THE TAXATION OF CAPITAL GAINS IN RELATION TO NON-RESIDENTS OF AUSTRALIA

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This article discusses the effect of the capital gains tax legislation on a resident Australian taxpayer who ceases to be a resident for taxation purposes, and on a person who has not been a resident of Australia for taxation purposes. It is the object of this paper to review whether the capital gains tax legislation as it relates to non-residents provides scope for tax planning and/or avoidance.

Residence - persons other than companies

It is obvious from reading s 25(1) of the Income Tax Assessment Act ("the Act") that the word "resident" (of Australia for taxation purposes) is important in determining tax liability, because:

- resident taxpayers are assessed on income derived from both within and from outside Australia, but

- non-resident taxpayers are assessed only on income sourced within Australia.

The only definitions relating to determination of residence in the Capital Gains Tax provisions contained in Part IIIA of the Act, are found in s 160H. This section provides tests which determine the residence of a "resident trust estate" or "resident unit trust". The section gives no guidance in respect of the residence of individuals or companies.

Section 160H needs to be read in conjunction with, and is supplemented by, s 6(1) which provides definitions applicable to the whole of the Act "unless the contrary intention appears". Section 6(1) defines "taxpayer" as "a person ["person" being defined to include a company] deriving income or deriving profits or gains of a capital nature". Section 6(1)'s definition of "non-resident" is unhelpful in that it merely describes a "non-resident" as "a person who is not a resident of Australia".

It is therefore necessary to examine the meaning of the word "resident" (or "resident of Australia"). Under its ordinary meaning, cases have considered dictionary definitions where "resides" means "to dwell permanently or for a considerable time, to have one's settled or usual abode, to live in or at a particular place." No one factor has been found to be decisive. In *FC of T v Miller*[1] it was found it depends on a question of fact and degree.

The courts have stated that the issue of residence is looked at annually, because income tax is assessed annually, therefore it is necessary for taxpayers to demonstrate that they were a non-resident for the year of income.

If a person does not reside in Australia within the ordinary meaning of reside, they may still be a resident for tax purposes.

Section 6(1)(a) of the definition of "resident", which relates to a person, other than a company, contains three additional statutory tests.

1 The domicile test

A person other than a company, whose domicile is in Australia, is deemed to be a resident unless the Commissioner is satisfied that the person has a permanent place of abode outside Australia. The issue then is whether the person has a "permanent place of abode outside of Australia". Permanent is used in the sense of everlasting, not as a contrast to temporary or transitory. This is illustrated in *FC of T v Applegate*[2] where a solicitor was transferred to the New Hebrides to open up a branch office. He severed most links with Australia and left no assets, but due to ill health returned after about two years.

Northrop J held the view that Applegate had a permanent place of abode outside Australia during the period of his stay, even though he always intended to, and did eventually, return to Australia after an indefinite, but substantial stay. "If...a taxpayer...has formed the intention to, and in fact has resided outside Australia, then truly it can be said that his permanent place of abode is outside Australia...".[3]

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1 (1946) 73 CLR 93.
2 (1979) 79 ATC 4307.
3 Ibid at 4314.

be Australian residents while overseas as:

- intended and actual length of absence (generally less than 2 years is considered transitory);
- movements, duration or continuity in one country (a stay of more than 2 years would be considered a substantial period), and whether return to Australia is at some definite point in time;
- whether the taxpayer has established a home outside Australia;
- whether any residence or place of abode exists in Australia or has been abandoned because of overseas absence;
- association that the taxpayer has with a particular place in Australia, for example, bank account, family ties, etc.

2 The 183 day rule

An individual who has lived more than a half year in Australia, is usually considered a resident, unless the Commissioner is satisfied that the person's "usual place of abode" is outside Australia and the person does not intend to take up residence in Australia. The 183 day rule is a test for incoming rather than departing residents.

3 The superannuation test

A person who is a member of the superannuation scheme established by deed under the Superannuation Act 1990 or who is an "eligible employee" (or a spouse or child under 16 of that employee) with reference to the Superannuation Act 1976.

Residence of companies

Section 6(1)(b) of the Act relates to the residence of companies, (and section 160H would appear conceptually to apply similar tests to unit trusts). Section 6(1)(b) contains three tests of residence for companies, depending on the place of incorporation.

- The first test of residence makes resident a company incorporated in Australia, and is based on the view that the state which confers legal personality on a company should be entitled to tax its worldwide profits. This is simple to administer, but also easy to manipulate for tax planning purposes.

- A company is resident where its business is carried on in Australia, and
  - either its central management and control is located in Australia; or
  - its voting power is controlled by shareholders who are residents of Australia.

Taxable Australian assets

Subject to an adjustment for inflation made with reference to the Consumer Price Index, when an asset has been held for over one year, the rules contained in Part IIIA of the Act operate to impose a liability for capital gains tax on gains on the disposal of assets acquired, or deemed to have been acquired, after 19 September 1985.

