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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES No. 6) BILL 2015

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Treasurer, the Hon Scott Morrison MP)

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Glossary

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

Abbreviation	***Definition***
CGT	capital gains tax
Commissioner	Commissioner of Taxation
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
TAA 1953	*Taxation Administration Act 1953*
TARP	taxable Australian real property

General outline and financial impact

Capital gains tax treatment of earnout rights

Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* to change the capital gains tax (CGT) treatment of the sale and purchase of businesses involving certain earnout rights – rights to future payments linked to the performance of an asset or assets after sale.

As a result of these amendments, capital gains and losses arising in respect of look-through earnout rights will be disregarded. Instead, payments received or paid under the earnout arrangements will affect the capital proceeds and cost base of the underlying asset or assets to which the earnout arrangement relates.

Date of effect: These amendments apply from 24 April 2015.

However, taxpayers that have made statements to the Commissioner of Taxation (Commissioner) or undertaken other actions in reasonable anticipation of announcements made about the amendments in the 2010-11 Budget are protected against the Commissioner applying the law in a way that is inconsistent with what they have anticipated.

Proposal announced: This measure was first announced on 12 May 2010 in Press Release No. 98 of 2010 as part of the 2010-11 Budget.

On 14 December 2013, in a media released titled 'Integrity restored to Australia's tax system' the then Assistant Treasurer announced that the Government would proceed with this measure.

Financial impact: This measure has the following estimated financial impact over the forward estimates ($m). The impact of the measure was first reported in the 2010-11 Budget.

2015-16	***2016-17***	***2017-18***	***2018-19***
-5	-5	-5	-5

Human rights implications: This Schedule does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — Chapter 1, paragraphs 1.156 to 1.162.

Compliance cost impact: This measure will result in a small reduction in compliance costs for businesses utilising earnout arrangements, due to the reduced complexity of such arrangements.

Foreign resident capital gains tax withholding regime

Schedule 2 to this Bill introduces a new regime that imposes withholding obligations on the purchasers of certain Australian assets. The purpose of the regime is to assist in the collection of foreign residents' capital gains tax (CGT) liabilities.

Date of effect: 1 July 2016.

Proposal announced: This proposal was announced in the 2013-14 Budget.

Financial impact: This measure is estimated to have a gain to revenue of $330 million over the forward estimates period.

Human rights implications: Schedule 2 does not raise any human rights issues. See *Statement of Compatibility with Human Rights* — Chapter 2, paragraphs 2.140 to 2.143.

Compliance cost impact: These amendments have a medium compliance cost totalling $770,000 per year over a 10 year duration, comprising medium implementation impact and medium impact in ongoing compliance costs.

Compliance assessment: impact on business

Impact: This measure will affect individuals and entities that purchase certain types of taxable Australian property from a foreign resident, with an exemption for all transactions involving taxable Australian real property CGT assets below $2 million. Further affected are intermediaries involved in the property or share/unit settlement process, particularly conveyancers.

Main points:

- There is expected to be an overall increase in compliance costs, falling mainly on the purchaser and their representative. Individuals and entities will need to understand the new withholding regime and will need to take steps in order to fulfil their obligation as part of the transaction process.

- The extent of the compliance burden placed upon purchasers is limited by the application of the clearance certificate process, which is completed by vendors.

- Purchasers, or conveyancers working on their behalf, will need to fill out a mandatory 'foreign resident withholding purchaser remittance form' and remit the withholding obligation.

- There will be a continual need for new entities purchasing taxable Australian property from foreign residents to evaluate their business arrangements. Purchasers will be liable for the amount not withheld; they will need to maintain records with the declaration/clearance certificate of a vendor's residency status and retain receipts of amounts withheld.

Chapter 1
Capital gains tax treatment of earnout rights

Outline of chapter

1.1 Schedule 1 to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to change the capital gains tax (CGT) treatment of the sale and purchase of businesses involving certain earnout rights - rights to future payments linked to the performance of an asset or assets after sale.

1.2 As a result of these amendments, capital gains and losses arising in respect of look-through earnout rights will be disregarded. Instead, payments received or paid under the earnout arrangements will affect the capital proceeds and cost base of the underlying asset or assets to which the earnout arrangement relates.

Context of amendments

Background

1.3 On 12 May 2010, the former Government announced that the tax law would be amended to provide look-through CGT treatment for qualifying earnout arrangements entered into as part of the sale of business assets.

1.4 On 14 December 2013, the then Assistant Treasurer announced that following consultation on a number of the 92 announced but unenacted measures of the former Government, the Government would proceed with several of the measures including the proposed amendments to provide look-through CGT treatment to qualifying earnout arrangements.

Earnout arrangements

1.5 An earnout arrangement is an arrangement whereby as part of the sale of a business or the assets of a business, the buyer and seller are not able to agree on a fixed payment and instead agree that subsequent financial benefits may be provided, based on the future performance of the business or a related business in which the assets are used.

1.6 In a standard earnout arrangement, the buyer agrees to pay the seller additional amounts if certain performance thresholds are met within a particular time. In a reverse earnout arrangement, the seller agrees to repay amounts to the buyer if certain performance thresholds are not met within a particular time. Some earnout arrangements combine the features of both a standard earnout and a reverse earnout as both the buyer and seller may be obligated to provide financial benefits depending on performance.

1.7 Earnout arrangements are used in the sale of businesses where there is difficulty agreeing about the value of the business. In this situation, the earnout arrangement allows parties to reach a mutually acceptable arrangement despite differences in how the parties value the business by linking additional financial benefits (or, for a reverse earnout, refunds of prior financial benefits) to the future economic performance of the business.

1.8 For example, two parties are negotiating the sale of the business where a significant part of the value of the business linked to its customer base – that is its goodwill. There is considerable uncertainty about how the sale and other factors may impact upon this goodwill. The parties could agree to a price based on the best available estimate of the business's value, but there would be a significant chance that the estimate would not reflect the actual future economic performance of the business. Alternatively, the parties could agree to an earnout arrangement under which part of the consideration for the sale was linked to the future economic performance of the business. This avoids the need to rely on an estimate by linking financial benefits to future events.

CGT and earnouts arrangements

1.9 For the purposes of CGT, a business consists of a number of CGT assets (including the business's goodwill, debts and contractual rights as well as the physical assets of the business).

1.10 The sale of a business will generally either involve the disposal of some or all of these assets, or, if the business is held through a company or trust, the sale of an interest or interests in the relevant entity, all of which will generally give rise to capital gains or losses.

1.11 The Commissioner of Taxation (Commissioner) provided public advice setting out the treatment of earnout rights – rights to future financial benefits under earnout arrangements – in a draft public ruling in 2007 (Draft Taxation Ruling TR2007/D10).

1.12 Under the view taken in this ruling, where the sale of a business involves an earnout arrangement, the earnout right or rights created are separate CGT assets.

1.13 Where an earnout right is provided by the buyer to the seller in relation to the disposal of a business (a standard earnout arrangement) the earnout right will be property the seller received (or is entitled to receive) in relation to the disposal and forms part of the capital proceeds of the disposal. Where a right is provided from the seller to the buyer (a reverse earnout arrangement), the right is an additional asset being provided along with the other business assets and the capital proceeds must be apportioned between the rights created and the other CGT assets that have been sold.

1.14 In all cases the tax consequences for the parties to the disposal are tied to an estimate of the value of the earnout right at the time the CGT event occurs. As the rationale for the creation of the earnout right is the difficulty in estimating the value of the business, it is likely that any estimate of the value of the earnout right will differ from the financial benefits that are in fact provided or received. If the estimated amount of these future financial benefits differs from the financial benefits actually provided or received there will be no change to the capital proceeds and cost base of the relevant business asset or assets.

1.15 Subsequent financial benefits provided under the right can result in a capital gain or loss for the holder of the right as a result of CGT event C2 occurring (see section 104-25 of the ITAA 1997). However, there are no CGT consequences for the entity obliged to provide financial benefits under the right. As a result, the costs of providing these financial benefits are generally not recognised in the CGT provisions.

1.16 The CGT concessions that can apply to the sale of business assets will not be relevant to either the amounts paid for the creation of the earnout right or subsequent financial benefits provided under the right. While the right may be linked to a business, it is a separate CGT asset with different characteristics and, unlike the business assets, will not satisfy the tests for relevant concessions (including the active asset test in the CGT small business concession – see section 152-35 of the ITAA 1997).

Consultation

1.17 This measure was subject to extensive stakeholder consultation.

1.18 Confidential consultation on proposed drafting instructions took place from 21 July 2014 to 4 August 2014. In this process, stakeholders were broadly supportive of the proposed approach. A number of technical issues were raised that result in changes to the instructions as well as some issues around the proposed scope of the amendments that resulted in a review of the proposed changes in light of the Government's announced policy.

1.19 Following the completion of preliminary draft legislation, confidential consultation on this draft legislation and explanatory material then took place from 29 January 2015 to 12 February 2015. In this process stakeholders raised a number of issues about the scope of the proposed changes. A number of these issues were out of the scope of the Government's announced policy, such as extending the proposed concessions beyond CGT. However, a number of changes to the draft were made to address other identified concerns, such as replacing the proposed retrospective application of the measure with an extension of the protection provided for reasonable anticipation of unenacted measures. A number of technical issues were also identified and addressed.

1.20 Finally, public consultation on updated exposure draft legislation and explanatory material took place from 23 April 2015 to 21 May 2015. A number of further minor changes were made to the proposed legislation following this consultation to address concerns and technical issues identified by stakeholders.

Summary of new law

1.21 Schedule 1 provides that taxpayers may disregard capital gains or losses that arise in relation to a qualifying right to financial benefits – a 'look-through' earnout right.

1.22 Instead, taxpayers must include financial benefits provided or received under or in relation to such rights in determining the capital proceeds of the disposal of the underlying asset (for the seller) or the cost base and reduced cost base of the underlying asset for the buyer.

1.23 Schedule 1 also amends the rules around amendments to assessments, interest charges, recognition of capital losses and access to CGT (and other) concessions to ensure this new treatment provides taxpayers with outcomes broadly consistent with those that would have arisen had the value of all of the financial benefits under the earnout right been included in the capital proceeds from the disposal of the underlying asset for the seller and the cost base or reduced cost base of the underlying asset for the buyer at the time of the relevant CGT event.

Comparison of key features of new law and current law

New law	*Current law*
Capital gains and losses in respect of a look-through earnout right are disregarded.	No special rules apply to capital gains or losses in respect of rights to future financial benefits under earnout arrangements.
Financial benefits under or in respect of a 'look-through' earnout right are included when determining the capital proceeds or cost base of the underlying business assets to which the arrangement relates.	No special rules apply to financial benefits provided under or in respect of earnout rights.
A taxpayer's assessment for a tax related liability that can be affected by financial benefits provided or received under a 'look-through' earnout right may be amended for up to four income years after the end of the income year in which the last potential financial benefit under the right was due to be paid.	No special rules apply to financial benefits provided under or in respect of earnout rights.
Capital losses arising from a CGT event related to an earnout right may not be taken into account in determining tax liabilities until such time as they cannot be reduced by future financial benefits received under a relevant look-through earnout right.	No special rules apply to losses arising under or in respect of earnout rights.

Detailed explanation of new law

1.24 Schedule 1 makes a number of modifications to the operation of the CGT provisions in respect of CGT events that happen in under or in relation to certain earnout rights – referred to as a ***look-through earnout right***.

Look-through earnout rights

1.25 A ***look-through earnout right*** is a right to future financial benefits which are not reasonably ascertainable at the time the right is created. The right must be created under an arrangement involving the disposal of a CGT asset that is an active asset of the seller, and the financial benefits under the right must be contingent on and reasonably related to the future economic performance of the asset (or a related business). ***[Schedule 1, item 4, sections 118-560 and 118-565 of the ITAA 1997]***

1.26 This definition reflects a variety of policy considerations around the scope of this measure.

1.27 Broadly, these amendments will allow for the deferral of the payments of income tax in relation to part of the consideration for the sale of a business or its assets. However, this deferral will be available only in particular circumstances – it is not intended to allow taxpayers to generally delay the payment of income tax.

1.28 Instead, the proposed changes are intended to ensure that the CGT provisions do not present a deterrent to a specific type of transaction – the sale of a business where a genuine disagreement about the value of the business going forward is resolved by at least one of the parties agreeing to provided future financial benefits linked to the performance of the business. The requirements around look-through earnout rights limit the availability of the deferral to this specific circumstance.

Disposal

1.29 To this end, to be a look-through earnout right, a right must be created as part of an arrangement for a disposal of the business or its assets – that is, the disposal must cause CGT event A1 to happen. ***[Schedule 1, item 4, paragraphs 118-565(1)(b) and (c) of the ITAA 1997]***

1.30 Under the CGT provisions, where a disposal occurs, CGT event A1 will happen, either on its own or, in some cases, in addition to one or more other CGT events. Sometimes, when CGT event A1 happens in addition to another CGT event, it will not be the most specific CGT event that happens in that situation. In this situation, the gain or loss that arises may be determined under the rules applying to the other CGT event (see section 102-25 of the ITAA 1997). However, in this situation, CGT event A1 still happens in addition to the other event and so the relevant right may still be a look-through earnout right.

1.31 The requirement around disposal is intended to limit the benefit of this concession to arrangements for the disposal of a business. The CGT concession for look-through earnout rights is intended to address the difficulties in determining the value of a business (or certain assets of the business). It is not intended to provide tax benefits to temporary transfers (such as a loan or the granting of a lease), ongoing business relationships (such as the purchase of an ownership interest) or complex financing arrangements where there is no final disposal of the underlying asset.

1.32 In some cases a right may relate to the disposal of more than one CGT asset. In this case, the financial benefits provided under the right will need to be reasonably apportioned between the various assets, consistent with the general apportionment rules for CGT (see sections 112-30 and 116-40 of the ITAA 1997)

The business or its assets

1.33 Additionally, what is disposed of must be an active asset of the business before it is sold. ***[Schedule 1, item 4, paragraph 118-565(1)(d) of the ITAA 1997]***

1.34 As discussed this measure applies to the sale of a business or the assets of a business. The concept is already found in the CGT law as 'active asset'.

1.35 Active asset is defined in section 152-40 of the ITAA 1997. Broadly, and subject to certain exclusions, an active asset is an asset of the taxpayer that is used in the business of the taxpayer or a connected or affiliated entity. A membership interest in an Australian resident company or trust will also be an active asset if at least 80 per cent of the assets of the company or trust (by value) are active assets (rather than passive investments).

1.36 It is important to note that applying the special rules around membership interests may involve a number of steps – for example, if the sole asset of Company A is a share in Company B, which itself only holds a share in Company C, the character of interests in both A and B will depend on the character of the assets of C.

