Chapter 3

Views on the bill

3.1 The final chapter of this report canvasses submitters' views on the proposed legislation. Stakeholders expressed concern that the meaning of a 'clean building' in proposed section 12-430 and the meaning of a 'clean building managed investment trust' in proposed section 12-425 of the *Taxation Administration Act 1953* are drafted too narrowly. Their concern is that eligible international investors will be restricted in the type of 'green buildings' for which that would be eligible for the 10 per cent final rate of withholding tax. These restrictions, they argue, would distort the investment incentives by allowing only certain investments in clean buildings to be eligible for the lower tax rate.

3.2 This chapter examines the evidence received by the committee on the following aspects of these proposed sections:

- the exclusion of retrofitted buildings from the definition of a 'clean building' in proposed paragraph 12-430(1)(a) of the Taxation Administration Act;
- how the commencement of construction of a clean building is defined in proposed subsection 12-430(2);
- the exclusion of building extensions and mixed purpose buildings in proposed subsection 12-430(3);
- the operation of the energy rating requirement in proposed subsection 12-430(4); and
- the incidental assets that eligible managed investment trusts (MITs) are entitled to hold in proposed subsections 12-425(1) and (2).

The exclusion of retrofitted buildings—proposed paragraph 12-430(1)(a)

3.3 The main area of stakeholder concern is the bill's exclusion of retrofitted buildings from the definition of a 'clean building'.[1] The EM states that existing buildings that are retrofitted or extended are not within the scope of the bill's provisions. It elaborates: 'a building which is substantially or significantly extended or retrofitted will not change its character from an existing building and are not clean buildings'.[2]

3.4 The Property Council claimed that the bill 'discourages' investment in green retrofit of existing buildings by only providing the incentive to entirely new

1 Proposed paragraph 12-430(1)(a) of the Taxation Administration Act

2 Explanatory Memorandum, paragraph 1.30.

constructions.[3] As a consequence, it argued that under the proposed legislation, owners will be encouraged to demolish existing structures and waste the building's embodied energy. The Property Council proposed that the bill should allow refurbishment and retrofit of existing structures to stop what it called 'perverse environmental outcomes'.[4]

3.5 The Green Building Council of Australia (GBCA) put the same argument.[5] In support of including retrofitted buildings within the proposed legislation, the GBCA noted:

- the demolition of existing buildings will result in the loss of embodied energy and the waste of materials and resources;
- the disincentive in the bill for retrofitting is at odds with the National Strategy on Energy Efficiency which emphasises upgrading buildings to improve energy efficiency;
- Green Star ratings can be attained for retrofitted buildings and there are many examples of energy-efficient refurbishments of heritage and existing buildings in Australia; and
- GST law recognises a substantially retrofitted building as new.[6]

3.6 The City of Melbourne argued in its submission that the bill's exclusion of retrofitted existing buildings 'has the potential to dis-incentivise improvements to existing building stock in favour of the construction of new buildings'. It drew the committee's attention to the programs that the City has currently in place to promote retrofitting of building stock. This includes the 1200 Buildings program which aims to retrofit two thirds of the City's commercial building stock over 10 years to improve energy performance.

3.7 The City of Melbourne proposed amending the bill to extend the 10 per cent withholding tax rate to existing buildings which undergo an energy efficiency upgrade after 30 June 2012. It proposed that the energy performance standard to which existing buildings would need to be upgraded should be different to that applied to new buildings. The City indicated that a relevant measure for existing buildings should:

- consider the base level of energy performance prior to retrofit, and the average level of energy performance typical of the given building type;
- be developed in consultation with industry and determined by regulation; and

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3 Property Council of Australia, *Submission 5*, p. 9.

4 Property Council of Australia, *Submission 5*, p. 9.

5 Green Building Council of Australia, *Submission 2*, p. 4; Green Building Council of Australia, *submission to Treasury*, 13 September 2012, p. 3.