In the context of residents, the capital gains rules apply, by virtue of s 160L(1), to every disposal of an asset owned by a person who is a resident of Australia, or a person in the capacity of a trustee of a resident trust estate or of a resident unit trust, whether that asset is situated in Australia or elsewhere, or (for assets constructed or created after 25 June 1992) not situated anywhere. Subsection 160L(2) limits the liability to capital gains tax to the disposal of "a taxable Australian asset" acquired after 19 September 1985, in relation to a non-resident who is a person, or a person in the capacity of a trustee of a resident trust estate or of a resident unit trust.

An asset is deemed to be a taxable Australian asset by virtue of s 160T if, inter alia, the asset is:

- land or a building situated in Australia. Land is defined in s 160K(1) as including a legal or equitable estate or interest in land, or in a stratum unit; a right, power or privilege over, or in connection with land; or a share in a company under a company title arrangement that entitles the holder of the share to a right of occupancy of the flat or unit;

- used in carrying on a trade or business in Australia. This provision would include such assets as depreciable plant and equipment, goodwill and other intangible assets, but not trading stock, because s 160L(3) of Part IIIA specifically excludes trading stock. It is not necessary that the asset is being used for the purpose of carrying on a trade or business at the time of disposal, provided that the asset has been used for this purpose at some stage by the taxpayer;

- a share, or an interest in a share, in an Australian resident private company;

- an interest in a resident trust estate. A trust is resident under s 160H(1) where the trustee was a resident or central management and control of the trust estate was in Australia, at any time during the year of income;

- a share, or an interest in a share, in an Australian resident public company, where the taxpayer (or associated person as defined in s 160E) was the beneficial owner of at least a 10% interest in the company at any time during the five years immediately prior to disposal, and after 19 September 1985, (excluding share capital that carried no right to participate beyond a specified amount in a distribution of profits or capital);

- a unit in a resident unit trust. A unit trust is a resident unit trust if any trust property is situated in Australia or a trustee carried on business in Australia, and either the central management and control is in Australia or residents held more than 50% of the beneficial interest in income or capital,[4] but only where the taxpayer or his or her associates were the beneficial owners of at least a 10% interest in the unit trust at any time during the five years immediately prior to disposal, and after 19 September 1985.

  There is no requirement that the unit trust is a public unit trust. As the definition of unit trust contained in s 160H(3) makes no distinction, it would appear that units in private, as well as public unit trusts fall within the scope of this subsection as taxable Australian assets where a non-resident holds at least 10% of the units. Thus non-residents investing in less than 10% of units in unit trusts would have no capital gains tax liability on profits made on the sale of those units;

- an option or right to acquire the listed taxable Australian assets referred to in s 160T(a)-(g);

- a share in, or a security of a company, received by the taxpayer as consideration for the disposal of another asset to the company, where the previous disposal took place after 28 January 1988 and before 26 May 1988, was subject to the roll-over relief provisions of ss 160ZZN, 160ZZNA or 160ZZO, and the taxpayer was a non-resident when that roll-over relief occurred.

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4 Subsection 160H(3).

The meaning and scope of "taxable Australian asset" was widened in relation to an act, transaction or event, or construction or creation of assets after 25 June 1992. Expansion of the concept of the meaning of asset in s 160A, and amendments to s 160M(6) and (7) resulted in additional paragraphs and a subsection being added to s 160T. Subsection 160T(1) now provides specific rules to deem there to have been a disposal of a taxable Australian asset if:

(l) the following conditions are satisfied:

(i) there is a disposal of the asset because paragraph 160M(6A)(b) applies; and

(ii) the asset is not a taxable Australian asset under another paragraph of this section; and

(iii) the consideration in respect of the disposal of the asset was derived from a source in Australia or if there had been such consideration it would have been derived from such a source; or

(m) the following conditions are satisfied:

(i) there is a disposal of the asset because subsection 160M(7) applies; and

(ii) the asset referred to in paragraph 160M(7)(a) is a taxable Australian asset under another paragraph of this section.

Prior to amendment of s 160M(7), when interpreted literally, it was a wide-reaching provision. It applied to a disposal by the person who received money or consideration for an asset created by its disposal. In broad terms it deemed as a disposal, the act, transaction or event relating to a person who receives money in return:

- in the case of the asset being a right, for the forfeiture or surrender of the right, or for refraining from exercising the right; or

- for use or exploitation of the asset.

Hill J in *FC of T v Cooling* said:[5]

> the purpose of subsection 160M(7) was to deal with the case where an

[5] (1990) 90 ATC 4472 at 4494.

> asset of a taxpayer was not disposed of in the ordinary sense as a result of the transaction (ie not within section 160L) ...

As assets which could be caught by s 160M(7) did not fall within the ambit of taxable Australian assets described in s 160T, a disposal could not have occurred of a taxable Australian asset acquired by a non-resident after 19 September 1985, as required by s 160L(2). Whilst s 160M(5)(c) refers to the creation of an asset by a person constituting the acquisition by the person, the asset being disposed of is not, according to Hill J[6] "an actual asset", but a "fictitious asset".

