BTWG DISCUSSION PAPER: CORPORATE TAX REFORM OPTIONS

21 September 2012

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1. Executive Summary

On 13 August 2012 the Business Tax Working Group (BTWG) released a discussion paper that canvasses options for cutting the company tax rate using revenue-neutral business tax proposals.

In principle, the Property Council supports the Government's plan to:

- improve productivity; and,
- ensure Australia's future prosperity.

However, the property industry is concerned that a number of proposed funding options will hurt productivity, undermine investment and unfairly shift the tax burden to capital intensive sectors of the economy.

The property industry is particularly concerned with two potential funding options:

1) cutting back interest deductions through tighter thin capitalisation rules; and,
2) removing building depreciation.

The Property Council recommends the Federal government:

- reject proposals to scale back building depreciation;
- reject any narrowing of the thin capitalisation rules; or,
- carve out property trusts and stapled vehicles from any changes to the regime.

1) Thin Capitalisation

The Federal Government should not tighten thin capitalisation rules to fund a corporate rate cut because:

1) proposed changes reduce Australia's ability to attract the capital needed to finance infrastructure and development – property projects will be harder to fund;
2) by applying proposed changes to trusts in the same manner as companies, mum and dad superannuation fund investors (as beneficiaries of Australia's property trusts), are paying for the corporate tax cut;
3) proposed changes discriminate against capital intensive investments and will jeopardise property projects – projects will be more expensive;
4) the changes are unnecessary - Australia's thin capitalisation regime is not radically out of step with other countries.

It is self defeating to remove incentives that drive competitiveness in return for a marginal decline in the corporate tax rate.

Thin capitalisation rules should not be sacrificed for a corporate rate cut.

At the very least, the impact of any changes to thin capitalisation should be minimised by carving out property trusts and staples.

2) Building Depreciation

The property depreciation regime exists for sound reasons.

It recognises that the use-value of buildings decline as they generate assessable income.

The Australian tax system should continue to recognise this reality.

Failure to do so will crimp the Australia’s productivity and international competitiveness. It would also remove the incentive to provide the nation with a built environment that serves long-term national interests.

Rather than scrapping depreciation, the Australian Government should commit to aligning depreciation rates with the true, evidence-based, economic lives of assets.

2. Thin Capitalisation

2.1 Introduction

Property trusts and staples are effective and efficient vehicles for driving domestic and global investment in Australian real property.

Trust structures (**Property Trusts**) include:

- listed property trusts (including stapled groups);
- wholesale funds;
- investment syndicates; and,
- club style investments that involve a small number of investors.

In most cases, Property Trusts are also Managed Investment Trusts (MITs).

Property Trust investors include superannuation funds (who invest on behalf of mums and dads), large institutional investors, individuals and self managed superannuation funds.

Property Trusts are not taxed in their own right.

Trust income is taxed in the hands of the investor in a similar way to direct property investments. This makes it a very efficient and effective investment.

Thin capitalisation rules apply to Property Trusts as well as companies. These rules limit debt interest deductions for global entities investing in Australia.

Property Trusts rely on debt financing to fund projects. Debt is used to fund capital shortfalls that cannot be bridged with equity investment.

Many types of projects (in particular large infrastructure projects) rely on global investment because domestic investors are unable to fund them.

Tighter thin capitalisation rules will reduce debt interest deductions available to borrowers. It will increase the cost of a project and make investment less attractive for both global debt and equity investors.

MIT withholding taxes only recently doubled for global investors and tightening thin capitalisation will further wound Australia's ability to attract international capital.

Projects will become more expensive and harder to fund.

Critically, Property Trusts are unable to use a corporate tax rate cut - Mum and dad superannuation investors (as the beneficiaries of Australia's property trusts), will unfairly shoulder the burden of any corporate tax cut.

Tightening the rules serves no practical purpose because Australia's thin capitalisation rules are not more generous than other countries.

2.2 Inequity of proposed changes

Thin capitalisation rules limit interest deductions for global entities investing in Australia.

The rules apply to all entity types including trusts and partnerships – not just companies.

