The Tax Summit – The Tax Institute

Session 13.4, Tapped out on Treaties & TARP, Corporate Stream

Presented at Mellbourne Convention and Exhibition Centre (MCEC) on 5-7 September 2023

Presented by Andrew de Wijn

Author:

Paul McNab
McNab Tax Lawyers

© Paul McNab 2023
Disclaimer: The material and opinions in this paper are those of the author and not those of The Tax Institute. The Tax Institute did not review the contents of this paper and does not have any view asto its accuracy y. The material and opinions in the paper should not be sued or treated as professional advice and readers should rely on their own enquires in making any decisions concerning their own interests..
Liability limited by a scheme approved under professional standards legislation.

Contents

Overview. What is TARP? 3
Structure of division 855 5
Taxable Australian Real Property 6
Indirect Real Property Interest 7
Non-portfolio, principal asset tests 7
Court decisions re principal asset test 8
Trusts, treaties and partnerships 10
Permanent establishment in Australia 11
Collection of the tax 12

Overview. What is TARP?

The Australian tax system uses a number of concepts to determine the nexus a taxpayer must have before they are liable to Australian tax on a particular fact pattern. Non-residents generally only need to consider the Australian tax consequences of Australian "sourced" income, or capital gains transactions where the asset is a direct or indirect interest in Australian real property or relates to a business carried on by the foreign resident, through a permanent establishment in Australia.

Australia generally tries to reserve the right, in its double tax treaties, to tax certain capital gains which are directly or indirectly attributable to real property or rights relating to real property. In addition, some treaties require a credit to be give for the tax paid in Australia. In some cases, the gain may be protected from Australian tax because it is business profits or "other" income and not attributable to a permanent establishment here.

The assets which give rise to Australia claiming a right to tax capital gains of non-residents are actually collectively referred to as "taxable Australian property", and is defined in s855-15 ITAA 1997[1]:

CGT assets that are taxable Australian property	
Item	***Description***
1	**Taxable Australian real property (see section 855-20)*
2	*A *CGT asset that:* *(a) is an *indirect Australian real property interest (see section 855-25); and*
	(b) is not covered by item 5 of this table
3	*A *CGT asset that:* *(a)you have used at any time in carrying on a *business through:* *(i) if you are a resident in a country that has entered into an *international tax agreement with Australia containing a *permanent establishment article — a permanent establishment (within the meaning of the relevant international tax agreement) in Australia; or* *(ii) otherwise — a *permanent establishment in Australia; and*
	(b) is not covered by item 1, 2 or 5 of this table
4	*An option or right to *acquire a *CGT asset covered by item 1, 2 or 3 of this table*
5	*A *CGT asset that is covered by subsection 104-165(3) (choosing to disregard a gain or loss on ceasing to be an Australian resident)*

As you can see, included in that concept is "Taxable Australian real property" (or "TARP"), itself defined in s855-*20:*

> ***855-20*** *A *CGT asset is* **taxable Australian real property** *if it is:*
>
> *(a) real property situated in Australia (including a lease of land, if the land is situated in Australia); or*
>
> *(b) 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.*

The words "mining, quarrying or prospecting right" are defined in s995-1 as:

> ***mining, quarrying or prospecting right*** *is:*
>
> *(a) an authority, licence, permit or right under an * Australian law to mine, quarry or prospect for * minerals, * petroleum or quarry materials; or*

[1] Section references in this paper are to the Income Tax Assessment Act 1997, unless otherwise indicated.

(b) a lease of land that allows the lessee to mine, quarry or prospect for minerals, petroleum or quarry materials on the land; or

(c) an interest in such an authority, licence, permit, right or lease; or

(d) any rights that:

*(i) are in respect of buildings or other improvements (including anything covered by the definition of **housing and welfare**) that are on the land concerned or are used in connection with operations on it; and*

(ii) are acquired with such an authority, licence, permit, right, lease or interest.

