Non-Residents And Capital Gains Tax: An Examination of the Theory and Practical Operation of the Rules

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ABSTRACT

The construct of “necessary connection with Australia” is used as a basis to determine whether non-resident is liable for capital gains tax in Australia. The ambit of this construct is set out by a set of specific rules in the tax legislation. The effect is that a domain has been carved out of the CGT tax net wherein non-residents can realise capital gains without being subject to capital gains tax. Many anomalies, and hence potential for exploitations, exist within the current legislative framework. The most significant hole, and one that has received the most publicity, in this regard is the use of interposed entities to shift the gains away from the reach of the Australian tax authorities. The Australian Government is in the process of strengthening its taxing rights in respect of CGT under bilateral tax treaties. This is achieved by means of amendment to tax legislation, as well as through renegotiation with the respective tax treaty partners; and, at the same time, proposals are on the agenda to amend the CGT law to ensure that the integrity of Australia CGT regime is not compromised through the use of interposed entity. This direction is consistent with the policy principle of equity and neutrality. The success or otherwise of the proposed measures would hinge upon the authorities’ abilities to address the enforcement difficulties that the proposed measures may face in practice.

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INTRODUCTION

Capital gains tax (CGT) as a taxation regime has been around for close to two decades. Since its inception, it has been migrated from the *Income Tax Assessment Act 1936* ("ITAA36") to the *Income Tax Assessment Act 1997* ("ITAA97"), and it has also seen numerous changes and additions. CGT applied both to residents of Australia and non-residents; but in the latter case, further rules need to be considered in determining tax liability. In recent years, problems have emerged in relation to the application of the CGT regime to non-residents, as happened in the *Lamesa's* case[1] and as alluded to in *A Platform for Consultation*[2]. This paper examines the operation of the CGT regime as it applies to non-resident. A particular focus of this paper is to consider the extent that a non-resident can make the payment of CGT optional. This paper evaluates the problem identified in *A Platform for Consultation* in this regard, as well as the recommendation to address this issue in *A Tax System Redesigned*.[3]

The following structure is adopted. In the first part, the legislative framework of the CGT regime is briefly stated. In the next part, the central provisions (ie. Division 136) dealing with non-resident are considered in detail. The ambit of these provisions are considered, and so are the anomalies or opportunities that may enable a non-resident to escape from Australian capital gains tax. This is followed by an examination of the use of interposed entities within the current regime. This paper concludes by commenting on the effectiveness and policy rationale of the proposed tax reform measures to deal with capital gains derived by non-residents.

CAPITAL GAINS TAX LEGISLATIVE FRAMEWORK

Before examining the application of the capital gains tax provisions to non-resident, the general legislative framework in relation to capital gains tax is outlined here.

General Structure

The CGT provisions are contained within Part 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (ITAA97).[4] The core rules are found within Part 3-1; Part 3-3 contains specialised rules dealing with specific topic. CGT is not a separate tax; the

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[1] *FCT v Lamesa Holdings BV* (1997) 77 FCR 597.

[2] Review of Business Taxation, *A Platform for Consultation, Discussion Paper 2 Volume II: Building on a Strong Foundation*, February 1999.

[3] Review of Business Taxation, *A Tax System Redesigned: More Certan, Equitable and Durable*, July 1999.

[4] Prior to the Tax Law Improvement Project, the CGT provisions were initially to be found in Pt IIIA of the *Income Tax Assessment Act 1936*, from sections 160AX to 160ZZU. Provisions imposing tax explicitly on capital gains were first introduced on 19 September 1985. Before that date, only certain capital gains are caught in the tax net- namely those arise under section 25A and section 26AAA of ITAA36.

net capital gains are statutory income that forms part of the taxpayer's assessable income under section 6-10 of ITAA97. The possibility that there is a doubt taxation of the capital gains, where the gains are otherwise included in the assessable income as ordinary income or another provision of the tax legislation, is solved by disregarding the capital gains in such instances.[5]

Under ITAA97, a CGT liability arises if and only if the situation falls within a "CGT Event" and where the relevant CGT asset is acquired after 19 September 1985. There are 37 CGT Events in Division 104.[6] This approach to CGT liability could be contrasted to that under the old part IIIA of ITAA36, which relies on the concept of disposal of asset; the old approach have resulted in the needs to create convoluted concept such as fictional creation of assets, fictional assets, and deemed disposal. The identification of actual events provides a much more systematic and conceptually clearer approach to the imposition of tax liability.

There is a capital gain where the proceeds flowing from the CGT events exceed the cost base, or indexed cost base where applicable,[7] of the relevant CGT assets that is the subject of the CGT event. The capital gains can be reduced by any capital losses that the entity made during the current or prior income year. The "net capital gain" may be further reduced if the CGT discount applies.[8] This "net capital gain" is then included in the assessable income of the entity under section 102-5 of ITAA97.

The above general approach to the taxation of capital gains applies equally to resident and non-resident of Australia. In relation to non-resident, further rules need to be considered. These rules are essentially designed to protect the tax base of Australia by ensuring that non-residents remain liable to certain Australian CGT liabilities. The design of these rules applies a sort of nexus tests as a basis to tax non-residents. Capital gains derived by a non-resident may be subject to Australian tax in two ways:

1. The gains may be regarded as ordinary income and taxed where it is sourced in Australia. However, to the extent that it is "business profit" it may be exempt under applicable tax treaty assuming that the gains are not attributable to a permanent establishment that the non-resident may have in Australia;[9] or

2. The gains arise from assets having the "necessary connection with Australia".

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[5] Section 118-20.

[6] With the introduction of the consolidation regime, a few additional CGT Events may also be added in relation to the adjustment process regarding tax value of assets.

[7] Indexation is abolished after 21 September 1999.

[8] Only if the indexation approach is not adopted, and for CGT Event that arise on or after 21 September 1999. The reduction is 50% for individual or trust, and 1/3 for superannuation fund. Refer to Division 115.

[9] Eg. see Australia-US DTA Article 7(1).

There are also rules that operate to balance the need to attract foreign investments in Australia. For instance, venture capital entities such as pension funds from certain so called "white CFC countries" are exempt from Australia CGT for gains on disposal of venture capital equity in resident investment vehicles on or after 10 December 1999,[10] provided that the shares or units are held for at least 12 months. The rationale for this exemption is that these foreign funds are exempt from tax in their home countries, meaning that the imposition of tax liabilities in Australia will lower the rate of return on the investment, and hence, make investment in Australia unattractive.

Taxation of CGT: Jurisdictional Limits

The jurisdictional limits of Australia in respect of CGT are considered next.

Jurisdiction to Tax Under Section 6-5

In Australia, the amount of tax payable by a taxpaying entity is determined by applying the appropriate tax rate to the "taxable income" of the entity.[11] Taxable income is assessable income less deductions.[12] The notion of "assessable income" is where the jurisdictional limit comes into the equation. In relation to statutory income (since the focus of this paper is on CGT),[13] sub-section 6-10(4) provides that Australian resident needs to include statutory income from all sources; while sub-section 6-10(5) provides that non-resident only need to include:

(i) Statutory income from Australian sources; and

(ii) Statutory income that a provision includes in assessable income on some basis other than having an Australian source.

That is, a dual approach to taxation is adopted: the concepts of residence and source set the jurisdictional limits of Australian tax law. This is consistent with the international norm of taxing resident on a worldwide income basis, and taxing non-resident on a source country basis, subject to modification by applicable double tax agreements (DTAs).

Subparagraph 6-10(5)(a) include statutory income that has an Australian source. This begs the question: what is the source of capital gain? There are no statutory source rules in this regard, and so reliance must be placed on case laws. Whilst the case laws dealing with source rules for income tax purposes are well established, the same

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[10] See sub-division 118-G. This new exclusion was introduced in the *New Business Tax System (Capital Gains Tax) Act 1999*, following Recommendation 19.1 in *A Tax System Redesigned*. It is only available, at least initially, to pension funds of the US, UK, Canada, France, Germany and Japan.

[11] Section 4-10.

[12] Section 4-15.

[13] Statutory income are income that included in assessable income by a provision in the tax legislation (section 6-10(2)), meaning that the net capital gains included under section 102-5 is statutory income. Mirror provisions deal with ordinary income in section 6-5.

arguably cannot be said for capital gains. In Australia, the starting position is the classic statement in *Nathan v FCT*[14] that it is a "practical, hard matter of fact". For capital gains, the source is arguably the *situs* of the relevant asset. Here lies the problem. In most case, the *situs* would probably be clear. Land, for example, is clearly either located in Australia or not; but, where it is in relation to intangible assets such as rights the answer may not be clear. Source of capital gains cannot always be readily identified, or, the nexus is just not clear. This is where subparagraph (b) comes into play as it includes statutory income in assessable income using a basis other than source. This aspect is examined next.

Jurisdiction to Tax Under CGT Provisions

As noted above, the core rules operate in the same way for a resident and a non-resident. However, in the case of a non-resident, an important precondition for a tax liability to arise is the need to have a sufficient nexus with some Australian asset. This nexus requirement is operationalised through the notion of "necessary connection with Australia" in Division 136. Thus, non-residents are only liable to capital gains tax where the gains arise from assets that have the necessary connection with Australia.

Does this means that source is no longer relevant to the taxation of capital gains derived by non-resident? Whilst the assessability of capital gains to a non-resident does not turn on source rule as such, however, it seems that the underlying rationale is consistent with the general norms of international taxation: non-resident is taxed only on income that is sourced in the jurisdiction. That is, the notion of a "necessary connection with Australia" (or its predecessor under section 160T of a "taxable Australian asset") serves as a proxy for the source rule. Instead of relying on common law to determine whether the source of capital gains is from Australia, a statutory nexus test is adopted instead to clearly delineate what assets are regarded as giving rise to capital gains 'source' in Australia. A statutory test, in this regard, is much more practical.[15]

Capital Gains and Double Tax Agreements

In addressing tax issues on the international arena, it is necessary to consider the operation of the applicable DTA. It is not the intention here to explore in depth the issues raise by the interaction of the capital gains tax regime and doubt tax

[14] (1918) 25 CLR 183.

[15] Woollner, et al. (2002) have expressed the same view: "…while technically not a source rule, this concept perform the same function (ie. it defines Australia's jurisdiction to tax non-residents on capital gains)."

agreements that Australia had with other countries.[16] By way of general background, it suffices to make the following points.

DTA operates to modify the taxing rights of the countries subject to the bilateral agreement. In this regard, the taxing rights of Australia in respect of CGT that is attributed to non-resident may be modified.

