
TREASURY LAWS AMENDMENT (HOUSING TAX INTEGRITY) BILL 2017

EXPOSURE DRAFT EXPLANATORY MATERIAL

DRAFT

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
CGT	capital gains tax
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
TARP	taxable Australian real property

Chapter 1

Capital gains tax changes for foreign residents

Outline of chapter

- 1.1 Schedule 3 to the exposure draft of this Bill would amend the *Income Tax Assessment Act 1997* (ITAA 1997) to:
- remove the entitlement to the capital gains tax (CGT) main residence exemption for foreign residents; and
 - modify the foreign resident CGT regime to clarify that, for the purpose of determining whether an entity's underlying value is principally derived from taxable Australian real property (TARP), the principal asset test is applied on an associate inclusive basis.
- 1.2 All legislative references in this Chapter, unless otherwise stated, are to the ITAA 1997.

Context of amendments

- 1.3 As part of the 2017-18 Budget, the Government announced a range of reforms to reduce pressure on housing affordability. Schedule 3 to the exposure draft of this Bill would implement two of the reforms to the operation of the CGT rules for foreign residents.
- 1.4 A third reform to the CGT rules for foreign residents is contained in the *Treasury Laws Amendment (Foreign Resident Capital Gains Withholding Payments) Act 2017*. That Act modified the foreign resident capital gains withholding payments regime from 1 July 2017 to:
- increase the withholding rate to 12.5 per cent; and
 - reduce the withholding threshold to \$750,000.

Main residence exemption

- 1.5 The amendments in Part 1 of Schedule 3 to the exposure draft of this Bill would remove the entitlement to the CGT main residence

exemption for foreign residents that have dwellings that qualify as their main residence. Therefore any such capital gain or loss arising upon disposal of a foreign resident's main residence needs to be recognised.

1.6 The main residence exemption disregards a taxpayer's capital gain or loss for CGT purposes (providing an exemption) if:

- the taxpayer is an individual; and
- the dwelling was the taxpayer's main residence throughout the ownership period.

1.7 The main residence exemption also provides a partial exemption if the dwelling was the taxpayer's main residence for only part of the ownership period or if it was also used in part to produce assessable income.

1.8 For the purpose of the main residence exemption a dwelling includes:

- a building (e.g. a house) or part of a building (e.g. an apartment or townhouse) that consists wholly or mainly of accommodation; and
- a caravan, houseboat or other mobile home; and
- any land immediately under the unit of accommodation.

1.9 It also includes adjacent land that, together with the land under the dwelling, does not exceed two hectares, and adjacent structures (for example a storeroom, shed or garage) to the extent that they are used mainly for domestic or private purposes.

1.10 The main residence exemption may also apply to:

- an individual who is a beneficiary in, or any entity that is a trustee of, a deceased estate of a deceased person who used the dwelling as a main residence; and
- the trustee of a trust that is or has been a special disability trust where the dwelling was the main residence of the individual who is or has been:
 - the principal beneficiary of the trust; or
 - another beneficiary who inherits the dwelling upon the death of the principal beneficiary.

Principal asset test

1.11 The amendments in Part 2 of Schedule 3 to the exposure draft of this Bill would modify the foreign resident CGT regime to clarify that, for the purpose of determining whether an entity's underlying value is principally derived from TARP, the principal asset test is applied on an associate inclusive basis.

1.12 Under the foreign resident CGT regime, a capital gain or capital loss made by a foreign resident in respect of a membership interest is disregarded unless both the non-portfolio interest test and the principal asset test are satisfied in relation to the interest.

1.13 The purpose of the non-portfolio interest test is to establish whether a foreign resident entity has sufficient interest in another entity. The test is satisfied if the sum of the direct participation interests held in the other entity by the foreign resident entity and its associates is 10 per cent or more.

1.14 The purpose of the principal asset test is to determine when an entity's underlying value is principally derived from TARP. A membership interest held by a foreign resident in another entity will pass the principal asset test if the sum of the market values of that entity's assets that are TARP exceeds the market values of that its assets that are non-TARP.

