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Doing business or investing in Australia: A Tax Guide

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Foreign investment in Australia - an overview

Australia has a complex tax landscape with taxes applicable at both a Federal level (such as income tax and Goods and Services Tax (**GST**)) and at the State and Territory level (such as stamp duty and land tax). The Australian Taxation Office (**ATO**) is the key revenue authority responsible for the administration of Federal tax laws, and each State and Territory has a separate revenue authority to administer the tax laws applicable in the respective jurisdiction.

Australia is a key destination for foreign investment, with foreign direct investment exceeding $1 trillion in 2021. Key industries with strong investment activity include mining, real estate, Australian manufacturing and financial services and insurance.[1]

Approval from the Foreign Investment Review Board (**FIRB**) may be required when investing in Australia. Where FIRB approval is required for a particular investment or transaction, Treasury will consult with the ATO and will generally impose tax conditions on the FIRB application which must be complied with as part of the approval. This process ensures that the Australian taxation authorities maintain high visibility over the different types of structures and jurisdictions used when investing in Australia and can allocate their resources accordingly.

1 https://www.dfat.gov.au/trade/trade-and-investment-data-information-and-publications/foreign-investment-statistics/australian-industries-and-foreign-investment

Key tax law concepts

In this section, we explore several key tax law concepts you should consider prior to doing business or investing in Australia. This includes tax residency, source, revenue v capital, dividend imputation system, tax losses, capital gains tax and tax grouping.

1. Tax Residency

Tax residency is a cornerstone of the Australian tax regime. Where an entity (i.e. company, trust, individual etc) is a tax resident of Australia, it will be taxable both locally in Australia and on its worldwide income. Therefore, where the income has been taxed in a foreign jurisdiction, the Australian tax resident will need to consider its compliance obligations in both jurisdictions, the availability of foreign tax credits, and the effect of any Double Tax Agreement (**DTA**).

Corporate Tax Residency

Currently, a company will be an Australian tax resident where:

- It is incorporated in Australia; or
- If it is a foreign incorporated company, carries on a business in Australia and either:
    - has its central management and control (**CMC**) in Australia, or
    - its voting power is controlled by shareholders who are Australian residents.

In the 2018 decision of *Bywater,*[1] the High Court adopted a broader interpretation of the requirement to carry on a business and have central management and control in Australia. Companies with individual directors physically present in Australia participating in the decision-making process of the company, are at greater risk of being considered to be carrying on a business in Australia, and so be an Australian tax resident.

The ATO published PCG 2018/9 to clarify its view on the corporate residency tests after the Bywater decision and has adopted a compliance approach for foreign incorporated companies relying on the old law. The transitional period is due to end on 30 June 2023.

The former government announced in the 2020-21 Federal Budget that it will make technical amendments to clarify corporate residency by introducing the concept of a 'significant economic connection to Australia' before being an Australian tax resident.

However, as the legislation remains unenacted, it is currently unclear how exactly this test will operate and will no doubt result in novel issues for foreign incorporated companies.

2. Source

Where an entity is not an Australian tax resident, it may still be taxed on its income 'sourced' in Australia. Australia does not have codified source rules but rather requires the consideration of common law principles and any applicable DTA. For example, a non-resident may have Australian sourced income under the common law if, considering factors such as the location of trading activities or where contracts are formed and executed etc, it has an Australian source. However, this may be overridden by the articles of an applicable DTA, such as the business profits article.

2 *Bywater Investments Ltd v Federal Commissioner of Taxation* (2016) 260 CLR 169; TR 2015/5.

3. Revenue v Capital

One of the most nuanced and critical principles of the Australian tax law is the classification of an amount of income, gain, loss or outgoing as 'revenue' or 'capital'. There is no bright-line test but rather requires a detailed consideration of all the facts and circumstances surrounding the taxpayer and transaction. Relevant facts include, the nature of the taxpayer, nature of the underlying asset, the taxpayer's objective intention in entering into a particular transaction and timing of the relevant scheme. Despite a significant body of case law and ATO guidance issued to assist taxpayers navigate this, it is very much open to alternate views. Recent seminal cases such as *Sharpcan*[2], *Healius*[3] , *Mussalli*[4] and *Greig*[5] demonstrate the complexities in getting the distinction right and the willingness of the ATO to litigate these matters.

Why the distinction between 'revenue' and 'capital' is critical

Timing of deductibility

An outgoing on revenue account may be deductible upfront but if treated on capital account may be dealt with under the capital gains tax (**CGT**) regime, deductible over a period of time or give rise to a capital loss.