An argument exists that under DTA negotiated before the introduction of the CGT regime in Australia, the taxing rights of Australia over non-resident's capital gains are given exclusively to the country of residence. This would of course means that non-resident (assuming they are regarded as such under the DTA) would effectively be exempt from Australian CGT under the applicable tax treaty. The Australian Taxation Office (ATO), not surprisingly, disagreed with this view. They argued in *Taxation Ruling* TR 2001/12 that Australia's taxing right with respect to capital gains are not so limited, because the capital gains was not a tax to which the pre-CGT treaties[17] intend to apply, and that the so called "distributive rules" within such treaties would not limit domestic law taxing right in this regard. It has been observed that, not only is the ATO's position contrary to the leading tax commentators and practitioners, the ruling is not based on any concrete reasoning; the "logic" in the ruling relies instead on a whole matrix of factors that collectively somehow established that capital gains are not covered by pre-CGT tax treaties and that the distributive rules in those treaties do not limit taxing rights over capital gains.[18]

In the case of pre-CGT treaties, the ATO acknowledges implicitly, not with the clarity that one would expect from a tax ruling, that certain "borderline gains" may well be protected. These are essentially gains that fall within the grey area of the classic income/ capital distinction. Such gains, if properly construed as income, would fall within an assessment provisions other than CGT provisions, and hence, should be protected under the treaties. In particular, they are likely to fall within the business profit article. These gains include those from profit-making undertakings or purposes, sale of trading stocks as part of a disposal of business, gains representing recoupment of depreciation (ie. balancing adjustment).

The scope that business profit article may apply is, however, disputed by the ATO. It could be argued that the business profit articles in DTA is capable of effectively

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[16] For a further discussion of the issues see Crosland, V. and Yeung, D. 'Double Tax Agreements and the Treatment of Capital Gains Derived by Non-Residents' (1998) 27 ATRev 55.

[17] The pre-CGT treaties are: Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Korea, Malaysia, Malta, the Netherlands, New Zealand, Noway, Philippines, Singapore, Sweden, Switzerland, United Kingdom, and United States.

Note that the Singapore and Malaysia treaty have been amended to include a broad CGT articles; also United States and Canada treaties will soon be likewise amended as well.

[18] Saunders, S. "ATO: Pre-Capital Gains Tax Treaties Don't Prevent Taxation of Gains Now", 26 Tax Notes Intl 389, (29 April 2002). For a further critique see also Gzell, I. 'International Tax: Current Issues' 2001) 4 The Tax Specialist 114.

exempting a non-resident (ie. a resident of another contracting state to adopt the terminology of tax treaty) from Australian CGT in that business profit includes, by definition, taxable income which also encompasses capital gains.[19] The ATO do not agree with this interpretation in its ruling; but the ATO conceded that business profit would apply at least in the case of profit arising from an adventure in the nature of trade. This position merely follows the High Court decision in *Thiel v FCT*[20]. Consequently, should such a gain be realised by a resident of another contracting state who is not carrying on business in Australia at or through a permanent establishment it would thus be entitled to an exemption under the business profit article.[21]

Certain DTAs also contained an "alienation of property" article that addresses the taxing rights over capital gains on Australian asset. The ambit of such articles have been the subject of the case of *FCT v Lamesa Holdings BV*[22], which concerns in particular, the issue as to whether the Articles covers the indirect disposal of underlying Australian asset. Whilst the outcome of the case was in the negative, subsequent amendment to the law has resulted in the possible extension of Australia taxing rights in this regard.[23]

In summary, two broad possibilities seem to exist:

1. *Pre-CGT Treaties*

   Australia has taxing rights over capital gains notwithstanding the absence of an "alienation of property" article. However, this would only be so for pure capital gains, ie. gains that falls within the CGT provisions and nowhere else. If it falls within another assessment provision, tax treaties may afford it some protection, especially if the "business profit" article could apply.

2. *Post-CGT Treaties*

   Such treaties have an alienation of property article, and hence, establishing Australian taxing right over capital gains.[24] However, such an article by itself does not mean that there is a tax liability.[25]

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[19] Section 3(2) of the *International Tax Agreement Act 1953*, and section 6-10.

[20] 90 ATC 4717. In that case it was held that the gains on the purchase of units in a unit trust, the conversion of units into shares, and the sale of part of the shares, was "business profit" because the taxpayer "invested in the units with the clear purpose and intention of selling all of them and or the shares into which they might be converted for profit".

[21] See Abrahamson, J. 'Tax Planning for Cross-Border mergers and Acquisitions in Australia' (2000) 3 The Specialist 230., and also Gzell, I. "The Implications of Thiel's Case", International Fiscal Association, Sydney Seminar, 21 August 1991.

[22] (1997) 36 ATR 589.

[23] The legal validity of this amendment may be questioned. Refer to discussion in subsequent section below on page 28.

[24] Eg. Article 13(4) of the Australia – South Africa DTA. This is also the first tax treaty containing an alienation of property article that gives Australia taxing right over direct and indirect alienation of real property.

LINKING NON-RESIDENT TO AUSTRALIAN TAX BASE

As noted above, the territorial limits of the Australian CGT provision is established by the notion of "necessary connection with Australia", subject to applicable double tax agreement. This section considers the type of assets that are taken by the legislation to have the necessary connection with Australia. In this regard, nine categories of assets are set out under section 136-25. Each of these categories will be examined in turns below.

Assets with Necessary Connection With Australia

Land, Building or Structure in Australia – Category 1

Category 1 provides that the following asset has the necessary connection with Australia:

(a) land, or a building or structure, in Australia;

(b) an interest in land in Australia, or a right, power or privilege to do with land in Australia;

(c) a stratum unit in Australia, or an interest in a stratum unit in Australia;

(d) a share in a company that owns a building on land in Australia that gives you a right to occupy a flat or home unit in the building

The rationale for taxing gains from land, buildings and structure located in Australia is clear as what could have a closer nexus with Australia. The ambit of this category needs to be ascertained however.

The drafting of the provisions may be compared with that in ITAA36. Under the old equivalent provision of section 160T(1)(a), assets comprising land and building are regarded as "taxable Australian Asset". "Land" is broadly defined under section 160K with the effect that lesser interest in land is also covered.[26] This ambit is likewise repeated in paragraph (b) of Category 1 that includes interests, rights, power or privileges in connection with land in Australia. Category 1 thus has a broad scope. For example, references to "right… to do with land" could possibly include things like disposal of nomination rights under an option to purchase land.[27]

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[25] Refer to page 28 below.

[26] Burns, L. and Hamilton, R. "Application of the Australian Capital Gains Tax To Non-Residents" (1996) 12 Tax Notes Intl 199.

[27] Burns, L. and Hamilton, R. *op. cit.* , at p 206; Indeed, the EM to the *Income Tax Assessment Act (Capital Gains) Bill 1986* that introduces the old provision, indicates that the old definition includes "right to exploit, or to explore for natural resources.".

It is equally clear from the provision, like the old section 160T(1)(a),[28] that it covers only *direct* interests in land. Disposal of shares in a company or interest in a trust that in turns hold land would fall outside the ambit of the provision.[29] Paragraph (c) and (d) is not intended to deal with such cases; they are merely there to cater for the legal mechanism used in Australian to hold certain real property.

An interesting issue arise concerning the application of this category to indirect land holding through a trust. In the context of the old section 160T(1)(a) an argument was raised to the effect that a disposal of an interest in a trust, other than discretionary trust,[30] could be caught on the basis that the beneficiary of the trust have an equitable interest in the trust estate, and that the definition of land under the old section 160K includes an "equitable estate" in land. The new provision made no reference to equitable estate. With the removal of this reference, it could be argued that indirect land holding through trust is now even more unlikely to be caught by Category 1 (even if they could be so caught under the old provision).

Alternatively, it could be argued that the scope of the new provision is no different to the old one such that it could well apply to indirect holding through non-discretionary trusts. First, ITAA97 merely rewrites the old legislation, without changing the operation of the law, unless such an intention is expressly stated. Second, and more importantly, it could be argued that the notion of equitable interest is covered by paragraph (b) that refers to "interest in land, or right, power or privilege to with land…". However, the meaning of "interest" here is unclear. Does it simply refer to the various proprietary interests that a person can have in a land? Alternatively, does it refer to the much boarder equitable interest that a beneficiary of trust has in the trust property? The former interpretation would appear to be the better view in that there is no indication that such a wide interpretation is ever intended.[31] The terms of the trust deed may affect this conclusion – for example, if the beneficiary is absolutely entitled to the trust property as against the trustee, he or she could be regarded as having the necessary "interest" in the land.[32]

The fact that land, building and structure are separately referred to in paragraph (a) of Category 1 reinforces the broad scope of the provision. This seems to cater for cases

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[28] Burns, L. and Hamilton, R. *op. cit.,* at p206.

[29] Disposal of shares may still be regarded as having the necessary connection with Australia where the land was previously roll-overed into the company under one of the rollover provisions, such as under Division 122. Category 8 is then relevant. Refer to below

[30] This does not apply to potential beneficiaries of discretionary trust because they are mere discretionary object, whose rights are limited to those requiring the trustee to properly administer the trust. See *Gartside v FCT* [1968] AC 553.

[31] Indeed, Commentator has noted that reference to "interest" in the context of Category 3 merely intend to cover joint ownership situation. Refer to footnote 39 and the associated section.

[32] Ie. the principle in *Saunders v Vautier* (1841) 49 ER 282. This is consistent with the framework of the CGT legislation which provides that if a beneficiary is absolutely entitled to the assets as against the trustee, action of the trustee is deemed to be that of the beneficiary. Refer to section 106-50.

where building or other structure (located on land) is regarded as separate CGT asset under the legislation.[33] The (new) provision does not appear to cover disposal of *interest* in a building or structure, just like the old provision,[34] whereas the provision explicitly refer to *interest* in land.

In this regard, it is interesting to consider the interaction of this definition with the taxation of partnership in Australia. In Australia, the disposal of CGT assets of a partnership is taxed in the hand of the partners, not the partnership itself.[35] Where a partner disposed of their interest in a partnership, they are taken to have disposed of their respective fractional interest in the underlying CGT assets. If, in a situation, where the CGT assets of the partnership is a building that is treated as a separate asset for CGT purposes (eg. if it is subject to the capital allowance provision), then a deem disposal of the partner's fractional interest in the building would not have the necessary connection with Australia. Nor, of course, would the partner be subject to any further tax in respect of his or her interest in the building. By comparison, if the partner owns the building directly, and dispose of his interest therein, the partner would be subject to tax under the capital allowance provision by way of a balancing adjustment. As the building is located in Australia, it would likely be that the proceeds would be taken to have an Australian source, and hence, be exposed to Australian tax.

Another interesting issue concerns the operation of this category to lease. In particular, would the granting of a lease by a non-resident give rise to CGT? The granting of a lease in general would give rise to CGT Event F1.[36] Lease, by its very nature, represents an interest in some real property, such as land or building. From the definition in Category 1, it could be argued that a lease over land would be caught; however, a lease over building or structure may not be caught because whilst Category 1 cover *interest* in land under subparagraph (b), it does *not* cover *interest* in building or structure (in situation where the building or structure constitute a separate CGT asset).[37]

CGT Asset Used by a Permanent Establishment in Australia – Category 2

Consistent with the source basis of taxation of non-resident in section 6-5, Category 2 essentially captures branch assets of non-resident business conducted through a permanent establishment ("PE") in Australia. In particular, it covers the disposal of

[33] Refer to situations listed in section 108-55 of ITAA97.

