The Senate

Standing Committee on Economics

Tax Laws Amendment (2007 Measures No. 3) Bill 2007 [Provisions]

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Senate Standing Committee on Economics

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Chapter 1

Reference

1.1 On 10 May 2007, the Senate referred the provisions of the Tax Laws Amendment (2007 Measures No. 3) Bill 2007 to the Senate Standing Committee on Economics for report by 6 June 2007.

1.2 In accordance with the usual practice, the committee advertised the inquiry in *The Australian* on Wednesday 16 May 2007, calling for submissions by Monday, 21 May 2007. Details of the inquiry were placed on the committee's website. The committee also wrote to a number of organisations and stakeholder groups inviting written submissions.

1.3 Submissions were received from eleven organisations and individuals, as listed in Appendix 1. Notwithstanding the limited number of submissions and their high quality in identifying and discussing issues, it was also decided a hearing would be held on Friday 1 June 2007 as part of the inquiry.

Acknowledgments

1.4 The committee thanks all those who contributed to its inquiry by preparing written submissions. Their work has been of considerable value to the committee. The committee would particularly like to thank representatives of the Property Council of Australia, the Investment and Financial Services Organisation (IFSA) and officials of the Treasury for their cooperation and advice.

Background to the bill

1.5 The Bill is an omnibus bill which collates ten Schedules into one comprehensive package of changes.

1.6 The Bill makes necessary amendments to the following Acts:

- *Income Tax Assessment Act 1936*;
- *Income Tax Assessment Act 1997*;
- *Fringe Benefits Tax Assessment Act 1986*;
- *Income Tax (Transitional Provisions) Act 1997*; and
- *Taxation Administration Act 1953.*

Outline of the bill

1.7 The Bill will implement changes to Australia's taxation system in the following areas:

- distributions to entities connected with a private company and related issues;
- a non-concessional contributions cap during the simplified superannuation transitional period;
- assessment of capital gains of testamentary trusts;
- superannuation death benefits of certain defence personnel and police;
- extension of the transitional period relating to the application of accounting standards under the thin capitalisation rules;
- repeal of dividend tainting rules;
- interest withholding tax exemption;
- investments and disposal of interests in forestry managed investment schemes;
- Australian trust distributions to non-resident trustees; and
- new withholding arrangements for managed fund distributions to foreign residents.

Chapter 2

The bill

Schedule 1—Distributions to entities connected with a private company

Overview

2.1 Schedule 1 of the bill amends conditions relating to payments and loans to entities—shareholders or associates—connected with a private company under Division 7A of the *Income Tax Assessment Act 1936* (ITAA). As noted in the second reading speech, the schedule is intended to reduce the likelihood that taxpayers will inadvertently trigger a deemed dividend, reduce the punitive nature of the provisions and give the Commissioner of Taxation a discretion to disregard a deemed dividend triggered by honest mistakes:

> The amendments in this schedule reduce both the extent to which taxpayers can inadvertently trigger a deemed dividend under division 7A of the Income Tax Assessment Act 1936, and the punitive nature of the provisions. The amendments remove the automatic debiting of the company's franking account when a deemed dividend arises under division 7A.
>
> The amendments give the Commissioner of Taxation a discretion to disregard a deemed dividend that has arisen because of an honest mistake or omission by a taxpayer, providing greater flexibility to administration of the provisions. Further, certain shareholder loans will be able to be refinanced without triggering a deemed dividend, and division 7A compliant loans will be exempted from fringe benefits tax.[1]

2.2 The effect of the amendments is to reduce ongoing compliance costs and tax penalties for private companies.[2]

Removal of automatic debiting of a private company's franking account

2.3 Currently, where a deemed dividend arises under Division 7A of Part III of the ITAA 1936, the private company's franking account is debited and the shareholder

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1 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 1.

2 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 2.

pays tax on the deemed dividend at their marginal rate of tax.[3] The purpose of this Division is to prevent private companies from making tax-free distributions of profits to shareholders in the form of payment, loan or forgiven debt.[4]

2.4 The Explanatory Memorandum (EM) describes this current arrangement as a 'double penalty', debiting the private company and taxing the shareholder.[5] It notes that 'the tax impost resulting from a breach of Division 7A is considered to be out of proportion with the tax mischief involved'.[6] Accordingly, Schedule 1 of the bill will remove the automatic debiting of a private company's franking account. This means that shareholders and associates will be taxed only on the amounts received from the private company. These amounts will be included in their assessable income as unfranked dividends. This measure will be backdated to 1 July 2006.

2.5 Division 7A of the ITAA 1997 is a self-assessing provision. Prior to December 1997, the provision only applied when the Commissioner formed the opinion that the amount loaned, paid or credited represented a distribution of profits. After 4 December 1997, the provisions relating to the treatment of deemed dividends under Division 7A of the Act operated automatically through self-assessment. However, there have recently been concerns that this system is 'unduly punitive' and that its requirements for compliance are unclear. The EM explains that advice from the accounting profession and the ATO 'indicates that in practice the application of Division 7A is widely misunderstood by taxpayers resulting in inadvertent and frequent breaches of the provisions'.[7]

Section 109RD

2.6 To avoid inadvertent breaches of Division 7A, new Section 109RD provides discretion for the Commissioner of Taxation to disregard deemed dividends or allow them to be franked where they have been triggered by honest mistakes or omissions by taxpayers.[8] This discretion will apply to the 2001–02 income year and later income years. Further, the Commissioner will have discretion to disregard a deemed dividend where minimum yearly repayments have not been made on a private company loan because of circumstances beyond the control of the recipient of a loan.[9] The Commissioner can specify a later time by which these repayments must be made.[10]

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3 A franking account is an account into which taxation debits and credits are passed on to shareholders who have received franked (tax paid) dividends on their shareholdings.