*However, a right in respect of anything covered by the definition of **housing and welfare** in relation to a quarrying site is not a **mining, quarrying or prospecting right**.*

An issue arose in FC of T v Resource Capital Fund IV LP[2] as to whether "general purpose leases" or a "miscellaneous licence" fell within the definition of "mining quarrying or prospecting right". The Federal Court held that:

97. *Neither the general purpose leases nor the miscellaneous licence come within paragraphs (a), (b), or (c) of the definition of "mining, quarrying or prospecting right" in s 995-1 of the 1997 Act. The dispute between the parties centred, however, on whether they fell within paragraph (d) of the definition, namely, rights that:*

   *(i) are in respect of buildings or other improvements (including anything covered by the definition of **housing and welfare**) that are on the land concerned or are used in connection with operations on it; and*

   (ii) are acquired with such an authority, licence, permit, right, lease or interest….

98. *Neither the general purpose leases themselves, nor the miscellaneous licence itself, however, gave rights to the buildings or other improvements as contemplated by paragraph (d)(i) of the definition of "mining, quarrying or prospecting right". There is a distinction between mining and the further processing of minerals once they have been extracted from the ground….*

101. *It follows, however, that the value of the assets to be determined for purposes of s 855-20 do not include the value of the general purpose leases, the miscellaneous licence or the plant and equipment used by Talison Lithium in the processing of the minerals after extraction by mining: see also Placer Dome Inc v Commissioner of State Revenue [2017] WASCA 165. The Greenbushes operations carried on by Talison Lithium comprised two distinct sets of operations, namely mining and mineral processing. The first required a mining lease but the second did not. The first set of operations constituted mining for minerals for which a licence was required under the Mining Act, but the second set of operations, constituting the processing of the minerals, did not require a mining licence. Section 85(2)(b) of the Mining Act expressly provided, subject to the Act and to any conditions to which the mining lease was subject, that the lessee of a mining licence owned all minerals lawfully mined from the land under the mining lease. The ordinary meaning of mining is the "action, process or industry of extracting ores" and that activity was complete upon the recovery of the ore from the earth in the absence of an extended meaning: see Macquarie Dictionary "mining"; Federal Commissioner of Taxation v ICI Australia Ltd (1972) 127 CLR 529 at 563-4; cf also Collector of Customs v Bell Basic Industries Limited (1988) 83 ALR 251. It follows that on this basis of assessment of the RCF IV and RCF V partners there is to be excluded from the taxable value of the capital gain, the value attributable to the general purpose leases, the miscellaneous licence and the plants used in the processing operations rather than in the mining.*

In a theme we will return to later, careful analysis of the tangible and intangible assets is required by the taxpayer. Requiring access to significant levels of evidence. Although the Full Federal Court[3] overturned the

[2] [2018] FCA 14, And not further addressed before the full court on appeal.

[3] Commissioner of Taxation v Resource Capital Fund IV LP [2019] FCAFC 51

decision without expressly addressing the principal assets test, it is possible that these particular conclusions are no longer valid by implication of the Full Federal Court decision.

It has become common for the expression "TARP" to be used informally to simply refer to the broader category of "taxable Australian property". We will not use it in this sense in the paper. Although the title of this session focusses on TARP alone, this paper will also actually touch more broadly on the treatment under Division 855 of other capital gains made by non-residents. TARP is of course included within this.

Structure of division 855

The main operative provisions of interest in this paper are found in Subdivision 855-A.

Subdivision 855-B deals with rules in relation to entities becoming Australian residents. It broadly gives rules for determining the cost base of assets owned by individuals, companies and trusts which become Australian tax residents. The rules are not relevant to assets which are taxable Australian property, and I do not propose to deal with them.

It is important to remember that CGT transactions may also give rise to a gain which is assessable income under s6-5[4].

The starting point for CGT events happening after 12 December 2006 is s855-10, which provides that a person who is a foreign resident (or trustee of a foreign trust for CGT purposes just before a CGT event happens), may disregard the capital gain or loss from the event if the event happens in relation to a CGT asset that is not "taxable Australian property".

> ***855-10(1)*** *Disregard a *capital gain or *capital loss from a *CGT event if:*
>
> *(a) you are a foreign resident, or the trustee of a *foreign trust for CGT purposes, just before the CGT event happens; and*
>
> *(b) the CGT event happens in relation to a *CGT asset that is not *taxable Australian property.*

The concepts of "what is a CGT asset in relation to which a CGT event happens" is elaborated on in s855-10(2).