[34] Burns, L. and Hamilton, R.. *op. cit.*, at p206.

[35] Section 106-5 of ITAA97.

[36] Section 104-110.

[37] This may be contrasted with the view expressed in Kontelj, S. 'Capital Gains Tax and Non-Residents' [1995] Law Inst J 42.

CGT that the taxpayer has used "at any time in carrying on a business through a permanent establishment in Australia."

A permanent establishment for this purpose is defined in section 6(1) of ITAA 1936 to mean "a place at or through which the person carries on any business". It has often been said that the notion of a permanent establishment under section 6(1) is broader than the notion under DTA. This disparity of scope could result in inconsistent tax treatment. For example, if a PE exists under the section 6(1) definition, but not under the applicable DTA, a capital gain that arises through assets used by the PE in Australia would be taxable under the CGT regime, but the some amount would otherwise not be taxable in Australia because it would not have been attributable to the PE Australia! To the extent that this conflict exist, there would be incentive to structure transactions to recharacterise the arrangement.

The potential wide scope of Category 2 should be noted. It could include assets *not* located in Australia or where the use in Australia constitutes only a small part of the asset total use. An example is an item of contractual rights (assuming it is not an intellectual property that is governed by the new capital allowance regime) used worldwide (and hence include Australia) but owned by a company resident outside Australia.

In addition, it is sufficient that the asset has been used at *anytime* though a PE in Australia; there is no need for the assets to be used immediately before the disposal or during the income year of the disposal. This gives the section a very broad scope of operation; CGT could be imposed notwithstanding that the non-resident business have ceased to operate through a PE in Australia, such that the assets have since been "transferred" (within the business) to another business unit located in another country. So long that the CGT asset has at some stage been used by the PE, then it could trigger a capital gain liability. Such an outcome would seem to be at odd with the principle that a non-resident is only tax on income sourced in Australia. This inconsistency is partially addressed by an apportionment mechanism that effectively taxed only the capital gains attributable to the *period* that the asset was used by the Australia permanent establishment.[38] Anomies could still arise however, because the capital gain or capital loss will not be apportioned by reference to the *proportion* of use in Australia during the period that the asset was used by the permanent establishment.

Share in Australian Resident Private Company – Category 3

Category 3 of section 136-25 includes shares in Australian resident private company as asset as having the necessary connection with Australia. The precise wordings are:

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[38] Section 136-30 of ITAA97.

> "A share, or an interest in a share, in a company that is an Australian resident, and a private company, for the income year in which the CGT event happens."

There are three important qualifications for an asset to fall within this category. First, it must involves "shares" in a company, or, "interest" in a share. Whilst an argument may be made that reference to interest could include the 'interest' that a beneficiary of trust estate may have in situation where the trust held the shares; the better view seems to be that the reference to an "interest in a share" is intended to deal with the joint ownership of shares rather than the interest that a beneficiary may have in the assets of a trust.[39] The comments regarding the use of the word "interest" in the context of Category 1 is also relevant here.[40]

Second, the company must be an Australian resident for tax purposes. The term "resident" took on its meaning in paragraph (b) of the definition in section 6(1) of ITAA 1936. Under this definition, there are two broad basis by which a company is classified as a resident of Australia: incorporated in Australia, or, central management and control is located in Australia. A residual test based on the residence of shareholders is also provided, although this test may have little practical application.

Importantly, note that the company must be a resident for the income year in which the CGT event happens. As in the old section 160(1)(c), issue of interpretation arises where the residency status of the company changed during the income year in which the CGT event happens. There are a couple of possibilities:

(i) The company is a resident at any time during the income year

(ii) The company must be resident for the whole income year

(iii) Treat the pre and post resident change period as different income year

By switching the residence of a company (which is arguably not that hard for company incorporated outside Australia), and by timing the disposal of shares in the company such that the disposal occur during an income year where the company is classified as a non-resident, a non-resident shareholder could avoid Australian CGT on the share disposal. It is significant that a change of residence of company only trigger a CGT event in relation to assets not having the necessary connection with Australia.[41] This means that a resident company with substantial real property located in Australia could change its resident status without triggering CGT liability in respect of those Australian assets at that point. In subsequent income year, the non-resident shareholder could then dispose of the shares in the now non-resident

[39] Paragraph 18 230 of *Australian Tax Practice Cooper's Capital Gains Tax*, 2002.

[40] See above on page 7.

[41] Refer to CGT event I3, sub-section 104-160(3).

company without attracting any Australian CGT liability as the share do not fall within Category 3. Substantial tax could be avoided.

Third, the company needs to be a “private” company. A “private company” is a company that is not a “public company” under section 995-1 of ITAA97, which refers to the definition in section 103A of ITAA36. For the purpose of the present discussion, it is sufficient to note that it includes companies listed on certain stock exchanges.[42] As the definition in that provision looks at the status of the company at the end of the income year, it will include a company listed during the course of the income year.

Interest in Australian Resident Trust – Category 4

Category 4 of section 136-25 captures assets in the form of “an interest in a trust that is a resident trust for CGT purposes for the income year in which the CGT event happens.” This is the trust analogy of Category 3.

This category seems to cover various type of trust, from the discretionary trust to the fixed or unit trust. This can be inferred from the definition of a “resident trust for CGT purposes” in the Dictionary in section 995-1,[43] which has two aspects, covering both unit trust and trust other than unit trust. An argument has however been made that the interest referred to must be a beneficial interest in the trust, and hence, it was argued that this category would have no application to beneficiaries of a discretionary trust unless they are presently entitled to income or capital.[44]

The operation of the Category 4 test to non-unit trust could result in bizarre tax outcome. This stems from the fact that the test looks to the residence of the trustee. Pursuant to the definition, such a trust is a resident trust if a trustee of the trust is a resident of Australia at any time during the income year, or, where the central management and control of the trust is in Australia at any time during the income year. Arguably the residence of the trustee, or, indeed, even the central management and control, may not he a good proxy for the measures of nexus with Australia. A trust with non-resident trustee, and hence a non-resident trust, may have assets that is located in Australia. Whereas, a resident trust because one of the trustee is a resident, may not have any assets located in Australia. Yet, the disposal of the interest by non-resident in the latter trust would be subject to capital gain, as the interest would have the necessary connection with Australia, whereas disposal of interest in the former case would not!

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[42] Refer to section 103A(2) for details lists.

[43] The definition mirrors that of the older definition in section 160H of ITAA36.

[44] Refer to ATP commentary, paragraph 4 360. The commentaries also refer to the possibility that there may be such an “interest” where the beneficiary is a default beneficiary. However, the better view under modern trust law is that there are little difference between default beneficiary and discretionary object of a trust. See *CSD (NSW) v Buckle* (1998) 37 ATR 393.

Why the disparity? If anyone is to be taxed, should the liability not arise in relation to the former case rather than the latter? An even more absurd scenario would be where one of many executors of a deceased estate happens to be an Australian resident, the non-resident beneficiary could be liable for Australian CGT should they dispose of their interests in the deceased estate, notwithstanding that the deceased estate has no other connection with Australia, including with no property located in Australia or otherwise connected with Australia.[45]

Notwithstanding the practical difficulties in terms of tracing and enforcement, an approach that looks at whether the underlying assets of the trust estate have the requisite nexus with Australia would seem to be preferable. In this regard, it is interesting that the test for unit trust has such a pre-condition. A unit trust is a resident in two broad situations: (i) any property situated in Australia and central management and control of the trust is in Australia, or, (ii) the trust carries on a business in Australia and more than half of the beneficiary interests in the income or property of the trust are held by Australian resident. That is, the test specially looks for nexus that the trust has with Australia. The test for non-unit trust has no such requirement. Could the difference be explained by the Treasury commonly acknowledged dislike of non-unit trust, especially discretionary trust!

Share in Australian Resident Public Company – Category 5

Category 5 covers the following:

> "A share, or an interest in a share, in a company:
>
> (a) that is an Australian resident, and a public company, for the income year in which the CGT event happens; and
>
> (b) in which you and your associates beneficially owned at least 10%, by value of the shares of the company (except shares that carried a right only to participate in a distribution of profits or capital to a limited extent) at any time during the 5 years before the CGT event happens."

Whereas Category 3 deals with resident private company, Category 5 deals with public resident company. The broad thrust of Category 5 is that "portfolio holdings" is taken not have the necessary connection with Australia. For example, the sale of 1,000 shares in the National Australian Bank, a listed company, by a non-resident would not be taxable under the Australian CGT provision as it is a portfolio holding in a listed company. This exclusion serves the policy rationale of encouraging foreign investment in Australian companies. The argument is that by excluding capital gains, the potentially higher return on investment may provide an incentive, or at least, remove a barrier to investment in Australia. However, it would seem that a lower

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[45] Burns, L. and Hamilton, R.. *op. cit.*, at p211.

corporate tax rate may provide a greater incentive for foreign investment, since foreign investor are not entitled to any imputation credits (and on the assumption that they do not get an indirect tax credit in their home country for the underlying tax paid by the Australian company).[46]

A fixed threshold of 10% is adopted to delineate the portfolio and non-portfolio investment. Once this threshold is exceed, if even for a short period during preceding 5 years, the shareholding would be regarded as non-portfolio and be subjected to CGT. Notice that the test is concern with beneficial ownership, meaning that the legislation can look through a trust arrangement.

To protect the integrity the provision, an associate inclusive test is used to measure the threshold. The now almost standard broad definition of " associate" in section 318 of ITAA36 is used for this purpose.[47] In the absence of such a test, it is not inconceivable that situation could be structured such that multiple non-resident entities own shares in an Australian public company, whereby none by itself exceed the 10% threshold, and where the ultimate control of these foreign entities rest, in substance (if not in form) with the same controller (which many or may nor be Australia resident). Disposal of the shares in these foreign entities would not be exposed to Australian CGT. Admittedly, the fact that public company is by definition a company listed on official stock exchange makes this hard (indeed if at all possible) to implement in practice.[48]

A second issue concerns the measures of the 10% rule. This may be compared to the old section160T(1)(d) of ITAA36, where the 10% threshold was measured by reference to issued capital. Situation may exist where the non-resident shareholder has less than 10% of the shares in a public resident company, but where the non-resident voting interest exceed 10%. It would, for example, not be difficult to structure an ownership profile whereby the non-resident owns less than 10% of the issued share capital of the company, but in fact have majority controlling interest in the company. Under Category 5, the threshold is measures with reference to "value". Whilst a mismatch between the percentage ownership and the value may still be possible, it is submitted that the gap (if any) may not amount to much as it is likely that the value of shares track closely with the voting or dividend rights attached to the said shares.

