The Senate

Economics Legislation Committee

Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 [Provisions] and related bills

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Senate Economics Legislation Committee

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Chapter 1

Introduction

1.1 On 20 September 2018, the Senate referred the provisions of the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018; Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2018; and Income Tax Rates Amendment (Sovereign Entities) Bill 2018 to the Economics Legislation Committee for inquiry and report by 9 November 2018.[1] As the bills are directly related to one another, all three bills are to be dealt with together in this inquiry report.

1.2 The primary bill under examination in this inquiry, the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018, contains the major substantive changes to the tax system. The two shorter bills complement the aim of the primary bill through relatively minor alterations to existing tax law. Accordingly, the majority of the analysis and comment will be on the primary bill.

1.3 In essence, the introduction of these bills is to protect the integrity of Australia's corporate tax system by neutralising the tax benefits delivered by staples and other structures, and ensuring active business income is taxed at the top corporate rate.[2]

1.4 On the 20 September 2018, the Hon. Stuart Robert MP, Assistant Treasurer, gave his second reading speech for the three bills. Speaking specifically about the primary bill, the Assistant Treasurer explained:

> Most taxpayers comply with Australia's tax rules and pay their fair share of tax here. However, some foreign investors have been using complex arrangements known as stapled structures and other broader tax concessions to extract profits from Australian businesses almost tax free. This is done by converting trading income into more favourably taxed passive income in land-rich sectors such as infrastructure.
>
> Combined with existing tax concessions for foreign pension funds and sovereign wealth funds, some foreign investors can achieve tax rates well below 15 per cent on all their Australian business income—in some cases, tax free. These tax benefits are only available to foreign investors and place Australian investors and businesses at a competitive disadvantage. Because these concessions are only available to foreign investors, it results in a two-tiered tax system that distorts investment decisions and biases investment towards land-rich industries…

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1 *Journals of the Senate*, No. 121, 20 September 2018, p. 3843.

2 Second reading speech, the Hon. Stuart Robert MP, Assistant Treasurer, *House of Representatives Hansard*, 20 September 2018, pp. 32–33.

> Hundreds of millions in revenue is being forgone. Left as is, this could grow in the order of billions.
>
> The measures in this bill build on the government's work in protecting the integrity of Australia's corporate tax system.[3]

Conduct of the inquiry

1.5 Submissions to the inquiry closed on 11 October 2018. The committee received 16 submissions and one public hearing was held. The submissions are listed in Appendix 1 of this report. Witnesses who appeared at the public hearing are listed in Appendix 2.

Acknowledgements

1.5 The committee thanks all submitters and witnesses who provided evidence to the inquiry.

Scope and structure of the report

1.6 The report consists of two chapters:

- Chapter 1 (this chapter) provides an overview of the inquiry and provides a background to the bills and a summary of the bills' main provisions; and
- Chapter 2 details the views on the bills as received in submissions and oral evidence to the inquiry as well as the committee's views and recommendations.

Overview of the bills

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

1.7 The explanatory memorandum (EM) to the bill states that the purpose of the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (the 'Fair Share of Tax' bill) is to neutralise the tax benefits of stapled structures and prevent trading businesses from accessing a 15 per cent tax rate on active business income distributed to foreign investors. It also ensures that foreigners that invest in Australian agricultural and residential property do not get a tax advantage over domestic investors.[4]

Schedules to the Fair Share of Tax bill

1.8 The bill consists of five schedules:

- Schedule 1—Non-concessional Managed Investment Trust (MIT) income
- Schedule 2—Thin capitalisation

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3 Second reading speech, the Hon. Stuart Robert MP, Assistant Treasurer, *House of Representatives Hansard*, 20 September 2018, p. 32.

4 Second reading speech, the Hon. Stuart Robert MP, Assistant Treasurer, *House of Representatives Hansard*, 20 September 2018, p. 33.

- Schedule 3—Superannuation funds for foreign residents withholding tax exemption
- Schedule 4—Sovereign immunity
- Schedule 5—Contingent amendments relating to definition of provide affordable housing

Summary of amendments

1.9 **Schedules 1 and 5** to this bill amend the *Income Tax Assessment Act (ITAA) 1997*, the *ITAA 1936* and the *Tax Administration Act (TAA) 1953* to improve the integrity of the income tax law for arrangements involving stapled structures and to limit access to tax concessions for foreign investors by increasing the MIT withholding rate on fund payments that are attributable to non-concessional MIT income to 30 per cent—that is, at the rate equal to the top corporate tax rate.[5]

1.10 An amount of a fund payment will be non-concessional MIT income if it is attributable to income that is:

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.[6]

1.11 Transitional rules apply to fund payments that are attributable to existing investments. If the transitional rules apply, the existing MIT withholding tax rate of 15 per cent will continue to apply until, broadly:[7]

- for MIT cross staple arrangement income relating to a facility that is not an economic infrastructure facility—1 July 2026;
- for MIT cross staple arrangement income relating to a facility that is an economic infrastructure facility—1 July 2034;
- for MIT trading trust income—1 July 2026;
- for MIT agricultural income—1 July 2026; and
- for MIT residential housing income—1 October 2027.[8]

1.12 **Schedule 2** to this bill amends the *ITAA 1997* to improve the integrity of the income tax law by modifying the thin capitalisation rules to prevent double gearing structures.[9]

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5 *Explanatory Memorandum*, p. 10.

6 *Explanatory Memorandum*, p. 10.

7 *Explanatory Memorandum*, p. 11.

8 *Explanatory Memorandum*, p. 11.

9 *Explanatory Memorandum*, p. 79.