Application of tax losses

Different categories of tax losses can only be applied against particular categories of assessable income. Importantly, capital losses can not be applied against revenue gains.

Application of the CGT regime

The Capital Gains Tax (**CGT**) regime provides a number of concessions to gains on capital account (such as the CGT discount) which are not available to revenue gains. As such, a capital gain may result in a lower tax liability for the taxpayer as opposed to a revenue gain via the application of relevant concessions, if available.

Non-resident investors

Generally, non-resident entities will not be subject to tax on capital gains, unless the gain is sourced from a transaction involving Australian real property or an interest in a company or trust which, in turn, holds an interest in Australian real property.

3 *Federal Commissioner of Taxation v Sharpcan Pty Ltd* [2019] HCA 36.
4 *Federal Commissioner of Taxation v Healius Ltd* [2020] FCAFC 173.
5 *Mussalli v Commissioner of Taxation* [2021] FCAFC 71.
6 *Greig v Commissioner of Taxation* [2020] FCAFC 25.

4. Capital Gains Tax

Australian Capital Gains Tax (**CGT**) is not a separate tax but rather a separate regime for taxing capital gains. A capital gain is a gain arising from an event (referred to as a 'CGT event') in relation to a capital asset where the proceeds (referred to as 'capital proceeds') exceeds the cost (referred to as the 'cost base'). A common example is the disposal of shares in a company held on 'capital account' (as discussed in section 3). Conversely, a capital loss may arise where the capital proceeds are less than the reduced cost base. These losses may be carried forward subject to satisfying relevant capital loss recoupment rules.

Net capital gains (capital gains less capital losses) are included in the relevant taxpayer's assessable income and subject to tax at the appropriate tax rate (i.e. 25% or 30% for companies or at the individual's marginal tax rate).

5. Dividend imputation system

A unique feature of Australia's tax system is the 'imputation system'. To prevent double taxation, companies may pass the benefit of the corporate tax paid on their profits to Australian resident shareholders by attaching a tax credit known as a 'franking credit' to the distribution. The franking credit then operates to offset some or all of the tax liability on the distribution payable by the Australian resident shareholder. The franking credit will vary depending on the level of franking and the applicable corporate tax rate (i.e. 30% or 25%).

For non-resident shareholders, fully franked dividend distributions will not be subject to further Australian dividend withholding tax. Where a distribution is only partially franked, then dividend withholding tax may apply to the unfranked portion at the rate of 30%, subject to the application of a reduced withholding rate under a relevant DTA.

On 16 February 2023, the *Treasury Laws Amendment (2023 Measures No. 1) Bill 2023* was introduced into Parliament. The Bill is designed to align the tax outcomes for on market and off market share buy-backs undertaken by listed public companies by:

- preventing part of the purchase price for an off-market buy-back or selective share capital reduction from being taken to be a dividend (effectively making it unfrankable); and
- making the distributions paid as consideration for a selective share capital reduction unfrankable.

The Bill also introduces measures that make certain distributions funded by capital raisings unfrankable to address artificial arrangements to release otherwise trapped franking credits.

Once enacted, these measures will apply to:

- relevant off-market share buy-backs and selective capital reductions that are announced to the market or which occur after 7:30 pm AEDT on 25 October 2022; and
- relevant distributions funded by capital raisings made on or after 15 September 2022.

6. Tax losses

Companies and trusts can carry forward tax losses (from revenue and capital accounts) from prior income years to future income years. This enables companies to offset assessable income and capital gains indefinitely where the requisite tests are satisfied.

Broadly, companies must satisfy a continuity of ownership of 50% referred to as the continuity of ownership test (**COT**), or failing COT, must satisfy the business continuity test (**BCT**). The applicable trust loss recoupment tests will depend on whether the trust is a fixed trust or non-fixed trust. Importantly, trust capital losses are not subject to any test to be carried forward or utilised, compared to companies which must satisfy either COT or BCT. The loss recoupment regime requires annual compliance and testing to ensure the tax losses remain available and should be considered where there are significant transactions, such as an initial public offer (**IPO**), sale or acquisition of a business.

Temporary loss carry back rules also provide a refundable tax offset that eligible small businesses can claim:

- after the end of their 2020–21, 2021–22 and 2022–23 income years
- in their 2020–21, 2021–22 and 2022–23 company tax returns.

Eligible entities get the offset by choosing to carry back losses to earlier years in which there were income tax liabilities.