Tighter thin capitalisation rules will further restrict the interest deductions available to borrowers and increase taxable income. This means an increased cost burden to investors and higher costs on projects.

Tax on income from a trust is paid individually by each Property Trust investor. Property Trust investors will not benefit from a corporate rate cut.

In reality, Property Trust investors (largely mum and dad superannuation investors),will foot the bill for a corporate rate cut they cannot use. This outcome is clearly inequitable.

This table summarises the impact on investors:

Investor Type	**Taxation Basis** **(trust taxable income)**	**How thin cap changes impact Investors?**	**Does the investor benefit from Corporate Rate Tax Cut?**
Resident Individuals (mums and dads)	taxed at the investor's marginal tax rates	Increase in personal tax paid by individual resident investor	**No**
Resident Superannuation Investors (complying)	taxed at 15%	Increase in income tax paid by superannuation fund	**No**
Global Investors in MIT's	taxed at 15% on a withholding tax basis	Increase in withholding tax paid by foreign investors	**No**

MIT withholding taxes only recently doubled for global investors and tightening thin capitalisation will further wound Australia's ability to attract international capital.

The MIT withholding tax rate doubled to 15% on 1 July 2012. This was done without warning or consultation.

Doubling the MIT withholding tax rate has spooked global investors and made them reluctant to commit to new property investment and development projects in Australia.

Changing the thin capitalisation regime to fund a corporate tax rate cut amounts to a further effective increase in withholding taxes.

The property industry does not support tighter thin capitalisation rules for capital intensive entities such as property trusts and staples.

2.3 How Does Australia's regime compare internationally?

The Australian thin capitalisation regime is not more generous than the regimes in comparable countries.

Summarised below are some key features of various thin capitalisation regimes.

Country	Debt	Formula	Other method
Australia	All	3:1	
Korea	Related party with a guarantee	3:1	
Russia	Related	3:1	
Belgium		5:1	
Chile	Related	3:1	
United States	All	1.5:1 debt equity ratio (for related party debt) 50% EBITDA cap subject to 1.5:1 ratio	
China	Related	2:1	Arm's length
Japan	All	3:1	
Germany	Related	30% EBITDA cap	Only applicable if interest expense is > €3m Substantial other concessions including equity ratio concession
Brazil	Related	2:1	
United Kingdom	Related		Arm's length
Canada	Related	1.5:1	
Indonesia	Related		Arm's length
South Africa	Related		Arm's length

It is not valid to simply compare the headline debt:equity ratio of the Australian thin capitalisation regime to the ratio in other countries. The Australian thin capitalisation regime as a whole is often more restrictive than the regimes of other countries. For instance:

- The Australian thin capitalisation regime covers all debt (both related and third party) whereas other regimes typically apply to related party debt only.

- Breach of the Australian thin capitalisation regime will result in a permanent denial of interest deductibility. In other countries, the deductibility of interest is delayed (e.g. United States).

- Interest paid on debt is subject to interest withholding tax in Australia, whereas in a number of other countries there is either no interest withholding tax or there are accepted financing techniques whereby interest withholding tax is not payable on related party debt.

- Further, interest withholding tax is payable on interest that is denied as an income tax deduction under the thin capitalisation regime whereas in some other countries such disallowed interest is treated as a dividend (typically tax preferred).

2.4 What are the Impacts?

Tighter thin capitalisation rules mean that:

- **future property construction / development projects will be in jeopardy** as the IRR of projects will decrease with the increasing tax burden – investment hurdle rates will increase and the viability of projects will be put at risk;
- **existing projects will face increasing risk of breaching financial covenants** that trigger penalties and additional financial costs;
- **entities will need to re-negotiate finance** to replace some or all debt with equity – this will limit the finance available for new projects and/or push up the cost of new projects where debt must be used; and
- **employment in the property construction/development sector will be at risk** where projects are scuppered.

Therefore, changes to thin capitalisation will impede capital intensive entities that provide critical amenities including offices, retail, court houses, hospitals, roads, rail and social infrastructure.

State Government community infrastructure projects that are reliant on international capital will be particularly affected by tighter thin capitalisation rules.

The four scenarios below outline the impacts of tighter thin capitalisation rules.

