Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

11 October 2018

Dear Committee

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

PricewaterhouseCoopers (**PwC**) welcomes the opportunity to make a submission to the Senate Economics Legislation Committee in relation to the Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 (**Bill**).

The intention of our submission is to highlight several key policy issues which we believe should be considered by the Committee as part of its inquiry and report. We would be happy to discuss any aspect of our submission points with you further.

PwC makes the following general submissions on the Bill.

Agriculture

The measures relating to agricultural land generally apply to tax income and capital gains that relate to Australian agricultural land at the non-concessional tax rate of 30%. Recognising that agricultural investments are often long term investments, the measures sensibly provide transitional arrangements which provide for the current statutory framework to continue to apply (for investments made before 27 March 2018) until 1 July 2026.

PwC's submission is limited to suggesting a narrow amendment to the arrangements relating to the taxation of capital gains on investments eligible for transitional relief (i.e. investments made before 27 March 2018). The nature of this amendment, and the basis for it, is described further below.

Broadly, the current provisions operate so that once the transitional arrangements cease on 30 June 2026, any capital gains on disposal of Australian agricultural land (direct or indirect) would be subject to tax at a rate of 30%.

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This creates a disconnect, and a potential structural distortion, whereby transactions which occur 1 day apart (e.g. 30 June 2026 versus 1 July 2026) could have a vastly different tax outcome (15% taxation v 30% taxation). The policy risk of this disconnect is that the market for Australian agricultural land will be distorted as investors are incentivised to realise gains before the 'fiscal cliff' created by the end of the transitional arrangements.

The potential consequences of this market distortion could include (but are not limited to):

- *Reduction in land values in the period up to 1 July 2026*: This could occur as institutional investors are incentivised to sell for tax reasons before 30 June 2026. This potential reduction in land values would impact not just the foreign investors directly affected, but also Australian farmers who rely on the efficient operation of markets for reasons including bank covenants (e.g. loan to value ratios) and inter-generational succession planning.

- *Deadweight costs to the economy:* The current transitional arrangements incentivise institutional investors to 'asset recycle' - that is, sell assets with unrealised gains and, in the best case, re-invest in Australian agricultural land to re-set the cost base of those assets - every example of asset recycling creates deadweight costs to the economy. That is, costs such as stamp duty and non-productive time spent on undertaking these transactions rather than managing Australian agriculture for sustainable growth.

- *Discouraging institutional investment*: Australian agriculture requires patient, long-term capital to allow it to sustainably grow and flourish as a world class industry. The 'fiscal cliff' at 30 June 2026 penalises institutional investors who are investing for the long-term (often in partnership with Australian farmers). It perversely rewards investors who buy and sell assets over the short term. Any policy that encourages, and rewards, long-term investment is good for the growth of the Australian agricultural industry.

Our recommendation to correct the issues outlined above, is simple, efficient and fair. In short we recommend modifying the transitional arrangements as they relate to capital gains in one of two ways.

Preferred amendment

The preferred modification would be to modify the provisions so that where a MIT continues to hold a transitional investment in agricultural land (directly or indirectly) and disposes of it after 30 June 2026, the capital gain should be taxed as follows:

- the accrued capital gain at the end of the transitional period (i.e. the unrealised appreciation up to 30 June 2026) would be taxed at 15%; and

- the capital gain on any accretion in value that occurs after 30 June 2026 would be subject to the non-concessional tax rate of 30%.

The gain would be taxed on disposal of the asset. The Government has previously adopted such a system with respect to the transition of pre-capital gains tax (**CGT**) assets into the CGT regime through Division 149 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) as well as other commencement day regimes. As a result, the legislative framework for such an implementation

mechanism already exists within the architecture of Australia's taxation laws. The administration of this proposal could be supported by only allowing a MIT to qualify for this rule if it obtains a contemporaneous third party valuation from a qualified valuer.

Alternative amendment

If the above alternative is not preferred (notwithstanding the strong policy justifications for it), we would recommend that, at the very least, institutional investors should be given the ability to elect to be taxed on any gains that have accrued up to 30 June 2026 at the concessional tax rate of 15%, with the consequence of "re-setting" the capital gains tax cost base of that asset.

The capital gain calculated under this election should be based on an independent market valuation conducted as at 30 June 2026 (to preserve the integrity of the measure).

Whilst this method would result in investors paying tax on unrealised gains (and therefore would still discourage long term investment), it should ameliorate the negative consequences of potential market distortions and deadweight costs of 'asset recycling'.

MIT Residential Housing Measures

Submission 1: The tax policy does not help address housing affordability and increasing housing supply in Australia

The inclusion of managed investment trust (**MIT**) residential housing income as non-concessional MIT income (i.e. to be taxed at the corporate tax rate) will create an additional barrier and disincentive for foreign institutional investors seeking to invest in large scale 'build to rent' residential real estate projects in Australia. Growth in this sector is needed to increase the availability of housing supply in Australia (particularly alternative forms of housing that do not require large deposits and bank loans). This approach is also out of step with State initiatives to address housing affordability and increasing housing supply.