> ***855-10(2)*** *The *CGT asset in relation to which a *CGT event happens includes the following:*
>
> *(a) for CGT event D1 (about creating contractual or other rights) — the CGT asset that is the subject of the creation of the contractual or other rights;*
>
> Example:
>
> *You grant an easement over land in Australia. The land is the subject of the creation of the rights in the easement. Therefore, the CGT event happens in relation to the land.*
>
> *(b) for CGT event D2 (about granting an option) — the CGT asset that is the subject of the option;*
>
> *(c) for CGT event F1 (about granting a lease) — the CGT asset that is the subject of the lease;*
>
> *(d) for CGT event J1 (about a company ceasing to be a member of wholly-owned group after roll-over) — the roll-over asset.*

[4] See for instance TD 2010/21

It is useful to consider, in a little more detail, the matters that fall under s855A.

Taxable Australian Real Property

The definition of TARP in s855-20 (above) firstly refers to "real property", specifically including a lease of land if the land is in Australia. The expression "real property" is not defined in tax legislation but is a term with an extensive history in Australian property law. It would generally include some interests in physical land, such as profits a prendre and easements. These are more in the nature of contractual rights over land, than actual physical land. In the second part of the definition the concept is said to include "mining, quarrying and prospecting" rights, to the extent not included in the normal concept of "real property" if the minerals, petroleum or quarry materials are situated in Australia.

In both parts of the definition in s855-20 a key question is whether the land is "situated in Australia" or whether the other rights are in relation to something that is "situated in Australia".

"Australia" is defined in s960-505 as:

> ***960-505(1)*** **Australia***, when used in a geographical sense, includes each of the following:*
>
> *(a) Norfolk Island;*
>
> *(b) the Coral Sea Islands Territory;*
>
> *(c) the Territory of Ashmore and Cartier Islands;*
>
> *(d) the Territory of Christmas Island;*
>
> *(e) the Territory of Cocos (Keeling) Islands;*
>
> *(f) the Territory of Heard Island and the McDonald Islands.*

Note 1:

> *Section 15B of the* Acts Interpretation Act 1901 *provides that an Act is taken to have effect in the coastal sea of Australia as if the coastal sea were part of Australia.*
>
> ***960-505(2)*** **Australia***, when used in a geographical sense, includes an offshore area for the purposes of the* Offshore Petroleum and Greenhouse Gas Storage Act 2006*.*

Note 2:

> *The offshore area includes all things located in that area, including all installations and structures such as oil and gas rigs. The area also extends to the airspace over, and the sea-bed and subsoil beneath, that area.*

Note 3:

> *The offshore area includes the exclusive economic zone and the continental shelf of Australia.*

Although the legislation extends "Australia" well beyond the traditional territorial waters, there seems to be little doubt about the validity of its territorial reach[5]. Especially since the property affected is either clearly within Australia's traditional territory[6], or exists by virtue of the operation of Australian law.

Indirect Real Property Interest

S855-25, 855-30 and 855-32 extend the reach of the real property concept in s855-20 to certain "indirect interests" in real property. Gains or losses on such assets are within the Australian tax base.

The starting point is the definition of taxable Australian property in s855-15 (above) where item 2 in the table includes a CGT asset that "is an "indirect Australia real property interest".

The structure of the three key provisions is complex. S855-25 sets out a number of steps to determine if a membership interest is an "indirect Australian real property interest".

Membership interest is defined in s960-135 in broad language in include each interest or right in or in relation to the entity.

Non-portfolio, principal asset tests

S855-25(1) requires that the interest be a "non-portfolio interest" (s960-195) at the test time, or throughout a 12-month period in the two-years prior and pass the principal asset test at that time (s855-30).

Essentially the non-portfolio requirement ensures that foreign residents with a 10% or greater interest in a public company or unit trust must be examined. A non-resident with a less than 10% interest will not have an indirect Australian real property interest.

The principal asset test requires an examination of the underlying assets of the entities in the corporate chain. I will set out the provision first then discuss its operation.

