

## Foreign Resident Main Residence Exemption (MRE) Removal

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The *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019* ("**New Legislation**") was introduced into Federal Parliament on 23 October 2019. Where applicable, the new legislation seeks to deny access to the CGT Main Residence Exemption ("**MRE**") to "**affected foreign residents**" (see below).

### IMPORTANT

- **Where the new measures apply, potentially substantial additional CGT obligations will impact 'Affected Foreign Residents' (and potentially their beneficiaries or executor) - see page 3 and the worked example at page 6 below. The New Legislation seeks to amend a significant number of sections within:**
  - **the existing Subdiv 118-B ITAA 1997 Main Residence Exemption provisions; and**
  - **the existing Div 128 ITAA 1997 provisions which provide concessional CGT treatment (including MRE access) in a variety of circumstances following a taxpayer's death.**
- **Importantly, even if a particular existing legislation provision is not one of the numerous sections specifically amended by the New Legislation, to the extent any existing provision in the ITAA 1997 requires a partial or full MRE in order to apply, it will become unavailable to any Affected Foreign Resident (or their beneficiary/executor - see page 3) who has been denied access to the MRE denied under the New Legislation.**

### How will the Main Residence Exemption (MRE) Removal Apply?

As illustrated below, where a dwelling:

- has been fully or partially used as a main residence (i.e. generally eligible for a complete or partial main residence exemption upon sale or death of the taxpayer); but
- the CGT Event or death which affects the dwelling occurs from 1 July 2020 (or in some cases from 730pm on 9 May 2017 if acquired from that date - see the note at C in the diagram below),

then either:

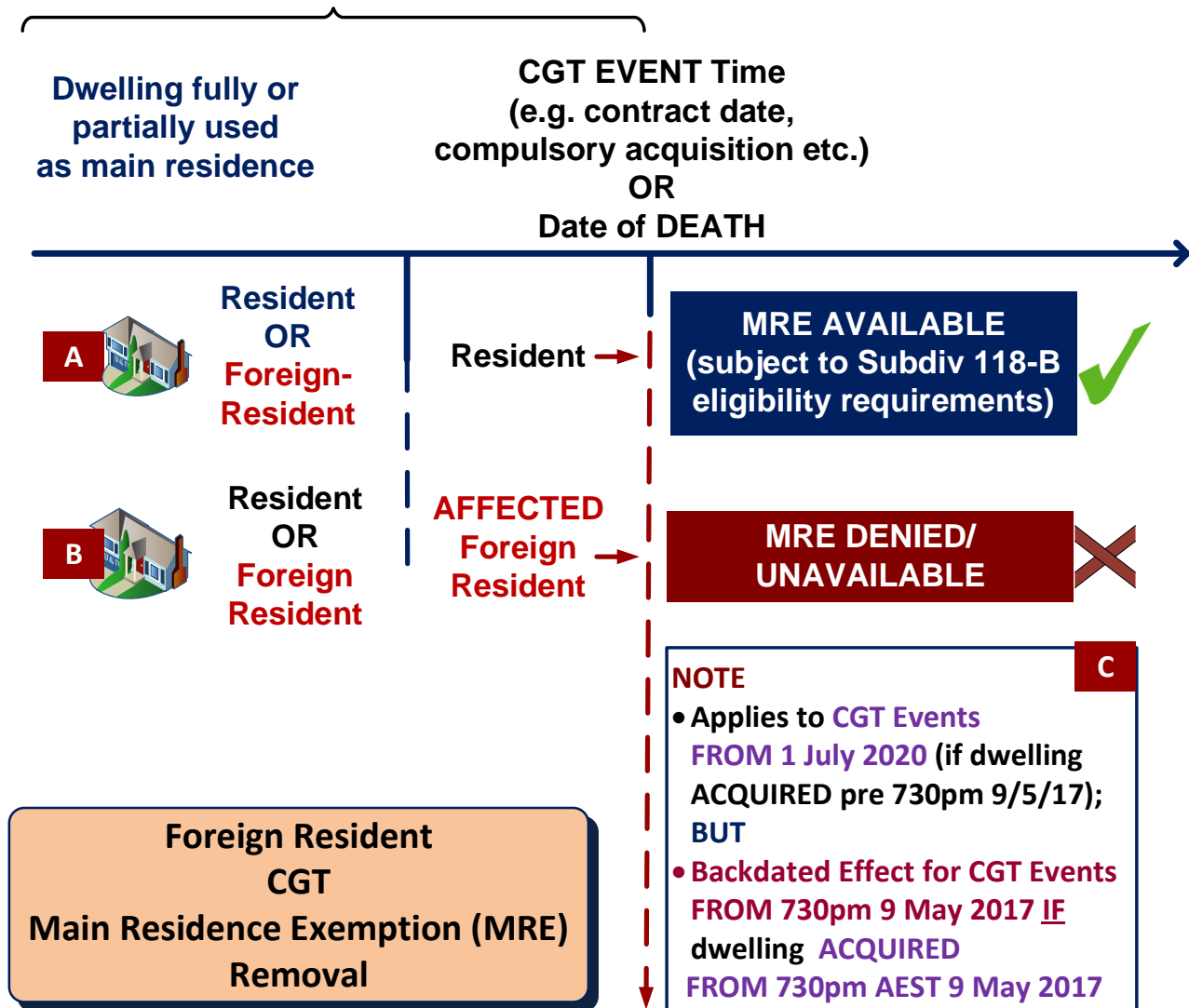
- there will be no change to the existing MRE treatment (subject to meeting existing Subdiv 118-B ITAA 1997 eligibility requirements) provided that the relevant taxpayer is a tax resident (or otherwise not an *Affected Foreign Resident* - see page 3) at the CGT Event or date of death (regardless of any foreign residence status prior to that date) - **see A** below; or

