Deal Advisory Tax Insights

New foreign resident withholding tax on real estate transactions comes into force

Purchasers may be required to withhold 10 percent tax on the sale of certain Australian real property interests under contracts entered into on or after 1 July 2016.

Who will be required to withhold?

The withholding tax will be payable by purchasers, be they resident or non-resident, acquiring relevant Australian assets from a non-resident vendor unless an exemption applies.

The relevant assets are:

- Taxable Australian real property ("TARP");
- An indirect Australian real property interest - i.e. interests in entities with a market value predominantly comprised of Australian real property assets; or,
- An option or right to acquire such property or interest.

The amount of the withholding tax is 10 percent of the purchase price for the asset and is payable on or before the day the purchaser becomes the owner of the property, i.e. generally on or before settlement rather than contract date.

Excluded transactions

The withholding tax will not apply on "excluded transactions", i.e. acquisitions:

- Of TARP or company title interests with a market value less than AUD 2M;
- Occurring on a stock exchange or conducted using a broker-operated crossing system;
- Where other withholding tax obligations arise;
- That are securities lending arrangements; or,
- Where the vendor is a company under external administration.

Identifying non-resident vendors

Where the relevant asset is TARP, or a company title interest (i.e. strata title), the vendor will be considered to be a non-resident unless a "clearance certificate", issued by the Commissioner, is obtained from the vendor.

Otherwise, 10 percent of the proceeds must be withheld by the purchaser unless a variation of the withholding amount is obtained from the Commissioner (see below).

For assets other than TARP or a company title interest, no obligation to withhold will arise where the vendor provides the purchaser with a declaration that:

- The vendor is a resident; or,
- That the asset is not an indirect Australian real property interest.

Where no declaration is provided, no withholding will apply where the purchaser does not know or have reason to believe that the vendor is a non-resident unless the vendor has an address outside of Australia or the purchaser is authorised to provide a payment to a place outside of Australia in which case the purchaser must have reasonable grounds to believe the vendor is a resident.

Variation of withholding amounts

An application can be made to the Commissioner to vary the amount of withholding where, for example, no tax liability is expected to arise or where the asset is subject to a security interest and the payment of withholding to the Commissioner would undermine the creditor's security.

Tax credit for foreign resident vendor

The foreign resident vendor will be entitled to a credit in its income tax return for the amount paid to the Commissioner and this credit entitlement arises when the Commissioner makes an income tax assessment for the income year. The availability of the credit is dependent on the purchaser actually paying the amount to the Commissioner.

Practical issues to consider

Timing of variation requests and clearance certificates

The timing of variation requests will be an important consideration to ensure that the variation is received before the purchaser withholds a payment. The ATO is currently estimating that clearance certificates will be issued within one to 14 days depending on their complexity. Variation requests, which would inherently be more complex, are expected to be processed within 28 days.

It will be prudent to include within the contract of sale a clause requiring that the purchaser does not withhold and pay the withholding amount to the ATO before an agreed number of days before completion to provide the Vendor time to obtain the relevant notices from the ATO.

As the availability of a tax credit for the vendor is dependent on the withholding tax actually being paid, vendors should require purchasers provide evidence of the payment having been made to the ATO.

Declarations from the vendor

It will be prudent to include the following declarations within the contract of sale of assets other than TARP or company interests where no withholding is required:

– vendors are an Australian resident; and/or

– the relevant asset being membership interests are not indirect Australian real property interests.

These declarations are only valid for a period of six months from the time made.

As there is a blanket assumption that withholding applies on transactions involving TARP and company interests, all Australian resident vendors need to obtain a clearance certificate.

For other vendors, it is important to estimate the amount of CGT that may arise. To the extent to which the CGT ultimately payable is less than 10 percent of the proceeds, it will be important to apply for a variation from the ATO otherwise full withholding will apply.

Do I have an indirect TARP interest?

In certain transactions, there may be uncertainty as to whether an indirect TARP interest exists, for example in an infrastructure context or where an entity holds a mixture of land and other assets.

Although a purchaser can rely on a declaration from a vendor that an interest is not a TARP interest, no reliance can be placed on declarations that the purchaser knows to be false. Where there are differences of opinion between a vendor and a purchaser, this may lead to inconsistency in the withholding position adopted by the purchaser and the position reflected in the tax return of the vendor (e.g. where a vendor considers the interest to be non-TARP but the purchaser is of a different view).

Accordingly, vendors may need to enter into early, active discussions with purchasers to agree a position where uncertainty exists on the TARP status of the interests being sold.

What is the purchase price?

Withholding tax is calculated on the purchase price. Where the purchase price is adjusted under the contract, it will be necessary to take into account the purchase price after adjustments to determine the purchase price.

Where a transaction is taking place on a non-arm's length basis, market value consideration will need to be substituted for the purchase price. This will be of particular relevance for transactions between related parties.

Should GST be included?

Whether Goods and Services Tax ("GST") should be included in the calculation of withholding tax is dependent on whether the purchaser will be entitled to a GST credit for the purchase. The amount of GST is generally 1/11th of the purchase price but may vary.

Where the purchaser is entitled to input tax credits for the GST component paid to the vendor, the withholding tax should be determined based on the GST exclusive purchase price. In circumstances where no GST input tax credits are allowable to the purchaser, such as where the margin scheme is used, the withholding tax should be determined based on the GST inclusive purchase price.

Agreeing the allocation of purchase price

The withholding tax will only apply to the portion of the purchase price allocated to relevant TARP assets or interests. Vendors and purchasers may have divergent interests as to how the allocation is conducted (e.g. a purchaser may have capital losses and favour an allocation to TARP assets).

Previously such allocations were not a focus, as vendors and purchasers typically adopted their own position. Given the requirement to withhold on TARP assets and report and pay this amount to the ATO, we expect there will be an increased focus on purchase price allocations on transactions where withholding applies.

Non qualifying look-through earnout rights

The proposed rules provide no guidance in relation to non-qualifying "look-through earnout rights" arrangements such as earnout rights providing financial benefit for more than five years.

Based on the guidance provided by the Commissioner in draft Taxation Ruling TR 2007/D10, under a standard earnout arrangement, the cost base of an asset includes the market value of the earnout rights. Accordingly to comply with the proposed withholding rules, a valuation of the earn out rights will need to be undertaken before completion. The valuation of earnout rights upfront will be difficult as these are based on financial benefits not ascertainable at the time right is created.

Tax administration

Vendors will need to lodge an Australian tax return to obtain a tax credit for any tax withheld by purchasers.

Where a vendor does not have an Australian Tax File Number ("TFN"), consideration should be given to obtaining one prior to the purchaser remitting the withholding tax to the ATO. This will allow the vendor's entitlement to a tax credit being able to be easily identified by the ATO on lodgement of the vendor's income tax return.

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