

4.93 For those roll-overs that currently require a foreign resident's original interest (be they shares, units, options or rights) to be taxable Australian property, an additional condition will also generally apply to require that the new shares, units, options or rights be taxable Australian property. The new interests need only be taxable Australian property at the time they are issued or just after the completion time of the relevant event. This is an integrity measure that ensures the replacement asset has similar Australian tax outcomes to the original asset. Any subsequent capital gain or capital loss from a CGT event in relation to the replacement asset will be subject to the general principal in section 855-10 to determine if it is to be disregarded for Australian tax purposes. ***[Schedule 4, items 48 to 53, 55, 56 and 58 to 60, subparagraphs 124-240(f)(ii) and 124-245(e)(ii), paragraphs 124-295(7)(b), 124-300(7)(b), 124-365(4)(b), 124-375(4)(b), 124-450(4)(b) and 124-460(4)(b), subparagraph 124-520(1)(e)(ii), subsection 124-795(1) and note to subsection 124-795(1)]***

How does this measure apply to a permanent establishment in Australia of a foreign resident?

4.94 CGT events that occur in relation to the assets of an Australian permanent establishment of a foreign resident are subject to Australian CGT under subitem 3(a) in the table in section 855-15. This subitem covers the direct disposal of assets that have been used by the foreign resident at any time in carrying on a business through a permanent establishment in Australia. ***[Schedule 4, item 2, subitem 3(a) in the table in section 855-15]***

4.95 Where the business assets of an Australian permanent establishment include either taxable Australian real property, indirect Australian real property interests or relate to assets that are covered by a choice made by a person ceasing to be a resident of Australia (subsection 104-165(3)), then those assets are instead treated as taxable Australian property under those items, rather than as business assets of the Australian permanent establishment. ***[Schedule 4, item 2, subitem 3(b) in the table in section 855-15]***

4.96 For the purposes of this measure, a 'permanent establishment' takes the meaning in section 23AH of the ITAA 1936. Therefore, where a tax treaty applies, the term takes its meaning from the definition in the relevant tax treaty. Where no tax treaty applies, the relevant definition of permanent establishment is set out in subsection 6(1) of the ITAA 1936. ***[Schedule 4, item 2, subitem 3(a) in the table in section 855-15]***

4.97 Consistent with the operation of the current CGT regime, a capital gain or capital loss from the disposal of an asset used by a foreign resident in carrying on a business or trade at, or through, a permanent establishment in Australia is determined by reference to the period of such use. This treatment will apply only to an asset that is covered by item 3 in the table in section 855-15 (which specifically excludes item 1, 2 or 5 in that table).

4.98 A capital gain or capital loss on the disposal of an asset referred to in item 3 in the table in section 855-15 is proportionately reduced if the foreign resident used the asset in carrying on a trade or business through a permanent establishment in Australia for only part of the relevant period. ***[Schedule 4, item 2, section 855-35]***

Application and transitional provisions

4.99 Where a taxpayer, prior to the date of Royal Assent for this Bill, had made a choice upon ceasing to be an Australian resident under subsection 104-165(2) to disregard the capital gain or capital loss on assets covered by CGT event I1, then the effect of that choice will remain

in force. That is, assets that were taken to have the necessary connection with Australia will now be taxable Australian property until one of the two events referred to in subsection 104-165(3) occurs. This again ensures that gains accrued while the owner was a resident of Australia cannot be avoided by the owner acquiring foreign resident status. ***[Schedule 4, item 109, section 104-165 of the Income Tax (Transitional Provisions) Act 1997]***

4.100 This Bill also moves to the *Income Tax (Transitional Provisions) Act 1997* a provision (section 104-166) that relates to a further exception for CGT assets that are covered by CGT event I1. This exception concerns individuals who have been Australian residents less than five years of the preceding 10 years. That exception (subsection 104-165(1)) was repealed and replaced with the exemption for temporary residents measure (Schedule 1 to the *Tax Laws Amendment (2006 Measures No. 1) Act 2006*). However, section 104-166 ensures that Australian residents who were in Australia at the time of Royal Assent of the *Tax Laws Amendment (2006 Measures No. 1) Act 2006* will still be able to take advantage of it for up to five years, but only on one occasion. ***[Schedule 4, item 8, note to section 104-165; item 9; item 109, section 104-166 of the Income Tax (Transitional Provisions) Act 1997]***

4.101 Schedule 4 applies to CGT events occurring on or after Royal Assent of this Bill. ***[Schedule 4, item 111]***

Consequential amendments

What happens on ceasing to be a resident?