1.37 Assets that are not active assets are not sufficiently linked to the conduct of a business to fall within the intended scope of the concession for earnouts.

1.38 However, the general definition of active asset gives rise to two difficulties in the context of the application of these amendments to shares and interests in trusts.

1.39 First, the definition of active asset specifically excludes interests in non-resident entities. This exclusion reflects particular policy considerations in the context of the general small business concessions. However, in the context of this measure there is no policy reason why interests in foreign entities should receive different treatment.

1.40 To address this first issue, the amendments allow interests in foreign entities to be active assets for the purpose of this measure. ***[Schedule 1, item 4, subsection 118-570(2) of the ITAA 1997]***

1.41 Secondly, determining if such interests are active assets requires valuing the assets of the underlying entity. As one of the problems these amendments are intended to address is that businesses and their assets can be difficult to value, requiring a valuation to access the concession would run counter to this purpose.

1.42 To address this second issue, the amendments provide that an eligible share or an interest in a trust is treated as an active asset in the hands of an entity for the purpose of determining if a look-through earnout right exists. To be an eligible share or interest:

- the entity holding the share or interest must either:
  - if they are an individual, be a CGT concession stakeholder in relation to the company or trust; or
  - if they are not an individual, own a sufficient share of the business that they would be a CGT concession stakeholder were they an individual,
- the trust or company must carry on a business and have carried on a business or businesses for at least one prior income year; and
- for the immediately preceding income year, at least 80 per cent of the assessable income of the trust or company must have come from the carrying on a business or businesses and not been derived as an annuity, interest, rent, royalties or foreign exchange gains, or derived from or in relation to financial instruments.

[Schedule 1, item 4, section 118-570 of the ITAA 1997]

1.43 This alternative test allows taxpayers to avoid the need to value the assets of the trust or company. Instead, they need only look at how the trust or company has earned its income over the past income year. This achieves broadly the same policy goal – of ensuring the concession is available only in relation to the sale of a business – while relieving taxpayers of the compliance costs associated with obtaining a reliable valuation in respect of contingent future financial benefits.

1.44 This alternative test is only available for taxpayers that have a sufficiently large interest in the relevant entity that they qualify as a CGT concession stakeholder (or would qualify if they were an individual). Generally this means that the entity must be entitled to at least 20 per cent of any distributions and hold at least 20 per cent of any voting rights. This reflects the intention of the amendments to apply to disposals of a business, not to the sale of a passive investment.

1.45 Consistent with the rules for active assets generally, this alternative test is not restricted to assets held by the taxpayer. Where the character of a share or interest held by the taxpayer depends on the character of the shares or rights held by other entities, this alternative test can also apply when determining the characters of the shares or interests held by that other entity.

1.46 For the purposes of this test, it does not matter if the relevant interest is an interest in an Australian resident or foreign entity.

Example 1.1

Jonathan is approached by XYZ Ltd which wishes to purchase Gardening Ltd and Building Ltd. Both companies are both wholly-owned by Holding Ltd, a company wholly-owned and controlled by Jonathan.

Following negotiations Jonathan and XYZ Ltd agree that Jonathan will sell his shares in Holding Ltd to XYZ Ltd for $1 million, plus the right to a further payment of up to $250,000 based on the performance of Gardening Ltd and Building Ltd against certain profit targets over the next two years.

For this right to be a look-through earnout right, amongst other things, Jonathan's shares in Holding Ltd must be an active asset.

For shares in a company to be an active asset of a taxpayer for these purposes, either:

- at least 80 per cent of the market value of the assets of the company, including any cash or financial instruments held by the company, must be active assets; or
- the company, in which the taxpayer had a small business participation percentage of at least 20 per cent, had been carrying on business for at least one whole income year and during that time at least 80 per cent of the income of the company derived from carrying on that business and not from passive investment.

As Holding Ltd is not carrying on a business its shares cannot qualify to be treated as active assets under the extra method provided under these amendments. Therefore, Jonathan's shares will only be an active asset if Holding Ltd's shares in Building Ltd and Gardening Ltd are active assets.

Gardening Ltd holds no assets that are not active assets. As a result, Holding Ltd's shares in Gardening Ltd are also active assets.

Building Ltd holds financial instruments that cannot be active assets and the value of some of its active assets, particularly its goodwill is difficult to determine. However, Building Ltd has been in existence for five income years and, in the past income year, more than 99 per cent of its income related to its building services business, with less than 1 per cent being derived from financial instruments.

As Holding Ltd has a small business participation percentage of 100 per cent in Building Ltd, its shares in Building Ltd can be treated as an active asset.

As a result, all of Holding Ltd assets can be treated as active assets and so Jonathan's shares in Holding Ltd can also be treated as active assets for these purposes, permitting Jonathan to treat the right to future payments as a look-through earnout right provided the other requirements are satisfied.

Contingent on the future economic performance of the asset

1.47 For a right to be a look-through earnout right, future financial benefits provided under the right must be linked to the future economic performance of the asset or a business in which the asset is used and not reasonably ascertainable at the time the right is created. ***[Schedule 1, item 4, paragraphs 118-565(1)(a), (f) and (g) of the ITAA 1997]***

1.48 The concession provided to look-through earnout rights is only intended to cover rights created to resolve uncertainty about the value of the business that is being sold due to difficulties determining future economic performance, not to all deferred payment arrangements.

1.49 Where the measure of performance relates to a business, there must be a reasonable belief at the time of the disposal that the asset will actually be used in this business. If there is no intention to use the asset in the business, then the economic performance of the business is not a reasonable proxy for the performance of the asset.

1.50 In the case of the entity disposing of the asset, this will be based on what is reasonable given their knowledge of the intention of the other party (which may well be limited). Generally, in the absence of evidence to the contrary, if the assets of a business are sold to an entity for use in carrying on a business, they will continue to be used for this purpose.

Contingent on economic performance

1.51 Economic performance is a flexible and wide concept, broadly encompassing the success of the relevant economic activity. Given the breadth of the concept and the variety of context in which it can apply, there is no one means of measuring economic performance. Instead, measuring this performance generally involves identifying various features that represent or are associated with performance in the particular context.

1.52 For financial benefits to be contingent on the economic performance of a particular business or asset, the benefits must be linked to a reasonable measure of this performance in the context of the business or asset.

1.53 Whether a particular measure appropriately identifies economic performance will depend on the context of the business or asset in question. Measures that may be appropriate include both financial measures such as the profit, sales or turnover of the business (or the business in which the asset is used) and non-financial measures such as the number of clients retained or attracted. In some cases, indirect measures of performance may be appropriate – for example, in the case of a CGT asset that is an interest in a holding company, the sole asset of which is a controlling interest in a third entity, an accurate measure of the economic performance of the third entity is also likely to be an accurate measure of the economic performance of the holding company.

1.54 However, any measure adopted must be reasonable in the particular context. Hence, while some measures such as profit will often be appropriate, and others, such as the performance of financial indicies, are very unlikely to be appropriate, it is always necessary to consider how the economic performance of the business can reasonably be measured. For example, some research and development businesses may well not expect to make a profit for a considerable period after they start up, even if they are extremely successful. For these businesses, during this period in their operations, short-term profit may not necessarily be a good measure of their economic performance.

1.55 In considering this, it is important to distinguish between economic performance and the discovery of further information about an existing asset. Many assets are sold subject to a warranty that a financial benefit will be provided if the asset is found not to meet certain standards. This is a right to a contingent financial benefit. However, it cannot qualify as a look-through earnout right as the payment is not linked to the economic performance of the asset – the value generated by its use. Rather, the benefit is contingent on a discovery about the nature of the asset – the asset not actually meeting the promised standards. Such rights are not intended to benefit from the concessions provided for look-through earnout rights.

1.56 That said, while this divide is clear in the case of warranties and other similar specific agreements relating to information and valuation, economic performance and measures of economic performance can be affected by such valuation issues. The fact that a measure of performance may be affected by income and valuation issues does not necessarily mean that the measure is inappropriate. Often, even the best measures of the economic performance of a business or asset can potentially be affected by valuation issues.

1.57 For example, a right to future financial benefits in relation to a potential mineral resource based on the value of any ore reserves once identified would likely not be contingent on economic performance - rather it is solely contingent on obtaining further information about an existing asset. However, a right to financial benefits based on the profit of the entity owning the resource may well be contingent on economic performance, despite the fact that this profitability may be very significantly affected by what is found out about the value of the mineral rights.

Reasonably related to economic performance

1.58 For a right to be a look-through earnout right, in addition to the financial benefits being contingent on the future economic performance of the asset or the business in which it is used the value of the benefits must also reasonably relate to this performance. ***[Schedule 1, item 4, paragraph 118-565(1)(g) of the ITAA 1997]***

1.59 This means that, for example, a right to future financial benefits provided as part of the sale of a business where the financial benefits are contingent on the business meeting certain profit targets would generally not qualify as a look-through earnout right if the value of the financial benefits to be provided clearly exceeded the amount of the profits themselves.

1.60 This requirement does not entail a precise or mathematical link between performance and payment – a lump sum payment may well be as appropriate as a percentage of profits if it appears in the circumstances a reasonable estimate of economic performance. Further, in the context of commercial arrangements it is generally for the parties, not the Commissioner to determine what value they place on a particular benefit. However, the value of the contingent financial benefits provided under the right must neither be out of all proportion to the benefits that could have been reasonably expected to result from performance nor otherwise wholly unrelated to the contingency to which they are linked. For example, a right under which the same benefit would be provided if either a contingency occurs or does not occur would likely be considered to fail this requirement.

1.61 To the extent financial benefits provided under a right may not reasonably relate to economic performance, they are for some other purpose than resolving this uncertainty and are outside the intended scope of this concession.

Example 1.2

Cake Co has acquired a number of businesses including Cupcake Ltd and Muffin Ltd as part of a plan to expand from the wholesale to retail baking sector.

As part of the purchase of Cupcake Ltd and Muffin Ltd, Cake Co agreed to provide a right to future payments to the former owners of these businesses if certain conditions are met.

For Cupcake Ltd, Cake Co has agreed to provide payments of fixed amounts if the number of customers making purchases from Cupcake Ltd exceeds a specified number. These payments may be contingent on economic performance – the number of purchases can be a reasonable measure of economic performance of a business, especially a retail business.

For Muffin Ltd, Cake Co has agreed to provide payments based on the outcome of certain litigation being undertaken by Muffin Ltd and based on an independent valuation of the performance of the business two years after the purchase.

The payment based on the outcomes of litigation is not contingent on economic performance. It does not relate to the performance of Muffin Ltd or any of its assets but to clarification by a court of legal obligations – while this may affect the value of Muffin Ltd or its assets it has nothing to do with their economic performance.

The payment based on the independent valuation of Muffin Ltd may be contingent on economic performance. The value of a business at a time may be a reasonable measure of its performance up to that time. In this context, it is unlikely to matter that the value of Muffin Ltd may well have been affected by the outcome of the litigation.

Reasonably ascertainable

1.62 For a right to be a look-through earnout right, the financial benefits provided must also be not be reasonably ascertainable at the time the right is created. ***[Schedule 1, item 4, paragraph 118-565(1)(a) of the ITAA 1997]***

1.63 In most cases, the fact that financial benefits are contingent will mean that they are also reasonably unascertainable. However, in some cases a benefit may be contingent on future events where there is little or no doubt that these events will transpire and the quantum of the payment is fixed or can reasonably be determined given what is known. In this case, the benefit can reasonably be ascertained and the right cannot be a look-through earnout right.

Five year payment limitation

1.64 For a right to be a look-through earnout right, the right must not require financial benefits to be provided more than five years after the end of the income year in which the relevant CGT event occurs in relation to the disposal of the relevant active asset. ***[Schedule 1, item 4, paragraph 118-565(1)(e) of the ITAA 1997]***

1.65 The requirement only applies to payments under the look-through earnout right – other payments, such as the payment of instalments may be made in relation to the disposal without affecting the character of the right.

1.66 The purpose of this requirement is twofold.

1.67 First, this requirement ensures concessions for look-through earnout rights are not available to long-term profit sharing arrangements. Such arrangements are in substance the transfer of equity and should be treated similarly to other such transfers, such as the issuing of shares.

1.68 Secondly, the requirement places a reasonable limit on the period of deferral to avoid providing excessive and distorting benefit to look-through earnout rights. The intention of the measure is to address the potential difficulties created by valuing earnout rights for tax purposes, not to create tax incentives for the use of earnout rights.

1.69 This requirement is not breached simply because one party or another may be late in providing a financial benefit under the look-through right, even if the other party tolerates this lateness.

1.70 It will also not be breached if the agreement includes provisions that allow for a delay in payment contingent on events, such as a dispute over the terms of the agreement being subject to a binding arbitration process. However, the relevant contingency must be outside the control of either party and not a contingency that a reasonable person would consider likely at the time of the agreement. Further, while this process may involve a delay in when payment is required, it must not result in any change in the amount payable under the agreement. ***[Schedule 1, item 4, subsection 118-565(3) of the ITAA 1997]***

1.71 However, the five year requirement will be breached if the agreement includes an option for the parties to extend the period over which financial benefits are provided or to enter into a new agreement providing for the continuation of substantially similar financial benefit in relation to the asset.

1.72 Further, if the parties vary the right to extend the period over which financial benefits are provided beyond five years or enter into a new agreement to create an equivalent right to further future financial benefits after this time then the right will be taken to have never been a look-through earnout right. ***[Schedule 1, item 4, section 118-565(2) of the ITAA 1997]***

Example 1.3

David has purchased Wine Ltd from Adam. Under the arrangement, David undertook to make a number of further payments to Adam based on the profits earned by Wine Ltd, the last of which was due one month before the 5 year anniversary of the sale. The right to these further payments met the requirement to be a look-through earnout right.

The conditions for this final payment to be made are satisfied, but, due to a series of administrative errors, David is 12 months late in providing the payment.

As a result, the final payment under the look-through earnout right occurs more than 5 years after the end of the income year in which the sale occurred. However, this does not affect the character of the right as a look-through earnout right – the late payment by David does not alter the fact that the right still only provided for financial benefits over five years from the end of the relevant income year.

Example 1.4

Judy has sold her business, Pharma Co, to Vanessa.

Under the arrangement, Vanessa agrees to provide Judy with 5 per cent of the annual profit of Pharma Co over the next three years if the profits for the year exceed a fixed threshold. This right qualifies as a look-through earnout right.

In the third year of the arrangement, Judy and Vanessa agree that the payments will continue for a further five years in exchange for Judy making a lump sum payment to Vanessa.

As a result of this extension, Judy is now entitled to receive future financial benefits that are contingent on economic performance more than five years after the income year in which she disposed of the business.