1.13 For the purposes of determining associate entity debt, associate entity equity and the associate entity excess amount under the thin capitalisation provisions, a trust (other than a public trading trust) or partnership that is an associate of the other entity referred to in the relevant provisions will be an associate entity of that other entity if the other entity holds an associate interest of 10 per cent or more in that trust or partnership.[10]

1.14 In addition, in determining the arm's length debt amount, an entity must consider the debt to equity ratios in entities that are relevant to the considerations of an independent lender or borrower.[11]

1.15 **Schedule 3** to this Bill amends the *ITAA 1936* to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by limiting the withholding tax exemption for superannuation funds for foreign residents.[12]

1.16 Therefore, a superannuation fund for foreign residents will not be liable to withholding tax on amounts of interest, dividends or non-share dividends it receives from an Australian entity only if:

- the income derived by the superannuation fund is exempt from income tax in the country in which it resides;
- the superannuation fund has a portfolio like interest in the entity that pays the dividends, non-share dividends or interest to it; and
- the superannuation fund does not have influence (either directly or indirectly) over decisions that comprise the control and direction of the operations of the entity that pays the dividends, non-share dividends or interest to it.[13]

1.17 **Schedule 4** to this bill amends the *ITAA 1936* and the *ITAA 1997* to improve the integrity of the income tax law to limit access to tax concessions for foreign investors by codifying and limiting the scope of the sovereign immunity tax exemption.[14]

1.18 An amount of ordinary income or statutory income of a sovereign entity will be non-assessable non-exempt income (NANE) if, broadly:

- the amount is a return on a portfolio-like membership interest, debt interest or non-share equity interest in an Australian company or MIT; and
- no member of the sovereign entity group has influence (either directly or indirectly) over decisions that comprise the control and direction of the operations of the Australian company or MIT.[15]

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10 *Explanatory Memorandum*, p. 79.

11 *Explanatory Memorandum*, p. 79.

12 *Explanatory Memorandum*, p. 86.

13 *Explanatory Memorandum*, p. 86.

14 *Explanatory Memorandum*, p. 94.

15 *Explanatory Memorandum*, p. 94.

1.19 An amount of ordinary income or statutory income that is NANE of a sovereign entity is also exempt from withholding tax.[16]

1.20 Unless another provision in the *Income Tax Rates Act 1986* applies to set a different rate, a sovereign entity will be liable to pay income tax on its taxable income at a rate of 30 per cent—that is, the rate equal to the top corporate tax rate.[17]

Income Tax (Managed Investment Trust Withholding Tax) Amendment Bill 2018

1.21 This bill has only one schedule which makes amendments to the *Income Tax (Managed Investment Trust Withholding Tax) Act 2008*. These amendments ensure that fund payments that are attributable to non-concessional MIT income will be subject to MIT withholding tax at the top corporate tax rate.[18]

Income Tax Rates Amendment (Sovereign Entities) Bill 2018

1.22 This bill has only one schedule, which makes amendments to the *Income Tax Rates Act 1986*. These amendments will result in sovereign entities paying a taxable income rate of 30 per cent unless another existing rate or sovereign immunity applies.[19]

Commencement

1.23 Commencement of the bills will be on Royal Assent; however the amendments apply from various times depending on circumstances. In some cases, transitional rules apply to appropriately protect existing arrangements from the impact of the amendments.[20]

Financial impact

1.24 The EM states that, as a package, the 2018–19 Budget measure 'Stapled structures—tightening concessions for foreign investors' is estimated to have the following gain to revenue over the forward estimates period, as outlined in Table 1.[21]

Table 1: Financial impact over the forward estimates period

2018-19	***2019-20***	***2020-21***	***2021-22***
$30m	$80m	$125m	$165m

16 *Explanatory Memorandum*, p. 95.

17 *Explanatory Memorandum*, p. 95.

18 Second reading speech, the Hon. Stuart Robert MP, Assistant Treasurer, *House of Representatives Hansard*, 20 September 2018, p. 34.

19 Second reading speech, the Hon. Stuart Robert MP, Assistant Treasurer, *House of Representatives Hansard*, 20 September 2018, p. 34.

20 *Explanatory Memorandum*, p. 3.

21 *Explanatory Memorandum*, p. 3.

Regulation impact on business

1.25 According to the EM, the compliance costs of the package of measures in Schedules 1 to 5 in the primary bill overall involve a low compliance cost impact, comprising a medium implementation impact and a low increase in ongoing compliance costs.[22]

1.26 In summary, the package of measures in the primary bill comprehensively tackles the various tax settings that are combined with stapled structures to deliver low tax rates to foreign investors and is the most effective option in providing significant revenue protection.[23]

1.27 Moreover, the EM argued that domestic investors will not be disadvantaged when competing for investment under the current tax settings.[24]

1.28 According to the EM, some marginal projects could potentially be affected due to the higher withholding tax rate faced by foreign investors. Although tax can have a significant impact on investment decisions, tax is only one of many factors that investors consider in their investment decisions. There are a multitude of other factors that investors consider, such as the regulatory, political and social environment of their investment.[25]

1.29 The EM argued that the net benefits derived from the significant revenue protection and removal of distortions provided by the package outweigh concerns about increased complexity and compliance costs, as well as the potential impact on investment.[26]

Compatibility with human rights

1.30 The EM states that these bills are compatible with human rights as they do not raise any human rights issues.[27]

22 *Explanatory Memorandum*, p. 6.

23 *Explanatory Memorandum*, p. 6.

24 *Explanatory Memorandum*, p. 6.

25 *Explanatory Memorandum*, p. 6.

26 *Explanatory Memorandum*, p. 6.

27 *Explanatory Memorandum*, p. 152.

Chapter 2

Issues arising from submissions

2.1 The committee received a total of 16 submissions for this inquiry. The issues raised were:

- purpose built student accommodation;
- 'Build to Rent' property investment;
- agricultural investment;
- issues concerning sovereign immunity;
- the ongoing use of stapled structures;
- technical comments on the legislation drafting; and
- threshold for economic infrastructure facility exception.