6 Green Building Council of Australia, *Submission 2*, p. 4.

- be determined by regulation and subject to regular review to align with industry practice.[7]

3.8 The Sustainable Melbourne Fund (SMF) also critiqued the bill on the basis that it gives disincentives to invest in retrofitted buildings. It noted in its submission that the City of Melbourne is seeking to catalyse the environmental retrofit of 1200 non-residential buildings, representing 70 per cent of the commercial building stock within the municipality. To this end, environmental upgrade finance was introduced in 2011 to enable non-residential building owners to access capital to undertake environmental improvements. The SMF noted that it is the third party administrator of the environmental upgrade finance mechanism for the City of Melbourne's 1200 Buildings program.[8]

3.9 The SMF's submission detailed some of the potential cuts to energy costs and employment opportunities from the 1200 Buildings program. It noted that the combined opportunity of retrofit activity in the City of Melbourne, New South Wales and South Australia 'is estimated to be in the order of $4–$8 billion'.[9]

3.10 The SMF recommended amending the proposed definition of a clean building to include a building constructed prior to 1 July 2012 which has achieved an increased NABERS energy rating of 2.5 stars from the previous year.[10]

Commencing construction of a 'clean building'—proposed subsection 12-430(2)

3.11 The second issue of stakeholder concern is the matter of defining at what point the construction of a clean building is deemed to have commenced. As chapter 2 of this report noted, proposed subsection 12-430(2) of the Taxation Administration Act states that 'the construction of the building is taken to have commenced at the time the works on the lowest level (including any basement level) of the building commence'.

Comment on the draft bill

3.12 In its submission to Treasury's consultation on the provisions of the draft legislation, the Canada Pension Plan Investment Board (CPPIB) argued that the definition in the draft bill of 'newly constructed' in proposed section 12-430 of Schedule 1 to the Taxation Administration Act is too narrow. CPPIB, an investor in a number of Australian infrastructure and property projects, claimed that the clarification in paragraph 1.20 of the draft EM is 'likely to result in a number of anomalies that would preclude worthwhile "clean building" projects from qualifying'.

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7 City of Melbourne, *Submission 4*, p. 3.

8 Sustainable Melbourne Fund, *Submission 3*, p. 1.

9 Sustainable Melbourne Fund, *Submission 3*, p. 2.

10 Sustainable Melbourne Fund, *Submission 3*, p. 2.

This paragraph stated that the commencement of the construction of the foundation occurs when ground is broken for the purpose of excavating to establish the building's foundations.[11]

3.13 CPPIB gave the following examples of worthwhile projects that it claimed would be exempt from the provisions of the draft bill:

- newly constructed buildings that form part of ongoing or planned urban renewal projects;
- projects that are developed in stages and where some of the stages of the development occur entirely after 1 July 2012;
- otherwise eligible new buildings that are constructed after 1 July 2012 above existing structures;
- a newly constructed building that is constructed on a common basement built as part of a phased development of a precinct; and
- projects where only preparatory works were undertaken before being abandoned prior to 1 July 2012. If new owners were to commence to start construction of a new energy efficient building after 1 July 2012, the project would not qualify.

3.14 The CPPIB proposed in its submission to Treasury that paragraph 1.20 of the draft EM be removed and a section inserted into proposed section 12-430 of the Taxation Administration Act to state that construction of the foundations excludes all preparatory work to the site.

3.15 In its submission to Treasury, the GBCA also argued that the draft bill would disqualify a range of buildings that 'should reasonably be considered eligible'. It argued that if the policy intention is to create an incentive to invest in newly-constructed energy-efficient buildings, this intention would still be met where significant works have not yet been undertaken and projects meet other requirements.[12] The GBCA claimed:

> Using the date of practical completion, or of Green Star or NABERS Energy certification, is more likely to create an incentive to invest in newly-constructed energy-efficient buildings without creating an additional layer of bureaucracy connected to the date on which foundation work was started.[13]

11 Draft Explanatory Memorandum, paragraph 1.20.

12 Green Building Council of Australia, *Submission to Treasury*, 13 September 2012, p. 3.

13 Green Building Council of Australia, *Submission to Treasury*, 13 September 2012, p. 3.

The amendment to proposed subsection 12-430(2)