A third issue concerns the build-in exclusion, namely that "shares that carried a right only to participate in a distribution of profits or capital to a limited extent". This

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[46] See Vann, R. "Foreign Investment Rules: The Ralph Report and International Taxation", Taxation Institute of Australia, 28 April 2000.

[47] This is not the place to analyse the associate definition; suffice to note that it is prudent that this test be examined carefully as what may seem like an "associate", may not in fact be one, and vice versa.

[48] Additional hurdles, quite apart from taxation law, would be disclosure requirements under the Corporations Act and Stock Exchange Listing Rules, and the public profile of the entities concern may restrict its abilities to undertake high risk or tax aggressive ventures.

means shares with limited income or capital entitlements, such as most preference shares, would not need to be counted in applying this threshold test. Possibility for exploitation is kept to “a limited extent” rather than the reference to “specified amount” under section 160T(1)(d). Under the old provision, a profit and capital entitlement could be restricted by a specified amount even though that the same share may have a substantial proportion of the voting, dividend and capital rights.[49] This new definition is arguably more robust.

The operation of Category 5 effectively treats non-resident investors differently to resident investors. It gives non-resident investors potentially higher rate of return as they can invest up to 10% (by value) in a public company without incurring any CGT. In other words a legal way of avoid CGT exist.[50]

Even resident taxpayer could exploit this mechanism by investing in Australian public company using a non-resident investment vehicle. Whilst accrual taxation regime, such as the CFC and FIF rules may operates to address such situation to some extent, the effectiveness of such mechanism could be doubted given the lack of an effective mechanism in practice to trace transactions set up to exploit the tax legislation.[51] For example, how to determine whether a non-resident entity used to acquire shares in Australia is a genuine non-resident or one that is “set up” by a resident? Such enforcement difficulties is made more complicated where the foreign countries involved has no DTA with Australia, and indeed, where it is a tax havens which often have secrecy provision that prevent the flow of relevant information to the Australian authorities.

It has been said that this category may also apply to corporate limited partnership (CLP) on the basis that it is a public company.[52] This statement flows from the fact that under the tax legislation a CLP is treated as a company that is *not* a private company.[53] Logic dictates that if the company is not private then it must be a public company. However, it is submitted that this may not be the case as a matter of statutory interpretation. There is no provision stating that a CLP is a public company, nor is there a provision that states that a company that is not a private company is a public company. The statement in section 103A(1) saying that a company that is private company if it is not a public company does not automatically means that the reverse is true. It is noted, however, that the Commissioner has discretion under section 103A(5) to treat a company, presumably a CLP that is deemed to be a

[49] See Burns, L. and Hamilton, R.. *op. cit.*, at p210; and Blaikie, A. ‘Internal Aspects of Capital Gains Tax’ (1987) 21 TIA54 742 at p746.

[50] Smith, B. ‘The Taxation of Capital Gains in Relation to Non-Residents of Australia’ (1994) 4 Revenue L J 42. at p52.

[51] Smith, B., *op. cit*., at p52.

[52] Burns, L. and Hamilton, R.. *op. cit.*, at p210.

[53] Section 94J and 94N.

company, as a public company. Although in the case of Category 5, the Commission may have little motivation to make such a determination as to do so would effectively exclude the disposal from Australian CGT! Anyhow, it is questionable whether this Category could in fact apply to a CLP in that it may not have shares upon which the provision could apply!

Unit in an Australian Resident Unit Trust – Category 6

Category 6 is in essence the same as Category 5 except it is concern with unit trust:

> "A unit in a unit trust:
>
> (a) that is a resident trust for CGT purposes for the income year in which the CGT event happens; and
>
> (b) in which you and your associates beneficially owned at least 10% of the issued units in the trust at any time during the 5 years before the CGT event happens."

Comments similar to those regarding Category 5 may be made, but four points are noted here. First, the threshold here is measured by reference to the number of units on issue *not* their value. It is curious that this remains the case given that Category 5 have moved onto a value based approach that is better able to ensure the integrity of the measures. Consequently, with unit trust manipulations that would be barred to company remains.[54] Second, unlike companies why is there is no distinction between private and public unit trust? Such inconsistency is difficult to comprehend, in particular, as a unit trust is in substance very similar to a company.

Third, it is not clear exactly what is a "unit trust" for the purpose of the legislation. Presumably, it refers to the common meaning that a unit trust is a trust where the investment is held through a construct called "unit" under the trust deed. If this is the case, then what is in substance a discretionary trust may be converted or disguised to look like a unit trust.

The final point is that it may be questioned whether this non-portfolio exclusion for unit trust works given the overlaps that this test has with Category 4. Unit in a unit trust that does not have the necessary connection with Australia, because the non-resident and his or her associates owned less than 10% of the issued units, may nonetheless be caught under Category 4. These units still represent an interest in a trust, and provided the trust is a resident trust, the condition in Category 4 would have been satisfied, and hence, the unit would have the necessary connection with Australia.

[54] Refer to above at page 13.

Option or Right to Acquire CGT Asset – Category 7

Category 7 is in these terms:

> "An option or right to acquire a CGT asset of the kind referred to above."

What is a "CGT asset of the kind referred to above"? Two interpretations would seem possible. It could be referring to the general category of CGT assets mentioned in Category 1 to 6, such that virtually *all* CGT assets could be encompassed. The better view seems to be that Category 1 to 6 set the limit as to the "kind" of CGT asset that could fall within Category 7. The inquiry is thus a two stage one: first, whether there is a CGT asset that falls within Category 1 to 6, and if so, second, whether there is an option or right to acquire that asset. For example, option or right to acquire shares in a resident company or unit trust would not be caught by Category 7 if the option or right relates to less than 10% of the value of the company or less than 10% of the issued units in the trust.

Coincidentally, it is also interesting that the option or right to acquire would not fall within Category 7 notwithstanding that the option or right together with the shares or units that the non-resident may have in the company or trust exceed the 10% threshold. There being no provisions that aggregate the assets to be acquired under the option or right with the assets already owned by the non-resident in the company or trust.

An issue arise as to whether a right or option in Category 7 would extend to unissued shares or unissued units. With respect to unit, it seems clear that "unissued unit" is not cover, as Category 6 referred expressly to "issued unit". In relation to unissued share, the position is more contentious.[55] One argument is that it would not, because the share does not exist until it has been issued.[56] However, it may be argued, on the basis of the wording and purpose of Category 7 that it would necessarily include unissued shares (or perhaps even units) because the option or the right to acquire contemplates a scenario where the shares or units do not exist yet but came into existence on exercise of the option.

The drafting of this category also means that *not* all assets having the necessary connection with Australia will necessarily be included.[57] For instance, option or right to acquire rollover assets (of the kind referred to in Category 8 and 9), or, assets that the taxpayer has elected to treat as having a necessary connection when the individual cease to be a resident.[58]

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[55] See Burns, L. and Hamilton, R.. *op. cit.* at p211.

[56] Paragraph 18 270 of Australian Tax Practice, *Cooper's Capital Gains Tax*, 2002.

[57] The same with the old section 160T(1)(h). See Burns, L. and Hamilton, R.. *op. cit.*, at p211.

[58] Refer to subsection 104-165(2) & (3) (ie. the old 160M(11B).

Further, where the option or right is in relation to a PE asset that is the subject of Category 1, unfair outcome could arise. It was noted previously that assets could be covered even though it may have been used by the PE for only part of time. Capital gains or losses that arise under Category 1 may be reduced under section 136-30 where the CGT asset have been used by the PE for only part of the period; but this provision would have no application to gains falling under Category 7 as it only applies to gains from CGT asset that has been used by a taxpayer in carrying on a business through a PE in Australia. Thus, disposal of the option or right would be fully taxed, whereas if the asset itself were disposed of, part of the gains made would have been ignored.

The above also means that the incident of the tax may not coincide with the period in which the CGT assets are being used by the PE. That is, a CGT liability could arise, notwithstanding that at the time of disposal of the right or option the asset is no longer used by the PE.

These are not new problems.[59] It is unfortunate that these structural defects have not been addressed during the tax law rewrite process.

Certain Rollover Assets – Category 8 and 9

The CGT provisions contain various rollovers whereby the effects of certain capital gains (and/or loss) are disregarded. The policy rationale for these rollovers is to facilitate commercial or business transactions by preventing tax costs to impede commercial transactions or business reorganisation. However, because the rollover has the effect of disregarding CGT liability, it can also be a very useful tool in terms of tax planning. In the context of this paper, the use of non-resident entities as part of such rollover strategy could, in the absence of integrity measures, result in the removal of CGT assets from Australian jurisdiction, and hence, render subsequent disposal of the CGT asset free from Australian CGT.

The drafter of the CGT legislation is mindful of such possibilities. Consequently, whenever non-resident entities are involved in a rollover, additional measures are put into place to ensure that Australia maintains its abilities to tax the disposal of those assets. This is achieved by ensuring that the asset has a necessary connection with Australia.[60] In the case of a rollover of asset from an individual, trustee or a partner (of a partnership) to a wholly owned company, the asset being transferred must have a necessary connection with Australia if either the transferor or transferee is a non-

[59] Refer to Burns, L. and Hamilton, R. *op. cit.*, which comments on the old provision.

[60] These rules are summarise in the table in the Appendix.

resident.[61] This ensures that the roll-overed asset remains within Australia taxing jurisdiction should the non-resident dispose of the asset subsequently.

Further, as part of such rollover, shares or securities in the company could be issued (as consideration for the transfer of asset). If the company issuing such shares or securities is a non-resident, then it follows from the above noted categories that the shares would otherwise not have the necessary connection with Australia in the absence of special provision such as Category 8. That is, by undertaking the rollover the non-resident would have swapped an asset that has a necessary connection with Australia and replaced it with one (ie. the share) that do not have such a connection. Category 8 operates by making such shares or securities issued by a company to a non-resident transferor as having a necessary connection with Australia.

Category 8 is in the following terms:

> "A share or security in a company that you received as consideration for your disposal of another CGT asset to the company and:
>
> (a) you chose to obtain a roll-over under Division 122 (roll-over of assets by an individual or partnership to a company) or Subdivision 126-B (roll-over of assets within a company group) because of the disposal; and
>
> (b) either you were not an Australian resident just before the disposal, or you were a trustee of a trust that was not a resident trust for CGT purposes for the income year in which the disposal happened."

Category 8 also extends to sub-division 126B rollover,[62] as it is possible that shares or similar securities could also be issued as part of such a rollover (even though the issue of shares is not a requirement of such rollover, nor is such issue of shares common in practice).

