

SCENTRE GROUP

28 September 2017

Manager
Financial Services Taxation Unit
Corporate and International Tax Division
The Treasury

By email: affordablehousingtax@treasury.gov.au

Increasing the supply of Affordable Housing

Scentre Group welcomes the opportunity to respond to the exposure draft legislation and explanatory material issued on 14 September 2017 in relation to providing affordable housing through MITs (Exposure Draft).

Scentre Group

Scentre Group (SCG) is the owner and manager of the Westfield Shopping Centres in Australia and New Zealand. SCG is a top 20 ASX listed stapled property group. It was formed in June 2014 through the merger of the Australian and New Zealand operations of the former ASX listed Westfield Group with the former ASX listed Westfield Retail Trust.

SCG has retail real estate assets under management valued at \$45.7 billion and shopping centre ownership interests valued at \$32.3 billion as at 31 December 2016. The Group has a broad investor base that covers Australian individual and super fund investors as well as international institutional investors.

SCG is an internally managed stapled Australian real estate investment trust (AREIT). The Group manages every aspect of its portfolio – from design, construction and development to leasing, management and marketing. As many of the shopping centres in the portfolio are owned in partnership with leading property investment institutions these services are also provided to the third party property co-owners.

The Group's ownership interest in the Westfield Shopping Centres in Australia and New Zealand are ultimately held by two ASX listed managed investment trusts (MITs). In addition, the Group manages a separate ASX listed MIT which owns interests in a shopping centre.

Comments on the Exposure Draft

SCG is a member of the Property Council of Australia (PCA) and supports the PCA submission provided to Treasury in relation to the Exposure Draft.

SCG supports the Government's desire to increase the pool of affordable housing available in Australia. However, SCG is concerned that some of the provisions in the Exposure Draft will have unintended and adverse implications for its business of investing in shopping centres.

In particular, SCG is concerned in relation to the following three areas:

Owner and Operator of  in Australia and New Zealand

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- SCG (and MITs in general) should be able to hold interests in residential premises as an incidental part of broader eligible investment business activities (whether in Australia or overseas)
- SCG (and MITs in general) should be able to hold interests in residential premises overseas (provided the investment satisfies the eligible investment business requirements)
- SCG is concerned that some of the comments in the explanatory material in relation to the application and scope of eligible investment business in the Public Trading Trust rules do not accord with accepted industry and ATO practice.

Further details of these concerns and our suggested changes are set out below.

Application and scope of eligible investment business

For a property trust the key aspect of eligible investment business that it must satisfy is that the trust is investing in land for the purpose, or primarily for the purpose, of deriving rent. It is generally accepted that this test does not require the investment to produce rental income at all times and that provided the primary purpose of an investment is to derive rental income (now or in the future) activities such as acquiring, developing, constructing, altering, repairing and improving the premises on the land will satisfy the test.

For example, the Explanatory Memorandum to Tax Laws Amendment (2008 Measures No. 5) Bill 2008 states at paragraph 5.5 –

“Division 6C applies to tax the income of certain ‘public unit trusts’ and their equity holders like companies and their shareholders if the trust is a ‘public trading trust’. A public unit trust is a public trading trust if at any time during an income year it operates, or controls operations of an entity that carries on activity that is not an eligible investment business. An eligible investment business is defined in section 102M of Division 6C as any, or any combination of:

- *investing in land (**including the acquisition and development of land**) for the purpose or primarily for the purpose of deriving rent [our emphasis]; or*
- *investing or trading in any, or any combination of, the financial instruments as listed in the definition in section 102M, paragraph (b).”*

MITs should be able to hold interests in residential property as an incidental part of broader eligible investment business activities (whether in Australia or overseas)

MITs that own commercial or retail property investments will often look to re-develop or expand those investments. In order to do so the MITs (or controlled entities) may acquire interests in properties near their existing assets. These properties may be commercial, retail or residential properties. For SCG, this may involve the acquisition of a residential property adjoining one of its shopping centres. This acquisition would be made to provide capacity for future expansion of the shopping centre.

