Chapter 3

Issues in relation to Schedules 1, 4, 8 and 10

Schedule 1—Distributions to entities connected with a private company

3.1 The committee did not take oral evidence on Schedule 1 of the bill. However, it notes support for the measures in this Schedule from the Taxation Institute of Australia. In a media release on 6 December 2006, the Vice-President of the Institute, Mr Peter Moltoni, welcomed the Government's decision to adopt 'our recommendation' to stop the automatic debiting of a private company's franking account when a deemed dividend arises. He claimed that the decision to repeal section 108 of the ITAA shows that the Government is 'serious about continuing real tax reform for small business'. Mr Moltoni also noted that giving the Commissioner of Taxation the discretion to disregard a deemed dividend 'will go a long way to restoring equity and the Government is to be commended'.[1]

Schedule 4—Taxation of superannuation death benefits to non-dependants

Submissions

3.2 Two submissions were received in relation to this schedule. The first, from the United Firefighters Union, argued that the benefit should be extended to the dependents of other workers who die on the job each year. The Union argued that this would include, but not necessarily be limited to, emergency services workers.

3.3 The second submission, from the Association of Superannuation Funds of Australia (ASFA), indicated that ASFA does not oppose the measure. ASFA, like the Firefighters, appears to be focussing on a wider group of workers. ASFA pointed out that under the recent simplified superannuation changes, there are differing rates of tax depending on whether a superannuation death benefit is paid to a dependant or a non-dependant, even when the deceased member is aged over 60. ASFA argued that there should be consistency of taxation for the benefits of deceased super fund members aged 60 and over.

3.4 Some committee members, while emphasising that they did not wish to denigrate in any way the risks faced by the defence forces and police, queried why these benefits were not being extended to other emergency services personnel. The

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1 Taxation Institute of Australia, 'A victory for commonsense on shareholder loans', *Media Release*, 6 December 2006, http://www.taxinstitute.com.au/go/media-releases/a-victory-for-commonsense-on-shareholder-loans (accessed 31 May 2007).

example of fire fighters sent to other countries to assist in fire emergencies was noted, and Treasury representatives were asked whether they had looked at the costs of extending the measure to other groups. Treasury representatives advised that they had not done so, because this is a policy issue.[2]

3.5 The committee did not explore the ASFA submission with Treasury representatives, but notes that the policy underlying the schedule is targeted at specific groups and does not have wider application. As such, it is not an appropriate vehicle for considering ASFA's argument.

Schedule 8—Forestry managed investment schemes

The plantation timber industry's position on the bill

3.6 The committee received a joint submission on Schedule 8 from the National Association of Forest Industries, Tree Plantations Australia, Treefarm Investment Managers Australia and the Australian Plantation Products and Paper Industry Council. These groups support the legislation, arguing that it resolves 'ten years of instability and uncertainty about the future ongoing taxation arrangements for retail forestry'.[3]

3.7 The joint submission argued that the forestry managed investment market is highly sensitive to policy change and investor confidence. In this context, it emphasised the importance of the bill in terms of removing:

- the sunset clause on the existing 12 month prepayment rule. This rule allows a plantation manager a maximum of 12 months to carry out 'seasonally dependant agronomic activities' for which the grower has paid and claimed the business tax deduction. Under the sunset clause, this rule was to terminate in July 2008;[4]
- the requirement to test whether investors are 'carrying on a business'; and
- the tax impediment in tax ruling TR 2000/8 to the secondary market trading of interests in forestry managed investment schemes.[5]

3.8 The submission also outlined some of the technical and timing issues that Treasury and ATO officials had to consider in developing the legislation. In particular, it noted the Government's 'surprise intention' to implement the legislation as of 1 July 2007 rather than at 30 June 2008, when the 12 month prepayment rule is due to expire. Under the transitional arrangements, the existing regime will continue to be available

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2 *Committee Hansard*, 1 June 2007, p. 27.

3 *Submission 7*, p. 1.

4 For a more detailed explanation of this rule, see Les Nielson and Peter Hicks, Tax Laws Amendment (2007 Measures No. 3) Bill 2007, *Bills Digest No. 159*, 2006–07, pp. 21–22.

