20 August 2024

Director
International Tax Unit
Corporate and International Tax Division
Treasury
Langton Crescent
Parkes ACT 2600
By email: MNETaxIntegrity@treasury.gov.au

Dear Sir/Madam,

Australian Custodial Services Association
Strengthening the foreign resident capital gains tax regime – Consultation paper submission

Thank you for the opportunity to provide feedback, and comments, regarding implementation details about the Government's Budget measure to strengthen the foreign resident capital gains tax regime.

The Australian Custodial Services Association (ACSA) is the peak industry body representing members of Australia's custodial and investment administration sector. Our mission is to promote efficiency and international best practice for members, our clients, and the market. Members of ACSA include NAB Asset Servicing, J.P. Morgan, HSBC, State Street, BNP Paribas Securities Services, BNY Mellon, Citi, Clearstream, Netwealth and The Northern Trust Company.

Collectively, the members of ACSA hold securities and investments in excess of AUD $5.0 trillion in value in custody and under administration for Australian clients comprising institutional investors such as the trustees of major industry, retail and corporate superannuation fund, life insurance companies, responsible entities and trustees of wholesale and retail investment funds, and various forms of international investors into Australia.

Please find enclosed Appendix A which contains our feedback, and comments, on the specific questions raised in the Treasury consultation paper (dated July 2024) titled *Strengthening the foreign resident capital gains tax regime* (the **consultation paper**).

Thank you again for the opportunity to participate in this consultation. Please contact Fergus Walshe (email fergus.walshe@au.bnpparibas.com) or myself if you have any comments about this submission.

Yours sincerely

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About ACSA

www.acsa.com.au

Custodians provide a range of institutional services, with clients typically favouring a bundled approach to custody and investment administration. Solutions may include traditional custody and safekeeping, investment administration, foreign exchange, securities lending, tax and financial reporting, investment analytics (risk, compliance and performance reporting), investment operations middle office outsourcing and ancillary banking services.

These services represent key investment back-office functions – often representing the client's asset book of record and essential source data in relation to the investments they hold.

The key sectors supported by ACSA members include large superannuation funds and investment managers, as well as other domestic and international institutions.

ACSA works with peer associations, regulators and other market participants on a pre-competitive basis to encourage standards, promote consistency, market reform and operating efficiency.

Note: The views expressed in this letter are prepared by ACSA for the purposes of consideration by Treasury in response to *Strengthening the foreign resident capital gains tax regime – Consultation paper* and should not be relied upon for any other purpose. The comments in this letter do not comprise financial, legal or taxation advice and should not be regarded as the views of any particular member of ACSA.

APPENDIX A

Consultation paper questions

Economic interests in TARP and other integrity matters

1. **We are interested in views on the appropriateness of the policy principle for continuing to exclude economic interests, and whether there would be any unintended consequences from changing the treatment of economic interests in TARP, to ensure they are taxed equivalently in Division 855 of the ITAA 1997 with membership interests in TARP.**

In the *Review of International Taxation Arrangements* (2002), the Board of Taxation made recommendations to the Government regarding how to better target and strengthen Australia's capital gains tax (**CGT**) laws for foreign residents. The Government adopted these recommendations by introducing *Tax Laws Amendment (2006 Measures No. 4) Bill* 2006 (the **2006 measures**). The Explanatory Memorandum to the 2006 measures stated:

> *"Capital gains tax and foreign residents*
> *Schedule 4 to this Bill amends the income tax law to better target and strengthen Australia's capital gains tax (CGT) laws for foreign residents.*
>
> *This is achieved by narrowing the range of assets on which foreign residents will be subject to Australian CGT to Australian real property and the business assets (other than Australian real property) of a foreign resident's Australian permanent establishment. The integrity of the narrower CGT tax base is strengthened by including rules covering indirect holdings of Australian real property by foreign residents.*
> *....*
> *4.1 Schedule 4 to this Bill inserts Division 855 and Subdivision 960-GP into the Income Tax Assessment Act 1997 (ITAA 1997). This Schedule also repeals Division 136 of the ITAA 1997 and makes changes to various provisions of the Income Tax Assessment Act 1936 (ITAA 1936). The changes narrow the range of assets on which a foreign resident will be liable to Australian capital gains tax (CGT) to Australian real property and the business assets (other than Australian real property) of a foreign resident's Australian permanent establishment. To complement this change, the integrity of the CGT regime is strengthened by including foreign resident indirect holdings of Australian real property. This ensures that capital gains and capital losses on a foreign resident's indirect, as well as direct, interests in the targeted assets are subject to Australia's CGT regime.*
>
> *Context of amendments*
> *4.4 This measure implements the Government's decision to reform the CGT treatment of foreign residents. The decision was announced in the Treasurer's Press Release No. 44 of 10 May 2005.*
>
> *4.5 The CGT and foreign residents measure will further enhance Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's current broad foreign resident CGT tax base.*
>
> *4.6 More generally, the amendments will encourage investment in Australia by aligning Australian law more consistently with international practice. This results in greater certainty and generally lower compliance costs for investors.*
>
> *4.7 The amendments also align Australia's domestic law with the approach adopted in Australia's tax treaties. By aligning our law with Australia's treaty practice, Australia's approach to capital gains becomes more consistent. There will also be additional benefits from enabling Australia's tax treaties to be further aligned to*

the Organisation for Economic Co-operation and Development (OECD) standards. By bringing Australia more in line with international practice, this will relieve the pressure to compromise other aspects of Australia's preferred tax treaty practice. This will result in more favourable tax treaty outcomes for Australia.

4.8 The reforms better target and strengthen the application of CGT to foreign residents. This is achieved firstly by narrowing the range of assets on which a foreign resident is subject to Australian CGT to Australian real property, and the business assets of an Australian permanent establishment of a foreign resident (other than real property assets, which are covered under the real property rules). This aligns Australia's law more closely with OECD practice.

4.9 Secondly, the integrity of this narrower CGT tax base for foreign residents will be strengthened by applying CGT to non-portfolio interests in interposed entities, including foreign interposed entities, where more than 50 per cent of the value of the interposed entities' assets is attributable, whether directly, or indirectly through one or more other interposed entities, to Australian real property. This is consistent with Australia's tax treaty practice and the OECD Model Tax Convention on Income and on Capital (OECD Model).

4.10 The integrity part of the measure ensures foreign investors cannot avoid Australian CGT consequences by holding their Australian assets through interposed entities. For example, the foreign resident may establish a foreign company that then invests in the Australian assets. But for special rules, the sale of that company by the foreign resident would not be subject to Australian CGT consequences, whereas the direct sale of the Australian assets would. This overcomes a tax anomaly that would otherwise arise between foreign residents who invest directly in Australia versus those who invest indirectly."

The following points are noted in relation to the 2006 measures:

- The design principle to strengthen Australia's CGT laws for foreign residents was to narrow, rather than expand, Australia's foreign resident CGT tax base
- The Government's policy objective was to:
  - further enhance Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's broad foreign resident CGT tax base; and
  - bring Australia more in line with international practice
- To complement the change, the integrity of a narrower CGT tax base for foreign residents was strengthened by applying CGT to non-portfolio interests in interposed entities
- Relevantly, economic interests continued to be excluded from Australia's foreign resident CGT tax base, notwithstanding the twin existence, at the time, of:
  - The OECD model treaty which prescribed the right to tax income from immovable property to the State of source (founded on the OECD's view that there is always a very close economic connection between the source of this income and the State of source)
  - Synthetic instruments (including total return swaps over Australian real property).