1.15 Where an asset of an entity is a membership interest in another entity then, for the purpose of applying the principal asset test, that asset is taken to be two assets — an asset that is TARP and an asset that is non-TARP. The market value of the deemed TARP asset is taken to be nil if, broadly, the foreign resident entity's total participation interests in the other entity is less than 10 per cent.

Summary of new law

1.16 Schedule 3 to the exposure draft of this Bill would amend the ITAA 1997 to:

- remove the entitlement to the CGT main residence exemption for foreign residents; and
- clarify that, for the purpose of determining whether an entity's underlying value is principally derived from TARP under the foreign resident CGT regime, the principal asset test is applied on an associate inclusive basis.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
<i>Main residence exemption — individuals</i>	
Individuals who are foreign residents at the time a CGT event occurs to a dwelling in which they have an ownership interest are not entitled to the main residence exemption.	Individuals who are foreign residents are entitled to the main residence exemption in the same way as individuals who are residents of Australia for taxation purposes.
<i>Main residence exemption — deceased estates</i>	
<p>A trustee of a deceased estate is not entitled to the main residence exemption in respect of an ownership interest in a dwelling of a deceased individual if the deceased was a foreign resident at the time of death.</p> <p>A beneficiary of a deceased estate is not entitled to a main residence exemption in respect of an ownership interest in a dwelling of a deceased individual if the deceased was a foreign resident at the time of death.</p>	<p>A trustee of a deceased estate is entitled to the main residence exemption in respect of an ownership interest in a dwelling of a deceased individual who was a foreign resident at the time of death in the same way as if the deceased had been a resident at that time.</p> <p>A beneficiary of a deceased estate is entitled to a main residence exemption in respect of an ownership interest in a dwelling of a deceased individual who was a foreign resident at the time of death in the same way as if the deceased had been a resident at that time.</p>
<i>Main residence exemption — special disability trusts</i>	
<p>A trustee of a special disability trust is not entitled to a main residence exemption in respect of an ownership interest in a dwelling if the principal beneficiary of the trust was a foreign resident at the time a CGT event occurs to the dwelling.</p> <p>A trustee of a special disability trust is not entitled to the main residence exemption in respect of an ownership interest in a dwelling if the principal beneficiary was a foreign resident at the time of death.</p>	<p>A trustee of a special disability trust is entitled to a main residence exemption in respect of an ownership interest in a dwelling if the principal beneficiary of the trust was a foreign resident at the time a CGT event occurs to the dwelling. This applies in the same way as if the principal beneficiary had been a resident at that time.</p> <p>A trustee of a special disability trust is entitled to the main residence exemption in respect of an ownership interest in a dwelling if the principal beneficiary of the trust was a foreign resident at the time of death. This applies in the same way as if the principal beneficiary had been a resident at that time.</p>

<i>New law</i>	<i>Current law</i>
<p>A beneficiary who is bequeathed an ownership interest in a main residence at the time of death of the principal beneficiary of a special disability trust is not entitled to a main residence exemption accrued by the special disability trust if the principal beneficiary was a foreign resident at the time of their death.</p>	<p>A beneficiary who is bequeathed an ownership interest in a main residence by the principal beneficiary of a special disability trust is entitled to a main residence exemption accrued by the special disability trust. This includes where the principal beneficiary was a foreign resident at the time of their death. The exemption applies in the same way as if the principal beneficiary had been a resident at that time.</p>
<i>Principal asset test</i>	
<p>Under the foreign resident CGT regime, a capital gain or capital loss made by a foreign resident in respect of a membership interest is disregarded unless both the non-portfolio interest test and the principal asset test are satisfied in relation to the interest.</p> <p>The principal asset test applies in relation to certain membership interests held by a foreign resident entity in another entity and is satisfied if the market value of the other entity's TARP assets exceeds the market value of its non-TARP assets.</p> <p>For these purposes, if the entity being tested holds a membership interest in another entity, the membership interest is treated as if it were two assets — a TARP asset and a non-TARP asset. However, the market value of the TARP asset is taken to be nil if the total participation interests held by the holding entity's and its associates in the other entity is less than 10 per cent.</p>	<p>Under the foreign resident CGT regime, a capital gain or capital loss made by a foreign resident in respect of a membership interest is disregarded unless both the non-portfolio interest test and the principal asset test are satisfied in relation to the interest.</p> <p>The principal asset test applies in relation to certain membership interests held by a foreign resident entity in another entity and is satisfied if the market value of the other entity's TARP assets exceeds the market value of its non-TARP assets.</p> <p>For these purposes, if the entity being tested holds a membership interest in another entity, the membership interest is treated as if it were two assets — a TARP asset and a non-TARP asset. However, the market value of the TARP asset is taken to be nil if the entity's direct participation interest, or the holding entity's total participation interest, in the other entity is less than 10 per cent.</p>