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- access to the MRE will be denied entirely if the taxpayer is an 'Affected Foreign Resident' (see page 3 below) at the time of the CGT Event (or date of death) with any previous residence status and/or main residence use treated as irrelevant - see **B** below.

### TIP

If a foreign resident genuinely returns to Australia as a tax resident prior to the relevant MRE CGT Event or death date, there will be no change to existing MRE access. In such cases there may, however, be adverse CGT discount implications (under existing provisions) due to the former foreign residence status if only a partial MRE is available. Correctly advising on (often complex) tax residence status and the time it commenced and ceased will be critical for purposes of the new approach illustrated below.



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### NOTE

It is noted that capital gains on dwellings acquired from 9 May 2017 are usually likely to be lower than gains on earlier acquisitions. Importantly, however, the new legislation (as currently drafted) imposes a significantly backdated application of the new measure to such dwellings, to the extent that the taxpayer is an '*Affected Foreign Resident*' (see page 3 below) at the time of the relevant CGT Event or Death. The legislators' apparent rationale is that those acquiring dwellings from Budget night 2017 should have been aware of the announced new measures. This backdating approach has been maintained notwithstanding that:

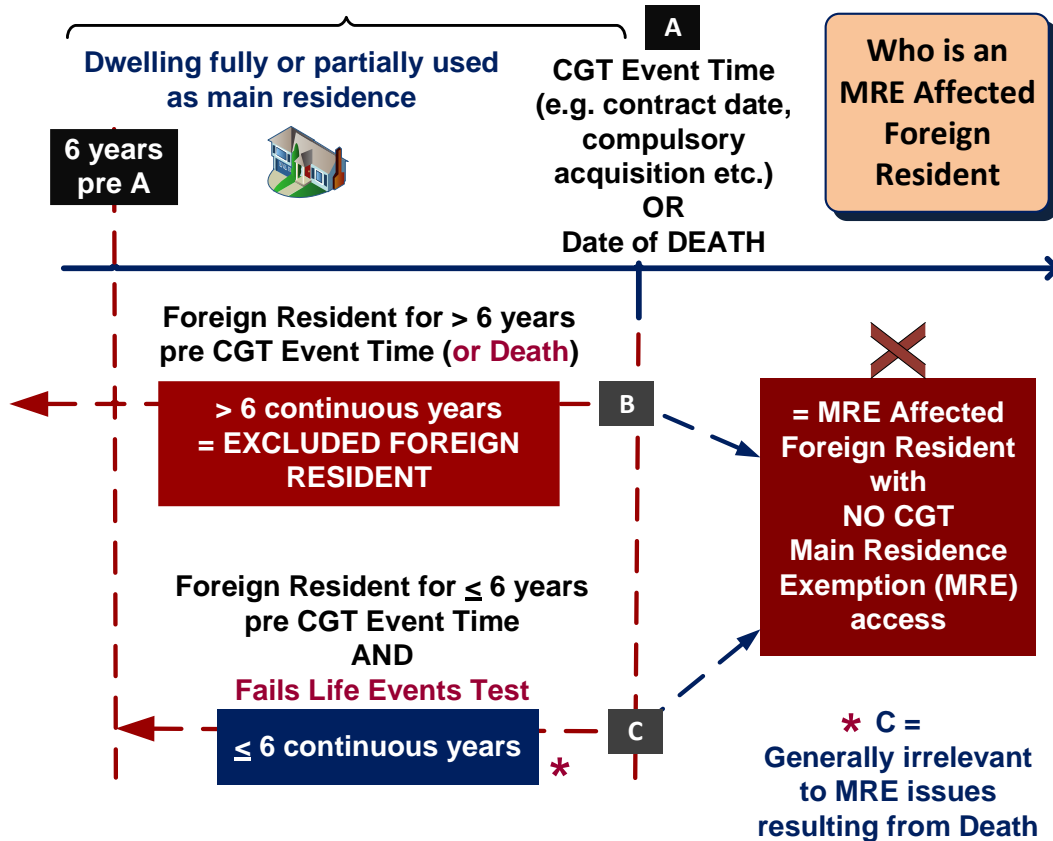
- the previous Parliament's version of this Bill suffered lengthy delays and was ultimately prorogued when the 2019 Federal Election was called; and
- this New legislation has been introduced more than 2.5 years after the original Federal Budget announcement in 2017.

### Who is an "*Affected Foreign Resident*"?

"*Affected Foreign Resident*" is terminology used by Tax Astute to encompass two types of foreign resident for income tax purposes who may lose access to the MRE under the new legislation. As illustrated in the diagram below, MRE removal may arise under the new legislation if either:

- at CGT Event Time (*or date of death*) an interest in a dwelling (which has been fully or partially used as a main residence) is held by an individual who has been a **foreign resident for income tax** purposes for **> 6 continuous years** up to and including the CGT Event time (*usually contract date*) or date or date of death (i.e. an "*excluded foreign resident*" - see B below); or
- at CGT Event time an interest in a dwelling (*which has been fully or partially used as a main residence*) is held by an individual who:
  - has been a **foreign resident for income tax** purposes for **≤ 6 continuous years** (see C below) up to and including the CGT Event time (*usually contract date*); and
  - **fails** the **life events test** (*see the Note at page 4 below*)

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### NOTE

The "Life Events Test" can only be passed if the foreign resident (and/or their spouse or < 18 year old child) have suffered adverse life events during the foreign residence period such as:

- diagnosis of a terminal medical condition;
- death (of a spouse or < 18 year old child); or
- the dwelling's CGT Event resulted from a marriage/relationship breakdown scenario which generally results in CGT roll-over under existing s 126-5 ITAA 1997 (e.g. transfer of the dwelling under Family Court Order, Binding Financial Agreement or similar).

### IMPORTANT

In practice, the life events test will not apply to many foreign residents shown at C. Where the life events test is failed, even an individual who has only been a foreign resident for a matter of weeks or months prior to the CGT Event time will generally lose their entire main residence exemption under the new legislation on the basis that they were a foreign resident at CGT event time.

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### NOTE

As noted with an \* at C in the diagram above, where a MRE issue relates to the death of a taxpayer (including as primary beneficiary of a Special Disability Trust) then the  $\leq 6$  year continuous foreign residence scenario at B will generally be irrelevant (i.e. adverse outcomes for death MRE scenarios are generally limited to deceased individuals who were "excluded foreign residents" with  $> 6$  years continuous foreign residence for tax up to and including their date of death).

