

# REMOVAL OF CGT MAIN RESIDENCE EXEMPTION FOR FOREIGN RESIDENTS

**FirstTech Strategic Update** – Craig Day, Executive Manager

In December 2019 new rules<sup>1</sup> were legislated which remove the capital gains tax (CGT) main residence exemption for foreign tax residents (as well as for certain beneficiaries of a deceased foreign tax resident). Therefore, individuals who sell their home in Australia while living and working abroad could incur significant tax liabilities on capital gains that may previously have been exempt.

As a result, clients thinking of moving overseas to live and work should be made aware of these changes and what options they may have in relation to maintaining their home in Australia.

In addition, clients already living overseas should also be made aware of the changes as transitional rules may apply to allow them to sell their home in Australia prior to 1 July 2020 without being affected.

## Background

Under the CGT provisions, taxpayers that are foreign residents are liable to pay capital gains tax where a CGT event occurs in relation to an interest in taxable Australian property, which includes residential property.

However, under the previous rules, foreign tax residents, such as Australian citizens who had moved overseas to live and work, were able to apply a full or partial main residence exemption for CGT events that occurred in relation to a dwelling that qualified as their main residence.

Note – under the absence rule<sup>2</sup>, individuals can continue to treat a dwelling as their main residence for CGT purposes after they have ceased to live in the property either:

- indefinitely or
- for a period of up to six years where the dwelling was used to produce assessable income.

In addition, a beneficiary of a deceased foreign resident could apply the main residence exemption on the sale of a property that qualified as the deceased's main residence under the absence rule where the property was sold within two years of death<sup>3</sup>.

## New rules

The new rules remove an individual's ability to claim a full or partial main residence exemption where a CGT event occurs in relation to a dwelling, where the owner is a foreign resident at the time of the CGT event. (Note – an exemption to this rule may apply where a specified life event occurs within a certain period of a person becoming a foreign resident – see Exemptions for specified life events below for more detail).

A foreign resident is defined as a person who is not a resident of Australia for tax purposes<sup>4</sup>.

Importantly, the new rules do not contain any apportioning rules to recognise periods of ownership where an individual:

- used a dwelling as their main residence, or
- was able to treat a dwelling as their main residence under the absence rule.

In addition, it's also important to note the rules that can trigger a CGT event<sup>5</sup> when an individual stops being an Australian tax resident do not apply to a taxable Australian property, such as a residential property.

<sup>1</sup> Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019. This Bill previously lapsed on the calling of the last federal election.

<sup>2</sup> See s118-145 Income Tax Assessment Act 1997.

<sup>3</sup> See s 118-195 Income Tax Assessment Act 1997.

<sup>4</sup> For more information on tax residency please see the ATO website page: <https://www.ato.gov.au/Individuals/international-tax-for-individuals/work-out-your-tax-residency/>

<sup>5</sup> CGT event I1 (section 104-160 in Income Tax Assessment Act 1997)

Therefore, becoming a foreign resident will not trigger a CGT event to crystallise the capital gain in relation to a dwelling and re-set its cost base to its market value at the time the individual ceased to be a tax resident. Consequently, an individual would need to account for the full amount of capital gain or loss based on the original cost base of the dwelling.

Finally, it should also be noted that any taxable capital gains realised by foreign residents will be taxed at non-resident tax rates and that foreign residents will generally only have restricted access to the 50% individual CGT discount<sup>6</sup>.

Therefore, under these rules, a client who sold their main residence after moving overseas and becoming a foreign tax resident could incur significant tax liabilities in Australia.

## Effective date of the new rules

The new rules apply to CGT events occurring from the date of announcement on 9 May 2017 (7.30pm Canberra time).

However, it's important to note that transitional provisions apply to allow a foreign resident (or the LPR or beneficiaries of their estate or the trustee of their special disability trust) to apply the main residence exemption for CGT events occurring prior to 1 July 2020 where the ownership interest in the dwelling was held by the relevant entities throughout the period starting just before 7.30pm on 9 May 2017 and ending just before the CGT event happens.

Therefore, the effective date for the removal of the main residence exemption for dwellings acquired on or before 9 May 2017 is 1 July 2020.

## Exemptions for specified life events

The new rules include an important exclusion that may allow a foreign resident to still apply a full or partial main residence exemption.

To qualify for this exemption, the foreign resident must not have been an excluded foreign resident (ie, they must have been a foreign resident for a continuous period of six years or less) at the time of the CGT event and one of the following specified life events occurred during that period:

- the person's spouse, or minor child, died
- the person, their spouse or their minor child had a terminal medical condition during all or part of the period of foreign residency
- the CGT event occurs because of a matter involving the distribution of assets between the foreign resident and their spouse (or former spouse) in a family law context, such as in the event of divorce or separation or similar maintenance agreements. This includes where an enforceable distribution takes place under a corresponding foreign law.