Detailed explanation of new law

Main residence exemption

1.17 The amendments to the main residence exemption are contained in Part 1 of Schedule 3 to the exposure draft of this Bill. Individuals who are foreign residents at the time a CGT event occurs to a dwelling in which they have an ownership interest are not entitled to the main residence exemption for any part of the exemption that arises from their use of the dwelling. The CGT event that generally applies is CGT event A1 disposals (see section 104-10), however other CGT events can also apply to a dwelling.

1.18 Therefore affected foreign residents will need to recognise the capital gain or loss that arises from the CGT event because the main residence exemption does not apply. There are no other changes to the CGT main residence exemption provisions.

1.19 For the purposes of the main residence exemption a dwelling includes the property on which the dwelling is located.

1.20 A foreign resident is an entity that is not a resident for taxation purposes in Australia. Individuals who are Australian residents for taxation purposes at the time a CGT event occurs to a dwelling will not be affected by this measure.

Example 1.1: Residency status of working visa holder

James, a New Zealander, obtains a special category visa and comes to Australia. He purchases a dwelling and establishes it as his main residence. He is a resident of Australia for taxation purposes while he resides here. James continues to reside in the dwelling for several years. He signs a contract to sell the dwelling, departing Australia several months later (to return to live in New Zealand).

James was an Australian resident for taxation purposes at the time CGT event A1 occurs to the dwelling - that is, when he signs the contract to sell it. As James was not a foreign resident at the time CGT event A1 occurred he is entitled to the main residence exemption in respect of his ownership of the dwelling.

1.21 To give effect to this measure amendments are made to the main residence exemption provisions in Subdivision 118-B.

Main residence for the whole of the ownership period

1.22 The main residence exemption does not apply if, at the time a CGT event occurs to the ownership interest in a dwelling, the individual that owns it was a foreign resident. [*Schedule 3, item 4, subsection 118-110(3)*]

1.23 However, if at the time a CGT event occurs the individual is a resident for taxation purposes in Australia, they continue to be eligible for the main residence exemption (provided they satisfy the other requirements).

1.24 For individuals that have an ownership interest in a dwelling the most common CGT event is CGT event A1 which occurs on the sale or disposal of that interest. CGT event A1 occurs at the time a contract for sale is signed. Other CGT events that may apply are listed in section 118-110 and the details and timing of when they occur are contained in Division 104.

1.25 The main residence exemption applies to disregard a capital gain or loss in relation to a CGT event that happens to a CGT asset that is an ownership interest in a dwelling if:

- it is held by an individual;
- the dwelling was, or was taken to be, the main residence of the individual throughout their ownership period; and
- the interest did not pass to the individual as a beneficiary in, or as trustee of, the estate of a deceased person.

1.26 The main residence extension provisions that allow a dwelling to be taken to be a main residence in certain circumstances continue to apply. They include moving into a dwelling, changing main residences and absences and repairing or renovating a dwelling.

1.27 The main residence exemption is apportioned if part of the area of the dwelling to which the main residence exemption would otherwise apply was used for income producing purposes.

Example 1.2: Main residence exemption denied

Vicki acquired a dwelling on 10 September 2010, moving into it and establishing it as her main residence as soon as it was first practicable to do so.