Due to this, the right is now not a look-through earnout right and is taken to have never been a look-through earnout right. Judy and Vanessa may now need to request that the Commissioner make appropriate changes to their income tax assessments.

Arm's length

1.73 Finally, all look-through earnout rights must be created as part of arrangements entered into on an arm's-length basis. ***[Schedule 1, item 4, paragraph 118-565(1)(h) of the ITAA 1997]***

1.74 The concessions provided to look-through earnout rights are only intended to be available for commercial transactions. Allowing the concessions to be available for non-commercial arrangements is inappropriate and would create scope for abuse.

Rights to receive financial benefits for ending a look-through earnout right

1.75 A right will also be a look-through earnout right if it is a right to receive financial benefits provided in exchange for ending a right that is a look through earnout right under the general rules. ***[Schedule 1, item 4, subsection 118-565(4) of the ITAA 1997]***

1.76 A right to receive payment for ending an earnout right generally includes a right to receive a payment for transferring the entitlement to payment to another, as the original entitlement has been lost.

1.77 Payments to end a look-through earnout rights are in effect a replacement for the payments that would have been made under the right. By providing the same tax treatment even where the financial benefit may be provided by a third party, these amendments avoid inconsistent tax treatment and unnecessary complexity.

Consequences of a right being a look-through earnout right

1.78 Broadly, if a right is a look-through earnout right, two consequences arise:

- the value of the right is disregarded for the purposes of CGT; and
- the value of any financial benefits made or received under the right is included in either the capital proceeds arising from the disposal (for the seller) or the cost base of the acquisition (for the buyer).

Disregarding the right

1.79 Generally, when a taxpayer creates or disposes of a CGT asset, the taxpayer must take into account any money and property received when determining the capital proceeds arising from the CGT event or events. Similarly, when acquiring a CGT asset, a taxpayer takes into account the full value of any money and other property provided to acquire the asset in determining the cost base of the asset.

1.80 However, as was identified previously, in the case of earnout rights this can pose difficulties. The purpose of providing the right to future financial benefits under such arrangement is often to resolve difficulty in agreeing a valuation. In this context, requiring a valuation goes against the rationale for the concession.

1.81 To address this, any capital gain or loss arising in respect of the creation or cessation of a look-through earnout right will be disregarded. ***[Schedule 1, item 4, section 118-575 of the ITAA 1997]***

1.82 Similarly, the value of a look-through earnout right will not be taken into account in determining the capital proceeds of the disposal of the active asset for the seller nor the cost base and reduced cost base of the asset acquired by the buyer. ***[Schedule 1, items 1 and 3, paragraphs 112-36(1)(a) and 116-120(1)(a) of the ITAA 1997]***

Adjusting the capital proceeds and the cost base for subsequent financial benefits

1.83 In the place of taxing the value of the look-through earnout rights, Schedule 1 amends the income tax law to include the value of any financial benefits subsequently provided or received under or in relation to such a right in the original capital proceeds of the disposal for the related asset for the seller, or the initial cost base and reduced cost base of the asset for the buyer as at the date of the original acquisition. ***[Schedule 1, items 1 and 3, paragraphs 112-36(1)(b) and (c) and 116-120(1)(b) and (c) of the ITAA 1997]***

1.84 This ensures that the amounts received under a look-through earnout right is appropriately recognised in the tax system, without requiring the right itself to be valued.

Example 1.5

Anna sells all of the shares in her business, ABC Co, to Purple Ltd in March 2016.

Under the sale arrangement, Anna receives an upfront payment of $1 million at the time of sale and a right to two future payments of up to $100,000 in March 2017 and March 2018 provided the turnover of ABC Co exceeds an agreed threshold during 2016 and 2017 respectively. This right is a look-through earnout right.

At this time Anna’s capital proceeds for the sale of the business are $1 million – the total of the upfront payment she has received. Anna has also received the right to future payments which she would generally need to include in the capital proceeds, but as this is a look-through earnout right, the value of the right is disregarded when working out the capital proceeds.

As Anna has a cost base of for ABC Co of $600,000, at this time Anna has a capital gain of $400,000 (capital proceeds of $1 million less the cost base of $600,000) as a result of the sale.

ABC Co's turnover exceeds the agreed threshold in 2016 and so Purple Ltd pays Anna a further $100,000.

As a result of this payment, the capital proceeds from the sale of ABC Co at the time of the original CGT event are now considered to be $1.1 million – made up of the $1 million initial payment and the $100,000 payment she received in March 2017. She has now made a capital gain of $500,000 (capital proceeds of $1.1 million less the cost base of $600,000) as a result of the sale.

Finally, in July 2017, Purple Ltd decides it would prefer to end the arrangement immediately. It offers to pay Anna $50,000 if she will agree to forgo her right to further payments under the look-through earnout right and Anna agrees to this offer.

This financial benefit provided to terminate a look-through earnout right is treated in the same way as a financial benefits provided under the right.

As a result, Anna's total capital proceeds for the sale are $1.15 million, made up of the $1 million initial payment, the subsequent $100,000 payment under the earnout right and the $50,000 payment to end the earnout right.

Anna's final capital gain from the sale is $550,000 (capital proceeds of $1.15 million less the cost base of $600,000), which is considered to have arisen in March 2016 at the time of the original CGT event.

1.85 In circumstances where a taxpayer subsequently disposes of an asset that is subject to an ongoing look-through earnout right before their obligations or entitlements in relation to financial benefits under the right are exhausted, their cost base for the asset may change as a result of any subsequent financial benefits they pay or receive. In this situation, the taxpayer will need to adjust the capital gain or loss on that subsequent disposal.

Choices and timing

1.86 This approach results in the amount of a capital gain or loss changing as a result of financial benefits provided or received in subsequent income years. A number of special rules are required to ensure that this does not disadvantage taxpayers or impose unnecessary compliance and administrative costs.

1.87 The first difficulty that could arise relates to the gap between the CGT event and the financial benefits provided under an earnout right.

1.88 As the financial benefits may be provided up to five years after the end of the income year in which the CGT event occurred, for some taxpayers, the period of review for the income year in which the CGT event occurred may have passed before the taxpayer has provided or received the financial benefits requiring the amendment.

1.89 To address this, these amendments extend the period of review for all of a taxpayer's tax-related liabilities that can be affected by the character of the look-through earnout right. The amendments also extend the period of review in respect of tax-related liabilities that can be affected by the character of rights that are treated as never having been a look-through earnout right (see paragraph 1.72). ***[Schedule 1, items 1 and 3, subsections 112-36(3) and 116-120(3) of the ITAA 1997]***

1.90 For these tax-related liabilities, the period of review is the later of the period of review that would normally apply and four years after the end of the final income year in which financial benefits could be provided under the look-through earnout right.

1.91 This extension applies to all tax-related liabilities that can be affected by the change to a capital gain or loss as a result of financial benefits provided under a look-through earnout right. This includes liabilities in subsequent years and tax-related liabilities for taxes other than income tax. For example, the small business CGT retirement concessions provide, broadly, that certain contributions to superannuation linked to capital gains arising from the sale of business asset are not counted towards non-concessional superannuation contribution caps. If the amount of the relevant gain for a taxpayer changes as a result of the financial benefits provided under an earnout right, the extended amendment period would apply to the assessment of the taxpayer's non-concessional contributions.

1.92 In certain limited cases, changing the capital proceeds or cost base of a CGT asset held by one taxpayer may impact upon the tax-related liabilities of another taxpayer. For example, certain small business CGT concessions provide benefits for CGT concession stakeholders in a company. This extension will also apply to the tax-related liabilities of these related entities if they can be affected by the character of a right as look-through earnout right.

1.93 The extension also applies to a taxpayer's right to object where they are dissatisfied with an assessment. Where the Commissioner amends a taxpayer's assessment because of a financial benefit provided or received under an earnout right or a right that is taken to never have been an earnout right, the taxpayer may object in the same way the taxpayer may object to any other amendments to an assessment. Where a taxpayer is dissatisfied with an assessment as the Commissioner has not made an amendment due to a financial benefit provided or received under an earnout right, these amendments will allow the taxpayer to object within 60 days of receiving notice of the Commissioner's decision not to amend the assessment, even if they would otherwise be out of time. ***[Schedule 1, items 1, 3 and 33, subsections 112-36(5) and 116-120(5) of the ITAA 1997 and paragraph 14ZW(1)(aaaa) of the Taxation Administration Act 1953 (TAA 1953)]***

1.94 The second difficulty is that, under the general CGT law, a taxpayer is not able to change a choice that they have previously made.

1.95 In this situation, where the amount of a gain or loss may substantially vary from the amount of the gain or loss identified in the year in a way that is uncertain, it would not be reasonable to require taxpayers to adhere to their initial choice (indeed in some situation a taxpayer may not have been eligible to make the choice they now wish to make based on the gain or loss in that initial year).

1.96 These amendments will permit taxpayers to amend a choice made previously where the choice relates to a capital gain or loss that can be affected by financial benefits provided under a look-through earnout right. The decision to vary a choice must be made by the time the taxpayer is required to lodge a tax return for the period in which the financial benefits under the look-through earnout right is received. ***[Schedule 1, items 1 and 3, subsections 112-36(2) and 116-120(2) of the ITAA 1997]***

1.97 Thirdly, taxpayers must generally pay interest on the amount of any income tax due for an income year that is not paid by the due date for payment. Similarly, but in more limited circumstances, the Commissioner may pay taxpayers interest on overpayments of tax.

1.98 As financial benefits provided or received under look-through earnout rights modify the capital proceeds of a disposal and the cost base of the asset acquired in an earlier year, underpayments and overpayments will unavoidably arise in this year for affected taxpayers. The imposition of interest on these amounts would not be appropriate.

1.99 Instead, the Schedule provides that:

- taxpayers are not be subject to interest on any shortfall that arises as a consequence of financial benefits provided or received under a look-through earnout right, as long as the taxpayer requests an amendment to their relevant income tax assessment within the period they must lodge their income return for the income year in which the financial benefit was provided or received; and

- the Commissioner is not be liable to pay interest on any overpayment of tax that arises as a result of financial benefits provided or received under a look-through earnout right.

[Schedule 1, items 34 to 37, subsections 280-100(5), 280-102A(4) and 280-102B(4) in Schedule 1 to the TAAct 1953 and subsection 9(1B) of the Taxation (Interest of Overpayments and Early Payments) Act 1983]

1.100 Effectively, neither taxpayers nor the Commissioner need to pay interest solely because a financial benefit is provided or received under a look-through earnout right.

1.101 The final difficulty is that this measure may result in changes to the capital loss available to taxpayers back over five years. This means that in some cases where entities dispose of assets and receive a look-through earnout right, they will initially be in a capital loss position. However, they will have a strong expectation that this will change as a result of subsequent financial benefits they will receive under the right.

1.102 Under the normal rules governing the income tax treatment of capital losses, this notional loss could affect tax positions in each year until the year in which the last potential payment under the earnout right is due to be paid. This could potentially result in financial benefits that reduce this loss requiring amendments to assessments not just to the year in which the disposal occurred, but to every subsequent year in which part of the loss was applied. Over a five year period, this could potentially involve 15 separate amendments (that is, assuming one financial benefit was received in each income year, one amendment would be made in the first year to the assessment of the original year, two in the second year to the assessments for both the original year and the first year and so forth, up to the fifth year where five amendments would be needed, resulting in a total of 15 amendments).

1.103 Further, in this situation the taxpayer would also receive an excessive tax benefit. By being able to make use of the ‘loss’ they have incurred on the disposal until subsequent financial benefits are received under the earnout right, they have been able to defer not just the payment of any tax on the eventual capital gain from the disposal, but also in respect of other capital gains arising in subsequent years.

1.104 To avoid these concerns, capital losses arising from the disposal of assets to which look-through earnout rights relate are temporarily disregarded until and to the extent that they become certain. ***[Schedule 1, item 4, section 118-580 of the ITAA 1997]***

1.105 Once such losses become certain, they are available from the year in which the loss was originally incurred, not when the amount became certain.

Example 1.6

In June 2016, Lucas sold his business, Software Enterprises Ltd (a small business entity with only active assets) to Buyer Co.

Lucas receives a fixed upfront payment of $750,000 and has a number of additional entitlements to future payments under several look-through earnout rights contingent on a variety of profit and performance targets being met by Software Enterprises. As he has a cost base of $800,000 for Software Enterprises, at this stage Lucas has made a capital loss of $50,000. However, as Lucas may potentially receive further payments of an amount greater than $50,000 under the look-through earnout rights, he must disregard this loss in both the current year and subsequent years.

In the 2016-17 financial year, Lucas receives further payments totalling $250,000 under the look-through earnout rights. This payment is included in the capital proceeds of the sale of Software Enterprises, meaning that Lucas has now received a total of $1 million and has a capital gain of $200,000. This gain results in an increase in his income tax liability for that year.

At the same time as Lucas lodges his tax return for the 2016-17 year, he also requests an amendment to his assessment for the 2015-16 income year to include the additional capital gain resulting from the payment under the rights. As a result he would not be subject to shortfall interest charge on any amount of additional tax he must pay for the 2015-16 year as a result of this amendment – in effect he is in the same position as if the payment had been taxed in the income year in which it was received.

In June 2020, Lucas receives a final payment of $100,000 under the look-through earnout rights. Consistent with the previous payments this amount is included in the capital proceeds of the sale and Lucas requests an amendment to his income tax assessment for 2015-16 to reflect the increased capital gain of $300,000.

As an individual who did not satisfy any of the conditions for a longer amendment period, Lucas’s assessment for 2015-16 would normally only be able to be amended by the Commissioner for two years from the date of the original assessment. By June 2020, this period would have passed.

However, in this case, the Commissioner may still amend Lucas’s assessment in respect of the payment as it is a financial benefit under a look-through earnout right that affects the amount of Lucas’s income tax liabilities for the year in which the sale occurred and the amendment is sought within four years of the end of the income year in which the final potential financial benefit under the right was to be provided.

Access to CGT concessions

1.106 The changes to the treatment of look-through earnout rights are only intended to affect a taxpayer's entitlement to CGT concessions insofar as this may occur as a result of the value of the underlying disposal now including all of the amounts provided for and under the earnout right.

1.107 In general, this is achieved without the need for additional special rules. Taxpayers are entitled to remake choices relating to the disposal or the asset they received as a result of the disposal. As a result, taxpayers may reconsider any choices and their entitlement to concessions in light of subsequent receipts and payments to ensure that the resulting gain, loss or cost base reflects any concessions that are available and only those concessions that are available.

1.108 Likewise, in some cases, a taxpayer may not initially be in a position to elect that a concession to apply to a CGT event. Alternatively, a taxpayer may be concerned that anticipated future financial benefits in respect of a look-through earnout right may mean that they cease to be eligible for a concession to apply after they have taken irrevocable actions based on this concession (such as making contributions to superannuation). In these cases, as the taxpayer can remake choices they can simply wait until it is clear whether or not they will be finally eligible for the concession before making any choice.

