NZSUPERFUND
Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

Mr Brendan McKenna
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Department of Treasury
Langton Crescent
Parkes ACT 2600

cc: Mr David Pullen
Parliament House

10 August 2018

Dear Brendan

Stapled Structures – Integrity Package (second stage)

We refer to our previous submissions dated 19 April 2017 and 31 May 2018 regarding the Stapled Structures Integrity Package and our meeting in Canberra on 27 April 2018 along with a number of our peer funds.

This submission is by the Guardians of New Zealand Superannuation (GNZS) as manager and administrator of the New Zealand Superannuation Fund (NZSF). NZSF is a long-term, growth-oriented, global investment fund. The NZSF is funded by the government of New Zealand and its purpose is to provide for the future funding of retirement benefits paid by the government of New Zealand which are guaranteed to all New Zealanders aged 65 and older.

GNZS welcomes the opportunity to provide submissions to Treasury on the Exposure Draft legislation and is committed to engaging positively and constructively with you on these matters. We also acknowledge the positive revisions and amendments made to date to the integrity package as a result of previous submissions by ourselves and others.

We would be pleased to have further discussions with you in respect of the matters raised herein at your convenience.

Submission 1: 100% ownership requirement for Agri-MIT transitional rules

We are concerned about the requirement in the second stage exposure draft measures for the agricultural Managed Investment Trust (MIT) transitional rules to be limited to 100% owned MITs, and note that this appears to be contrary to the policy intent set out in the supporting Explanatory Memorandum (EM).

Specifically, the exposure draft legislation only provides for transitional relief for indirect agricultural income if the MIT holds 100% of the asset holding entity (refer paragraph (f) of section (1) of Item 12 of Part 3). This 100% ownership requirement differs from the EM which only refers to a requirement that *"the MIT had a participation interest in the entity for the whole of that period"* (refer to 1.173 of the EM).

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The limit on transitional relief to indirect investments only if they are 100% owned by a MIT:

- is distortionary because it creates asymmetric treatment between direct and indirect investments;
- is arbitrary because it changes the tax treatment for long-term investments without any reasonable transition period (and therefore is contrary to the 27 March 2018 policy announcement); and
- is contrary to policy objectives because it penalises investors who have created joint ventures with Australian farmers (relative to investments which are 100% foreign owned).

NZSF has made long term investments in Australian agriculture based on the MIT regime. NZSF's ownership interest in these investments falls below 100%. These investments have been made by taking an interest in a unit trust that owns the relevant land, in combination with other local investors in the unit trust.

We submit that the transitional rules should apply to any amounts derived, received or made by a MIT from an entity in which it holds a participation interest (i.e. consistent with the EM) over the relevant period.

Submission 2: taxation of unrealised capital gains for Agri-MITs

The exposure draft legislation contemplates certain types of investors accessing concessional MIT withholding tax rates on capital gains accruing on assets held prior to Treasury's initial policy announcement (27 March 2018) and during the investor's transitional period. For example, capital gains realised in respect of stapled structures continue to qualify for a 15% capital gains tax rate, and sovereign investors with immunity will receive a deemed market value cost base for capital gains tax purposes on 1 July 2026.

Agricultural MITs on the other hand are not eligible for the same grandfathering or concessions. Instead, any capital gains realised by investors in agricultural assets after the 7 year transition period[1] would become subject to Australian income tax at the applicable corporate income tax rate (currently 30%).

NZSF has made significant investments prior to 27 March 2018 in Australian agricultural land through its joint venture with the Bondfield Family (Palgrove Beef). As part of the investment analysis undertaken, the agricultural business forecast capital gains to accrue in respect of these land holdings by 30 June 2026. NZSF would therefore be adversely affected by the current position in the exposure draft legislation.

We submit that in circumstances where an agricultural MIT continues to hold a transitional investment in agricultural land and disposes of it after the transition period, it would be appropriate to limit the rate of tax on any accrued capital gain at the end of the transitional period to 15% – with any subsequent accretion in value subject to tax at the corporate income tax rate.

[1] In relation to the Sovereign Immunity changes, Schedule 4, Part 2 item 6, unless otherwise covered by a private binding ruling from the ATO with a longer application period.

This approach would limit distortion in market prices caused by taxation. Agricultural assets generally have a small market and therefore the expected increase in selling arising in 2026 as a result of this change could have a significant direct impact. For example, an excess of vendors could result in falling prices, with direct and subsequent impacts for surrounding property valuations.