On 1 July 2018 Vicki vacated the dwelling and moved to New York. Vicki rented the dwelling out while she tried to sell it. On 15 October 2019 Vicki finally signs a contract to sell the dwelling with settlement

occurring on 13 November 2019. Vicki was a foreign resident for taxation purposes on 15 October 2019.

The time of the CGT event A1 for the sale of the dwelling is the time the contract for sale was signed, that is 15 October 2019. As Vicki was a foreign resident at that time she is not entitled to the main residence exemption in respect of her ownership interest in the dwelling.

Note: This outcome is not affected by:

- Vicki previously using the dwelling as her main residence; and
- the absence rule in section 118-145 that could otherwise have applied to treat the dwelling as Vicki's main residence from 1 July 2018 to 15 October 2019 (assuming all of the requirements were satisfied).

Example 1.3: Main residence exemption applies

Amita acquired a dwelling on 20 February 2003, moving into it and establishing it as her main residence as soon as it was first practicable to do so. On 15 August 2020 Amita signs a contract to sell the dwelling and settlement occurs on 12 September 2020.

Amita used the dwelling as follows during the period of time for which she owned it:

- residing in the dwelling from when she acquired it until 1 October 2007;
- renting it out from 2 October 2007 until 5 March 2011 while she lived in a rented home in Paris as a foreign resident (assume the absence provision applies to treat the dwelling as her main residence);
- residing in the dwelling and using it as a main residence from 6 March 2011 until 15 April 2012;
- renting it out from 16 April 2012 until 10 June 2017 while she lived in a rented home in Hong Kong as a foreign resident (assume the absence provision applies to treat the dwelling as her main residence);
- residing in the dwelling from 11 June 2017 until it was sold.

The time of CGT event A1 for the sale of the dwelling is the time the contract for sale was signed, that is 15 August 2020. As Amita was an Australian resident for taxation purposes at that time (as she had re-established her Australian residency) she is entitled to the full main residence exemption for her ownership interest in the dwelling as it is,

or is taken to be, her main residence for the whole of the time that she owned it.

Main residence for part of the ownership period

1.28 The partial main residence exemption no longer applies if, at the time a CGT event occurs to the ownership interest in a dwelling, the individual that owns it is a foreign resident. *[Schedule 3, item 10, subsection 118-185(3)]*

1.29 The partial main residence exemption applies to partially disregard a capital gain or loss from a CGT event that happens to a CGT asset that is an ownership interest in a dwelling if:

- it is held by an individual;
- the dwelling was, or was taken to be, the main residence of the individual for part of their ownership period; and
- the interest did not pass to the individual as a beneficiary in, or as trustee of, the estate of a deceased person.

1.30 The partial main residence exemption applies to the portion of the capital gain or loss that relates to the period when the dwelling was the individual's main residence. The individual accounts for the portion of the capital gain or loss for the period they owned the dwelling for which it was not their main residence (apportioned on a number of days basis).

1.31 In other respects the partial main residence exemption applies in the same way as the full main residence exemption.

Example 1.4: Partial main residence exemption denied

Terry acquired a dwelling on 20 August 2010.

On 13 November 2019 Terry signs a contract to sell the dwelling and settlement occurs on 11 December 2019. At this time he was a foreign resident.

Terry used the dwelling as follows during the period of time for which he owned it:

- renting it out from when he acquired the property until 5 June 2011;
- establishing the dwelling as a main residence and residing there from 6 June 2011 until 17 June 2019; and

- leaving the property vacant from 18 June 2019 until it was sold. From 19 June 2019 Terry resided in London.

The time of CGT event A1 for the sale of the dwelling is the time the contract for sale was signed, that is 13 November 2019. As Terry was a foreign resident at that time he is not entitled to the main residence exemption in respect of his ownership interest in the dwelling, even though he used the dwelling as his main residence for part of the time that he owned it.

