27 August 2007

Committee Secretary
Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

By email on economics.sen@aph.gov.au

Dear Sir

**Re: Inquiry into the Provisions of the Tax Laws Amendment (2007 Measures No.5) Bill 2007**

**Introduction**

The Property Council of Australia welcomes the opportunity to provide comment on the measures contained in TLAB No 5.

Overall the Bill provides much needed reform, particularly in the areas of asset financing (Schedule 1) and stapled entities (Schedule 8).

We believe however that both of these measures could be improved upon through minor variation or amendment.

This submission sets out our principle areas of concern and where appropriate offers solutions for the Committee's consideration.

We look forward to discussing our submission with the Committee at its upcoming hearings.

**Schedule 1 – Tax preferred entities - Asset Financing**

Schedule 1 amends the income tax law to modify the taxation treatment of leasing and similar arrangements between taxpayers and tax preferred end users (such as tax-exempt entities and non-residents) for the financing and provision of infrastructure and other assets.

As a replacement to the previous draconian anti-avoidance rules Division 16D and section 51AD which denied capital allowance deductions for certain leases with tax exempt entities, Division 250 is warmly welcomed.


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The new Bill represents a significant improvement to many of the difficulties apparent in the current law and in earlier drafts of the Bill.

In particular, we welcome

1. The extension of exclusions to short term real property leases up to 5 years in length
2. The extension of the exclusion for financial benefits to $50million (up from $30 million)
3. The extension of the exclusion for assets valued up to $30 million (up from $5 million)
4. Concessions to allow you to reduce the limited recourse debt to the extent that other debt is held as security
5. Improvements to the "expected financial benefits test"
6. Removal of the annihilating provision section 51AD from 1 July 2003

**Areas of Concern**

Our main area of concern is the discrimination against the use of non-recourse debt for assets used by non-residents. This is clearly most likely to apply in cases where the asset is located outside of Australia.

In order to be caught by the provisions of Division 250, you must lack a predominant economic interest in the asset.

You will lack a predominant economic interest if more than the allowable percentage of the cost of acquiring or constructing the asset is financed (directly or indirectly) by limited recourse debt.

In most cases the allowable percentage is 80%.

However under S250-115(2)(b) where the end user is a non-resident, the allowable limit is 55%.

**We submit that there is no sound public policy grounds for this distinction and RECOMMEND that the allowable percentages be aligned at 80% irrespective of whether the end user is a non-resident or not.**

In fact, there are strong policy grounds for the equal treatment of resident and non-resident users.

They are:

**1. Boosts tax in foreign jurisdictions –** Unless amended, the proposals would generate additional foreign taxes payable by Australian investors in foreign RE, with a directly equivalent reduction in Australian tax revenue.

Rental from foreign real estate is invariably taxable in the country the real estate is located. Interest paid on debt used to purchase the real estate is invariably deductible (subject to thin cap limits which vary) in that country. The same amounts are taxable in Australia either directly for direct investment or via foreign trusts, or by CFC attribution if via a CFC. Australian tax is reduced by a credit or deduction for the amount of foreign tax paid.

By limiting debt to 55%, interest deductions will be limited, creating higher taxable income in the foreign jurisdiction, more foreign tax, and hence directly and equivalently lower Australian tax due. 80% would be a reasonable estimate of market norms for gearing levels, and so would be acceptable to the Australian property industry

**2. Handicaps Australian competition for investment -** The proposals would put Australian investors in foreign real estate at a competitive disadvantage when bidding for foreign real estate assets against competitors from outside Australia.

Globally real estate is sought as an investment asset. Bidding competitively is usual. The cost of equity capital is always higher than debt capital (basic economic theory and also capital markets reality). Hence if Australian investors in foreign real estate have to bid with 45%+ equity funding they will be at a competitive disadvantage to non -Australian investors in foreign real estate who will typically have 80% or greater debt levels. Australian REITs etc will increasingly be unable to acquire real estate.

This would be particularly disappointing, given the Australian REIT market has created one of the most efficient capital markets in the world for raising capital to invest into real estate. An Australian tax impediment would undermine this global market leadership.

**3. Australian investors take more risk and effectively pay more to Foreign Banks for it -** The proposals would simply give an advantage to (usually) foreign bank lenders (to Australian investors in foreign real estate), by allowing the investors to borrow only up to 55% of purchase price, when typically banks will lend 70% to 90% of cost. The banks will charge the same interest rates but take less risk. All this does is transfer investment risk to the Australian investor from the foreign bank.

Putting a low threshold like 55% in hurts Australian property investors, and will mostly, simply provide a commercial benefit to foreign banks (at the cost of Australian business).