1.109 However, some of the CGT small business concessions require things to be done or decisions to be made within a fixed period of the time the relevant CGT event occurs. Specifically:

- the CGT small business retirement exemption in Subdivision 152-D of the ITAA 1997 allows a taxpayer to disregard all or part of a capital gain, if, relevantly, the taxpayer contributes an equivalent amount to their superannuation, or if the taxpayer is a company or trust, the superannuation of the CGT concession stakeholder of the company or trust, either when the proceeds are received or at the time the choice is made for an individual, or seven days after these times for a trust or company;

- the CGT small business 15 year exemption in Subdivision 152-B of the ITAA 1997 permits a company or trust may disregard an amount in determining its taxable income if, amongst other things, the amount is paid to a CGT concessional stakeholder within two years after the relevant CGT event;

- additionally, section 292-100 of the ITAA 1997 provides, amongst other things, that if the taxpayer receives a payment from a trust or company of the sort described in the second dot point above within two years of the relevant CGT event and subsequently contributes this amount to superannuation, the amount of this contribution does not count towards the non-concessional contributions cap; and

- the CGT small business 'rollover' allows the taxpayer to disregard a capital gain, but may result in a capital gain arising for the taxpayer under certain other CGT events (CGT events J2, J4, J5 and J6) if the taxpayer does not acquire an appropriate asset or undertake suitable expenditure within a the replacement asset period, which ends two years after the last CGT event in the year in which the 'rollover' is accessed.

1.110 These concessions would be problematic in the context of look-through earnout rights as actions may need to occur before the final amount of the relevant capital gain or loss is known.

1.111 To address this, the period for accessing these concessions is extended.

1.112 For the CGT small business retirement exemption, special rules already exist for instalment payments that allow the concession to apply where amounts are contributed as payments are received. However, there may be doubts about whether financial benefits under an earnout right are instalments. The amendments would specifically apply the same rules to financial benefits received under or in respect of earnout rights. ***[Schedule 1, items 14 and 17, paragraphs 152-125(1)(b) and 292-100(4)(b) of the ITAA 1997]***

1.113 For the CGT small business 15 year exemption, and the related concession under section 292-100 in relation to non-concessional contributions, the two year period is extended to last until two years after the final potential financial benefit under the look-through earnout right is concluded. ***[Schedule 1, items 15 and 16, subsections 152-305(1B) and 152-335(2A) of the ITAA 1997]***

1.114 Further, the Government proposes to make separate consequential changes to the regulations regarding acceptance of superannuation contributions to ensure that any forced delay in making contributions does not affect a taxpayer's entitlement to make the contribution.

1.115 Finally, for the CGT small business 'rollover', the replacement asset period would similarly be extended until two years after the final potential financial benefit under the look-through earnout right could have been provided. ***[Schedule 1, items 6, 8 to 12 and 18, paragraph 104-185(1)(a), subsections 104-190(1A) to (3) and (5), paragraph 104-198(1)(a), subsections 104-198(2) and (4) and the definition of replacement asset period in subsection 995-1(1) of the ITAA 1997]***

Example 1.7: Access to CGT concessions

Returning to Example 1.6, upon receiving the final payment under the look-through earnout right, Lucas chooses to access the small business rollover in relation to the gain.

Broadly, the small business rollover provides that, amongst other things a taxpayer may disregard a capital gain if:

- the gain arises from the disposal of an active asset; and
- the net value of the individual's CGT assets (together with the CGT assets of their connected and affiliated entities) does not exceed $6 million.

If after accessing the rollover exemption a taxpayer does not acquire an appropriate replacement asset (broadly an active asset of equivalent value) within the replacement asset period they would be subject to additional tax.

Normally Lucas would be unable to access this exemption in respect of the full amount of the gain as under the CGT law he makes a binding choice not to apply the concession by not applying at the time when the gain first arose.

However, as the gain arose due to financial benefits in respect of a look-through earnout right this rule does not apply. The choice can be remade provided Lucas decides to revise the choice before he is due to lodge his income tax return for the 2019-20 income year – the income year in which he received the final financial benefit under the look-through earnout right.

Similarly, generally the replacement asset period ends two years after the relevant CGT event occurred, so Lucas would be subject to additional tax if he has not already acquired a replacement asset. However, as the relevant CGT event was a disposal to which a look-through earnout right relates, this period is extended until 6 months last date on which a financial benefit could be provided under the arrangement, allowing Lucas until December 2020 to acquire a replacement asset.

It should be noted that while Lucas's choice now means that he may have paid too much tax in 2015-16 as a result of the now disregarded capital gain, he is not entitled to interest from the Commissioner on this overpayment as it has arisen as a result of financial benefits under a look-through earnout right.

Access to CGT concessions – the maximum net asset value test

1.116 A particular problem would also arise in respect to the maximum net asset value test.

1.117 This test, found in section 152-15, is one of the tests that can make taxpayers eligible to access the small business CGT concessions. To satisfy the test, the value of the CGT assets of the taxpayer and any entities that they control or are controlled by must not exceed $6 million at the time of the relevant CGT event.

1.118 As this valuation is separate from the determination of cost base or capital proceeds, it could require the taxpayer to value an asset that is subject to a look-through earnout right.

1.119 Consistent with the overall purpose of the amendments, Schedule 1 revises the maximum net asset value test to provide that when working out the value of an entity's CGT assets just before the time of a CGT event, taxpayers should be able to elect not to include the value of any look-through earnout right the entity may hold, but instead take into account any financial benefits that the entity may have provided or received under the look-through earnout right after that time. ***[Schedule 1, item 134, section 152-20]***

1.120 Special rules are also included to make sure that the value of these financial benefits is not taken into account multiple times where the look-through earnout right relates to an asset that the entity holds at the time of the valuation. ***[Schedule 1, item 134, subsection 152-20(5) of the ITAA 1997]***

1.121 The election to use this method may only be made once no further financial benefits can be provided under the look-through earnout right.

CGT concessions and the implications of changes to capital proceeds

1.122 The availability of some CGT concessions is linked to the capital proceeds of the CGT event or the income or turnover of a taxpayer in the relevant income year. Similarly, some CGT concession apply only where the taxpayer has a capital gain but not where the taxpayer has a capital loss or vice versa.

1.123 These characteristics in the past income year can change based on financial benefits that the taxpayer provides or receives in relation to a look-through earnout right.

1.124 As a result, a taxpayer may become eligible or cease to be eligible for a CGT concession as a result of these financial benefits. Such changes will require an alteration to the taxpayer's assessment or assessments reflecting the availability or loss of the concession in addition to the changes required as a direct result of the financial benefits under the look-through earnout right.

1.125 As previously outlined, a taxpayer will not be subject to shortfall interest charge on additional tax that they must pay as a result of providing or receiving financial benefits under a look-through earnout right. However, to the extent a taxpayer has accessed a concession for which they are ultimately not eligible due to these financial benefits, any additional tax that arises falls outside the scope of that exception and the taxpayer will be subject to shortfall interest charge.

1.126 Additionally, while the receipt of financial benefits under a look-through earnout right may allow the taxpayer to remake choices and often extends the period in which a choice can be made, it does not entitle the taxpayer to undo the actions they have taken in that period. For example, if a taxpayer has made contributions to superannuation in order to access a concession, they cannot withdraw these contributions now they are no longer available.

Foreign resident CGT withholding and transactions involving look-through earnout rights

1.127 Schedule 2 of this Bill, introduces a new regime that imposes withholding obligations on, broadly, the purchasers of certain types of taxable Australian property (see Chapter 2 for more information on Schedule 2).

1.128 Where the relevant taxable Australian property is an active asset of a business (for example if it is land used for the purposes of a business and not for generating rent) it may also potentially be subject to a look-through earnout right as part of the sale.

1.129 However, under the general rules for look-through earnout arrangements any future financial benefits linked to the economic performance of the asset may well only be included in the capital proceeds of the underlying asset after the time the initial withholding tax is calculated and paid. Therefore, an additional rule is necessary to ensure a portion of the future financial benefit payment is paid to the Commissioner.

1.130 If a transaction to which foreign resident capital gains withholding applies involves a look-through earnout right, the taxpayer does not need to include any amount referable to the future financial benefits under the look-through earnout right. ***[Schedule 1, item 40, subparagraph 14-200(3)(a)(i) in Schedule 1 to the TAA 1953]***

1.131 Instead, if the original transaction required a purchaser to pay an amount to the Commissioner, the purchaser must also pay an amount to the Commissioner with respect to any financial benefits provided under look-through earnout rights at such time as the benefit are received. ***[Schedule 1, item 41, section 14-205 in Schedule 1 to the TAA 1953]***

1.132 The purchaser must pay 10 per cent of the financial benefit to the Commissioner. The Commissioner may vary the required amount (see paragraphs 2.95 to 2.103 in Chapter 2). ***[Schedule 1, item 41, subsection 14-205(4) in Schedule 1 to the TAA 1953]***

Example 1.8: Withholding and look-through earnout rights

> Patrick acquires farm land from a vendor he knows to be a foreign resident. The purchase price for the premises is $3 million.
>
> Because the parties are uncertain as to the value of the farm land, Patrick also agrees to pay, to the vendor, a future amount calculated on the profits that Patrick is able to generate from the farm land. The right to receive this payment is, in the hands of the vendor, a look-through earnout right.
>
> Patrick withholds $300,000 from the purchase price and pays this amount the Commissioner.
>
> Two years later, Patrick's business farm has been very successful. He is required to pay $50,000 to the vendor under the terms of the sale contract. Patrick is required to pay $5,000 to the Commissioner and may withhold this amount from the payment to the foreign resident vendor.

1.133 Generally, if the purchaser was required to withhold with respect to the original transaction, financial benefits will be subject to these additional rules. However, the latter obligation may be relieved where there is a change in circumstances relating to the residency of the person ultimately receiving the financial benefit.

1.134 This may arise because the residency of the original foreign resident changes. Alternatively, the financial benefit may be directed towards a person who was not a part of the original transaction. In either case, the question, of whether the person receiving the benefit is a relevant foreign resident, is reassessed at the time the financial benefit is provided or received.

Example 1.9: Look-through earnout rights and changes in circumstance

Further to Example 1.8, assume that, before the payment of the $50,000, the vendor provided Patrick with a declaration that the vendor was now an Australian resident for income tax purposes. Patrick is not required to pay any amount to the Commissioner.

Consequential amendments

Consolidation

1.135 Subsection 705-65(5B) of the ITAA 1997 was inserted into the law to create special rules to deal with earnout arrangements in the context of consolidated groups.

1.136 Broadly, it requires consolidated groups to revise the allocated cost amount of an entity that joins the group to take account of subsequent money or property provided in respect of the acquisition of a membership interest in the entity where the subsequent money or property was not taken into account in working out the allocated cost amount when the entity joined the group.

1.137 Prior to these amendments, there were concerns about the effectiveness of this section. As the provision only applies where amounts were not taken into account in determining the initial cost base, if the value of the right to future money or property is taken into account at that time, subsection 705-65(5B) of the ITAA 1997 would not apply.

1.138 However, as this measure will now mean that the value of the right is explicitly disregarded when determining the initial cost base, subsection 705-65(5B) of the ITAA 1997 will now operate as originally intended.

Contingent on economic performance

1.139 Contingent on economic performance is a defined term in the ITAA 1997. It generally bears its ordinary meaning, but specifically provides that the ability or willingness of an entity to meet obligations and the receipts or turnover of an entity or activity are to be disregarded in determining if a right is contingent on economic performance.

1.140 The first matter, disregarding the ability or willingness of an entity to meet an obligation to satisfy the right or provide the return is included for avoidance of doubt – a financial benefit contingent on the choice or capacity of another is not contingent on economic performance.

1.141 However, the second matter, disregarding receipts and turnover is a modification of the ordinary meaning. While there are many cases in which receipts or turnover may not link to economic performance, there are many other cases in which it can be an appropriate measure. This exclusion reflects the context of the use of the term within the ITAA 1997.

1.142 This restriction presents a problem for the current amendments, where the exclusion of measures of economic performance based on receipts and turnover would unduly limit the scope of the concession. At the same time, it would be problematic to create another term with the same meaning as the ordinary meaning of ‘contingent on economic performance’.

1.143 To address this, a consequential amendment has been made to remove the existing definition of ‘contingent on economic performance’ so that the term now bears its ordinary meaning. Existing references to ‘contingent on economic performance’ have been replaced by the new defined term ‘contingent on aspects of economic performance’, which is defined in exactly the same way as ‘contingent on economic performance’ was previously. No change to the outcomes under the existing law results from the change in terminology, ***[Schedule 1, item 26, subsection 974-85(1) of the ITAA 1997]***

1.144 The power under the present law to modify the meaning of ‘contingent on economic performance’ by regulation will be retained in relation to the new term ‘contingent on aspects of economic performance’. ***[Schedule 1, items 18 to 25 and 27 to 31, paragraphs 25-85(2)(a) and 230-15(4)(a), subsection 230-460(13), table items 2 in subsections 820-930(2) and 974-75(1), paragraph 974-80(2)(a), the example in subsection 974-80(2), the heading to subsection 974-85(1), subsection 974-85(2), paragraph 974-85(4)(c), subsection 974-140(1) and the definitions of ‘contingent on the economic performance’ and ‘contingent on aspects of the economic performance’ in subsection 995-1(1) of the ITAA 1997]***

Other consequential amendments

1.145 A number of minor consequential amendments have been made to headings and guidance materials to reflect the consequences of the principal amendments made by this Schedule. ***[Schedule 1, items 2, 5, 7 and 42, item A1 in the table in section 116-25, the heading to section 104-190, the definition of look-through earnout right in subsection 995-1(1) of the ITAA 1997 and item 101 of the table in subsection 250-10(2) in Schedule 1 to the TAA 1953]***

Application and transitional provisions

Application date

1.146 Most of the amendments made by Schedule 1 will apply to all earnout arrangements entered into on or after 24 April 2015, the first working day on which draft legislation to give effect to this measure was made public. ***[Schedule 1, item 37]***

1.147 The amendments relating to the interaction of these amendments and the foreign resident capital gains withholding regime will apply to acquisitions made on or after the later of 1 July 2016 and first day both these amendments and the foreign resident capital gains withholding regime have commenced. ***[Schedule 1, item 43]***

1.148 This ensures that the changes to deal with the interactions of the two sets of rules only apply if both sets of rules are in place. See Chapter 2 for more information on the foreign resident capital gains withholding regime.