3.16 The committee highlights the fact that proposed section 12-430 of the Tax Administration Act has been amended following Treasury's consultation on the draft bill. Proposed subsections 12-430(1) and (2) now define a clean building as one where the construction occurred on or after 1 July 2012 and where construction 'is taken to have commenced at the time the works on the lowest level (including any basement level) of the building commence'.[14] Further, paragraph 1.27 of the current EM states:

> ...any works preparing the site for construction and works undertaken below the lowest level of the proposed building do not represent the commencement of construction for the purposes of this measure. This includes any excavation, environmental remediation or site stabilisation works.[15]

3.17 In its submission to this inquiry, the GBCA supported the provision that building will be taken to have commenced construction when the works on the lowest level begins. It noted that this will allow for previous site preparation and remedial works as well as instances where a new building is constructed on top of an existing structure such as a car parking facility, public infrastructure, building or previous foundations.[16]

Technical issues relating to 12-430(2)

3.18 Both the GBCA and the Property Council identified that the word 'not' was omitted from the EM relating to this issue of when construction of a building will be taken to have commenced.[17]

Recommendation 1

3.19 The committee recommends that paragraph 1.28 of the Explanatory Memorandum be amended to state:

> **Therefore, buildings such as those built on top of previous foundations or on top of shared car parking facilities will <u>not</u> be considered to have commenced construction until works on the lowest level of the building commences.**

3.20 The Property Council also recommended that the bill should specifically state that commencement of construction does not include 'any works preparing the site for construction and works undertaken below the lowest level of the proposed building'.

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14 Proposed subsection 12-430(2) of the *Taxation Administration Act 1953*

15 Explanatory Memorandum, paragraph 1.27.

16 Green Building Council of Australia, *Submission 2*, p. 3.

17 Green Building Council of Australia, *Submission 2*, p. 6; Property Council of Australia, *Submission 5*, p. 8.

While this is clear from the EM, the committee agrees with the Property Council that the bill should make explicit reference to 'preparing the site for construction'.

Recommendation 2

3.21 The committee recommends that the following sentence be added to proposed subsection 12-430(2) of the bill:

> **The commencement of construction does not include any works preparing the site for construction or works undertaken below the lowest level of the proposed building.**

Including extensions—proposed subsection 12-430(3)

3.22 However, the GBCA argued that the definition of a clean building does not go far enough. Specifically, it claimed that the definition should include major building extensions that can be demonstrated as being distinct from the original building, such as a new wing added to an existing facility, or major retrofits.[18] The Property Council also supported including extensions in proposed section 12-430.[19]

3.23 In this context, the GBCA drew the committee's attention to the Green Star rating system's eligibility criteria for both 'functionally autonomous' buildings and 'building extensions'. It listed seven criteria under the Green Star system by which a project can qualify for assessment as a building extension, and recommended that these requirements be included in the legislation.[20]

Restrictions on the types of eligible buildings—proposed subsection 12-430(3)

3.24 A related concern raised by stakeholders is the bill's definition of a 'clean building' in terms of an office building, a hotel or a shopping centre (proposed subsection 12-430(3)). The GBCA argued that limiting eligibility for the 10 per cent withholding tax to these buildings 'will mean that many significant investment opportunities will be lost'. It noted that many offices, hotels and shopping centres include a range of other facilities and mixed used that would mean they are ineligible.[21]

3.25 The GBCA recommended that the legislation be amended to include offices, hotels and shopping centres which can demonstrate that at least 80 per cent of their Gross Floor Area is comprised of the space type relevant for that use. It noted that the

18 Green Building Council of Australia, *Submission 2*, p. 3.

19 Property Council of Australia, *Submission 5*, p. 14.

20 Green Building Council of Australia, *Submission 2*, p. 4.

21 Green Building Council of Australia, *Submission 2*, p. 4.

Council would 'be pleased to work with Government' to assist in defining this threshold.[22]

3.26 However, the committee believes that the GBCA's concerns may be overstated. The EM states that in terms of an office building:

> ...incidental uses, such as a child care centre, limited retail and food outlets will not exclude the building from being an office building. In each case, whether or not a building is considered to be an office building is a question of fact. For example, a distribution centre that stores goods and has an office component is not an office building under ordinary concepts. This is regardless of whether the distribution centre is currently in use or not.[23]

3.27 The EM adds:

> To be eligible as a hotel, a building must wholly or mainly provide short-term accommodation for travellers. To be eligible as a shopping centre, a building must be predominantly used for retail purposes. However, a shopping centre would ordinarily include facilities such as cafes and restaurants. Such associated facilities would not preclude a building from being considered a shopping centre.[24]

3.28 The committee believes that these explanations are reasonable. It is appropriate that clean building MITs deriving assessable income from offices, hotels and shopping centres that incidentally include amenities such as community facilities and affordable housing are eligible for the 10 per cent withholding tax rate. The committee notes, however, that a threshold of the type proposed by the GBCA should be considered if, following the passage of the legislation, there is doubt or disagreement as to what constitutes an 'incidental' use of a building.

The energy rating requirement—proposed subsection 12-430(4)

3.29 The GBCA also commented on proposed subsection 12-430(4), relating to the requirement of a 5 Star Green Star rating or a 5.5 NABERS rating. It claimed that it is aware of 'many examples' of projects that initially had no commitment to achieve an energy rating, but had subsequently sought and achieved a rating as the project progressed. The GBCA thereby foresaw a situation under the bill where a building without the requisite energy rating would not qualify for the 10 per cent withholding tax if construction commenced prior to 1 July 2012, despite the project managers subsequently achieving a rating. The GBCA argued that, if amended, the bill could be a 'powerful incentive' for projects in their early stages to achieve better environmental outcomes.[25]

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22 Green Building Council of Australia, *Submission 2*, p. 4.

23 Explanatory Memorandum, p. 10.

24 Explanatory Memorandum, p. 10.

25 Green Building Council of Australia, *Submission 2*, p. 4.

Income from other (incidental) assets—proposed section 12-425

3.30 Another issue raised in submissions to both this inquiry and the Treasury consultation on the draft legislation relates to proposed section 12-425 of the *Taxation Administration Act 1953*, which defines a clean building MIT.

3.31 The draft bill did not contain a safe harbour for income incidental to a clean building. The GBCA argued in its submission to Treasury that the draft legislation would require investors to quarantine clean building investments in MITs from ineligible income streams. It noted that these streams might include advertising hoardings, communications towers, parking arrangements, affordable housing or other units, or childcare centres.[26]

3.32 The Property Council also identified problems with the draft legislation's definition of a clean building MIT and argued the case for the bill to include tracing provisions. It argued that the draft bill would disqualify clean buildings that earn incidental income and disqualify mixed used developments.[27]

3.33 The CPPIB argued in its submission to Treasury that the requirement that the concessional rate apply to MITs that only hold energy efficient buildings should be removed. It argued that the proposal unnecessarily restricts property funds from investing in a property portfolio that includes clean energy efficient buildings as well as other buildings.[28]

The amendment to the draft bill

3.34 The committee emphasises that the bill in its current form has been amended to allow for some incidental assets in the operation of a clean building MIT. Chapter 2 explained that the bill defines a clean building MIT as a trust that does not derive assessable income from any taxable Australian property (other than from the clean buildings or assets that are reasonably incidental to those buildings). The bill proposes a 5 per cent safe harbour 'for certain income reasonably incidental to a clean building'. A trust is not defined as a clean building MIT if the assessable income of the trust derived from assets that are reasonably incidental to clean buildings is greater than 5 per cent of total assessable income derived from clean buildings.