Purpose built student accommodation (PBSA)

2.2 The issue most commented on by submitters was the effect of moving the tax rate from 15 per cent to 30 per cent for those foreign investors who chose to invest in purpose built student accommodation (PBSA) through Managed Investment Trusts (MIT).[1]

2.3 Humphreys Lawyers, acting for Urbanest Pty Ltd, GSA Australia Pty Ltd and Scape Australia Management Pty Ltd, argued a 30 per cent rate will significantly reduce returns to foreign investors:

> The issue we have with the new bill is that, by doubling the rate, we're effectively reducing the returns to this industry by about 20 per cent. The problem is they're in the market for capital from investors in commercial projects. These are essentially commercial buildings. You're going to have one equity provider or a small number of equity providers investing in these large buildings. They expect returns.[2]

2.4 Also, Asia Pacific Student Accommodation Association (APSAA) argued there may be an impact on Australian education export services:

> These provisions of the bill…will harm the higher education sector, reduce exports and employment, decrease availability of housing, increase pressure

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1 Scape Australia, *Submission 1*; King & Wood Mallesons, *Submission 2*; Humphreys Lawyers, *Submission 3*; PricewaterhouseCoopers, *Submission 4*; Asia Pacific Student Accommodation Association, *Submission 7*; IGen Funds Management, *Submission 8*; Property Council of Australia, *Submission 9*; Financial Services Council, *Submission 12*; and StudyPerth, *Submission 14*.

2 Mr Paul Humphreys, Managing Director, Humphreys Lawyers, *Committee Hansard*, 1 November 2018, p. 14.

> on infrastructure and damage Australia's reputation as a destination for investment.[3]

2.5 Pricewaterhouse Coopers (PwC) believed the bill should be modified to treat foreign investment in student accommodation consistently with other commercial residential premises such as hostels. PwC:

> …do not see a clear rationale for why foreign investment in student accommodation should be treated differently from investment in other commercial residential premises which qualify for the 15 per cent concessional rate. This inconsistent treatment has the potential to create economic distortions and investment bias, which is contrary to sound tax policy principles.[4]

2.6 Submitters argued that student accommodation cannot be considered in the same category as other residential investment[5] and argued for an amendment to the bill.[6]

'Build to Rent' property investment

2.7 Some submissions advocated giving foreign investors a low tax rate to encourage investment in the 'Build to Rent' sector.[7] The Property Council of Australia said:

> …we disagree with the decision to impose a 30 per cent withholding tax rate on investment in build-to-rent housing, which is double the rate of other asset classes where that investment is coming from eligible countries. This will inevitably make these investments less attractive for long-term, patient global capital and result in less build-to-rent housing being created than otherwise would be the case.[8]

2.8 The Housing Industry Association (HIA) raised concerns of a different type. While recognising that 'Build to Rent' is common in Europe and that such accommodation offers some advantages, it discourages home ownership which HIA, as an organisation, strongly supports. HIA concluded:

> In encouraging Built to Rent schemes in Australia, the government should consider the impact of such schemes on:

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3 Asia Pacific Student Accommodation Association, *Submission 7*, p. 1.

4 Ms Kirsten Arblaster, Partner, Pricewaterhouse Coopers, *Committee Hansard*, 1 November 2018, p. 2.

5 Scape Australia, *Submission 1*, pp. 1–2 and PricewaterhouseCoopers, *Submission 4*, p. 4.

6 Asia Pacific Student Accommodation Association, Submission 7, p. 3.

7 King & Wood Mallesons , *Submission 2*; PricewaterhouseCoopers, *Submission 4*; Property Council of Australia, *Submission 9*; Financial Services Council, *Submission 12*; Housing Industry Association, *Submission 11*.

8 Mr Ken Morrison, Chief Executive, Property Council of Australia, *Committee Hansard*, 1 November 2018, p. 7.

- Existing investors in the housing industry, principally individuals, who use investments in housing as a store of wealth;
- The impact on the changing incentives of home tenure away from ownership to long-term rentals on wealth generation; and
- The impact of providing financial incentives on the type of dwellings made available.[9]

Agricultural investment

2.9 Some submissions sought to maintain for foreign investors a low tax rate for their investments in agricultural land.[10]

2.10 These submissions largely came from the banking and financing industry, such as the Financial Services Council[11] and Rural Funds Management:

- It is not or should not be an objective of the proposed legislation to specifically target passive foreign investment in A-REITs that invest in agricultural assets; and
- The proposed changes are too broad and are inconsistent with the policy objectives of existing tax laws in other contexts and proposed tax laws in the Bill. In their current form the changes capture all foreign MIT investors even where they are passive investors and have no active control over the direct purchase of agricultural land and little influence over the MIT.[12]

Sovereign immunity

2.11 Two submissions sought clarification of the bill's impact on sovereign immunity. PwC raised a number of technical questions, for example PwC noted:

> …the Bill is intended to provide foreign government investors an exemption from Australian tax where they earn income or make gains on realisation of qualifying investments.
>
> However, because of the current legislative drafting, there is a risk the provisions could be interpreted in a manner such that gains would be taxable to these investors in many if not most cases.[13]

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9 Housing Industry Association, *Submission 11*, p. 4.

10 King & Wood Mallesons, *Submission 2*; PricewaterhouseCoopers, *Submission 4*; Rural Funds Management Limited, *Submission 10*; Financial Services Council, *Submission 12*.