We agree that consistency is an important policy principle and there ought to be consistent tax treatment for the same type of underlying asset, noting that:

- The consultation paper outlines a proposal to include a definition of real property within the Commonwealth's tax legislation. In our view, any such definition should be comprehensive and clearly articulate the types of assets which are real property. Concepts such as "close economic connection" are unhelpful, generate uncertainty and create a complex framework for ascertaining tax liability (particularly tracing and assessing economic interests through indirect ownership structures)
- A related question is whether amending Australia's domestic tax law (without any accompanying change to the definition in real property in Australia's property law and tax treaties) will be sufficient to:

  - overcome statutory severance in some States (which establish a specific rule to determine whether an asset is to be treated as a fixture of a chattel (i.e. separate from the land))
  - more generally, ensure a consistent tax treatment for the same type of underlying asset (including across all of Australia's bilateral tax treaties)
- If it is insufficient to merely amend Australia's domestic tax law (with no accompanying change to Australia's property law and tax treaties), inconsistent outcomes may arise for the same type of assets (depending on which Australian bilateral tax treaty applies). This may raise behavioural concerns regarding cross border structuring and treaty shopping
- If consistency of tax treatment for the same type of asset is to be a policy principle underpinning the design of the new measures, we respectfully submit that the same definition of real property should also apply in the context of the Managed Investment Trust rules. This may also require that the definition of "rent" is expanded to include income from licence fee arrangements
- The appropriateness of a policy that seeks to capture all forms of economic value (with a close economic connection) derived from Australian assets also needs to consider the fundamental differences between economic and membership interests. Economic interests often function as financial instruments that allow for risk management, without conferring control or direct economic benefits linked to legal ownership.

A further consideration is that Australia's existing general anti-avoidance provisions, and specific integrity rules, may be enlivened to guard against the use of synthetic arrangements to circumvent CGT on actual disposals of taxable Australian real property.

For the reasons outlined above, we respectfully submit that there is no compelling policy reason to remove the long-standing policy principle to exclude assets with a "close economic connection" to Australian land and/or natural resources.

2. Are there other consequences of the proposed reforms that raise similar behavioural concerns? Do you consider that additional integrity rules are required to address them, or that the existing general anti-avoidance rules, and other specific integrity rules, provide sufficient protection?

The proposed reforms (in their current form) are likely to create adverse perceptions of sovereign risk for existing investments (that were not within the foreign resident CGT base at the time of acquisition), but will now be captured within the foreign resident CGT base under the proposed reforms.

In order to mitigate adverse behavioural concerns (which may otherwise lead to decreased investment flows into Australia), we respectfully submit that the implementation details of any proposed new measures should include, from a fairness, equity and sovereign risk perspective, at least one of the following:

- Grandfathering rules
- Transitional rules
- Market value step up rules as at implementation date (i.e. 1 July 2025).

We respectfully submit that:

- Australia's existing general anti-avoidance rules, and specific integrity rules, provides sufficient protection in many cases
- That said, the specific integrity rule in section 855-30(5) of the *Income Tax Assessment Act* 1997 could be further strengthened by incorporating a 365 day test, whilst also retaining the purpose test.

ATO notification of non-IARPI vendor declarations

3. Treasury is interested in views on the appropriateness of the $20 million threshold, and whether there may be any unintended consequences, noting the considerations outlined above.

We respectfully submit that a $20 million threshold is too low and should be increased, having regard to various factors including:

- There should be a greater balance between providing the ATO with information on high value transactions, and supporting (rather than disrupting) commercial transactions
- A related question is whether the ATO will have sufficient resources to adequately respond within the prescribed set review period. The lower the notification threshold, the greater the volume of transactions that will require adequate ATO resources.

4. **Similarly, we are interested in views on the appropriate timeframe with which foreign resident vendors will be required to notify the ATO in advance of a transaction (i.e., the set review period), noting the policy intent, as outlined above.**

The proposed set review period commences from date of the relevant CGT event or settlement (which is earlier). If exchange and settlement occurs on the same day, this proposal may be unworkable in practice (or very difficult to implement).

The consultation paper notes on page 13 that "*high value transactions in scope would generally be expected to be planned well in advance of settlement*." A couple of comments:

- If a vendor lodges a declaration early (ie before the CGT event occurs and before the review period commences), the 365 look back testing period is not locked in at the time of lodgment of the vendor declaration. Events after the date of the vendor declaration lodgment may change the facts and/or asset valuations
- By their nature, certain high value transactions (including special situations, opportunistic deals, distressed sales) can often occur in a very short timeframe; they are not necessarily planned well in advance of settlement.