It appeared that s 160M(7) could not apply to non-residents, because it made no reference to the deemed disposal of a taxable Australian asset. This left open the opportunity for tax avoidance arrangement to be entered into, where, for example, non-taxable payments were made for a surrender of rights. In *Hepples v FC of T*[7] the taxpayer received $40,000 in return for entering into a restrictive covenant with his employer. Lack of consensus among the seven High Court Judges resulted in the taxpayer's appeal being allowed, even though a majority believed either s 160M(6) or s 160M(7) applied. As a consequence amendments were made to s 160M(7) which widened its ambit.

New s 160T(1)(m), together with changed wording in s 160M(7)(b) were inserted and defeat the argument that the amended s 160M(7), which deems the taxpayer has disposed of a fictional asset, does not apply where the taxpayer is a non-resident, because the fictional asset is not a taxable Australian asset.

Section 160T(l)(M) removes previous uncertainty by clarifying that where s 160M(7) applies to the disposal of a fictional asset, the fictional asset is a taxable Australian asset to a non-resident. Prior to amendment, the definition of a taxable Australian asset did not contemplate the disposal of a non-existent asset, and therefore s 160M(6) was considered not to have application to a non-resident.

According to the explanatory memorandum, the new s 160T(1)(l) means that where s 160M(6) deems that a non-resident has disposed of an asset because he or she created an incorporeal asset in another person, the asset so acquired and taken to be disposed of by s 160M(6A) is a taxable Australian asset. This results in the taxpayer being subject to tax where consideration received for creating that asset is derived from an Australian source.

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6 Ibid at 4493.
7 (1991) 91 ATC 4808.

Section 160T(2), applicable to the construction or creation of assets after 25 June 1992, deems that consideration referred to in s 160T(1)(l)(iii), if not of an income nature, is to be taken to be of an income nature for the purpose of determining the consideration that was or would have been derived from a source in Australia. Section 160T(1)(l)(iii) entitles a non-resident to a capital loss equal to incidental costs where no consideration is received by the non-resident for creating an incorporeal asset.

The amended legislation does not provide guidelines to determine the source of the consideration. In line with current methods of determination of source, the explanatory memorandum says that factors that are to be taken into account include:

- where the contract was negotiated and made;
- the place of payment of the consideration and source of funds used as the consideration;
- the subject matter of the contract;
- where the contractual obligations are to be performed.

These rules can provide the mechanism for circumvention of payment of Australian tax. Determining "source" has been fraught with problems for the Australian Taxation Office.

Source

"Source" is not defined in the Act, therefore it assumes its common meaning. "Source" is important because pursuant to s 25(1), where the source of income or a capital gain of a non-resident is outside Australia, there are no Australian tax consequences.

In *Nathan v FC of T*, the High Court judgment read by Isaacs J, said of "source":[8]

> The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the

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8 (1918) 25 CLR 183 at 189-190.

> ascertainment of the actual source of a given income is a practical, hard matter of fact.

In *FC of T v Efstathakis* Bowen J, said of "source":[9]

> the answer is not to be found in the cases, but in the weighing of the relative importance of the various factors which the cases have shown to be relevant.

In *FC of T v Mitchum*[10] a contract was entered into in Switzerland, whereby Mitchum was paid in California. He worked 11 weeks in Australia, and the Court held he was not liable for Australian income tax: the dominant source was where the contract of service was made.

Barwick CJ said:[11]

> The conclusion as to the source of income for the purposes of the Act is a conclusion of fact. There is no statutory definition of "source" to be applied, the matter being judged as one of practical reality. In each case, the relative weight to be given to the various factors which can be taken into consideration is to be determined by the tribunal entitled to draw the ultimate conclusion as to source. In my opinion, there are no presumptions and no rules of law which require that the question be resolved in any particular sense.

In *Thorpe Nominees Pty Ltd v FC of T*, when interpreting the phrase a "practical hard matter of fact" the court said:[12]

> Obviously the word "hard" was not used in the sense of difficult, but as an indication to a person concerned with making the inquiry that it was necessary to be down-to-earth, practical and hard-headed about the task in hand.

Thorpe's case involved an elaborate tax minimisation scheme in which an agreement entered into in Switzerland granted an option to the taxpayer, a company incorporated in Australia, to acquire land for less than its value from a related Australian resident company. The money was paid and received in Australia. Lockhart J[13] said:

> Viewed as a matter of substance rather than form it is plain...that the source of the income in question is Australia not Switzerland.

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9 (1979) 79 ATC 4256 at 4258-4259.
10 (1965) 13 ATD 497.
11 Ibid at 501.
12 (1988) 88 ATC 4886 at 4895.
13 Ibid at 4894.

Source rules are important to a non-resident, because there will be no Australian tax consequences to a non-resident on foreign-sourced income. A non-resident of Australia therefore has the mechanism available to avoid an Australian tax liability if it is possible to give income or a capital gain a foreign source.