Part of the property on which the main residence is located is compulsorily acquired

1.32 The main residence exemption also no longer applies if, at the time a CGT event occurs to part of an individual's ownership interest in a dwelling as a result of a compulsory acquisition, they are a foreign resident. *[Schedule 3, item 21, subsection 118-245(3)]*

1.33 This component of the main residence exemption applies where a part, but not the whole, of an ownership interest in a dwelling that is a main residence is being compulsorily acquired. Examples where this may occur include a compulsory acquisition of:

- adjacent land, for example for a transport corridor; and
- rights over the adjacent land that restrict its use, for example placing an easement over part of the property to use it as a corridor for utilities or drainage.

Example 1.5: Compulsory acquisition of land adjacent to dwelling that is a main residence

Samuel acquired a dwelling on 23 July 2016 on a 1,000 square metre block of land. He moved into it and established it as his main residence as soon as it was first practicable to do so.

Samuel used the dwelling as follows from when he acquired it:

- residing in the dwelling until 24 June 2018; and
- renting it out from 25 June 2018, when he started living in a rented residence in Los Angeles as a foreign resident (assume the absence rule applies to treat the dwelling as his main residence).

On 16 June 2020 the local council compulsorily resumed 100 square metres of the land on which Samuel's dwelling was situated. Settlement occurred on 14 July 2020.

The time of the CGT event for the compulsory acquisition of the land occurred on 16 June 2020. As Samuel was a foreign resident at that time he is not entitled to the main residence exemption for the compulsory acquisition of part of his ownership interest in the adjacent land.

Deceased estate — where the beneficiary was a foreign resident beneficiary

1.34 If the deceased was a resident of Australia for taxation purposes at the time of death then the main residence exemption accrued by the deceased for the dwelling continues to be available to the beneficiary or beneficiaries of the deceased estate that are bequeathed the property. This includes the exemption attributable to:

- the period during the deceased person's lifetime they used the dwelling as their main residence;
- the period that occurs within two years of the deceased's death (or within such longer period allowed by the Commissioner of Taxation); and
- the period following the deceased's death where the dwelling was the main residence of an individual who was the spouse of the deceased immediately before their death and/or an individual who had a right to occupy the dwelling under the deceased's will.

1.35 However, the beneficiary is denied any additional component of the main residence exemption that they accrued in their own right if they were a foreign resident at the time at which a CGT event occurred to the dwelling. *[Schedule 3, item 11, subsection 118-195(1A)]*

Example 1.6: Foreign resident beneficiary inherits main residence from a deceased person — Australian resident at time of death

Con acquired a dwelling on 7 February 2001, moving into it and establishing it as his main residence as soon as it was first practicable to do so. He continued to reside in the property and it was his main residence until his death on 9 August 2017.

Jacqui, Con's daughter, inherited the dwelling following Con's death. Upon inheriting the dwelling, Jacqui rented it out. It was not her main residence at any time. On 25 January 2021 Jacqui signs a contract to sell the dwelling and settlement occurs on 23 February 2021.

Jacqui resides in Buenos Aires and is a foreign resident for the whole of the time she has an ownership interest in the dwelling.

Jacqui is entitled to a partial main residence exemption for the ownership interest that she has in the dwelling at the time she sells it, being the exemption that accrued while Con used the residence as his main residence (7 February 2001 until 9 August 2017). She is not entitled to any main residence exemption that she accrued in respect of the dwelling (9 August 2017 until 25 January 2021). This is because she was a foreign resident on 25 June 2021, the day on which she signed the contract to sell her ownership interest, which is the day on which CGT event A1 occurred.

Note: Jacqui will need to apply section 118-200 of the ITAA 1997 to work out the amount of the capital gain or loss that she realises from the sale of the ownership interest in the dwelling.

If Jacqui had instead sold the dwelling on or before 9 August 2019 she would have been entitled to a full main residence exemption. This is because the whole of the main residence exemption would have, or would be taken to have, accrued from Con's use of the residence. This includes the two year period following Con's death.

