12 November 2002

The International Tax Project
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Secretariat,

Review of International Tax Arrangements

Attached is the Property Council's submission to the Board of Taxation's Review of International Tax Arrangements.

The Property Council welcomes the Government's initiative in improving our international tax system.

We look forward to working constructively with the Board of Taxation during the review.

Yours sincerely,

Peter Verwer
Chief Executive

12 November 2002

The International Tax Project
Board of Taxation Secretariat
C/- The Treasury
Langton Crescent
PARKES ACT 2600

Dear Secretariat,

Review of International Tax Arrangements

Attached is the Property Council's submission to the Board of Taxation's Review of International Tax Arrangements.

The Property Council welcomes the Government's initiative in improving our international tax system.

We look forward to working constructively with the Board of Taxation during the review.

Yours sincerely,

Peter Verwer
Chief Executive

LEVEL 26 AUSTRALIA SQUARE 264-278 GEORGE STREET SYDNEY NSW 2000
PH 02 9252 3111 - FAX 02 9252 3103
Email info@nat.propertyoz.com.au - www.propertyoz.com.au

PROPERTY COUNCIL of Australia

Review of International Tax Arrangements

A report prepared by the Property Council of Australia – October 2002

The **Voice** of Leadership

LEVEL 26 AUSTRALIA SQUARE 264-278 GEORGE STREET SYDNEY NSW 2000
PH 02 9252 3111 - FAX 02 9252 3103
Email info@nat.propertyoz.com.au - www.propertyoz.com.au

PROPERTY COUNCIL of Australia

Table of Contents

1.0 Executive Summary

This report provides a set of recommendations for the Board of Taxation to consider in their review of international tax arrangements.

The Property Council welcomes the Federal Government's initiative in reviewing our international tax arrangements.

Commercial property provides productivity platform of the Australian economy and listed property trusts invest in assets that generate retirement wealth for nine million ordinary Australians.

Australia is the world leader in securitised property investment vehicles, with listed property trusts representing over 5 per cent or $40 billion of the total market capitalization of the ASX.

Australian property trusts are now a major player in offshore property markets, with Westfield and Lend Lease among the largest property owners in the United States.

This report suggests improvements to our international tax system designed to:

- provide a solid platform on which to encourage a large number of offshore companies to set up an Australian regional headquarters;
- allow more Australian property trusts to expand offshore and distribute foreign dollars back into Australia's retirement pools; and,
- encourage offshore property investors to plough money into Australian property trusts.

In particular, the Property Council key recommendations include:

1. Introducing exemptions from the Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) regulations, which creates a more targeted regime.
2. An exemption for unit trusts from interest withholding tax on debentures, thereby eliminating the existing bias towards companies.
3. Changes to the treatment of foreign currency gains or losses, as they relate to both foreign source income and capital transactions.
4. Establishing clear and competitive tax rules that encourage non-residents to invest in Australian property trusts.

Additional recommendations relevant to the commercial property sector have been included in this report.

The Property Council looks forward to further consultations with Government and the Board of Taxation.

In addition the Property Council supports the submissions lodged by the following organisations:

- Business Coalition for Tax Reform;
- Investment and Financial Services Association;
- Westfield Holdings Limited;
- Westfield Trust; and,
- Westfield America Trust

2.0 Introduction – the Australian Commercial Property Industry

The Australian listed property trust (LPT) industry is one of the most dynamic investment markets in the Australian economy. Over the past fifteen years LPT assets have increased by a total of 2000%. Today, LPTs represent over 5% of the total capitalisation of the Australian Stock Exchange (ASX) with total market capitalisation of $40 billion. There are close to 50 Australian property trusts listed on the ASX, with 33 LPTs in the ASX 300.

In 1985 LPT assets were valued at around $2 billion. Today they total more than $50 billion. The average market capitalisation of an LPT in 1989 was $175 million, compared to $685 million just ten years later.

Listed property trusts are established under Australian Law and listed on the Australian Stock Exchange. They are regulated by the Corporations Law, ASX listing rules, trust constitutions and compliance plans, ASIC policy, general trust law and tax law, as well as dealers licensing and real estate agent licensing requirements.