By virtue of s 4(2) of the Income Tax (International Agreements) Act 1953, where there is a double tax agreement, this will generally override the Australian legislation in determining the source of income and taxing rights of both countries.

Remaining loopholes

Section 160T prescribes an exhaustive list of taxable Australian assets. The explanatory memorandum to Bill No 4 1992 says that the new s 160M(5)(b), applying to the construction or creation of an asset by a non-resident for herself or himself, and (c), applying to the construction or creation of a corporeal asset for a non-resident, mean that where a non-resident has acquired an asset, that asset is a taxable Australian asset to the non-resident if the asset falls within the existing s 160T.

Even with the 1992 amendments, the effect is that a non-resident taxpayer, who disposes of an asset defined in s 160A, but not covered by the descriptions in s 160T of taxable Australian assets is not subject to capital gains tax with respect to that asset. This means that certain provisions contained in the capital gains tax legislation and which are applicable to resident taxpayers have no force in respect of a non-resident.

Tax planning or avoidance opportunities still exist due to the limitation imposed by the exhaustive definition of taxable Australian assets. For example the capital gains tax provisions of Part IIIA do not apply, by virtue of s 160T(d), where a non-resident, together with associates, owns less than 10% of the issued share capital of an Australian public company. This means the non-resident can invest or trade in shares in Australian public companies and, provided ownership in each Australian public company is less than 10%, there are no capital gains tax consequences in respect of any capital profits.

Thus a non-resident company could buy, say, 9.9 million shares for $1 each in an Australian resident listed company with 100 million issued shares, and resell them at $3 each, making a $19.8 million profit. There would be no capital gains tax consequences for profits made on the shares which are listed on the stock exchange and can be freely traded. Similarly, other bodies falling within the definition of a public company, such as mutual life insurance companies, could be utilised for tax avoidance purposes, by issuing certain 10 year insurance bonds offshore. This "less than 10%" non-residence provision can be used effectively by non-residents to gain a tax advantage not available to residents, and to legally avoid capital gains tax.

The Australian Taxation Office lacks effective mechanisms to trace transactions set up to take advantage of Australia's tax legislation as it relates to non-residents. For example, they cannot effectively determine the legality of transactions which involve tax evasion where residents of Australia pose as non-residents from countries with no double tax agreement with Australia.

Where a non-resident company or other entity is used to hold shares, and central management and control of the entity is outside Australia, it is often not possible to separate bona fide non-residents from Australian residents involved in tax avoidance arrangements. In many countries, especially tax havens without a double tax agreement with Australia, for example, Vanuatu or Hong Kong, there is secrecy, and no domestic tax liability on income sourced from outside those countries, so no tax liability is incurred on such gains made by a non-resident company operating from these countries.

Controlled foreign companies and trusts

Legislation, effective from 1 July 1990, extended liability to tax to profits of non-resident entities in non-comparable taxing jurisdictions to Australia. This was done by "attributing" income to residents with a significant interest in those entities, at the point of derivation of income by the resident.

The foreign accruals taxation system, which commenced on 1 July 1990, was introduced to replace a system where certain income of Controlled Foreign Companies and Controlled Foreign Trusts in tax havens was not subject to tax until it was repatriated to Australia, so as to tax income when it was derived. Section 160M(12A) - (12B), (13A), (14A) and s 160 ZFB apply special rules to change of residence by Controlled Foreign Companies ("CFCs") and Controlled Foreign Trusts ("CFTs") which results in Part IIIA applying to assets other than taxable Australian assets owned by CFCs and CFTs.

Assets, other than taxable Australian assets, owned by a CFC in a tax haven are deemed to have been acquired at their market value or cost base, whichever gives the smaller gain or loss, on 30 June 1990. One effect is that even assets owned by the CFC prior to 20 September 1985, the date of introduction of capital gains tax legislation, became post capital gains tax assets. The measures exempt CFCs in comparably taxed overseas (listed) countries from the new regime.

Part IIIA can apply to the calculation of the amount to be attributed to the resident, but it is beyond the scope of this article to explore this aspéct of the legislation.

Tracing provisions

There are no tracing provisions in relation to taxable Australian assets. Thus, where a non-resident private company is interposed between the non-resident and the Australian assets, the shares in the interposed non-resident entity will not be designated as a taxable Australian asset and their disposal will not be subject to capital gains tax in Australia. The relevant provision is s 160T(c) which provides that a sale of shares in a private company is only subject to capital gains tax in the case of a non-resident taxpayer where the private company is a resident of Australia.

The lack of tracing provisions provides an effective mechanism for a taxable Australian asset to be disposed of by a non-resident private company without generating a liability to capital gains tax. According to Woellner, this is "a device which has already been utilised by some taxpayers".[14]

Changes in residence

A change of residence has capital gains tax implications. Section 160M(8) provides the general rule which applies to Australian residents who become non-residents for taxation purposes. For companies, incorporation in Australia is fixed, but changes to central management and control of the company or changes to voting power controlled by Australian resident shareholders could change the residence and trigger s 160M(8).