4.102 Amendments made by this measure maintain the existing policy for taxpayers that cease to be residents of Australia.

4.103 Under the existing law, when a taxpayer ceases to be a resident of Australia there is deemed to have been a disposal of all the assets owned by the taxpayer at the time that the taxpayer ceases to be a resident (other than those assets continuing to have the necessary connection with Australia or assets acquired before 20 September 1985). These requirements ensure that tax on gains that accrued while the owner was a resident of Australia, in respect of assets other than those that remain taxable for a foreign resident, cannot be avoided by the owner acquiring foreign resident status.

4.104 To ensure that this policy is maintained, a CGT asset that is an indirect real property interest (item 2 in the table in section 855-10) is not included in the limited list of taxable Australian property assets and

consequently CGT event I1 or I2 will apply to these interests. ***[Schedule 4, items 3 and 10, subsections 104-160(3) and 104-170(3)]***

4.105 These interests are instead considered to be assets that are taxable Australian property. This is because an indirect real property interest may fall in and out of Australia's CGT regime over time (due to the non-portfolio and principal asset tests). A former resident could avoid any Australian tax liability on a gain accrued up until the time of the residency change if the indirect real property interest was subsequently disposed of when it became non-taxable Australian property.

4.106 Consistent with the treatment of assets that are not taxable Australian property, the cost base and the reduced cost base of the indirect real property interest is its market value at the time of the residency change. However, this condition does not apply in those circumstances where the capital gain or loss is disregarded because it relates to either:

- an asset acquired before 20 September 1985;
- a qualifying share or right, not covered by an election in section 139E of the ITAA 1936, where the cessation time for that right or shares has not yet occurred; or
- for individual taxpayers, an election was made under subsection 104-165(2) to disregard the capital gain or capital loss resulting from the application of CGT event I1.

[Schedule 4, items 4 and 11, subsections 104-160(4A) and (4B) and 104-170(4A) and (4B)]

4.107 The effect of the election is that an asset subject to the election will be treated as a taxable Australian property asset until the earlier of:

- the time of a CGT event occurring in relation to that asset where the taxpayer ceases to own that asset; or
- the time immediately after the taxpayer again becomes a resident.

4.108 Capital gains or capital losses made over the period during which the taxpayer was not a resident would therefore be included in capital gain and capital loss provisions at the time of disposal of the asset. This is currently the case for assets subject to this election.

4.109 An additional condition to paragraph 104-165(3)(a) has been added to ensure that only where the CGT event involves ceasing to own the asset will the asset no longer be considered to be taxable Australian

property. ***[Schedule 4, items 5 and 7, note 2 to subsection 104-160(6) and paragraph 104-165(3)(a)]***

What happens on becoming an Australian resident?

4.110 Amendments made by this measure maintain the existing policy for those taxpayers that are becoming an Australian resident for taxation purposes. The amendments made by this Bill involve moving the relevant provisions from Division 136 to Division 855 and replacing existing references to 'having the necessary connection with Australia' with 'that is taxable Australian property'. These amendments apply to individuals or companies that become Australian residents, to a trust that becomes a resident trust and to a controlled foreign company that becomes an Australian resident. ***[Schedule 4, item 2, sections 855-45, 855-50 and 855-55]***

4.111 A consequence of narrowing the range of assets considered to be taxable Australian property for foreign residents, is that those taxpayers becoming Australian residents now acquire a greater range of assets at the time of becoming an Australian resident for CGT purposes. Assets to which this applies are those assets that would not be taxable Australian property if held by a foreign resident.

4.112 Those assets deemed to have been acquired on becoming a resident will be valued in line with existing practice. The first element of the cost base, or reduced cost base, is the market value of the relevant asset at the time the foreign resident becomes an Australian resident. ***[Schedule 4, item 2, subsections 855-45(2) and (3), 855-50(2) and (3), 855-55(2) and (4)]***

What about the managed fund provisions?