Category 9 is in similar terms, but deal with rollover assets that arise under the scrip for scrip rollover provision in subdivision 124-M. The scrip-for-scrip rollover provision in subdivision 124-M is a relatively new provision.[63] In broad terms, this roll-over makes it possible to exchange interests in a company or fixed trust without attracting capital gains tax. This measure has greatly increased the flexibility in corporate restructuring and mergers and acquisitions. The situation involving non-residents entities may be analysed by dividing the situations into two scenarios: one

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[61] Refer to tables in sub-sections 122-25(6) & (7) for individual and trustee, and sub-sections 122-135(6) & (7) for cases involving partners of partnership.

[62] Subject to transitional rules under the new consolidation regime, the sub-division 126-B rollover will cease from 1 July 2002. Currently transition rules enable wholly owned group (that has not chosen to form a consolidated group) to continue to access this rollover up till the end of the2004 income year. Refer to *New Business Tax System (Consolidation) Bill (No. 1) 2002*.

[63] Ie. it has an operative date from 10 December 1999.

involving Australian "original entity" (being the entity in which taxpayer seek to exchange interest in the replacement entity for), and the other involving non-resident "original entity".

Australian Resident Original Entity

Where the original interest held by a non-resident *does not* have the necessary connection with Australia,[64] the relief provisions would have no application as there is no capital gain or loss.

Where the original interest held by a non-resident *does* have the necessary connection with Australia, the replacement entity must be an Australian resident or a resident trust for CGT purposes.[65] This essentially ensures that the replacement interest issued have the necessary connection with Australia. Whilst this condition would mean that such replacement interest would fall within Category 3 and 4 of sub-division 136-25, and hence, be regarded as asset having the necessary connection with Australia; it is curious that a new Category 9 was introduced to specifically make such replacement interest as asset with a necessary connection with Australia. It is not immediately apparent as to the need for Category 9.

Non-Resident Original Entity

Where both the original company and the acquiring company is a non-resident, roll-over would only be available if :[66]

- The original Company has at least 300 members; or
- The acquiring company has at least 300 members or a wholly-owned subsidiary of a non-resident ultimate holding company that has at least 300 members; or
- There is a cancellation of the shares in the target without new shares being issued to the acquirer.

However, rollover relief remains available where there is a cancellation of the interests acquired in the original entity and no new interests are issued to the acquiring entity.[67] Further, controlled foreign company is treated as a non-resident for the purpose of determining whether any interests it holds in a company or trust, as a

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[64] Eg. Shares in a resident private company or at least 10% shareholding in a resident public company.

[65] Refer to section 124-795(1). The rollover relief dealing with non-resident entities is expected to be further refined when foreign income source rules are reviewed.

[66] Sections 124-795(4) and (5). This rule apply from 13 April 2000. This limitation is imposed to counter the possibility of tax-free repatriation of dividends paid out of low taxed profits channelled through a listed comparable tax country (ie. where Australian taxed, if any, would not be payable due to the allowance of foreign tax credits under s23AJ of ITAA36)

[67] Refer also to paragraph 11.53 of the EM.

result of choosing scrip-for-scrip rollover, have the necessary connection with Australia.[68]

Such specific deeming provision is particularly important in the context of rollover. In the absence of provision that deem the replacement shares or securities as having a necessary connection with Australia, the rollover relief provision can be exploited, or create opportunities, to effectively take the asset outside Australia's CGT tax net.

Indeed, other tax advantages could also arise. This fact is highlighted by the flaw in the legislation as originally legislated.[69] Under the original scrip for scrip provisions, the roll-over could be used in situation involving non-resident original entity and a non-resident acquiring entity. This could lead to arrangement design to effectively repatriate low tax profit without further tax liability by making use of the foreign dividends exemption under section 23AJ. A simple situation where this may occur is where an Australian resident interest holder exchanged its shares in a non-resident entity (being a resident of a country that is not a listed comparable tax country) in return for newly issued shares in a non-resident acquiring entity that is a resident of a comparable tax country. This arrangement would then enable the resident to access the section 23AJ exemption that it is not otherwise entitled to, by channelling the dividend from the original entity through to the acquiring entity then onward distribute it to the resident taxpayer. This unintended loophole has resulted in the insertion of subsections 124-795(4) and (5), which deny the rollover relief in situation involving non-resident original entity and a non-resident acquiring entity unless the original or acquiring entity is widely held (ie. with at least 300 members before the arrangement). It is perceived that with a widely held entity "the risk of abuse of the exemption of foreign dividends is lower where entities are not closely-held".[70]

Is Division 136 Exhaustive?

There are two related facets to this question. The first facet concerns whether Division 136 is meant to set out all the assets having the necessary connection with Australia. The second aspect looks at whether the requirement to have a necessary connection with Australia apply to all non-resident, irrespective of the CGT event that gave rise to the gains.

In relation to the first, it could be said that Division 136 purport to identify all the circumstances when asset being disposed of has the necessary connection with Australia.[71] The table in section 136-10 sets out the relevant CGT assets that needs to

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[68] Sections 396(3) and 406(3) of ITAA36.

[69] For further details refer to paragraphs 11.49 to 11.51 of the EM to *New Business Tax System (Miscellaneous) Bill (No. 2) 2000*.

[70] Paragraph 11.54 of EM to the *New Business Tax System (Miscellaneous) Bill (No. 2) 2000*.

[71] Ie. Just like the old section 160T. See Smith, B. , *op. cit.* & Kontelj, S., *op. cit.*

have a necessary connection with Australia for each CGT Event identified therein. The table also specifies the relevant Division 136 categories that need to be considered in respect of each CGT Event. The general impression is thus that all the assets having a necessary connection with Australia can be determined under this Division.

However, this is not the case. Certain assets may have a "necessary connection with Australia" notwithstanding that it is not cover by one of the category in sub-division 136-25. In particular, an asset may have the necessary connection where an individual has made an election under section 104-165 at the time when they cease to be a resident of Australia.[72] This provision is designed so that resident who becomes a non-resident have the option of deferring the payment of CGT as a result of CGT Event I1 occurring. That CGT Event I1 is meant to be a separate category quite apart from Division 136 may be gleaned from the fact that this event is not mention in the table in subsection 136-10.

The second aspect is whether the necessary connection requirement is a pre-requisite to the taxation of non-resident in all cases. Regard may be had to the Guide to Division 136, which provides in section 136-1 that "A non-resident makes a capital gains or loss only if a CGT event happens to a CGT asset that has the necessary connection with Australia." *Case 11,021*[73] confirms as much. That case concerns the application of the old section 160ZZT, or the equivalent of section 103-230 (ie. CGT Event K6), which imposes capital gains tax on otherwise pre-CGT assets where the majority (ie. 75% or more by market value) underlying property of the company are made up of post-CGT assets. It was held that this section only apply to resident, or, to non-resident if the shares are "taxable Australian asset", or "asset with the necessary connection with Australia" under current terminology. It was not in that case, and hence, the disposal by the non-resident was not subject to CGT. Thus, as a matter of general principle, the requirement to have a necessary connect with Australia needs to be considered; however, in relation to certain CGT Events this requirement is irrelevant, as capital gains or losses will not arise in the hand of non-resident.[74]

Assets Excluded From CGT Tax Net

Because non-resident is only liable to CGT if the relevant asset has the necessary connection with Australia, certain assets of non-resident would fall outside the CGT tax net. These assets include:[75]

[72] It is curious that this election is only available to an individual, but not to a company or trust even though CGT Event I1 and I2 applies to company or trust that change their residence status.

[73] (1996) 33 ATR 1081.

[74] Refer to section 136-20 which states that there will be no capital gains or losses from CGT Events C3, D3, I1, I2, K2 and K5.

[75] See Burns, L. and Hamilton, R.. *op. cit.*, at p213.

Debt securities. Disposal of debt by non-resident would probably not give rise CGT liability except in the rare occasion where the debt security fall within Category 2, 7 or 8.

Industrial and Intellectual Property. Unless in the case where the industrial or intellectual property is use by a PE in Australia and hence fall within Category 2, its disposal would not give rise to any CGT liability to the non-resident taxpayer.

Interest in a Partnership. Although a partner's residual interest in a partnership is a CGT asset under the legislation,[76] it is curious that this asset is not cover by any of the category in section 136-25. Hence, disposal by a non-resident partner of his or her residual interest in a partnership would be CGT free! To the extent that it is practically possible to allocate disposal proceeds to the partner's residual interest in the partnership, as oppose to allocating all the proceeds to the fractional interest in the underlying property, the disposal could be CGT free as the residual interest would have no necessary connection with Australia. Indeed, to the extent that goodwill can be shifted to the residual interest, the amount of CGT could be kept to a minimum.

Asset Not Cover By Division 136: Tax Free Capital Gains?

In summary, capital gains or losses will not be derived by non-resident in two broad situations:

(i) where the CGT Events are not one listed in the table in section 136-10. In particular, notes that CGT Events C3, D3, I1, I2, K2 and K5 will not give rise to capital gains or losses.[77]

(ii) If the CGT Event is listed in the table in section 136-10, where the asset do not have the necessary connection with Australia, as determine under section 136-25.

Although the transaction may have no CGT consequences in Australia, the sale is not necessarily tax free in Australia. The gain could, depending on the factual circumstances, be assessable as ordinary income under section 6-5 where, for example, it constitutes profit from a sale transaction if there is an intention to realise the profit,[78] or, the gains are attributable to an arrangement constituting a business of buying assets located in Australia.[79] This could be the case where the buying and selling of the assets, such as shares, were on a substantial scale and the criteria of

[76] Section 108-5(2)(d).

[77] Section 136-20.

[78] Ie. application of the *Whitford Beach v FCT* 83ATC 4277*, Myers v FCT* 85 ATC4601 principles. See also *Taxation Ruling TR 92/3.*

[79] Ie. profit arising from an adventure in the nature of trade as in *Thiel v FCT, op. cit.*

investment is the capital growth potential of the asset.[80] In some instance, the trading stock provisions may also impose tax on the proceeds.

The question whether these profits or gains is assessable to the non-resident then turns upon the source of the income as non-resident is only taxed on income with an Australian source. Factors like place of contract, place of payment and place of performance would then be relevant.

Moreover, the payment could also be caught by other provision in the tax legislation. A notable example is the possible application of royalty withholding tax. Whilst disposal of industrial or intellectual property would not trigger a CGT liability (unless where category 2 of the table in section 136-25 apply), the method of "disposal" could give rise to a royalty withholding tax obligation. This could be the case where the disposal is by way of a licence as oppose to by assignment.[81]

If the capital gains tax provision do not apply, and the disposal falls instead within another assessment provision, a more unfavourable tax position will likely be the outcome, as the concessional tax treatment for capital gains would not be available.

THE HOLE IN THE CGT TAX NET

With the taxation of capital gains derived by non-resident turning on the notion of "necessary connection with Australia", it follows that assets that do not fall within this notion are outside Australia CGT tax net. The bulk of the assets that fall within this notion are covered by sub-division 136-25 which functions substantially as an exhaustive code in this regard. In addition, an asset could also have the necessary connection with Australia where the non-resident made an election under CGT Event I2. In any event, the existence of such a boundary effectively carves out a domain whereby non-residents can realise asset without incurring Australian tax liability.