LPTs offer investors some of the nation's best property assets managed by professional trust managers, which investors would be unable to access directly. Public listing provides investment liquidity. Income flows directly to unit holders and is assessed in their hands. LPTs are required by their constituent documents and the tax law to distribute all of their income derived in a year. Fierce competition between funds ensures that LPT distributions to members are maximised, increasing the yield to unit holders.

2.2 Property Investment Offshore

The Consultative Paper prepared by Treasury for the Review of International Taxation Arrangements, discusses options to attract equity capital for offshore expansion of Australian businesses, promoting Australia as a location for internationally focused companies, and promoting Australia as a global financial services centre.

The commercial property industry, through LPTs, has proved to be highly successful in expanding overseas.

In 2000 and 2001 approximately 40% of all capital raised by Australian listed property trusts was raised for direct investment in US property holdings, though fiscally transparent US REITs. By 2005 UBS Warburg predicts Australian LPT investment in US REITs will exceed $20 billion. In that time, UBS Warburg also expect foreign investment by specialist Australian property security funds, which invest in LPTs, REITs and similar transparent real estate holding entities, to exceed $2 billion - $3 billion.

3.0 Controlled Foreign Company (CFC) Rules

Recommendation

Exempt collective investment vehicles, which distribute all of their income, from the Controlled Foreign Company rules. Such an exemption should apply to all entities investing in 'Broad Exemption Listed Countries'.

The Property Council believes that Australia should not discourage offshore investment into jurisdictions that have a similar tax system to Australia.

As noted in the Treasury consultation paper, the current CFC regime is overly complex, imposing uncertainty, unnecessary tax liabilities and substantial compliance costs on Australian taxpayers with interests in CFCs.

The Problem

The Australian Government enacted the CFC rules in 1991 with the stated policy intention of introducing:

> *"an accrual system of taxing foreign source income that has been derived in low tax countries by Australian controlled entities and has been accumulated offshore, avoiding Australian tax",* **(Treasurer's second reading speech, December 1989).**

However the CFC rules have become an impediment to conducting business. Key problems with the regime include:

1. The unfocused 'catch-all' result of the current legislation that creates massive compliance costs, with very little revenue gain.

2. The attribution of capital gains which are subject to concessionary treatment in a 'Broad Exemption Listed Country '(BELC);

3. Deemed capital gains which only arise due to the application of Australia's CGT rules to the CFC. Problems 2 and 3 are partially acknowledged in Option 3.1 in the Consultation Paper dealing with extending rollover relief under the CFC rules.

The effect of the CFC measures places Australian investors in CFCs at a competitive disadvantage to local entities and to other foreign investors who are not limited by the rules.

There are little (if any) benefits to Australian revenue by applying the CFC rules to entities investing in BELCs and the application of the CFC rules does not justify the substantial compliance costs created by the regime.

Listed property Trusts and CFCs

Listed property trusts repatriate offshore funds to Australian investors by investing in offshore property via a local flow-through vehicle - Australian LPTs rarely acquire foreign property directly.

By way of example, LPTs invest in the United States via US Real Estate Investment Trusts (REITs).

<u>US REITs distribute all of their income to investors in the same way as Australian listed property trusts.</u>

Some Australian LPTs spread their investments into foreign property by adding holdings in a US REIT or similar flow through real estate holdings to their asset portfolio. Others acquire controlling interests in the offshore entity, to control the assets of the foreign entity.

The Australian property investment market has seen great demand for exposure to foreign real estate such that there are now three vehicles listed on the ASX that invest solely in US REITs:

1. Westfield America Trust;

2. Lend Lease US Office Trust.

3. Macquarie Prologis Trust.

The longest established vehicle is Westfield America Trust (WAT), which was floated on the Australian Stock Exchange in May 1996 and is now the second largest listed property trust in Australia, with market capitalisation of $6.4 billion, and total assets of $16.4 billion.

