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11 October 2018

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; Income Tax Rates Amendment (Sovereign Entities) Bill 2018

Thank you for the opportunity to present Rural Funds Management's (RFM) views on the abovementioned legislative bills (Bills) to the Senate Economics Legislation Committee.

RFM is the manager of the Rural Funds Group (ASX: RFF). RFF is an Australian Real Estate Investment Trust (A-REIT), listed on the Australian Securities Exchange (ASX). The A-REIT sector is a significant component of the ASX with a market capitalisation of $116 billion.

We have previously made submissions to and have held discussions with the Department of Treasury regarding the proposed changes to the tax rules applicable to MITs investing in agricultural land, as part of the proposed changes to the stapled/MITs tax rules. Our submissions were made on 18 April 2018 and 10 August 2018 throughout the consultation processes for (respectively):

- The Treasury's 27 March 2018 discussion paper titled "Tax treatment of stapled structures" (March 2018 Discussion Paper); and
- The Treasury's 26 July 2018 exposure draft legislation titled "Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax and Other Measures) Bill 2018" (July 2018 Exposure Draft).

Executive summary

Overview

1. This submission relates to the proposed definition of "MIT agricultural income" contained in Schedule 1, items 11 and 12 of Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 and the proposed tax law changes in relation thereto. Broadly, if enacted in its current form, the relevant measures would increase the withholding tax rate from 15% to 30% for fund payments

made to all foreign investors from income (rent and capital gains) of managed investment trusts (MITs) investing in agricultural land.

2. Consistent with our submission to the Department of Treasury on 10 August 2018 on the Exposure Draft, RFM believes that the proposed changes should not proceed in its current form, because:

    a. The proposed changes would have adverse impacts on the supply of capital to Australia's agricultural industry;

    b. 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

    c. 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. Please refer to possible alternatives below.

Adverse impacts on Australia's agriculture and related fund management industry

3. Contrary to the statements in the Explanatory Memorandum to the Bills (at paragraph 5.141) to the effect that domestic farmers would not be disadvantaged, any restrictions in foreign investment in agriculture would indeed disadvantage domestic farmers and Australia's agricultural industry as a whole. As explained in further detail below, the ability to attract capital is particularly important in Australia's agricultural sector, as it effectively relieves private family businesses of the need to build substantial capital before they can expand their domestic agricultural businesses. Whilst most capital originates from domestic investors, access to capital from foreign (but passive) investors is increasingly important, given certain limitations in domestic equity markets relating to the size and appetite for funding agricultural investments.

4. In his Second Reading Speech on 20 September 2018, the Assistant Treasurer stated that "the government recognises that there are sectors where incentives are justified to attract foreign investment in the Australian economy". We strongly believe that Australia's agricultural industry is one that justifies incentives to attract foreign investment, given the importance of access to capital and the increasing importance of foreign capital for the industry and domestic agricultural investment (and as summarised above and detailed below).

5. If enacted in its current form, this disincentive for all foreign investment will have a significant detrimental effect on agricultural MIT’s and investment in Australian rural infrastructure. The MIT regime was developed to support Australia’s funds management industry by attracting investment from both domestic and foreign sources. The implication of these proposed changes will significantly reduce the attractiveness of Australia’s funds management industry to foreign investors.

No clear policy objective of targeting foreign investments in agriculture

6. There appears to be no clear policy objective of specifically targeting foreign investment in the agricultural sector, whilst not targeting foreign investment in other sectors such as the office, retail and industrial property sectors. The proposed changes would place agricultural A-REITs at a clear disadvantage to A-REITs investing in these other sectors. This would be contrary to any policy objective of levelling the playing field and contrary to the tax reform hallmark of achieving equity for all taxpayers.

The proposed measures are too broad and are inconsistent with other measures

7. The proposed measures affect all foreign investors in an agricultural MIT. This is too broad, as (in their current form) they capture all foreign MIT investors even where:
    a. They are passive investors with no active control over the direct purchase of agricultural land and little influence over the MIT - this would be inconsistent with existing and proposed tax laws (including those proposed in the Bill) mentioned at paragraph 10b below; and/or
    b. Neither the MIT or its investors (domestic or foreign) derive any (or very limited) active income, given that the MIT's income is primarily third party rental or passive income received from third party operators that operate independent primary production businesses - this would be contrary to:
        i. The third party rent exception for cross staple arrangements (see paragraph 1.61 onwards of the Explanatory Memorandum to the Bills); and
        ii. The stated context and intention of the proposed legislation to prevent differential tax treatments arising from the conversion of active income to concessionally taxed passive income (see paragraphs 1.9, 1.10, 1.11, 1.16, 5.9-5.14, 5.20, 5.48 (and Figure 3), 5.50 of the Explanatory Memorandum to the Bills).

