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To Committee Secretary
Senate Standing Committees on Economics
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600
Australia

Dear Committee Secretary

Submissions on the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018

King & Wood Mallesons welcomes the opportunity to provide our comments on the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 ("**Bill**").

King & Wood Mallesons acts for a wide range of participants in the types of arrangements and investments that are the subject of the proposed measures. This includes not only the foreign resident investors that are the target of most of the measures, but also the Australian resident institutional investors and fund managers that would be competing with foreign resident investors for the types of assets and structures that will be affected by the proposed measures.

While our experience with these clients have informed our views, the views expressed in this submission are our own and are not provided on behalf of or in support of any particular client or industry groups.

We have had the opportunity to review submissions that are being made as a part of your review of this Bill by particular clients and industry groups. We agree with and support the submissions being made by many of these clients and industry groups on the policy aspects of the measures set out in the Bill, especially around the appropriateness from a policy perspective of imposing higher tax rates on foreign passive investment in Australian agriculture and residential property (particularly in the student accommodation as well as the growing "build to rent" sector).

As these points have already been well made in another submissions, the focus of our submission is on highlighting certain more technical aspects of the measures set out in the Bill, particularly around the transitional concessions provided, that should easily be remedied from a legislative drafting perspective.

We believe that it is crucial that these points be remedied, not only to allow the measures to achieve their policy objectives, but also to prevent inappropriate and counterproductive actions being taken to avoid the anomalous outcomes.

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1 Executive summary

Transitional measures – agricultural investments

- The transitional concession that excludes certain income of a MIT from being "MIT agricultural income" where it is derived, received or made before 1 July 2026 ("**Transitional Concession End Date**") should be modified to extend to that portion of any capital gains made after the Transitional Concession End Date to the extent that they are attributable to accrued but unrealised capital gains up to the Transitional Concession End Date on "Australian agricultural land for rent" that is subject to the transitional concession (i.e. held by a MIT before 27 March 2018).
- This would have the effect of allowing capital gains, which are attributable to a period before the Transition Concession End Date, receiving their existing tax treatment (i.e. eligible for a 15% rather than a 30% tax rate), consistent with the objective of the transitional concession. It would also prevent inappropriate and artificial trading and market distortions from occurring in the market for Australian agricultural land for rent around the Transitional Concession End Date.

Transitional measures – residential accommodation

- The transitional concession that excludes certain income of a MIT from being "MIT residential housing income" where it is derived, received or made before 1 October 2027 should be extended to all facilities where an investment decision has been made to enter into an arrangement for the acquisition, creation or lease of the facility prior to 20 September 2018. As currently drafted, the concession only applies to student accommodation facilities where a contract for the acquisition, creation or lease of the facility has been entered into.
- This would have the effect of allowing income from student accommodation facilities which MITs have already invested in, whether through acquiring an interest in land or an option to acquire an interest in land and conducting feasibility studies, from being eligible for the transitional concession and not excluded simply because no contract has been entered into. This is consistent with the stated policy objectives of the transitional concession.

2 Submissions – transitional measures for agricultural investments

Current operation of transitional measures is inequitable

As currently drafted, the transitional concession for capital gains made on MIT agricultural investments operates on what can loosely be described as a "cliff" based approach. That is:

- if a capital gain is made on the date that is before the Transitional Concessional Date final day of the transitional concession, the entire capital gain made is eligible for the lower 15% withholding tax rate; and
- if the sale is made the following day, the entire capital gain will be subject to the higher 30% withholding tax rate.

This is an inequitable and arbitrary outcome. There is no good founding, in policy, why changing the disposal date by one day, should generate such a significant difference in tax outcomes.

The inequity and inappropriateness of this outcome can be contrasted with the approach adopted in other jurisdictions for similar tax measures.

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For example, other jurisdictions which have imposed new taxes or increased the tax rate on capital gains will typically allow a "re-basing" of the assets at the relevant transition date. This ensures that gains made on existing investments up to the allowed transition date are protected from the higher rate of tax. A good example of this is the recent UK tax reforms which removed the exemption from capital gains tax on UK real property for foreign investors.

Indeed, other transitional concessions included in the same Bill allow for unrealised gains up to the date at which the transitional concession falls away to retain their concessional tax treatment.

For example, the transitional concession for the restrictions to the sovereign immunity principle imposed as part of these measures under the Bill allow qualifying entities to have, after the final date that this transitional concession is available, a cost base in their assets which are no longer exempt from Australian tax equal to the market value of the asset at the transition date. Again, this ensures that gains which have accrued to these assets up to the transition date are appropriately protected from tax, consistent with the purpose of the transitional concession.