The offset effectively represents the tax the eligible entity would save if it was able to deduct the loss in the earlier year using the loss year tax rate. As it is a refundable tax offset, it may result in a cash refund, a reduced tax liability or a reduction of a debt owed to the ATO.

Key features of the CGT regime

Non-resident taxpayers

Generally, non-resident taxpayers will only be subject to Australian CGT made on the disposal of 'Taxable Australian Property' (**TAP**), subject to the applicable DTA. TAP includes a direct or indirect real property interest, such as mining, quarrying or prospecting rights. An indirect real property interest is where the non-resident taxpayer holds 10% or more 'participation interest' in a company or trust, where the underlying market value of the assets is comprised of 50% or more of Australian real property. If the capital gain is subject to tax, no CGT discount is available. However, in light of the recent Federal Court decision of *Greensill*[6] caution should be had where non-resident beneficiaries of Australian discretionary trusts receive capital gains in relation to non-TAP assets.

In that case, the Federal Court was required to consider the complex interaction of Australia's taxation laws as they apply to trusts and individuals, as well as specific deeming provisions. The key questions was whether the non-resident taxpayer was entitled to disregard a capital gain arising from non-TAP assets held by the Australian resident discretionary trust. The Federal Court held the paramountcy of the legislative texts above all other policy considerations in deciding that the non-resident beneficiary would be taxable on the capital gain, even though, if they had held the relevant non-TAP asset directly they would have been entitled to disregard the capital gain as it did not result from the disposal of TAP. The case serves as an example of the complexity of Australia's tax laws.

CGT discount

Where the eligibility requirements are satisfied, Australian resident individuals and trusts may reduce their capital gains by 50% and complying superannuation funds may reduce their capital gains by 33%. Companies cannot access any discount on capital gains, and the CGT discount is not applicable to all CGT events.

Market value substitution rule

There are multiple integrity provisions under the CGT regime. A common integrity provision is the 'market value substitution rule', which applies to CGT events when the parties are not dealing with each other on arm's length terms. The effect is that for the purposes of calculating any CGT liability, the proceeds received by the vendor are replaced by the market value of the asset, and the purchaser receives the market value as the asset's cost base going forward.

Rollovers

There are several 'rollover' provisions under the CGT regime that enables CGT to be deferred or disregarded in particular circumstances. For example, rollover relief may be available when shares in a company are exchanged for shares in another company or units in a unit trust are exchanged for units in another unit trust.

6 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2020] FCA 559.

7. Tax grouping – TCG and MEC

Australia has a complex tax grouping regime known as ‘consolidation’. Generally, the regime allows wholly owned Australian resident entities (i.e. companies, trusts and partnerships) to be grouped to form a single corporate entity for Australian income tax purposes.

A Tax Consolidated Group (**TCG**) consists of an Australian resident company as the ‘head company’ and its wholly owned ‘subsidiary members’. A Multiple Entry Consolidated (**MEC**) group consists of wholly owned Australian resident subsidiaries (one of which is the ‘provisional head company’) of a foreign resident company, commonly known as sister companies. An election is required to be filed with the ATO to form a TCG or MEC group.

On formation, members of the group are disregarded for Australian income tax purposes, and only the head company of the TCG or provisional head company of the MEC is recognised. Members of a consolidated group are joint and severally liable for income tax if the head company defaults. However, this can be managed by having a valid Tax Sharing Agreement (**TSA**) in place.

Tax grouping

Tax grouping is common in large corporate groups and complex structures. Below we list some of its benefits.

Intragroup transactions disregarded

All transactions between members of the same consolidated group are disregarded for Australian income tax purposes.

Pooling of tax attributes

Tax losses and franking credits from different group members can be pooled together.

Streamlined group structuring

Assets and shares in subsidiaries can be transferred between members without the need for any rollover.

Reduced compliance cost

Consolidation of multiple taxpayers into a single taxpayer means only a single tax return for a unified accounting period is required to be lodged and only one entity needs to make the relevant tax instalments.

Common investment structures

Choosing the correct investment or business structure is critical to achieving your objectives. Each investment structure has its own tax advantages and disadvantages. In this section, we outline the details of suitable investment structures to consider.

1. Company

An Australian resident company is subject to tax on its worldwide income and capital gains. The tax is imposed on the net income of the company.

The applicable tax rate is 25% for 'base rate entities' or 30% for all other resident and non-resident companies.

Non-resident companies investing in Australia will be subject to tax on income derived from Australian sources (excluding those amounts subject to withholding tax such as dividends and royalties paid offshore) and capital gains made on TAP.