The exclusion of non-resident from Australian CGT in relation to non-Australian assets itself is not a problem as this is consistent with the dual taxing principal of international taxation that non-resident is only tax on their foreign sourced income. The concern is that such non-Australian assets may have underlying (which could be substantial) Australian assets. In particular, a foreign interposed entity can be deliberately inserted to create this very outcome. The use of a corporate entity and

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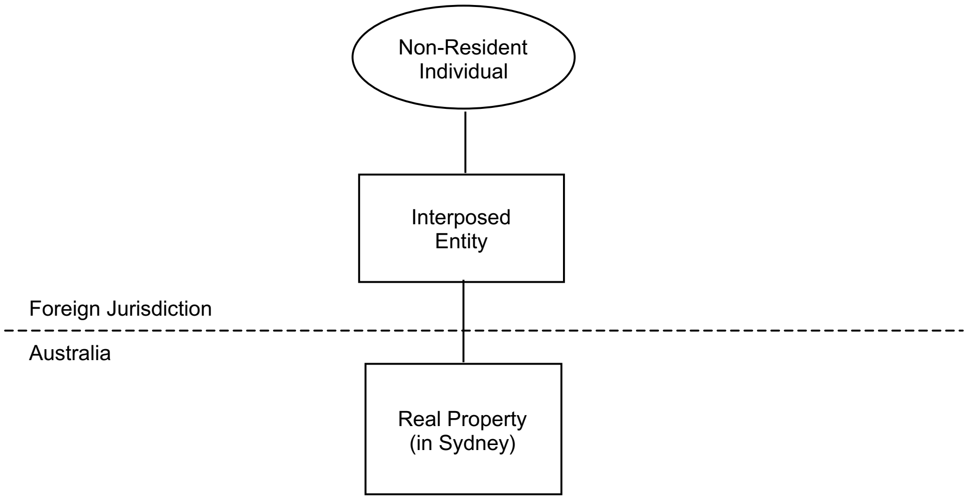
[80] See *London Australia Investment Co Ltd v FCT* 77 ATC 4398. In this case an investment company engaged in continuous large scale acquisition and disposal of shares, and the High Court held that the company was carrying on a business of investing for the purpose of producing income, and the acquisition and disposal of shares was done as part of that business, and hence, the gain was on revenue account.

[81] See Burns, L. and Hamilton, R.. *op. cit.*, and also Blaikie, A. 'Internal Aspects of Capital Gains Tax' (1987) 21 TIA54 742.

trust vehicle as the interposed entity is examined below.[82] The scenario is broadly the same in both cases. A non-resident individual owns shares or interest in a company or a trust (ie. the interposed entity). This interposed entity is located in a foreign jurisdiction. This entity has an investment in a real property in Sydney. The real property, the shares or interests in the interposed entity are all post-CGT assets.



Company

The problem arises where the interposed company is a non-resident.[83] From the above analysis of subdivision 136-25, shares in a non-resident companies do not have the necessary connection with Australia under the CGT provisions, and hence, disposal of such shares by a non-resident will be not be caught by the CGT tax net. This may be compared to a situation where the non-resident company dispose of the real property directly, in which case, Australian CGT would crystallise as the asset would have the necessary connection with Australia (under category 1). Likewise, if the interposed entity is a resident company, then disposal whether by the company or disposal of shares in the company would trigger a CGT liability. Thus, the existing rules makes it possible for non-resident to be effectively sheltered from Australian CGT liability. Opportunities arises for non-resident to avoid Australian CGT by disposing of shares in a non-resident holding company or by selling shares in the non-resident company

[82] In relation to a partnership this issue is arguably insignificant (except perhaps in the case of a corporate limited partnership that is taxed like a company). This is because for CGT purpose, disposal by a partner of their interest in the partnership is taken to result in the disposal of their respective interest in the underlying asset of the partnership. If that underlying asset has the necessary connection with Australia, CGT liability would be crystallised.

[83] The creation of a non-resident company is not difficult nowaday.

that carries on business in Australia through a branch arrangement. There being no tracing provision in the legislation that look through the interposed entity.[84]

It has been observed that whilst technically this may be possible, in practice such strategies may not be viable from a commercial perspective as prospective purchaser may not want to buy into a structure with a built in contingent Australian capital gains tax liability.[85]

Trust

The use of a trust as the interposed entity gives rise to much the same ability to shelter the non-resident individual from Australian CGT. That is, interests in a non-resident trust is not an asset that has the necessary connection with Australia. Consequently, disposal of such an interest by a non-resident is free of CGT. By comparison, a direct disposal of the Sydney property by the trust (whether a resident or non-resident) would be subject to CGT. The same would be the case if the non-resident disposes of his or her interest in a resident trust.

The reference of Category 3 to "interest" in a trust also raises an additional possibility that is different to the company scenario. It is accepted law that a potential beneficiary of a discretionary trust does not have an "interest" in the trust as such.[86] Consequently, it is, in theory, possible for a beneficiary of a discretionary trust to "dispose" of his or her "interest" without triggering CGT regardless whether the trust is a resident or non-resident trust. This could be achieved by way of a simple change of trustee that would be permitted under most trust deed. By substituting a new trustee[87] that is effectively controlled by a new owner, the ownership of the trust would have effectively shifted to the new owner. A disposal of the trust is effected in substance. This may be referred to as an "in substance" disposal.

It would seem arguable that there is no CGT liability from such an "in substance" disposal. Of course, there is the possibility that the tax authority may regard this as effecting a trust resettlement, and resulting in capital gains by way of CGT Event E1. However, it is submitted that this position is not supported by recent authorities, and it would be practically impossible for the ATO to establish in any event, particularly when all that is happening is a change of trustee that is permitted under the original

[84] See AAT *Case 11,021*, *op. cit*. In the judgment, Olney J, when commenting upon the operation of the old section 160ZZT (ie. equivalent to CGT Event K6), noted that, in the absence of specific legislative provision, the provision should not be construed in such a way as to require a deem disposal of an underlying property.

[85] See Rigby, M. "International Tax Implications of Ralph Review's Final Report", Taxation Institute of Australia, 14 October 1999..

[86] *Gartside v FCT, op. cit.* A discretionary object merely has a right to have the trust duly administered.

[87] The new trustee should also have the same residence status as the outgoing trustee as otherwise the residency status of the trust would change, and hence, potentially triggering CGT Event I1 (ie. where a trust cease being a resident trust).

terms of the deed.[88] Anyhow, this is not an issue that is peculiar to the international tax context and hence will not be elaborated further here. This is a structural issue that prevail the domestic taxation of trust in Australia.

The Lamesa Problem

The above demonstrates the existence of a gapping hole in the CGT legislation in relation to the taxation of capital gains of non-resident. The problem has a separate but related dimension as well: the interaction between domestic tax rules and DTA.

This issue with DTA is highlighted by the now famous case of *FCT v Lamesa Holdings BV*[89]. This case concerned Lamesa, a company registered in Netherlands and hence a non-resident under the Australia/ Netherlands DTA, that owns shares in ARL. ARL is the parent company of a whole chain of wholly owned Australian subsidiaries. One of these subsidiary is ARIMCO Mining, who is the owner of some gold mining leases in Australia. Lamesa disposed of the shares in ARL, and the issue is whether Australia has taxing right over the gains that arise on disposal. The court held that the Australia/ Netherlands DTA did not permit this. In particular, the court considered whether this disposal was subject to Article 13 of the DTA and whether the profit on disposal was subject to tax in Australia. It was held that the DTA was concerned with "direct" interests, and hence, the holding of the lease interest through the interposed companies prevent the Article from applying because the asset of the subsidiary could not be regarded as the assets of the parent.

This case essentially confirmed that non-residents that hold Australian real property through interposed entities or chain of interposed entities do not need to pay Australian CGT on disposal of interest in the interposed entity. This was possible because the DTA articles deal with disposal of land and shares of a company, the assets of which consists wholly or principally of real property in Australia. By interposing an entity that has no direct ownership over any land in Australia, the conditions in the "Alienation of Property" article would fail. That is, the profits are not from alienation of real property, rather they are profits from disposal of shares, which would not be governed by the alienation of property article. If anything, it would fall within the business profit article and so is subject to tax in the country of residence (in the absence of a PE).

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[88] See *FCT v Commercial Nominees of Australia Limited* (2001) 47 ATR 220. The ATO's view (as indicated in its Statement of Principles) that this case should be confined to superannuation fund may be doubted, and indeed, its view is arguably somewhat flawed.

[89] (1997) 77 FCR 597.

Amendment Post-*Lamesa*: What do they do?

As a result of this case, the Australian government responded by amending the *International Tax Agreement Act 1953*. The aim is to overcome the *Lamesa's* decision. A new section 3A was inserted.[90] This section applies where:

- A DTA makes provisions in relation to income, profits or gains from the alienation or disposition of shares or comparable interest in companies, or interest in other entities; and
- The assets of the company or the entity consist wholly or principally of real property or other interest in relation to land; and
- The provision is given the force of law before 27 April 1998.

The effect of this section applying is that the relevant DTA provision is "taken to extend to the alienation or disposition of shares or any other interests in companies and other entities, the values of whose assets is wholly or principally attributable, whether directly, or indirectly through one or more interposed companies or other entities, to such real property or interests."

This provision only applies if the real property or land concerned is situated in Australia. The EM to the amendment stated that the purpose is to:[91]

> "ensure that Australia is able to maintain its taxing right over alienation of Australian real property in situations where it is owned by non-residents either directly or through a chain of interposed entities…"

This section enables Australia to tax the alienation of shares or comparable interests in companies or interests in other entities, where the value of whose assets is wholly or principally attributable, whether directly or indirectly, to real property in Australia. In other words, this legislation is designed to protect the taxing rights of Australia over income, profits or gains on the alienation or effective alienation of Australian real property despite the presence of interposed entities. However, the effectiveness and legal validity of such a provision to prevent the use of interposed entities to circumvent Australian capital gains tax may be questioned. The following issues have been raised:[92]

- The retrospective application of the provision on transactions commenced before April 1998 but completed after that date may be too harsh;

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[90] The amendment was introduced under the *Taxation Laws Amendment Bill (No11) 1999*, which received royal assent on 5 September 2000 as the *Taxation Laws Amendment Act (No 114) 2000*. This amendment has an operative date of 27 April 1998.

[91] Paragraph 1.3 to the *Taxation Laws Amendment Bill (No. 11) 1997*.

[92] Shaddick, R. and Edmonds, G. New Development in Cross Border Anti-Avoidance, Taxation Institute of Australia, 22 August 2000, and as identified in Seventh Report of 2000, Senate Standing Committee for the Scrutiny of Bills, 7 June 2000.