WAT has over 21,000 unit holders. Its sole asset is a controlling interest in Westfield America Inc, a US REIT. Westfield America Inc holds a portfolio of 61 Westfield Shopping Centres across the United States.

<u>WAT distributed A$212 million in foreign dollars to unit holders in the year to 31 December 2001.</u>

CFCs and Income Accumulation

The key purpose of the CFC provisions is to prevent the accumulation of income in low tax jurisdictions and thereby defer the incidence of Australian tax.

However offshore investments by LPTs are by their very nature the **direct opposite** of income accumulation. LPTs must distribute all of their income to unit holders, be it local or foreign sourced. An LPT must therefore ensure that all foreign source income is distributed to the Australian LPT in the year it is derived.

The CFC rules still apply, however, to attribute income of a foreign real estate holding entity controlled by an LPT, despite the fact that all of the distributable income of that entity is distributed. The attributable income and the distributable income will not always align leading to distortions in tax liabilities on the flow-through foreign income.

This creates barriers to the Australian property industry investing overseas, adding uncertainty, potentially additional tax liabilities, and complexity.

In 1999 the Australian Government amended the CFC rules to provide specific exemption for CFCs that are US REITs; s356(4A-4D). This amendment recognises the unique nature of public property investment vehicles, and is an appropriate exemption that has enabled significant expansion by Australian investors, through LPTs, into the US property market.

Revamping the CFC regime will remove the existing tax barriers to investing offshore, triggering further listed property trust expansion overseas and thereby increasing the flow of foreign dollars into Australia's retirement pools.

The Solution

The CFC rules play an important role in Australia's international taxation arrangements, based on their original policy objective. Over time, however, the rules have become significantly wider, and more burdensome, and no longer operate only to attribute income from offshore entities accumulating income.

The CFC rules as they stand are a significant barrier to Australian property investment offshore, and the expansion of Australian LPTs overseas.

To address these deficiencies, the Property Council suggests the following improvements to the CFC provisions.

Recommendation One

Amend the CFC rules to exclude entities that do not accumulate income offshore, in line with the original policy intent of the legislation.

Such entities include listed property trusts, managed investment schemes and similar collective investment vehicles, which distribute all of their income to investors.

Controlled foreign entities that distribute a stated proportion of their income to Australian controllers within a given period should not be subject to attribution under the CFC rules.

An exemption of this type conforms with exemptions provided in similar regimes internationally. In particular, the CFC rules in the United

Kingdom contain an exemption for all entities that distribute a certain proportion of profits to UK entities.

An amendment of this type will alleviate the need for entity specific exemptions such as that for US REITs. If necessary, the REIT exemption could be widened to include all foreign real estate holding entities that fully distribute income.

Recommendation Two

The CFC rules could be simplified and aligned with their original policy goal, by exempting all entities resident in any of the existing broad exemption listed countries (BELCs) from the CFC rules where 90% of the entity's income is derived in that country or other listed countries.

Consideration should also be given to expanding the list of exempt countries beyond the current seven broad exemption listed countries.

3.1 Other Technical CFC and Related Issues

In addition to the suggested solution above, the existing CFC rules contain a number of anomalies which should be rectified. Some specific anomalies are:

3.1.1 Treatment of limited partnerships established in broad exemption listed countries.

Limited partnerships are often the preferred ownership vehicle for commercial real property located in foreign countries, including the UK and the US.

Under Australian tax law, limited partnerships are treated as a company for Australian tax purposes. Thus, a foreign limited partnership is treated as a company for the purposes of the CFC rules. However, according to draft Taxation Determination TD2001/D14, a UK or US limited partnership will be treated as a resident of no particular unlisted country unless the limited partnership itself is subject to tax in the UK or the US as appropriate. As UK and US limited partnerships are generally treated as “look through” entities in their home jurisdiction, they do not satisfy the ATO’s “subject to tax” requirement.

The Treasury Consultation Paper states that the Government will consider amending Australian tax law in relation to the treatment of limited partnerships. It is possible that the amendments may treat Limited Partnerships as “look through” entities for Australian tax purposes. This “solution” will be based on the current law.