A typical loan/value ratio for property investment would be in the range 60% - 90%, ie that is what arms length bank lender will lend (varies from jurisdiction to jurisdiction, property tp property, etc). To be competitive in acquiring foreign assets Australian investors need to be able to borrow up to these levels - otherwise their cost of total capital will have a greater equity component than foreign bidders (and equity has a higher cost than debt). So the commercial imperative is to borrow , say, 80%. Typically the foreign bank lender will lend this based on mortgage security of the underlying real estate. But if the Australian investor has to reduce the limited recourse element to say 55% it would typically do this by giving some form of recourse to other group assets (parent co guarantee, etc).Hence the foreign bank ends up getting greater security for their loan than they want or need, which gives the bank a financial benefit, paid for by greater risk taken by the Australian investor. There would no price change in the debt pricing to reflect this, as the loan would already be finely priced.

**4. Equalising the threshold does not give an advantage Foreigners -** Making the threshold the same at 80% is not a concession to foreigners - it is just ensuring an anti-avoidance provision does not apply inappropriately.

**5. Foreign Investors aren't interested in tax benefit transfer -** With foreign real estate it will - by definition - have a tax exempt end user, so applying an anti-avoidance provision because there is a tax exempt end user seems anomolous. As all users will be tax exempts there is no question of a tax benefit transfer.

**6. The current provisions penalise Australian Investment -**The industry has changed considerably since 1999. Australia is running out of real estate assets for investment. Investment funds need to flow into offshore real estate. Australians invest in foreign real estate as an important channel for the huge Australian investment funds which brings revenue back onshore. Penalising such investment is penalising the Australian investors, not the foreign end users (tenants) of the property.

**Schedule 8 - Australian property trusts and stapled securities**

The Property Council welcomes changes which allow the interposition of a head trust and consequential CGT rollover and Division 6C relief.

The additional control test changes to Division 6C are also warmly welcomed.

The Property Council views these reforms as the first stage of a now widely recognised need to comprehensively reform Division 6 of the Income Tax Assessment Act, particularly as it relates to real estate investment trusts (REITs). We look forward to engaging Government on this process in due course.

**Area of Concern**
Our only area of concern is purely a technical one. It appears to us that inadvertently, while the Bill does provide stapled entities which are made up of a tax paying trust and a non-tax paying trust with CGT relief it inadvertently does not provide them with Division 6C relief.

**We submit that there is no public policy grounds upon which to found that distinction and RECOMMEND that the Bill be amended to rectify this mistake.**

Our detailed analysis follows:

Our particular concern relates to the wording of the proposed section 102NA as set out in paragraph 4 of Schedule 8 of the Bill dealing with "Certain interposed entities not trading trusts".

Section 102NA provides that a unit trust will not be a trading trust if the conditions in sub sections (1) and (2) are satisfied.

Sub section (2)(b) provides that the trustee of the interposed trust must not control the affairs or operations of another entity that carries on a trading business other than a company that was one of the stapled entities or a subsidiary or entity controlled by a stapled entity that is a company.

This appears restrictive as it does not permit the trustee of the interposed trust to control the affairs of a trust carrying on a trading business even where that trust is taxed like a company under Div 6C.

This seems inconsistent to the policy evident in the Div 124Q rollover provisions which clearly contemplates that all of the stapled entities may be trusts (including a trading trust or trusts). A stapled LPT that holds its management business through a staple headed by a trust should not be treated differently to a stapled LPT that holds its management business through a stapled headed by a company. The choice of company or trust to head the staple is not governed by tax issues but rather by the stapling deed and the need to have identical constitutions for each stapled entity.

**We submit that the following amendment to sub paragraphs (i) and (ii) be considered to address this issue**:

"(i) a company **or trust**, that was, before the scheme was completed, one of the stapled entities referred to in Subdivision 124-Q of the Income Tax Assessment Act, 1997; or

(ii) a subsidiary of one of those stapled entities [that is a company - **delete**], or an entity that is controlled or able to be controlled, directly or indirectly, by that **entity** [company - **delete**]"

We do note however that the word "subsidiary" is defined in the Act by reference to companies only and therefore it may not be appropriate for it to remain in sub para (ii).

**Conclusion**

Tax Laws Amendment Bill No5 contains much needed reform which should be implemented without delay.

There is however some minor changes which are required in order to ensure that policy intent of these measures are met.

Once again, we look forward to discussing our submission with the Committee and in the interim, if you have any questions please do not hesitate to contact the undersigned.

Yours faithfully,

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