8. Also, specifically relating to investments in Australian agriculture, the proposed changes contradict the Government's objective of encouraging investments in agriculture, as evidence from the Standing Committee on Agriculture and Water Resources' inquiry into the barriers to superannuation fund investment in Australian agriculture, announced 24 May 2018.

9. More generally, the proposed changes also contradict and are in direct contrast to the well-articulated policy objectives of various recent legislative reforms including, in no particular order of priority, the Investment Manager Regime (IMR, 2012-2015), Managed Investment Trusts (MITs, 2008-18), the Corporate Collective Investment Vehicles (CCIVs, 2017-18) and the Asia Region Funds Passport (ARFP, 2017-18).

    These important tax reforms were introduced and amongst other things, were specifically designed to attract foreign investment to Australia and to promote the use of Australian fund managers by removing/limiting tax impediments to investing in Australia. Most significantly, these tax reforms allow/will allow (when passed into law) Australian fund managers to actively market their services globally, including promoting Australia as a regional financial services and funds management centre.

    Without some form of carve out for listed Australian funds, fund managers like RFM will be significantly disadvantaged in attracting capital from both foreign and domestic investors/sources.

Possible alternatives/solutions

10. Possible alternatives would include:

    a. Maintaining the 15% MIT withholding tax concession for agricultural MIT's that are REITs listed on the ASX. The requirements for listing are significant and would deter direct investors from using the structure merely to achieve tax outcomes. These listing requirements include requirements for entities to be widely held and specific corporate governance, disclosure, risk management and ethical rules and responsibilities.

       Maintaining tax concessions for listed entities would be consistent with existing tax policies, such as the availability of the concessionary ownership tracing rules for widely held entities in Division 166 of the *Income Tax Assessment Act 1997 (Cth)*.

    b. Another approach is to maintain the 15% MIT withholding tax concession, but limited to agricultural MIT's in which any single foreign investor has an ownership interest of less than 10 per cent (on a single foreign investor basis) and/or does not have sufficient influence over the MIT's key decision-making.

       This approach would be consistent with the following:

       i. The proposed measures in the Bill that limit certain tax exemptions to specific types of foreign investors such as foreign pension funds and foreign sovereign funds. These measures adopt a concept of ownership (using a 10% threshold) and influence which should equally apply to foreign investors investing in agricultural MIT's.

       ii. The Investment Manager Regime, the third element of which was included in Tax and Superannuation Laws Amendment (2015 Measures No. 1) Bill 2015. Element 3 of the IMR provides an exemption for Australian sourced capital and revenue gains realised by a widely held foreign fund in respect of portfolio (less than 10%) Australian investments. Further, an indirect IMR concession was provided for those foreign investors using a qualifying independent Australian fund manager.

       iii. The foreign resident CGT exemption, which in effect exempts foreign residents from CGT for gains made on indirectly held Australian taxable property if the foreign resident's interest is less than 10% (see sections 855-25(1)(a) and 960-195 of the *Income Tax Assessment Act 1997 (Cth)*).

       iv. The notional 10% ownership rule in sections 166-225 and 166-230 of the *Income Tax Assessment Act 1997 (Cth)*, which have the effect of not requiring ultimate ownership tracing for shareholders with less than 10% stake in the tested company that are widely held (for the purposes of testing continuity of ownership of companies that have carried forward tax losses).

    c. Tightening the 'closely held' restrictions in the MIT requirements. Under the current MIT rules and the 'closely held' restrictions, a trust cannot qualify as a MIT if the foreign resident individual investor holds ownership interest in the trust of 10% or

more.[1] Should Treasury consider it appropriate to restrict foreign investment in certain agricultural MIT's, such 'closely held' restrictions may be updated to apply to foreign resident investors of all types rather than just targeting foreign resident natural persons.

RFF’s ownership analysis

Of RFF’s approximate 12,000 investors, 89% are domestic investors and 11% are foreign. Only recently have foreign investors taken a higher proportion of RFF’s register, which is a consequence of RFF’s growing market capitalisation and the increasing size of each new equity raising. A full breakdown of investors is contained in Figure 1.

Figure 1: RFF’s ownership interest[2]

Unitholders	Ownership (%)
RFM and directors of RFM	5
Retail – Australian	64
Institutional – Australian	20
Institutional – International	11

The international institutional component of RFF’s register comprises approximately 40 individual investors including a Japanese fund manager with a passive holding of 4%. Following the Treasury's recent announcements on the March 2018 Discussion Paper and the July 2018 Exposure Draft, these investors have provided feedback and duly raised their concern about the proposed amendments. We note that as RFF grows, foreign capital is becoming more important particularly when RFF does go to market to raise equity. The equity that has been raised has been invested in the acquisition and development of Australian agriculture assets which have provided value to RFF’s unitholders as well as providing investment in rural and regional Australia.

