

***CRP 2017/1 - Explanatory statement -***



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## Explanatory Statement

# Taxation Administration (Remedial Power – Foreign Resident Capital Gains Withholding) Determination 2017

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### General outline of determination

1. This determination is made under section 370-5 of Schedule 1 to the *Taxation Administration Act 1953* (TAA). All references to legislative provisions in this Explanatory Statement are references to Schedule 1 to the TAA, unless otherwise stated.
2. This determination modifies the operation of sections 18-15, 18-20 and 18-25 to ensure an entity's credit entitlement for amounts paid to the Commissioner of Taxation (Commissioner) under the Foreign Resident Capital Gains Withholding (FRCGW) legislation in Subdivision 14-D, is made available in the income year in which the transaction that caused Subdivision 14-D to apply is recognised for tax purposes for the entity.
3. This determination is a legislative instrument for the purposes of the *Legislation Act 2003*.

### Date of effect

4. This determination commences on the first day the instrument is no longer liable to be disallowed, or to be taken to have been disallowed, under section 42 of the *Legislation Act 2003*.
5. The instrument applies retrospectively to align the application date of the instrument with the application date of the FRCGW legislation, being 1 July 2016. Retrospective application ensures the benefit of the modification is available to entities that have already entered into contracts that may straddle income years. This ensures that vendors, who have entered into relevant contracts on or after 1 July 2016, do not encounter adverse cash flow or compliance cost consequences which may have occurred but for the instrument.
6. Importantly, the retrospective application of this instrument is limited by the operation of subsection 370-5(4). This ensures that this instrument, made under section 370-5, will not apply if its application would produce a less favourable result for an entity. Nothing in this instrument prevents a taxpayer from applying the law as it is enacted.
7. Under section 12(2) of the *Legislation Act 2003*, this instrument does not adversely affect the rights or liabilities of any person other than the Commonwealth.

### **What is the effect of this determination?**

8. The modification made by this instrument would be expected to apply where a vendor sells a relevant asset (usually real property) that is subject to Subdivision 14-D and the sale process of exchange and settlement straddles more than one income tax year.
9. The effect of this instrument is to ensure that, where a settlement period for a transaction that is subject to FRCGW covers more than one income year for the vendor:
  - a vendor will be entitled to a credit in respect of an amount paid to the Commissioner; and
  - the credit entitlement will be made available in the same income year as that in which the transaction giving rise to the payment to the Commissioner is recognised for tax purposes for the vendor.
10. The instrument also applies for credit entitlements to a partner, trustee or beneficiary where the vendor is a partnership or trust.
11. This is consistent with the general application of the crediting provisions, which seek to ensure credit entitlements for amounts withheld are made available to entities in the same income year as that in which their tax liability related to the withholding amount is recognised for tax purposes.
12. This will reduce adverse cash flow impacts that could otherwise arise for vendors, associated with having to wait until the end of the income year in which settlement occurs to claim their FRCGW credits. This will also reduce vendor compliance costs associated with having to lodge income tax returns for multiple income years, in respect of the same transaction, that would otherwise arise.
13. This modification would most commonly apply where the transaction giving rise to the application of FRCGW would result in a capital gains tax liability for the vendor. However, it could also apply in situations where the transaction would be taxed on a revenue basis, such as in a property development scenario.
14. The modification made by this instrument does not apply if the modification would produce a less favourable result for an entity (subsection 370-5(4)).