11 Financial Services Council, *Submission 12*, p. 3.

12 Rural Funds Management Limited, *Submission 10*, p. 2.

13 PricewaterhouseCoopers, *Submission 4*, p. 5.

Ongoing use of stapled structures

2.12 The Tax Justice Network (TJN) expressed concern that there will remain tax advantages to unit holders of trusts in a stapled structure, which may mean that these will continue to be an attractive vehicle to avoid paying tax. Further, TJN argued that such stapled structures have not demonstrated an overall benefit to Australia or that they necessarily attract foreign investment:

> …TJN-Aus would question the need to maintain cross stapled structures, as it is not clear that a strong case has been made as to their benefit to the general Australian community. The Committee should seek concrete evidence from the Australian Treasury of the benefits derived from allowing for cross staple structures, against the likely government revenue loss they create. It is not enough to simply assert that such tax concessions attract foreign investment. It should be possible to back up such a claim with evidence that can be interrogated.[14]

Technical issues

2.13 Global Infrastructure Partners' submission raised questions about the drafting of the bill in terms of how it impacted.

- from the testing of the portfolio interest at the first level of investment in Australia; and
- to fund managers from the aggregation of common managed stakes for the purposes of the influence test.[15]

2.14 The Financial Services Council raised technical administration questions for non-agricultural primary production businesses.[16]

Threshold for economic infrastructure facility exception

2.15 The Northern Territory (NT) Government's submission was broadly supportive of the bills but raised that the approved economic infrastructure facility exception, as currently proposed with its $500 million project threshold, has the potential to impact smaller jurisdictions.[17]

Committee view

2.16 The committee notes that while submitters raised concerns about specific aspects of the bills and how these would affect their particular industry, many

14 Tax Justice Network, *Submission 5*, p. 2.

15 Global Infrastructure Partners, *Submission 6*, p. 3.

16 Financial Services Council, *Submission 12*, pp. 3–4.

17 NT Government, *Submission 14*, p. 1.

generally agreed with the aims and substance of the proposed legislation.[18] There is certainly a view that the integrity of the tax system must be maintained and strengthened.

2.17 The issues raised with regard to specific concessions for particular sectors of the economy were canvassed during consultations conducted by Treasury. While some submitters disagreed with the final outcomes, they still supported the general thrust of the policy. Indeed:

> It's in the legislation [build-to-rent housing projects within an MIT], which we're happy about, but it's taxed at a higher rate, which we don't understand and we're not happy about.[19]

2.18 The committee recognises the need to strike balance and compromise with this and other proposed legislation, and regards the bills to be a suitable and balanced package. The Treasury observed:

> Broadly, the measures contained in this bill limit the scope of concessions for passive income to sectors for which they were originally intended and prevent active income from being converted into passive income. In the case of sovereign immunity and pension funds, the measures bring our tax treatment more into line with Australia's treaty practice and with tax settings in other countries. The package maintains concessions for affordable housing and nationally significant economic infrastructure, reflecting explicit policy decisions of the government. There are also quite generous transitional provisions.[20]

2.19 Given that the most commented on aspect of the bills were those provisions that apply to PBSA, and that submitters have argued that student accommodation is more of a commercial venture than a residential venture, the committee notes the explanation from Treasury as to why foreign investors in PBSA should be required to pay the 30 per cent tax rate:

> When you add significant services to accommodation, it starts to look an awful lot less like bare rent and more like running a business of accommodation. It's similar to a hotel rather than a bare rent situation. Commercial activities were not supposed to be accessing the concessional rate in the first place. And then the government announced that it was

18 Mr Stuart Landsberg, Pricewaterhouse Coopers, *Committee Hansard*, 1 November 2018, p. 5; Mr Ken Morrison, Property Council of Australia, *Committee Hansard*, 1 November 2018, p. 6 & p. 7; Mr David Bryant, Rural Fund Management Ltd., *Committee Hansard*, 1 November 2018, p. 18; Dr Mark Zirnsak, Secretariat, Tax Justice Network Australia, *Committee Hansard*, 1 November 2018, p. 22.

19 Mr Ken Morrison, Property Council of Australia, *Committee Hansard*, 1 November 2018, p. 10.

20 Mr Paul McCullough, Division Head, Corporate and International Tax Division, Department of Treasury, *Committee Hansard*, 1 November 2018, p. 31.

> excluding residential accommodation, so you don't get out of the residential accommodation exclusion, in my view, by arguing that it's commercial.[21]

2.20 Despite there being some objection by a few stakeholders to aspects of the final package, it remains the committee's view that the package as presented strengthens and protects the integrity of Australia's corporate tax base and does so by finding the right balance between taxation rates, concessions and transition periods. Accordingly, the committee recommends the bills be passed.

Recommendation 1

2.21 The committee recommends that the bills be passed.

Senator Jane Hume
Chair

21 Mr Paul McCullough, *Committee Hansard*, 1 November 2018, p. 34.

Additional Comments from Labor Senators

1.1 Labor Senators support the broad intent of this legislation, which is to improve the integrity of the income tax law.

1.2 Labor Senators in these additional comments will set out some views on both the Government's backflip on 'Build to Rent' policy as well as commenting on other concerns raised in the committee process.

The Government's 'Build to Rent' backflip

1.3 Labor Senators do want to point out that this legislation enacts a backflip in Government policy, which originally ruled out Managed Investment Trust investing in Managed Investment Trusts residential property with the exception of affordable housing from 14 September 2017:

> The draft legislation released today also includes an integrity measure which clarifies that, from today, MITs cannot acquire investments in residential property, except where it is affordable housing. This will prevent MITs from investing in houses, units and apartments to hold for long term rent (other than affordable housing).[1]

1.4 The original announcement was a complete surprise to the investment and property sectors:

> Senator KETTER: Mr Morrison, you mentioned that domestic institutional investors are hesitant to jump into the build-to-rent sector because it's relatively new to Australia. When you think about the policy journey that we've been on with this issue, it's hardly surprising. If you go back to 14 September last year, it was announced that build-to-rent was being ruled out for anything other than affordable housing. You had no warning of that announcement at that point, did you?
>
> Mr [Ken] Morrison: Correct. There was no consultation on that. Because build-to-rent hadn't been a part of the Australian marketplace prior to now, the pre-existing MIT regime didn't single out residential build-to-rent housing at all. …
>
> That announcement was unfortunate. We certainly criticised that at the time. It certainly sent a shockwave through an emerging sector and an emerging interest within the property industry and offshore capital.[2]

1.5 The Property Council went even further and acknowledged that the former Treasurer, now Prime Minister, had both deterred and deferred investment in this sector:

> Mr Morrison: Subsequent to the announcement that was made that build-to-rent housing couldn't be included within an MIT, until the clarification

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1 The Hon Scott Morrison MP & The Hon Michael Sukkar MP, *Increasing the supply of affordable housing*, 14 September 2017.