5 *Submission 7*, p. 6.

past 1 July 2007 to enable industry and the ATO to 'bed down' the ATO's new guidelines and procedures. The submission described this decision as 'sensible and necessary'.[6]

3.9 The joint submission stated that the plantation timber industry's consistent position on the issue of the forestry managed investment scheme tax regime has been to remove the sunset clause and the impediment to secondary market trading. The industry proposed to government that a specific deduction be created under section 8-5 of the ITAA 1997; government proposed a '70 per cent test' in place of its initial proposal of a dollar value cap on first-year. The submission noted that this approach introduces additional compliance and record-keeping requirements for companies, taxpayers and the regulator. However, it concluded that:

> …the Bill that has resulted from Treasury's consultation process…strikes a workable balance of fulfilling the Government's diverse policy objectives…without imposing an administrative burden that the parties will find unacceptable in order to achieve these outcomes.[7]

Treasury's response

3.10 Mr Blair Comley, General Manager of the Business Tax Division in Treasury, told the committee that the 70 per cent figure:

> …was a policy decision made by government. It reflected a balance between the desire to have investment funds directed into the forestry industry and a concern about excessive fees, commissions and other things that were not flowing into forestry.[8]

Committee comment

3.11 The committee supports the amendments in Schedule 8 of the bill. They are consistent with government's strategic plans for the forestry industry as established in the 1997 strategy, *Plantations for Australia: the 2020 Vision*.

Schedule 10—Distributions to foreign residents from managed investment trusts

Submissions

3.12 Of the 11 submissions received by the committee, six commented on Schedule 10 and all made the same point: that to implement a withholding tax at the 30 per cent company tax rate will be a disincentive to foreign investors, notwithstanding the ability of the investor to claim various deductions. They contend

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6 *Submission 7*, p. 11.

7 Submission 7, p. 13.

8 Mr Blair Comley, *Committee Hansard*, 1 June 2007, p. 28.

that similar tax arrangements in other countries only attract a 15 per cent tax rate or less. The following is a typical comment:

> The Investment and Financial Services Association (IFSA) submits that Australia needs a withholding tax regime, which is both competitive and removes the need for complex administration… IFSA advocates the introduction of a flat and final withholding tax at the rate of 12.5 per cent.
>
> Our nearest neighbours, and competitors, have far more competitive rates of withholding: Japan has a withholding tax rate of 7 per cent on REITs (Real Estate Investment Trusts) (and 0 per cent for super funds), Singapore imposes 0 per cent for individuals and 10 per cent for other investors and Hong Kong has an effective rate of 15 per cent on REITs, as does the US.
>
> The proposed 30 per cent rate is not final and, in addition to the compliance burden for Australian fund managers, permits the investor to offset it with deductions. After these deductions, the same net Australian tax cost as a reduced flat rate could be produced.
>
> However, many non-resident investors in Australian funds are large institutions (eg pension funds), who are only concerned with obtaining the best return for their investors.
>
> They are interested in the headline rate, as well as minimising any compliance costs. If they need to lodge an Australian tax return, and obtain a refund, when they could simply invest in a jurisdiction like Hong Kong, they will – even if the rate is ultimately the same… Australian managed funds are concerned that, if the present system is not changed, it will be a major deterrent to offshore investment.[9]

3.13 IFSA also raised concerns about various aspects of administrations including the definitions of 'managed unit trust' and 'intermediary', as well as compliance costs and under distributions of funds.

Public hearing

3.14 Both the Property Council of Australia (PCA), and the Investment and Financial Services Association (IFSA) attended the 1 June 2007 hearing and reiterated their fundamental argument; namely, that a withholding tax levied at the company rate of 30 per cent was a disincentive to foreign investors regardless of the various deductions that may be claimed to offset it.

3.15 IFSA claimed that reducing the rate to 15 per cent or below would increase the industry's economic capacity and Australia's Gross Domestic Product. They also argued that increasing the attractiveness of Australian property trusts would attract

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9 Investment and Financial Services Association (IFSA), *Submission 6*, pp 5-6. For other similar comments, please see: the 16 May 2007 letter addressed to the Treasurer, Mr Peter Costello MP, by the Business Coalition for Tax Reform; Real Estate Institute of Australia, *Submission 2*; The GPT Group, *Submission 3*; Barclay's Global Investors, *Submission 4*; and Property Council of Australia, *Submission 5*.

capital inflows and assist in maintaining low domestic interest rates. Mr Richard Gilbert told the committee that:

> …the relevant point for domestic housing, residential, is that we need in this country as much capital as we can get in order to keep that interest differential down. If we do not get that right, rates could be affected upwards.[10]

