KPMG submission

Exposure Draft

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

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Executive Summary

KPMG is grateful for the opportunity to provide feedback on the exposure draft of *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax and Other Measures) Bill 2018* ("ED"), its draft explanatory materials ("EM") and accompanying consultation paper.

Our feedback from discussion with foreign investors since the release of the ED is that they were surprised by the title of the ED and found it unnecessarily confrontational. The reduced rate of withholding tax applicable to investors in managed investment trusts ("MIT") was designed to improve Australia's attractiveness to foreign investors. Australia remains a net capital-importing country, as the Commonwealth government has emphasised in discussion of its enterprise tax plan. Given these dynamics, we strongly suggest that Treasury reconsider the title of this legislation.

Summary of comments on the ED

1) Proposed section 25-115 *Income Tax Assessment Act 1997* ("ITAA 97") should include a provision to the effect that the choice exercised under this section is one of the choices covered by paragraph 177C (2) (b) *Income Tax Assessment Act 1936* ("ITAA 36"). This paragraph in ITAA 36 would prevent the Commissioner of Taxation from applying the general anti-avoidance provisions to the making of that choice.
2) The definition of *"commercial residential premises"* should be modified (even if only for the purpose of this Bill) in order to remove the uncertainty that currently exists as to whether various student accommodation and similar developments fall within the definition or not.
3) Income from Australian agricultural land held for rent should be eligible to be treated as MIT concessional income where the land is actually used for some non-agricultural purpose that does not generate non-concessional MIT income.
4) The transitional rules for the residential MIT rules should be clarified so that they follow the design of the transitional rules for the cross-staple rent which allows projects that entered into a contract for the construction of a facility to qualify.
5) The transitional provisions for economic infrastructure assets should also apply where the facility is the subject of a long-term lease.
6) The availability of MIT concessions for affordable housing and build-to-rent projects is welcome, however in KPMG's view these measures do not go far enough and are unlikely to create a sustainable platform to encourage capital into this asset class. The definition of affordable housing should be expanded to provide concessions for all rental income from projects with an acceptable level of affordable housing stock.
7) We recommend the transitional rules allow that distributions from the underlying MIT investment are subject to the transitional rules regardless of whether the MIT holds a 100% interest in the underlying entity. The entitlement to transitional relief should be limited to the total participation interest held at the relevant transition date.

8) The transitional provisions relating to investment assets of a sovereign entity should be expanded to include assets which were the subject of “early engagement” on a private ruling with the Commissioner of Taxation on or before 27 March 2018.

9) The interests of those members of a sovereign entity group which are not “covered sovereign entities” should not be taken into account when determining a sovereign entity group. The ATO should also be provided with a statutory discretion to determine that a sovereign entity does not form part of a sovereign entity group.

Introduction

KPMG welcomes the opportunity to comment on the ED and EM as published by Treasury on 26 July 2018.

Part A – Cross-staple payments

1. Choice for proposed section 25-115 ITAA 97 to apply to cross-staple payments of rent

Proposed section 25-115 will allow an asset entity and an operating entity which are parties to a cross-staple arrangement to choose that a payment of rent from the operating entity to the asset entity should be specifically deductible to the operating entity under that section, rather than under section 8-1.

We understand that the purpose of including this specific deduction is so that the general anti-avoidance provisions of Part IVA ITAA 36 should not apply to the making of this choice, due to the operation of subsection 177C(2)(b). In other words, Part IVA of ITAA 36 should not apply to the deduction being claimed for cross staple rent.

Given that this was not one of the choices available to taxpayers at the time that Part IVA came into effect, it would be helpful for the Bill to state that the choice in section 25-115 is covered by paragraph 177C (2) (b) ITAA 36. At the very least, the EM should state that the government's intention is this paragraph should apply.

2. Definition of residential premises for the purpose of Schedule 1 Taxation Administration Act 1953

Where an amount of rental income is attributable to residential premises, it will be treated as non-concessional managed investment trust ("MIT") income unless it relates to *"commercial residential premises"* as defined in section 195-1 of *A New Tax System (Goods & Services Tax) Act 1999* ("GST Act").

This statutory definition includes a hostel or boarding house, but excludes "*accommodation provided to students <u>in connection with</u> an educational institution that is not a school"*.

The ED picks up the GST definition of *"commercial residential premises"* and this definition has been considered by the Federal Court decision in *ECC Southbank Pty Ltd as trustee for Nest Southbank Unit Trust & Anor v. Commissioner of Taxation* (2012) 205 FCR 505 ("Urbanest case") in which it was held that the student accommodation was commercial residential property for GST purposes. The Commissioner of Taxation's public ruling *GSTR 2012/6*, at Examples 6 and 7, also allows for such an outcome.