Submission 3: "contract" vs "assets held" at 27 March 2018

There is a lower threshold to access the transitional provisions for 'MIT cross stapled arrangement income' (Item 10) compared to the transitional provisions for 'MIT agricultural income' (Item 12). Specifically:

- For 'MIT cross stapled arrangement income' – the transitional rules apply to arrangements where an entity "entered into a contract before 27 March 2018 in respect of the acquisition or creation of a facility" or an entity owns a facility at a time before 27 March 2018.

- For 'MIT agricultural income' – the transitional rules apply where a MIT (directly or indirectly) "held the asset" before 27 March 2018.

The transitional test for 'MIT cross stapled arrangement income' caters for a circumstance where a taxpayer has committed to paying a purchase price subject to existing taxation laws under a contract that has been signed, but not completed. There is no equivalent provision in the agricultural transitional rules.

A trust that is majority owned by NZSF had entered into a conditional contract to acquire agricultural land before 27 March 2018 with settlement set to occur after FIRB approval was obtained. This investment was made under the existing taxation laws and before any knowledge of the extent of the change in the tax policy to exclude agricultural land from the MIT regime. NZSF was therefore unable to factor the change in Australia's taxation laws into the valuation and purchase price for this investment.

As there is no clear policy reason for the difference in approach, we submit that the transitional timing rule that applies to 'MIT cross stapled arrangement income' should also apply to the Agricultural MIT transitional provisions.

Submission 4: Extend transition for future enhancements to Agri- MITs

The MIT cross staple arrangement transitional rules will also cover future expansions and enhancements where assets are added to an existing facility or improve or extend its functionality. The EM provides examples illustrating how this will apply (refer in particular to examples 1.19 – 1.21).

We submit that the 'enhancement of a facility' concept should also apply to Agriculture MITs and that the EM should include agri-specific examples to clarify the scope and application of this rule in an agriculture context. We have provided the following examples to illustrate the types of expenditure we submit should be eligible to be included as a future enhancement and which do not represent a new facility in their own right:

- Life-cycle expenditure to maintain functional efficacy, ie costs that relate to the maintenance and/or improvement of the existing capital base such as fencing and land improvements in respect of land that qualifies for the transitional treatment.

- Expenditure in relation to organic growth in the ordinary course of business such as where the business acquires an adjoining grazing block in order to allow for increases in stock numbers.

The above examples should be considered to be consistent with the comments provided in the EM and the factors that should be considered in determining whether a collection of assets together comprise a facility (refer to paragraph 1.157 of the draft EM).

Investors should be allowed to include such capital expenditure within the concessional MIT asset base as an existing agriculture facility during the transitional period. Practically, we also submit that this would remove the need to have to bifurcate what are likely to be (in many instances) de minimis or non-material amounts of rent.

Submission 5: overlap between transitional relief measures

NZSF's investments in agricultural land potentially fall into the transitional regimes for 'MIT cross staple arrangement income' (Part 3, Item 10) and the 'MIT agricultural income' (Part 3, Item 12). As the outcomes differ between the two transitional regimes (and in the event the two transitional regimes are not aligned despite our submissions recommending that they should be) it would be helpful to have an anti-overlap rule that confirms the order of priority between the regimes and therefore the outcomes that affected investors can expect.

Submission 6: Aggregation of interests for the Sovereign Immunity Exemption

The exposure draft legislation provides a framework for determining sovereign immunity and only exempts sovereign entities where they hold less than 10 per cent of an entity's ownership interest and do not influence an entity's key decision making[2]. The draft legislation specifies that in order to test whether the 10 per cent threshold test is satisfied, a sovereign entity's interest in a particular entity must be aggregated with the interest of other sovereign entities from the same sovereign entity group (sovereign entities from the same foreign country and the same foreign government)[3].

Primary submission: No aggregation of sovereign entity interests where separate governance

We are concerned with the notion of aggregating interests held by sovereign entities who are otherwise independent investment bodies from the same foreign country to determine whether or not the 10 percent safe harbour threshold has been exceeded. Our primary submission on this sovereign immunity matter is that where a sovereign entity has a separate Board of Directors responsible for choosing the entity's investment mandate (and therefore the deployment of capital for each relevant investment) the 10 percent safe harbour threshold should be determined on an individual entity by entity basis. In the situation where a separate Board of Directors exists, we submit that there should be no aggregation of sovereign entity interests from the same foreign country and the same foreign government.