Deceased estate — deceased was foreign resident

1.36 If the deceased person was a foreign resident at the time of their death then the portion of the main residence exemption accrued by the deceased in respect of the dwelling (see paragraph 1.34) is not available to the beneficiary. *[Schedule 3, item 13, subsection 118-195(3)]*

1.37 Beneficiaries continue to be entitled to the main residence exemption for any part of the exemption that they accrue in their own right (provided that they are not a foreign resident at the time the CGT event for the ownership interest in the dwelling occurs). For the purposes of the apportionment calculation, the days for which the deceased person held the ownership interest in the dwelling are treated as non-main residence days. This ensures that no component of the main residence exemption applies for this period. *[Schedule 3, items 14, 15 and 16, subsections 118-200(2), (3) and 4)]*

1.38 The main residence exemption does not apply if:

- the deceased person was a foreign resident at the time of their death; and
- the beneficiary that inherits the ownership interest in the dwelling was a foreign resident at the time the CGT event occurs.

1.39 If the main residence exemption does not apply the beneficiary must account for the whole of the capital gain or loss that accrues on the ownership interest in the dwelling.

1.40 The main residence exemption also does not apply if the deceased person was a foreign resident at the time of death and the dwelling was sold by the trustee of the deceased estate. [*Schedule 3, item 18, subsection 118-210(6)*]

Example 1.7: Resident beneficiary inheriting a dwelling from a deceased person who was a foreign resident at the time of death

Edwina acquired a dwelling on 7 February 2011, moving into it and establishing it as her main residence as soon as it was first practicable to do so. Edwina used the property as follows:

- residing in the dwelling until 25 September 2016;
- renting the property out from 26 September 2016 at which time Edwina moved to Johannesburg.

Edwina passed away on 20 January 2018. At this time she was a foreign resident for taxation purposes.

Rebecca inherits the dwelling from Edwina. Rebecca moves into the dwelling and establishes it as her main residence on 21 January 2018. She continues to reside in it and use it as her main residence until she sells it. She signs the contract to sell the dwelling on 2 February 2020 (at which time she is a resident of Australia for taxation purposes) with settlement occurring on 2 March 2020.

The deceased estate main residence exemption provisions apply to Rebecca's sale of the dwelling as follows:

- the period that Edwina owned the dwelling (2,539 days) is treated as non-main residence days (as Edwina was a foreign resident at the time of her death); and
- the period from when Rebecca moved into the property until she signed the contract for sale (the date of CGT event A1) of 742 days are main residence days as she used the property as her main residence for the whole of this time.

The capital gain or loss amount is the amount that the capital gain or loss would be if no main residence exemption applied. Assume, for the purposes of this example, that the capital gain amount for the dwelling is equal to \$100,000.

Therefore Rebecca's capital gain or capital loss will be equal to:

$$\begin{aligned} &= \text{CG or CL amount} \quad \times \quad \frac{\text{Non-main residence days}}{\text{Days in ownership period}} \\ &= \$100,000 \quad \times \quad \frac{2,539}{3,281} \end{aligned}$$

= \$77,385

Rebecca must include a capital gain of \$77,385 in her assessable income for the 2019-20 income year.

Special disability trusts

1.41 The main residence exemption applies to a dwelling held by a special disability trust for the benefit of its principal beneficiary provided this beneficiary uses it as their main residence. The main residence exemption applies in this way to enable the main residence exemption to apply to a special disability trust in the same way as if the principal beneficiary had directly owned the dwelling.

1.42 The main residence exemption no longer applies if:

- at the time a CGT event occurs to the ownership interest in a dwelling of a special disability trust, the primary beneficiary of that trust was a foreign resident; or
- a CGT event occurs to a dwelling while it is held by the trustee of the special disability trust after the death of the principal beneficiary and at the time of death the principal beneficiary was a foreign resident.

[Schedule 3, items 19 and 20, paragraph 118-218(1)(d) and subsection 118-225(5)]

1.43 Any component of the main residence exemption that was accrued by the special disability trust while it held the dwelling on behalf of the principal beneficiary is denied to a beneficiary¹ that acquires the dwelling after the principal beneficiary's death if, at the time of death, the principal beneficiary was a foreign resident. *[Schedule 3, item 20, subsection 118-225(5)]*

1.44 This ensures that the main residence exemption for a special disability trust that holds a dwelling on behalf of a principal beneficiary continues to operate in the same way as the main residence exemption does for an individual that holds the dwelling in their own right.