2 Mr Ken Morrison, *Committee Hansard*, pp. 9–10.

> with the draft legislation, the message that went out to the world was that the Australian government doesn't support build-to-rent housing.
>
> …
>
> Senator KETTER: Do you have a sense of the investment opportunities that were abandoned or delayed as a result of this policy debacle?
>
> Mr Morrison: There was definitely capital switched off and there were definitely project plans which were delayed.
>
> …
>
> Mr Morrison: Last year, two of our members were actively offshore seeking global capital for a build-to-rent pipeline. They had secured $1 billion each of capital in their pipelines. Obviously, the turns in the policy announcements here put a pause on that. They are now moving through, albeit with certainly lower international capital support than they had been able to muster about 12 months or more ago.
>
> …
>
> Senator KETTER: When you think about that, can you explain to me why the then Treasurer and now Prime Minister would want to increase sovereign risk and perhaps deter investment in this particular sector?
>
> Mr Morrison: You would have to put that to him, I would say.[3]

1.6 The next announcement by the Government was on Thursday 26 July at 5pm when, under Treasury exposure draft legislation consultation titled 'Improving the integrity of stapled structures (second stage)', the Government announced its intention to finally allow 'Build to Rent' investment through MITs:

> 1.22 In the 2017-18 Budget package, the Government announced that MITs would be prevented from investing in residential premises unless they are commercial residential premises or affordable housing.
>
> 1.23 Following consultation, and to adopt an approach more consistent with the stapled structures measures that were subsequently developed, the announced approach has been refined.
>
> 1.24 As a result, MITs will be able to invest in residential housing that is held primarily for rent. However, distributions derived from investments in residential housing that are not used to provide affordable housing will be non-concessional MIT income that is subject to a final MIT withholding tax set at the top corporate tax rate.[4]

1.7 In these explanatory materials and through the inquiry process, it was clear that no consultation had occurred prior to the original announcement on

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3 Mr Ken Morrison, *Committee Hansard*, pp. 11–12.

4 Department of the Treasury, *Exposure Draft Explanatory Materials*, accessed via https://static.treasury.gov.au/uploads/sites/1/2018/07/c2018-t311121b-01-ExposureDraft-EM.pdf .

14 September 2017, and it was only after the Government consulted with the investment and property sectors that it was clear that an error had been made.

1.8 While the Government's revised announcement is welcome, Labor Senators remain concerned about the impacts of the Government's past decision making and how it has deterred investment and new supply in Australia's housing market, despite the Government's so-called commitment to housing affordability.

Concerns raised through the committee process

1.9 Labor Senators will now raise central concerns brought to the committee's attention through the inquiry process.

Student accommodation

1.10 The primary concern raised through this committee process is that the legislation as currently drafted will not allow offsite student accommodation to be treated as commercial residential properties and as such will face a typical 30 per cent withholding tax as compared to the concessional rate of 15 per cent that was, in Treasury's view, originally targeted at commercial and retail property:

> The introduction of the MIT regime was aimed at increasing international attractiveness of Australia's fund management industry, especially commercial and retail property funds, by lowering the tax on distributions to foreign investors, particularly on rental income. In practice, the tax is levied as a withholding tax when distributions are transferred out of Australian MITs to overseas investors. In recent years, the withholding tax rate has generally been 15 per cent.[5]

1.11 Treasury looked to GST rules for guidance initially, but had determined that it was not in keeping with the original intent of concessional MIT withholding tax arrangements:

> Government had announced that residential property would no longer be taxed at 15 per cent and it would need to be taxed at 30 per cent, so the question for the legislation then is: what is residential property? We've got to define that thing. Luckily for us, at the time there was a definition that was already being used in the GST context, so we picked that up and we adopted that. That was the basis of our consultation that occurred in July and August. What came out of that consultation was that a number of stakeholders raised with us that there was uncertainty about whether some off-campus student accommodation would be treated as commercial or as residential. As it transpires, the GST law says that accommodation in connection with, essentially, university accommodation—it's not exactly those words, but essentially that's what it says—is residential. But, for off-campus stuff, there appears to be a case that says, 'If it's not directly in connection with one university'—so 'on campus' is that university and it's in connection with that, and 'off campus' might be a number of universities that it's in connection with. There's almost a loophole in there that says that the off-campus stuff gets treated differently to the on-campus stuff. That

5 Mr Paul McCullough, *Committee Hansard*, p. 30.

> was raised with us, and it was said, 'It would be good if you could provide certainty that off-campus is intended to be commercial.' We went, 'That doesn't seem to make sense. What we're looking at here is: is this long-term accommodation that people live in or is this like hotels, a short-term turnaround accommodation?'
>
> It was clear to us that the GST definition that we'd picked up, as it's been interpreted in the law, wasn't serving the purposes that we set out to achieve through the law. After our formal consultation had closed, we consulted directly with a number of stakeholders who'd raised these issues and similar issues with us. We had about a month of targeted discussions with stakeholders at that point, and then the government settled on the changes that you now see in the bill.[6]

1.12 Student accommodation providers rejected the argument that their accommodation is more residential than commercial in nature, primarily arguing that the configuration of the room arrangements makes it difficult to re-convert these buildings so that units and apartments could be offered to in the residential market:

> Firstly, when it comes to purpose-built student accommodation, we have restrictive covenants placed on the title of our buildings that prevent them being used for anything other than student accommodation. Secondly, the construction form of our buildings is so unsuited to residential. We don't have car parking in our buildings. The floor-to-floor heights of our buildings are unsuited to residential. They are much shallower floor heights. The room sizes are quite compact. They're 13½ square metres. So they don't lend themselves to conversion. And they don't have balconies. They would never pass the test set on us by planning authorities for conversion. It would require absolute demolition of our buildings to then redevelop the sites as residential.[7]

1.13 The second concern raised was the transitional arrangements only apply where a project had a construction contract signed on or before the date the legislation was introduced into Parliament. Stakeholders raised concerns that while some projects had not reached a later stage of signing a construction contract, significant commitments such as the purchase of land and project development work had been committed under the assumption of a 15 per cent withholding rate:

> Moreover, the proposed increase in the tax rate does not provide any relief for investors who have committed to developments, having entered into contracts to acquire sites prior to 20 September. Of our committed 4,500 beds over five developments, just over 50 per cent of our beds will not be grandfathered. It, in effect, creates a retrospective tax event for these committed projects. This will have a dramatic adverse impact on the viability of our projects that are in this planning phase.
>
> To prevent these unintended consequences flowing from the proposed bill, we encourage the parliament to amend the proposed bill so that managed

6 Mr Brendan McKenna, *Committee Hansard*, p. 33.

7 Mr Jonathan Gliksten, *Committee Hansard*, p. 14.

> investment trusts that hold student accommodation assets remain subject to a 15 per cent withholding tax, or, as a reluctant fallback position, at least ensure that transition rules apply to existing developments that had been committed prior to 20 September; that is, contracts that acquired the land and not just entered into a construction contract.[8]

1.14 Labor Senators note the concerns raised about the definition of commercial residential property in the bill and its impact on student accommodation providers. Labor Senators believe that the Government should consider changes that better accommodate significant project development work and investments already committed at the time that the legislation was introduced.

Agriculture

1.15 Stakeholders also raised concerns about the policy decision to return agricultural MIT investment to a 30 per cent rate rather than the concessional 15 per cent rate that is currently accessible.

1.16 Rural Funds Management accepted the arguments that tax integrity rules need to be tightened but raised concerns about the policy decision to now allow agricultural MIT investments to access the concessional rate (emphasis added):

> Senator KETTER: What's your understanding of the policy rationale for transitioning to the 30 per cent tax rate for agricultural MITs?
>
> Mr Bryant: When the bill was read in parliament, the memorandum stated that the rationale was to create a level playing field. There are two aspects to the legislation. First of all, there has been the emergence of tax avoidance, if that's the right term, through structuring and the creation of this cross-stapling arrangement. What they've done is converted farm operating income, the business of farming, into something that seems like a passive investment to, therefore, attract the lower rate of tax. The purpose of the legislation is to stop that. We commend it and think it's a very good idea.
>
> …
>
> The stated purpose is to create a level playing field. Presumably the concept is that, if a foreign investor is paying 30 per cent tax, that is a level playing field with an Australian investor. If they're competing with an Australian super fund, they are paying 15 per cent tax. If they're competing with an Australian farmer who uses their self-managed fund to acquire property—which is quite common—they're paying 15 per cent tax. So a 15 per cent tax would be sufficient for a level playing field.
>
> It's worth taking a step back to look at the core of the 2018 legislation. That was to create a 15 per cent tax for passive investors. The logic behind it—and I recall thinking at the time, 'That makes sense'—is that a foreign investor who is simply deriving passive income from genuine property rents, not structured property rents, or interest from a bond or something would pay tax at 15 per cent. That, to my mind, is a fair tax for a foreign

8 Mr Trevor Hardie, *Committee Hansard*, pp. 26–27.

> investor who is making no call on the services that government provides and our taxes fund, such as education, health care, age pensions, disability pensions or drought assistance. A genuine passive foreign investor who makes no call on government services is paying a fair share of tax by paying 15 per cent. That fair share of tax is being maintained for 42 other REITs, and we are the 43rd that will have to pay more than our fair share. Foreign investors will have to pay more than their fair share of tax.
>
> …
>
> I expect that there is an element in the legislation where government is trying to determine who should invest in Australian agriculture and the circumstances under which they do.[9]

1.17 PricewaterhouseCoopers also raised concerns about agricultural investment transition arrangements::

> The first issue we wish to raise relates to the transitional measures for the agriculture sector. The currently proposed transition measures would see the MIT withholding tax rate on capital gains relating to Australian agriculture land move from 15 per cent on 30 June 2026 to 30 per cent on 1 July 2026. We believe that this has the potential to create unintended structural distortions of the market, harming Australian farmers and the broader economy. This dramatic and sudden change in tax treatment will mean that investors will be more likely to sell assets in the period up to 30 June 2026, thereby distorting the market. We believe the transitional relief in respect of MIT agricultural income should be amended to remove the potential fiscal cliff created by the legislation as it's currently drafted. We recommend modifying the transitional arrangements so that foreign investors are taxed on any gain, whether realised or unrealised, in the period up to 30 June 2026 at the current rate of 15 per cent, and then all gains accrued after that date should be taxed at 30 per cent. We believe this limited amendment will minimise the risk to Australian owners of agricultural land adversely affected by structural distortions arising from foreign investors selling in the period up to 30 June 2026; minimise the risk to the Australian economy of deterring long-term foreign capital, which is important to maintaining industries' competitive advantage; and maintain the efficient operation of the market for Australian agricultural land.[10]

1.18 Furthermore, PricewaterhouseCoopers explained how local farmers might be adversely impacted by this legislation:

> We think this means that investors will be looking to sell in the period before 2026, which can hurt Australian farmers who might have loan-to-value covenants in their banking requirements or might be looking to sell as part of succession. This can be a structural distortion, and that's what we're trying to avert with our submission.[11]

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9 Mr Jonathan Gliksten, *Committee Hansard*, p. 14.