- The amendment may amount to an "unilateral abrogation of Australia's treaty obligations by amending domestic law", and for such change to be legally valid, it arguably requires acceptance by the treaty parties concern.[93] It can be questioned whether such a unilateral rewrite of a DTA provision is possible or legally valid.[94]
- The term "alienation or disposition" is still undefined.

Further, it should be noted that the amendment merely apply to tax treaties containing an "alienation of property" article,[95] and not all treaties have such an article. Further, such article does nothing to extent the scope of Australian domestic law. DTA by itself does not impose any tax liability; it merely delineates taxing rights between the contracting states. In order that the gains be assessable it must still fall within an operative provision of the tax legislation. That is, the disposal of the shares or similar interest would still require to have the "necessary connection with Australia". The real question is whether the operative taxing provisions in the *Income Tax Assessment Act* support such a CGT liability. Currently, these provisions do not; but there is an intention to extend the scope of the law in this regard. This aspect will be explored next.

THE PROPOSED REFORM: SOME COMMENTS

Whilst this gapping hole has been a know issue for a long time,[96] there have been little action or incentive on the part of the Government to address the issue. It only became a more concrete concern as a result of the various reports produced by the *Review of Business Taxation*.[97] On the Government's agenda is to tax the disposal by non-resident of shares in non-resident entities where the transaction involves the effective

[93] Whilst it is known that the Commissioner have written to the treaty parties concern regarding the proposal on 28 April 1998, the nature of the respond, if any, remains unknown.

[94] ATP, *Australian Tax Handbook 2002*, p1472; and Hamilton, R., Deutsch, R. and Raneri, J. *Guidebook to Australian International Taxation* (2001, 7th ed), Prospect Media, St Leonards, paragraph 6.688.

[95] Tax treaties entered into prior to 1986 do no include an "alienation of property" article, or if there is one, such article is of limited scope. See Abrahamson, J., *op. cit.*

[96] Even back in 1993, commentators are already noting that this is "a device which has already been utilised by some taxpayers", and thus, presumably creative tax practitioner would have 'exploited' this opportunity for their clients years before that. See Woellner, Vella & Burns, *Australian Taxation Law*, 4th ed (1993), at para 10-430; and also Smith, B., *op. cit.*

[97] This issue was raised by the Treasurer on 27 April 1998 in a Press Release 39/1998, and in paragraphs 30.73 in *A Platform for Consultation*. The needs to take action is probably also heighten by the publicity attracted by high profile case like *Lamesa* (see discussion on page 27).

disposal of underlying assets that have a necessary connection with Australia.[98] This rule was originally meant to be operative from 1 July 2001.[99]

The proposal is to tax non-resident companies with assets that have the necessary connection with Australia where control of the company has shifted. At the time where there is such a shift in control, the non-resident company will be deemed to have disposed of those assets at its market value at that time. More specifically, the following pre-conditions need to be satisfied.

First, the assets having the necessary connection with Australia must be the principal assets of the company. This threshold test will be determined by reference to the market value of the company's assets and based on whether the relevant assets produce the majority of the company's income. How would the rule deal with multiple interposed companies? Alternatively, where the successive ownership interest goes "in" and "out" of Australia? For instance, where underlying asset is share in a non-resident company, which in turn own assets located in Australia? It is likely that there will be tracing provisions to address these issues. Whilst their mechanics have not been revealed, it is possible to surmise that they are likely to be exceedingly complex. In any event, the practical workability of such rules in the international context may be seriously questioned.[100]

Second, for there to be a deem disposal, the non-resident must "control" the interposed entity and that the control of the non-resident company must pass from the non-resident to another entity. Measurement issues regarding control that are similar to those above would undoubtedly arise.

Third, the deemed disposal will not occur where any gain on sale of the interposed company is subject to tax in a broad exemption listed country, or, would have been subject to tax in such a country if rollover relief had not been claimed in the relevant country. This exemption is arguably too narrow; it would be preferable if the exemption is available to non-resident of countries where the sale of the shares are taxed at a rate comparable to that in Australia.[101]

Further, pursuant to *A Platform for Consultation*, the proposal is that the amount of the notional gain would be determined with reference to the proportionate change in control. Paragraph 30.76 therein cited an example where a non-resident reduced its shareholding in a non-resident company that holds assets with the necessary

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[98] Refer to Recommendation 21.7 of the Ralph Report, and also Treasurer's *Press Release* No. 74 on 11 November 1999. This measure was originally intend to take effect from 1 July 2001.

[99] This measures will now not be operative before 1 July 2002. The measure to deal with the use of non-resident interposed entities will be the subject of further review to be conducted following a review of the Doubt Taxation Agreement policy. See Treasurer Press Release 016, 22 March 2001.

[100] Refer to comment on enforcement below on page 31.

[101] Rigby, M., *op. cit.* Ie. there being arguably many comparatively taxed countries that are not covered by the standard listed countries.

connection with Australia from 52% to 27%. The market value of the asset exceed the cost base by $100 Million. The example suggests that a capital gain of $25 Million would arise because of a 25% change in control level. However, uncertainties exist. What if the shares triggering the deemed disposal are sold again? Would there be a further deemed disposal? Possibility of double taxation would arise. Some fairly complex adjustment mechanisms could be required.[102]

Indeed, what change of control is required? Is it changes that result in the non-resident losing control, in the sense of less than 50% voting, dividends, etc rights. To counter avoidance, rules that look at the control over a period of time are required. It is also possible that, under the proposal, double taxation could arise. Whilst, the deemed disposal would likely result in cost base adjustment to the non-resident company, the deemed disposal would likely not be recognised by the foreign country's capital gain tax regime.[103]

Overall, the proposed approach is consistent with the general framework of taxation of capital gains derived by non-resident. The disposal is to "trace" through to identify the "source" of the gains. If the gain has an Australian source – by way of a proxy measurement of "necessary connection with Australia" – it is taxed. In this regard, the proposed ruled to tax capital gains derived through the use of non-resident interposed entities structure are just simply elaborate tracing rules!

Enforcement Issues

Intricate and complex rules can be drafted to try to capture a diverse variety of scenarios to avoid structure being set up to place capital gains outside the reach of Australia taxing authorities. In practice, a big problem is enforcement. Commentators have stated this problem in the context of Category 2 as follows: [104]

> "[f]rom a practical perspective it may be difficult for the ATO to apply the CGT provisions to assets in category 2 where the disposal of the asset occurs outside Australia, particularly where the permanent establishment has ceased to exist (eg where a construction project has ended)."

Simply put, the difficulty is: how to tell whether the underlying assets have the necessary connection with Australia?

One way to address the enforcement issue is to adopt a withholding mechanism, as suggested by Recommendation 21.6 in *A Tax System Redesigned*.[105] It is suggested

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[102] Refer to discussion in Rigby, M., *op. cit.*

[103] See Rigby, M., *op. cit.*for example illustrating this.

[104] Paragraph 18 220 of Australian Tax Practice Cooper's Capital Gains Tax, 2002.

[105] Treasurer Press Release 016, 22 March 2001, indicates that this measures was to be introduced from 1 July 2002.

that a withholding tax of around 10% be imposed on the gross amount paid in respect of the disposal where the underlying asset have the necessary connection with Australia. The withholding tax will be credited against the non-resident's final tax liability. That is, unlike dividend and royalty withholding tax, it will not be a final tax such that lodgement of tax return would still be required. The enforcement difficulties are addressed here by shifting the burden onto the entity undertaking the disposal. Although the ultimate tax liability would not change, it would have the effect of affecting the cash flow of the non-resident investors.[106]

An alternative suggestion is that measures be introduced to require a resident who elect to defer CGT when ceasing to be an Australian resident to give appropriate security to the ATO.[107]

It seems that to a large extent the enforcement difficulty is an information one. It is submitted that this could be addressed to some extent through the use of disclosure rules.[108] The additional compliance complication that this would cause would need to be considered however. For instance, the entity could be required to disclose the nature and location of the CGT asset that is sold during the income year. Indeed, such disclosure rules would seem to be required if the proposed withholding mechanism itself is to be properly enforceable.

DTA

Will the gain arising under the proposed deemed disposal be protected by tax treaty?

Two provisions are briefly considered below. Issues concerning anti-treaty shopping rules in DTA may also be relevant.[109] These will not be reviewed here.

1. Business Profit Article.

An argument could be put that the gains is protected by the business profit articles under tax treaty provided that the notional gains was not a business profit attributable to a business conducted by an Australian permanent establishment. The business profit articles typically provides that "the profit of an enterprise of one of the States shall be taxable only in that State unless the enterprises caries on business in the other State through a permanent establishment situated therein."[110] The terms "profits" is

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[106] Rigby, M., *op. cit.*

[107] See Hamilton, R., Deutsch, R. and Raneri, J. *Guidebook to Australian International Taxation* (2001, 7th ed), Prospect Media, St Leonards, paragraph 4.380.

[108] Such a disclosure requirement would be consistent with recent legislative tread to require more information disclosure by the taxpayer. For example, the ultimate beneficiary disclosure rules in relation to the taxation of trust, and the recently introduced disclosure rules under the new simplified imputation system.

[109] Refer to Gazell, I. 'Treaty Shopping' (1998) 27 ATRev 65.

[110] Article 7(1) of the Netherlands- Australia DTA.

not generally defined in the DTA, but sections 3(2) of the *International Agreements Act 1953* provides that "reference in an Agreement to profits of an activity or business shall, in relation to Australian tax, be read, where the context so permits, as a reference to *taxable income* derived from that activity or business." (emphasis added) The term "taxable income" in Australia clearly covers the statutory capital gains that arise under the CGT provisions.[111] The fact that it is taxable income alone is not adequate, it must also be derived from the "activity or business" of the relevant taxpayer. This could pose a problem in the interposed entity scenario, where the gains arise from a change in the ownership of the entity's holding the Australian asset. In this case, it is simply "not clear that it is derived from that company's business or activity. The company continues to hold the assets and has done nothing to the assets in the course of its business or activity that triggers a gain."[112]

The Commentary on Article 13 of the OECD Model convention indicates that the provision could apply to gains arising from revaluation, as opposed to disposal, of assets. The deemed disposal is clearly not a revaluation, but it could be argued that it is closely analogous to the revaluation scenario.[113] After all, in both situation, accrued but unrealised gains are taxed. Hence, it was argued that if a gain arising from an actual disposal were protected under the DTA, a deemed disposal would be so protected also.[114] Note that this argument would fail in relation to treaty countries with DTA like Article 10A(5) of the Singapore-Australia tax treaty, which provides that nothing in the treaty "affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature."[115]

2. Alienation of property article.

Such an article typically provides that other than income or gains arising in connection with the alienation of real property, "income or gains from the alienation of capital assets of an enterprise of one of the Contracting Sates….. shall be taxable only in that State", unless the assets form part of the business property of a permanent establishment in the other State.[116] Similar to the argument above, it would seem that the alienation article could also apply to deemed disposal under the proposed measures.

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[111] Section 4-15 and 6-10 of ITAA97.