Consequential amendments

1.45 Schedule 3 to the exposure draft of this Bill would also make consequential amendments to:

¹ This includes a beneficiary of the special disability trust and a beneficiary under the deceased estate.

- the guide material and examples contained in the law for the main residence exemption to reflect the substantive amendments; and
- remove inoperative references to CGT events I1 and I2 from Subdivision 118-B. CGT events I1 and I2 ceased to apply to TARP, which includes dwellings, following amendments made *Tax Laws Amendment (2006 Measures No. 4) Act 2006*.

[Schedule 3, items 1 to 3, 5 to 9, 12, 17 and 18; sections 118-100, 118-105 and 118-120; paragraphs 118-120(2)(a), 118-195(2)(a) and 118-210(5)(a) and examples following subsections 118-145(4), 118-170(4), 188-178(2) and 118-185(2)]

Principal asset test

1.46 The amendments in Part 2 of Schedule 3 to the exposure draft of this Bill modify the foreign resident CGT regime to clarify that, for the purpose of determining whether an entity's underlying value is principally derived from TARP, the principal asset test is applied on an associate inclusive basis. This will remove any doubt that disaggregated holdings of membership interests are properly taken into account when applying the principal asset test.

1.47 Under the foreign resident CGT regime, a capital gain or capital loss made by a foreign resident in respect of a membership interest is disregarded unless both the non-portfolio interest test (section 960-195) and the principal asset test (section 855-30) are satisfied in relation to the interest.

1.48 The principal asset test applies in relation to certain membership interests held by a foreign resident entity in another entity. The test is satisfied if the market value of the other entity's TARP assets exceeds the market value of its non-TARP assets.

1.49 For these purposes, if the entity being tested holds a membership interest in another entity, the membership interest is treated as if it were two assets — a TARP asset and a non-TARP asset. However, the market value of the deemed TARP asset is taken to be nil if the *total participation interests* (as defined in section 960-180) held in the other entity by the foreign resident holding entity and its *associates* (as defined in section 318 of the *Income Tax Assessment Act 1936*) is less than 10 per cent. That is, the holding entity's total participation interests are worked out on an associate inclusive basis. *[Schedule 3, item 24, item 1 of the table in subsection 855-30(4)].*

1.50 In determining the holding entity's total participation interests in the other entity on an associate inclusive basis, the following amounts will be added together:

- the holding entity's *direct participation interest* (as defined in section 960-190) and *indirect participation interest* (as defined in section 960-185) in the other entity; and
- if an entity is an associate of the holding entity, the associate entity's direct participation interest and indirect participation interest in the other entity.

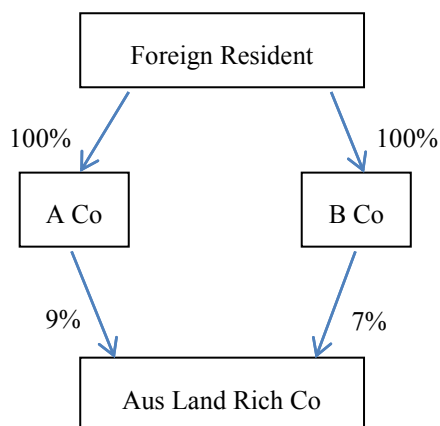
1.51 However, applying the principal asset test on an associate inclusive basis may result in a direct participation interest or an indirect participation interest being counted more than once. Therefore, for the purposes of working out the total participation interests held by the holding entity and its associates, the direct participation interests and indirect participation interests held in the other entity are counted only once. [Schedule 3, item 25, subsection 855-30(4A)]

Example 1.8: Operation of the principal asset test

An Australian entity, Aus Land Rich Co, holds land (which is TARP).