Transitional rules

Protection for taxpayer anticipation

1.149 These amendments do not apply prior to 24 April 2015. However, taxpayers that have reasonably and in good faith anticipated changes to the tax law in this area as a result of the announcement by the former Government will have their current income tax treatment preserved. ***[Schedule 1, item 38]***

1.150 This protection measure introduced by this Schedule operates by reference to the protection measure introduced in relation to certain tax measures announced by former Governments that did not proceed in section 170B of the *Income Tax Assessment Act 1936*.

1.151 This approach protects taxpayers that have reasonably anticipated changes without requiring complex retrospective changes or requiring taxpayers to make amendments to comply with the specific provisions of the final law the detail of which could not have been anticipated.

1.152 As with this earlier measure, the protection will operate by placing a statutory bar on the Commissioner amending an income tax assessment in relation to a particular contained in a statement, to the extent that the particular represents the taxpayer's reasonable anticipation of the announced changes to the law and satisfies the timing conditions.

1.153 Amongst other things, the timing conditions for the earlier protection measure applied differently to events before and after 14 December 2013 (see subsection 170B(3) of the ITAA 1997). For the purposes of this measure, the timing conditions will apply differently based on whether events happened before, or on or after 24 April 2015. Broadly, this means that the conditions will be satisfied if either:

- the statement is made between the date of the announcement and 23 April 2015 and if the statement was made in a return, the return was not required to be lodged before 24 April 2015; or

- the statement is made in a return lodged on or after 24 April 2015, the return was not required to be lodged before that date, no prior return had been lodged or assessment made for that income year, and the statement relates to the application of the taxation law to events prior to 24 April 2015 or to which the taxpayer was committed prior to 24 April 2015.

1.154 Also consistent with the prior measure, any protection under the measure will be lost if the taxpayer makes a statement for a later year of income that is not consistent with the anticipated amendments reflected in the taxpayer's original statement in a way that is to the taxpayer's benefit. Assessments may be amended at any time to give effect to the loss of protection.

Example 1.10

On 14 February 2014, Lauren enters into an arrangement to sell her business, Trapeze Services, to Circus Ltd. As part of the sale, Circus Ltd agrees to provide two annual payments of up to $100,000 contingent on ticket sales and profitability of Trapeze Ltd over those two years.

Lauren lodges her 2013-14 tax return on 30 July 2015. In this return, she anticipates, that the announced measure relating to CGT treatment for earnout arrangements will apply this transaction, based on the original announcement on 11 May 2010 and the discussion paper issued on 12 May 2010.

As a result of this anticipation, Lauren does not include the value of the two future payments contingent on performance when determining her capital gains from the sale of Trapeze Services. Provided her anticipation is reasonable, Lauren will receive the benefit of the protection rule and the Commissioner will not be able to amend this assessment, even though the amendments made by this Schedule will not apply at this time.

In February 2015, Lauren receives the full $100,000 payment available under the earnout right for that year.

Lauren's return for the 2014-15 income year will be lodged after 23 April 2015. However, the timing rule means that Lauren will be protected if she lodges her return on the basis of the law as she has anticipated it in her prior return and this anticipation was reasonable, as this will be a statement relating to circumstances prior to 24 April 2015.

Subsequently, in February 2016, Lauren again receives the full $100,000 available for that year.

In this case both the payment and the lodgement of the return occur well after 23 April 2015. However, again, Lauren will be protected against subsequent amendments by the Commissioner if she prepares her return on the basis of the law as she had previously anticipated. The statements in the return relate to the circumstances of her original transaction and the rights created under the transaction, to which Lauren was committed prior to 24 April 2015.

It is open to Lauren to prepare either or both of these subsequent returns on a basis that is not consistent with the law as she had anticipated in her original return. However, if she does and this is not to her detriment, the protection measure will no longer apply in respect of the statements in any of Lauren's returns and the Commissioner will apply the law as it stood at those times.

1.155 This protection measure affects how the Commissioner will apply the law in relation to earlier periods but does not actually change the law in these periods and so does not strictly speaking have retrospective effect. Additional, while the measure may affect past liabilities, it does so only to the benefit of the taxpayer.

Statement of Compatibility of Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Capital gains tax treatment of earnout rights

1.156 This Schedule 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

1.157 This Schedule amends the *Income Tax Assessment Act 1997* to change the capital gains tax treatment of the sale and purchase of businesses involving certain earnout arrangements – rights to future payments linked to the performance of an asset or assets after sale.

1.158 As a result of these amendments, capital gains and losses arising in respect of look-through earnout arrangements will be disregarded. Instead, payments received under the earnout arrangements will affect the capital proceeds and cost base of the underlying asset or assets to which the earnout arrangement relates.

1.159 There amendments can apply to transactions entered into as far back as 17 October 2007. However, the application is generally beneficial and optional for all parties. As a result, no taxpayer will be disadvantaged as a result of the retrospective application of these provisions.

Human rights implications

1.160 This Schedule does not engage any of the applicable rights or freedoms.

1.161 In substance, these amendments only alters the time at which capital gains or losses are recognised for tax purposes, and addresses technical issues.

Conclusion

1.162 This Schedule is compatible with human rights as it does not raise any human rights issues.

Chapter 2
Foreign resident capital gains tax withholding regime

Outline of chapter

2.1 Schedule 2 to this Bill amends the *Taxation Administration Act 1953* (TAA 1953) to introduce a new regime that imposes withholding obligations on the purchasers of certain Australian assets. The purpose of the regime is to assist in the collection of foreign residents' capital gains tax (CGT) liabilities.

Context of amendments

2.2 Foreign residents are subject to CGT on any capital gains they make from the disposal of certain Australian assets. Voluntary compliance with these requirements, however, is extremely low and compliance action, by the Australian Taxation Office, is difficult to undertake.

Taxation of foreign residents' capital gains

2.3 Australia's current foreign resident CGT regime was introduced in 2006, with the insertion of Division 855 into the *Income Tax Assessment Act 1997* (ITAA 1997). Consistent with international practice and Australia's international tax treaties, this regime promotes foreign investment in Australia. Subdivision 855-A operates to disregard a capital gain or capital loss made by a foreign resident unless the relevant CGT asset is taxable Australian property. Broadly, this includes:

- a direct or indirect interest in taxable Australian real property (TARP);
- an asset used in carrying on a business through a permanent establishment in Australia; or
- rights and options with respect to these assets.

Taxable Australian real property

2.4 A CGT asset is TARP if, under section 855-20, it is:

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

Indirect Australian real property interests

2.5 The objects of the foreign resident CGT regime (section 855-5) include ensuring that interests in an entity are subject to Australia's capital gains tax laws if the entity's underlying value is principally derived from Australian real property.

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

2.7 An 'indirect Australian real property interest' includes a non-portfolio interest (an interest of 10 per cent or more) in an entity whose underlying value is principally derived from Australian real property.

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

Compliance and collection

2.9 Foreign residents are required to lodge tax returns if they have derived Australian assessable income, including from a capital gain that is not disregarded under Division 855. Compliance with this obligation is very low in the case of foreign resident CGT liabilities. The Commissioner of Taxation (Commissioner) has a number of powers to assist in the collection of these liabilities; however, it can be difficult to apply these measures when funds from disposing of an asset have left the country, and there are no other assets in Australia to meet the tax liability.

2.10 Where the Commissioner is aware that a foreign resident has a tax liability, the Commissioner may be able to issue an income tax assessment. The ability of the Commissioner to enforce an assessment against a foreign resident, however, will depend on the circumstances, particularly whether the taxpayer is present in Australia or has other investments in Australia.

2.11 Where the taxpayer has other property in Australia, the Commissioner may seek a freezing order (*Mareva* injunction) against those assets, which can then be applied to the taxpayer's tax liability. Freezing orders can also extend to other parties in possession of or with the means of controlling the assets of the non-resident, or to assets which are in substance the assets of the non-resident albeit legally owned by another party. However, a foreign resident will often not have other Australian assets to satisfy a tax liability.

2.12 The Commissioner may also issue a notice under section 255 of the *Income Tax Assessment Act 1936* (ITAA 1936) to a person that is in control of a non-resident's money, requiring that person to pay the non-resident's tax. However, this mechanism requires that an assessment be raised to crystallise a tax liability (which can be done on an ad hoc basis) and is only effective where the assessment is made and the notice is served while the third party still has present or prospective control over the non-resident's funds. The money can be passed onto the non-resident within days, limiting the Commissioner's ability to give practical effect to the notice before the funds flow out of Australia. The Commissioner is also unlikely to have immediate knowledge of the transaction.

Withholding taxes

2.13 Withholding taxes are amounts that a person (the payer) withholds from a payment they make to another person (the recipient). Withholding taxes represent the (sometimes estimated) tax liability of the recipient. Withheld amounts are paid to the Commissioner. There is currently no specific withholding regime for capital gains and related property transactions.

2.14 A withholding tax may be final or non-final:

- A final withholding tax represents the final tax liability for the person receiving the withholding payment. Final withholding tax regimes exist for many revenue payments (for example dividends, interest payments and royalties) made to foreign residents.

- A non-final withholding tax is collected as an estimate of the recipient's final income tax liability. The recipient is still required to lodge an income tax return and pay any outstanding debit. They claim a credit for the amount of tax withheld in the income tax return at this time. Pay as you go withholding from salary and wages is an example of a non-final withholding tax.

2.15 The amendments establish a non-final withholding regime.

2.16 The amendments impose an obligation on the payer to pay an amount to the Commissioner. The person subject to the obligation is entitled to withhold the amount from any payment to the person with the primary tax liability.

2.17 Division 13 in Schedule 1 to the *Tax Administration Act 1953* (TAA 1953), which deals with the collection of tax with respect to alienated personal services income, is an example of this approach to withholding. Further examples are contained in Division 14, which imposes obligations with respect to the provision of non-cash benefits and certain accruing gains.

2.18 Mechanisms for the payment of withheld amounts to the Commissioner, including the creation of offences and the imposition of penalties, are contained in Division 16. Division 18 provides that recipients of a withholding payment are generally entitled to a credit for the amount withheld or a refund. Credits are applied to the recipient's income tax liability once they have lodged their income tax return.

Summary of new law

2.19 The amendments in Schedule 2 to the Bill impose a 10 per cent non-final withholding obligation on the purchasers of certain Australian assets where they acquire it from a relevant foreign resident.

2.20 The obligation does not require withholding as such, but does require the purchaser to pay 10 per cent of the first element of the cost base (usually, the purchase price) to the Commissioner. This amount may be withheld from the payment the purchaser makes to the vendor.

2.21 The obligation will apply to the acquisition of an asset that is:

- TARP;
- an indirect Australian real property interest; or
- an option or right to acquire such property or such an interest.

Summary of exemptions

2.22 To minimise the compliance costs that arise from these amendments, no obligation is imposed in any of the following situations:

- transactions involving TARP and certain indirect Australian real property interests, valued less than $2 million;
- a transaction that is conducted through a stock exchange or a crossing system;
- an arrangement that is already subject to an existing withholding obligation;
- a securities lending arrangement; or
- transactions involving vendors who are subject to formal insolvency or bankruptcy proceedings.

2.23 In addition, no obligation is imposed in any of the following situations:

- in the case of TARP and certain indirect Australian real property interests, where the vendor obtains a clearance certificate from the Commissioner; or
- in the case of other types of property covered by the amendments:
  - where the vendor has made a declaration that they are an Australian resident for income tax purposes; or
  - where, if the CGT asset acquired is a membership interest, the vendor has made a declaration that the interest is not an indirect Australian real property interest.

2.24 The vendor declarations only exempt a specific vendor and withholding may still apply if the transaction involves multiple vendors.

Comparison of key features of new law and current law

New law	*Current law*
A purchaser that acquires certain Australian assets from a vendor that is a relevant foreign resident must pay 10 per cent of the purchase price to the Commissioner. The purchaser may withhold this amount from the vendor.	No equivalent.

Detailed explanation of new law

2.25 The withholding regime applies to purchasers that acquire certain taxable Australian property assets. When the purchaser acquires the asset, they must pay an amount, equal to 10 per cent of the first element of the cost base (usually, the total purchase price) to the Commissioner. The purchaser may withhold the amount from any amount owed to the vendor of the asset.

2.26 This differs from the majority of withholding rules in two respects.

2.27 Firstly, the obligation applies to, in effect, the total purchase price for the asset acquired, rather than to a specific payment. This prevents multiple withholding obligations arising in relation to a single transaction that is completed through instalments.

2.28 Although there is no obligation to withhold as such, the obligation to pay the amount to the Commissioner is still described as a withholding obligation because the payment amount may be withheld from the vendor.

2.29 Secondly, the obligation is imposed on the purchaser of the property. Other withholding regimes that operate on a flow of funds basis may impose withholding obligations on intermediaries. Intermediaries are not required to withhold under the amendments.

Conditions for the obligation

2.30 Purchasers are only required to pay an amount to the Commissioner when the following conditions are satisfied:

- the asset acquired is a relevant Australian asset ***[Schedule 2, item 1, paragraph 14-200(1)(c) in Schedule 1 to the TAA 1953]***;

- the acquisition is not an excluded transaction ***[Schedule 2, item 1, subsection 14-200(1) in Schedule 1 to the TAA 1953]***; and
- any vendor of the property is a relevant foreign resident, and:
  - where the asset is TARP or a certain type of indirect Australian real property interest, the vendor has not obtained a clearance certificate from the Commissioner ***[Schedule 2, item 1, paragraph 14-210(1)(e) and subsection 14-210(2) in Schedule 1 to the TAA 1953]***;
  - in the case of other assets covered by the amendments, the purchaser has not received a declaration from the vendor that they are an Australian resident, and the purchaser satisfies the knowledge condition – that is the purchaser knows or has reason to believe the vendor is a foreign resident ***[Schedule 2, item 1, subsections 14-210(1) and 14-210(3) in Schedule 1 to the TAA 1953]***;or
  - in the case where the asset is a membership interest, the vendor has not made a declaration that the membership interests are not indirect Australian real property interests ***[Schedule 2, item 1, subsection 14-225(2) in Schedule 1 to the TAA 1953]***.

Relevant assets

2.31 The withholding obligation arises when a purchaser acquires an asset that is:

- TARP;
- an indirect Australian real property interest; or
- an option or right to acquire such property or such an interest.

[Schedule 2, item 1, paragraph 14-200(1)(c) in Schedule 1 to the TAA 1953]

2.32 These assets are detailed at paragraphs 2.4 to 2.8.

2.33 The amendments only apply to these assets. Other assets that are taxable Australian property are not subject to the amendments. For example, an asset, not being an asset listed in paragraph 2.31, that is used in carrying on a business through an Australian permanent establishment is not subject to the amendments.

2.34 The scope of the amendments reflects that the compliance burden of withholding in relation to these assets would be too high. In addition, foreign residents with a taxable presence in Australia represent a lower compliance risk.