4.113 Amendments made by this Bill move a specific treatment for capital gains and capital losses made by foreign residents from interests in, or through interests in, fixed trusts from Subdivision 768-H into Division 855. The general operation of the CGT and foreign resident rules will ensure that a capital gain or a capital loss on an interest in a fixed trust made by a foreign resident is disregarded if that interest is not taxable Australian property. The provisions specifically dealing with the distribution of capital gains to foreign beneficiaries will continue to operate. ***[Schedule 4, items 2, 29 and 40, section 855-40, item in the table headed 'foreign residents' in section 12-5, subsection 121-30(2); Schedule 4, item 87]***

Capital gains and capital losses on interests in active foreign companies

4.114 Amendments to the participation exemption rules in Subdivision 768-G ensure those rules continue to operate as intended by applying only to Australian companies and their controlled foreign

companies ***[Schedule 4, item 84, subsection 768-505(1)].*** A further amendment results from changing the references from assets having the 'necessary connection with Australia' to 'taxable Australian property'. This ensures that those assets that would effectively be 'Australian assets' continue to be excluded from benefits available under Subdivision 768-G ***[Schedule 4, item 86, paragraph 768-540(1)(c)].*** The heading to this Subdivision has also been renamed ***[Schedule 4, item 83, Subdivision 768-G].***

What if the capital gain or capital loss is calculated in another currency?

4.115 A foreign resident will be able to use the applicable functional currency to calculate the capital gain or capital loss. In order to reduce compliance costs, a foreign resident will not have to make an election to do so. ***[Schedule 4, items 97 to 99, section 960-61, subsection 960-70(3) and the table in subsection 960-80(1)]***

Division 128 — Effect of Death

4.116 Amendments have also been made to ensure appropriate outcomes when assets of a deceased foreign resident are passed to the deceased's 'Legal Personal Representative' or a beneficiary in their estate. These amendments ensure that those CGT assets, which form part of the estate and are not taxable Australian property, will be treated as being acquired by the deceased's Legal Personal Representative or beneficiary in their estate for the market value of the asset on the day the deceased died. ***[Schedule 1, items 71 and 72, item 1 and column 2 in the table of subsection 128-15(4), item 3A in the table of subsection 128-15(4)]***

General

4.117 Many consequential amendments result from the renaming of those assets on which foreign residents will be subject to Australian CGT from CGT assets having the 'necessary connection with Australia' to 'taxable Australian property'. ***[Schedule 4, items 6, 13, 16, 18, 19, 21, 22, 26, 27, 28, 30 to 32, 34, 35, 39, 41 to 44, 46 to 53, 55, 56, 58, 59, 63 to 70, 74 to 82, 86, 90, 91, 96, 110, subsection 104-165(3), section 19 of the Financial Corporations (Transfer of Assets and Liabilities) Act 1993, paragraph 23AH(3)(c) of the ITAA 1936, paragraph 396(2)(b), subsections 396(3), 406(2), 406(3) and 438(4) of the ITAA 1936, subparagraph 245-55(4)(a)(ii) and paragraph 245-65(2A)(b) of Schedule 2C to the ITAA 1936, paragraphs 104-215(2)(b) and 104-230(7)(c), item 15 and column 2 in the table in section 109-55, item 15A and, column 2 in the table in section 109-55, item 16 and column 2 in the table in section 109-55, paragraph 116-95(1)(c), subsections 122-25(6) and (7), subsections 122-135(6) and (7), subsection 124-70(4), subparagraphs 124-240(f)(ii) and 124-245(e)(ii), paragraphs 124-295(7)(b), 124-300(7)(b), 124-365(4)(b), 124-375(4)(b), 124-450(4)(b) and 124-460(4)(b), subparagraph 124-520(1)(e)(ii), subsections 124-795(1) and 124-870(3), paragraph 125-55(2)(b), note to subsection 125-55(2), subparagraph 125-70(1)(f)(ii), paragraph 126-20(1)(c), column 4 in the table in subsection 126-50(5), paragraphs 126-75(1)(c) and 130-80(4)(c), note 1 to subsection 130-80(4),***

paragraph 130-83(4)(c), note 1 to subsection 130-83(4), paragraph 130-85(4)(c), note 1 to subsection 130-85(4), subparagraphs 170-255(1)(d)(ii), (iii) and (iv), paragraphs 768-540(1)(c), 768-920(1)(c), 768-920(2)(d) and 768-955(1)(b), section 136-25 of the Income Tax (Transitional Provisions) Act 1997]