A company structure is ordinarily chosen where there is an operating business being carried on, rather than for collective investment. Profits can be retained at the company level and fully franked dividends can be paid out when required (if the profits are subject to tax).

Companies can also generate significant tax attributes, such as carried forward tax losses, and can form TCGs and MECs. Furthermore, there are certain concessions which only apply to companies, such as disregarding capital gains on the sale of non-portfolio shareholdings (i.e. 10% or more) in foreign active companies.

2. Trust

A 'trust' is not a separate legal entity but rather a term used to reference a relationship between the legal owner (the trustee) of the asset (trust property) and the beneficial owners of the asset (beneficiaries). Generally, a trust is not liable to pay tax as it is paid at the beneficiary level at the applicable rate of tax (i.e. it is a flow-through structure). A trust will only pay tax on the income in very limited circumstances, for example when there are no beneficiaries who have been made presently entitled to the income.

There are several different types of trusts with the most common investment vehicle type being Managed Investment Trust (**MIT**) and the Attribution Managed Investment Trust (**AMIT**). These vehicles have a unitised trust arrangement so that investors can hold units and have clearly defined rights to the income and capital of the unit trust.

Broadly, a trust will be a MIT where it is a managed investment scheme under Australian corporate law, managed or operated by an entity holding an Australian Financial Services Licence (**AFSL**) and meets the 'widely held' requirement and 'closely-held' restriction.

An AMIT is a type of MIT. To be an AMIT investors in the MIT must have 'clearly defined rights' to the income and capital of the MIT, and the trustee of the MIT must make an irrevocable election into the AMIT regime.

In the 2023-24 Federal Budget, the Federal government announced the following measures in relation to MIT withholding rates:

1. From 1 July 2025, the "clean building MIT" withholding tax rate of 10% on income distributions (excluding dividends, interest, and royalties) will be extended to MITs which hold data centres and warehouses. The data centres and warehouses are required to meet the relevant energy efficiency standard and be constructed after 7:30 PM (AEST) on 9 May 2023 (**Budget Night**).
2. From 1 July 2024, MITs which hold new eligible build-to-rent (**BTR**) projects constructed after Budget Night will be eligible for a reduced final withholding tax rate on income distributions of 15%. The Government announced that BTR projects must have:
   a. 50 or more apartments or dwellings made available for rent to the general public;
   b. minimum 10 year ownership period for the dwellings; and
   c. minimum 3 year leasing term for each dwelling.

Key benefits of investing in a MIT

- **Flow through tax treatment:** income and gains retain their identity and source as they flow through the MIT to the beneficiaries (i.e. they remain dividends, capital gains, non-assessable income etc).
- **MIT withholding rates:** where a MIT is also a 'Withholding MIT', distributions of income (excluding dividends, interest and royalties) to foreign beneficiaries in an information exchange country may be subject to a concessional withholding tax rate of 15%. The concessional rate does not apply to distributions sourced from rental income from residential accommodation.
- **Capital account election:** a MIT can elect to treat certain assets as 'capital assets' such as shares, units in a unit trust and land. The capital treatment may allow foreign resident investors to obtain an exemption from Australian income tax on gains arising from such assets and reduce the tax on the gain for Australian resident investors (i.e. apply the CGT discount if available).

Key benefits to electing to be an AMIT

- **Fixed trust status:** this is particularly beneficial when applying the trust loss provisions.
- **Attribution model:** beneficiaries of MITs and other trusts are generally taxed under a 'present entitlement' model, while investors in AMITs are taxed under an 'attribution' model. This means a trust can attribute amounts of taxable income, exempt income, non-assessable non-exempt income, tax credits and tax offsets to investors on a fair and reasonable basis in accordance with the constituent documents. Investors pay tax on the amount attributed to them even if the amount distributed is different.
- **Unders and overs:** trustees of AMITs have flexibility when there is a variance between the amount attributed to investors and the amount attributable
- **Upward adjustment to cost base:** when the amounts distributed to the investor is less than the amount attributed, there is an upward adjustment in the cost base of the units in the AMIT held by the investor.

3. CCIV

On 10 February 2022, the *Corporate Collective Investment Vehicle Framework and Other Measures Bill 2021* (**Bill**) was passed by the House of Representatives and the Senate and received royal assent on 22 February 2022. The legislation outlines the new regulatory and tax frameworks for the Corporate Collective Investment Vehicle (**CCIV**) regime. The CCIV regime is designed to internationalise the Australian funds management industry, incorporating elements of similar regimes in Singapore, Hong Kong, the United Kingdom and other jurisdictions.