Section 160M(8) provides that a person who ceases to be a resident is deemed to have disposed of every asset acquired after the introduction

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14 Woellner, Vella & Burns, *Australian Taxation Law* 4th edn (1993) para 10-430.

of capital gains tax on 19 September 1985, other than taxable Australian assets (which are subject to capital gains tax on disposal by a non-resident). The deemed disposal is for a consideration equal to the market value of the assets at the time of ceasing to be a resident. Subsections (9) and (10) contain equivalent provisions for trust estates and unit trusts ceasing to be residents.

Section 160M(11A) limits deemed disposals, provided that the taxpayer has not disposed of the assets prior to departure. It provides that s 160M(8) and (11) will not apply to a natural person who was a resident (not necessarily continuously) for less than 5 of the 10 years preceding the change of residence, except in relation to assets acquired before becoming a resident, or as a result of the death of a person. Without this section, a short-term resident would be deemed by s 160M(12) to acquire all post 19 September 1985 assets, other than a taxable Australian asset, at market value upon commencement of residence, and be deemed to have disposed of those assets at market value upon becoming a non-resident again under s 160M(8).

Section 160M(11B) allows a natural person ceasing to be a resident to elect to treat all assets as taxable Australian assets, and thus defer liability to capital gains tax until the assets are actually disposed of, or the person becomes a resident again. This election is not available to either a trust or a company. This exemption is not available to a trust estate[15] or a unit trust.[16]

Resident to non-resident

If a person who is a resident becomes a non-resident, generally the person's assets which were subject to the capital gains tax rules while the person was a resident, but are not subject to those rules from when the person becomes a non-resident, will, under s 160M(8) be deemed to have been disposed of for their market value. Thus all assets owned by that person, other than taxable Australian assets and assets acquired prior to 20 September 1985, will be subject to the capital gains tax disposal rules.

Example 1

> A resident of Australia acquired less than 10% of the shares in an Australian public company, Z Ltd in October 1985 for

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15 Subsection (13).
16 Subsection (14).

> $2,000, and moved permanently to Hong Kong in August 1988, when the market value of those shares was $5,000. That person is deemed to have disposed of those shares in August 1988 for their market value. The amount to be included as a capital gain in the person's assessable income in the year of income when the person became a non-resident, the year ended 30 June 1989 is $2,520.[17]

There will be no deemed disposal, and thus no capital gain to be included in assessable income, in the case where a resident of Australia becomes a non-resident and owns at least 10% of the shares in an Australian public company which were acquired after 19 September 1985, because these shares are taxable Australian assets by virtue of s 160T(e).

Non-resident to resident

If a person who is a non-resident becomes a resident, the person's assets which are not subject to the capital gains tax rules while the person is a non-resident, (that is assets other than taxable Australian assets and assets acquired prior to 20 September 1985), are deemed to have been acquired at their market value at the time the person becomes a resident. When any of those assets are disposed of, the capital gain or loss will be calculated with the cost base being the market value at the date the person became a resident, and the date of acquisition being the date the person became a resident.

Example 2

> The person in example 1 becomes a resident in January 1991, when the market value of the shares in Z Ltd is $4,000, and sells them in September 1991 for $6,500. The capital gain is $2,500, calculated using the market value of the shares when the person became a resident of Australia as the cost base. This cost base is not indexed because the sale takes place within 12 months of the date that the person became a resident,

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17 The difference between $5,000, being the market value of the shares in Z Ltd at the date the person became a non-resident, less $2,480, being the indexed cost base (because the shares in Z Ltd have been held for more than 12 months) of the shares, calculated with reference to section 160ZJ, that is $2,000 x 1.240. 1.240 is the factor calculated to 3 decimal places (subsection 160ZJ(6)) of 182.4 (the index number for the quarter ended 30 September 1988) divided by 147.1 (the index number for the quarter ended December 1985).

and this is now the deemed date of acquisition of the shares.

Where a resident of Australia becomes a non-resident and later becomes a resident again and owns at least 10% of the shares in an Australian public company which were acquired after 29 September 1985, there is no deemed disposal.

Assume the same facts applied as in examples 1 and 2, but the shareholder's holding in Z Ltd was at least 10% of the shares. The capital gain provisions would apply on the disposal in September 1991, would be calculated using the indexed cost base of $2,000, that is $2,000 x 1.466 (ie 215.7/147.1), and the amount included in assessable income in the year ended 30 June 1992 would be $6,500 less $2,932, or $3,568.

In these examples, a person who held at least 10% of the shares has gained two advantages:

- a timing advantage, as there was no capital gains tax liability in 1989 on the change from resident to non-resident status; and

- less capital gains tax is payable overall.

It is recognised that different facts will result in differing results, which may give an advantage either to the small or substantial shareholder.

Section 160T contains no reference to part disposals, and it appears possible for the non-resident person to dispose of a proportion of the shares, to bring ownership to less than 10% of the shares in the Australian shares and then hold the remaining shares for not less than 5 years, when they are no longer taxable Australian assets. The shares will then not be subject to Australian capital gains tax on their subsequent sale, if the person remains a non-resident.