### **Background**

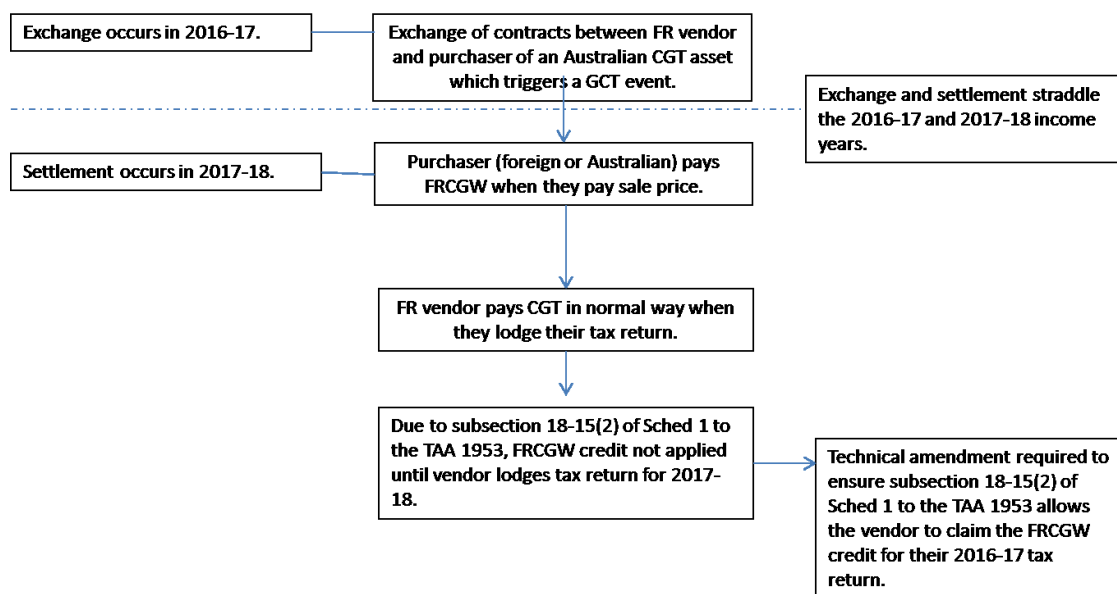
15. Subdivision 14-D (referred to below as 'the FRCGW legislation') was given effect by the *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016*. The FRCGW legislation imposes an obligation on purchasers to pay an amount to the Commissioner, which is equivalent to 10% of the purchase price of certain Australian assets, where the purchaser has reason to believe that the vendor is a foreign resident. These amounts are treated as withholding payments under subsection 10-5(2)(b).
16. The obligation to withhold generally applies to the acquisition of an asset that is taxable Australian real property, an indirect Australian real property interest, or an option or right to acquire such property or interest (as defined within Division 855 of the *Income Tax Assessment Act 1997*).
17. Generally, the purchaser is required to pay the 10% withheld to the Commissioner on or before the point at which they become the owner of the asset being transferred.

18. FRCGW applies to contracts on certain acquisitions of taxable Australian property from relevant vendors that have been entered into on and after 1 July 2016. FRCGW will usually apply where the vendor is a foreign resident. However, there are circumstances where FRCGW could apply to a resident vendor. This Explanatory Statement refers generically to those vendors who are subject to FRCGW as 'vendors'.
19. At the end of the income year the vendor will lodge their income tax return declaring, for example, a capital gain that is not disregarded under Division 855 of the *Income Tax Assessment Act 1997*. The vendor would usually claim a credit for the amount of FRCGW that has been withheld and paid to the Commissioner.
20. The main crediting provision is section 18-15, with section 18-20 applying where the recipient is a partnership and section 18-25 applying to trustees. Any difference in tax is then reconciled, resulting in the vendor being required to pay any shortfall or having any excess refunded to them.
21. However, when a transaction that causes the application of Subdivision 14-D is recognised for income tax purposes by an entity (usually the vendor, but can be a partner in a partnership or a beneficiary of a trust where the partnership or the trust is the vendor) in an income year, the current law can prevent the entity from claiming a withholding tax credit in the same income year.
22. For example, a capital gain may arise in relation to year 1 (on exchange of contract) and settlement under the contract, the withholding payment to the Commissioner and the foreign resident vendor's credit entitlement occurs in a subsequent income tax year (for example, year 2).
23. The Commissioner's Remedial Power (CRP), given effect by the *Tax and Superannuation Laws Amendment (2016 Measures No. 2) Act 2017*, confers power to the Commissioner to make, by disallowable legislative instrument, one or more modifications to the operation of taxation or superannuation law to ensure the law can be administered to achieve its intended purpose or object.