Where an individual has been a foreign resident for a continuous period of more than six years, they will be an 'excluded foreign resident' and will be ineligible to apply the main residence exemption regardless of whether one of the above specified life events occurs.

As a result, individuals who experience one of the specified life events within a period of six years of becoming a foreign resident may wish to consider disposing of a dwelling that would qualify for any main residence exemption prior to becoming an excluded foreign resident.

## Beneficiary's ability to apply main residence exemption on dwelling inherited from a foreign resident

Under the new rules, a beneficiary's ability to apply the main residence exemption on the sale a dwelling they inherited from a foreign resident will depend on whether the foreign resident was an excluded foreign resident at the time of death.

### Deceased was not an excluded foreign resident

A beneficiary of a foreign resident will be eligible to apply any main residence exemption that accrued to the deceased on a dwelling where the deceased was not an excluded foreign resident at the time of death (ie the deceased had been a foreign resident for a continuous period of six years or less at the time of death). This includes any exemption attributable to:

- the period during which the dwelling was the deceased's main residence
- the period within two years of the deceased's death (or within such longer period allowed by the ATO)
- 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 (regardless of the residency status of that spouse or individual).

For example, where a beneficiary sold a dwelling that qualified as a deceased foreign resident's main residence within two years of death, and the deceased had been a foreign resident for a continuous period of six years or less at the time of death, the beneficiary would be eligible to apply the main residence exemption.

Note – these rules may also allow a foreign resident beneficiary to claim a full or partial main residence exemption on a dwelling they inherited from a foreign resident that was not an excluded foreign resident at the time of death (ie, the deceased had been a foreign resident for six years or less at the time of death).

However, it should be noted that a beneficiary will be denied any additional component of the main residence exemption that they accrue in their own right if they are a foreign resident when they dispose of the dwelling.

<sup>6</sup> Note – in 2013 the Federal Government amended the capital gains discount rules in section 115-105 of to:

- remove access to the 50% individual discount for any capital gains accrued by foreign residents after 8 May 2012, and
- apportion the 50% individual discount for individuals who were a tax resident on 8 May 2012 but who later stopped being a tax resident.

## Deceased was an excluded foreign resident

A beneficiary of a foreign resident that was an excluded foreign resident at the time of death (ie the deceased had been a foreign resident for a continuous period of more than six years at the time of death) will not be eligible to apply any main residence exemption that accrued to the deceased on a dwelling prior to their death.

For example, if a beneficiary inherited a dwelling from a foreign resident that had been living overseas for more than 6 years at the time of death, the beneficiary would not be eligible to apply any main residence exemption that had previously accrued to the deceased on the dwelling.

In addition, if the beneficiary moved in and established the dwelling as their own main residence, they would only be entitled to a partial main residence exemption which would exclude the deceased foreign resident's main residence period when they sold the property.

### FirstTech comment

#### Issues with calculating dwelling's cost base (or reduced cost base)

Where a foreign resident or their beneficiaries (or the trustee of their estate) is required to bring to account all or part of any capital gain or loss on the disposal of a dwelling that previously qualified as a main residence, they will need to calculate the dwelling's cost base or reduced cost base.

However, for post CGT assets this may be difficult unless proper records have been maintained in relation to the different elements of the property's cost base (or reduced cost base), including original purchase price, stamp duty, legal expenses and the cost of any capital improvements, ie renovations.

Note, the beneficiaries or the LPR of a foreign resident that was not an excluded foreign resident at the time of death (ie, the deceased had been a foreign resident for a continuous period of six years or less at the time of death) may be eligible to re-set the dwelling's cost base to its market value of at the time of death<sup>7</sup>. This would be relevant where only a partial main residence exemption will apply.

## Transitional rules

It's important to note the new rules include transitional rules that allow foreign residents, or foreign resident beneficiaries of a deceased estate, to access the main residence exemption where a CGT event occurs prior to 1 July 2020.

However, this will only apply where the dwelling was held by the individual foreign resident (or the LPR or beneficiaries of the foreign resident's estate or the trustee of the foreign resident's special disability trust) throughout the period starting just before 7.30pm on 9 May 2017 and ending just before the CGT event happens.

As a result, some foreign residents may look to bring forward the sale of a main residence to qualify for this concession.

## Case studies

### Main residence owner is foreign resident at time of sale

Shane is an IT professional and acquired a dwelling on 20 October 2015 for \$500,000. He moved in immediately and established it as his main residence.