SCENARIO: TRUST PROPERTY PROJECT – URBAN RENEWAL AND INFRASTRUCTURE

The Project

- A substantial urban renewal and infrastructure project comprising (say) retail, office as well as roads, libraries, parks and school.
- Valued at $1 billion dollars.
- Built by a trust and held for rental income - these projects are typically funded by global investors because few domestic investors are able to provide the funding required.
- Project is debt funded to 75% with 67.5% of that debt arms length (assume 8% interest).
- Project's market value is anticipated to be $1.2 billion after seven years of rental.

Consequences of tighter Thin Capitalisation Rules

The simple return on equity (RoE) for each year based on after tax rent received under the current thin capitalisation rules equals **5.6%**

Even with a 1% drop in the corporate tax rate to 29%, the RoE falls to **4.29%** where the safe harbour is reduced to 60% and arms length test removed.

If we assume a 5% RoE requirement, the project becomes commercially unviable at 4.29% and will be scrapped.

SCENARIO: GLOBAL LENDER IN PROPERTY PROJECT – URBAN RENEWAL AND INFRASTRUCTURE
The Project • Urban renewal project as above. • In negotiations the global lender will typically consider the RoE, IRR, project duration and any additional costs to determine the appropriate lending level.
Consequences of tighter Thin Capitalisation Rules A change in thin capitalisation that reduces to the RoE as above to 4.29% is effectively similar to revaluing the project downwards for its total returns. This increases the risk for the project and the interest rate at which the lender is willing to fund the project. The lender will see an advantage to ceasing negotiations on this project and looking for a higher return in a similar project elsewhere. Alternatively the lender may require a substantially higher interest rate, forcing a further downgrade in profitability. The project may become unviable at higher interest rates. If the thin capitalisation changes occur during the life of the project, it is likely that debt and financial covenants will be triggered. Penalties may arise and substantial expenses incurred to renegotiate debt facilities. Global investors also face increased costs from disallowed deductions relating to the project which is effectively an additional increase in the withholding tax. All the entities domestic and global investors effectively subsidise the corporate rate cut.

SCENARIO – CORPORATE STAPLE – DEBT RAISING
The Project • A typical corporate stapled entity may raise debt across both the trust and corporate entities through the stapled group's corporate rating. • The corporate may raise debt in excess of the thin capitalisation threshold to fund projects and developments now and into the future. • The staple will settle for interest deductions being denied above the threshold in order to ensure there is debt available as and when it is needed.
Consequences of tighter Thin Capitalisation Rules Where the thin capitalisation safe harbour is reduced to 60% and or the arms length test removed the staple will lose more interest deductions which will directly impact both the trust and the corporate side of the staple. Ultimately, the trust receives no benefit from the corporate rate tax cut and the staple as a whole loses a substantial proportion of their interest deductions. In one example, a reduction of the threshold to 60% will **cut 50% of the interest deductions** available. Their calculations indicate that the staple would need a **corporate rate cut in excess of 6%** to maintain their financial position. The investors bear the burden of the thin capitalisation changes and obtain no substantial benefit from the rate cut.

2.5 Proposed carve out

A carve out from the proposed changes to the thin capitalisation rules should be provided for economic groups principally engaged in:

- investing in land for the purpose of deriving rent; and / or
- undertaking property construction activities; and / or
- undertaking property development activities.
- investing in senior living assets (i.e. retirement villages and/or aged cared facilities)

This will address the inequity of the proposed changes described at **Error! Reference source not found.** and the impacts of the changes on the property development / construction sector at 2.5 above

There are no integrity issues with this proposal.

Division 855 has already adopted prescriptive tests to determine if an entity is principally engaged in activities associated with real property. The Sub-division 768-G exemption also applies prescriptive rules to determine if an offshore entity is engaged in passive or active activities. Integrity provisions already exist in these rules which could be replicated in the proposed carve out.

As a starting point we propose that a prescriptive approach similar to the methodology in Division 855 would be appropriate.

Further, given the associate rules contained in the current thin capitalisation provisions, the ability to manipulate any carve out would be severely restricted. The current associate rules ensure that all controlled entities within an ownership group are subject to the thin capitalisation provisions.