## Explanation

24. Through this instrument, the operation of the crediting provisions in sections 18-15, 18-20 and 18-25 are modified to ensure a credit for an amount paid to the Commissioner under the FRCGW provisions is made available to the entity, in the same income year as that in which the sale of the asset subject to FRCGW is recognised for tax purposes for the entity.
25. The modification made by this instrument will potentially apply in respect of any amounts withheld (and paid to the Commissioner) under Subdivision 14-D. This could include amounts withheld in respect of resident vendors if they do not supply an ATO clearance certificate confirming that the purchaser is not required to withhold and pay an amount to the Commissioner.
26. This modification is consistent with the intent of the crediting provisions in sections 18-15, 18-20 and 18-25 and would be reasonable to ensure the FRCGW provisions do not impose undue cash flow or compliance cost impacts on entities entering into contracts, the settlement of which occurs in a subsequent income year.
27. The diagram below provides an example of a transaction to which the instrument applies:

Example of FRCGW transaction straddling two income years



28. The simplest straddling cases and the most common that are likely to arise are where a contract entered into in May or June settles in July or August of the same calendar year and gives rise to a capital gain for the vendor. In these cases, the current operation of the law will increase compliance costs for vendors, as they will generally be required to lodge two separate Australian tax returns:
- One for the income year in which the liability to pay tax on the capital gain arises (the year of exchange). In simple straddling cases all elements of the CGT event will be completed by the time the vendor seeks to finalise their prior year tax return.
  - One for the subsequent income year (the year of settlement), in which the vendor would claim their entitlement to a refund for the FRCGW amount paid to the Commissioner.
29. This will also have an adverse impact on the cash flow of a vendor where a property purchase straddled two (or more) income years, as the vendor would be required to wait until the end of the income year of settlement to claim back their FRCGW amount.
30. The following examples set out how the modification will operate.

Example 1: Contract settled in the year of income after the year in which the contract was entered into

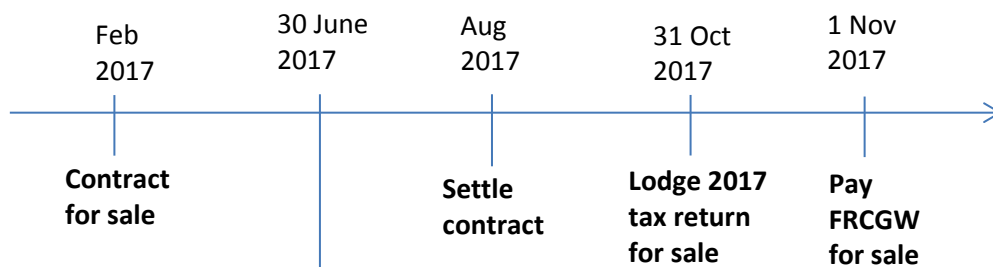
31. Ms Nguyen entered into a contract for the sale of a residential property that she had as an investment in February 2017 for AUD\$3m. Ms Nguyen was not able to obtain a clearance certificate as she is not an Australian tax resident, nor were her circumstances conducive to receiving a variation to the FRCGW 10% rate.
32. The contract settled in August 2017. At that time the purchaser paid AUD\$300,000 FRCGW to the Commissioner.

33. Prior to 31 October 2017 Ms Nguyen lodged her 2017 Australian tax return thereby complying with her tax return lodgement obligations. She included the capital gain from the sale of the property and any income generated from the property during the 2016-17 income year.
34. Without the modification to the crediting provisions, the FRCGW credit is available in the income year in which the FRCGW is paid by the purchaser. This means that Ms Nguyen could not claim the FRCGW credit in her 2017 tax return in which she is required to include the capital gain. She would have to wait until she lodges her 2018 Australian tax return which should be no earlier than July 2018 to claim the FRCGW credit.
35. The modification of the crediting provisions will allow Ms Nguyen to claim the FRCGW credit under section 18-15 in respect of the amounts paid by the purchaser to the Commissioner in her 2017 Australian tax returns when lodged in October 2017.



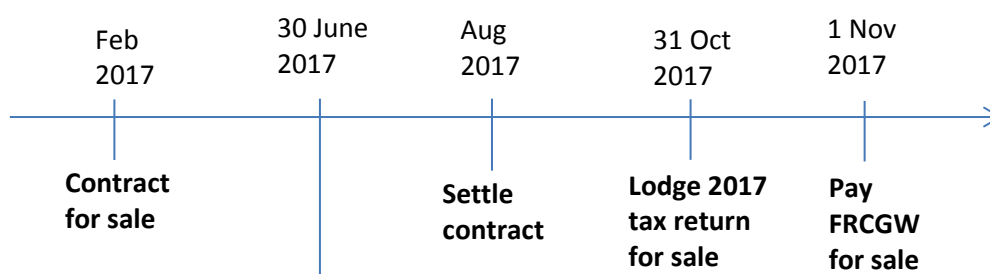
Example 2: Contract settled and income tax return lodged before late payment of withheld amount