10 Ms Kirsten Arblaster, *Committee Hansard*, p. 1.

11 Mr Stuart Landsberg, *Committee Hansard*, p. 2.

1.19 In response to these matters, Treasury have expressed a view that the expansion of concessional arrangements to agriculture was not in keeping with the original policy intent and that the current transition arrangements are sufficient:

> All I'm saying is that the standard tax rate that we apply to investments in Australia and to businesses run in Australia is 30 per cent, and we have a targeted concession—the MIT concession—that was introduced largely with the view to promoting commercial-property funds. We've sees that spread to a range of different sectors—agricultural and residential—and the question, really, is: is there a compelling case for an explicit concession for those sectors? Is there a clear public policy reason to subsidise these sectors?[12]
>
> The way the transitional rules work is that there is a seven-year period for agriculture starting on 1 July next year, during which any income earned from an agricultural MIT would continue to be able to receive the concessional rate, the 15 per cent rate, provided that that investment was sunk before the date of announcement, so it was already a committed investment. At the point that that seven-year period expires, the tax rate goes to the new tax rate, the 30 per cent tax rate, for those. PwC raised that there might be accrued capital gains that someone might have towards the end of that period and that, following the expiry of the seven-year period, that would be taxed at 30 per cent. That's correct. That's what happens under the proposed law.
>
> …
>
> I think that, with agriculture, what you have is a relatively recent market in agriculture. Agricultural REITs and agricultural staples have only really emerged in the last few years, so it's not like, at this point in time, there are significant capital gains embedded in those, compared to, say, sovereign immunity, where sovereign immunity as a practice has been around for 30 years or more.
>
> …
>
> I guess a seven-year period is a lot of time for a business to work out what it wants to do with its investment. Does it want to keep it? Does it want to sell it? When does it do it? When can it do it in a market that creates a smooth transition? On balance, the government thought that there wasn't a compelling case for a special cost based reset in this instance.[13]

Sovereign immunity

1.20 PricewaterhouseCoopers also raised concerns about the operation of sovereign immunity provisions:

> The policy intent on sovereign immunity is very sensible, because it is a part of tax systems worldwide to provide immunity for sovereign governments when they are undertaking activities in another country. It is

12 Mr Brendan McKenna, *Committee Hansard*, p. 32.

13 Mr Brendan McKenna, *Committee Hansard*, pp. 31–32.

> not an immunity that is provided by every government around the world, but it is a fairly consistent position. Australia has provided that immunity for a long time, but the manner in which that immunity has been provided has been through administrative actions taken by the commissioner, and there was a lack of clarity as to the legislative base for what the commissioner was doing. There were two previous attempts to introduce legislation in this area, both of which didn't proceed. In fact, they were commenced by your side of politics, Senator, but in previous governments. The development of this legislation is very sensible and is something that our act needs.
>
> The issue the legislation has is that sovereign immunity should really cover three types of activity: investment activity, consular activity and contracting activity. This legislation covers investment activity but it has gaps in the way it covers investment activity. They are readily obvious gaps and should be fixed in the draft of the legislation. This legislation has no provisions at all to deal with contractual activity that one sovereign government might undertake in another country. That oversight also needs to be fixed. So, we have provisions that deal with consular activity, which is an embassy having a bank account, and that has been readily resolved. The investment provisions deal with the flow of income in regard to investments. But they deal only with capital gains in regard to the disposal of investments. Within the tax law there is a series regimes that tax the disposal of investments other than as capital gains. None of those regimes have been specifically excluded, and they should be. A simple example of that is that if a foreign investor invests in a bond and earns interest income, the interest income will be exempt, but if they make a gain on the sale of the bond, the gain on the sale of the bond will be taxed. That is illogical. We should exclude both the flow and the residual amount. Then, in contractual affairs we need to have an exclusion for contractual affairs, otherwise as a country we will simply embarrass ourselves in dealing with foreign jurisdictions.[14]

1.21 Treasury offered the following response to these concerns:

> They refer to revenue gains and question whether revenue gains can obtain the benefit of sovereign immunity. We believe they do. The EM makes specific reference to revenue gains in a number of paragraphs, confirming that you can get sovereign immunity in respect of revenue gains. So, we don't think a technical amendment is required on that point.[15]

Effectiveness of the bill

1.22 The Tax Justice Network also raised concerns that this legislation does not remove the tax incentives for cross stapled structures entirely:

> We also think that the bills don't completely remove the incentives for cross-stapled structures. Our understanding is that allowing these structures to exist will potentially still provide some incentives for people to look at these arrangements in certain circumstances and potentially gain benefits

14 Mr Paul Abbey, *Committee Hansard*, p. 4.

15 Ms Kathryn Davy, *Committee Hansard*, p. 39.

> from them—and I think that would be an issue that we would encourage the committee to explore strongly with the ATO when they appear in the next session. We do raise some issues about that and note that even those who promote the current cross-stapled structures do point out there are other benefits. But our understanding is that, beyond the benefits they name, there are other ones around the tax treatment of payments to beneficiaries versus dividends being paid out to shareholders.
>
> To that end, we are also perhaps a bit provocative in our submission in suggesting that it would be worth having a broader review of these cross-stapled structures to see what genuine economic benefits they deliver to Australia—and I'm certain there will be some benefits there—weighed up against the potential forgone revenue to government, and what the evidence is that they do stimulate investment. I do note other witnesses have tended to just take for granted that, whenever a tax break is applied, it somehow stimulates investment, despite research evidence from reputable economic bodies globally suggesting that isn't always the case, so therefore it's a proposition worth testing and weighing up from that point of view.[16]