In relation to an appropriate timeframe, the consultation paper states on page 13:

> "*…a longer review period, such as 45 or 60 days, would further enhance the ATO's ability to review these vendor declarations before the CGT event or settlement, better protecting the integrity of the withholding regime*"

In general, a longer review period causes longer delays to commercial transactions. We respectfully submit that the length of the prescribed review period should be balanced with the intention (as outlined in the consultation paper on page 13) that the new process do not unduly delay commercial transactions.

5. **What information should the purchaser be required to consider, and when, in determining whether a declaration is false (and if so, to withhold)? We also welcome views on whether not knowing the declaration to be false at the time the declaration is given to the purchaser remains the appropriate threshold, in light of the new ATO notification process?**

We respectfully submit that imposing further obligations on a purchaser would not be appropriate and would unduly disrupt commercial transactions. The reasons include the following:

- The information asymmetry between vendor and purchaser
- The existing penalty regime imposed on a vendor for an incorrect vendor declaration
- The intention (as stated in the consultation paper) that the new notification process will "*provide the ATO with information on high value transactions, addressing current information asymmetries and assisting the ATO to take action to support the collection of CGT liabilities owed by foreign residents*."

6. **Are the current administrative penalties for the failure to lodge an approved form and for providing a false and misleading vendor declaration sufficient for ensuring compliance with the new requirements? If not, what is an appropriate level? This question should be considered in the context of the threshold identified at question 3 above.**

We respectfully submit that:

- The current administrative penalties for the failure to lodge an approved form, and for providing a false and misleading vendor declaration, should not be increased
- Implementation plans should instead focus on ensuring greater certainty regarding the assets which are subject to CGT pursuant to the proposed changes (which in turn provides more clarity on when to withhold and facilitates compliance with the new requirements)

7. How can the approach to this new process assist the purchaser in complying with their obligations, including clarity on when to withhold?

The consultation paper states on page 13:

> "*As a general point, in the absence of ATO intervention within the review period, the purchaser can rely on the vendor declaration*."

An ATO auto-receipt provides confirmation that a vendor declaration that the sale is not an indirect Australian real property interest (**non-IARPI vendor declaration**) has been lodged with the ATO. However, until the expiry of the ATO review period, neither the vendor declaration nor the ATO auto-receipt provides certainty to the purchaser or vendor that the ATO agrees, or disagrees, with the non-IARPI vendor declaration.

If the approach to the new process incorporates a positive confirmation from ATO that it agrees with a vendor declaration, and the timing of such positive confirmation does not delay a commercial transaction, the new process may potentially assist some (but not all) purchasers in complying with their obligations.

Custodians, administrators and fund managers are often involved in corporate actions (e.g. an off market buyback conducted by an Australian public company) which breach the $20 million threshold. We respectfully submit that if a notification requirement is implemented, the new process should include appropriate carve-outs to implement the following intention (as stated in the consultation paper on page 13):

> "*The measure, as announced, does not seek to alter the current legislation which applies to exclude certain transactions from the existing foreign resident capital gains withholding regime, such as transactions on an approved stock exchange, or the non-portfolio interest test which prevents membership interests of less than 10 per cent from being an IARPI*."

That is, a non-portfolio interest of less than 10 per cent (which breaches the $20 million threshold) should be a bright line, legislative carve out from the proposed notification requirements.

Some foreign residents hold assets using an Australian custodian. We respectfully submit that it is inappropriate to impose vendor declaration and any potential withholding tax requirements on Australian resident custodians and administrators. Any such obligation should remain with the vendor (who has carriage of the requisite information and associated tax analysis). We also respectfully submit that custodians should not be penalised for relying on investor representations, given the lack of information to validate across 365 days.

We note for reference that ACSA provided submissions in relation to the introduction of the foreign residents capital gains withholding provisions seeking to ensure there were no inadvertent implications for custodial arrangements. With the currently proposed expansion to these rules, we submit that it would assist for the provisions to clearly exclude custodians from the provisions.