36. Assume the same facts as Example 1, except the purchaser did not pay the FRCGW until November 2017, despite the contract settlement in August 2017.
37. Under the current law, Ms Nguyen would have to wait until she lodged her 2018 Australian tax return to obtain the FRCGW credit (as the FRCGW was paid on 1 November 2017). This lodgement could be as late as 31 October 2018 (provided it is not lodged late), which would be 12 months after the FRCGW was paid by the purchaser.
38. The modification allows Ms Nguyen to request an amendment to her 2017 income tax return from 1 November 2017 to include the FRCGW credit under section 18-15.



Example 3: Contract settled with partnership and income tax return lodged before late payment of withheld amount

39. Assume the same facts as Example 2, except the sale is by the Nguyen Partnership (comprising Mr and Ms Nguyen, who are both foreign residents and are equal partners).
40. The Nguyen Partnership was not able to obtain a clearance certificate and is not an Australian tax resident, nor were the circumstances conducive to receiving a variation to the FRCGW 10% rate.
41. Under the current law, Mr and Ms Nguyen would have to wait until they lodged their 2018 Australian tax returns to be entitled to the FRCGW credit under section 18-20 (as the FRCGW was paid by the purchaser on 1 November 2017). This lodgement could be as late as 31 October 2018 (provided the returns are not lodged late), which would be 12 months after the FRCGW was paid by the purchaser.
42. The modification allows Mr and Ms Nguyen to request amendments to their 2017 income tax returns from 1 November 2017 to include the FRCGW credit under section 18-20.



Example 4: Contract settled with foreign trust with foreign resident beneficiaries presently entitled to income of the trust, and income tax return lodged before late payment of withheld amount

43. Assume the same facts as Example 3, except the sale is by the Nguyen Trust (comprising of a foreign resident trustee, and Mr and Ms Nguyen as equal beneficiaries who are foreign residents and presently entitled to a share of the income of the trust for the 2017 income year).
44. Under the current law, the trustee is assessed on and is liable to pay tax in respect of Mr and Ms Nguyen's share of the net income of the trust. The trustee would have to wait until the trust's tax return for the 2018 year is lodged to be entitled to the FRCGW credit under section 18-25 (as the FRCGW was paid by the purchaser on 1 November 2017). This lodgement could be as late as 31 October 2018 (provided the return is not lodged late), which would be 12 months after the FRCGW was paid by the purchaser.
45. The modification allows the trustee to request an amendment to their 2017 income tax returns from 1 November 2017 to include the FRCGW credit under subsections 18-25(4) and (5).

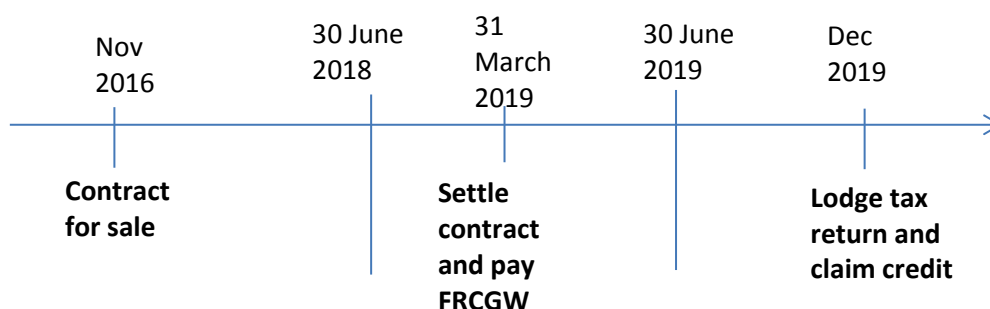
Example 5: Sales on revenue account

46. The impact of this modification will depend upon how the vendor accounts for the revenue it earns – on a cash or accruals basis.