### Resident vs Affected Foreign Resident Main Residence Exemption (MRE) Scenario

As illustrated in the scenario provided in the table below, due to the combined triple effect, for an Affected Foreign Resident, of:

1. No access to the MRE regarding the capital gain (see G below);
2. No market value cost base uplift upon first income producing use of a former main residence (per existing s 118-192 ITAA 1997) because the requirement for partial MRE cannot be satisfied by the Affected Foreign Resident (see D below); and
3. The application of a reduced CGT Discount to reflect the Affected Foreign Resident's period of foreign residence (per existing s 115-115(3) ITAA 1997 - see F below),

The **net taxable capital gain** based upon the facts provided in the scenario below would be:

- **\$628,800** for an individual who is an **Affected Foreign Resident** at the CGT Event date/contract date (where the CGT Event happens after the 1 July 2020 commencement date applicable to the scenario); but
- **only \$9,524** for an **individual who is a resident at the CGT Event date/contract date** in relation to the same property and factual scenario, solely due to more concessional treatment under each of the above concessional CGT provisions due to the ability to access a partial MRE regarding the capital gain (and an assumption that residence status was achieved throughout the 21 year ownership period shown).

### IMPORTANT

- **For ease of illustration, a years' basis calculation was used at H for the resident taxpayer's MRE reduction - in practice a strict days' basis is required by Subdiv 118-B ITAA 1997.**
- **Different periods of foreign residence, rental use, acquisition date and more would change the outcome arising from the specific factual scenario shown below.**

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Resident vs Affected Foreign Resident MRE Scenario			
		Tax Resident at Contract Date/ CGT Event in 2021	Affected Foreign Resident at Contract Date/CGT Event in 2021 (and for 1 year prior)
A	Acquisition Cost of Main Residence in 2000	\$400,000	
B	Market Value when Rented Out in 2014 <i>(after 14 years Main Residence Use)</i>	\$1.2 Million	
C	Sale Proceeds in 2021 <i>(after 7 years Rental Use)</i>	\$1.6 Million	
D	CGT Cost Base	(\$1.2 Million) <i>(market value at first income producing use s 118-192 ITAA 1997)</i>	(\$400,000) <i>(s 118-192 ITAA 1997 market value cost base CANNOT apply as Affected Foreign Resident &amp; NO MRE access)</i>
E	<b>Gross Capital Gain</b>	\$400,000 (C - B)	\$1.2 Million (C - A)
F	CGT Discount Reduction	(\$200,000) 50%	(\$571,200) 47.6%* <i>(per s 115-115(3) ITAA 1997 &amp; 1 year foreign resident status 47.6% = (21-1 years) ÷ (2 x 21))*</i>
G	<b>Net Capital Gain</b>	\$200,000 (E - F)	\$628,800 (E - F)
H	Main Residence Exemption Reduction	Main Residence Use for 20 ÷ 21 years* = (\$190,476) reduction <i>(per ss 118-145 &amp; 185 ITAA 1997 partial absence rule/MRE)</i>	<b>Not Applicable</b>
I	<b>Taxable Capital Gain</b>	\$9,524 (G - H)	\$628,800 (= G)

**\* IMPORTANT**

**For ease of illustration, annual/years basis used in place of days basis required by legislation.**

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### IMPORTANT

The substantially higher capital gain shown for the affected foreign resident in the scenario above (i.e. 66 times higher than the \$9,524 taxable capital gain had the same property been sold by a taxpayer who remained a resident throughout) highlights the importance of potentially affected individuals considering (subject to appropriate financial advice) alternative options to the Affected Foreign Resident outcome shown such as:

- signing a sale contract prior to 30 June 2020;
- otherwise signing a sale contract before ceasing to be an Australian tax resident;
- returning to Australia and genuinely re-commencing tax residence prior to the CGT event/contract date; and/or
- in cases of relationship breakdown involving a foreign resident of  $\leq 6$  continuous years, noting that transfer of a former main residence dwelling under a Family Court Order or Binding Financial Agreement (or similar written agreement per existing s 126-5 ITAA 1997) may reinstate access to the main residence exemption as an effective "*life event*".

### IMPORTANT:

The existing MRE provisions, and the proposed changes to them, represent complex legislative issues, a full analysis of which is beyond the scope of this summary Tax Astute Snapshot overview. Tax Astute clients should refer to their detailed Client Guide for numerous further details.

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### WANT MORE DETAILS?

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- Tax Astute training session;
- Tax Astute reference notes; and
- detailed multimedia recording.

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