4.118 Other consequential amendments have resulted from moving the provision dealing with CGT and foreign residents from Division 136 to Division 855. ***[Schedule 4, items 1 and 2; Schedule 4, items 17, 20, 23 to 25, 33, 36 to 38, 73, 89, 92 to 95, paragraphs 102AAZB(a) and 399(1)(c) of the ITAA 1936, section 408 of the ITAA 1936, paragraphs 410(d) and 410(e) of the ITAA 1936, item 15 and column 4 in the table in section 109-55, item 16 and column 4 in the table in section 109-55, items 1 and 2 and column 4 in the table in section 112-87, note 2 to subsection 128-25(2), note to section 768-915, note to subsection 768-920(4), subsections 768-920(5) and (8) and section 768-950]***

4.119 A further change from the renaming of those assets on which foreign residents will be subject to Australian CGT is that the term 'necessary connection with Australia' has been removed from the list of definitions in the ITAA 1936 and replaced with the term 'taxable Australian property'. Similarly, amendments have also been made to the Dictionary in the ITAA 1997. ***[Schedule 4, items 14, 15, 104 and 107, subsection 6(1) of the ITAA 1936, subsection 995-1(1)]***

4.120 Amendments have also resulted from inserting a definition of a 'foreign trust for CGT purposes' and changing references from 'not a resident trust for CGT purposes' to 'a foreign trust for CGT purposes'. ***[Schedule 4, items 45 and 101, paragraph 124-70(3)(b), subsection 995-1(1)]***

4.121 An amendment to the temporary residents provisions ensures those rules continue to operate as originally intended. For taxpayers who are temporary residents, a capital gain or loss will be disregarded if, assuming the taxpayer were a foreign resident, the capital gain or loss from a CGT event would have been disregarded under the new Division 855. ***[Schedule 4, item 88, paragraph 768-915(b)]***

4.122 The residency requirements that currently must be met before certain roll-overs can take place have also been removed as they are no longer necessary given the conditions that now apply to roll-overs ***[Schedule 4, items 54, 57 and 62]***. A further change also repeals subsections 124-795(4) and (5) as these conditions are no longer considered necessary as all non-portfolio dividends paid to an Australian resident company are now exempt ***[Schedule 4, item 61]***.

4.123 Definitions have also been inserted into the Dictionary for 'direct participation interest', 'foreign trust for CGT purposes', 'indirect Australian real property interest', 'indirect participation interest', 'non-portfolio interest test', 'taxable Australian property', 'taxable Australian real property', and 'total participation interest'. ***[Schedule 4, items 100 to 103 and 105 to 108, subsection 995-1(1)]***

REGULATION IMPACT STATEMENT

Policy objective

4.124 The purpose of the CGT and foreign residents measure is to further enhance Australia's status as an attractive place for business and investment.

4.125 This measure implements the Government's decision announced in the Treasurer's Press Release No. 44 of 10 May 2005 to reform the CGT treatment of foreign residents. This measure follows on from other international tax measures already implemented following the Government's response in May 2003 to the Board of Taxation's report *International Taxation – A Report to the Treasurer*.

The objectives of this measure

4.126 The CGT and foreign residents measure aims to better target and strengthen Australia's CGT laws by more closely aligning Australia's laws with OECD practice through narrowing the range of assets on which foreign residents will be subject to Australian CGT.

Implementation options

4.127 The CGT and foreign residents measure is the result of the Government's decision to further examine, in consultation with the business community, two recommendations (Recommendations 3.6 and 3.10(1)) made by the Board of Taxation in its report on the *Review of International Taxation Arrangements*.

- Recommendation 3.6 — to tax certain disposals by foreign residents of interests in foreign interposed entities with underlying Australian assets.
- Recommendation 3.10(1) — to provide CGT conduit taxation relief for foreign residents to the extent that the gain from the disposal of an interest in an Australian entity had an underlying foreign source.

4.128 The outcome of that examination was the Government's decision to narrow the range of assets on which a foreign resident will be subject to Australian CGT. This decision more closely aligns Australia's

CGT laws with OECD practice. Australian CGT will now only apply to CGT events that occur in relation to Australian real property assets and the business assets of a foreign resident's permanent establishment in Australia. This effectively removes the need for a CGT conduit regime as recommended in Recommendation 3.10(1) of the *Review of International Taxation Arrangements*.