The CCIV regime is designed to internationalise the Australian funds' management industry, incorporating elements of similar regimes in Singapore, Hong Kong, the United Kingdom, and other jurisdictions. In effect since 1 July 2022, the new regulatory and tax regime introduces flow-through corporate entities that, despite being an incorporated company paying legal form dividends, will effectively be treated as a trustee of one or more unit trusts (referred to as 'sub-fund trusts') for all tax law purposes. The tax regime operates through a series of complex deeming principles to create this tax law fiction. For tax law purposes, a CCIV may be a trustee of an ordinary unit trust, a MIT, an AMIT or a combination of all depending on the nature of each sub-fund trust.

Investors in CCIVs will generally be taxed as if they had invested directly in the underlying assets. This means that taxpayers can offset the capital gains and losses against their own income, as opposed to getting a dividend which will always be income.

Given the infancy of the new regime, it will surely be an area generating novel tax issues for investors and fund managers.

Current emerging tax issues under the CCIV regime

Rollover

No specific CGT rollover provisions have been included in the legislation to convert existing structures (such as current AMITs) to the CCIV regime. Investors and existing funds will need to rely on current CGT rollover provisions provided for under the tax law.

Tax and capital losses

No trust loss transfer provisions are included in the legislation to allow for the transfer of carried forward tax and capital losses from existing structures to a CCIV, where existing structures are converted.

Franking credits

No holding period modifications for the purposes of the 'qualified person' rules, specifically the 45-day holding period rule. This means where an existing structure is converted to a CCIV, it will not inherent the historic 45-day holding period qualification such that it will need to satisfy the requirement again.

CFC attribution accounts

No transfer mechanism has specifically been provided for, to transfer current attribution account balances under the controlled foreign company (**CFC**) regime where an entity transitions into the CCIV regime. This may result in double taxation where income already attributed is repatriated to the CCIV.

4. Venture capital

In addition to the investment vehicles mentioned previously, there are a number of specialised investment vehicles for investing in start-up or early-stage businesses in Australia.

Specialised investment vehicles for investing in start-up or early-stage businesses

The two main vehicles are venture capital limited partnerships (**VCLPs**) and early-stage venture capital limited partnerships (**ESVCLPs**). These two vehicles receive favourable tax treatment for eligible venture capital investments, which generally means investment in smaller companies or start-ups. Tax concessions extend to investors in Early Stage Innovation Companies (**ESICs**).

Venture Capital Limited Partnerships (VCLP)

Broadly, gains (revenue and capital) made on the disposal of eligible investments by the VCLP will be exempt from Australian income tax for the foreign investors (referred to as limited partners).

The manager's carried interest in the VCLP is subject to concessional treatment.

Early Stage Venture Capital Limited Partnerships (ESVCLP)

The tax concessions available to foreign resident investors in the VCLP is extended to resident and non-resident investors in the ESVCLP.

Investors may be eligible to obtain a 10% non-refundable tax offset for new capital invested in the ESVCLP.

Early Stage Innovation Companies (ESIC)

While not itself an investment vehicle, an Early Stage Innovation Company (**ESIC**) is a newly established corporate entity which itself is a start-up. Concessions are available to investors who invest in ESICs. Tax concessions include a 20% non-refundable tax offset for equity investments up to 30% of the total ESIC equity (capped at $200,000 per investor inclusive of all investments in the ESICs made by the investor) and an exemption from CGT on disposal of shares in the ESIC where the investor has held the shares for a period of between 12 months up to 10 years.

International tax considerations

This section outlines the key international tax considerations that you need to be aware of when doing business or investing in Australia.

1. Australia has endorsed the OECD's BEPS 2.0 project

In October 2021, the Organisation for Economic Co-operation and Development (**OECD**) released a statement that provided a glimpse into how multinational enterprises (**MNEs**) will be taxed in years to come (**October Statement**). Notably, 137 jurisdictions have agreed to the October Statement (including Australia). The October Statement builds on the two-pillar solution to base erosion and profit shifting (**BEPS**) that the OECD has been developing in recent years.

Pillar One is aimed at reallocating rights to tax certain MNEs to 'market jurisdictions'. These rules will only apply to multinationals with an annual global revenue exceeding €20 billion and with a pre-tax profit to revenue ratio exceeding 10%. The new multilateral convention to implement Pillar One is scheduled to be finalised by mid-2023 for entry into force in 2024.

