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New foreign resident CGT withholding tax

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From 1 July 2016, a buyer of Australian real estate from a foreign resident seller, for $2 million or more, will need to collect 10% of the sale price and pay it to the Australian Taxation Office (**ATO**). Changes to the tax law have introduced this new withholding tax, designed to prevent foreign resident sellers from avoiding capital gains tax on the sale of Australian real estate. The coverage of the new rules, however, could be broader than just Australian real estate. Potentially, the new rules may cover indirect interests in Australian real estate, such as shares or units in companies or unit trusts that own significant land assets. In this article, we examine the new rules and their practical implications.

Coverage of new rules

There are 4 conditions that need to be met for the new rules to apply, as follows:

Conditions		Comments
1	Contract exchanged on or after 1 July 2016	For the new rules to apply, contracts must be exchanged on or after 1 July 2016. A contract resulting from the exercise of an option on or after 1 July 2016 is also caught by the new rules.
2	Value of property $2 million or more	The value of the CGT asset must be $2 million or more. Assets with a value of less than $2 million are not covered by the new rules.
3	Property must be taxable Australian property	The contract must relate to Australian real property or an indirect interest in Australian real property (see discussion below).
4	Seller must be non-resident	The seller must be a foreign resident for Australian tax purposes (see discussion below).

Below we consider the last 2 conditions in more detail.

Taxable Australian property

The new rules only apply to taxable Australian property. Taxable Australian property includes the following:

Australian real property with a value of $2 million or more	This includes: ▪ land or buildings ▪ leases over Australian real property ▪ a mining, quarrying or prospecting right to minerals, petroleum or quarry materials in Australia.
Indirect interests with a value of $2 million or more in Australian real property	For an indirect interest to be covered, it must be: ▪ a 10% or greater interest in an Australian company or unit trust; and ▪ 50% or more of the company's or the unit trust's assets, in terms of market value, must be Australian real property, either: i. at the time of the transaction; or ii. in a 12 month period that began no earlier than 24 months at the time of the transaction.
Options or rights to acquire property or indirect interests	Options or rights to acquire either of the above are also taxable Australian property.

The requirement of a value of $2 million or more refers to the market value of the property. The ATO has indicated that in most cases, the market value of property will be its sale price. Where the sale price has been negotiated between a seller and a buyer, acting on an arm's length basis, the ATO will consider the sale price to be the market value of the property.

However, the new rules adopt an inconsistent approach to the value of property depending on whether the interest is direct or indirect. For direct interests, it is the real property that needs to have a value of $2 million or more. For indirect interests, it would appear to be the shares or units that need to have a value of $2 million or more. The rules could therefore apply to an indirect interest with a value of $2 million or more, which relate to a company or unit trust that owns Australian **real** property with a value of $2 million or less. This is rather odd, since the rules appear to be targeted at foreign sellers avoiding CGT in respect of the sale of **real** property (as opposed to shares or units).

The new rules do not apply to transactions:

- relating to shares or units listed on an approved stock exchange;
- involving a foreign resident seller under external administration or in bankruptcy; and
- already covered by another withholding tax provision.

Foreign resident sellers

The new rules only apply to transactions involving non-tax resident sellers. If an entity is not an Australian resident, for Australian tax purposes, then they will be a foreign seller. In broad terms, under Australian domestic tax, the question of whether an entity is an Australian tax resident is determined as follows:

Entity type	Residency criteria
Individual	▪ ordinarily resides in Australia ▪ is domiciled in Australia, i.e. they have a permanent home in Australia ▪ is present in Australia for 183 days or more within an income year.
Trust	▪ has a trustee who is an Australian resident ▪ has its central management and control in Australia.
Company	▪ is incorporated in Australia ▪ carries on business in Australia and has its central management and control in Australia ▪ carries on business in Australia and has its voting power controlled by shareholders who are Australian tax residents.

Different rules apply to other entities.

However, the rules for determining tax residency may be different if Australia has a double taxation agreement with the country in which the foreign resident is located. The determination of the residency of an entity may therefore turn out to be a complicated process and result in a delay in effecting the transaction.

Practical implications

The new rules raise a number of practical issues, as follows:

- how does a buyer determine a seller's tax residency status?
- is the 10% withholding tax rate always appropriate?
- when does a buyer have to pay the withholding amount to the ATO?

How to work out a seller's tax residency status?