As an example, we estimate that over the next 40 years, Greater Sydney will grow from having a population of 4.8 million to around 8 million people. This will create the need for around 725,000 new homes over the next 20 years. The "build to rent" sector will help to meet a portion of this demand over the forecast period. However, the 'build to rent' sector in Australia is in its infancy and foreign capital is needed to increase housing supply in Australia. Accordingly there are strong policy reasons to retain the MIT concessional rate on foreign capital flowing into these projects.

We are aware that:

- Foreign institutions are looking to invest into Australian "build to rent" projects, however the 30% tax rate has been flagged as a significant deterrent.
- Australian based fund managers and developers are struggling to attract foreign capital into 'build to rent' projects because of the inability to access the MIT regime.
- Shopping centres that are currently owned / co owned by foreign investors currently obtain access to the 15% MIT rate. Many of these have substantial potential for 'build to rent' additions through 'over site developments' in central locations and along existing transport infrastructure

networks (reducing cost for Governments). The enactment of the legislation as currently drafted will slow development of these assets.

- Foreign investors are alternatively looking to provide debt into various 'build to rent' projects rather than equity, shifting risk to the Australian investors, in particular Australian superannuation funds. It is not clear whether this is an intended outcome. Additionally, investments in debt (rather than equity or MIT entities) by foreign investors will attract a lower tax rate as Australia has a 10% interest withholding tax rate for foreign investors.

- Rental accommodation capital is currently provided in Australia by retail investors who hold a small number of properties and possibly only a single property. This class relies on negative gearing to support its investment practices and investment loan lending. We will continue to rely on this investment class if we do not eliminate barriers to wholesale investment.

Submission 2: Student accommodation should not be excluded from the MIT regime

The rationale for this policy change is unclear and was adopted as a late addition to the Bill, with little or no opportunity for consultation with stakeholders such as foreign pension and sovereign wealth fund investors or operators in this market. The rationale is also at odds with other policy initiatives of the Government, such as the desire to develop Australia's education export market by attracting foreign students. In this regard we note that the current tax settings are:

- assisting the growth in Australia's education exports, which is Australia’s 3rd largest export - 85% of the occupancy is international student;

- addressing the under-supply of special purpose student accommodation facilities in Australia (the ratio of beds to full time students in Australia ranges from 9-12%, but in the UK is ~33%, with Australia increasing the number of students annually); and

- facilitating the development of alternative buildings with a focus on communal space and service offering.

We also note that purpose built student accommodation is not a substitute or competing product that could impact mum and dad investors. This is because room sizes are typically ~18sqm in student accommodation products, the capital cost of construction is high (circa $50 - $200 million) and suited to institutional investment, and State planning laws mandate that the rooms must be occupied by students undertaking an approved education course.

The size of the "off campus" market is at least $5 billion (but could be higher) and approximately half of this is funded via equity. This part of the market is dominated by four (4) key players all of which are owned wholly or partly by foreign sovereign wealth funds, pension funds, insurance funds or private equity investors. The feedback to us has been that these investors are surprised by the proposed changes to MIT regime and taxation of their investments in this sector.

Sovereign immunity - potential drafting deficiency

It appears that 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.

This creates an unnecessary and significant risk on a fundamental question around the scope of the immunity for these investors who have a low risk appetite and are seeking certainty of outcomes under the regime.

Preferred amendment

A minor technical amendment to the Bill would put the issue beyond doubt and mitigate any market impacts resulting from the uncertainty.

We recommend inserting a clarifying provision at the end of section 880-105 that states "for the purposes of this Division, a return includes a gain made on disposal or otherwise on realisation of the asset"

Problem in more detail

The Sovereign Immunity provisions in the Bill provide a CGT exemption for gains made by qualifying foreign government investors on certain Australian 'membership interests', 'non-share equity interest' and 'debt interests'. The provisions also treats 'returns on' such interests as non-assessable.

It appears from the above that the intention is to exempt from Australian tax income from qualifying investments and gains made on realisation of those investments.

Notwithstanding this apparent intention, the drafting creates significant uncertainty for foreign government investors on the tax outcomes on gains made on disposing of or otherwise realising their investments where those gains are not taxed under the CGT provisions but would instead be taxed as revenue gains. This is because:

- there are specific tax deeming rules that treat gains on 'debt instruments' as being on revenue, rather than capital account; and
- for equity investments, the size and sophistication of these investors and the level of turnover in their investment portfolios is likely to mean those assets are revenue assets.

Given this, the CGT exemption may be somewhat redundant in many cases.