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[2] In accordance with the draft legislation, contained under proposed subsections 880-105(1)-(5) of the Income Tax Assessment Act 1997 (ITAA 1997). The draft legislation limits the exemption to trusts that are MITs in the relevant income year.

[3] Subsection 880-105(1)(f) of the ITAA 1997.

To provide practical context to this issue and our experience we note the following:

- A foreign government may have established a number of sovereign funds for different purposes (within the same level of foreign government). In the case of New Zealand, the New Zealand Government has three Crown Financial Institutions (CFIs) that would meet the definition of sovereign entity (ie: the New Zealand Superannuation Fund, the Accident Compensation Corporation and the Earthquake Commission). These entities would be considered members of the same sovereign entity group. The New Zealand Local (State) Government may also have a number of funds that would meet the definition of sovereign entity and together would be considered members of the same sovereign entity group.

- All of the New Zealand sovereign entities have separate Boards of Directors and investment mandates. None of them are influenced, directed, controlled or subject to the instruction of any other sovereign entity (or any single, central authority in New Zealand).

- It would not be feasible to definitively determine whether or not the New Zealand Government exceeded the 10 percent threshold when aggregating the investments held across the separate sovereign entities (within the particular sovereign entity group) from time-to-time. Other than in the rare situation where they were co-investing together in a particular entity, individual sovereign entities would not be aware of what investments the other CFIs had made irrespective of whether they were investments in listed or unlisted entities / vehicles.

We submit that the 10 percent safe harbour threshold should be determined on an individual entity by entity basis where a sovereign entity has a separate Board of Directors responsible for choosing their own investment mandate. There should be no aggregation of foreign government interests in this situation unless it is clear that the Sovereign Entities within the sovereign entity group are working together to avoid the intent of the stapled securities integrity measures.

Secondary submission: No aggregation of sovereign entity interests where one entity does not seek to claim the benefit of sovereign immunity or it is not an eligible covered sovereign entity

In the event that our primary submission on sovereign immunity was not accepted then we believe the definition of ‘sovereign entity group’ (refer Schedule 4, Part 1, Item 5 - proposed section 880-20) should be amended for the reason outlined below.

We are aware there could be situations where a sovereign entity elects not to claim sovereign immunity benefits or is excluded from claiming any benefits as it is not an eligible covered sovereign entity. In these situations, such an entity should be excluded from being part of the sovereign entity group which is subject to the portfolio interest test (refer to the proposed section 880-105(3)).

Therefore, in the event that our primary submission on sovereign immunity was not accepted, then we submit that that the definition of ‘sovereign entity group’ should be amended to exclude those sovereign entities that qualify as members of a sovereign entity group but who do not seek to access the benefits of sovereign immunity or are excluded from claiming the benefits as they are not an eligible covered sovereign entity.

Submission 7 – Sovereign immunity – easing the compliance burden in relation to the transitional rules

Codifying sovereign immunity creates uncertainty as to whether or not sovereign organisations meet the covered sovereign entity definitions. We submit that for the avoidance of doubt the legislation should specify that any organisation that had a sovereign immunity ruling in force as at 27 March 2018 remains eligible for codified sovereign immunity on a prospective basis unless there is a fundamental change in their business.

Inconsistent treatment for Agriculture infrastructure

The inconsistent treatment of agricultural infrastructure in comparison to other infrastructure investment by non-resident investors, in relation to both transitional periods and cost base adjustments on affected assets at the end of the transitional period, is concerning and appears contrary to the general messaging by the Government in relation to the integrity package, which included:

- creating a level playing field for both domestic and non-resident investors, as well as between different classes of non-resident investors, and

- a commitment to ensuring Australia remains an internationally competitive location for foreign investment.

Our perspective is that agriculture investment is a key part of Australia’s productive infrastructure and investment in this sector is important given the challenges that lie ahead (such as climate change, increasing periods of drought, pressures on water supply, etc). We believe that long term patient capital such as that offered by NZSF will support investment throughout the cycle and thereby allow the sector to unlock its potential given its proximity to the critically important Asian markets together with the increased nutrition requirements of their populations.

In our view, there appears to be no reason why different tax frameworks apply to investments deemed to be either an economic infrastructure facility or agricultural infrastructure, and would support a policy that adopts a consistent approach between these categories of infrastructure.

We trust that the above information will be of use to you in respect of the implementation of the policy reforms.

Yours sincerely

John Payne
Head of Tax