In practice, it may be difficult for a buyer to work out whether a seller is an Australian tax resident or a foreign tax resident. To overcome this difficulty, the new withholding tax rules require an Australian resident seller to provide a buyer with either an ATO clearance certificate or a written declaration confirming that they are an Australian tax resident.

The starting point for all $2 million or more sales should be to assume that the seller is a foreigner. Only if the seller provides a clearance certificate or a written declaration, before settlement, will it be safe for a buyer not to collect and pay the new 10% withholding tax to the ATO.

The table below sets out the key similarities and differences between clearance certificates and written declarations:

Items	Clearance certificates	Written declarations
Key similarities	▪ either may be provided by a seller to a buyer to confirm the seller's Australian tax residency. ▪ both must be provided by settlement.	
Key differences	▪ valid for 12 months ▪ issued by ATO ▪ seller's representative may apply on seller's behalf ▪ application form available on the ATO's website from 27 June 2016 ▪ if the application is automatically approved, a clearance certificate will be issued within around 5 to 10 days. However, no precise timeframe has been given by	▪ valid for 6 months ▪ prepared by buyer or their legal representatives ▪ no approved form for written declarations ▪ templates will be available on ATO's website from 1 July 2016 ▪ may also be used to declare that an interest is not an indirect Australian real property interest

	ATO ▪ if there are any irregularities in the application process, some manual processing may be needed and application may take up to 28 days	

Is 10% an appropriate withholding rate?

The 10% withholding tax rate may not always be appropriate in the circumstances of the sale. This will be the case where, for example, the seller makes a capital loss on their sale. Thus, the new rules allow either the seller or the buyer to lodge a “variation application” to the ATO requesting a lower withholding tax rate.

When does the new withholding tax need to be paid to the ATO?

The new rules require buyers to pay the new withholding tax to the ATO on or before the day the buyer becomes the owner of the property (i.e. generally by settlement). However, it may be impractical to expect a buyer to pay at least $200,000 to the ATO before settlement. Most buyers need a loan to fund the purchase of their property and banks will not release funds to a buyer until such time as they can obtain security over the property.

Practically speaking, the ATO has recognised this difficulty, stating that it will allow a grace period between settlement and the latest date for payment of the withholding tax. However, the ATO has not indicated how long this grace period will be. A buyer may therefore be able to pay the tax after settlement, without penalty. It should be noted, however, that interest at the general interest charge rate will apply if the withholding tax is not paid within the grace period (at present, this rate is 9.28% per annum).

Non-final tax

Foreign resident sellers should note that the new withholding tax to be collected by buyers is not the only tax that they may have to pay. Once a buyer has paid the withholding tax to the ATO, the foreign resident seller will still need to lodge an income tax return to include their taxable capital gain or income, and a credit will be available for the amount that the buyer already withheld and paid to the ATO. Additional tax may therefore need to be paid by a foreign seller, depending on their circumstances.

Conclusion

The new withholding tax appears to be designed to prevent foreign residents from avoiding their CGT liabilities on the sale of Australian real estate. However, the rules are wider. The new rules will result in an additional compliance burden for all parties involved in property and security transactions. A failure to follow the rules may result in significant penalties. From 1 July 2016, it is expected that the question of the seller's tax residency status will be included in most buyers' requisitions, where the transaction involves a sale price of $2 million or more. It is also expected that the question of whether certain indirect interests in Australian real estate are covered by the new rules will become a major area of contention between sellers, buyers and the ATO. This could sometimes delay the effecting of such transactions.

Application of provisions - flowchart

Exchange of contracts happens on or after 1 July 2016?

No → The foreign resident CGT withholding tax (**CWT**) does NOT apply.

Yes ↓

Is buyer buying Australian real estate or shares or units in an Australian company or unit trust whose majority assets are Australian real estate?

No → CWT does NOT apply.

Yes ↓

Is value of real estate or shares or units $2 million or more?

No → CWT does NOT apply.

Yes ↓

Is seller an Australian tax resident or a foreign tax resident?

Australian resident → CWT does NOT apply. Seller may provide buyer with a **written declaration** or an ATO **clearance certificate** certifying seller's Australian tax resident status.

Foreign resident → 10% CWT applies. Buyer needs to withhold 10% of sale price and pay withholding amount to ATO by settlement.

However, if either seller or buyer considers withholding rate too high, they may apply to ATO for a variation.