The Property Council is keen to work with government to determine the exact nature of the exemptions and to ensure that any potential integrity concerns are addressed.

It is critical that the carve out applies to a stapled group, not just the trusts because the debt and equity raising activities affect the staple as a whole.

A company stapled to a trust cannot raise equity without the trust also raising equity. Where one side of the staple raises equity that is not needed by the other side of the staple, loans need to be established between the stapled entities. Both entities are affected by any changes in the debt.

Equally, any external debt raising by either a stapled trust or a stapled company is likely to require the explicit support of the other stapled entity (eg, through guarantee arrangements).

2.6 Specific comments on funding options

In relation to the specific options included at pages 24 – 27 of the Paper we provide the following comments.

Arms length Test

The arms length test was included in the thin capitalisation rules to recognise *'that some funding arrangements may be commercially viable notwithstanding that they exceed the prescribed limits. It also makes the rules more consistent with Australia's DTAs*.'[1] These reasons remain valid.

The basis of the arms length test is that an entity should be permitted to borrow up to an amount that it could have (or indeed does) borrow from commercial third party lenders.

The removal of the arms length test will discriminate against projects which have a greater capacity for debt funding.

While the arms length test creates an administrative burden for the ATO, this should be no greater than the burden that currently exists in respect of the application of the transfer pricing provisions.

We do not believe this is a reasonable basis on which to argue for the removal of the arms length test, as proposed in the Paper.

It is also counter intuitive for the arms length test to be removed in thin capitalisation rules, when the current trend is to include arms length integrity rules in MIT and other tax legislation.

This is best illustrated by the recent experiences of a US Life Company that was trying to invest in first mortgage debt on Australian Commercial property that had a blue chip corporate tenant.

The US Life Company wanted to provide debt at 85% of the value of the asset (85% Loan Value Ratio (LVR)) on the basis that the level of risk on the loan approximated the risk of the tenant defaulting on its obligations under the lease. The investment was effectively de-risked and was comparable to a corporate bond.

This type of investment would be jeopardised by the removal of the arm's length debt test even though the independent third party lenders are willing to provide debt financing in excess of the safe harbour amount due to de-risking of the investment.

The property industry does not support removal of the arms length test.

EBITDA Approach

Options A.4 and A.5 on page 27 of the Paper propose a repeal of the current thin capitalisation rules and replacing them with a cap on the deductibility of interest determined broadly by reference to the 'earnings before interest, taxes, depreciation and amortisation' (**EBITDA**).

The property industry does not support this approach.

An EBITDA approach discriminates against asset intensive industries, such as the property industry, where income returns are a smaller part of overall returns from an investment.

Asset intensive industries require significant capital outlays to generate an appropriate level of income return.

[1] Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001

As such, interest expense would be expected to represent a greater proportion of EBITDA compared with other industries.

Therefore, an EBITDA approach to thin capitalisation is likely to result in greater denial of interest deductions.

The EBITDA approach will also increase complexity for business as it involves new concepts and presumably detailed definitions and application provisions.

The increase in complexity goes against the Government's goal to simplify the tax system.

World Wide Gearing Test

The worldwide gearing test has an important role in the context of the purpose of Australia's thin capitalisation rules.

It prevents groups from having a higher gearing in Australia than they have on other investments and operations.

The limit is set at 120% of worldwide gearing to allow some leeway due to the precise mechanics of the calculation.

If the limit was reduced to 100%, groups would need to adopt a lower gearing ratio for Australia than applies to the rest of their global operations.

If other countries required lower gearing than worldwide gearing, groups would be left with non-deductible interest despite having lower debt in a particular country (ie, Australia) than their average worldwide debt.

Threshold Changes

As noted above, the reduction of the thin capitalisation threshold to 60% will heavily impact capital intensive entities including property trusts and staples.

The impact of any changes to the corporate side of a staple will adversely affect the trust investment vehicles that receive no net benefit from the corporate rate tax cut.

The property industry does not support removal of the threshold for capital intensive entities such as property trusts and staples.

3 Building Depreciation

3.1 Introduction

The BTWG canvasses options that would reduce capital allowances for buildings.

