Legal Update

A Summary of the 2017 Budget Outcomes for Foreign Property Investors

The 2017 Federal Budget handed down on 9 May 2017 expressly targeted foreign investment in Australian assets, particularly residential real property, which has been framed as a response to concerns regarding national housing affordability.

Foreign Investment Policy – New Annual Vacancy Charge

Stricter foreign investment policy has manifested in the proposed ‘annual vacancy charge’ for foreign-owned residential property. Currently the Foreign Investment Review Board (FIRB) scheme declares that it seeks to channel foreign investment towards increasing new housing stock, where approval is readily available for acquisitions of new dwellings. However, it seems direction of investment to construction of new dwellings is not enough, if the resultant housing stock is left unoccupied.

The new rules will apply to foreign persons who make a foreign investment application to acquire residential property after 7.30pm on 9 May 2017. For foreign persons purchasing in a new development with a New Dwelling Exemption Certificate, the policy applies to all contracts for new dwelling purchases formed after that date.

<u>Recapping Australia’s Foreign Investment Policy</u>

By way of review, the current Australian government policy on foreign investment in Australian assets requires that foreign persons are required to obtain approval for acquisition of interests, including real property (residential, commercial and rural), business assets, tenements, securities and so on.

A ‘foreign person’ means an individual not ordinarily resident in Australia (note the test does not concern Australian citizenship); a foreign government entity; a corporation, trustee or partnership of which a foreign entity owns an interest of 20% or more; or a corporation, trustee or partnership in which two or more foreign individuals own an aggregate interest of 40% or more.

Some classes of assets have value thresholds, where only acquisitions of a deemed significant value require approval of the FIRB; and some nationalities benefit from higher thresholds for certain asset classes.

However, there is no threshold applicable to residential real property: acquisitions of any value require FIRB pre-approval. Vacant land for residential development, and newly constructed dwellings usually gain approval with ease, whereas approval for existing dwellings is limited to circumstances such as where the person is a temporary resident of Australia, the property is to be redeveloped, or the property is acquired by a significant business enterprise to house Australian staff.

The application fee for proposed investment in Australian real residential property is annexed to the value of the proposed acquisition. For the 2016-17 financial year, the fee for property valued at up to AU$1 million is $5,000, a fee of $10,100 for values between $1 million and $2 million and so on, more than doubling for each additional $1 million in value.

Developers of newly constructed dwellings in a multiple lot scheme may apply for a New Dwelling Exemption Certificate for a fee of $25,300 plus a reconciliation fee annexed to the number and value of lots in the scheme. This means that foreign buyers of lots in the development do not need to make their own application for approval.

Citizens and permanent residents of New Zealand are exempt from the need to obtain FIRB approval for acquisition of land, as are Australian citizens not ordinarily resident in Australia. That exemption also extends to spouses of those people, if land is purchased as joint tenants.

Annual Vacancy Charge

The annual vacancy charge is a new penalty which applies to foreign-owned and under-used property. Property is 'under-used' if it is vacant for a cumulative six months in any year from the date of settlement. To avoid a penalty liability, the property must be 'used' for at least 183 days for the 365 days immediately following each anniversary of settlement of the acquisition. Those days needn't be consecutive.

The dwelling is properly 'used' if it is used as a residence. This means occupation by the foreign owner or a residential tenant, and includes use by friends or family without a formal rent agreement or monetary consideration. A period in which the property is genuinely available for rent counts towards the days that the property is in use as a residence. Vacant residential land and existing dwellings which have been acquired for development or redevelopment are exempt from the charge for the period of construction.

The charge applied if a foreign-owned dwelling is under-used is the amount equal to the application fee paid at the time of acquisition; or for interests acquired in new developments under a New Dwelling Exemption Certificate, the amount equal to the reconciliation fee at the time of acquisition. This is not an insignificant charge and for most will be a strong disincentive for foreign owners to allow properties to remain vacant for extended periods. The test is assessed on an annual basis and so the charge is payable every year that the property meets the 'under-used' criteria. It is yet to be seen whether the relevant charge will be indexed to account for inflation, given that it is set to be based on a prior fixed amount.

The new policy is yet to be legislated, and information remains in guidance form, notwithstanding that the policy is to be applied from the date of announcement in May. That means that whilst it is *unlikely* that the annual vacancy charge will extend to those exempt from requiring FIRB approval for land acquisition, namely New Zealand citizens and Australian non-residents, it cannot be known with certainty at this stage.

Removal of CGT Exemption on Main Residence for Foreign Owners

Following the Budget announcement on 9 May 2017, foreign and temporary tax residents will no longer be permitted to claim the main residence capital gains tax exemption, for all sales occurring after Budget night. Those foreign and temporary tax residents who owned property on Budget night may continue to claim the exemption on sales occurring up until 30 June 2019.