RFF’s foreign investors are passive investors that have no influence on the investment activities of RFF, nor any ability to drive up land prices. Our view is that our unique specific circumstances as a listed independent fund manager differs greatly from foreign investors that are making direct investments in land acquisitions, which is why we see RFM’s structure to be unintentionally caught up in the proposed changes.

Our understanding is that the MIT regime was initially set up to promote and enhance the competitiveness of the funds management industry in Australia by encouraging both domestic and foreign investment.[3] In addition, Australia has enacted other tax measures - including the Investment Manager Regime[4] and the proposed tranches relating to Corporate Collective Investment Vehicles[5] - each of which is consistent with the policy basis of enhancing the competitiveness and cohesiveness of the Australian managed funds industry and to further emphasise the Government's objective to secure Australia's position as a financial services centre.

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[1] Section 275-30(1)(c) of the *Income Tax Assessment Act 1997 (Cth).*
[2] Register analysis conducted 16 July 2018
[3] See Explanatory Memorandum to the *Income Tax (Managed Investment Trust Withholding Tax) Bill 2008*, at paragraphs 1.5 to 1.9; see also *Revised Explanatory Memorandum to the Tax Laws Amendment (2010 Measures No. 3) Bill 2010*, at paragraphs 5.1 to 5.15
[4] See Explanatory Memorandum to *Tax and Superannuation Laws Amendment (2015 Measures No 1) 2015*, at paragraphs 7.1 and 7.9
[5] See Explanatory materials to the First tranche of the *Treasury Laws Amendment (Corporate Collective Investment Vehicle) Bill 2018*, at paragraphs 1.1 to 1.9

The proposed changes to the MIT withholding tax rate for agricultural land would be discouraging investment in the funds management industry, as well as investment in Australian agriculture, one of Australia's key industries. An exemption applied to A-REITs investing in agriculture would be consistent with government policy objectives of maintaining an orderly investment regime for passive foreign investors across all property sectors.

The importance of attracting capital in Australian agriculture and RFM's role

RFF fulfils an important role in assisting the Australian agricultural industry to access capital. In an industry dominated by private family ownership, expansion of this important sector of the Australian economy has been held back by the absence of alternative sources of capital.

Due to their structure, private family businesses are not commonly prepared or able to access external equity investors to assist the expansion of their business. For this reason, the rate at which businesses can expand is limited to the rate of increase in equity from retained earnings. This component of profits – often simply the capital growth in their property – is then used to access additional debt, to fund either expansion or investments in productivity. This is often a slow process.

RFF has provided a new source of capital, largely domestic, for the expansion of farm businesses. Businesses are now able to lease assets from RFF, rather than acquire them. This enables farm businesses to reduce expansion capital requirements to a marginal increase in working capital. This capital structure has proven attractive to both private family businesses, and listed farming corporations seeking to expand their businesses without burdening their balance sheets with the lower returns typically generated from property assets. A capital structure that is common to all industries utilising office, retail or industrial property assets.

In practice, RFF has used its access to equity markets as an A-REIT, to fund over $800 million of Australian farms, all of which have been substantially transformed to increase productivity. RFF typically acquires unimproved land used for grazing livestock or annual crops, then outlays significant additional capital to enhance the asset to a higher and more productive use by tenants. A most recent example, is RFF acquired 'Kerarbury', a $20 million corn and cotton farm in NSW, and transformed it into Australia's largest almond orchard valued at $200 million once mature. This increase in capital value is the consequence of substantial capital expenditure and an accurate reflection of the economic growth in all aspects of this property.

RFF's investment in Kerarbury will create 60 additional full-time jobs on that property. Furthermore, it has catalysed the development of a substantial increase in almond plantings; the development of secondary processing; the formation of contract farming businesses; the construction of new housing in nearby towns and other consequential economic benefits that are consistent with the economic growth created by productive capital investment.

Where RFF's investments do not result in a change of land use, it has consistently invested in enhancing the productivity of assets by funding capital improvements. Recent examples include enhancing the carrying capacity and profitability of cattle properties, which again drives increased employment and other economic benefits.

RFF represents an alternative source of capital for Australian farm businesses that have historically been dependent on debt and retained earnings for their expansion. RFF's investments in land use enhancement and productivity gains have further enhanced the ability of farm businesses to generate

profits and create economic growth within Australia's agricultural industries, that is benefiting regional Australia and the wider economy.