The Property Council supports this very worthwhile proposal, however we recommend that the Government finalise the review of international tax arrangements before amending the law relating to limited partnerships.

The review may create a better solution to the limited partnerships problem without the need for specific amendments to the law.

3.1.2 Flow through of exempt dividends

Under existing tax law, certain non-portfolio dividends paid to companies are treated as exempt income for Australian tax purposes. For example, under s.23AJ, a non-portfolio dividend paid directly to an Australian resident company by a company that is a resident of a listed country is exempt from Australian income tax. Similar exemptions are contained in the CFC provisions.

However, the exemption in s.23AJ does not apply where the non-portfolio interest is held indirectly through a trust. In other words, the interposition of a trust disentitles a corporate beneficial recipient of a non-portfolio dividend to the exemption, notwithstanding that the corporate beneficiary indirectly holds a non-portfolio interest in the underlying company.

This position potentially applies in bare trust or nominee situations as well as for holdings in unit trusts.

The Property Council argues that a dividend should retain its character as an exempt dividend on distribution by an interposed trust regardless of whether the trust is a bare trust or a unit trust.

3.1.3 Functional currency rules for CFC attribution calculations

Where a CGT event has occurred in relation to a CFC, the calculation of a capital gain to be included as attributable income picks up the foreign currency conversion rules in the CGT Provisions. That is, the disposal proceeds for an asset is converted to Australian dollars at the disposal time and the calculation of the cost base of the asset converts the purchase price to Australian dollars at the acquisition time.

As a result, there can be capital gains (and thus attributable income) on transactions entered into by a CFC which are due solely to exchange rate movements (i.e. there is no gain in the functional currency) and no economic gain to the CFC.

Moreover, because CGT assets include assets such as loans and other receivables, capital gains can arise by reason of the mere receipt of such amounts by a CFC where they are denominated in the functional currency of the CFC.

The Property Council recommends that CFC rules should be amended such that all capital gains and capital loss calculations are performed in the functional currency of the CFC - only the net capital gain should be converted to Australian dollars.

3.1.4 Provisions to ignore bare trusts/nominee arrangements

For the purposes of the foreign investment fund ("FIF") measures in Part XI, s.484 provides that the existence of nominee arrangements or bare trusts are to be disregarded such that the beneficial owner of the relevant FIF interest is the entity to which the FIF rules apply.

There is no comparable provision in the CFC rules. Accordingly, there is a technical risk that the existence of the nominee or bare trust should be recognised in applying the CFC measures. The resulting complexity and attendant compliance costs are not justified by any Australian revenue benefit.

The Property Council recommends that nominee or bare trust arrangements should be ignored for the purposes of the CFC rules. In particular, we suggest that the Government implement recommendation 16.11 of the Ralph Review of Business Taxation, which ignores all bare trusts for taxation purposes.

3.1.5 Extension of the branch profits exemption

Broadly, income derived in carrying on a business in a BELC is exempt from Australian tax or attribution except to the extent that the income is eligible designated concession income ("EDCI") or not subject to tax. Broadly, EDCI is interest, royalties and capital gains which are subject to concessionary tax treatment of the BELC.

As with the CFC/FIF provisions there are unwarranted compliance costs in applying the branch profit exemption. In addition, if the proposed exclusion from the CFC/FIF provisions for CFCs/FIFs carrying on activities is enacted there will be inconsistent treatment for CFC/FIF and for branch profits.

Accordingly, the branch profits exemption in s.23AH and in the CFC provisions should be extended to exempt all profits derived from carrying on a business in a BELC.

4.0 Foreign Investment Fund (FIF) Rules

Recommendation

Exempt collective investment vehicles, which distribute all of their income, from the Foreign Investment Fund rules.

The Problem

The Foreign Investment Fund rules inhibit the offshore expansion by the Australian property industry, adding unnecessary compliance costs and real tax barriers to investing overseas.

The FIF rules have become much broader than originally intended. In short, the FIF rules, like provisions for CFCs, were originally intended to target investment in offshore income accumulation vehicles.