4 EM, p. 38.

5 EM, p. 12.

6 EM, p. 38.

7 EM, p. 39.

8 EM, p. 12 and pp 21–29.

9 EM, p. 13.

10 EM, p. 30.

Amendments to conditions applying to shareholder loans

2.7 Schedule 1 of the bill makes five key changes to the treatment of loans made by a company to a shareholder under Section 7A of the ITAA (1936).

2.8 The first relates to the conversion of a private company's payment to a shareholder into a loan. Currently, paragraph 109D(3)(c) of the ITAA 1936 states that these payments cannot be treated as a loan unless there is an express or implied obligation to repay the amount to the private company. Where this obligation applies, the money must be repaid or put 'on a commercial footing' before the company's lodgement day for it not to be treated as a dividend.[11]

2.9 The bill allows a payment not already covered by paragraph 109D(3)(c) to be converted to a loan. The shareholder will have until the lodgement date for the company's tax return to either repay the loan in full or enter into a written loan agreement with the company. This can be done under the terms of Section 109N of the ITAA 1936, which requires minimum yearly repayments on the loan before the end of each financial year until the loan is repaid. This amendment will thereby prevent a deemed dividend arising.[12]

2.10 Second, the bill amends the treatment of loans paid from shareholders to private companies that fall short of minimum yearly repayments. Currently, where these repayments have not been met in an income year, the amount of the deemed dividend is the amount of the outstanding loan balance. The bill amends the amount of the deemed dividend to be the amount of the shortfall in the income year.[13]

2.11 Third, the bill enables private company loans to shareholders to be refinanced without resulting in a deemed dividend. Section 109N of the Act states the criteria for loans that do not attract a deemed dividend under Division 7A. Subsection 109R(2) provides that payments must not be taken into account—in the context of the repayments referred to in paragraph 2.8—if the shareholder intended to obtain the loan from the private company of an amount similar to or larger than the payment. The EM explains that this subsection prevents loans from being continually refinanced, thereby avoiding the operation of Division 7A.

2.12 The bill inserts subsection 109R(5) so that a loan can be refinanced without the attracting a deemed dividend under the provisions of subsection 109R(2). The context for this amendment is when a private company loan becomes subordinated to a loan from another entity, and the refinancing of the private company loan by the shareholder takes place because of that subordination.[14] The subordination must have arisen because of circumstances beyond the control of the shareholder.

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11 EM, p. 16.

12 EM, p. 17.

13 EM, pp. 17–18.

14 EM, p. 19.

2.13 The EM gives the example of a shareholder with a loan from the private company and a bank loan. The shareholder defaults on the bank loan and is required by the bank to make the private company loan subordinate to the bank loan. In other words, the shareholder must make the required payments on the bank loan before any repayments can be made on the loan from the private company. The shareholder can, under the provisions of the bill, refinance the loan with the private company to extend the term of the loan and reduce the yearly repayments.[15]

2.14 Fourth, the bill provides for the term of a loan to be extended in circumstances where an unsecured loan is converted to a loan secured by a mortgage over real property. Under Section 109N, the maximum term of this loan is 25 years less the period of the term already expired in the old loan. The EM provides the example of a private company that makes an unsecured seven year loan to one of its shareholders. The loan is refinanced after three years and a new loan is secured with the company by a mortgage over real property. The new loan is a maximum term of 22 years (25 less 3 years).[16]

2.15 Fifth, the bill amends Section 109UA of the Act to exempt guaranteed loans from attracting a deemed dividend where the shareholder enters into a loan agreement with the private company and that loan meets the requirements of section 109N. The EM provides the example of a bank that has made a loan to a shareholder of a private company. The company guarantees the loan but the shareholder defaults, meaning the company is liable to make a payment to the bank. This liability will cause a deemed dividend to arise unless the company and the shareholder enter into a loan agreement that meets the minimum interest rate and maximum term criteria in section 109N.[17]

Schedule 2—Transitional excess non-concessional contributions

The amendments

2.16 These amendments to the *Income Tax (Transitional Provisions) Act 1997* are designed to close a potential loophole that might result from the recently-legislated simplified superannuation arrangements.

2.17 Under that legislation, non-concessional superannuation contributions up to a limit of $1 million may be made to a superannuation fund by a member of the fund from 10 May 2006 to 1 July 2007, and receive concessional taxation treatment from 1 July 2007.

2.18 Superannuation contributions made by persons on behalf of other persons, but which are not government co-contributions or contributions made on behalf of a

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15 EM, p. 20.

16 EM, p. 20.

17 EM, p. 32.

spouse, employee or child, are not currently subject to the cap. These amendments would ensure that such contributions also would be subject to the cap.

2.19 The measure was announced by the Minister for Revenue and Assistant Treasurer on 24 April 2007. The Minister announced that the Government would act to address any avoidance activities undertaken with the date of effect of 7 December 2006.

Schedule 3—Capital gains of testamentary trusts

2.20 The provisions of Schedule 3 are summarised in the Explanatory Memorandum (EM) as follows:

> These amendments amend Subdivision 115-C of the ITAA 1997 to allow a trustee of a resident testamentary trust[18] to make a choice that has the effect that the trustee, rather that an income beneficiary, will be assessed on capital gains of the trust.