Pillar Two is aimed at ensuring certain MNEs with revenue above €750 million are subject to a global minimum corporate tax rate of 15% by introducing Global anti-Base Erosion (**GloBE**) rules. The OECD released technical guidance on Pillar Two on 2 February 2023 to clarify the interpretation of GloBE rules to ensure coordinated implementation in domestic legislation.

The Federal Government in the 2023-24 Federal Budget, announced that it will fast-track Australia's implementation of Pillar Two by introducing:

1. a 15 per cent global minimum tax for MNEs, achieved by way of legislating:
    a. the Income Inclusion Rule (IRR) for income years commencing on or after 1 January 2024; and
    b. the Undertaxed Profits Rule (UTPR) for income years commencing on or after 1 January 2025.
2. a 15 per cent domestic minimum tax applying to income years starting on or after 1 January 2024.

While no legislation has been released, it is intended that the IIR will operate to attribute the profits of subsidiaries in low taxed jurisdictions to the parent entity in proportion to the parent entity's ownership in the subsidiary and for the parent entity to pay any additional top-up tax to achieve the minimum 15% tax. Where income is not caught by the IIR, the UTPR will operate to adjust the profits of the subsidiary in the low tax jurisdiction to achieve the minimum 15% tax.

2. Australian double tax treaty network: Multilateral Legislative Instrument

Australia has a complex system of bilateral DTAs with 45 countries, with an intention to significantly expand the tax treaty network by the end of 2023.

The purpose of the DTA network is to allocate taxing rights between different jurisdictions and Australia in respect of income or gains derived by non-resident taxpayers. DTAs also address common tax issues such as taxation of interest, dividends, royalties, permanent establishments and dealing with issues of 'source'. The intention is to prevent double taxation of the same income or gain in different jurisdictions by way of either a full tax exemption or foreign tax offsets.

The Multilateral Legislative Instrument (**MLI**) is a multilateral treaty which came into force in Australia on 1 January 2019. The MLI modifies the operation of applicable Australian DTAs by implementing measures to prevent multinational tax avoidance and resolve tax disputes more effectively.

Whether the MLI applies to certain treaties will depend on whether both jurisdictions have taken the necessary actions to implement the MLI for that specific DTA and as such, must be considered on a treaty-by-treaty basis.

3. Australian withholding taxes

Interest, unfranked dividends, and royalty payments made by Australian residents to non-residents are subject to a final withholding tax. Unfranked dividends and royalty payments are generally subject to a 30% withholding tax, while interest payments are generally subject to a 10% withholding tax.

However, these rates may be modified by the relevant DTA. To prevent double taxation, withholding tax is not payable on franked dividends, as franked dividends are paid out of profits that have already been subject to corporate tax in Australia. Certain interest payments to non-resident super funds and sovereign entities are exempt from withholding tax, where the relevant provisions are satisfied.

An exemption from interest withholding tax is also available to Australian resident companies where they satisfy the 'public offer test' on the issue of debentures and syndicated loan facilities (this is commonly referred to as the 128F exemption).

Australia also has a CGT withholding regime. Subject to limited exceptions, a purchaser is required to withhold and remit to the ATO 12.5% of the purchase price from a transaction where the vendor is a foreign resident (or deemed foreign resident) and the transaction involves TAP (as discussed under the CGT section above) with a value of $750,000 or more under the foreign resident capital gains tax withholding (**FRCGTW**) regime.

4. Limitations on interest deductions – Thin Capitalisation

The thin capitalisation rules (or '**Thin Cap**' for short) is an integrity regime aimed at preventing excessive gearing of Australian businesses.

The regime seeks to deny Australian taxpaying entities tax deductions for interest and other financing costs where, broadly, the average total debt of the entity exceeds 60% of the average value of total assets. Where the level of debt exceeds this threshold, debt deduction denial will occur unless the entity satisfies the "arm's length debt test".

There is a de minimis threshold of $2 million of the pre-tax value of the interest and debt deductions which must be met before the Thin Cap regime will apply to an entity. The regime is complex as there are multiple thresholds and tests depending on how the Australian taxpayer is classified. The regime will apply to Australian entities investing overseas, their associates (outward investors) and foreign entities investing into Australia (inward investors).

In the 2022-23 Federal Budget, the Government announced a number of amendments to the Thin Cap regime to align its approach with the OECD recommended approach under Action 4 of the BEPS Action Plan.

These measures include replacing the existing tests with new earning-based thresholds, and a new arm's length test in the form of an 'external third-party debt test' targeted at 'general class investors' – a new singular concept collectively referring to each of the following entities under the existing regime: an 'outward investor (general)', 'inward investment vehicle (general)' and 'inward investor (general). These new rules will disallow an entity's debt deductions based on the entity's earnings or profits for the income year.