4.129 The application of Australian CGT to disposals 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 Australian real property, addresses Recommendation 3.6 of the *Review of International Taxation Arrangements* as it applies to protect the narrower foreign resident CGT tax base.

Assessment of impacts

Impact group identification

4.130 The CGT and foreign residents measure in this Bill impacts on all foreign residents, be they individuals, companies, trusts or trustees of foreign trusts who hold interests in Australian assets or resident entities.

4.131 Narrowing the range of assets on which foreign residents are subject to Australian CGT means that many foreign residents who may have previously been subject to Australian CGT will now fall outside the scope of the regime.

4.132 As this measure only applies to non-portfolio (ie, 10 per cent or more) interests in entities, a foreign resident with interests of less than 10 per cent in Australian entities will not be subject to Australian CGT. Further, where a foreign resident holds a non-portfolio interest in an entity, more than 50 per cent of the value of the entity's assets must be attributable to Australian real property before there are Australian CGT consequences.

4.133 There will however be foreign residents previously outside Australia's tax net who will now come within the scope of Australia's CGT regime as a result of the implementation of this measure. Foreign residents affected are those holding non-portfolio interests in foreign interposed entities where more than 50 per cent of the value of the entity's assets is attributable to Australian real property, whether the Australian real property is held directly by those entities or held through a chain of interposed entities.

Analysis of costs / benefits

4.134 It has not been possible to provide a fully detailed analysis of the impacts on compliance costs because of the lack of available information on affected taxpayers. However, some general observations are outlined.

Compliance costs

4.135 Australian resident taxpayers will generally be unaffected by this measure since it only applies to foreign residents. However, Australian residents may be required to provide information to foreign residents to enable them to determine their Australian tax obligations.

4.136 Similarly, foreign residents who directly own Australian real property will also generally be unaffected by this measure since the CGT treatment for direct ownership of real property remains unchanged. Where that foreign resident is an entity owned by other foreign residents it may be required to provide information to those other foreign residents to enable them to determine their Australian tax obligations.

4.137 This measure will result in significant compliance cost savings for a wider range of foreign residents who hold portfolio interests (less than 10 per cent) in Australian entities. The portfolio limitation which previously applied only to interests in public companies and unit trusts has now been extended to cover interests in all entities. Compliance costs for these foreign residents should be reduced, as they will no longer be required to determine the amount of a capital gain or capital loss for Australian tax purposes.

4.138 Narrowing the asset base on which foreign residents are subject to CGT to Australian real property and the business assets of a foreign resident's Australian permanent establishment will mean that many foreign residents who formerly held Australian CGT assets (now referred to as taxable Australian property) will no longer do so. For these taxpayers compliance costs should also be reduced, as capital gains or capital losses that result from these assets no longer need to be determined for Australian tax purposes.

4.139 Compliance cost reductions should also result from aligning Australian treatment of capital gains and capital losses more closely with Australian tax treaty practice and internationally accepted practice. This should result in increased consistency and clarity and less duplication of records for foreign investors.

4.140 The inclusion of integrity provisions that seek to include capital gains and capital losses on interests in interposed entities where more than 50 per cent of the value of the entity's assets is principally attributable to

Australian real property may result in increased costs for some taxpayers. Firstly, taxpayers who prior to this measure were outside Australia's tax net may now come within the scope of Australia's CGT regime where they have a non-portfolio interest in an interposed foreign entity where more than 50 per cent of the value of the entity's assets is principally attributable to Australian real property. While most foreign residents would already maintain records in relation to the entity as a result of taxation obligations in their country of residence, additional costs may result from the need for additional tracing and valuation information necessary to comply with Australian tax obligations. Some additional costs may also arise in relation to their dealings with their tax advisor.

4.141 Limiting this measure to capital gains and capital losses on non-portfolio interests carves out many small foreign investors from the operation of this measure. The further requirement that the non-portfolio interest must be in entities where more than 50 per cent of the value of the entity's assets is principally attributable to Australian real property will additionally carve out other foreign investors not investing in entities that are land rich.

4.142 Taxpayers may incur some additional compliance costs if they require advice from the Australian Taxation Office (ATO) and taxation professionals in respect of this measure.