Foreign Resident has an indirect interest in Aus Land Rich Co through its wholly owned subsidiaries:

- A Co — which holds 9 per cent of the membership interests in Aus Land Rich Co; and
- B Co — which holds 7 per cent of the membership interests in Aus Land Rich Co.



Foreign Resident simultaneously disposes of its interests in A Co and B Co.

The non-portfolio interest test (section 960-195) is satisfied in relation to each of these holdings as Foreign Resident holds more than 10 per cent of the membership interests in A Co and B Co respectively.

The principal asset test (section 855-30) will be satisfied in relation to each of these holdings if the market value of A Co's and B Co's TARP assets exceeds the market value of their non-TARP assets.

In applying the principal asset test, the membership interests A Co and B Co hold in Aus Land Rich Co are treated as if they were two assets — a TARP asset and a non-TARP asset.

Under item 1 of the table in subsection 855-30(4), the market value of the deemed TARP asset will be taken to be nil if the total participation interests Foreign Resident and its associates hold in Aus Land Rich Co is less than 10 per cent. However, the item does not apply because the total participation interests Foreign Resident and its associates (A Co and B Co) hold in Aus Land Rich Co is 16 per cent.

Consequently, for the purpose of applying the principal asset test in relation to the interests Foreign Co holds in A Co and B Co, the market value of the deemed TARP asset and the deemed non-TARP asset must be worked out under item 2 of the table in subsection 855-30(4).

Application and transitional provisions

1.52 Schedule 3 to the exposure draft of this Bill would commence on the first day of the next quarter following the day of Royal Assent.
[Clause 2]

Main residence exemption

1.53 The amendments to the main residence exemption in Part 1 of Schedule 3 to the exposure draft of this Bill would generally apply to CGT events happening at or after 7:30 pm, by legal time in the Australian Capital Territory, on 9 May 2017 (application time). *[Schedule 3, item 23]*

1.54 However, the amendments to the main residence exemption do not apply for certain dwellings held before the application time (see paragraph 1.53). The amendments do not apply to a capital gain or loss from a CGT event that occurs to a dwelling if the CGT event occurs on or before 30 June 2019:

- if an individual or trustee of a special disability trust held an ownership interest in the dwelling to which the CGT event relates at all times from immediately before the application time until immediately before the CGT event happens; or
- if an individual acquired the property as a beneficiary of a deceased estate and at all times from immediately before the application time until immediately before the CGT event happens to the dwelling that individual, the deceased person, the trustee of the deceased estate of the deceased person, the trustee of a special disability trust on behalf of a principal beneficiary or a combination of these entities held the ownership interest in the dwelling.

[Schedule 3, item 22, section 118-110 of the Income Tax (Transitional Provisions) Act 1997]

Example 1.9 Dwelling that is a main residence that was owned before 9 May 2017 is disposed of on or before 30 June 2019

Samantha acquired a dwelling on 13 April 2013 moving into it and establishing it as her main residence as soon as it was first practicable to do so. On 10 January 2019 Samantha signs a contract to sell the dwelling and settlement occurs on 7 February 2019.

Samantha used the dwelling as follows when she owned it:

- residing there until 15 September 2016; and
- renting the property out from 16 September 2016 until it was sold (assume the absence provision applies to treat the dwelling as her main residence during this later period).

From 16 September 2016 Samantha resided in rented accommodation in Bahrain and was a foreign resident.

CGT event A1 for the sale of the dwelling occurs when the contract for sale was signed, that is 10 January 2019. As Samantha held her ownership interest in the dwelling on or before 9 May 2017, she continued to own it until it was sold and it was sold before 1 July 2019 she is entitled to the main residence exemption under the transitional rule.

Principal asset test

1.55 The amendments in Part 2 of Schedule 3 to the exposure draft of this Bill would clarify that, for the purpose of determining whether an entity's underlying value is principally derived from TARP under the foreign resident CGT regime, the principal asset test is applied on an

associate inclusive basis. These amendments apply in relation to CGT events happening at or after 7:30 pm, by legal time in the Australian Capital Territory, on 9 May 2017. *[Schedule 3, item 26]*