Section 160M(3) not applicable to non-residents

Under general principles, there is no disposal on the occurrence of certain events, for example where a debt is cancelled, because there has not been a corresponding acquisition, and the asset no longer exists.

However, s 160M(3) extends the operation of capital gains tax to situations not within the ordinary concept of disposal, and deems the cancellation of a debt to result in a change of ownership.

For persons classed as resident in Australia, capital gains tax potentially applies when a person disposes of an asset acquired after

19 September 1985. Take the example of a debt paid by a debtor. Section 160M(3)(b) applies; but although satisfaction of the debt (by payment) would constitute disposal of the debt by the creditor, it is unlikely that the consideration (the payment) would exceed the cost base or indexed cost base. Section 160M(3)(b) also provides for change of ownership of an asset upon cancellation of the debt principal. Where the person cancelling the debt is a resident, a capital loss is incurred under s 160ZC. This loss can be offset against present year or future capital gains; capital losses are not otherwise deductions under the Act. Conversely, the person who has had the debt cancelled has made a capital gain, with a nil cost base, and is subject to capital gains tax on that gain.

For non-residents, in the year of disposal, capital gains tax only applies where the asset is a taxable Australian asset pursuant to s 160T. The categories of taxable Australian assets do not include cancellation of debt principal, therefore, for non-residents, capital gains tax rules do not apply to the cancellation of a debt. It would appear possible for a resident cancelling the debt of a non-resident to be able to offset the capital loss against other capital gains made that year, or, where that person is in business, and relying on well established principles, against business profits.

Section 160M(3) also covers other situations, with similar effect where the asset falls outside the definition of a taxable Australian asset. These are:

- a declaration of trust, in relation to an asset, where a beneficiary is absolutely entitled to the asset as against the trustee; and

- where an asset is a debt, chose in action or any other right, or an interest or right in or over property - the cancellation, release, discharge, satisfaction, surrender, forfeiture, expiry or abandonment in law or at equity of an asset being a debt.

Principal residence - temporary absences

Section 160ZZQ provides that a person's principal residence and surrounding curtilage of up to two hectares is exempt from the capital gains tax rules, provided that the land is used primarily for private or domestic purposes associated with the dwelling. The two hectares includes, according to Taxation Determination TD 92/171, land acquired after the dwelling has been acquired.

A taxpayer who works or moves overseas and who ceases to be a resident for taxation purposes, ceases to use her or his principal residence as a principal residence. It is usual in such circumstances that the residence is rented, or otherwise put to any use for the purpose of gaining or producing assessable income.

Part IIIA permits an election to be made under s 160ZZQ(11A) for s 160ZZQ(11) to apply. The election of the taxpayer must be made on or before the taxpayer lodges her or his return in the year of income when the disposal took place, or, where the taxpayer has died, and the election is made by the surviving joint tenant, or a trustee, on or before the lodgment of the return of the deceased taxpayer's estate for the income year in which the taxpayer died. The Commissioner has the power to extend the time that the election is made.

Prior to self assessment, the written election was required to be lodged with the Commissioner. Under Taxation Laws Amendment (Self Assessment) Bill 1992, s 160ZZQ(11A) was amended so that, although the election is still required to be made in writing, it does not need to be lodged with the Commissioner. The election would need to be held with the taxation records of the taxpayer.

The effect of the election is that whilst the taxpayer is absent, s 160ZZQ(11) deems the sole or principal residence exemption to apply whilst the residence is being used to produce assessable income for a period of up to six years, whether the period is continuous or represents the aggregation of two or more periods. In the case where the taxpayer dies without making an election before the expiration of the six year period that the principal residence is being used to produce assessable income, and the surviving joint tenant or trustee lodges an election, the dwelling it treated as having been the deceased taxpayer's principal residence during the applicable period.

Subsection (11) cannot apply unless the taxpayer ceases to use a dwelling which has been used by that taxpayer as her or his sole or principal residence. For example, if a taxpayer brought a property and immediately rented it out for three years to X, an election cannot be made for the period that the dwelling was rented to X under s 160ZZQ(11)(a). Conversely, if the taxpayer occupied the dwelling for a period of time, and then vacated it, worked overseas for three years and rented it out for that period to Y, he or she would be entitled to make an election under subs (11) for the period that the dwelling was rented to Y.

The period of time the exemption applies is unlimited if the residence is not used to produce assessable income. For example, if the taxpayer owned a dwelling for 10 years and lived away from the dwelling for eight years, if the dwelling was left vacant, there would be no capital gains tax, but if the dwelling was rented for the whole of the 8 years, two tenths would be subject to capital gains tax, ie the proportion that the taxpayer owned the dwelling minus the six year relief period (two years), divided by the total period of ownership (10 years).

The exemption is not affected in the case where the taxpayer does not resume occupancy, but disposes of the dwelling on return to Australia after an absence, during which the residence has been income producing for no more than the six years. This is because whilst the taxpayer is overseas, he or she is not taken to have had another principal residence, even if a dwelling has been purchased overseas and occupied by the taxpayer during the absence.