2.21 Under the current law, the taxation liability of an income beneficiary is assessed on the beneficiary's share of the testamentary trust's income which may include capital gains from which the beneficiary is not entitled to benefit.

2.22 The Schedule is intended to enable trustees of the trust to choose to be assessed on the capital gains of the trust, so that, if the choice is made, tax will in effect borne by the capital beneficiaries of the trust who will be assessed on capital gains of the trust.

2.23 In a detailed explanation the Government has provided several examples to illustrate how the proposed law would operate, under the following headings:

- Trusts for which a choice can be made;
- Circumstances in which a choice can be made;
- How choice is to be made; and
- Consequences if the trustee makes a choice.[19]

The EM provides information with regard to the period for making a choice and for amending an assessment to give effect to a choice.

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

2.24 Schedule 4, ‘Taxation of superannuation death benefits to non-dependants (eg: parents and siblings) of defence personnel and police killed in the line of duty’, will amend the *Income Tax Assessment Act 1997* (ITAA 1997). The amendments will

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18 A testamentary trust is a trust which is created through the grantor's will and does not become operational until the grantor's death.

19 EM, pp 58 – 65.

make superannuation death benefits paid to non-dependants of defence personnel and police tax free, in line with the concessional treatment that will be applied for dependants of these people from 1 July 1997 following the introduction of the Simplified Superannuation reforms.

2.25 The circumstances of 'killed in the line of duty' will be set out in regulations. There will be some excluded circumstances, such as suicide, which will over-ride included circumstances such as participation in an overseas deployment.

2.26 While the legislation will apply from 1 July 2007, the concessional treatment of benefits for non-dependents will be back-dated to 1 January 1999 through the use of ex-gratia payments, which are to be made on behalf of the Commonwealth by the Commissioner of Taxation. The cost of the amendments is $0.2 million per year.[20] It is not clear whether this costing also includes the cost of ex-gratia payments.

Schedule 5—Thin capitalisation

2.27 This is a very short schedule making one simple amendment to the ITAA 1997. The effect of the amendment will be to extend by one year a transitional period relating to the application of accounting standards under the thin capitalisation rules.

2.28 The thin capitalisation rules are designed to prevent foreign-owned entities from allocating excessive debt to their Australian operations. They do this by disallowing business expenses that would otherwise be legitimate business expenses if debt levels exceed certain thresholds.

2.29 On 1 January 2005, Australia introduced new accounting standards that are equivalent to International Financial Reporting Standards. These replaced the previous Australian Generally Accepted Accounting Standards. There are some differences between the two sets of standards, which have an effect on the thin capitalisation calculations of a number of entities.

2.30 Accordingly, the Government introduced a three-year transitional arrangement allowing entities to elect, on an annual basis, to use one or the other standard for the purposes of making calculations under the thin capitalisation rules. This arrangement is extended by one year as a result of the amendment in the schedule.

2.31 The second reading speech for the bill states that the extension will enable a 'thorough assessment' of the impact on the thin capitalisation rules of the change in accounting standards. It will also provide time to develop and consult on any changes to the rules that are considered appropriate.[21]

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20 EM, p. 6.

21 The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 1.

Schedule 6—Repeal of dividend tainting rules

2.32 According to the EM, this schedule will repeal the seven sections (46G to 46M) of the ITAA 1936 that deal with dividend tainting rules because the schemes that the rules were primarily directed at preventing can no longer be entered into.

2.33 There are also three consequential amendments proposed to the ITAA 1997. The proposed amendments will ensure that distributions from a share capital account continue to be unfrankable, and will also enable the Commissioner of Taxation, when considering whether to apply a general anti-avoidance rule relating to the imputation system, to take into account whether a distribution is sourced from unrealised or untaxed profits.

Schedule 7—Clarification of exemption from interest withholding tax

2.34 Schedule 7, 'The Clarification of exemption from interest withholding tax (IWT)', more closely specifies those debt interests that are eligible for exemption from Interest Withholding Tax (IWT).

2.35 The amendments proposed in Schedule 7 ensure this exemption remains consistent with the Government's original policy, which was to ensure that Australian business does not face a restrictively higher cost of capital, or constrained access to capital, as a result of the IWT burden being shifted from the non-resident lender to the Australian borrower.

Background

2.36 Legislative amendments in 2005 extended various exemptions in order to reflect the 2001 changes to Australia's debt/equity rules. This was to enable hybrid instruments now characterised as debt interests (under the debt/equity rules) as eligible for the exemption where they performed a capital raising function. However, the 2005 amendments unintentionally resulted in the exemption being potentially available to all debt interests. This represented a threat to the integrity of the tax system and was not consistent with the Government's original policy intent.

2.37 Schedule 2 of the Tax Laws Amendment (2006 Measures No. 7) Bill 2006 sought to introduce changes to the IWT. The bill was considered by this committee in February 2007. During that inquiry, four of the five submissions received by the committee expressed concerns about the amendments in Schedule 2, particularly with regard to the effect of the changes on the syndicated loan market.

2.38 Submitters were concerned that Schedule 2 reversed the pre-existing situation and would prejudice the ability of Australian firms to participate in the syndicated loan market. They contended that without the IWT exemption, Australian borrowers would be forced to pay more for the cost of capital as non-resident lenders would charge higher rates on loans to compensate for IWT. In its report of February 2007, the committee described the concerns expressed in submissions and evidence about syndicated loans and expressed the view that it would be desirable for the Government

to respond to concerns raised about this issue. Ultimately, Schedule 2 was removed from the bill when it came before the Senate in March 2007.