Based on the drafting of the ED and associated EM as well as discussions with Treasury in relation to the definition of MIT residential housing income, it appears as if it is intended that rental income derived from some or all student accommodation is intended to constitute MIT residential housing income. However, there is some uncertainty as to intended policy outcome for student accommodation under the definition of *"commercial*

residential premises" from a MIT perspective and whether it is consistent with the GST outcomes outlined in public ruling *GSTR 2012/6.*

It would be in the best interests of all stakeholders for the Bill to include additional material that provides greater clarity that the intention is that certain student accommodation (and other potentially impacted asset classes) will be considered commercial residential premises and capable of generating concessional MIT income. This should include clarification that on-campus accommodation would be considered to be provided *"in connection with an education institution"* but that off campus accommodation would not fall within this exclusion. At the very least, the inclusion of additional examples in the EM would assist in clarifying the policy intention.

3. Transitional rules for residential assets

It is unclear as to whether the transitional rules for MIT residential housing only apply to dwellings completed at 14 September 2017. If this were the situation then the transitional rules would not cover investments that were already contractually committed and for which a construction contract had been entered or construction commenced as at 14 September 2017 but where the dwelling is not completed until after this date.

This is a significant issue for a number of student accommodation projects and other residential developments where construction was contracted prior to 14 September 2017 but completes after this date.

It is recommended that the transitional rules for the residential MIT rules should follow the design of the transitional rules for the cross-staple rent which allows projects that entered into a contract for construction of a facility to qualify for transitional relief.

4. Agricultural land on which permissible activities can also be situated

The ED proposes that amounts derived from "Australian agricultural land for rent" would be treated as non-concessional MIT income.

This concept includes land that could reasonably be used for carrying on a primary production business, even if no such business is being carried on at the time. It could also include land where a primary production business could be carried on in parallel with the installation and operation of an economic infrastructure facility, in particular energy or communications infrastructure such as electricity transmission or telecommunications base stations. Similarly, it could include land with agricultural potential which has been acquired for the purpose of being developed for some other eligible use, such as the construction of a shopping centre.

We submit that the government's policy intention would be better achieved by modifying the concept of income from "Australian agricultural land for rent" to exclude income derived from the rental of land where the land is actually put to some non-agricultural usage. This could be achieved through amending section 12-465(6) as follows:

"(6) ***Australian agricultural land for rent*** is an asset that is real property situated in Australia (including a lease of land, if the land is situated in Australia) if the asset:

(a) is used, or could reasonably be used, for carrying on a *primary production business; and

(b) is held primarily for the purposes of deriving rent; <u>unless</u>

<u>(c) that rent is not *non-concessional MIT income.</u>

For economic infrastructure assets, an alternative approach could be considered under which a specified de minimis holding of agricultural land for rent (determined as a percentage of overall project value) would not inhibit access to the transitional relief.

5. ***Transitional measures should be available for assets held under a long term lease.***

Section 10(2) of the transitional measures in the ED outlines the circumstances under which cross-staple income from an economic infrastructure facility may qualify for transitional relief.

Relevantly, the provisions as currently drafted require that at the transition time the entity must either:

- Have entered into a contract for the acquisition or creation of the facility; or
- Own the facility.

Many of the recent large-scale privatisation transactions have involved the granting of long-term leases, which could fall outside these strict qualification criteria provided by section 10(2). We submit that the drafting of the ED should make clear that facilities held under a long term lease should also qualify for transitional relief.

6. ***Incentivisation of build to rent and affordable rental housing projects***

The ED contains a framework that facilitates the Managed Investment Trust (MIT) concessions being proposed for certain affordable rental housing developments. This is a very welcome development given the undersupply of affordable housing in the Australian market, however in KPMG's view these measures do not go far enough and are unlikely to create a sustainable platform to encourage capital into this asset class.

Our discussions with clients and industry stakeholders indicates a significant appetite to invest into affordable rental housing within build-to-rent developments, disability housing developed under the National Disability Insurance Scheme and similar style developments, albeit with an acknowledgement that those affordable housing projects will generally not be commercially viable at market land prices unless:

- There is a mixture of affordable and at-market stock within the development; or
- Design and funding concessions are granted to assist the affordable component; or
- The land price is significantly discounted.

Such mixed developments are actively disincentivised under the draft affordable housing measures, as only the affordable component will qualify for a 15% rate of taxation. The at-market component will be taxed at 30%, which given the inherently lower headline returns from the affordable housing component of the development means that these projects on a consolidated basis are unlikely to be commercially viable as compared to alternative classes of property investment which derive at-market income and/or could qualify for MIT concessions in full.