The Property Council asserts that a well-designed and efficient depreciation regime should directly reflect the economic lives of income-producing buildings.

In short, the depreciation system should recognise that the use-values of buildings decline in the course of producing assessable income.

This submission:

- summarises the purpose of a depreciation regime;
- outlines the drivers of depreciation;
- quantifies the economic lives of income-producing buildings based on domestic and international research; and,
- highlights flaws in in the New Zealand and United Kingdom models referenced in the TGWG discussion paper.

3.2 What is Purpose of a Depreciation Regime?

Building assets wear out as they generate assessable income.

The factors that drive obsolescence reduce an asset's competitiveness – its capacity to meet market demands – and diminish an asset's income generating capacity.

A modern tax system recognises declining economic use-value by allowing taxpayers to make capital deductions over an asset's working life.

A system that fails to align capital deductions with an asset's economic life will:

- distort the allocation of scarce capital by artificially favouring assets with a longer depreciation cycle;
- penalise asset owners who innovate – for instance, green buildings cost more than assets constructed on a code-compliant, business as usual (BAU) basis. Low depreciation rates force property owners to pay tax on the capital they inject to boost competitiveness, deliver additional sustainability (green buildings) or deliver supplementary community benefits (such as, social infrastructure which generally delivers lower investment returns); and,
- reduce the incentive to recapitalise buildings in order to retain their competitive servicing of evolving market demand.

In other words, lower depreciation rates lead to higher taxes. This results in sub optimal investment allocations.

The recent re-building of Christchurch following the 2011 earthquake provides a vivid example of these externalities.

As New Zealand does not provide depreciation benefits, property owners are re-building Christchurch to comply with the minimum requirements of the construction code.

This is hardly surprising, as the absence of a depreciation system means owners are penalised for every dollar invested beyond the requirements of the code.

Why spend more to green buildings or deliver social benefits when any additional investment increases assessable liabilities?

3.3 What Does Economic Life Mean?

An asset's economic lifecycle concludes when the net investment required to restore the asset to market competitiveness equals its original construction cost.

Numerous international studies categorise the drivers of economic life:

Physical depreciation

A building's fabric, plant and fixtures wear out over time.

Technological obsolescence

Technological changes can render buildings or their components functionally inefficient.

A building's rental growth is tied directly to its ability to meet the changing productivity needs of occupants. For instance, buildings with services or floor configurations that don't keep pace with trends in versatile, collaborative workplaces can be shunned by tenants.

The stringency levels of Property Council's guidelines on building quality grades have increased markedly over the years in line with building performance expectations.

Environmental obsolescence

The revolution in green buildings has directly impacted on building design and, therefore, construction costs.

For instance, low greenhouse gas (GHG) co and tri-generation plant can wear out faster than traditional energy producing systems.

The Property Council/IPD investment performance index shows that the market values of non-green buildings are increasingly discounted by the market. This is proof of both technological and environmental obsolescence.

Legal obsolescence

The introduction of new legislation in relation to occupational health and safety, access for those with disabilities, or emerging resilience standards speeds up obsolescence. That is, government policies force unplanned capital injections so that buildings meet mandated expectations.

The spatial planning policies of governments can also impact on the competiveness of buildings. Planning policy changes can mean buildings no longer meet "highest and best use" investment criteria

Social and economic obsolescence

Trends in community expectations may result in occupiers demanding higher indoor environmental, working amenity and security standards.

Higher expectations can also impact on buildings that deliver lifestyle services in hotels, retail centres, retirement living or aged care facilities.

Structural change within an economy can speed up obsolescence. For instance, the diminishing importance of the manufacturing sector renders traditional industrial buildings less competitive than logistics and warehouse distribution space.

In all these cases, obsolescence is driven by factors external to the asset.

Aesthetic or Visual Obsolescence

A building may become architecturally out-dated or simply unsightly.

A rational tax system will recognise and account for these obsolescence drivers.

3.4 What is the Economic Life of Different Building Types?

In 2010, KPMG prepared a report on tax depreciation for non–residential buildings for the Property Council of New Zealand.

