

In response to the Board of Taxation's Review of International Taxation Arrangements ("RITA"), various foreign income measures with respect to controlled foreign companies ("CFC") were enacted and became effective in 2004. However, besides the recommendations made in RITA, various other reforms were introduced to complement the RITA package including the narrowing of the CGT rules for non-residents, the removal of the foreign loss and foreign tax credit quarantining rules, tax relief for conduit foreign income, and the foreign income exemption for temporary residents. Besides the foreign loss and foreign tax credit quarantining rules, all other recommendations have either been introduced into Parliament or enacted in the past year.

Capital Gains Tax & Non-Residents

Under the current rules, a non-resident of Australia will only be subject to capital gains tax in Australia on the disposal of assets that have "a necessary connection with Australia". There are 9 asset categories that have the "necessary connection with Australia", which include the following:

- (i) land or a building or structure in Australia;
- (ii) an asset that has been used at any time to carry on business through a permanent establishment in Australia;
- (iii) a share in a resident private company;
- (iv) an interest in a resident trust estate;
- (v) a share in a resident public company, if the taxpayer and its associates owned at least 10% of the shares in the company at any time during the 5 years preceding the capital gains tax ("CGT") event;
- (vi) a unit in a resident unit trust, if the taxpayer and its associates owned at least 10% of the issued units in the trust at any time during the 5 years preceding the capital gains tax event;
- (vii) an option or right to acquire a CGT asset of the kind referred to above;
- (viii) a share or security in a company that the taxpayer received as consideration for disposing of another CGT asset to the company where the taxpayer chose to obtain a rollover under Division 122 or subdivision 126-B for the disposal;
- (ix) A share in a resident company or a unit in a resident trust that a non-resident acquires as a result of a scrip for scrip rollover under Subdivision 124-M.

However *Taxation Laws Amendment (2006 Measures No 4.) Bill 2006*, which was introduced into Parliament on 22 June 2006, seeks to amend this rule to limit its application to "taxable Australia property". The new rules are contained in the proposed *Division 855*, which will apply on or after Royal Assent of the Bill.

In general, the implications of the proposed *Division 855* are two-fold. First, it narrows the range of assets that non-residents will be taxed on for CGT

purposes and second, it introduces “land-rich” type tracing rules to tax entities that have direct or indirect real property interests in Australia.

Under the proposed rules, non-residents of Australia will only be subject to capital gains tax in Australia on the disposal of “taxable Australia property”, which broadly encompasses the following five asset categories:

1. Taxable Australian Real Property - Taxable Australian real property is defined under the proposed rules to include:
 - Real property situated in Australia; and
 - A mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry materials are situated in Australia.

2. Indirect Australian real property interests - Under the proposed rules, a non-resident of Australia will have an indirect Australian real property interest if:
 - the non-resident entity and its associates hold at least 10% interest in the entity being disposed of at that time or throughout a 12 month period beginning no earlier than 24 months before the relevant CGT event; and
 - More than 50% of the total market value of assets held by the entity being disposed of (“First entity”) and other entities (which the First entity had an interest in) are attributable to taxable Australian real property.

The assets of the other entities will be attributable to taxable Australian real property where the non-resident entity has an indirect interest of at least 10% in the other entity/entities. Where the non-resident entity’s indirect interest is less than 10%, only the market value of the First entity’s shareholding in the other entities (rather than the market value of the other entities’ assets) will be included in the calculation. The market value of the First entity’s shareholding will be treated as a non-taxable Australian real property asset in the calculation.

3. Australian Permanent Establishment Assets - All assets used by a non-resident at any time to carry on a business through a permanent establishment in Australia will be treated as taxable Australian property and be subject to CGT upon disposal.

4. An option or right to acquire any of the above CGT assets - This category is consistent with the current rules (asset category 7).

5. An asset in respect of which the taxpayer made a *subsection 104-136(3)* election when ceasing to be an Australian resident – This category is also consistent with the current rules for individuals ceasing to be Australian tax residents.

Removal of Foreign Loss & Foreign Tax Quarantining

The foreign loss and foreign tax credit quarantining rules will be removed, thereby allowing resident taxpayers to claim foreign losses against domestic income. Previously, a foreign loss could only be used to offset foreign income of the same class. If there was no foreign income available from the same class, the foreign loss would be quarantined. The foreign loss could also not be used to offset Australian income. Under the new changes, the need to classify the different kinds of foreign losses into different classes will be removed. These changes have not yet been introduced into Parliament.

Tax Relief for Conduit Foreign Income

The CFI rules were introduced as part of the Government's review of international tax arrangements ("RITA") in *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005*, applying from the first income year commencing after 1 July 2005. There are 2 aspects to the CFI rules:

Exemption from Withholding Tax

Under the new rules, conduit foreign income can be distributed from an Australian corporate tax entity ("CTE") to a non-resident in the form of unfranked dividends without attracting any Australian tax. Conduit foreign income is basically foreign income that is not assessable in Australia when derived by an Australian CTE. It includes non-portfolio dividends, foreign branch income, tax-exempt gains from the sale of a foreign company with an underlying active business, foreign income to which a foreign tax credit has been claimed, and off-shore banking income.

For CFI purposes, an Australian CTE is:

- An Australian resident company
- An Australian resident corporate limited partnership
- A corporate unit trust that is a resident unit trust
- A public trading trust that is a resident unit trust

CFI Distributed to an Australia CTE

The second aspect of the rule allows conduit foreign income to be distributed to other Australian CTEs without attracting any Australian tax. The income

therefore retains its character as conduit foreign income. Accordingly, when it is distributed to the ultimate non-resident owner in the form of unfranked dividends, it will still be exempt from dividend withholding tax. The conduit foreign income must however, be distributed to another entity within a specific timeframe, which is usually before the due date for lodgement of the income tax return of the receiving entity.

Foreign Source Income Exemption for Temporary Residents

New measures directed at temporary employees were introduced as at 1 July 2006, which entitle these temporary employees to various tax concessions. The concessions available include:

- a) The exemption of foreign source income of temporary residents;
- b) No capital gain or loss will arise upon disposal of assets that do not have the “necessary connection with Australia” by temporary residents;
- c) Interest withholding tax obligations of temporary residents will be removed;
- d) Temporary residents will be exempt from the Foreign Investment Fund, Controlled Foreign Companies and Transferor Trust Rules regimes; and
- e) Withdrawals from foreign superannuation funds will be exempt from Australian tax.