1.23 Treasury offered the following response to these concerns:

> They refer to revenue gains and question whether revenue gains can obtain the benefit of sovereign immunity. We believe they do. The EM makes specific reference to revenue gains in a number of paragraphs, confirming that you can get sovereign immunity in respect of revenue gains. So, we don't think a technical amendment is required on that point.[17]

1.24 In response to questioning, Australian Tax Office officials explained their thinking about possible response to new schemes that might emerge after the passage of this legislation:

> Senator KETTER: Have you tried to war-game how a sharp operator might try to respond to these laws? I take it that's part of your role.
>
> Ms Knight: We have given consideration to various ways in which perhaps entities may structure or try and devise new structures. We largely thought that the general anti-avoidance rules should apply and that, if companies used artificial and contrived structures to avoid the proposed bill, we would look at applying the general anti-avoidance rules.
>
> Senator KETTER: Are there any other powers or processes that you might apply?
>
> Ms Knight: Part of the tax act that is, I suppose, fairly important for stapled structures is division 6C. The policy intent behind division 6C is that publicly listed trading trusts are taxed as corporate entities. It contains rules about the types of investments that can be held within a trust without division 6C applying. Essentially they need to be passive investments held primarily for the purpose of deriving rent. And as part of our compliance

16 Dr Mark Zirnsak, *Committee Hansard*, p. 22.

17 Ms Kathryn Davy, *Committee Hansard*, p. 39.

> activities we do look at whether or not the asset trust side of a staple satisfies or doesn't satisfy the provisions of division 6C.[18]

Conclusion

1.25 Labor Senators support the intent of this bill and support its passage.

1.26 Notwithstanding this, Labor Senators note concerns raised in relation to the bill, particularly concerns about transitional arrangement for the student accommodation sector. Labor Senators believe that the Government should consider changes that accommodate better transitional arrangements for projects where significant investment and project development work had already been well advanced but had not reached the stage of signing construction contracts at the time the legislation was introduced into the Parliament. Labor Senators believe there should be stability in tax policy for projects that take considerable time and resources to prepare and where the project lifetime spans multiple decades.

1.27 Labor Senators are also concerned about the lack of cogent policy argument to support successive decisions in relation to concessional taxation arrangements for agricultural MIT investment. In the absence of clear arguments for reform, at least some stakeholders have concluded that the rationale lies more in politics than good policy. Labor Senators consider that sustained investment in the agricultural sector over time will require transparent, consultative and consistent policy making for key variables such as tax.

Senator Chris Ketter
Deputy Chair

Senator Jenny McAllister
Senator for New South Wales

18 Ms Fiona Knight, *Committee Hansard*, p. 38.

Appendix 1
Submissions and additional documents

Submissions

1. Scape Australia
2. King & Wood Mallesons
3. Humphreys Laywers
4. PricewaterhouseCoopers
5. Tax Justice Network Australia
6. Global Infrastructure Partners
7. Asia Pacific Student Accommodation Association (APSAA)
8. IGen Funds Management (part of Intergen Property Group)
9. Property Council of Australia
10. Rural Funds Management Limited
11. Housing Industry Association (HIA)
12. Financial Services Council
13. Northern Territory Government
14. StudyPerth
15. Name Withheld
16. Infrastructure Partnerships Australia (IPA)

Answers to questions on notice

1. Department of Treasury: Answers to written questions taken on notice (received 19 October 2018).
2. Property Council of Australia: Answers to questions taken on notice at a public hearing in Melbourne on 31 October 2018 (received 5 November 2018).
3. Department of Treasury: Answers to questions taken on notice at a public hearing in Melbourne on 31 October 2018 (received 6 November 2018).
4. Australian Taxation Office: Answers to questions taken on notice at a public hearing in Melbourne on 31 October 2018 (received 6 November 2018).

Appendix 2
Public hearings

Melbourne, 31 October 2018

Members in attendance: Senators Hume, Ketter.

ABBEY, Mr Paul, Partner, PricewaterhouseCoopers

ARBLASTER, Ms Kirsten, Partner, PricewaterhouseCoopers

BEESTON, Mr James, Assistant Commissioner, Law Advice and Resolution, Public Groups and International, Australian Taxation Office

BRYANT, Mr David, Managing Director, Rural Funds Management Ltd

DAVY, Ms Kathryn, Principal Adviser, Department of Treasury

GLIKSTEN, Mr Jonathan, Director, Iglu Pty Ltd

HARDIE, Mr Trevor, Chief Executive Officer, I-Gen Funds Management, Intergen Property Group

HUMPHREYS, Mr Paul, Managing Director, Humphreys Lawyers, acting for Urbanest Pty Ltd, GSA Australia Pty Ltd and Scape Australia Management Pty Ltd

KALOFONOS, Mr Dennis, Director, Capital Transactions, Intergen Property Group

KNIGHT, Ms Fiona, Acting Deputy Chief Tax Counsel, Australian Taxation Office

LANDSBERG, Mr Stuart, Partner, PricewaterhouseCoopers

McCULLOUGH, Mr Paul, Division Head, Corporate and International Tax Division, Department of Treasury

McKENNA, Mr Brendan, Principal Adviser, Department of Treasury

MORRISON, Mr Ken, Chief Executive, Property Council of Australia

NGO, Ms Belinda, Executive Director, Capital Markets, Property Council of Australia

VOURGOUTZIS, Mr Alex, Director, Tax Counsel Network, Australian Taxation Office

WAIGHT, Mr Stuart, Executive, Rural Funds Management Ltd

WERBIK, Mr Andrew, Assistant Commissioner, Law and Policy Design, Law Design and Practice, Australian Taxation Office

YAP, Mr Daniel, Financial Controller, Rural Funds Management Ltd

ZIRNSAK, Dr Mark, Secretariat, Tax Justice Network Australia