The KPMG study analysed five recent international survey of building depreciation and concluded that:

- the economic lives of buildings are considerably shorter than current statutory depreciation rates; and,
- the economic lives of buildings are getting shorter, due primarily to technological advancements, the greening of buildings, stricter legislation and higher community expectations.

One recent study of office buildings calculates economic depreciation at 16 years. Another, based on the 'survival ratio' of assets – taking account of demolitions – estimates the economic life of offices at 13 years and industrial buildings at seven years. Still another puts shopping centre and hotel lives at 15 and 18 years.

In 2007, the most comprehensive study into economic lifecycles concluded that actual depreciation rates for buildings are almost triple the official rates used in the Canadian and U.S. tax systems.

KPMG concluded that "we have not come across any studies which suggest that buildings do not depreciate."

The comparative analysis of international studies conducted by KPMG corroborated historical research conducted by the Property Council of Australia.

In 1988, the Property Council divided buildings of different types into 60 elemental components. Industry experts calculated the economic lives of each element as a share of original construction cost.

The study concluded that the typical economic lifecycle of premises was:

- Offices – 21 years
- Shopping centres – 18 years
- Hotels – 15 years

On the basis of this domestic and international evidence, there is a strong case for increasing statutory depreciation rates for various asset types NOT reducing or eliminating them.

3.5 Do the New Zealand and UK building depreciation systems provide a model for Australia?

The BTWG discussion paper cites the UK and New Zealand property depreciation systems on several occasions.

However, the paper ignores the huge differences between the Australian tax system and regimes operated in these countries. For instance:

- New Zealand does not levy stamp duty or capital gains tax. The New Zealand Treasury said this was the main reason for scrapping depreciation benefits in 2010. That is, the elimination of depreciation represented a direct revenue trade off - the New Zealand Government cancelled property depreciation in order to raise revenue.
- Neither the UK or New Zealand systems operate on the basis of distinctions at work in Division 40 and 43 of the Australian depreciation/capital allowances regime.

  Consequently, the Australian treatment of ductwork/pipework for heating, ventilation and air conditioning plant, wiring for smoke detection (to name just two) would need to be totally overhauled if we adopted the UK or New Zealand models. In Australia, these items are part of the amortisation framework, whereas they are treated as plant in the UK and New Zealand.
- New Zealand differentiates between building shell and fit out. Australia does not. Structure integral to plant such as new lift shafts qualify for a deduction in the UK. Once again, any move toward a New Zealand/UK system would require the transposition of some elements from a capital allowances regime to the depreciation regime.
- The UK offers Enhanced Capital Allowances which are 100% deductible in the first year of a building's life. These allowances relate to sustainable technologies such as energy efficient lighting, rainwater harvesting, co and tri-generation etc. Would such a system be introduced in Australia if we intend to mimic the UK?
- New Zealand bases all deductions for acquisition of buildings on the purchase price of assets rather than historical costs, as is the case in Australia. Once again, there is a mismatch between the model proposed in the discussion paper and the Australian approach.

The options outlined in the BTWG paper would require a fundamental recasting of the Australian building depreciation system.

Such an approach would create significant compliance costs. There is no evidence that it would deliver quantifiable dividends to either property owners or the broader Australian community.

Consequently, the BTWG should reject tinkering with the property depreciation system.

Any overhaul should be driven from first principles, involve extensive consultation and be subject to rigorous cost/benefit analysis.

3.6 Conclusion

The property depreciation regime exists for sound reasons.

It recognises that the use-value of buildings decline as they generate assessable income.

The Australian tax system should continue to recognise this reality.

Failure to do so will crimp Australia's productivity and international competitiveness. It would also remove the incentive to provide the nation with a built environment that serves long-term national interests.

Rather than scrapping depreciation, the Australian Government should commit to aligning depreciation rates with the true, evidence-based, economic lives of assets.

Contacts

Please contact the following about any aspect of this submission:

Peter Verwer

Chief Executive

Property Council of Australia

pverwer@propertyoz.com.au

0407 463 842

02 9033 1926

Andrew Mihno

Executive Director

Property Council of Australia

amihno@propertyoz.com.au

0406 454 549

02 9033 1944