Current operation of transitional measures creates inappropriate incentives

The current "cliff" based approach also creates inappropriate incentives to investors who have investments that are subject to the transitional concession to implement structures that allow them to capture the benefit of the transitional concession for the gains made up to the date that the transitional concessional ends.

This could involve, for example, "churning" the assets near the end of the transitional period (to crystallise the unrealised gains) or even earn-out structure. Designing a measure that encourages and incentivises undertaking artificial and tax-drive transactions of this kind is both inappropriate and inefficient.

However, even if the transactions being undertaken shortly before the Transitional Concession End Date were genuine third party sales, the way in which the transitional measure is likely to create a market distortion at this time. This is because it is likely that a very large number of foreign investors will, around this time, all be seeking to sell their investments (as otherwise the entire benefit of the transitional concession falls away from the perspective of their capital gains).

This will have an inappropriate and inefficient impact on asset values in this market at this time, which benefits no one through the creation of uncertainty.

Methods that could be adopted to address these issues

There are a number of relatively simple "fixes" to this problem.

The first, and arguably most appropriate and equitable way, is to amend the Bill such that for any disposals of MIT agricultural investments which have been subject to the transitional concession after the Transitional Concession End Date, a taxpayer is deemed to make two capital gains or losses on the disposal of the investment:

- The first capital gain would be a concessional capital gain, and it would be based on the original cost base of the asset and deemed proceeds which are equal to the market value of the asset on the transition date.

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- The second capital gain would be a non-concessional capital gain, and it would be based on a deemed cost base equal to the market value of the assets on the transition date and the actual proceeds received.

If this is regarded as inappropriate, another option would be to allow holders of investments which are subject to the transitional concession to be able to elect, at the end of the transitional period, to realise all of the unrealised gains on the assets until the transition date at the existing tax rate.

While this option generates a similar overall tax outcome to the first option, this option is arguably inequitable as it requires investors to artificially accelerate their taxing point. There may also be practical restrictions to this option, as the relevant MITs will have a taxable capital gain to pass through to investors without adequate cash to distribute the capital gain to investors.

3 Submissions – transitional measures for residential accommodation

Transitional measures currently exclude certain existing student housing investments

The current transitional provisions in the Bill relating to "MIT residential housing income" apply to exclude amounts from being non-concessional "MIT residential housing income" where:

- an amount is included in the assessable income of the MIT;
- the relevant amount would be MIT residential housing income of the MIT because it is attributable to a facility that consists of or contains a residential dwelling asset;
- the MIT derived, received or made the relevant amount before 1 October 2027; and
- the MIT derived, received or made the relevant amount because the MIT held the facility:
  - just before the transition time; or
  - in relation to student housing facilities, the MIT entered into a contract for the acquisition, creation or lease of the facility just before the transition time.

The relevant transition time for the purposes of student housing facilities is the date the Bill was introduced into the House of Representatives (20 September 2018).

Reliance on date of contract for acquisition inappropriate and unrealistic

The Bill relies on the 'contract for the acquisition, creation or lease of the facility just before the transition time' as an indicator of the time the MIT is committed to developing the residential dwelling.

This is inappropriate. In our experience, investors in student housing facilities will often become committed to developing a facility, and will have invested significant resources in a facility, prior to the time that they enter into the contract for the acquisition, creation or lease of the facility. This is because most prudent investors in such assets will, understandably and appropriately, and consistent with significant capital projects in other industries and fields, perform significant feasibility studies before definitely committing to a project and signing the contract for its acquisition.

Further, there is also a significant time lag between the time a decision to invest is made (i.e. when an entity acquires an interest in land) and when a construction contract is entered into. Given the long lead time associated with these type of investment decisions, significant costs would be incurred

during this time in relation to the design, development and documentation of the facility, and the planning process more generally.

If the intention of the transitional measure is to protect existing investments which may have been made, the transitional relief should extend to circumstances where it can be established that the relevant entity has made an investment decision to enter into an agreement to acquire land or an interest in land under an option or other such arrangement (upon which a facility will be acquired, created or leased) prior to the relevant transition date, even where the contract for the acquisition, creation or lease of the facility has not actually been entered into.

Please do not hesitate to contact Scott Heezen [redacted] or the undersigned if there are any questions.

If the Committee agrees with any of the amendments being suggested, we would be delighted to assist with preparing the amendments to the Bill that would be required to implement the amendments.

Yours faithfully

Kai-Chen Lamb | Partner
King & Wood Mallesons