2.39 Schedule 7 of this bill will reintroduce the amendments which the Government believes now fully expresses the Government's initial intentions.

Definitions

What is Interest Withholding Tax?

2.40 IWT is a 10 per cent withholding tax on the gross amount of interest paid or credited from Australia to non-residents.[22]

> IWT was first imposed in 1968 to replace an assessment system of taxing interest payments to non-residents that was open to abuse. The view underlying the IWT system was that since IWT levied by Australia would generate a tax credit in the lender's home country, the burden of the tax would fall on foreign revenue collections. Unfortunately, the response of many foreign lenders was to increase interest margins on loans to Australia, shifting the burden of the tax to Australian borrowers. To avoid imposing higher capital costs on Australian business, limited exemptions from IWT were introduced in 1971 for certain types of offshore borrowing. The prime objective of the exemptions was, and has remained, to ensure Australian business does not face a higher cost of capital as a consequence of the imposition of IWT. The limitations also recognised that some forms of money raising have the potential to reduce the integrity of Australia's tax system and, consequently, the exemptions were targeted at arm's length arrangements.[23]

Further definitions

Debenture: is a long term debt instrument used by governments and large companies to obtain funds. A debenture is unsecured in the sense that there are no liens or pledges on specific assets. It is however, secured by all properties of the issuing company not otherwise pledged. In the case of bankruptcy, debenture holders are considered general creditors.[24]

Debt Interest: is defined by reference to Division 974 of the *Income Tax Assessment Act (ITAA) 1997*. It is a broad term that includes both financial

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22 Explanatory Memorandum (EM), p. 85. The taxation of interest paid or credited from Australia to non-residents, and residents operating through offshore permanent establishments, is dealt with in the IWT provisions contained in Division 11A of the *Income Tax Assessment Act 1936*. It provisions work in conjunction with the *Income Tax (Dividends, Interest and Royalties) Withholding Tax Act 1974*. The obligation for collecting the IWT is placed on the person making the payment (ie, the borrower). The provisions define 'interest' and stipulate when an amount of interest is subject to withholding tax.

23 EM, pp 81–82.

24 Bills Digest, p. 15.

instruments and financing arrangements, and embeds the concept of a non-contingent obligation to pay an amount to the holder of the debt interest, at least equal to its issue price, in the future. For the holder, this reflects receipt of a financial benefit, which need not amount to interest.[25]

Non-debenture debt: is a debt that is not secured by way of a debenture and would most likely be a debt secured by a charge over a specific asset of the issuing company.[26]

Non-equity shares: are shares in a company that are viewed as equity on a legal form assessment, but characterised as debt interests based on economic substance. As non-equity shares perform a similar capital raising function to debentures it is appropriate that they be eligible for IWT exemption, subject to satisfying the public offer test. An example of such an instrument may be a preference share issued by a company. Generally, preference share dividends, and capital returns (if any) are paid first before dividends paid in respect of ordinary shares.[27]

Syndicated loans: are loans or other form of financial accommodation where there are at least two lenders. They are close substitutes for debentures and are often used for large debt capital raisings as they are a means by which Australian borrowers can access offshore lending in order to benefit from greater liquidity in some of these markets.[28]

Syndicated loan facility: is a written agreement between one or more borrowers and at least two lenders and describes itself as a 'syndicated loan facility' or a 'syndicated facility agreement'. The agreement can accommodate one lender with the provision for the addition of other lenders.

Summary of the new law

2.41 Schedule 7 specifies that only non-debenture debt interests that are non-equity shares (including those subject to the related scheme rules in section 974-15 of the ITAA 1997), and syndicated loans will be eligible for IWT exemption, unless the non-debenture debt interest is prescribed as eligible for exemption by regulation.[29] The amendments clarifying the scope of the IWT exemption will apply only to interest paid in respect of debt interests issued on or after 7 December 2006.

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25 Senate Standing Committee on Economics, *Tax Laws Amendment (2006 Measures No. 7) Bill 2006*, February 2007.

26 Bills Digest, p. 15.

27 Bills Digest, p. 15.

28 EM, p. 83 & p. 89.

29 EM, p. 83.

2.42 Schedule 7 does differ in one significant effect to the IWT amendments that were introduced on 7 December 2006 in that the current amendments explicitly provide that debt interests that are syndicated loans are eligible for IWT exemption.[30]

Schedule 8—Forestry managed investment schemes

Background

2.43 Schedule 8 is the culmination of a review of the taxation of plantation forestry conducted by the Commonwealth Government since July 2005. In December 2006, the Assistant Treasurer and Minister for Revenue, the Hon. Peter Dutton MP, announced new arrangements for the taxation of investments in forestry managed investment schemes. The centrepiece of these plans was a separate statutory provision in the ITAA 1997 entitling investors in forestry managed investment schemes to immediate upfront tax deductibility for all expenditure. Mr Dutton explained that the proposed arrangements will provide greater certainty for investors, the continued expansion of Australia's plantation estate and reduced reliance on both native forests and overseas imports.[31] These are the key goals of the 1997 strategy, *Plantations for Australia: the 2020 Vision*.[32]

Schedule 8 Part 1—Investments in forestry managed investment schemes

2.44 The main provision of Schedule 8, Part 1 is to insert into Division 394 of the ITAA 1997 a tax deduction for initial and secondary investors in forestry schemes equal to 100 per cent of their contributions.[33] To be eligible for the deduction, however, there must be a 'reasonable expectation' at 30 June in the year in which an amount is first paid under the scheme, that at least 70 per cent of that expenditure is direct forestry expenditure (DFE).