> ***855-30(2)*** *A *membership interest held by an entity (the* ***holding entity****) in another entity (the* ***test entity****) passes the principal asset test if the sum of the *market values of the test entity's assets that are *taxable Australian real property exceeds the sum of the *market values of its assets that are not taxable Australian real property.*

Note:

> *The market value of any of the latter kind of assets that are duplicated within the test entity's corporate group could be disregarded (see section 855-32).*
>
> ***855-30(3)*** *For the purposes of subsection (2), treat an asset of an entity (the* ***first entity****) that is a *membership interest in another entity (the* ***other entity****) as if it were instead the following 2 assets:*
>
> *(a) an asset that is *taxable Australian real property (the* ***TARP asset****);*
>
> *(b) an asset that is not taxable Australian real property (the* ***non-TARP asset****).*
>
> ***855-30(4)*** *For the purposes of subsection (2), treat the *market value of the TARP asset and the non-TARP asset according to the following table.*

---

[5] Murray v Federal Commissioner of Taxation (1921) 29 CLR 134: The Queen v Foster (1959) 103 CLR 256; NSW v Commonwealth (1975) 8 ALR 1

[6] Within 12 nautical miles of the baseline, Atricle 3 United Nations Convention on the Law of the Sea (UNCLOS) : see also Australian Government Solicitor's Legal briefing No. 116 - Ruling the waves: Regulating Australia's offshore waters, last viewed 30 August 2023 https://www.ags.gov.au/legal-briefing-no-116#:~:text=the%20territorial%20sea-,International%20law,and%20its%20bed%20and%20subsoil.

Market value of the TARP asset and the non-TARP asset			
Item	***If:***	***the market value of the TARP asset is:***	***the market value of the non-TARP asset is:***
1	*the sum of the *total participation interests held by the holding entity and its *associates in the other entity is less than 10%*	*zero*	*the *market value of the *membership interest mentioned in subsection (3)*
2	*item 1 does not apply*	*the product of:* *(a) the sum of the *market values of all the assets of the other entity that are *taxable Australian real property; and*	*the product of:* *(a) the sum of the market values of all the assets of the other entity that are not taxable Australian real property; and*
		*(b) the first entity's *direct participation interest in the other entity*	*(b) the first entity's direct participation interest in the other entity*

Note 1:

For the purposes of item 2 of the table, it is necessary to work out the market value of any TARP assets and non-TARP assets in relation to any membership interests held by the other entity before working out the value of the TARP asset and non-TARP asset held by the first entity.

Note 2:

The market value of an asset of the other entity that is not taxable Australian real property, and is duplicated within the other entity's corporate group, could be disregarded (see section 855-32).

The process then involves looking through the corporate chain and categorising entities into those where membership interests held are less than 10% of the entities membership interests, and those that are not. The first group, if TARP are treated as having zero value and if non-TARP assets their market value is determined. In the second group it is necessary to consider the underlying assets of the entity and categorise them into non-TARP and TARP.

A final calculation is then done to determine whether the value of the membership interest that is the subject of the CGT event in the hands of the non-resident is more than 50% attributable to underlying TARP assets.

There are integrity rules to disregard acquisitions (or injections) that were done for more than an incidental purpose of avoiding the provisions (s855-30)(5)), and to avoid double counting of non-TARP assets (s855-32).

There are clear practical issues with this process, especially in the cases most likely to result in disputes where the structures are complex, there are intangible assets relating to real property and their value is hard to determine. The evidentiary issues for the taxpayer groups may be extremely difficult.

Court decisions re principal asset test

In FC of T v Resource Capital Fund III LP [7] we see some of these issues at play. There were three asset classes under consideration there, mining rights, mining information and plant and equipment.

[7] [2014[FCAFC 37

Mining information and plant and equipment were agreed to be non- TARP. The process of valuing the components for the statutory calculation was the subject of dispute. Essentially the argument revolved around two approaches:

1. Value mining information as a separate stand-alone asset at the cost of reproducing it including lost cash flow while it was recreated, value plant and equipment at replacement, attribute the remaining value to the mining rights, or

2. Take the total value (calculated on a DCF basis) and assume all assets would be sold as a parcel, so that much less value would be attributable to mining information, with more value attributable to mining rights.