Conversely, a person who remains a resident and purchases a replacement principal residence prior to disposing of her or his original principal residence, would, with the exception of a three month overlap provided in s 160ZZQ(8), be subject to capital gains tax on that dwelling if it was not nominated as the principal residence.

Capital gains and double tax agreements

The original purpose of double tax agreements was to prevent international double taxation on income. In most treaties, with the notable exception of Switzerland, the agreements also cover the prevention of fiscal evasion with respect to taxes on income.

Where Australia has a double tax agreement with another country, the provisions of the double tax agreement have legislative force by virtue of the Income Tax (International Agreements) Act. Section 4(2) states:

> The provisions of this Act have effect notwithstanding anything inconsistent with those provisions contained in the Assessment Act (other than section 160A [which limits credits to the amount of Australian tax payable] or Part IVA [the general anti-avoidance provisions] of that Act) or in an Act imposing Australian tax.

Thus the provisions of the Income Tax (International Agreements) Act have supremacy over the provisions of the Act, so that, even when the non-resident is prima facie liable for Australian capital gains tax, the double tax agreement may either limit or exempt the non-resident from a liability to Australian tax.

Most double tax agreements contain an "alienation of property" article to impose Australian tax on a non-resident's disposal of Australian real property. This takes effect, regardless of whether the asset is a taxable Australian asset, as defined in the Act.

Some of Australia's more recent double tax agreements contain provisions relating to the taxation of capital gains on real estate. In general, the provisions follow the recommendation of the OECD Model by providing that income from "the alienation of real property" is taxable, without limit, in the state where the property is situated.

"Alienation" has a broad meaning in the OECD Commentary, and under Australian laws. The rule is usually extended to apply in cases where the rights alienated are of natural resource exploration or exploitation rights or where shares in a company holding land or natural resource rights are disposed of.

Where there is a disposal of capital assets of an enterprise resident in a contracting state, (the state of "residence") the gain is taxable only by that state, unless the asset is part of the business property of a permanent establishment of the enterprise in another state (the state of "source"). In this case, the state of "source" may tax the gain on such disposals, because the disposals are deemed to have a source in that state, and the state of "residence" will be obliged to allow credit for tax paid in the state of "source". No other provision is made for capital gains, although in some cases they may be taxed as profits.

For non-residents of Australia, Part IIIA rules only apply to "taxable Australian assets" which is similar to an Australian "source" rule for the purposes of this part. For example, a US citizen could own shares in an Australian public company, whose assets are primarily Australian real estate. Article 13(2)(b) of the US/Australian double tax agreement provides that real property has the meaning it has under Australian law, and sub-para (ii) permits Australia to tax the capital gain on disposal of the shares or comparable interests in a company, where the assets are principally real property situated in Australia. Further, Article 27 provides general source rules and gives the capital gain a source in Australia. Due to the fact that the asset is not a taxable Australian asset, as defined in s 160T, there is no Australian tax imposed. The same situation would appear to apply for non-residents from countries without a double tax agreement with Australia.

One way that the operation of Part IIIA can be overridden by a double tax agreement is in the situation where the gain on the disposal of a taxable Australian asset, by a non-resident who is a resident of a treaty country, forms part of the non-resident's business profits. If the non-resident has no permanent establishment in Australia, the gain will be excluded from Part IIIA, by virtue of the provisions of the "business profits" Article. *Thiel v FC of T*[18] involved a non-resident investor, who entered into a single speculative investment in Australia, by buying units in a unit trust. He exchanged the units for shares in a company, and then sold the shares at a substantial profit. He obtained protection from having the capital profits assessed pursuant to s 25A and s 26AAA, under the business profits Article 7 of the Swiss-Australian double tax agreement. The Court held that a one-off transaction constituted "an enterprise carried on" by a non-resident, and that the profits were therefore exempt from Australian tax.

This provides the precedent for other non-resident taxpayers with no permanent establishment to argue that capital profits should, in accordance with the principle established in *FC of T v Myer Emporium Ltd*[19] be treated as business profits according to ordinary concepts, in order to take advantage of the exemption. Again the opportunity arises for tax avoidance involving non-residents to flourish.

The more recent double tax agreements with China, Papua New Guinea, Thailand, Sri Lanka, Fiji, Hungary, Kiribati, India, Poland and Hungary include a "catch all" paragraph in the Alienation of Property Article 13. A similar paragraph is included in Article 10A of the Protocol to the Singapore agreement.

For example, the China Agreement says:[20]

> Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of property other than that to which any of the [previous] paragraphs apply.

This provision confirms Australia's ability to tax capital gains arising from the alienation of property in this jurisdiction where the gains are not otherwise made the subject of a special provision within that article, and leaves unanswered the question of why earlier double tax treaties have not been renegotiated in the nine years since the introduction of Part IIIA, to include a similar paragraph. Even where there is a double tax agreement with Australia, it may not be possible for the Australian Taxation Office to obtain information to assist them.