*Cash basis*

47. Ms Nguyen owns a company, Nguyen Limited, develops and sells apartments

48. The apartments are not capital assets of the company. Proceeds made from selling apartments are treated on revenue account. Such sales are nevertheless within scope of Subdivision 14-D. Nguyen Limited does not qualify for a clearance certificate as it is not an Australian tax resident entity, nor are its operating conditions conducive to receiving a variation to the FRCGW 10% rate.
49. Nguyen Limited reports income on a cash basis. The company accounts for the proceeds made from sales of apartments as revenue when the proceeds are paid at settlement. This is the same time (and income year) in which the FRCGW obligation arises.
50. Nguyen Limited sells an off-the-plan apartment for AUD\$4m in November 2016. Payment arrangements are such that settlement will not occur until March 2019, when the apartment is completed.
51. When settlement occurs in March 2019, the tax impacts are reflected in Nguyen Limited's 2019 tax return. The company does not have a substituted accounting period and it lodges its 2019 tax return during Dec 2019. In its return it declares the AUD\$4m revenue from the sale of the apartment, but also claims the FRCGW credit of AUD\$400,000.
52. There is no requirement for the modification's application in this instance.



#### *Accruals basis*

53. A developer will typically recognise the assessable income from the sale of a property at the time the property settles rather than when the amount may be recognised as payable for accounting purposes. This is in line with the principle in *Gasparin v. Federal Commissioner of Taxation* (1994) 50 FCR 73 that the derivation of income from the sale of real property does not occur until settlement takes place.
54. In practice, this would mean there would be no requirement for the modification to apply to sales on revenue account recognised on an accruals basis. Nonetheless, if atypical circumstances arise and result in a timing mismatch between the income year in which sales proceeds are recognised for tax purposes and the income year in which credits for FRCGW payments are available, the modification could apply.

#### **Modification is not inconsistent with intended purpose or object of provision**

55. Sections 18-15, 18-20 and 18-25 were contained in the A New Tax System (Pay As You Go) Bill 1999.



56. In ascertaining the intended purpose or object of a provision consideration must be given to various documents, including the Explanatory Memorandum to the Bill containing the provision.
57. The Explanatory Memorandum for this Bill states the following in relation to these provisions:

“1.146 Standardised crediting rules applying to all other withholding arrangements are set out in new sections 18-15 to 18-25. These standardised rules are the same as those currently applying under the PAYE, PPS, RPS, no TFN and NRP withholding arrangements.”
58. The finding table contained in the Explanatory Memorandum provides the following generic equivalent provisions of the *Income Tax Assessment Act 1936*. Former subsections 221H(2), 221YHZK(1), 221YHZK(2) and 221YHZK(3) were the equivalent provisions.
59. Subsection 221H(2) was inserted into the *Income Tax Assessment Act 1936* by the Taxation Laws Amendment Bill (No. 5) 1998. Subsections 221YHZK(1), 221YHZK(2) and 221YHZK(3) were inserted into the *Income Tax Assessment Act 1936* by the Taxation Laws Amendment Bill (No. 4) 1986.
60. The explanatory materials accompanying the former provisions indicate that entities would be entitled to a credit for amounts withheld in the tax year in which an assessment has been made at the time that assessment is made, or at the point the Commissioner is satisfied no tax is payable.
61. Importantly, section 18-15 was amended after its introduction to allow credits in the income year in which a tax liability to which those credits relate arises.
62. Subsection 18-15(2) provides a credit in a prior year to withholding for certain amounts relating to personal services income derived in the prior income year, but paid in a later income year.
63. This subsection was inserted by the New Business Tax System (Alienation of Personal Services Income) Bill 2000. This amendment indicates that the general crediting provisions were capable of creating unintended outcomes due to timing mismatches.
64. The proposed remedial power modification to these crediting provisions would not be inconsistent with ensuring entities receive credits for amounts withheld for purchases of certain assets subject to FRCGW, in the income year in which the entity is assessed as liable for tax on gains to which the FRCGW relates. They would therefore not be inconsistent with the purpose of the provisions as demonstrated by the relevant explanatory memoranda and second reading speeches.

### **Modification is reasonable**

65. The Commissioner considers the modification to the crediting provisions to be a reasonable measure to ensure that the FRCGW provisions avoid creating unintended outcomes. Modifying the crediting provisions in this way is not inconsistent with the intended purpose or object of the crediting provisions, or the FRCGW provisions.
66. The issue where settlement occurs in a year subsequent to the year of exchange does not appear to have been considered by Parliament in creating the FRCGW provisions. The crediting misalignment produced in straddling cases results in unintended compliance costs and adverse cash flow impacts for affected entities. It is reasonable to conclude that interactions with the

crediting provisions in straddling cases would have been addressed if the issue had been considered.