2.45 The '70 per cent' rule is set out in section 394-35 of the ITAA 1997. The EM notes that a 'reasonable estimate' of 70 per cent DFE is:

> the amount of DFE under the scheme (the *sum* of the net present values of all DFE under the scheme) *divided* by the amount of payments under the scheme (the *sum* of the net present values of all amounts that participants in the scheme have paid or will pay) must be greater than or equal to 70 per cent.

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30 EM, p. 96.

31 The Hon Peter Dutton MP and Senator the Hon. Eric Abetz, 'Review of the Taxation of Plantation Forestry', *Joint Media Release*, 21 December 2006. The Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, *House of Representatives Hansard*, 10 May 2007, p. 3.

32 *Plantations 2020*, http://www.plantations2020.com.au/vision/ (accessed 24 May 2007).

33 A secondary investor is an investor who acquires an interest in a forestry scheme through secondary market trading (ie: trading in intangible assets—such as securities—after their initial issue and purchase).

2.46 Sections 394-10 and 394-15 of the ITAA 1997 establish the requirements for these deductions. The investor must be in a scheme whose purpose is establishing and felling trees in Australia, and must not have day-today control over the operation of a scheme. In addition, the trees must have all been established within 18 months of the end of the income year in which the first payment is made by the investor.[34] This provision extends the current 12 month prepayment rule.

2.47 The bill is a deliberate measure to encourage investment in forestry schemes in Australia through the tax system. The ITAA 1997 currently denies initial investors in forestry schemes from claiming tax deductions, as it excludes expenses that are capital in nature. Further, secondary investors do not receive deductions for their ongoing costs.[35] The new rules proposed in the bill waive the current requirement for taxpayers to demonstrate that they are 'carrying on a business' in order to access the deduction. Nor is there any requirement that the amount paid is revenue in nature.[36]

Schedule 8 Part 2—Disposals of interests in forestry managed investment schemes

2.48 There is currently uncertainty as to the deductibility of investors' contributions to forestry schemes. This uncertainty extends to whether an investor that disposes of their interest in the scheme prior to harvest had the intention of carrying on a business until harvest. This intention is required to qualify for some deductions. In practice, this is most likely to apply to cases of hardship. Where interests are disposed of due to hardship, there is also uncertainty as to how an acquiring investor's acquisition costs and proceeds are treated.

2.49 The Government has decided through these amendments to provide certainty to investors and industry by providing a specific deduction for investments in forestry managed investment schemes. As investors are no longer required to have an intention to hold the interests until harvest under the specific deduction, this change facilitates secondary market trading of those interests.

2.50 The existence of secondary markets, which the Government supports, should increase the financial transparency of forestry scheme investments by introducing pricing information into the market and increasing liquidity. This should increase the relative attractiveness of forestry investments.[37]

2.51 Schedule 8, Part 2 of the bill clarifies the tax treatment for sale and harvest proceeds that are received by secondary investors in forestry managed investment schemes and payments made by secondary investors in relation to forestry schemes. They provide for the deductibility of ongoing contributions made by a secondary investor to a forestry scheme and clarify the income tax treatment of sale or harvest

34 EM, p. 100.

35 EM, p. 102.

36 EM, p. 103.

37 EM, pp 127–128.

proceeds. These amendments are introduced together with a specific deduction provision for investors in forestry schemes.

2.52 Schedule 8, Part 2 introduces amendments that ensure that secondary investors can obtain deductions for ongoing contributions to forestry scheme arrangements under the new deduction provision. However, secondary investors cannot obtain a deduction for their acquisition costs under this provision. This ensures that sale or harvest proceeds received by a secondary investor are assessable income to the extent the proceeds match deductions obtained by the investor under the new deduction provision. Where secondary investors hold the interests on revenue account as trading stock, the balance of the proceeds will be assessable income. Where secondary investors hold the interests on capital account, the proceeds will be subject to a modified capital gains tax (CGT) assessment.

2.53 Proceeds received by initial investors will be treated on revenue account. In order to limit tax arbitrage that may arise from the different treatments and differences in tax rates between investors, Schedule 8 introduces a pricing rule and a four-year holding period rule which restricts initial investors from selling before four years.

2.54 Furthermore, arrangements intended to exploit any opportunities for arbitrage, for instance, through transfers to tax-preferred entities, such as self-managed superannuation funds, just before receipt of harvest proceeds, may be subject to anti-avoidance legislation as part of the ITAA 1936.[38]

2.55 The EM states that the proposed measures in Schedule 8 will add $61 million to government revenue in 2008–09, $103 million in 2009–10. In 2010–11, however, the EM lists an estimated revenue loss of $222 million.[39]

Schedule 9—Non-resident trustee beneficiaries

Introduction

2.56 Schedule 9 outlines amendments to ensure that a trustee can be taxed on net income of the trust in relation to a non-resident trustee beneficiary similar to the treatment of non-resident company and individual beneficiaries. This treatment is, in effect, similar to a withholding system because the beneficiary is still assessed on these amounts but can reduce their tax liability by the tax paid by the trustee.