[112] Rigby, M., *op. cit.*

[113] Rigby, M., *op. cit.*

[114] Rigby, M., *op. cit.*

[115] Rigby, M., *op. cit.* Similarly, the Australia-Malaysia DTA has been amended by a Protocol to expressly provide that Australian capital gains tax provision will generally apply to gains otherwise covered by the business profit article. The protocol was entered into on 2 August 1999 and are effective from 1 July 2000. It amends Article 13 of the DTA.

[116] Article 14(3) of the Irish-Australia DTA.

POLICY ASPECTS

Modern commentators often evaluate tax system using three criteria: equity (horizontal and vertical), efficiency and simplicity.[117] The following will take a look at the proposal in relation to the first two criteria. In relation to the last criteria, it suffices to note that it is largely irrelevant in the sense that simplicity has never been a justification for the introduction of capital gains tax in the first instance.[118]

Equity

The criteria of equity come in two favours: horizontal and vertical. Both encapsulate the sense of fairness expected by people in our society. Horizontal equity states that taxpayer in same position ought to be treated equally. This is consistent with people's sense of fairness and notion of natural justice in our society.[119] To achieve this aim, it has been noted that the tax system must not only actually be fair, but it must be seen (ie. perceive) to be fair and non-discriminatory in its application to different taxpayer.[120] Vertical equity requires that taxpayer ought to bear a tax liability in proportion to their respective abilities or wealth. This is also based on the notion of fairness in theory, although not a sense of fairness that is necessarily agreed upon by all. Vertical equity is largely put into practice through the mechanism of the progressive tax system. The argument is that progressivity of the tax system would break down to the extent that CGT is, or can be, excluded from the tax base because CGT is often seen to be a luxuries of the wealthy or well endowed taxpayers.

The introduction of Capital Gains Tax in Australia is largely justified on ground of horizontal and vertical equity. The Asprey Committee Report stated as follows:

> "[it is] on ground of equity that… the arguments for capital gains tax may reasonably be held to be so strong as to overwhelm the admittedly strong case against it on grounds of simplicity."

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[117] These criteria has its origin with the four maxim outlined by Adam Smith – loosely summed up as equality, certainty, convenience and freedom from economic burden. Smith, A. (1776) "An Inquiry into the Nature and Causes of the Wealth of Nations, (Part 2, Chapter II, Book Five), 1952 ed, Chicago: William Benton.

[118] See discission in Evans, C. 'The Australian Capital Gains Tax: Rationale, Review and Reform' (1998) 14 Australian Tax Forum 287. Also in this regard, that the Asprey Committee concluded as follow:

> "It is a tax which, in any administrable form, must be complex and difficult, and produce some anomalies and inequities of its own. There is no doubt whatever that any revenue it raises could be more cheaply and easily raised in other ways. By the criterion of simplicity it fails."

[119] Pedrick, WH. (1984) "Fair and Square for Taxation in Australia", Taxation in Australia, Vol 19, Sydney, TIA.

[120] Pedrick, WH., *op. cit.*

The proposal to close off the loophole whereby non-resident can effectively opt out of CGT by structuring their investment in a particular way would undoubtedly be consistent with the policy of equity. After all, why should non-residents be able to escape from Australian capital gains tax where a resident do not have such a privilege. The proposal would strengthen both horizontal and vertical equity accordingly.

Efficiency

Efficiency itself is a very ambivalent or unclear concept.[121] In the common parlance, it captures the idea of certainty in the sense of not arbitrary, as well as overlapping with the notion of simplicity. Efficiency is best taken to mean the absence of distorting influences, and in this regard is akin to the notion of neutrality.[122] That is, the economic or investment decisions are not affected by the existence or not of a particular tax. Whilst a case can be made to justify CGT on efficiency ground, the Asprey Committee itself acknowledged that there are strong arguments to the contrary also.[123]

Anyhow, it could be argued that the proposal is efficient to the extent that it removes tax as an influencing factor in investment decisions. It is not doubted that taxation impact will always be a consideration in all investment decisions (to say or to attempt otherwise is unrealistic). However, the removal of the interposed entity loophole would mean that structure or investment arrangement would not be taken for the main reason of avoiding Australian CGT tax. It is more likely that investment arrangement would be driven by factors other than taxation. This is desirable from a broader economic policy perspective as it reduces the distortion in the system. Taxation impact becomes more or less neutral.

CONCLUSION

Under the widely accepted dual approach to international taxation – residents are taxed on their worldwide income and non-residents are taxed on the basis of source – there will always be a difference between the tax rules applicable to residents and non-residents. The difference in these rules can often be exploited. In Australia, the concept of a "necessary connection with Australia" has been used as a proxy to determine whether capital gains made by non-resident is sourced in Australia, and hence, subject to tax in Ausralia. The presence of specific rules that delineate whether CGT Events will give rise to a tax liability to non-residents have made it possible to establish structure to circumvent the rules and to take the relevant capital gains outside the Australia CGT tax net. The classic example is the use of a non-resident

[121] See Evan, C., *op. cit.*, pp 295-297.

[122] Evan, C., *op. cit.*,

[123] See Evan, C., *op. cit.*, paragraph 23.11 of Asprey Report.

interposed entity – be it a trust or company – whereby disposal of the interests or shares in the non-resident entity is not subject to CGT as it does not have the necessary connection with Australia. Whilst, in most cases, this would probably mean the gains is free from Australian tax; in certain cases, the gains could still be subject to tax as an ordinary income sourced in Australia.

The Australian Government has announced new measures to strengthen the integrity of the CGT system. On the basis that the CGT regime has been introduced largely on the ground of equity and, to a smaller extent, efficiency, the proposal does seem fair and equitable. In so far that efficiency connotes neutrality it may also be said that the proposal is efficient as it would minimise the presence of artificial structure that try to exploit the existence of the CGT loophole. However, just like a lot of international tax issues, enforcement could prove to be difficult. The proposed measures will likely require immense administrative resources and international cooperation to effectively "track" the disposal of a foreign interest that relates to some underlying Australian assets.

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APPENDIX

CGT Rollover	*Can Transferor/ Transferee/ Other Entities Involved be a non-resident?*			*Additional Conditions: Certain assets required to have necessary connection with Australia for a non-resident individual and/ or trustee of a non-resident trust*
	Transferor (ie. entity otherwise making a gains)	*Transferee*	*Other Entities*	
Rollover of asset from individual or trustee to wholly owned company Subdivision 122-A	Yes Subject to additional condition	Yes Subject to additional condition	N/A	The CGT asset being rollovered to the company[124]
Rollover of asset from partners to a wholly owned company Subdivision 122-B	Yes Subject to additional condition	Yes Subject to additional condition	N/A	The CGT asset being rollovered to the company[125]
Replacement asset rollover for asset compulsorily acquired, lost or destroy Subdivision 124-B	Yes Subject to additional condition	N/A	N/A	The CGT asset (ie. the "original asset") that is compulsorily acquired, lost or destroy; and The CGT asset (ie. the "new asset") received or acquired as replacement.[126]
Exchange of shares in same company Subdivision 124-E	Yes Subject to additional condition	N/A	N/A	The shares (ie. the "original shares") owned by the taxpayer in the company[127]

[124] Table in subsection 122-25(6) & (7)

[125] Table in subsection 122-135(6) & (7)

[126] Subsection 124-70(4). Ie. old section 160ZZK.

Exchange of units in the same unit trust Subdivision 124-E	Yes Subject to additional condition	N/A	N/A	The units (ie. the "original units") owned by the taxpayer in the unit trust[128]
Exchange of rights or option to acquire shares in a company Subdivision 124-F	Yes Subject to additional condition	N/A	N/A	The rights to acquire shares in a company or rights to acquire an option to acquire such shares (ie. the "original rights"); or The option to acquire shares in a company (ie. the "original option").[129]
Exchange of rights or option to acquire units in a unit trust Subdivision 124-F	Yes Subject to additional condition	N/A	N/A	The rights to acquire units in a unit trust or rights to acquire an option to acquire such units (ie. the "original rights"); or The option to acquire units in a unit trust (ie. the "original option").[130]
Exchange of shares in one company for shares in another company (ie. interposing another company between an existing company and its shareholders) Subdivision 124-G	Yes Subject to additional condition	No Ie. original company must be a resident[131]	No Ie. interposed company must be a resident[132]	For both the disposal case and the cancellation or redemption case: Shares in the existing company (ie. the "original company")[133]
Exchange of units in a	Yes	No	No	For both the disposal case and the cancellation or

[127] Subsection 124-240(f)(ii).

[128] Subsection 124-245(e)(ii).

[129] Subdivision 124-295(7)(b).

[130] Subdivision 124-300(7)(b).

[131] Subsection 124-380(4).

[132] Subsection 124-380(4).

[133] Subdivisions 124-365(4)(b) – the disposal case-, and 124-375(4)(b) – the cancellation and redemption case.

unit trust for shares in a company (ie. interposing a company between an existing unit trust and its unitholders) Subdivision 124-H	Subject to additional condition	Ie. the trust must be a resident[134]	Ie. interposed company must be a resident[135]	redemption case: Units in the existing unit trust[136]
Conversion of a body to an incorporated company Subdivision 124-I	Yes	N/A	N/A	Interest in the body[137]
Scrip-for-scrip rollover Subdivision 124-M	Yes, but not if the acquiring entity is a non-resident[138] Subject to additional condition	Yes, but only if the original entity is a resident.[139]	No, unless the taxpayer is a resident	Replacement interest received by the taxpayer[140]
Trust to company rollover Subdivision 124-N[141]	Yes	No	N/A	No requirement as this rollover only apply where the transferee is an Australian resident[142]
Demerger rollover	Yes	N/A	N/A	The new interest acquired under the demerger must have

[134] Subsection 124-465(4).

[135] Subsection 124-465(4).

[136] Subdivisions 124-450(4)(b) – the disposal case-, and 124-460(4)(b) – the cancellation and redemption case.

[137] Subparagraphs 124-520(1)(e)(ii).

[138] Subsection 124-795(4). An exception exit for widely held entities (ie. one with more than 300 members). See subsection 124-795(5).

[139] As above.

[140] Whilst subdivision 124-M did not specifically state there is such a requirement, but this is the effect of the exception contain in subsection 124-795(1). See the Note to that subsection, and also to subsection 136-25 Category 9.

[141] A new provision recently introduced into Parliament under the *Taxation Laws Amendment Bill (No. 4) 2002*.

[142] Subsection 124-860(8).

Subdivision 125-B[143]	Subject to additional condition			necessary connection with Australia[144]
Rollover of asset between members of a wholly owned group of companies Subdivision 126-B	Yes Subject to additional condition	Yes Subject to additional condition	N/A	For disposal and creation case, Asset being rollovered[145]

[143] A rollover introduced under the *New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002*.

[144] Subdivision 125-55(2).

[145] Table in Subsection 126-50(5)