4.143 Tax professionals initially may incur additional costs in familiarising themselves with this measure.

Administration costs

4.144 As a result of this measure, the ATO may be required to provide additional advice to taxpayers and taxation professionals, including by public and private rulings. The ATO may also incur some initial costs in making changes to its material and educating staff about the measure.

4.145 The ATO may incur additional costs in its compliance activity to ensure that taxpayers are complying with the requirements of this measure. This increase results from the measure having application in circumstances that could involve the disposal of a foreign entity by a foreign resident. The ATO will monitor the application of this measure within the scope of their existing compliance and enforcement strategy.

4.146 However, administrative cost savings should result from the fact that the number of foreign residents subject to Australia's CGT regime should be reduced as a result of the range of assets subject to Australian tax having been narrowed and from a broadening of the existing non-portfolio interest exclusion to cover private as well as public entities.

Government revenue

4.147 The financial impact of the CGT and foreign residents measure is outlined in Table 4.1

Table 4.1: Financial impact of the CGT and foreign residents measure

	2006-07	*2007-08*	*2008-09*	*2009-10*
CGT and foreign residents measure	–$50 million	–$65 million	–$65 million	–$65 million

Economic benefits

4.148 This measure will better align Australia's taxation of foreign residents with international norms. This will further reduce disincentives for foreign residents to invest in Australia that currently may exist due to Australia's broad based CGT regime (when compared to other countries) and lack of CGT conduit relief. In particular, this measure seeks to overcome disincentives that exist for foreign residents to establish operations in Australia as a base for regional headquarter operations or to invest in Australian multinationals. Through further improvement of Australia's integration with the global economy, Australia will become a more attractive place for business and investment.

4.149 This measure will further reduce constraints on foreign resident investment into and out of Australia. The existing constraints tend to lock in existing investments, or require making such investments through interposed entities, due to the Australian CGT consequences of realising gains. This reduces the efficiency of capital allocation and increases the costs of investing in Australia compared with other countries.

4.150 This measure also increases equity across all foreign taxpayers by ensuring that all interests in Australian real property, whether held directly or indirectly, are taxable.

Consultation

4.151 Business, legal and accounting representatives and the ATO have been consulted extensively and have actively assisted in developing this measure. The more technical issues and the details of the measure were referred to a particular sub-group, known as the Reforms to CGT and Foreign Residents Working Group, on a confidential basis. Within

the confidentiality provisions, members of the working group consulted further within their organisations on aspects of this measure.

4.152 Bodies consulted as part of the processes outlined above include the:

- Business Council of Australia;
- Tax Institute of Australia;
- Corporate Tax Association;
- Certified Practicing Accountants Australia;
- Institute of Chartered Accountants in Australia;
- Australian Chamber of Commerce and Industry;
- Property Council of Australia;
- Law Council of Australia;
- Investment and Financial Services Association; and
- Australian Financial Markets Association.

4.153 Formal meetings with the sub-group took place in September 2005, April 2006 and May 2006. The main aspects of the measure covered included the operation of the principal asset test, the calculation of the capital gain or capital loss and the CGT treatment of roll-over assets.

4.154 Suggestions made by working group members on the legislative details of this measure were adopted where consistent with the policy objectives and the integrity of this measure.

4.155 The consultative group has been supportive of the consultation process.

Conclusion

4.156 The CGT and foreign resident measure is unlikely to have a large impact on compliance costs overall. Although compliance costs may rise for those foreign investors with indirect holdings in Australian real property, compliance costs will likely decrease for a large number of other investors due to the narrowing of the asset base on which foreign residents are subject to Australian CGT and the broadening of the non-portfolio requirement.

4.157 There are also benefits to Australia through aligning our law to be more consistent with accepted international practice, thereby encouraging investment in Australia. These measures also address an integrity issue by ensuring that direct and indirect investments by foreign residents in Australian real property are treated more equally. This will ensure improved equity amongst foreign resident taxpayers since investment choices will no longer alter taxation obligations as significantly as under present arrangements. It will also decrease the risks to Australian revenue from foreign residents using alternative investment structures to change their Australian tax obligations.

4.158 The Treasury and the ATO will monitor this taxation measure on an ongoing basis as part of the whole taxation system. This will ensure effective compliance.