2.35 Further assets and transactions are specifically excluded from the regime.

Excluded transactions

2.36 There are a number of transactions excluded from the scope of the withholding regime. A transaction that results in the acquisition of a CGT asset is excluded if any of the criteria in this section are met. This means that the purchaser acquiring the asset is not required to pay an amount to the Commissioner.

TARP less than $2 million

2.37 The amendments do not apply to TARP that has a market value of less than $2 million. ***[Schedule 2, item 1, subparagraph 14-215(1)(a)(i) in Schedule 1 to the TAA 1953]***

2.38 The purpose of this exclusion is to minimise compliance costs, alleviating the need for purchasers to undertake the preliminary compliance obligation of determining the residency status of the vendor. This exclusion will ensure that the amendments are clearly inapplicable to most residential property sales. ***[Schedule 2, item 1, paragraph 14-215(1)(a) in Schedule 1 to the TAA 1953]***

2.39 The exclusion applies to TARP, including residential premises, commercial property, vacant land, leasehold, easements, covenants, mortgages and stratum title schemes that have a value of less than $2 million. These will generally fall within the definition of TARP.

2.40 Where there are multiple purchasers, the *de minimis* threshold applies to the market value of the sum of all of the purchasers' interests. This ensures that joint purchasers cannot avoid the threshold. ***[Schedule 2, item 1, subsection 14-215(2)]***.

Company title interests

2.41 Under company title, entities own shares in a company that owns real property rather than any direct real property interest. The shares confer rights to occupy the real property to which the company has legal title. This is an indirect Australian real property interest.

2.42 Company title interests also fall within this exclusion if the value of the relevant interest is less than $2 million. ***[Schedule 2, item 1, subparagraph 14-215(1)(a)(ii)]***

2.43 This will align the treatment for entities that own property through company title with the treatment for those that own property through strata title.

2.44 Other indirect real property interests do not fall within this exclusion.

Transactions on a stock exchange

2.45 The amendments do not apply to 'on-market transactions' that are conducted on an approved stock exchange. The nature of these transactions makes it impossible for a purchaser to determine the identity and residency status of their counterparty. ***[Schedule 2, item 1, paragraph 14-215(1)(b) in Schedule 1 to the TAA 1953]***

2.46 'Approved stock exchange' is defined in subsection 995-1(1) of the ITAA 1997 and approved stock exchanges are listed in Schedule 5 to the *Income Tax Assessment Regulations 1997*. It is intended that these regulations would be updated to include Chi-X Australia Pty Ltd.

Transactions that are conducted on a broker-operated crossing system

2.47 A crossing system (also known as a 'dark pool') is a system that enables trading off market, although the trades are typically reported to the market immediately after they take place.

2.48 The amendments do not apply to transactions that are conducted using a broker-operated crossing system. Whether the transaction is effected on-market or on a crossing system is often outside of the vendor's control. As with transactions that occur on-market, it may not be possible for a purchaser to determine the identity and residency status of the counterparty. ***[Schedule 2, item 1, paragraph 14-215(1)(c) in Schedule 1 to the TAA 1953]***

2.49 'Crossing system' is defined in rule 1.4.3 of the *ASIC Market Integrity Rules (ASX Market) 2010*.

Other withholding obligations

2.50 It is intended that the amendments apply as a withholding regime of last resort. As such, the amendments will not apply where another withholding obligation applies to the transaction. ***[Schedule 2, item 1, paragraph 14-215(1)(d) in Schedule 1 to the TAA 1953]***

Securities lending arrangements

2.51 A securities lending arrangement is an arrangement under which a holder of securities agrees to provide its securities to a borrower for a specified period of time, with an associated agreement by the borrower to return equivalent securities at the end of the agreed period. These arrangements are typically entered into for purposes such as short-selling or hedging.

2.52 Securities lending arrangements are eligible for roll-over relief under section 26BC of the ITAA 1936. As these arrangements will not trigger a CGT liability for the vendor, they are exempt from the withholding obligation. ***[Schedule 2, item 1, paragraph 14-215(1)(e) in Schedule 1 to the TAA 1953]***

External administration and bankruptcy

2.53 Where the foreign resident is a company under external administration at the time of the transaction, the amendments will not apply. This will ensure that the withholding obligation does not disturb the priority of other creditors.

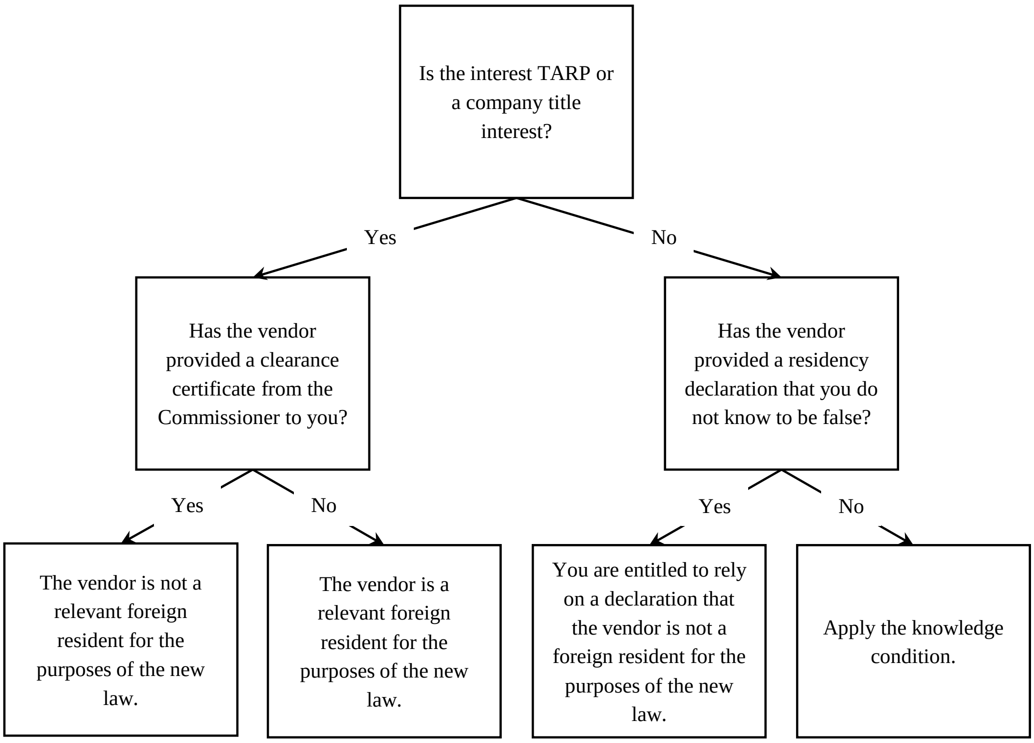
2.54 This exclusion will be satisfied if any of the conditions in paragraph 171A(1)(a) of the *Corporations Act 2001* are satisfied, or if the company is in the same or a similar position under a foreign law. ***[Schedule 2, item 1, paragraph 14-215(1)(f) in Schedule 1 to the TAA 1953]***

2.55 Where the foreign resident is an individual, the amendments will not apply where the transaction arises from the administration of a bankruptcy estate, a composition or scheme of arrangement, a debt agreement, a personal insolvency agreement, or same or similar circumstances under a foreign law. ***[Schedule 2, item 1, paragraph 14-215(1)(g) in Schedule 1 to the TAA 1953]***

Relevant foreign resident vendors

2.56 The obligation to pay an amount to the Commissioner only arises if the vendor is a relevant foreign resident (which, where applicable, may include a resident if they have not obtained a clearance certificate from the Commissioner).

Diagram 2.1: Are you dealing with a relevant foreign resident?



2.57 In the case where the CGT asset to which the transaction relates is TARP, or an indirect Australian real property company title interest, the entity will be treated as a relevant foreign resident unless a clearance certificate is obtained from the Commissioner certifying that the entity is not a relevant foreign resident for the purposes of these amendments. ***[Schedule 2, item 1, paragraph 14-210(1)(e) and subsection 14-210(2) in Schedule 1 to the TAA 1953]***

2.58 For other assets captured by the amendments, whether the purchaser is dealing with a relevant foreign resident will depend on whether they have received one of two declarations (which the purchaser does not know to be false), or whether the purchaser has reasonable grounds to believe the vendor is a foreign resident (referred to as 'the knowledge condition'). ***[Schedule 2, item 1, paragraphs 14-200(1)(b), and subsections 14-210(1) and (3) in Schedule 1 to the TAA 1953]***

2.59 If the purchaser acquires property from multiple vendors, the obligation to pay an amount may arise if any of the vendors is a relevant foreign resident.

The residency of the vendor

2.60 The definition, for tax purposes, of resident of Australia is contained in subsection 6(1) of the ITAA 1936. A foreign resident is a person other than a resident (subsection 995-1(1) of the ITAA 1997).

2.61 An individual (natural person) is generally an Australian resident if they reside here within the ordinary meaning of that term. An individual will also be an Australian resident if they:

- are domiciled in Australia; or
- are present in Australia for at least 183 days of the income year,

unless they have a permanent place of abode outside Australia.

2.62 A company is a resident of Australia if it is incorporated in Australia, if it carries on a business in Australia and has either its central management and control in Australia, or its voting power is controlled by shareholders who are Australian residents.

2.63 Tax residency can be a complex legal and factual question. The purchaser will often have limited information about the vendors to be able to determine the question. To overcome this difficulty for purchasers, additional tests determine when purchasers have sufficient knowledge about a vendor that withholding becomes appropriate.

Clearance certificates

2.64 Under the new law, the Commissioner may certify that, based on the information before the Commissioner, there is nothing to suggest that an entity is or will be a foreign resident during a specified period.

2.65 The certification as to residency by the Commissioner is only effective for the purposes of this Subdivision, and not for the purposes of the vendor's broader tax obligations. If the Commissioner decides to issue the certificate, it would be provided by the Commissioner to the entity, who would then need to provide it to the purchaser before settlement (that is, when the purchaser becomes the asset's owner). ***[Schedule 2, item 1, paragraph 14-210(2)(a) in Schedule 1 to the TAA 1953]***

2.66 The purchaser is entitled to rely on the clearance certificate and would not be required to pay an amount to the Commissioner.

2.67 The Commissioner may set a time period for the validity of the clearance certificate. The purchaser may rely on the certificate for multiple acquisitions (that is, the current acquisition and any future acquisitions made in that specified timeframe). ***[Schedule 2, item 1, subparagraph 14-210(2)(a)(ii) in Schedule 1 to the TAA 1953]***

2.68 A clearance certificate may only deal with the residency status of the vendor, and not the other matter for which a declaration is available (namely, a declaration that an interest is not an indirect Australian real property interest).

2.69 While the clearance certificate relates to the residency status of the vendor, the Commissioner may require an application for a clearance certificate to state whether the vendor holds the relevant asset on behalf of a foreign resident. This is intended to facilitate monitoring and compliance with existing tax laws. ***[Schedule 2, item 1, subsection 14-220(3) in Schedule 1 to the TAA 1953]***

2.70 A vendor that is dissatisfied with a decision made by the Commissioner about whether to issue a clearance certificate may object in the manner set out in Part IVC of the TAA 1953. ***[Schedule 2, item 27, section 20-80 in Schedule 1 to the TAA 1953]***

2.71 A certificate issued under this section will not amount to a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. An amendment is made to assist readers in this respect but is not intended to alter the operation of the law. ***[Schedule 2, item 1, subsection 14-220(4) in Schedule 1 to the TAA 1953]***

Example 2.1

Louis purchases real estate in Melbourne from Lucas for $3 million. Although Louis believes that Lucas is an Australian resident, unless Lucas provides Louis with a clearance certificate from the Commissioner, Lucas will be considered a relevant foreign resident. Louis would need to make a withholding payment to the Commissioner under the new law.

Example 2.2

Jane plans to sell a piece of real estate in Sydney to John for $4 million. Because Jane knows that she is a foreign resident at the time the transaction is entered into, she does not apply for a certificate from the Commissioner. In the absence of a certificate, Jane will be considered a relevant foreign resident for the purposes of these amendments. John is required to make a withholding payment to the Commissioner under the new law.

The knowledge condition

2.72 The knowledge condition is only relevant to acquisitions of indirect Australian real property interests (other than company title interests) and options and rights to acquire TARP or indirect Australian real property interests. It is not relevant to TARP and indirect interests that constitute company title interests, where the clearance certificate process applies.

2.73 If a purchaser does not know or have reason to believe a vendor is a foreign resident, the knowledge condition ensures that the obligation to pay an amount to the Commissioner does not arise. This provides certainty to purchasers. Purchasers not comfortable applying the knowledge condition may instead seek a vendor declaration that confirms that a vendor is not a relevant foreign resident (see paragraphs 2.80 to 2.85).

2.74 The knowledge condition does not apply where the purchaser obtains a residency declaration from the vendor. The purchaser is entitled to rely on the declaration, unless they know it to be false.