The Court said:

> 50. The question raised by the appeal is whether the market value of each asset is to be determined under s 855-30(2) as if each asset was the only asset offered for sale (as the primary judge held) or on the basis of an assumed simultaneous sale of SBM's assets to the same hypothetical purchaser (as the Commissioner contended).
> 51. That question is to be answered in the statutory context and by reference to the statutory purpose for which the values are to be determined: that is, to ascertain whether SBM's underlying value is principally in its TARP or non-TARP assets. In light of the statutory context and purpose, in our opinion it is implicit that to determine where the underlying value resides in SBM's bundle of assets, the market values of the individual assets making up that bundle are to be ascertained as if they were offered for sale as a bundle, not as if they were offered for sale on a stand-alone basis. The reference to "the sum" of the "market values" does not, even in its literal terms, require the ascertainment of the market value of each relevant asset separately, and then upon their ascertainment, an arithmetical calculation. The statutory criterion referred to in s 855-30(2) can still be applied by considering the matter on the basis of an assumed simultaneous sale of SBM's assets to the same hypothetical purchaser. In our opinion there is insufficient indication in the language and context of s 855-30 to found what is, in our respectful opinion, the artificial conclusion for which RCF contended.

In FC of T v AP Energy Investments Pty Ltd[8] similar issues were raised. The dispute there again focussed on the market value of mining information.

There were disputes as to what data and related expenditures were properly "mining information" and therefore non-TARP[9]. The Court also addressed the question of the proper method of valuation to be used, and said that the Tribunal did not fall into error in its process:

> *91. The Tribunal did accept (at [149]) Mr Longworth's valuation of Abra's mining information $21,158,707 as at 3 December 2007. It was entitled to do so. Mr Longworth was a person with specialised expertise accepted by the Tribunal and his informed valuation of the market value of Abra's mining information was ascertained using the sunk cost methodology, which he assessed was the appropriate method to determine the value the market had placed on the mining information of Abra as a minerals exploration company as at 3 December 2007.*
>
> …
>
> *94. Most significantly, and practically, it is apparent that the Tribunal was alive to the differences between Abra and SBM for valuation purposes. The Tribunal made clear (at [167]) what it could take from RCF. None of the statements by the Tribunal, taken alone, or in conjunction suggest that it applied the judgment and fell into legal error as a result.*

[8] [2016] FCA 577

[9] See at para 66 et seq

The importance of the contributions of a properly instructed valuer are apparent from the judgement. Highlighted by the Court's observation of the Commissioner's valuer that:

> *Mr Lonergan said on a number of occasions that if he had unlimited funds he would have done things differently.*[10]

Some issues in relation to the test were also raised before Pagone J in FC of T v Resource Capital Fund IV LP[11] where again the question of the appropriate valuation methodology was in dispute.

Trusts, treaties and partnerships

It was noted earlier that Australia generally reserves in its treaties the right to tax certain gains attributable to direct or indirect interests in real property. At first glance this would suggest that there would be few cases where the operation of Australia's treaties in relation to gains, the subject of Division 855, were explored.

Issues concerning the availability of treaty protection in relation to Division 855 were raised in the "Resource Capital" series of judgments, with significant divergences between the approaches taken the by Courts at various levels. In the full Federal Court judgement in FCT v Resource Capital Fund IV LP[12] the court held that no treaty protection was available for two taxpayers which were Cayman Island limited partnerships that held and disposed of interests in Talison Lithium Limited. The Commissioner assessed the taxpayer on the basis the profits were taxable under Art 13 of the Treaty, which generally allowed Australia to tax capital gains in accordance with its domestic law.

The limited partnerships were held to be the relevant taxpayers. On the facts, the gains were held to be income "sourced" in Australia. The limited partnerships themselves were not resident in the US and liable to pay US tax, however, and this prevented them from the benefits of any treaty protection that might have been available. The partners themselves, many of whom were no doubt US residents and taxpayers, would have been able to benefit from the treaty.

Although the decisions involved an analysis of issues of characterisation and valuation in relation to the definition of taxable Australian property and its application to the mining sector, in the end the decision turned on issues around the application of treaties to "look through" taxpayers.

The treatment of trusts has given rise to several disputes. It is common for foreign investors in real property to do so through trust or partnership structures. Division 855 contains some provisions expressly dealing with the treatment of trusts.

S855-40 provides:

> ***855-40(2)*** *A *capital gain you make in respect of your interest in a *fixed trust is disregarded if:*
>
> *(a) you are a foreign resident when you make the gain; and*
>
> *(b) the gain is attributable to a *CGT event happening to a *CGT asset of a trust (the* ***CGT event trust****) that is:*
>
> *(i) the *fixed trust; or*

[10] At para 32

[11] [2018] FCA 14, And not further addressed before the full court on appeal.