Index

Schedule 1: Marriage breakdown roll-over

Bill reference	*Paragraph number*
Item 1, subsection 118-75(1)	1.45
Item 1, subsection 118-75(2)	1.46
Items 2, 5 and 6, subsection 118-178(2), note 2 to subsection 126-5(5)	1.34
Items 3 and 7, paragraphs 126-5(1)(d) to 126-5(1)(f), 126-15(1)(d) to (1)(f)	1.19
Items 3 and 7, subparagraphs 126-5(1)(d)(i) and 126-15(1)(d)(i)	1.24
Items 3 and 7, subparagraphs 126-5(1)(e)(i) and 126-15(1)(e)(i)	1.24
Items 3 and 7, subparagraphs 126-5(1)(d)(ii), 126-5(1)(e)(ii), 126-15(1)(d)(ii) and 126-15(1)(e)(ii)	1.27

Items 4 and 8, subsections 126-5(3A) and 126-15(5)	1.28
Item 9, subsection 126-25(1)	1.29
Item 9, subsection 126-25(2)	1.30
Item 10	1.48

Schedule 2: Consolidation

Bill reference	***Paragraph number***
Items 1 to 5 and 7, subsections 701-35(1) and (3) of the *Income Tax (Transitional Provisions) Act 1997*	2.11
Item 6, subsection 701-35(2A) of the *Income Tax (Transitional Provisions) Act 1997*	2.9
Item 8	2.12

Schedule 3: Simplified imputation system: imputation for New Zealand residence companies

Bill reference	***Paragraph number***
Item 1, subsection 220-350(1)	3.7
Item 1, subsection 220-350(2)	3.8
Item 1, subsection 220-350(3)	3.10
Items 2 and 5	3.14
Items 3 and 4, paragraphs 128TB(1)(e) and (3)(e) of the ITAA 1936	3.13

Schedule 4: CGT and foreign residents

Bill reference	***Paragraph number***
Items 1 and 2; Schedule 4, items 17, 20, 23 to 25, 33, 36 to 38, 73, 89, 92 to 95, paragraphs 102AAZB(a) and 399(1)(c) of the ITAA 1936, section 408 of the ITAA 1936, paragraphs 410(d) and (e) of the ITAA 1936, item 15 and column 4 in the table in section 109-55, item 16 and column 4 in the table in section 109-55, items 1 and 2 and column 4 in the table in section 112-87, note 2 to subsection 128-25(2), note to section 768-915, note to subsection 768-920(4), subsections 768-920(5) and (8) and section 768-950	4.118
Item 2, subitem 3(a) in the table in section 855-15	4.94, 4.96

Bill reference	*Paragraph number*
Item 2, subitem 3(b) in the table in section 855-15	4.95
Item 2, sections 855-5 and 855-25	4.15
Item 2, subsection 855-10(1)	4.18
Item 2, paragraph 855-10(1)(b)	4.21
Item 2, subsection 855-10(2)	4.20
Item 2, section 855-15	4.24, 4.24
Item 2, paragraph 855-20(a)	4.28
Item 2, paragraph 855-20(b)	4.28
Item 2, subsection 855-25(1)	4.31
Item 2, paragraph 855-25(1)(a)	4.36
Item 2, subparagraph 855-25(1)(a)(ii)	4.37
Item 2, paragraph 855-25(1)(b)	4.39
Item 2, subsection 855-30(1)	4.59
Item 2, subsection 855-30(2)	4.61, 4.64, 4.64
Item 2, subsections 855-30(3) and (4)	4.62
Item 2, subsection 855-30(3)	4.65
Item 2, subsection 855-30(4)	4.66
Item 2, item 1 in the table in subsection 855-30(4)	4.67, 4.75, 4.76
Item 2, item 2 in the table in subsection 855-30(4)	4.69, 4.70, 4.71
Item 2, subsection 855-30(5)	4.63, 4.84, 4.86
Item 2, section 855-35	4.19, 4.98
Item 2, sections 855-45, 855-50 and 855-55	4.110
Item 2, subsections 855-45(2) and (3), 855-50(2) and (3), 855-55(2) and (4)	4.112
Items 2, 29 and 40, section 855-40, item in the table headed 'foreign residents' in section 12-5, subsection 121-30(2); Schedule 4, item 87	4.113
Items 2 and 12, paragraph 855-25(2)(a), item 1 in the table in section 960-190, subsection 960-190(2)	4.47
Items 2 and 12, paragraph 855-25(2)(b), item 1 in the table in section 960-190, subsection 960-190(2)	4.49
Items 3 and 10, subsections 104-160(3) and 104-170(3)	4.104
Items 4 and 11, subsections 104-160(4A) and (4B) and 104-170(4A) and (4B)	4.106
Items 5 and 7, note 2 to subsection 104-160(6) and paragraph 104-165(3)(a)	4.109