67. The modification operates in a similar manner to other tax law provisions, which treat a credit entitlement as arising in a preceding income year, where the payment and withholding have taken place in a subsequent income year. For example, subsection 18-15(2) currently treats an entitlement to a credit as arising in a previous year. This can apply where personal services income relating to a prior period is received before 14 July of the following income year in certain circumstances (see paragraph 16-155(2)(aa)).
68. In light of the intended purpose of the FRCGW and crediting provisions, the Commissioner considers it reasonable to exercise the Commissioner's discretion to use the remedial power for this issue.

### **Intended purpose or object of provision**

69. The intended purpose or object of sections 18-15, 18-20 and 18-25 is discussed earlier in this explanation (see paragraphs 55 to 64).

### **Compliance cost**

70. The proposed exercise of the CRP will result in minor compliance cost impacts. The modification should result in no or minimal impact for both implementation and ongoing compliance costs.

### **Budgetary impact**

71. The Commissioner has received advice from the Department of the Treasury that the proposed exercise of the CRP would have a negligible cost to the budget.

### **Consultation**

72. Subsection 17(1) of the *Legislation Act 2003* requires, before the making of a determination, that the rule-maker is satisfied that appropriate and reasonably practicable consultation has been undertaken.
73. Broad consultation has been undertaken. The draft determination and draft explanatory statement were published on the ATO Legal database <http://www.ato.gov.au> seeking feedback and comments for a period of four weeks. Notice of the draft determination was also published on <http://www.ato.gov.au> and subscription alerts issued. Tax professionals and tax associations regularly review both the Legal database and <http://www.ato.gov.au> and further promulgate advice of new drafts issued in their internal news bulletins. The major legal publishers also publish news of the drafts in their key tax alerting services – such as the *Weekly Tax Bulletin* (published by Thomson Reuters Australia) and *Tax Tracker* and *Tax Week* (published by CCH Australia). Additionally, draft determinations and draft explanatory statements were published on the ATO Consultation Hub.
74. Public consultation resulted in submissions from the Property Council of Australia and the Law Institute of Victoria. Both supported the CRP's use to resolve this issue. The Law Institute of Victoria expressly supported

retrospective application, given the adverse consequences that could otherwise arise for transactions which may have already been entered into and which could straddle income tax years.

75. In addition, targeted consultation on prospective CRP candidates is undertaken with the CRP Panel, a body comprised of private sector specialists, Treasury and ATO representatives. This Panel provided feedback on the legislative instrument and draft explanatory statement. This resulted in more targeted language in the instrument and additional examples in the explanatory statement. The CRP Panel also supported retrospective application of this instrument, to ensure entities that have already entered into relevant property transactions can nonetheless have the advantage of access to this modification.
76. The Board of Taxation was also consulted on the use of the CRP to resolve this issue, the draft legislative instrument and explanatory statement. The Board supported the CRP use and identified potential interaction issues with interest on early payments and over payments. These were investigated and found to be a function of the operation of the interest on early payment and over payment rules.

**Legislative references:**

*Taxation Administration Act 1953*

*Tax and Superannuation Laws Amendment (2016 Measures No. 2) Act 2016*

*Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016*

*Legislation Act 2003*

*Income Tax Assessment Act 1997*

*Income Tax Assessment Act 1936*

## **Statement of compatibility with Human Rights**

This Legislative Instrument is prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

### **Taxation Administration (Remedial Power – Foreign Resident Capital Gains Withholding) Determination 2017**

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

#### **Overview of the Legislative Instrument**

This Legislative Instrument is made under section 370-5 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) known as the Commissioner's Remedial Power. It modifies the operation of the crediting provisions in Schedule 1 to the TAA to permit an entity to claim a credit for an amount paid to the Commissioner, in respect of a transaction that is subject to the Foreign Resident Capital Gains Withholding (FRCGW) provisions in subdivision 14-D in Schedule 1 to the TAA. The modification ensures the credit for the amount paid to the Commissioner is made available in the same income year as that in which the tax liability related to the sale of the asset subject to FRCGW arises.

#### **Human rights implications**

This Legislative Instrument does not engage any of the applicable rights or freedoms. This Legislative Instrument modifies crediting provisions to permit an entity to claim a credit for amounts paid to the Commissioner in respect of a transaction that is subject to the FRCGW provisions.

#### **Conclusion**

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.