[12] [2019] FCAFC 51

*(ii) another fixed trust in which that trust has an interest (directly, or indirectly through a *chain of trusts, each trust in which is a fixed trust); and*

(c) either:

*(i) the asset is not *taxable Australian property for the CGT event trust at the time of the CGT event; or*

(ii) the asset is an interest in a fixed trust and the conditions in subsections (5), (6), (7) and (8) are satisfied.

The conditions in the later subsections essentially require the asset to not be taxable Australian property at the time, or that at least 90% of the underlying assets of the trust not be taxable Australian property.

The exemption does not, however, apply to the capital gain of a foreign resident beneficiary from a non-fixed resident trust, even if the underlying assets were non-taxable Australian property of the trust. The decisions in Peter Greensill Family Co Pty Ltd v FCT[13] and Nicholas Martin & Anor v FCT[14] illustrate the point.

Both decisions involved similar facts. They were Australian resident discretionary trusts that sold non-TAP assets, for the purposes of Division 855. In each case the trust distributed a substantial part of the gain to a foreign resident beneficiary of the trust. Greensill involved a gain from shares in a London financing company. The ATO assessed the trustee under s98 ITASA1936, saying that Division 855 did not apply to disregard the gain.

At a high level it might have been expected that Greensill should not have an Australian tax liability. A non-resident had received the benefit of a gain on disposal of a non-TAP asset. If this had been done other than through an Australian trust there would have been no Australian tax.

The taxpayer argued that the capital gain distributed was "from a CGT event" for the purposes of 855-10, and therefore was not taxable in Australia. The full Federal Court said:

> *Therefore, in conclusion, Thawley and Steward JJ were correct to hold that s 855-10(1) has no application to the facts of either case. The provision did not apply to the trustees of the respective trusts because both trusts are resident trusts. Likewise, the provision did not apply to the foreign beneficiaries to disregard any capital gain in the calculation of the amount under s 115-215(3) treated as the beneficiary's capital gain for the purposes of the application of div 102 to the beneficiary, because "the amount mentioned in s 115-225 in relation to the beneficiary" for the purposes of s 115-215(3) and s 115-220 is not a "capital gain … from a CGT event" within the meaning of s 855-10.*

Essentially there was a disconnect between the event giving rise to the tax liability under the trust provisions of the Act and the event protected by Division 855.

Permanent establishment in Australia

S855-15 also includes within the definition of taxable Australian property a CGTT asset that is used at any time in carrying on a business through a "permanent establishment" in Australia. "Permanent establishment" is defined in s6(1) ITAA 1936.

If you are a resident of a country that has an international agreement with Australia that has a permanent establishment article (defined as one similar to that in the UK treaty) then the treaty definition is used.[15]

[13] [2021] FCAFC 99

[14] [2021] FCAFC 99

[15] S855-16

S855-35 provides that any gain is proportionately reduced it the asset was only used in this way during the period from acquisition to the CGT event.

Collection of the tax

Disposals of assets by non-residents often raise particular collection risks for the ATO. Where the purchaser is also a non-resident the risks are accentuated. If the vendor were to take a view that no CGT is payable, then the Commissioner may have practical issues later disputing this position when the transaction proceeds have left or are never in the jurisdiction.

Where the transactions are significant, they may require Foreign Investment Review Board Approval or have a high media profile. The result has been a policy of active engagement by the ATO with taxpayers around significant transactions to ensure the interests of the revenue are protected. At a practical level this means that parties to such a transaction are well advised to proactively engage with the ATO, early. Failure to do so may result in settlement being delayed, or a large part of the proceeds being held by the ATO against a future review of the transaction.

A spectacular example of this can be seen in Deputy Commissioner of Taxation v State Grid International Australia Development Company Limited[16]. The judgement indicates that the Commissioner was dissatisfied by the level of engagement from the foreign vendor, and at 4.15pm the day before settlement the Commissioner applied for freezing orders over bank accounts belonging to the vendor and purchaser. The Court granted the orders at 12.15am the next day. The Commissioner had a view that the likely tax in dispute was $221m, as a result of the application of Division 855. The freezing order effectively applied to that amount.

[16] [2022] FCA 139