However, listed property trusts and their foreign equivalents must distribute all of their domestic and foreign income to investors.

Property investment vehicles are **yields** driven, and must maximise distributions to investors in order to remain competitive with other investment classes.

As such, property investment vehicles are **not**, by nature, income accumulation entities.

It is ironic that the current regime penalises vehicles which are specifically designed to repatriate foreign dollars into Australia and allow ordinary investors access to these ‘globalisation dividends’.

Listed Property Trusts and FIFs

In 1999 the Australian Government enacted a specific exemption from the FIF rules for interests in US REITs and for US regulated investment companies (RICs), by inserting Division 8 into Part XI of the ITAA 1936.

The purpose of the exemption, as stated in the Explanatory Memorandum (EM) to the Bill, was to:

- expose Australian managed funds to US competition and encourage efficiency in the Australian investment industry; and,
- prevent the deferral of Australian tax where profits are accumulated offshore in a FIF rather than remitted to Australian investors.

The exemption from the attribution rules for US REITs and RICs, which are described in the EM as, “fully distributing investment funds used widely in the US as vehicles for managing collective investments”, was stated to accord with the policy intend of the FIF rules, as “tax deferral opportunities do not arise because of the exemption”.

In the absence of the specific exemption, the FIF rules potentially apply to investments in fiscally transparent US real estate holding entities, by Australian LPTs. The FIF rules still apply to such flow through entities resident anywhere other than the USA.

International competition on a global scale can only be fostered if investment barriers created by our present international tax arrangements are removed.

Listed Property Trusts – Accumulation Vehicles?

The Foreign Investment Fund rules are specifically designed to target investments in offshore accumulation vehicles.

However offshore investments by LPTs are the exact opposite.

Australian LPTs must distribute all of their local and foreign source income to investors. When expanding offshore, LPTs must therefore ensure that the foreign income derived is fully distributed to the LPT, and in turn distributed to Australian unit holders, thereby maximising investment returns.

The Solution

The FIF rules need to be refocused to target the offshore accumulation of income. In the absence of a complete rewrite of the rules, specific exemptions from the FIF regime are necessary.

Recommendation One

Extend the existing Division 8 exemption for investment in US Real Estate Investment Trusts and Companies to any entity that distributes a stated proportion of its income, within a given period, to Australian members.

Recommendation Two

The Government has already recognised that there are certain vehicles with unique characteristics which prevent the offshore accumulation of income.

Treasury's Consultation Paper suggested an exemption from the FIF rules for investments by superannuation funds, and index funds.

The Property Council recommends the same exemption apply to listed property trusts, which would recognise that such vehicles distribute all of their income to investors.

LPT investments do not give rise to tax deferral opportunities because of the flow-through nature of the LPT. As such, there is no risk to Australian revenue by exempting these vehicles from FIF rules.

Instead, an exemption would create major opportunities for listed property trusts to **increase** the level of foreign dollars distributed to ordinary Australian investors.

Such opportunities arise from the enhanced ability of LPTs to expand offshore without the barrier of the FIF rules to hinder their investment.

5.0 Extension of Withholding Tax Exemption – Debentures Issued by Unit Trusts

Recommendation

Exempt unit trusts from interest withholding tax on debentures.

The Problem

Section 128F of the ITAA 1936 currently exempts from interest withholding tax interest paid or payable on certain publicly offered debentures issued by companies. However, a unit trust cannot access the interest withholding tax exemption.

Listed unit trusts should have access to all debt capital markets on the same basis as Australian corporates. It is illogical and an impediment to Australian listed trusts seeking capital for offshore expansion that a listed unit trust should have restrictions applying to its debt funding that do not apply to listed companies. It is also anomalous that a subsidiary company of a unit trust could access the exemption but the holding trust could not.

The policy objective behind the current section 128F was to improve and streamline the operation of the regime (introduced in 1971) in the context of modern overseas capital markets. Such an amendment would facilitate increased competition in the Australian financial market and the home lending market.