In simple terms, the effect of the capital gains tax is to add the amount of a capital gain to a taxpayer's taxable income for the relevant financial year. A capital gain is the positive difference between the financial benefit received from a CGT event (which ordinarily means disposal of the asset, namely, sale of a house) less the costs associated with the disposal of the asset; including the cost of acquisition of the asset, upkeep and maintenance, and costs associated with sale, which includes agents' fees and legal professional fees and outlays. It is also possible to incur a capital loss, which may be claimed as a deduction to taxable income.

Assets owned by individuals, trusts and superannuation funds which were acquired at least 12 months prior to the CGT event attract a 50% discount factor, so that only half of the amount of the capital gain is included in the taxpayer's taxable income. Moreover, residential real property that has been used as an individual taxpayer's main home is exempt from capital gains tax.

Foreign citizens are permitted to reside in Australia with the appropriate residency visa, and may own their home. However, it is now the case that they will be subject to the full extent of taxation liability upon the eventual sale of their residences.

What the Budget policy in its present form does not address is whether that change will extend to New Zealand citizens residing in property that they own in Australia. Citizens of Australia and New Zealand enjoy mutual benefits of a strong trans-Tasman relationship between the two nations, which extend to relative freedom to reside in either country and access to social security. In particular, New Zealand citizens are exempt from requiring FIRB approval to acquire real property in Australia.

However, the change to application of the CGT main residence exemption appears to encompass all non-citizens of Australia, including New Zealanders. On its face, there is no provision made which would allow New Zealand citizens living in Australia to claim the main residence exemption to CGT if they are to sell their home after 30 June 2019.

Foreign Resident CGT Withholding Scheme Changes

Finally, the 2017 Budget proposes a two-fold adjustment to the CGT withholding scheme, which has been effective since 1 July 2016.

At present the *Taxation Administration Act 1953* (TAA) provides that when an interest in a CGT asset held by a foreign resident is sold, 10% of the first element of the CGT asset's cost base (ordinarily, the purchase price) must be directed to the Commissioner for Taxation, a withholding for capital gains tax designed to increase foreign compliance with local tax laws. The withholding is not final: the foreign tax payer may claim a credit on its future tax return, or may be liable to pay a further amount. The main exemption from the scheme is where the first element of the cost base does not exceed the value of AU$2 million.

The Senate is set to pass legislation amending the withholding rate to 12.5%, and the threshold exemption value to $750,000. This means that purchasers of real property in Australia who acquire an included interest from a foreign entity will be required to withhold 12.5% of the price payable to the foreign vendor for the Commissioner, where the purchase price is $750,000 or higher.

The mechanics of the foreign resident CGT withholding scheme will remain unchanged. The scheme expressly applies to assets which are subject to CGT levied by the Australian Taxation Office when disposed of by a foreign owner; that is:

(i) all taxable Australian real property;
(ii) an indirect interest in Australian real property; or
(iii) an option or right to acquire an interest in (i) or (ii).

The definition is intentionally broad, and would include a leasehold interest, and a right to mine or prospect resources situated in Australia. An indirect interest would include the acquisition of a share in an entity which has an asset base of more than 50% in Australian real property. For that purpose, an assessable interest in the entity would need to be a non-portfolio interest: more than 10%.

A foreign resident capital gains withholding payment obligation is imposed on the Australian resident <u>purchaser</u> of an asset to which the scheme applies, rather than the foreign entity vendor. Thus the assessment of whether a vendor is a 'foreign entity' is contingent on the purchaser's state of knowledge at the time of entry into the transaction. While the scheme is not limited to real property transactions, that will be the most common class of transaction giving rise to a withholding obligation following the new lower exemption threshold.

A withholding payment obligation arises where the purchaser knows or reasonably believes the vendor entity[1] to be a foreign resident, or does not reasonably believe the entity to be an Australian resident and either has an address outside of Australia, or the purchaser has been authorised to pay the purchase price (or other financial benefit traded) to a place outside of Australia. Practically, if the seller of Australian real property is actually a foreign-based entity, it will be difficult for the purchaser subject to a withholding payment obligation to prove that it didn't or couldn't have known. Fortunately, a purchaser of real property can require the vendor to produce a clearance certificate from the Commissioner on settlement, to certify that the vendor entity is not foreign and the withholding liability is not triggered by the transaction.

The change that will be most felt broadly by relevant parties is the lowering of the exemption threshold to $750,000, meaning not only that more foreign vendors will be subject to capital gains tax withholding, but that a significant tier of purchasers will now need to exercise caution to ensure that a withholding obligation is not neglected.

For further information contact Paul McHugh.

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Thompson McNichol Lawyers
Suite 5, 32 Aerodrome Road | PO Box 552 | Maroochydore | QLD | 4558
E mail@tml.com.au | **P** 07 5443 1566 | **F** 07 5443 7196 | **W** tml.com.au

[1] For the scheme, 'foreign entity' refers to both natural and legal persons: individuals, companies, partnerships etc.