Bill reference	***Paragraph number***
Items 6, 13, 16, 18, 19, 21, 22, 26, 27, 28, 30 to 32, 34, 35, 39, 41 to 44, 46 to 53, 55, 56, 58, 59, 65 to 70, 74 to 82, 86, 90, 91, 96, 110, subsection 104-165(3), section 19 of the *Financial Corporations (Transfer of Assets and Liabilities) Act 1993*, paragraph 23AH(3)(c) of the ITAA 1936, paragraph 396(2)(b), subsections 396(3), 406(2), 406(3) and 438(4) of the ITAA 1936, subparagraph 245-55(4)(a)(ii) and paragraph 245-65(2A)(b) to Schedule 2C of the ITAA 1936, paragraphs 104-215(2)(b) and paragraph 104-230(7)(c), item 15 and column 2 in the table in section 109-55, item 15A and, column 2 in the table in section 109-55, item 16 and column 2 in the table in section 109-55, paragraph 116-95(1)(c), subsections 122-25(6) and (7), subsections 122-135(6) and (7), subsection 124-70(4), subparagraphs 124-240(f)(ii) and 124-245(e)(ii), paragraphs 124-295(7)(b), 124-300(7)(b), 124-365(4)(b), 124-375(4)(b), 124-450(4)(b) and 124-460(4)(b), subparagraph 124-520(1)(e)(ii), subsections 124-795(1) and 124-870(3), paragraph 125-55(2)(b), note to subsection 125-55(2), subparagraph 125-70(1)(f)(ii), paragraph 126-20(1)(c), column 4 in the table in subsection 126-50(5), paragraphs 126-75(1)(c) and 130-80(4)(c), note 1 to subsection 130-80(4), paragraph 130-83(4)(c), note 1 to subsection 130-83(4), paragraph 130-85(4)(c), note 1 to subsection 130-85(4), subparagraphs 170-255(1)(d)(ii), (iii) and (iv), paragraphs 768-540(1)(c), 768-920(1)(c), 768-920(2)(d) and 768-955(1)(b), section 136-25 of the *Income Tax (Transitional Provisions) Act 1997*	4.117
Item 8, note to section 104-165; item 9; item 109, section 104-166 of the *Income Tax (Transitional Provisions) Act 1997*	4.100
Item 12, subsection 960-185(1)	4.52
Item 12, subsection 960-185(2)	4.53
Item 12, section 960-180	4.56
Item 12, items 1 to 3 in the table in section 960-190	4.46
Item 12, item 3 in the table in section 960-190, subsection 960-190(3)	4.50
Item 12, section 960-195	4.35
Items 14, 15, 104 and 107, subsection 6(1) of the ITAA 1936, subsection 995-1(1)	4.119
Item 41, paragraph 122-25(6)(a)	4.92
Items 41 to 44, subsections 122-25(6) and (7), subsections 122-135(6) and (7)	4.90
Items 45 and 101, paragraph 124-70(3)(b), subsection 995-1(1)	4.120
Items 54, 57 and 62	4.122
Item 59, subsection 124-795(1)	4.88

Bill reference	***Paragraph number***
Item 61	4.122
Item 64, subsection 124-875(6)	4.89
Items 71 and 72, item 1 and column 2 in the table of subsection 128-15(4), item 3A in the table of subsection 128-15(4)	4.116
Item 83, Subdivision 768-G	4.114
Item 84, subsection 768-505(1)	4.114
Item 86, paragraph 768-540(1)(c)	4.114
Item 88, paragraph 768-915(b)	4.121
Items 97 to 99, section 960-61, subsection 960-70(3) and the table in subsection 960-80(1)	4.115
Items 100 to 103 and 105 to 108, subsection 995-1(1)	4.123
Item 107, section 104-165 of the *Income Tax (Transitional Provisions) Act 1997*	4.99
Item 111	4.101