Notwithstanding this, it is possible that a revenue gain realised by the investor (say on a disposal) would be non-assessable if the gain is a 'return on' the investment. While such an interpretation may be possible, this could be inconsistent with the meaning of that phrase in other part of the existing tax law. For example, there is longstanding precedent under the debt / equity rules contained in Division 974 of the ITAA 1997 which specifically deals with 'returns on' debt and equity instruments, which

would suggest a 'return on' an instrument could be read narrowly to only cover distributions or payments (such as dividends, non-share dividends and interest payments) made by the issuer.

Sovereign immunity - treatment of contractual arrangements entered by foreign governments

Division 880 purports to operate as a code for the taxation of foreign governments, whereas in the past, immunity from taxation was provided to foreign governments as an administrative concession by the Australian Taxation Office (**ATO**) based on the doctrine of sovereign immunity.

The current Bill provides an immunity from Australian taxation for foreign governments from:

- income from consular activities; and
- income and gains from certain Australian investments.

While the Bill provides welcome certainty to foreign governments undertaking consular activities or making certain investments in Australia, it does not appear to specifically deal with a range of other transactions where the foreign government earns income from Australia as part of performing governmental functions.

To this end, it is not clear whether under Division 880, there is any scope for the ATO to continue to provide foreign governments with immunity from Australian taxation in other circumstances which are not contemplated by the new law but ultimately do not involve commercial activity by the foreign government.

This may arise for example, where there are payments made to foreign governments under contractual arrangements between an Australian entity and a foreign government. In cases where the activity is commercial in nature, it would be appropriate for Division 880 to tax those payments. However, where contractual arrangements relate to governmental function it is not appropriate for Australia to seek to tax the foreign government on that income.

While there may be many examples of such arrangements that arise, two simple examples of this could be:

- An Australian service provider provides a service to a foreign government (say, in the provision of defence equipment). Due to a negligence claim against the Australian service provider, the foreign government receives a compensation payment from the Australian service provider.
- Australia makes payments to a foreign government defence department for the purchase of defence equipment.

Preferred amendment

We recommend that the Commissioner of Taxation be provided with a discretion to grant sovereign immunity in circumstances where a foreign government earns contractual income provided that the income is earned as part of performing governmental function and the entity receiving the payment is a Covered Sovereign Entity as defined.

Inequity around requirements to access sovereign immunity

In order to access the sovereign entity transition provisions, amongst other requirements, the sovereign entity must satisfy all of the following requirements:

1. sovereign entity acquired the investment asset on or before 27 March 2018;

2. sovereign entity applied for a private ruling on or before 27 March 2018;

3. before 1 July 2026, the Commissioner gave the entity a private ruling confirming the income from the investment asset was not subject to tax.

There are cases where:

- A sovereign entity would have entered a contract to acquire an investment on or before 27 March 2018.

- The sovereign entity would have as part of the ATOs early engagement process, lodged a draft private binding ruling with the ATO on or before 27 March 2018. The early engagement process for private rulings with taxpayers is an approach which is often encouraged by the ATO and provides a more flexible framework for the ATO's provision of advice in comparison to the legislated private ruling process. In this regard, the ATO generally prefers the 'final' ruling to be lodged at a later date (which is often more than three to six months after the initial early engagement process) when it is in a position to finalise the ruling.

The ATO then grants sovereign immunity under their existing practice, after 27 March 2018, on submission of the final ruling application.

Two key issues arise in these types of scenarios:

- The legislation does not make clear when a sovereign investor is taken to have "acquired the asset". For some parts of the tax law (such as the CGT rules, which is generally the most relevant rules in these circumstances), the asset is taken to be acquired when an investor enters a contract to purchase the asset. However, in other areas, the asset may only be taken to be acquired when the contract for the acquisition of the asset settles.

- In addition, it is not clear whether early engagement with the ATO and the submission of a draft ruling request would satisfy requirement that a private ruling have been applied for on or before 27 March 2018, even though this is the preferred approach by the ATO.

We submit that investors in such a situation should satisfy the requirements to access the transition rules and that providing them with access to the transition rules would be in line with the policy intent.

Furthermore, it would be inequitable to deny these investors access to the transition because they had a sunk investment at the transition date and were undertaking steps in good faith with the ATO to obtain a private binding ruling (including, the lodgement of a draft ruling).

Proposed solution

We recommend including comments in the explanatory memorandum to the Bill that note:

- For the purposes of this Division, a sovereign investor would be taken to have acquired that asset at the same time it is taken to be acquired for CGT purposes.
- A sovereign entity would be taken to have applied for a private ruling if they have lodged a draft private binding ruling with the ATO or otherwise commenced an early engagement process with the ATO by lodging a written request to engage with the ATO for the purpose of obtaining a private binding ruling.

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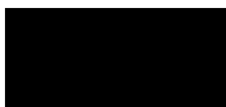
We trust that the above information will be of use to you in respect of the implementation of the policy reforms. We value and appreciate the opportunity for engaging with you in this process and would welcome the opportunity for further discussions with you to offer any further clarity in respect of the matters raised herein.

Yours sincerely



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