On 20 August 2017, Shane departed Australia and moved to the United Kingdom to take up a permanent position with a London based IT company. Shane became a foreign resident for tax purposes from that time onwards. Shane considered selling his property for its market value of \$750,000 prior to departure but decided to keep it and lease it out just in case London didn't work out.

On 1 October 2020, Shane signed a contract to sell the property for \$1,000,000 as he was enjoying living and working in London and had no plans to return to Australia in the foreseeable future.

As Shane is a foreign resident at the time he signed the contract to sell the property, he is not entitled to the main residence exemption in respect of his ownership interest in the dwelling.

As a result, Shane would be liable for a CGT liability on the \$500,000 gain (ignoring any cost base adjustments) at non-resident tax rates with only a partial<sup>8</sup> entitlement to the 50% individual CGT discount.

Alternatively, if Shane sold his property prior to 1 July 2020 he would qualify to apply the CGT main residence exemption under the transitional rules and would not incur any CGT liability on the sale of the property.

### Main residence owner re-establishes tax residency prior to sale

Caleb purchased an apartment in Sydney on 1 March 2010 which he then used as his main residence.

In 2016, Caleb moved overseas to live and work and was a foreign resident for tax purposes. While living overseas Caleb rented the apartment out.

<sup>7</sup> See section 128-15 of ITAA 97.

<sup>8</sup> Eligibility to 50% CGT discount proportioned based on days of tax residency versus total ownership period.

In 2019 Caleb moved back to Australia and rented an apartment in Melbourne. At this time he re-established his resident status for tax purposes. On 1 February 2020, Caleb signed a contract to sell his apartment in Sydney so he could buy a house in Melbourne.

Caleb was entitled to the full main residence exemption on the sale of the Sydney apartment, as he was an Australian tax resident at the time of the CGT event and was able to treat the property as his main residence during the period he lived in the property as well as for the period he lived overseas and in Melbourne under the six year absence rule.

### Deceased foreign resident specified life event

In 2010 Edward and Jackie bought a house in Jackie's name (for asset protection purposes) which they then moved into and established as their main residence. They were both tax residents at this time.

In early 2017 Edward and Jackie decided to rent out their home and move to the United States so they could live with and support Jackie's elderly parents. They both become foreign tax residents at this time.

However, in early 2020 Edward unexpectedly died. Jackie then decided to stay in the United States permanently and signed a contract to sell the property in Australia in early 2021.

Despite the fact that Jackie was a foreign tax resident at the time she signed the contract, she will be eligible to claim the main residence exemption as:

- she was not an excluded foreign resident as she had been a foreign resident for six years or less at the time of the CGT event, and
- her spouse died during her period of foreign residency.

In this case, Jackie can claim the main residence exemption for the period she used the dwelling as her main residence as well as for the four year period she was able to treat the property as her main residence under the six year absence rule.

### Beneficiary of an excluded foreign resident

In 1975 Bill and Maria immigrated to Australia from Greece with their two children. They initially settled in Melbourne and started working in a small business. In 1990 Bill and Maria sold their first home and bought a small house on a larger block. In 1991 they undertook major renovations to expand the size of the house.

In 2013 Maria died from a chronic heart condition. Later that year Bill decided to retire and move back to Greece indefinitely to live with and support his aging mother. He became a foreign

tax resident at that time. During this period Bill leased the family home to generate some additional income as he didn't have much super.

In July 2021 Bill was killed in a car accident while living in Athens. Under his will his two children inherited his house and they then sold it 12 months later in August 2022.

In this situation, Bill's children would not qualify for any main residence exemption on the sale of the family home as Bill was an excluded foreign resident at the time of his death as he had been living overseas for more than six years.

To calculate the taxable gain Bill's children would also need to determine the adjusted cost base of the property taking into account both the acquisition costs as well as the capital improvement (renovation) costs.

Note - had Bill instead died within a period of six years or less of becoming a foreign resident, he would not have been an excluded foreign resident at the time of his death. In this case, assuming the dwelling still qualified as his main residence under the six year absence rule at the time of his death, Bill's children could then sell the property CGT free within 2 years of Bill's death.

### Special disability trusts

The proposed removal of the main residence exemption also extends to a main residence held through a special disability trust.

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 is a foreign resident at the time a CGT event occurs to the dwelling (unless that principal beneficiary satisfies the life events test); 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 an excluded foreign resident.

Note – transitional provisions also apply to allow a trustee of a foreign resident's special disability trust to apply the main residence exemption to a CGT event occurring before 1 July 2020 where the trustee held an ownership interest in a dwelling throughout the period starting just before 7.30pm on 9 May 2017 and ending just before the CGT event happens.

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