3.16 The witnesses claimed that the 30 per cent 'headline' rate has a strong deterrent effect on potential investors into the Australian managed funds and property markets. This in turn would reduce the global competitiveness of Australian property trusts. Mr Robin Speed, Chairman of Speed and Stracey Lawyers, who has direct dealings with international investors, stated in response to a question for the committee that:

> The person on the other side of the phone cannot understand the 30 percent rate…. It has a dramatic chilling effect on any investment into Australia.[11]

3.17 Moreover, representatives from both organisations claimed that the administrative burden to lodge an Australian tax return in order to recoup part of their 30 per cent tax was likely to be a serious disincentive for investors. Overseas investors do not want the complication of doing this, and historically, very few of them do.

3.18 The IFSA and PCA representatives also argued that while a higher withholding tax rate had been a disincentive in the past, this was like to become worse in the future. Mr Trevor Cooke argued that the international funds market was dynamic, and that new entrants into the market such as Germany, China and possibly even India would make attracting foreign investment even more competitive.

> I think it is also important to recognise the changing nature of the investment landscape since 2003—in particular, sitting here in 2007 and looking forward to 2010. There is a worldwide structural oversupply of capital to meet the existing stock that is available for investment. There is a worldwide hunt for investment stock, and Australians have been at the forefront of that. But investors are being presented with a substantially increased choice, because other nations have embraced a weak regime—and I have mentioned the UK, Germany, Italy, Japan, Singapore, Hong Kong, Korea and others—while at the same time imposing lower tax rates on it. So, yes, the point is taken that foreign investors had limited choice, but they have increasingly had more choice. The other way of looking at it is that, since 2003, they have had more choice as to where they are going—and that will continue to be the case.[12]
>
> The point we are trying to make is that that landscape is rapidly evolving. Whether or not we are able to retain the competitive advantage that we have

10 Mr Richard Gilbert, *Committee Hansard*, 1 June 2007, p. 5.

11 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 7.

12 Mr Trevor Cooke, *Committee Hansard*, 1 June 2007, p. 9.

> built up over a period of time will in large part be driven by the taxation rate that applies to the investor. That is why withholding tax for foreign investors on Australian sourced income becomes an important component of that… our position will be substantially eroded and our ability to compete internationally will be eroded. The message that a headline rate of 30 per cent sends—the signal that it sends to an investor, irrespective of their ability to structure in—will dampen our competitiveness.[13]

Gearing of foreign investments in Australia

3.19 Mr Speed criticised the bill for legislating a headline withholding rate of tax rather than a final and flat withholding rate of tax. He told the committee that all other countries had opted for a final withholding tax of 15 per cent or less, with no scope for deductions.[14] Mr Speed told the committee that the effect of the high headline rate was that large foreign pension funds seeking to invest in Australia are deterred, given they most do not pay tax and that other countries have significantly lower withholding tax rates.

3.20 Mr Speed noted that, in theory, the large foreign pension funds are able to gear their investment at 75 per cent under Australia's thin capitalisation rules.[15] He added that 'rationally, you would expect them to gear'.[16] Mr Trevor Cooke, Executive Director of the Capital Markets Division of the Property Council of Australia told the committee that on the advice of the major investment houses in Australia, 'no one was not gearing'.[17] However, Mr Speed could not provide any indication of the extent to which foreign funds are currently gearing, and explained that this data would not be forthcoming for 'at least another three or four years'.[18]

3.21 However, the broader point emphasised by Mr Speed was that investors will not lodge an Australian tax return and claim deductions on the 30 per cent headline rate through gearing. He explained that 'whilst it may seem odd, the truth is that they [the foreign investors] do not want to do it [gear]. It is an administrative problem for them and they will not do it'.[19] Mr Richard Gilbert, Chief Executive Officer of the Investment and Financial Services Association, agreed that deductions on the 30 per cent headline rate are 'messy, complex and not attractive to overseas investors'.[20] These investors prefer to pay the final tax rate as they do in other countries. They are investing much larger sums in other countries where they do not have to structure their

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13 Mr Trevor Cooke, *Committee Hansard*, 1 June 2007, p. 14.

14 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 4.

15 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 4.

16 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 11.

17 Mr Trevor Cooke, *Committee Hansard*, 1 June 2007, p. 11.

18 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 11.