The summons in the case of *Packer and Consolidated Custodians Pty Ltd*

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18 (1990) 90 ATC 4717.

19 (1987) 87 ATC 4363.

20 Income Tax (International Agreements) Act 1953, Schedule 28 at Art 13(5).

and Bank One Columbus, NA v USA and Greenbay Ltd v USA[21] related "to a request for information under Article 25 of the Convention between the US and Australia for the avoidance of double taxation" issued "in the matter of the Australian Income Tax Liability of" Mr Packer.

The case involved a request to the US Internal Revenue Service by the Australian Taxation Office to obtain certain information from a US bank to "try and establish whether a loan of $ US 5 million is a back to back loan arrangement, or is supported in any way by a contemporaneous deposit fund."[22] The evidence states "that neither the Internal Revenue Code [of the US] nor the Convention authorises the Internal Revenue Service to summons information from US banks for use by Australian tax authorities." The treaty between the US and Australia did not assist the Australian Taxation Office in gaining the information requested, because the taxpayer had not breached tax laws in the US.

Conclusion

Tim Flahvin has said that non-residents receive special treatment under the capital gains tax provisions contained in Part IIIA of the Act. "A non-resident may secure a substantial tax advantage which is not available to residents" and "it may be that non-residents escape the capital gains tax net in circumstances which may not have been intended by the drafter of the legislation".[23]

This article has examined the proposition that the capital gains tax legislation, as it relates to non-residents, provides the opportunity for tax avoidance schemes to flourish and has discussed situations where this could occur.

The exhaustive definition of taxable Australian assets provides non-residents with the latitude to deal in assets which are not subject to capital gains tax. Whilst the amendments to s 160T and s 160M(6) and s 160M(7) widen the scope and meaning of "taxable Australian assets", currently existing shortcomings already discussed have not been changed. For example, the amendments have not closed the loophole

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21 US District Court, Southern Ohio District, Case No C2 87 1285.

22 Government Exhibit B, letter dated 16 January 1987 to Internal Revenue Service, Washington, USA from the Australian Taxation Office.

23 Flahvin T, "Non-Residents, Capital Gains Tax and the Double Tax Agreements" (1991) CCH Journal of Taxation 48.

which excludes non-residents from a capital gains tax liability in Australia in relation to their ownership of less than 10% of the issued share capital of an Australian public company.

It is recommended that:

- amendment be made to widen the definition of "taxable Australian asset" so that non-residents do not have the opportunity to escape the capital gains tax net;

- Part IIIA provisions which currently do not apply to non-residents due to the exhaustive definition of taxable Australian asset, be amended, and, where appropriate, refer to assets and taxable Australian assets. For example, s 160M(3) should be amended to include taxable Australian assets;

- Australian legislation should be reviewed, so that, in addition to residence, citizenship is the basis for taxation. (A major reason that exploitation of non-resident status occurs in Australia is that non-residents for taxation purposes are taxed only on income sourced in Australia, regardless of whether they were born in Australia or whether they are Australian citizens.) This suggestion is in line with United States' legislation, and would result in only non-resident aliens being classified as non-residents for taxation purposes;

- legislation should be enacted to include tracing provisions for interposed entities in the capital gains tax legislation;

- earlier double tax agreements be reviewed and amended to incorporate the "catch all" provision inserted in the "Alienation of Property" article which has been included in the more recent agreements, which gives Australia the ability to tax capital gains arising from the alienation of property. This is necessary for all agreements which were entered into prior to the enactment of capital gains tax in Australia;

- review is necessary of the appropriateness of the current overriding of the provisions of the Act where Australia has a double tax agreement with another country;

- there is a case for changing Australia's source rules to make them more determinate.

The residence test for companies is easy to administer, but also easy to manipulate, because incorporation can readily be arranged to meet legal requirements, in many places in the world, without the directors needing to leave home.

Tax avoidance is an international problem and, whilst moral issues are raised, it is a well established fact that a taxpayer has to comply with the law and no more.[24] The responsibility therefore rests with the drafters of legislation and the parliament to ensure fair, equitable and loophole-free tax law is enacted in the tax legislation.

Citizenship or nationality does not determine liability to Australian tax. This differs from the United States. United States' citizens, that is every person born or naturalised in the United States and subject to its jurisdiction, are required to submit a tax return and are generally subject to United States' income tax, (generally subject to tax credits for tax already paid), whether they reside in the United States or abroad.[25] This means that United States' citizens are taxed on world-wide income, regardless of where they live. The citizenship basis for taxing results in collection of taxes from a much wider base of taxpayers worldwide than the Australian base.

Whilst the Australian Government has reacted, sometimes with draconian legislation, to eliminate some resident and non-resident tax avoidance schemes, loopholes remain in the tax legislation which bestow special treatment under the capital gains tax provisions to non-resident taxpayers.

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24 *IRC v Duke of Westminister* (1936) AC 1; 19 TC 490.

25 US Reg 1.1-1(b).