2.57 These amendments ensure a trustee is liable to pay tax in relation to a non-resident trustee beneficiary in a similar way to that a trustee is currently liable to pay tax in relation to a non-resident company or individual beneficiary. [40]

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38 EM, p. 128.

39 Les Nielson and Peter Hicks, Tax Laws Amendment (2007 Measures No. 3) Bill 2007, *Bills Digest No. 159*, 2006–07, p. 27.

40 Explanatory Memorandum (EM), p. 147.

Background

2.58 Under the current law, a trustee is liable to pay tax on a beneficiary's share of the net income of the trust if the beneficiary is a non-resident company or individual at the end of the income year. However, a trustee is not currently liable to pay tax if the beneficiary is a non-resident trustee of another trust. This means the taxation of trustees in relation to non-resident beneficiaries is inconsistent. Further, although a non-resident trustee is liable to pay Australian tax under the current rules in relation to non-resident company or individual beneficiaries, collecting the tax is difficult.[41]

Summary of the new law

2.59 Schedule 9 introduces amendments that extend a trustee's liability to be taxed on the net income of a trust to include the case where a trustee beneficiary who is a non-resident at the end of an income year is presently entitled to trust income. The trustee is to pay tax on that beneficiary's share of the net income of the trust attributable to an Australian source. It is not clear whether the non-resident trustee beneficiary must themselves reside away from Australia.[42]

2.60 The broadening of the taxation of trustees does not apply to Australian managed investment trusts covered by the separate measure in Schedule 10. Similarly, it does not apply to Australian intermediaries covered by Schedule 10 to the extent their income is managed investment trust income.[43]

2.61 Transitional provisions implement the exclusion for Australian managed investment trusts and intermediaries from this schedule until the amendments in Schedule 10 apply. Specific provisions in that schedule will ensure the exclusion applies for later periods.[44]

Schedule 10—Distributions to foreign residents from managed investment trusts

Introduction

2.62 Schedule 10 to this bill is intended to implement a new withholding regime for distributions to foreign residents of net income of managed investment trusts attributable to Australian sources.

2.63 These amendments require trustees of managed investment trusts that make certain payments directly to foreign residents, to withhold from these payments tax at the company tax rate (30 per cent). Payments made from managed investment trusts

41 EM, p. 147.

42 Bills Digest, p. 29.

43 As discussed in Briefing Paper 10.

44 EM, p. 148.

indirectly through one or more Australian intermediaries are also subject to the withholding regime. In this situation, the Australian intermediary making the payment to the foreign resident will withhold at the company tax rate. Income consisting of dividends, interest or royalty income is generally excluded from this measure, as are capital gains on assets other than taxable Australian property.[45]

Background

2.64 Under the proposed law outlined in Schedule 9, a trustee presently entitled to income of a managed investment trust would be liable to pay tax on a beneficiary's share of the net income if they are a foreign resident at the end of the income year. The rate at which tax is payable depends on whether the foreign resident is a company, individual or trustee. This means that trustees of Australian managed investment trusts need to be cognisant of whether the foreign resident beneficiary is a company, individual or a trustee of a trust to determine the correct amount of tax payable.

2.65 Most distributions made from Australian managed investment trusts to foreign residents are made through one or more Australian intermediaries. The varying terms and conditions of the arrangement under which the intermediary provides its services, and the nature of the legal relationship between Australian intermediaries, managed investment trusts and foreign resident investors, can result in uncertainty about taxation obligations. This uncertainty may relate to both the requirement to pay tax and the rate of tax payable.

2.66 Schedule 10's amendments will simplify the existing tax collection mechanisms and avoid the complexities and uncertainties that could otherwise occur. They will do this by requiring withholding at a single rate for affected payments by managed investment trusts and intermediaries to foreign resident investors, regardless of the identity of the foreign resident or the relationship between the foreign resident investor and the intermediary.[46]

Definitions

2.67 To assist in understanding this brief and the EM, the following definitions are provided.

> **Managed investment trust**: for an income year, three requirements must be satisfied at the time of the making of the first fund payment:
>
> - the trust has a relevant connection with Australia;
> - the trust satisfies certain *Corporations Act 2001* requirements pertaining to the management of investments; and

45 EM, pp. 169–170.

46 EM, pp. 169–170.

- the trust is either listed or is widely held.[47]

Intermediary: To qualify as an 'intermediary' in respect of a payment, three requirements must be satisfied at the time of receipt of that payment:

- the entity has a relevant connection with Australia;
- the entity satisfies certain *Corporations Act 2001* requirements pertaining to the conduct of an intermediary business; and
- the entity must have received a notice relating to the payment.[48]

Summary of the new law

2.68 Schedule 10 introduces amendments that are intended to improve the efficiency of the managed funds industry in respect of the collection of tax from distributions to foreign residents.[49]

2.69 Payments covered by this measure are, broadly speaking, payments of income of a managed investment trust to the extent they form part of the net income of the trust, excluding dividends, interest, royalties, foreign source income and capital gains on assets that are not taxable Australian property. Dividends, interest and royalty payments are generally excluded because they are already ordinarily subject to their own withholding tax arrangements in the *Income Tax Assessment Act 1936*. Foreign source income and capital gains on assets that are not taxable Australian property are excluded because these are generally not taxable in the hands of foreign residents.[50]

2.70 The ultimate beneficiary is taxed on the relevant portion of their share of net income which is reasonably attributable to an amount that is subject to withholding. An appropriate portion of the amount withheld is available to the ultimate beneficiary as a credit.[51]

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47 EM, p. 172.