19 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 5.

20 Mr Richard Gilbert, *Committee Hansard*, 1 June 2007, p. 1.

affairs, and are therefore reluctant to gear the relatively small sums they might invest in the Australian real estate market.[21]

3.22 Mr Speed told the committee that there is therefore a legitimate debate about the extent to which companies are going to gear. In theory, through gearing, foreign companies investing in Australia can easily reduce their withholding tax rate to 12 per cent 'without being aggressive'.[22] However, industry representatives apparently dismiss the likelihood that companies will gear and contend that the combination of a high headline rate, no final flat rate in Australia, and perceived administrative difficulties with gearing is enough to cause potential foreign investors in Australia to look elsewhere.

IFSA's proposal

3.23 Submissions received prior to the public hearing proposed various rates, between 12.5 and 15 per cent. However, at the public hearing, the PCA and IFSA presented to the committee an alternative, compromise proposal that foreign investors in Australian funds receive the same tax treatment as Australian would receive when they invest in those overseas countries' funds.

> We believe it would uphold the Australian sense of balance and fairness—that is, it has parity, mutuality and reciprocity. The third point, which I think is critical, is that this is something which the board of tax suggested in its report.[23]

They recommended:

> …residents of a foreign country who are investors in Australian managed trusts will be reduced on a reciprocal basis to the same as that foreign country's tax treatment of Australian residents who invest in its managed investment funds.[24]

Treasury response to submissions and evidence

3.24 At the commencement of the public hearing, the Treasury representative reiterated the objectives of the amendments in this schedule, which were to simplify and strengthen the existing withholding tax arrangements:

> …the objective of this schedule is to simplify and streamline the existing withholding tax arrangements. It does replace multiple regimes and multiple rates with a more efficient collection mechanism regime and a

21 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 11.

22 Mr Robin Speed, *Committee Hansard*, 1 June 2007, p. 7.

23 Mr Richard Gilbert, *Committee Hansard*, 1 June 2007, p. 2.

24 Speed and Stracey Lawyers, 31 May 2007, tabled at public hearing, 1 June 2007.

> single rate. The object is one of simplifying and providing more certainty and reducing compliance costs.[25]

3.25 Treasury representatives pointed out that taxation is only one factor in influencing whether the Australian managed investment trust market is competitive internationally, and investors would look at a range of factors including the after tax rate of return and the strength of the economy, not just the tax rate:

> …it does not simply come down to tax. Looking at the reports from the retail investment trusts—the world reports that the accounting companies put out—in terms of rates of return, in Australia in 2006 the return was about 18.5 per cent. It was the third highest. As I recall, South Africa and New Zealand were relatively very small. Part of the attractiveness of investing in retail property trusts in Australia is the overall rate of return, the overall performance, the overall performance of the economy et cetera. Investors would take into account the after-tax rate of return, not simply the tax rate. That applies when looking at any type of international competitiveness. You are looking at a range of factors.[26]

3.26 Treasury representatives questioned the alleged deterrent effect of a 30 per cent withholding tax rate on foreign investment, noting that while there had been difficulties with collection, similar and higher rates (in the range 29 to 45 per cent), have been in place for some years, and during this period, inflows of foreign capital investment into Australian property trusts had been substantial. Mr Callaghan pointed out that '…in that assessment of how competitive the rate is you can look at the evidence that is occurring now'.[27]

3.27 Treasury representatives also questioned whether the 30 per cent rate is uncompetitive against international rates, stating that a number of other countries had rates that were similar, although rates may be lower where a double tax treaty is in place:

> Just commenting on the international comparisons, I think what has been quoted this morning is 15 per cent. Looking at different structures overseas, you are not always comparing like with like. We have different organisational structures, different regulatory structures. When we look at the withholding tax arrangements we find that in Canada there is a 25 per cent withholding tax on foreign distributions but it is reduced in double tax treaties, generally down to 15 per cent. In the United States there is a 30 per cent withholding tax on distributions from estate investment trusts but it is reduced to 15 per cent for portfolio investments under its double tax treaties; so they start off much higher. Similarly, in Korea there is a 27.5 per cent withholding tax but they reduce it down in their double tax treaties. Japan has a seven per cent rate but it is scheduled to increase to 15 per cent