2.75 The knowledge condition is also satisfied where the purchaser has specific knowledge that a vendor is a foreign resident. For example, a purchaser will have specific knowledge where the vendor discloses that they are a foreign resident for income tax purposes. It does not apply in cases of constructive knowledge. ***[Schedule 2, item 1, paragraph 14-210(1)(a) in Schedule 1 to the TAA 1953]***

2.76 The knowledge condition is satisfied where the purchaser reasonably believes a vendor is a foreign resident. For example, a purchaser may have a reasonable belief if the purchaser learns that the vendor is likely to be living overseas (although, even if correct, this is not determinative as to tax residency). ***[Schedule 2, item 1, paragraph 14-210(1)(b) in Schedule 1 to the TAA 1953]***

2.77 The knowledge condition is also satisfied where the purchaser has no reasonable grounds to believe that a vendor is an Australian resident and either:

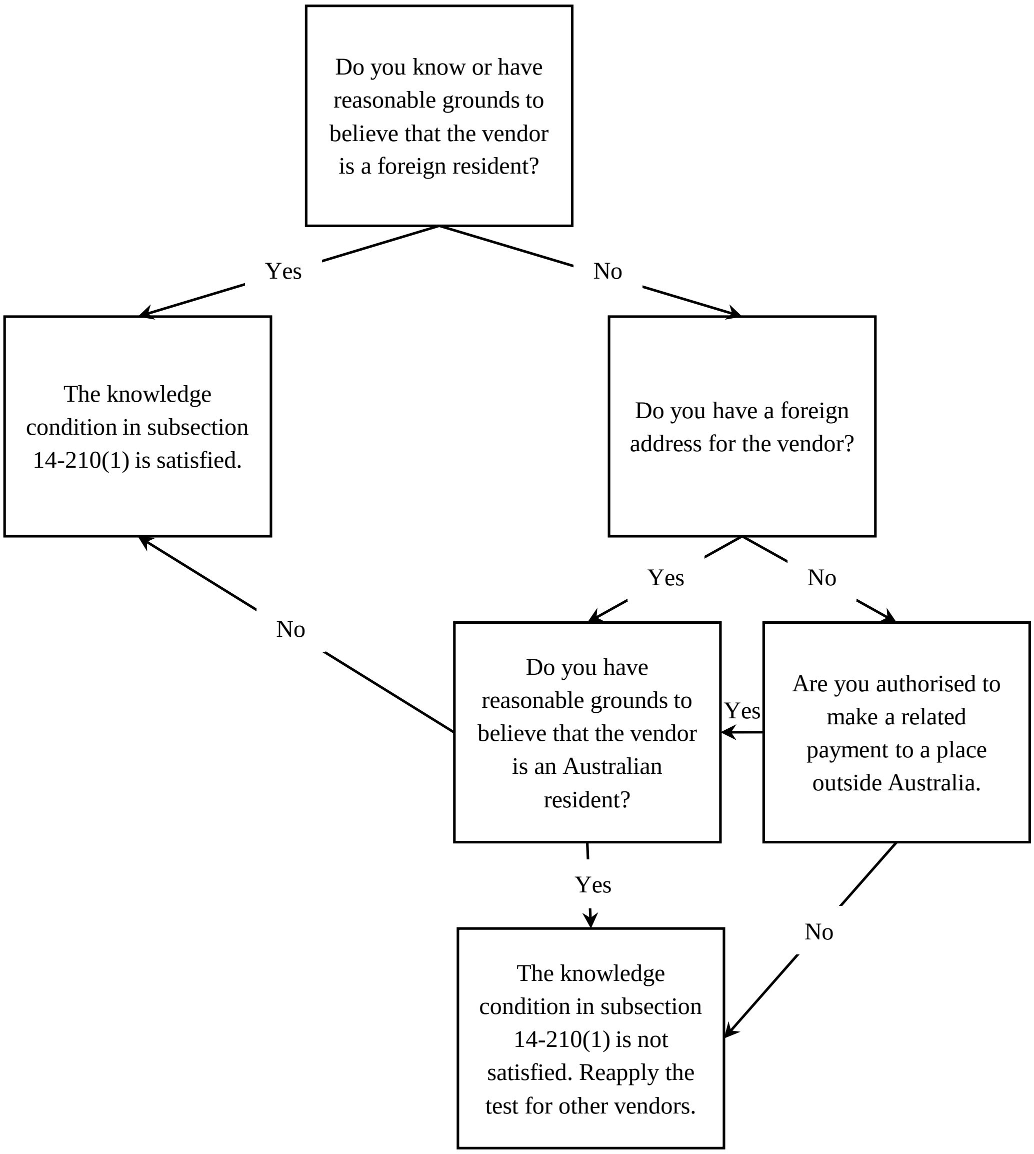
- the vendor has an address outside Australia according to any record that is in the purchaser’s possession, or is kept and maintained on the purchaser’s behalf, about the acquisition; or

- the purchaser is authorised to provide a financial benefit (for example, to make the payment) to a place outside Australia (whether to a vendor or to anyone else).

[Schedule 2, item 1, paragraph 14-215(1)(c) in Schedule 1 to the TAA 1953]

2.78 This test will mean that where there are reasonable grounds to believe that the vendors are Australian residents, withholding will not be required, even if an amount is paid outside Australia, or a vendor has an address outside Australia. However, if there are no reasonable grounds to believe that the vendors are Australian residents, and the amount is to be paid outside Australia, or a vendor has a foreign address, the knowledge condition will be satisfied. Whether or not there are reasonable grounds to believe that a vendor is or is not an Australian resident is to be considered on an objective basis. The question is whether a reasonable person in the position of the purchaser would have thought that there were reasonable grounds to support the relevant belief.

Diagram 2.2: The knowledge condition



2.79 The Regulations may prescribe additional circumstances where the knowledge condition will be satisfied. The Regulation-making power is intended to provide flexibility if it becomes necessary to prescribe additional tests in the future. ***[Schedule 2, item 1, paragraph 14-210(1)(d) in Schedule 1 to the TAA 1953]***

Declarations as to residency

2.80 A declaration as to residency can be relied upon in relation to indirect Australian real property interests (other than company title interests) and options and rights to acquire TARP or indirect Australian real property interests. Such a declaration is not relevant to TARP and indirect interests that constitute company title interests, where the clearance certificate process applies.

2.81 Where the purchaser of such interests believes the vendor may be a foreign resident, they can request that the vendor make a declaration confirming their residency. The vendor will not be a relevant foreign resident where the vendor has made a declaration that they are an Australian resident (unless the purchaser knows the declaration to be false). ***[Schedule 2, item 1, subsection 14-210(3) and subsection 14-225(1) in Schedule 1 to the TAA 1953]***

2.82 It is envisaged that vendor residents may use this declaration as a matter of course to establish their residency to a purchaser of indirect Australian real property interests or options and rights to acquire such interests or options and rights to acquire TARP. The declaration may be inserted into sale agreements as a standard clause contractual warranty. A purchaser that receives a declaration is entitled to rely on it (unless they know it to be false) and does not need to consider whether the reasonable grounds limbs of the knowledge condition are satisfied.

2.83 A purchaser will only know a declaration to be false if they have specific knowledge of the fact. That is, the purchaser must be a party to the fraud committed by the vendor or must have knowledge that the declaration is completely implausible. In all other circumstances, the declaration may be relied on. That a purchaser may have reasonable grounds to doubt the accuracy of a declaration does not, of itself, prevent the purchaser from relying on it.

2.84 A declaration is only effective in relation to the specific vendor. If an asset is acquired from multiple vendors, a purchaser may seek a declaration from each vendor.

2.85 A vendor may make a standing declaration which remains valid for 6 months after the day the declaration is made. ***[Schedule 2, item 1, subsection 14-225(3) in Schedule 1 to the TAA 1953]***

Example 2.3: Determining the residency of the vendor

> Andrew enters into an off-market transaction to acquire all of the shares in a company. The majority of the company's investments are in real property holdings throughout Australia. The shares, therefore, constitute indirect Australian real property interests.

Andrew does not know the vendor of the shares. Under the terms of the sale contract, Andrew is to transfer the purchase price of the shares to an overseas bank account in the name of an associate of the vendor.

At this stage, the knowledge condition in subsection 14-210(1) is satisfied. Andrew notifies the vendor that he intends to withhold a portion of the purchase price unless the vendor can provide Andrew with further information about his residency (or a declaration).

The vendor provides Andrew with a declaration that states that the vendor is an Australian resident for income tax purposes, which Andrew does not know to be false. The knowledge condition is no longer satisfied because Andrew has a declaration that the vendor is an Australian resident, that he is entitled to rely on.

Even if Andrew could not verify the declaration to the extent necessary for him to have a reasonable belief in its accuracy, he could rely on it (provided he did not know it to be false) and no payment obligation would arise.

Declaration membership interest is not indirect Australian real property interest

2.86 Another declaration can be made in the case of CGT assets that are membership interests (for example shares in a company). The vendor is likely to be in a better position than the purchaser to determine whether the membership interests satisfy the definition of an indirect Australian real property interest. ***[Schedule 2, item 1, subsection 14-225(2) in Schedule 1 to the TAA 1953]***

2.87 Membership interests that are not indirect Australian real property interests are not within the scope of the amendments. To support this, the amendments will not apply to a vendor where the purchaser relies on a declaration by the vendor that the interests are not indirect Australian real property interests. ***[Schedule 2, item 1, subsection 14-210(3) and subsection 14-225(2) in Schedule 1 to the TAA 1953]***

2.88 Before making a declaration, the foreign resident vendor must consider the level of their stake in the entity to which the interests relate. In addition, the vendor must consider whether the principal asset test is satisfied in relation to the entity. See paragraphs 2.5 to 2.8 for when membership interests are indirect Australian real property interests.

2.89 A purchaser may rely on the declaration even though the declaration may be inaccurate, unless the purchaser has specific knowledge that the declaration is false. ***[Schedule 2, item 1, paragraph 14-210(3)(b) in Schedule 1 to the TAA 1953]***

2.90 A vendor may make a standing declaration which remains valid for 6 months after the day the declaration is made. ***[Schedule 2, item 1, subsection 14-225(3) in Schedule 1 to the TAA 1953]***

Administrative penalties for false or misleading declarations

2.91 Penalties of up to 120 penalty units apply for declarations or purported declarations that are false or misleading in a material particular. ***[Schedule 2, item 1, section 14-230 in Schedule 1 to the TAA 1953]***

2.92 The machinery provisions for these administrative penalties are set out in Division 298 of Schedule 1 to the TAA 1953.

The amount to pay to the Commissioner

2.93 A purchaser must pay, to the Commissioner, 10 per cent of the first element of the cost base for the CGT asset. This will usually be the total consideration they paid, or are required to pay, to acquire the CGT asset. The total consideration includes the market value of any property given in respect of acquiring the CGT asset (see subsection 110-25(2) of the ITAA 1997). ***[Schedule 2, item 1, subsection 14-200(3) in Schedule 1 to the TAA 1953]***

Multiple purchasers

2.94 When working out the amount to pay to the Commissioner, it is important to correctly identify the CGT asset acquired. This is particularly the case where multiple purchasers each purchase interests in a property.

Example 2.4: Joint purchase of property

Annette and Allen purchase a residential property for $3 million from a vendor they know is a foreign resident. They acquire title to the property as joint tenants.

Under section 108-7 of the ITAA 1997, Annette and Allen are each taken to have acquired the property as tenants in common in equal shares.

The CGT asset that Annette has acquired is a 50 per cent interest in the property. The acquisition cost of the asset is $1.5 million. Annette must pay $150,000 to the Commissioner. Allen must pay the same amount to the Commissioner.

Between them, Annette and Allen are entitled to withhold $300,000 from the amount they pay to the vendor.

Variation of withholding amounts

2.95 The Commissioner may vary a payable amount, in relation to either a particular case or a class of cases. The variation may include a variation to nil. ***[Schedule 2, item 1, section 14-235 in Schedule 1 to the TAA 1953]***

2.96 A vendor or a purchaser may apply to the Commissioner for a variation of the amount. Reasons for a variation could include that:

- the foreign resident will not make a capital gain on the transaction (for example because they will make a capital loss or a CGT roll-over applies);
- the foreign resident will otherwise not have an income tax liability (for example because of carried-forward capital losses or tax losses); or
- there are multiple vendors, only one of which is a foreign resident.

2.97 The Commissioner may issue a variation (other than a class variation) to the applicant. However, the variation is only effective if it is provided to the purchaser. ***[Schedule 2, item 1, subsections 14-235(2) and (3) in Schedule 1 to the TAA 1953]***

Example 2.5: Applying for and receiving a variation

Victor is a foreign resident who is selling a commercial property with a cost base of $3 million.

Victor does not expect to be able to sell the property for $3 million or more (i.e. he expects to make a capital loss on the sale).

Victor applies to the Commissioner for a variation. The Commissioner issues a variation notice to Victor stating that the amount payable, to the Commissioner, by a purchaser of Victor's property is reduced to nil. The variation is subject to the condition that the purchase price for the property does not exceed $3 million.

Later, Paul agrees to purchase the property from Victor for $2.9 million. Victor provides a copy of the variation notice to Paul. The variation takes effect and Paul's liability to the Commissioner is reduced to nil.

2.98 Either party may object to a variation (other than a class variation) or the Commissioner's decision not to issue a variation. ***[Schedule 2, item 27, section 20-80 in Schedule 1 to the TAA 1953]***

2.99 A variation made in a particular case is not a legislative instrument within the meaning of section 5 of the *Legislative Instruments Act 2003*. An amendment is made to assist readers in this respect but is not intended to alter the operation of the law. ***[Schedule 2, item 1, subsection 14-235(4) in Schedule 1 to the TAA 1953]***

2.100 A variation applying to a class of cases is a legislative instrument. ***[Schedule 2, item 1, subsection 14-235(5) in Schedule 1 to the TAA 1953]***

Variation for sale of secured property

2.101 A creditor of the vendor may have a security interest (for example, a mortgage) over an asset that is subject to the amendments. There may be situations where the proceeds of the sale are insufficient to cover both the amount to be paid to the Commissioner and to discharge the debt the loan secures.

2.102 It is not the intention of these amendments to undermine the security of creditors in the event of a vendor's default. The Commissioner must consider this intention when deciding whether to vary a withholding amount. ***[Schedule 2, item 1, subsection 14-235(1) in Schedule 1 to the TAA 1953]***

2.103 To support this power, a secured or unsecured creditor may apply to the Commissioner for a variation. ***[Schedule 2, item 1, subsection 14-235(3) in Schedule 1 to the TAA 1953]***

Example 2.6: Power of sale

Chris, a foreign resident, owns a commercial property located in Australia. Chris owes $3 million to a bank, which is secured by a mortgage over the commercial property.

Chris' business has been performing poorly and he has missed a number of repayments on the loan. The bank decides to exercise its power of sale.

The property is sold for $2.9 million net of costs. The proceeds are insufficient to pay the Commissioner and discharge Chris' mortgage.

Chris would prefer that the Commissioner is paid in preference to the bank because he would be entitled to a credit for this amount. Therefore, he does not apply for a variation (even though one may be available if he made a capital loss).

The bank is entitled to apply for a variation and does so. The Commissioner considers the circumstances and concludes that requiring an amount to be paid to the Commissioner would prevent the bank from recovering the debt from its secured interest.

The Commissioner issues a notice to the bank that varies the amount to nil. The bank provides a copy of the notice to the purchaser. The purchaser is relieved of any obligation to pay an amount to the Commissioner.

Example 2.7: Other secured creditors

Daniel, a foreign resident, owns commercial property located in Australia. Daniel owes $2.9 million to a bank, which is secured by a mortgage over the property. Daniel has been meeting all of his obligations under the loan and there is nothing to suggest Daniel will have difficulty continuing to meet his obligations.

Daniel enters into a contract to sell the property for $3 million. The purchaser knows that Daniel is a foreign resident and will be required to pay $300,000 to the Commissioner when the property settles. In these circumstances, there will be insufficient sale proceeds available at settlement to discharge the mortgage.

Daniel is entitled to apply for a variation.