Applying different tax rates and holding structures to affordable and at market units within the same property or project, risks creating a legal and administrative challenge which will further complicate the property delivery and future operational management resulting in additional operating expenses which typically flow through to the residents.

In KPMG's view the MIT regime should proactively incentivise investment into these developments to increase the stock of available affordable rental housing, and to achieve this

we consider that the MIT concessions should be available for mixed projects with substantial affordable housing components. We suggest that this could be achieved through amending proposed subsection 12-470(2) to add new subsection (d) as follows:

"(2) The amount is ***MIT residential housing income*** of the *managed investment trust to the extent that it is attributable to an asset (whether or not held by the managed investment trust) that:

(a) is a *dwelling: and

(b) is *taxable Australian real property; and

(c) is *residential premises but not *commercial residential premises; and

(d) is a project or part of a project that has less than [X%] *affordable housing by number of dwellings in total."

The requisite affordable housing component should be determined through additional consultation, and modelling to determine the 'tipping point', however based on KPMG's preliminary discussions with sector participants we anticipate that an affordable housing requirement of no less than 20% should facilitate substantial new investment into this asset class.

7. *Residential and agricultural transitional rules*

The residential and agricultural transitional measures only apply to indirect interests where there is 100% ownership in the underlying entity which owns the relevant asset. This is an overly restrictive limitation on the ability to access the transitional rules and does not appear to be the intended outcome (see EM para 1.176).

We suggest that joint ventures or any ownership of less than 100% should be able to access the transitional rules,

We recommend the transitional rules should be amended such that distributions from the underlying MIT investment are subject to the transitional rules regardless of whether the MIT holds a 100% interest in the underlying entity. The entitlement to transitional relief should be limited to the total participation interest held at the relevant transition date.

Part B – Sovereign immunity

8. *Eligibility for transitional rules*

The proposed transitional provisions would allow a sovereign entity to benefit from them in relation to an investment asset, where the sovereign entity had applied to the Commissioner of Taxation for a private ruling on sovereign immunity or before 27 March 2018.

This provision is welcome. However it is a common feature of the Commissioner of Taxation's current rulings process that "early engagement' with the Australian Taxation Office ("ATO") on the key factual and technical features of a proposed ruling request may occur some months before the submission of the actual ruling application. The Commissioner introduced early engagement as a way of improving the outcomes of the private rulings process.

We recommend that the transitional provisions be modified such that a sovereign entity would be eligible for the transitional provisions in relation to an asset where it has written evidence that the ATO considers "early engagement" had commenced in relation to a private ruling on an investment asset on or before 27 March 2018, and a positive ruling is received before 1 July 2026.

9. Aggregation of covered and non-covered sovereign entities for the purpose of the portfolio and influence tests

The revised Exposure Draft Legislation broadly provides that sovereign entities will be aggregated for the purposes of the portfolio and influence tests if they are part of the same level of government (eg Federal, State or Provincial). These provisions are widely drafted and it will be difficult in practice for sovereign entities to ascertain (a) other entities that satisfy the requirements to be a "sovereign entity", and (b) interests held by other "sovereign entities" at the same level of Government. As drafted currently, sovereigns (as well as entities paying distributions to sovereigns) will potentially need to assess this issue on the occasion of every distribution from an underlying investment.

Although there may be public information available regarding the identity of other members of a sovereign entity group and the relevant interests held by those entities in certain limited circumstances (eg through public disclosures for listed entities), there are likely to be many instances where the requisite information is unavailable. These issues are compounded for entities that operate independently of the relevant government and therefore will have no access to this information in respect of other government entities.

The Exposure Draft Legislation also provides that "sovereign entities" will be aggregated with other sovereign entities even if that other sovereign does not satisfy the requirements to be a "covered sovereign entity". This can cause anomalous outcomes where an entity that does not benefit under the sovereign immunity rules (because it is not a "covered sovereign entity) is nonetheless counted for the purpose of determining the interests of a sovereign entity group under the portfolio and influence tests.

We submit that the revised Exposure Draft Legislation should be amended to:

- Amend section 880-20 to carve out from the definition of "sovereign entity group" (a) sovereign entities that operate an active trading business and (b) sovereign entities that are operated independently of a body politic of a foreign country or a foreign government agency and which have a specific purpose.
- Alternatively, section 880-20 should include a statutory discretion for the Commissioner of Taxation to determine that a sovereign entity does not form part of a "sovereign entity group" with regard to specific matters (e.g. the sovereign entity is operated independently).