A draft Bill introducing these amendments was released by the Government on 16 March 2023, with changes to the thin capitalisation rules proposed to apply to income years from 1 July 2023.

The Thin Cap regime and transfer pricing rules are often considered in conjunction when there are cross-border related party loan arrangements.

5. Transfer Pricing

Australia, like many OECD countries, has a complex regime of transfer pricing rules which apply to cross-border related party transactions. The intention is to prevent related party transactions resulting in higher deductions or lower income being recognised in Australia, resulting in an overall lower level of tax being paid (commonly referred to as a 'transfer pricing benefit').

The regime requires a reconstruction of transactions to determine whether the transaction is on 'arm's length' terms. This involves a study into what comparable independent parties transacting under similar conditions to the related parties would pay or receive for a particular transaction.

Transactions include the supply of goods and services, property, technology, and loan arrangements. Transfer pricing is currently a focus area for a lot of taxpayer disputes with the ATO with *Glencore*[1] being one of the most current and high-profile.

The case against Glencore concerned the pricing mechanism used in the purchase of copper concentrate by Glencore's Swiss-based company from its Australian subsidiary. The decision marked a surprising but much-welcomed win for taxpayers.

The Federal Court found in favour of Glencore on 3 September 2019 and the Full Federal Court went on to dismiss the Commissioner of Taxation's appeal on all but one issue. Bringing the matter to a close, the High Court dismissed the Commissioner's application for special leave to appeal on 21 May 2021. Glencore provides some key takeaways with respect to arm's length dealings with offshore related parties, such as the emphasis that should be placed on surrounding economic circumstances.

6. Hybrid mismatch rules

The hybrid mismatch rules operate in Australia to neutralise hybrid mismatches by cancelling deductions or including amounts in assessable income where there are:

- deduction or non-inclusion mismatches (**D/NI**) where a payment is deductible in one jurisdiction and non-assessable in the other jurisdiction;
- deduction or deduction mismatches (**D/D**) where the one payment qualifies for a tax deduction in two jurisdictions; and
- imported hybrid mismatches where receipts are sheltered from tax directly or indirectly by hybrid outcomes in a group of entities or a chain of transactions.

The ATO released PCG 2021/5 on 16 December 2021 which finalised the ATO's compliance approach to the assessment of relative levels of tax compliance risk associated with imported hybrid mismatches and updated the draft PCG with only minor changes.

PCG 2021/5 provides a framework of seven colour-coded risk zones ranging from white zone (where the ATO has provided clearance to the taxpayer), through green (low risk) to very high risk (red).

Unsurprisingly, the guideline is conservative in its approach and states that taxpayers should refrain from claiming any deductions that have not been through a full and extensive verification process as set out in the guideline. In other words, taxpayers are expected to prove that deductions should not be denied because of the hybrid mismatch rules, which may seem strange in the context of Australia's self-assessment framework.

Practically speaking, meeting the demanding expectations of the guideline will likely be difficult and burdensome, noting the ATO's recommended "top-down" and "bottom-up" approaches for non-structured arrangements.

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7 *Federal Commissioner of Taxation v Glencore Investment Pty Ltd* (2020) 112 ATR 378.

7. General Anti Avoidance

In addition to the *specific* anti-avoidance provisions outlined above, Australia also has extensive *general* anti-avoidance rules (commonly referred to as Part IVA). The Commissioner may reverse a tax benefit (such as the non-inclusion of an amount of assessable income, or the inclusion of a deduction) obtained in connection with a scheme that was objectively entered into for the dominant purpose of obtaining the tax benefit. The Commissioner will take into account the specific facts and surrounding circumstances of the scheme, including the manner the scheme was entered into, its legal form, and its substantive effect.

In the context of discretionary trusts, the recent decisions in *Minerva*[2] highlight the need to consider the potential application of Part IVA to seemingly routine decisions made by trustees; in that case, the Federal Court of Australia confirmed that a stapled structure had valid commercial purposes, but also held that the payment of distributions to a non-resident beneficiary could attract the application of Part IVA.

In the 2023-24 Federal Budget, the Federal government announced an unexpected expansion of the Part IVA legislation to include schemes:

- that reduce tax paid in Australia by accessing a lower withholding tax rate on income paid to foreign residents; and
- that achieve an Australian income tax benefit, even where the dominant purpose was to reduce foreign income tax.

The legislation is intended to apply for income years commencing on or after 1 July 2024, regardless of whether the scheme was entered into before or after 1 July 2024.