25 Mr Mike Callaghan, *Committee Hansard*, p. 21.

26 Mr Mike Callaghan, *Committee Hansard*, p. 24.

27 Mr Mike Callaghan, *Committee Hansard*, p. 22.

> after 1 April 2008. It only applies to listed property trusts. For unlisted property trusts it is 20 per cent. In Singapore, listed REIT is subject to 10 per cent, but this is temporary; it is scheduled to return to 20 per cent on 18 February 2010. So I think we have to be careful of these international comparisons.[28]

3.28 The rate in Japan also varies in accordance with whether the property trust is listed or unlisted, and in some circumstances where investments are substantial, can be as high as 30 percent:

> On 1 April 2007 it was only a temporary seven per cent. It is going to 15 per cent on 1 April 2008. As I say, it only applies to listed property trusts. For unlisted trusts it is 20 per cent. Like all things, in the case of Japan if a foreign investor owns more than five per cent of a listed REIT then any capital gain is subject to Japanese tax at 30 per cent.[29]

3.29 Treasury also advised the committee that the withholding tax only applies to returns on Australian real property, a mature market, 70 per cent of which is already securitised. As a result of this market maturity, the focus of activity for Australian managed investment trusts is now overseas, and returns from investments overseas flowing through Australian managed investment trusts to foreign investors are not subject to the tax.[30]

3.30 Responding to questions from committee members about what the cost to revenue would be if the proposed withholding tax rate was reduced to 15 per cent, Treasury said that the cost would be $100 million, without allowance for gearing by investors.[31]

Committee comments

3.31 The main question for the committee in consideration of this schedule was whether the implementation of a headline withholding tax rate of 30 percent would adversely affect the global competitiveness of Australia's managed investment trust market, as has been argued in most of the submissions made to the committee's inquiry.

3.32 The committee notes the evidence from IFSA, the Property Council and others that other countries have lower rates. However, on the basis of evidence from Treasury representatives, it is not correct that similar headline rates do not exist elsewhere, even though these may be reduced substantially where double tax treaties are in place.

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28 Mr Mike Callaghan, *Committee Hansard*, p. 24.

29 Mr Mike Callaghan, *Committee Hansard*, p. 24.

30 Mr Mike Callaghan, *Committee Hansard*, p. 22.

31 Mr Mike Callaghan, *Committee Hansard*, p. 26.

3.33 The committee agrees with Treasury's assessment that headline rates of tax alone are not going to be the sole determinant of overseas investment decisions. Investors will undoubtedly be interested in the after tax rate of return, but they will also be concerned about economic stability and management, and Australia is widely acknowledged as being a safe place to invest.

3.34 It is also important to note that this tax does not apply to returns from investments overseas flowing through Australian managed investment trusts to foreign investors. It applies only to returns on Australian real property. As several witnesses noted, the Australian real property market is mature, and 70 per cent is already securitised. Treasury told the committee that the property trusts have indicated that it is difficult looking for expansion of real property in Australia.[32] Consequently, the focus of activity for Australian property trusts is now overseas.

3.35 While an investment trust that has a mixture of Australian real property and overseas assets may become exposed to some withholding tax even though most of its assets may be overseas, it is only liable for the tax for that proportion of the distribution from Australian real property assets.[33] There are also options available using the demerger provisions to allow overseas property investments to be split off from Australian real property investments and therefore not subject to the tax. LPTs can also establish new trusts to attract new investment and hold exclusively foreign assets. As such, the case is not well made that this change would make the Australian property trust market uncompetitive, even if the tax rate of 30 per cent was seen by some potential investors as a potential deterrent.

3.36 While the committee considers that on balance, the 30 per cent rate is unlikely to have the effects on market competitiveness that some have predicted, nonetheless, it does not lightly dismiss the concerns expressed by those who gave evidence in submissions and the hearing. The committee therefore suggests that the government carefully monitor developments in the industry following passage of the legislation.

3.37 The committee considers that the approach suggested by IFSA at the public hearing has some merit, (see paragraph 3.23) but believes that this should only be implemented through double tax treaties.

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32 Mr Mike Callaghan, *Committee Hansard*, p. 22.

33 See EM paragraph 11.23 in relation to excluded amounts.

Recommendation 1

3.38 The committee recommends that when negotiating double taxation treaties, the Government considers reciprocal withholding tax treatment for distributions to foreign residents from managed investment trusts.

Recommendation 2

3.39 The committee recommends that the bill be passed.

Senator the Hon. Michael Ronaldson
Chair