48 EM, p. 184.

49 EM, p. 193.

50 EM, p. 170.

51 EM, p. 170.

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

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

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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

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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

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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

Labor and Democrat Senators' Dissenting Report

Introduction

4.1 The Government Senators' report on the Tax Laws Amendment (2007 Measures No. 3) Bill 2007 recommended that:

- when negotiating double taxation treaties, the Government considers reciprocal withholding tax treatment for distributions to foreign residents from managed investment trusts; and
- the bill be passed.

4.2 Labor Senators and the Democrats' Senator can not fully support either of these recommendations. Recommendation 1 is a fall-back position that will be very slow to implement. It is not a practical solution in a fast moving capital market. It is better that a decision be made now. With regard to Recommendation 2, the bill has 10 schedules, of which 9 are supported, but the effect of passing schedule 10 of the bill unamended would be to impose a withholding tax rate of 30 per cent.

4.3 The committee's evidence from written submissions and the public hearing supports the Australian Labor Party's (ALP) policy of having a flat and final withholding tax rather than a deductible headline nominal rate, and the rate for the withholding tax being 15 per cent. The ALP believes that imposing a withholding tax of 30 per cent would act as a disincentive to foreign investment in Australian managed funds and Australian property trusts.

The Government's 30 per cent withholding tax is uncompetitive

Funds industry disagreement with the Government's proposals

4.4 The majority report noted that most of the submissions received by the committee related to Schedule 10 of the bill. All of these submissions argued that the 30 per cent 'headline' rate of taxation is a disincentive for foreign investors and recommended a flat and final rate of 15 per cent or less. They argued that this rate was consistent with Australia's main competitors for foreign investment such as Hong Kong, Singapore and Japan.[1]

4.5 In evidence to the committee, the Property Council of Australia (PCA) and the Investment and Financial Services Association (IFSA) both argued that the 30 per cent rate was a disincentive to foreign investors regardless of the various deductions

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1 See Investment and Financial Services Association (IFSA), Submission 6, pp 5-6; 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*; MLC Limited, *Submission 11*; and Property Council of Australia, *Submission 5*.

that may be claimed to offset it. The Property Council of Australia's submission to the inquiry stated:

> If passed, this legislation will raise significant barriers to Australia's competitiveness as a manager of global funds. It will also be harder to build on our strengths as a regional financial hub.[2]

4.6 Mr Trevor Cooke, Executive Director, International and Capital Markets Division, Property Council of Australia noted:

> All of our competitors have a flat and final withholding tax rate, and all of them are at 15 per cent or lower. There is no doubt that globally there is downward pressure on these withholding rates as countries enter into double tax agreements designed to increase capital flows.
>
> It is our strong view that, unless the Australian government moves to reduce the withholding tax rate, to streamline it and make it more efficient by making it a final rate, the success of this sector will be in jeopardy. For that reason we support a 15 per cent final withholding tax.[3]

4.7 Similarly, Mr Robin Speed, Director, Speed and Stracey Lawyers commented:

> The issue is what the rate of tax is that should be collected and whether it should be a final tax. All other countries in the world have not taken that approach… We have seen that foreign investors—whether it is a Dutch pension fund or a UK pension fund say to us: what is the tax rate you have in Australia? We say, 'The rate is 30 per cent.' They are obviously amazed by that because it is so out of kilter...[4]

Gearing an administrative disincentive

4.8 Labor Senators and the Democrats' Senator acknowledge that foreign investors have the option of lodging an Australian tax return and gearing their investment to lower the 30 per cent headline rate of withholding tax. In practice, however, the need to gear is a disincentive for foreign investors to invest in the Australian market. Mr Robin Speed explained:

> So, as soon as you say, 'You're going to be hit with a 30 per cent withholding tax,' they say, 'Gee, that's a major problem for us. If it was 10 per cent, like Singapore, we can live with it, but we can't live with 30 per cent.'…. As soon as they are faced with a 30 per cent withholding tax, they will not lodge an Australian tax return. You just do not do that… The great bulk of people out there simply do not do that and simply tune out.[5]

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2 Property Council of Australia, *Submission 5*, p 1.

3 Mr Trevor Cooke, *Committee Hansard*, 1 June 2007, p. 3.

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

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

4.9 Mr Richard Gilbert, Chief Executive Officer of the Investment and Financial Services Organisation, agreed that deductions on the 30 per cent headline rate are 'messy, complex and not attractive to overseas investors'.[6] 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 affairs, and are therefore reluctant to gear the relatively small sums they might invest in the Australian real estate market.[7]

4.10 Industry representatives all argued that the combination of a high headline rate, the absence of a final rate, and perceived administrative difficulties with gearing is enough to cause potential foreign investors in Australia to look elsewhere.

The Government's costing of reducing the rate to 15 per cent is inaccurate

4.11 Labor Senators and the Democrats' Senator do not believe that the cost of reducing the rate to 15 per cent estimated by Treasury is accurate. No credibility can be attached to the $100 million cost Treasury estimated as it does not assume any gearing and Treasury does not appear to know how much is currently raised through withholding tax collections from non-residents.

4.12 Treasury admitted that they do not assume any gearing in their costing which, in the Labor and Democrats' Senators' view, inaccurately results in an overestimation of the cost of reducing the withholding rate to a flat and final rate of 15 per cent.