Additional changes to section 128F have further sought to encourage the development of the domestic corporate debt market and to further integrate that market with offshore corporate debt markets in order to increase competitive pressures in domestic lending, including an extension of the exemption to Australian branches of foreign banks.

There does not appear to be any explicit or specific policy reason in the Explanatory Memorandum or other supporting material arguing why the exemption is limited to companies and cannot be extended to unit trusts. It is probable that the exemption did not originally include unit trusts as they are a form of investment vehicle that was not common when the legislation was first introduced in 1971.

From a policy perspective, there appears to be no reason to discriminate between debentures issued by companies or unit trusts. Provided the tests for the widely held debentures exemption under section 128F are met, the policy objectives will be achieved and would allow entities such as unit trusts to access overseas funding at a competitive rate.

The Solution

The Property Council strongly recommends that the interest withholding tax exemption currently available in s128F for publicly offered debentures issued by companies should be extended to include publicly offered debentures issued by unit trusts, on the same basis as companies.

6.0 Taxation of Non-resident Investors in Unit Trusts

Income and gains derived by a unit trust retain their character on distribution to unitholders. This means that foreign source income derived by a unit trust is treated as foreign source income of the unitholder.

There is no Australian withholding tax imposed on the distribution of foreign source income by a unit trust to non-resident investors. Further, for resident unit trusts, non-resident investors are only subject to Australian capital gains tax on disposal of units if the investor holds at least 10% of the issued units of the trust.

Under current law there are two sources of income or gain on which non-resident investors could be subject to Australian tax which are considered inappropriate. The first is on foreign exchange gains on hedges over the foreign source dividend income, the second on any capital gain realised on the disposal of foreign assets held by a unit trust.

6.1 Foreign Exchange Hedges

The Current Law

Foreign currency gains, arising from a foreign currency hedge contract over foreign sourced income of an Australian resident entity, are generally treated as assessable Australian sourced income where the counter party to the hedge contract is an Australian financial institution.

A non-resident investor is generally subject to Australian tax on such a gain. Conversely a foreign exchange loss would be offset against any assessable foreign source income and would not give rise to an Australian tax deduction for the non-resident investor.

The Problem

Non-resident investors in a unit trust with hedges over foreign income may derive a small amount of Australian source income from the hedge contract and are liable to Australian tax on this amount. Notwithstanding there is no Australian tax on the underlying foreign source income.

However if the non-resident investor had invested in the foreign asset directly, rather than through an Australian unit trust, no Australian tax would be payable on the income derived from the foreign asset.

One alternative would be for the Australian unit trust to enter into hedging contracts with a foreign counter party where the hedging contract is executed in a foreign jurisdiction. This would generally result in any gain having a foreign source.

However it is inequitable for Australian tax law to discourage Australian entities from contracting with other Australian entities.

For an Australian unit trust with predominantly foreign source income the current treatment of small amounts of Australian sourced income arising from a hedge contract over foreign sourced income creates unnecessary paperwork for both the trust and the non-resident investor.

The complexity of the current tax system for non-residents cannot be overstated and the requirement to fill out an Australian income tax return by a non-resident investor for small amounts of Australian sourced income is overly burdensome.

The Solution

The Property Council recommends that the Government characterise foreign currency gains and losses arising from foreign currency hedges over foreign sourced income as having a foreign source rather than an Australian source regardless of the counterparty.

Australian resident investors in a unit trust would still be subject to tax on any foreign currency gain arising from the hedge as Australian resident investors are taxed on their worldwide income.

Non-resident investors in a unit trust would essentially be exempt from Australian tax on any foreign currency gain arising from such a hedge that is distributed to them. We believe this position is justified given:

- non-resident investors are currently not subject to Australian tax on distributions of foreign source income by trusts; and,
- one of the key policy objectives of the Consultation process in respect of the Review of International Taxation is to improve conduit income arrangements for Australian managed funds (Option 4.6).

We do not consider that the Australian tax base will be significantly affected should foreign currency hedge gains distributed to non-resident investors be excluded from the Australian tax net.