3.35 The GBCA supported this amendment, stating:

> ...supports the changes made to the Bill which now allows that clean building MIT fund payments may consist of income and capital gains from clean buildings and assets that are 'reasonably incidental' to those buildings. Assets that could be considered 'reasonably incidental' include car parking

26 Green Building Council of Australia, *Submission 2*, p. 2.

27 Property Council of Australia, *submission to Treasury*, p. 3.

28 Canada Pension Plan Investment Board, *Submission to Treasury*, 11 September 2012, p. 3.

facilities, telecommunications infrastructure attached to the building and advertising infrastructure.[29]

3.36 However, the Property Council argued that the 5 per cent limit on incidental income 'will unfairly penalise investors and is inconsistent with MIT rules under Division 6C of the Income Tax Assessment Act'. It noted that these rules allow trusts to effectively derive 25 per cent from a business reasonably incidental to the renting of land. The Council added that 'it is likely' that trusts complying with the MIT safe harbour will earn more than 5 per cent of income from a business reasonably incidental to a clean building.[30]

3.37 Both the GBCA and the Property Council noted that income and capital gains from any other land or building that do not meet the definition of a clean building cannot be included in a clean building MIT. Both argued that the government should consider a tracing provision to ensure that the correct taxation arrangements are applied only to eligible income streams within a MIT.[31]

Committee view

3.38 The committee strongly supports the provisions of this bill.[32] It meets two key public policy objectives, namely:

- ensuring that Australia remains an attractive destination for international investment; and
- promoting the development of an energy efficient commercial building sector in Australia.

3.39 The bill entwines these goals, promoting Australia as a place that provides foreign investors with a tax-based incentive to invest in energy efficient commercial buildings. The bill is an excellent example of the government's determination to achieve a competitive taxation framework with beneficial environmental outcomes.

3.40 The committee commends the government for listening to stakeholders' concerns and making sensible and appropriate changes to the draft legislation. It is appropriate that the legislation allows for some incidental assets in the operation of a clean building MIT, and excludes site preparation and works below the lowest level from the point at which building is considered to have commenced. In this context, the committee highlights the views of the Canada Pension Plan Investment Board

29 Green Building Council of Australia, *Submission 2*, p. 2.

30 Property Council of Australia, Submission 5, p. 5.

31 Green Building Council of Australia, *Submission 2*, p. 2; Property Council of Australia, *Submission 5*, p. 10.

32 The committee does draw attention to Recommendation 2 (above).

(CPPIB). The CPPIB, which recently decided to invest in the Barangaroo South Office development, stated in its submission to this inquiry:

> We believe this Bill will provide investors the certainty they need when making decisions to invest in new Clean Buildings. In particular, CPPIB welcomes changes in the Government's final Bill that:
>
> - provide further clarification of what constitutes a Clean Building, particularly to take account of new buildings located on reclaimed land or that form part of a wider urban renewal project;
> - allow Managed Investment Trusts (MITs) to derive non-qualifying income incidental to the Clean Building; and
> - allow a holding trust to hold investments in both Clean Building MITs and non-Clean Building MITs.[33]

3.41 The committee notes that the principal outstanding issue of concern relating to the bill is the apparent disincentive for investors to finance the retrofitting of established buildings. On this matter, the committee makes the following observations:

- first, the legislation would only be a disincentive in *relative* terms: a resident in an information exchange country who invests in new clean building MITs would be subject to a 10 per cent withholding tax; a resident in an information exchange country who invests in MITs that do not qualify under the legislation would be subject to a 15 per cent withholding tax. In other words, the bill is not an impost on foreign investors wanting to invest in MITs containing established buildings;
- second, and relatedly, since 2008 the overall level of withholding tax for an investor in an information exchange country has been reduced from 30 per cent to 15 per cent (see chapter 1);
- third, the government is aware that the vast majority of building stock is comprised of existing, older buildings, and already has in place programs to promote retrofitting and more efficient energy use in established buildings. The bill's focus on new buildings in no way harms the important contribution that retrofitting is making—and will continue to make—to achieving both environmental and commercial goals.

3.42 Finally, the committee believes that the 5 per cent safe harbour for certain income reasonably incidental to a clean building is appropriate. The threshold reflects the government's policy intent and should not be amended to align with the MIT threshold in Division 6C of the Income Tax Assessment Act.

33 Canada Pension Plan Investment Board, *Submission 6*, p. 1.

Recommendation 3

3.43 The committee recommends that the bill be passed.

Ms Deborah O'Neill MP

Chair