Global entities with an annual income of $1 billion or more are also subject to the Multinational Anti Avoidance Law (**MAAL**) and the Diverted Profits Tax (**DPT**).

The MAAL is designed to target contrived arrangements employed by large foreign enterprises to avoid paying tax in Australia, in circumstances where the enterprise is supplying goods or services to Australian customers.

The DPT addresses complex arrangements where large entities may attempt to reduce the tax they pay in Australia by redirecting profits offshore. The DPT is a 40% tax applied to the 'diverted profit'.

8. Research and Development incentives

The Australian Research and Development (**R&D**) tax incentive reduces R&D costs by offering tax offsets for eligible R&D expenditure for companies.

Eligible companies with a turnover of less than $20 million can receive a refundable tax offset, allowing the benefit to be paid as a cash refund if they are in a tax loss position. All other eligible companies receive a non-refundable tax offset to help reduce the tax they pay.

The program is available to companies who are:

- incorporated under Australian law; or
- incorporated under foreign law but an Australian resident for income purposes; or
- incorporated under foreign law and a resident of a country with which Australia has a double tax agreement.

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8 *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092.

9. Indirect taxes

Goods and Services Tax (GST)

Australia has a broad-based flat-rate value-added tax of 10% on the supply of goods, services, real property, intangible property and other items. GST operates in a similar way to other consumption and value-added taxes in other jurisdictions such as Canada, the United Kingdom, and New Zealand. The taxpayer making the supply will have the GST liability (i.e. liability to pay GST to the ATO) and the entity receiving the supply will ordinarily pay an increased amount for the good or service, which reflects the GST liability but will be entitled to claim a credit for the GST liability where the good or service is used in the carrying on of an enterprise.

Companies can form GST-groups. Similar to other tax groupings, GST groups allow business entities to operate as a single business for GST purposes. This streamlines compliance, and GST credits can be used across entities.

Exemptions from GST:

- the sale of a 'going concern' – where a transaction involves the sale of an enterprise and the transaction is the supply of all things necessary for an entity to continue operating the enterprise, the transaction supply may be exempt from GST.
- GST-free supplies – exports, supplies of certain food and medical supplies.
- Input-taxed supplies – financial supplies (such as loans and shares) and residential real property.

There are also GST withholding obligations for certain transactions. For example, where an entity makes a supply of new residential premises by way of sale or long-term lease, the purchaser will be required to withhold from the consideration a GST amount and remit to the ATO, unless an exception applies.

Stamp Duty

All Australian States and Territories impose stamp duty on transactions involving certain types of "dutiable property", including interests in land and acquisitions of business assets, with specific rules varying across the different jurisdictions.

Duty is also charged on acquisitions in land-owning companies and trusts, subject to certain thresholds. The duty is calculated as a percentage of the value of the relevant assets to a maximum of 6.5%.

In many States and Territories, there is a duty surcharge for "foreign" purchasers of direct and indirect interests in residential land. This can be as high as 8%, although this varies between jurisdictions.

The rules also capture some Australian-based entities with overseas investors. Detailed factual analysis may be required, and prospective investors in Australian land should seek advice before making an investment.

New South Wales has begun the process to replace stamp duty (and the current land tax) with a broad-based, annual property tax. This is in its early stages and the Government is continuing to consult on its design.

Land Tax

Each State and Territory also imposes an annual land tax, typically levied on the unimproved value of land.

Although there are many exemptions from land tax, land used for rental income or development, and vacant land, are generally taxable. Some States have land tax incentives for build-to-rent projects.

Similar to stamp duty, many jurisdictions impose a land tax surcharge for foreign owners of certain types of land. The surcharge can be up to 4% of the taxable value of land, in addition to usual rates each year.

The land subject to surcharge tax, and the definition of a "foreign" owner, vary from state to state so it is prudent for prospective investors to seek specific advice.

Windfall Gains Tax

Effective from 1 July 2023, the State of Victoria has introduced a new windfall gains tax.

The tax operates by charging up to 50% of the value uplift, which are certain planning changes made to allow development of the land.

Landowners can defer paying the tax until the land is sold, with a maximum deferral of 30 years if they also accrue interest at government bond rates. It remains to be seen whether other jurisdictions will impose a similar tax.

Contact our team

Arnold Bloch Leibler is renowned within the Australian business, legal and accounting communities as being the 'go-to' taxation law practice for corporate leaders, major companies and wealthy private clients. If you have any questions about the information contained in this publication, contact one of our team members below.

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