6.2 Conduit Rules for Capital Gains on Foreign Assets

The Current Law

The property sector has major concerns that non-resident investors may be subject to Australian tax on capital gains derived by a unit trust from its disposal of foreign capital assets (such as shares or real estate) due to the interaction of the Australian CGT rules and the withholding rules for distributions by trusts to non-residents.

The Problem

Non-resident investors are not subject to Australian tax where they invest directly or through offshore managed funds in assets located in foreign jurisdictions.

However if the same investment were held through an Australian unit trust, there is uncertainty as to whether the non-resident investors are subject to Australian tax on any capital gain derived by the unit trust from the disposal of the foreign asset.

The problem arises due to the uncertainty surrounding the source of capital gains derived by a resident unit trust. The tax law as currently drafted does not attribute a source to a capital gain made on the disposal of a foreign asset held indirectly by non-residents through an Australian unit trust. Non-residents are only subject to Australian tax on Australian source income and gains.

As foreign assets do not have the "necessary connection with Australia" for CGT purposes, the same CGT treatment should apply to indirect investments through Australian resident unit trusts in foreign based assets as currently applies to direct investments by non-resident investors of the same nature.

Whilst the Australian Taxation Office ("ATO") has recently issued Interpretative Decision ("ID") 2002/903 in respect of this issue, the issue has not been resolved at the legislative level. Broadly, the ID states that non-resident investors should not be subject to Australian tax on any capital gain derived by a unit trust from the disposal of the foreign asset as the capital gain is not attributable to sources in Australia. However it is preferable that amendments in respect of this issue be made at the legislative level to provide certainty for all taxpayers (not just taxpayers who fit the fact pattern of the ID).

The Solution

As noted in the August 2002 Consultation Paper, the Property Council believes that a comparable CGT treatment of direct and indirect investment into Australia can be achieved by exempting non-residents from Australian tax on unit trust income from the disposal of assets that do not have the "necessary connection with Australia".

We support the introduction of a simple exemption test for unit trusts that seeks to determine whether an asset has the necessary connection with Australia as if the trustee of the unit trust is a non-resident (Option 4.6).

7.0 Australians Managing Non-Resident Funds

Australian fund managers and property trust managers have earned a reputation for performance and returns on investments. The services of Australian managers are now sought in many countries to manage investments on behalf of members.

The Current Law

The current law, however, imposes a significant barrier to these successful Australian businesses expanding and competing overseas, by treating a trust estate as resident in Australia where the trustee or manager of the trust is resident in Australia.

The Problem

This creates an anomaly where the investment trust is constituted outside Australia, and has no investments or dealings in Australia, but is treated for Australian tax law as resident here simply because the trust manager is an Australian company. Such an approach:

- seriously distorts the worldwide tax consequences of the fund as it is suddenly subject to tax in Australia where the fund has no connection ; and,
- prevents Australian fund managers from managing non resident funds.

In order to expand their business offshore, Australian property and fund managers must now establish offshore subsidiaries to carry out the fund management functions, giving rise to significant cost burdens and exposure to Australian CFC rules, further adding complexity and cost. The result is to significantly reduce the value to Australian managers in operating foreign fund management entities.

The Solution

The Property Council recommends the Government amend the residence rules in the *Income Tax Assessment Act* to ensure that a trust estate or similar entity is not resident in Australia where the trustee or manager of that entity is an Australian entity.

8.0 Foreign Exchange Amounts on Property Transactions

The Current Law

There is significant uncertainty surrounding the correct taxation treatment of many foreign exchange gains and losses. This arises as the High Court decision in the ERA case in 1996 cast significant doubt on the operation on the taxation rules on the treatment of foreign exchange gains and losses contained in Division 3B of Part III of the ITAA.

Notwithstanding that the High Court decision was handed down in 1996 there has still not been any legislative amendment to clarify the operation of the law.

In May 2002 the Assistant Treasurer announced that consultation (including the release of exposure draft legislation) would be undertaken in relation to this issue with a view to introducing legislation in the spring sittings of Parliament (by the end of 2002).

