TAX **INSIGHT**

CHANGES MAY SEE **AUSSIE EXPATS TAXED** ON **DISPOSAL** OF THEIR **AUSTRALIAN HOME**

The Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019 (the Bill) was re-introduced to the House of Representative on 23 October 2019 despite widespread criticism of the retrospective nature of the legislation and unresolved issues surrounding the impact on certain Australian residents.

The Bill introduces law to deny foreign residents the Capital Gains Tax Main Residence Exemption (CGT MRE) irrespective of citizenship or period of ownership. The Bill, effective from 7.30pm AEST on 9 May 2017 was introduced well over two years after the original budget announcement on 9 May 2017.

There is a transitional period which has been extended to 30 June 2020; the transitional period will only apply where the sale relates to Australian residential property held by foreign residents prior to 7.30pm AEST on 9 May 2017. There is no transitional period for the sale of Australian residential property by a foreign resident which was acquired on or after 7.30pm AEST on 9 May 2017.

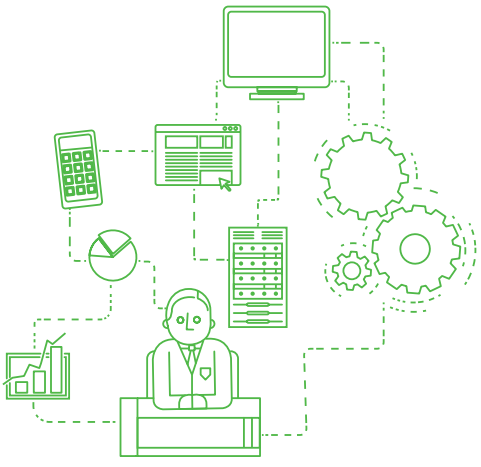
Unfortunately, the Bill was swiftly passed with the Senate ignoring concerns raised by professional bodies regarding the retrospective application of the Bill and the Senate Standing Committee issuing a report stating aspects of the Bill were inconsistent with the Rule of Law. The Bill received Royal Assent on 12 December 2019 and is now law.

> The Senate Standing Committee raised concerns that the approach by the Government to 'back-date' legislation by way of announcement, rather than enactment of law, challenged a fundamental principle of the rule of law which is in general, laws should only apply prospectively.

The general principles of the rule of law also provide that the law should be clear, accessible and capable of being easily understood so that the people bound by the law can comply it. A law with retrospective application such as this one, by its very nature was incapable of being known by (now former) Australian residents when they acquired their homes (as far back as 20 September 1985) therefore making it virtually impossible to comply with the record keeping requirements that would enable them to accurately determine the cost base of their home for CGT purposes.

Treasury repeatedly refused to acknowledge issues surrounding the retrospective nature of the removal of the CGT MRE. Instead, it took the view that as the legislation would only apply to certain CGT events that occurred after the announcement date it did not have retrospective application.

In taking this stance, Treasury has seemingly ignored that while the CGT disposal event may take place after the introduction of the legislation, the acquisition of the former Australian main residence may have occurred as far back as 20 September 1985. The implications for former Australian residents (who may still be Australian citizens) and sell their former Australian main residence post 1 July 2020, is that they will be denied the CGT MRE for their ***entire period of ownership***, not just the period they have been a foreign resident. This application is not only inconsistent with the intent of the original budget policy, it is inconsistent with the rule of law. Impacted taxpayers may find themselves being unfairly taxed as they have now been retrospectively denied the opportunity to comply with a law enacted years after they bought their Australian family home.



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WHO IS AFFECTED?

The legislation will apply to foreign residents including (but not limited to):

- Australian citizens who have relocated overseas and are no longer residents of Australia for tax purposes; and
- Foreign residents who acquired a main residence in Australia whilst working in Australia and have since returned overseas;
- Deceased estates where the deceased was an excluded foreign resident at the time of death;

Foreign residents will be denied the CGT MRE irrespective of whether:

- They continue to elect their Australian home as their main residence for Australian tax purposes; or
- They have used their former Australian home for income producing purposes and the special rule under section 118-192 of the Income Tax Assessment Act 1997 ("ITAA 1997") has applied to deem their ownership interest was acquired at the time the home was first used to produce assessable income, and a market value uplift to the cost base has been applied. In this situation, the legislation will apply retrospectively to deny the market value uplift and the property will be deemed to have been the main residence of the foreign resident for the entire ownership period.

LIFE EVENTS TEST

It is not all doom and gloom, a special rule has been introduced to provide relief where certain "life events" occur to a former Australian resident, they are overseas, and the life event is outside of their control (such as death, terminal illness or divorce).

The life events test will be satisfied at the time a CGT event happens where:

- The taxpayer has been a foreign resident for a continuous period less than 6 years: and
- One of the following applies:
  - The foreign resident or their spouse is diagnosed with a terminal illness during the period of non residency;
  - A child of the foreign resident is diagnosed with a terminal illness during the period of non residency, and was under the age of 18 at least one time during that period;
  - The spouse or child (under 18) of the foreign resident dies during the 6 year period of non residency;
  - The foreign resident experiences a marriage or relationship breakdown and a CGT event happens involving the foreign resident and their spouse (or former spouse) and subsection 126-5(1) of the Income Tax Assessment Act ("ITAA 1997") applies.