Potential impact of the changes

By increasing the withholding tax rate for all foreign investors, including passive investors, it would severely limit RFF's growth opportunities. RFF has gone to market regularly over the past 4 years to raise equity to fund new Australian agricultural acquisitions and developments including almond orchards, cattle properties and cotton properties located across various Australian towns and communities. As part of these equity raises, we have noted certain limitations in domestic equity markets due to the size and appetite for these types of investment. As such, RFF has obtained offshore capital to contribute to the funding of these new ventures. The foreign investors that RFF seeks to attract are passive investors with no influence on the key decision making, including the types of investments or properties that RFF is looking to acquire. By increasing the withholding tax rate, this would limit RFF's ability to raise foreign capital, limit RFF's growth prospects, and RFF's ability to continue to compete and complete new agricultural acquisitions and development.

RFF formally has the S&P Global Industry Classification Standard (GICS) of A-REIT. Imposing a higher withholding tax rate specifically on A-REITs with agricultural assets will significantly impact RFF's ability to fairly compete with other non-agricultural A-REITs.

Our view is that the proposed changes being targeted at MIT agriculture land holders specifically will provide limitations on the funds management industry. The focus of the MIT regime has been to encourage both domestic and foreign investment, which in turn has promoted investment in Australian funds management and agriculture. We believe our structure has provided benefits to both the Australian funds management industry and Australian agriculture through a structure to invest passively in Australian agriculture assets.

Further elaboration of proposed solutions and important policy considerations

The proposed changes appear to have unintended impacts as discussed above. The following elaborates on some possible solutions that may assist in achieving a targeted outcome on the specific policy objectives.

Having an exemption for entities that are listed on the ASX would eliminate the opportunity for foreign entities to set up special purpose entities designed to achieve tax outcomes through the MIT regime. The ASX requirements for listing cover off many requirements including corporate governance that could limit structures being set merely to achieve tax outcomes. Availing tax concessions for listed entities would be consistent with existing tax policies, such as the availability of the concessionary ownership tracing rules for widely held entities in Division 166 of the *Income Tax Assessment Act 1997 (Cth)*.

We note the Bills propose to have a higher withholding tax rate for all foreign investors of agricultural MITs, regardless of the foreign investor's level of influence. To distinguish between indirect passive and direct investment, an ownership threshold could be used to capture an individual foreign investor's influence over the operational and acquisition decision making ability. For instance, a higher withholding tax rate could apply for individual foreign ownership interests that were to exceed a certain threshold, say 10%, which would still temper direct foreign investment, but also continue to encourage agricultural funds management. Our understanding is that standalone individual interests below 10% are generally passive in nature, with little or no influence in any investment decision making.

Using a 10% ownership threshold concept was also suggested as part of Elements C and D of the Integrity Package Paper (proposed changes to withholding tax exemptions applicable to foreign pension funds and tax exemptions for foreign sovereign investors), and would be consistent with the use of 10% ownership threshold concept in existing tax rules, such as the Investment Manager Regime, the foreign resident CGT exemption and the notional 10% rule as noted in paragraph 10b above.

Another alternative would be tightening the 'closely held' restrictions in the MIT requirements. Under the current MIT rules and the 'closely held' restrictions, a trust cannot qualify as a MIT if the foreign resident individual investor holds ownership interest in the trust of 10% or more.[6] Should Treasury consider it appropriate to restrict foreign investment in certain agricultural MIT's, such 'closely held' restrictions may be updated to reflect such policy, so as to apply to a single foreign resident investor of all types (rather than targeting foreign resident individual (i.e. natural persons) investors only) and so as to determining the appropriate threshold percentage of such foreign ownership in the purported agricultural MIT.

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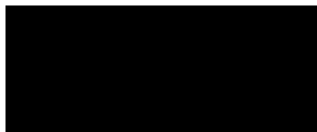
Again, we appreciate the opportunity to present RFM's views on the Bills and throughout the consultation process.

We would grateful, and respectfully request, that the matters in this submission to be further explored and discussed with the Economics Legislation Committee, in light of the Rural Funds Group's specific circumstances and the potential impact of the proposed measures.

We look forward to progressing these matters and discussions with the Economics Legislation Committee.

Kind regards,



David Bryant
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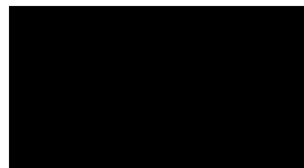

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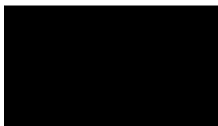

Daniel Yap
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[6] Section 275-30(1)(c) of the *Income Tax Assessment Act 1997 (Cth).*