Subsequently the Australian Taxation Office and Treasury undertook consultation in relation to this area. However, there has been no announcement as to the result of that consultation process.

We urge The Board of Taxation to pursue this issue with the Government.

The Problem

One policy issue of particular importance to the property investment industry in relation to the taxation of foreign exchange gains and losses is whether such gains and losses should all be treated on revenue account for taxation purposes or whether in some circumstances the taxation treatment should follow the commercial and accounting approach, and gains and losses should be included in the cost of assets.

LPTs and Foreign Transactions

Any assessable income derived by an LPT from foreign exchange gains in relation to capital transactions would be included in the taxable income of unit holders of the LPT who are presently entitled to the trust's income for an income year, notwithstanding that the LPT has not generated any corresponding net cash receipt to include in the distribution.

The problem arises in two main areas:

1. Under the CGT rules where there is a delay between entering a contract and settlement of the contact.

2. Where there is a foreign currency hedge entered into in relation to the obligations or receivables under another contract.

The Property Council believes that there should be a matching of such gains and losses with the character of the underlying transaction. Character matching will avoid situations where, for example, an exchange gain would be immediately assessable but a capital loss from the underlying transaction would be quarantined under the CGT rules.

Further, similar rules should apply for foreign currency hedging essentially in connection with capital transactions (ie an acquisition or a disposal of an item on capital account). This approach would also coincide with normal commercial practice and accepted accounting treatment.

The Solution

The Property Council recommends that any foreign currency gain or loss arising in respect of capital transactions should be treated as part of the cost base of the capital asset or part of capital proceeds on disposal of the asset as applicable.

This proposed treatment would align the taxation treatment of such foreign exchange gains and losses with the accounting treatment and commercial reality.

Simple amendments could be made to the CGT rules to achieve this, as follows:

1. Insert a cost base adjustment for:

   (a) a foreign currency gain or loss arising for an asset purchased under a contract where the consideration is denominated in a foreign currency and there is a delay between date of contract and of the amount due under the contract payment; and

   (b) a gain or loss arising on the disposal of foreign currency acquired under a contract entered into to acquire foreign currency to hedge an obligation to acquire an asset under a separate contract.

2. Insert an adjustment to the capital proceeds on disposal for:

   (a) a foreign currency gain or loss arising on the disposal of an asset under a contract where the disposal consideration is denominated in a foreign currency and there is a delay between the date of contract and receipt of the due under the contract; and

   (b) a gain or loss arising on the disposal of foreign currency received as consideration for the disposal of an asset where the foreign currency is disposed under a contract entered into to hedge the receipt of foreign currency on disposal of the asset.

9.0 Conclusion

This report suggests improvements to our international tax system designed to:

- provide a solid platform on which to encourage a large number of offshore companies to set up an Australian regional headquarters;
- allow more Australian property trusts to expand offshore and distribute foreign dollars back into Australia's retirement pools; and,
- encourage offshore property investors to plough money into Australian property trusts.

In particular, the Property Council key recommendations include:

1. Introducing exemptions from the Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) regulations, which creates a more targeted regime.
2. An exemption for unit trusts from interest withholding tax on debentures, thereby eliminating the existing bias towards companies.
3. Changes to the treatment of foreign currency gains or losses, as they relate to both foreign source income and capital transactions.
4. Establishing clear and competitive tax rules that encourage non-residents to invest in Australian property trusts.

The Property Council welcomes the opportunity to further consult with The Board of Taxation.

10.0 Contacts

Peter Verwer
Chief Executive
Property Council of Australia
Level 26 Australia Square
264-278 George Street
SYDNEY NSW 2000

Phone: 02 9336 6926
Fax: 02 9336 6966
Mobile: 0407 463 842

Email: pverwer@nat.propertyoz.com.au

Daniel Newlan
Policy Manager, Financial Sector
Property Council of Australia
Level 26 Australia Square
264-278 George Street
SYDNEY NSW 2000

Phone: 02 9336 6944
Fax: 02 9336 6966
Mobile: 0411 596 073

Email: dnewlan@nat.propertyoz.com.au