Options

2.104 Where a purchaser's acquisition of property is the result of the exercise of an option, a special rule applies to avoid double counting. Where a purchaser is required to withhold, the amount to which the 10 per cent is applied is reduced by any payments the purchaser made for the option (or to renew or extend the option). It is also reduced by the market value of any property the purchaser gave for, or to renew or extend, the option. ***[Schedule 2, item 1, paragraph 14-200(3)(a) in Schedule 1 to the TAA 1953]***

2.105 These special rules for options are designed to avoid double counting the purchase price of the option in determining the amount to be withheld. Under the existing law, an amount is required to be withheld from the purchase price at the time of the grant of the option (CGT event D2 happens to the foreign resident grantor of the option). When the option is exercised, the first CGT event is undone and the option payment is treated as part of the capital proceeds for CGT event A1 on the sale of an asset. The purchaser would then be entitled to withhold from the cost base of the asset, which is the sum of the option purchase price and the option exercise price (section 134-1 of the ITAA 1997). This would mean that the purchaser would effectively be required to withhold twice on the option purchase price.

2.106 This special rule avoids this double counting by reducing the amount to which the 10 per cent is applied by any payments the purchaser made for the option (or to renew or extend the option). The withholding amount is reduced on exercise of the option.

Requirements when paying the amount

When to pay an amount

2.107 The required amount must be paid to the Commissioner on or before the day the purchaser becomes the owner of the property. This is to be distinguished from the time the purchaser is taken to have acquired the asset for CGT purposes (generally backdated to the date the purchaser entered into the purchase contract). ***[Schedule 2, item 1, subsection 14-200(2) in Schedule 1 to the TAA 1953]***

Example 2.8: When to pay an amount when acquiring property

> Ben is acquiring a residential property for $3 million. Ben knows that the vendor of the property is a foreign resident and that the acquisition is subject to a withholding obligation.
>
> Ben enters into a contract for the purchase of the property on 1 August 2016 and pays a $150,000 deposit. The contract is settled on 1 October 2016 when Ben is required to pay the balance of $2.85 million to the vendor and receives a transfer of title to the property.
>
> Ben withholds $300,000 from the settlement amount (paying $2.55 million to the vendor). Ben must pay the $300,000 to the Commissioner by the same day, 1 October 2016.

2.108 No withholding obligation arises if the contract falls through and the change in ownership does not occur.

Form of payment

2.109 Payments to the Commissioner must be made through an electronic payment method approved by the Commissioner (for example Electronic Funds Transfer or BPAY). This is required through an amendment that applies section 16-85 in Schedule 1 to the TAA 1953 to the payments. ***[Schedule 2, item 17, subsection 16-70(3) in Schedule 1 to the TAA 1953]***

2.110 The Commissioner may allow alternative means of payment, including payment by cheque.

Notification to the Commissioner

2.111 A purchaser paying an amount to the Commissioner must notify the Commissioner (section 16-150 in Schedule 1 to the TAA 1953). The notification must be in the approved form and will be used to collect information necessary for the amount to be credited to the appropriate foreign resident taxpayer.

2.112 No obligation is imposed to provide annual reports to the Commissioner under section 16-153.

2.113 The approved form may allow the purchaser to quote the vendor's tax file number if the vendor has provided one. Amendments are made to allow purchasers to collect tax file numbers from foreign residents (where they have them) and provide them to the Commissioner. This will assist the Commissioner to match withholding payments to specific foreign residents. ***[Schedule 2, items 2 and 10 to 12, paragraph 202(s) of the ITAA 1936, and paragraphs 8WA(1AA)(b), 8WB(1A)(a) and 8WB(1A)(b) of the TAA 1953]***

Requirement to register

2.114 A purchaser paying an amount to the Commissioner must apply to register as a withholder (section 16-140 in Schedule 1 to the TAA 1953).

2.115 Withholders completing the one approved form when paying withheld amounts to the Commissioner will comply with both sections 16-140 and 16-150.

Withholding tax credits

2.116 A purchaser required to pay an amount to the Commissioner is entitled to withhold the amount from the foreign resident. ***[Schedule 2, item 16, subsection 16-20(2) in Schedule 1, to the TAA 1953]***

2.117 The foreign resident vendor will be entitled to a credit for the amount paid to the Commissioner (Division 18 in Schedule 1 to the TAA 1953). The entitlement to a credit arises when the Commissioner makes an income tax assessment (or determines that no income tax is payable) for the income year. The vendor must lodge an income tax return to claim the credit.

2.118 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.

2.119 Amendments are made to the definitions of 'amount required to be withheld', 'amount withheld' and 'withholding payment' to ensure that Division 18 applies correctly to amounts paid to the Commissioner. ***[Schedule 2, items 5 to 9, subsection 995-1(1) of the ITAA 1997]***

2.120 The availability of a credit to a foreign resident is contingent on the purchaser paying the amount to the Commissioner. A credit does not arise merely because an amount has been withheld from a payment made to the foreign resident that the withholder was required to pay to the Commissioner. See sections 18-15 and 18-20, and paragraph (b) of the amended definition of 'amount withheld'.

2.121 Part IIB of the TAA 1953 (about Running Balance Accounts) sets out how the Commissioner must treat a credit. These generic rules will apply to credits for amounts withheld under the new withholding regime.

Refund of amounts withheld in error

2.122 Subdivision 18-B provides for withholders or the Commissioner to refund withheld amounts, or amounts paid to the Commissioner, where there has been an error.

2.123 The Commissioner may refund an amount paid under the amendments (per section 18-70). However, a person receiving a payment, from which an amount is withheld under the amendments, may not claim a refund under section 18-65 from the purchaser. ***[Schedule 2, items 22 and 23, subparagraph 18-65(1)(a)(ii) and paragraph 18-65(6)(c) in Schedule 1 to the TAA 1953]***

Penalties and offences

2.124 The existing administrative penalties, specified in sections 16-30 and 16-35 in Schedule 1 to the TAA 1953, for failures to withhold will apply for the new withholding provisions. No amendment is required. This is because sections 16-30 and 16-35 impose a penalty where there is a failure to pay an amount as required by Division 14, and the new obligations created by these amendments are inserted into Division 14.

2.125 Similarly, the offence provision in subsection 16-25(2) for failing to withhold will apply to the new withholding provisions.

2.126 The general interest charge will apply to amounts that are not paid to the Commissioner by the required date. ***[Schedule 2, items 17 and 18, section 16-80, and subsections 16-70(3) and (4) in Schedule 1 to the TAA 1953]***

2.127 Division 268 in Schedule 1 to the TAA 1953 sets out provisions for the recovery of unpaid withholding amounts and allows the Commissioner to make an estimate of a person's withholding liability. Division 269 imposes penalties on directors of companies that fail to meet their withholding obligations. Division 298 sets out the machinery provisions for the collection and remission of penalties, and the imposition of interest on unpaid penalties.

2.128 The offence provision of section 20-35 will also apply to the new withholding obligations. Section 20-35 makes it an offence to claim, falsely, a credit owing to a person who has had a withholding payment made on their behalf.

2.129 Administrative penalties apply to making a false or misleading declaration (see paragraphs 2.91 to 2.92 above).

Application of the regime to particular transactions

2.130 This section details how the components of the regime operate together in particular transactions. This section also discusses interactions with other areas of the law.

Leases

2.131 A lease is a CGT asset that is TARP under section 855-20 of the ITAA 1997. Therefore, the acquisition of a lease asset by a lessee could be subject to withholding if the lessee has reason to believe the lessor is a foreign resident. However, the withholding obligation will only arise with respect to lease premiums paid for the grant of the lease.

2.132 A lease that does include the payment of a premium will not result in a withholding liability. Rent payable under the term of the lease does not form part of the first element of the cost base. This amount is used to determine the withholding amount.

Example 2.9: Lease

Richard, a foreign resident, owns a commercial property that he leases to Leigh. Leigh knows that Richard is a foreign resident.

Under the terms of the lease, Leigh agrees to pay Richard $3 million as a lease premium and to pay rent of $4,000 a month.

The first element of the cost base of Leigh's lease asset is $3 million. Leigh must pay 10 per cent of this amount, $300,000, to the Commissioner.

CGT event F1 happens to Richard and his capital proceeds are $3 million. Richard will be entitled to a withholding tax credit of $300,000 for the amount withheld.

The amendments do not apply to the rent payable under the lease because it does not form part of Leigh's first element of cost base.

Foreclosures

2.133 A foreclosure is an uncommon situation in Australia where a secured creditor assumes ownership of a secured asset. It is generally a remedy of last resort for the creditor and is generally only available where the creditor has attempted to exercise a power of sale.

2.134 The amendments apply to a foreclosing creditor in the same way they apply to a purchaser of an asset.

Example 2.10: Foreclosures

Mick, a foreign resident, owns a commercial property. Mick has a loan with a bank, which is secured by a mortgage over the property.

Mick is in default on his repayment obligations. The bank attempts to exercise its power of sale to recover the debt. The property is offered for sale in a public auction but the auction fails to receive a bid sufficient to discharge the mortgage and cover the bank's expenses.

The bank seeks, and is granted, an order for foreclosure. This results in the bank acquiring legal title to the property from Mick. As the bank has acquired title, the bank is the purchaser for the purposes of these amendments and would be subject to the withholding obligation.

The bank is entitled to apply for a variation to the withholding amount. In considering the application, the Commissioner will take into account the policy intention that these amendments do not prevent the bank from realising the value of its security. See paragraphs 2.101 to 2.103.

As the market value of the property is less than Mick's debt, the Commissioner considers that any withholding obligation would further diminish the value of the bank's security. The Commissioner, therefore, varies the withholding amount to nil.

Consequential amendments

2.135 The new withholding obligation is added to lists of withholding obligations and tax-related liabilities. ***[Schedule 2, items 13, 14 and 28, subsections 10-5(2) and 250-10(2) in Schedule 1 to the TAA 1953]***

2.136 Various references to Division 14 are updated to reflect that the Division contains multiple obligations. ***[Schedule 2, items 19 to, 21 and 24, paragraphs 16-140(1)(b), 16-143(2)(b) and 16-150(b), and subparagraph 18-70(1)(a)(ii) in Schedule 1 to the TAA 1953]***

2.137 Notes are added to Division 855 of the ITAA 1997 (about the capital gains tax obligations of foreign residents) cross-referencing the new withholding obligation. ***[Schedule 2, items 3 and 4, notes to section 855-15 of the ITAA 1997]***

Application provisions

2.138 The amendments apply in relation to acquisitions on or after 1 July 2016. ***[Schedule 2, item 30]***

2.139 A purchaser is generally taken to have acquired an asset on the date they entered into the contract to acquire it (see Division 109 of the ITAA 1997). Therefore, the amendments will not apply to transfers that occur under a contract entered into prior to 1 July 2016.

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Foreign resident capital gains tax withholding regime

2.140 Schedule 2 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

2.141 Schedule 2 introduces a new regime that imposes withholding obligations on the purchasers of certain Australian assets. The purpose of the regime is to assist in the collection of foreign residents' capital gains tax (CGT) liabilities.

Human rights implications

2.142 Schedule 2 does not engage any of the applicable rights or freedoms.

Conclusion

2.143 Schedule 2 is compatible with human rights as it does not raise any human rights issues.

Index

Schedule 1: Capital gains tax treatment of earnout rights

Bill reference	***Paragraph number***
Items 6, 8 to 12 and 18, paragraph 104-185(1)(a), subsections 104-190(1A) to (3) and (5), paragraph 104-198(1)(a), subsections 104-198(2) and (4) and the definition of replacement asset period in subsection 995-1(1) of the ITAA 1997	1.115
Items 14 and 17, paragraphs 152-125(1)(b) and 292-100(4)(b) of the ITAA 1997	1.112
Items 15 and 16, subsections 152-305(1B) and 152-335(2A) of the ITAA 1997	1.113
Items 18 to 25 and 27 to 31, paragraphs 25-85(2)(a) and 230-15(4)(a), subsection 230-460(13), table items 2 in subsections 820-930(2) and 974-75(1), paragraph 974-80(2)(a), the example in subsection 974-80(2), the heading to subsection 974-85(1), subsection 974-85(2), paragraph 974-85(4)(c), subsection 974-140(1) and the definitions of 'contingent on the economic performance' and 'contingent on aspects of the economic performance' in subsection 995-1(1) of the ITAA 1997	1.144
Item 26, subsection 974-85(1) of the ITAA 1997	1.143
Items 34 to 37, subsections 280-100(5), 280-102A(4) and 280-102B(4) in Schedule 1 to the TAA 1953 and subsection 9(1B) of the *Taxation (Interest of Overpayments and Early Payments) Act 1983*	1.99
Item 37	1.146
Item 38	1.149
Item 40, subparagraph 14-200(3)(a)(i) in Schedule 1 to the TAA 1953	1.130
Item 41, section 14-205 in Schedule 1 to the TAA 1953	1.131
Item 41, subsection 14-205(4) in Schedule 1 to the TAA 1953	1.132
Item 43	1.147
Item 134, section 152-20	1.119
Item 134, subsection 152-20(5) of the ITAA 1997	1.120

Schedule 2: Foreign resident capital gains withholding payments

Bill reference	***Paragraph number***
Item 1, subsection 14-200(1) in Schedule 1 to the TAA 1953	2.30
Item 1, paragraphs 14-200(1)(b), and subsections 14-210(1) and (3) in Schedule 1 to the TAA 1953	2.58
Item 1, paragraph 14-200(1)(c) in Schedule 1 to the TAA 1953	2.30, 2.31
Item 1, subsection 14-200(2) in Schedule 1 to the TAA 1953	2.107

Bill reference	***Paragraph number***
Item 1, subsection 14-235(3) in Schedule 1 to the TAA 1953	2.103
Item 1, subsection 14-235(4) in Schedule 1 to the TAA 1953	2.99
Item 1, subsection 14-235(5) in Schedule 1 to the TAA 1953	2.100
Items 2 and 10 to 12, paragraph 202(s) of the ITAA 1936, and paragraphs 8WA(1AA)(b), 8WB(1A)(a) and 8WB(1A)(b) of the TAA 1953	2.113
Items 3 and 4, notes to section 855-15 of the ITAA 1997	2.137
Items 5 to 9, subsection 995-1(1) of the ITAA 1997	2.119
Items 13, 14 and 28, subsections 10-5(2) and 250-10(2) in Schedule 1 to the TAA 1953	2.135
Item 16, subsection 16-20(2) in Schedule 1, to the TAA 1953	2.116
Item 17, subsection 16-70(3) in Schedule 1 to the TAA 1953	2.109
Item 17 and 18, section 16-80, and subsections 16-70(3) and (4) in Schedule 1 to the TAA 1953	2.126
Items 19, 20, 21 and 24, paragraphs 16-140(1)(b), 16-143(2)(b) and 16-150(b), and subparagraph 18-70(1)(a)(ii) in Schedule 1 to the TAA 1953	2.136
Items 22 and 23, subparagraph 18-65(1)(a)(ii) and paragraph 18-65(6)(c) in Schedule 1 to the TAA 1953	2.123
Item 27, section 20-80 in Schedule 1 to the TAA 1953	2.70, 2.98
Item 30	2.138