IMPACT ON FAMILY LAW TRANSFERS

The foreign resident marriage or relationship breakdown life event only appears to have application where the foreign resident disposes of the former Australian main residence because either a) they are required to sell their interest in the property under a Family Court order, or b) they are required to transfer their interest in the former Australian main residence to their former spouse who is an Australian resident for tax purposes under a Family Court order.

> The legislation and the Explanatory Memorandum are silent on the impact on Australian tax residents who obtain the ownership interest in a dwelling from a former spouse who subsequently becomes a foreign resident.

The CGT MRE relationship breakdown rollover requires taxpayers to have consideration for the way in which the dwelling was used by both the transferee and transferor spouse. Where the dwelling was not the main residence of both the transferee and transferor spouse for the entire period of ownership, the transferee spouse will only be eligible for a partial CGT MRE when they eventually sell the home (assuming they are an Australian resident at the time the property is sold).

Assuming the use of the dwelling is tested at the time the former spouse's ownership interest ends (i.e..... when the property is transferred under a Family Court order) if the former spouse is an excluded foreign resident at the time their ownership interest ends, the Australian resident transferee spouse will only be eligible for a partial main residence exemption, as the former non-resident spouse will be deemed never to have treated the home as their main residence.

If the property is not transferred in accordance with subsection 126-5(1) of the Income Tax Assessment Act 1997 (ITAA 1997), and the transferor spouse is a foreign resident at the time of the transfer, the Australian resident spouse will again only be eligible for a partial main residence exemption on the later sale of the property, as the foreign resident transferor spouse will a) be ineligible to claim the main residence exemption relating to their period of ownership and b) the 'life event' will not be covered by subsection 126-5(1) of the ITAA 1997.

This is an absurd outcome, particularly considering the dwelling may have been the family home for the entire period of ownership, and the dwelling will continue to be treated as the main residence of an Australian resident until it is disposed of in the future.

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ACTION REQUIRED

If you are a former Australian resident with a main residence in Australia and do not intend on re-establishing residency, you will no longer be eligible for the CGT MRE (if you are an excluded foreign resident).

If you acquired your Australian main residence prior to the time the original budget announcement was made on 9 May 2017, a grandfathering arrangement applies extending the commencement date of the law to 1 July 2020. This means you will only be eligible to claim the CGT MRE on your Australian home if you dispose of your ownership interest on or before 30 June 2020.

If you are a foreign resident and acquired your Australian main residence after the relevant time on 9 May 2017, the grandfathering arrangement may not apply and you may no longer be eligible to claim the CGT MRE. If you have or intend to, dispose of your ownership interest, you may be assessed on the capital gain on disposal (if any) for your entire period of ownership.

If you have separated from your former spouse, and your former spouse is now a foreign resident, we strongly recommend you obtain specialist taxation advice as to whether your former spouse was able to treat the property as their main residence at the time of transfer of their ownership interest to you. If your former spouse has been a foreign resident for less than 6 years at the time of the CGT event under subsection 126-5(1) of the ITAA 1997, you may also need advice from a Family Lawyer to ensure the transfer of ownership interest is an eligible event under the foreign resident 'life event' test.

RE-ESTABLISHING RESIDENCY

You may still be eligible for the full CGT MRE if you re-establish Australian tax residency before selling your home. Beware, as the Commissioner of Taxation may seek to apply the general anti avoidance provisions under Part IVA if he is of the opinion the re-establishment of residency has been contrived merely in order to apply the CGT MRE.

DETERMINING THE COST BASE

For foreign residents who are denied the CGT MRE under the new law, determining the cost base of the main residence will pose a challenge. **The cost base can include the following:**

- The amount paid to acquire the asset (you may need the original purchase contract to support this amount).
- Professional fees incurred in relation to acquiring and/or selling the property (e.g. agents commission, legal costs, conveyancing costs, accounting fees etc).
- Other legal fees in relation to holding the property.
- Stamp duty.
- Advertising costs (e.g.. advertising costs paid to the real estate agent).
- Borrowing expenses and interest on bank loans (this can relate to loans taken out to purchase the property or to undertake subsequent renovations).
- Renovation costs.
- Landscaping costs.
- Council rates.
- Water rates.
- Repairs.

For taxpayers who purchased their main residence based on law that applied from 20 September 1985, obtaining the necessary substantiating evidence to support the cost base of the former family home will pose a challenge.

As the main residence of Australian citizens has historically been exempt from CGT, many taxpayers would not have retained CGT records to enable them to accurately determine the cost base of their property for CGT purposes.

The Government repeatedly ignored calls to allow for a market value uplift for foreign residents on exiting Australia, so unless the Commissioner of Taxation uses his administrative powers to enable former residents to estimate the cost base of their property on a reasonable basis, many former Australians may be unfairly 'over taxed' on the disposal of their former Australian main residence.

We question if this is the overarching policy of the Government – that is, the beginning of the denial of tax deductions against assessable income for all taxpayers and the removal of all CGT exemptions. Time will tell.

The article above is intended for guidance only and cannot be relied upon as tax advice. If you, or someone you know may be impacted by this change to the law, we strongly recommend you seek advice from your tax adviser or your local RSM office.