4.13 Mr Mike Callaghan of Revenue Group in Treasury said in relation to the $100 million cost:

> The key assumption is one of gearing. In that estimate there is no allowance for gearing.[8]
>
> The reason for that is that we estimate it on the evidence we have in front of us. As was discussed this morning, if a foreign investor gears, if they want to claim the interest deduction they would have to lodge an Australian tax return. Very few foreign investors lodge an Australian tax return.[9]

4.14 This confirms that investors do not wish to engage with the complexity and compliance cost of claiming deductions and putting in tax returns. It is also in stark contrast with industry claims. Mr Cooke of the Property Council of Australia stated that:

> …having spoken to all the major investment banks who are advising the institutions coming in and also the law firms, as far as that goes, none of

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

7 Mr Robin Speed, *Committee Hansard*, 1 June 2007, pp 11 – 12

8 Mr Mike Callaghan, *Committee Hansard*, 1 June 2007, p. 22.

9 Mr Mike Callaghan, *Committee Hansard*, 1 June 2007, p. 22.

> them were not gearing. All of them were using some level of gearing—all of them.[10]

4.15 Further, when questioned on the amount of withholding tax from non-residents collected by the Government used in the costings, Mike Callaghan stated that the information:

> It is not published—a detailed breakdown.[11]

4.16 The Property Council of Australia's submission stated that:

> The Government's **approach is based on inaccurate Treasury costings**. Treasury says an internationally competitive withholding tax rate will cost more than $100 million a year, while industry says it will not impact on current revenues and could **increase tax income** over the medium term.[12]

4.17 This evidence leads Labor Senators and the Democrats' Senator to believe that very little weight can be put on Treasury's costings.

Labor's alternative

4.18 The ALP proposes to halve the 30 per cent withholding tax on distributions from Australian managed funds to non-resident investors. This proposed 15 per cent rate is at the upper end of relevant international rates. It will place Australian fund managers in a much better position to be able to compete to manage the global pool of managed funds, which is tipped to reach $60 trillion over the next three years.

4.19 Funds under management in Asia are expected to grow by 14 per cent per year over the medium to long term. Australia is well placed to capitalise on this growth, but only if Australia lifts the competitive impediments to our funds management industry.

4.20 Australia's fund management industry is well regarded across the globe and is well placed geographically to become the financial hub for the Asia-Pacific region. A 30 per cent withholding rate could hamper the potential growth of our funds industry which is irresponsible as more funds under management in Australia mean more export dollars. The Government's uncompetitive withholding tax regime is one of the key obstacles that will be lifted under Labor's policy.

4.21 Given the complexity and compliance costs of the Government's proposed tax regime would impose, Labor will also abolish the need for overseas investors paying withholding tax to lodge a tax return and claim debt as a deduction by making the flat rate a final rate. This flat and final tax rate will remove a significant burden that has

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10 Mr Trevor Cook, *Committee Hansard*, 1 June 2007, p. 11.

11 Mr Mike Callaghan, *Committee Hansard*, 1 June 2007, p. 23.

12 Property Council of Australia, *Submission 5*, p. 1.

threatened to hold back Australia's funds management industry from capitalising on the growth of funds under management in the region.

Conclusion

4.22 Labor Senators and the Democrats' Senator do not support the Committee's recommendation that when negotiating double taxation treaties, the Government considers reciprocal withholding tax treatment for distributions from managed investment trusts. Labor Senators and the Democrats' Senator believe that for Australia's fund industry to be as competitive as possible, a flat and final 15 per cent tax should be imposed for distributions to foreign residents from managed investment trusts.

Senator Ursula Stephens
Deputy Chair
ALP, New South Wales

Senator Annette Hurley
ALP, South Australia

Senator Ruth Webber
ALP, Western Australia

Senator Andrew Murray
Dem, Western Australia

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	Asia Pacific Loan Market Association Limited (APLMA)
2	Real Estate Institute of Australia (REIA)
3	The GPT Group
4	Barclays Global Investors
5	Property Council of Australia
6	Investment & Financial Services Association Ltd (IFSA)
6a	Investment & Financial Services Association Ltd (IFSA)
6b	Investment & Financial Services Association Ltd (IFSA)
7	National Association of Forest Industries; Tree Plantations Australia; Treefarm Investment Managers Australia; Australian Plantation Products and Paper Industry Council (NAFI; TPA; TIMA; A3P)
8	United Firefighters Union of Australia (UFU)
9	Australian Banker's Association (ABA)
10	The Association of Superannuation Funds of Australia Limited (AFSA)
11	MLC Limited

APPENDIX 2

Public Hearing and Witnesses

Friday, 1 June 2007 – Canberra

APPLEBY, Mr Daniel, Director
Speed and Stracey Lawyers

BROWN, Mr Colin Leslie, Manager, Costing and Quantitative Analysis Unit
Department of the Treasury

CALLAGHAN, Mr Mike, Executive Director, Revenue Group
Department of the Treasury

COLES, Mr Tony, Specialist Adviser
Department of the Treasury

COMLEY, Mr Blair, General Manager, Business Tax Division, Revenue Group
Department of the Treasury

COOKE, Mr Trevor, Executive Director, International and Capital Markets Division
Property Council of Australia

GILBERT, Mr Richard, Chief Executive Officer
Investment and Financial Services Association

LE, Mr Alexander, Policy Officer
Department of the Treasury

PRYKE, Mr Kieran, Chief Financial Officer
The GPT Group

SPEED, Mr Robin, Director
Speed and Stracey Lawyers

WARD, Ms Linda, Adviser, Superannuation, Retirement and Savings Division
Department of the Treasury