MITs may also acquire greenfield sites that they intend to develop into commercial or retail property investments to be held to derive rental income. As part of these developments properties around the main site may be acquired by the MITs (or controlled entities). Again, these properties may be commercial, retail or residential properties.

These investments are not separate businesses; rather they are part of, and incidental to, the broader commercial or retail investment business. Given the time take to make plans for developments and to get necessary consents these properties may be rented for a period of time before they are incorporated into the main business.

This position applies equally to retail and commercial activities in Australia and overseas.

While there is an "incidental" exception proposed in s. 275-10(4D)(d) of the Exposure Draft, where use of residential premises is incidental to the use of the dwelling or a larger asset that includes the dwelling, this exception does not appear to have application where a stand-alone dwelling is residential premises and the ownership of that dwelling is incidental to broader eligible investment business activities.

MITs should be able to hold an interest in residential premises overseas

The proposed limitation on MITs holding residential premises is not limited to Australian residential premises. We understand this is an unintended position. MITs should be able to invest in residential premises overseas (provided the investment satisfies the eligible investment business requirements).

We note that investment in foreign real estate (including foreign residential premises) by Australian MITs results in assessable foreign source income that is taxable in the hands of the Australian resident investors in the MIT. As the income is foreign source income there is no Australian withholding tax imposed on the distribution of this income to non-resident investors in the MITs.

Recommendations:

In relation to the above issues we recommend that:

- A further exclusion be included in section 275-10(4D) to allow for the holding of residential premises where that holding is incidental to a broader eligible investment business – this exclusion could be along the lines of:

"(e) the holding of the dwelling, whether by the trustee referred to in subsection (4C)(a) or by an entity controlled by that trustee, is incidental to a non-residential premises eligible investment business of the trustee."

- Section 275-10(4C)(a) be amended to include the words "in Australia" so that holding of residential premises overseas is allowed:

*"(a) the trustee of the trust holds an *ownership interest in a *dwelling that is in Australia and that is *residential premises but not *commercial residential premises"*

- The commentary in the explanatory material in relation to the application and scope of eligible investment business be amended to reflect current accepted practice. Suggested changes are set out in the attachment to this submission.

We look forward to working with you to ensure that the Government's policy can be implemented without unintended and adverse implications.

Please contact Dudley Heywood (our Head of Tax) directly on [REDACTED] to discuss these matters.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'Peter Allen', with a stylized flourish extending to the right.

Peter Allen

Chief Executive Officer

Attachment – Extracts from Explanatory Material with suggested amendments

2.10 There also currently is significant uncertainty about the eligibility rules for trusts being MITs if investments are made in dwellings that are residential premises. This is because there is a view that investment in residential property is not made for a primary purpose of earning rental income. It is instead for delivering capital gains from increased property values, and therefore not eligible for the MIT tax concessions. However, each investment needs to be considered on its merits.

Enabling MITs to invest in affordable housing

Eligibility conditions for dwellings that are residential premises (but not commercial residential premises)

2.22 The eligibility conditions for dwellings that are residential premises (but not commercial residential premises) are:

- investing in a dwelling used to provide affordable housing for the purpose or primarily for the purpose of deriving rent;
- constructing, altering, improving or repairing a dwelling to use it for a later period in the way described in the first dot point in this paragraph;
- preparing a dwelling for disposal immediately after having used the dwelling previously in the way described in the first dot point in this paragraph; and
- the use of a dwelling as residential premises is incidental to the earning of other income that is eligible investment business from the dwelling or an asset of which the dwelling is a part.

[Schedule 1, item 4, subsection 275-10(4D)]

2.23 References to using a dwelling that is residential premises to provide affordable housing has the same meaning as used in Chapter 1 (additional capital gains discount for affordable housing).

2.24 An interest in a dwelling that a trust holds that is used to provide affordable housing will need to be held for the purpose, or primarily for the purpose, of deriving rent. ‘For the purpose, or primarily for the purpose of deriving rent’ has the same meaning as it does for the definition of eligible investment business in section 102M of the *Income Tax Assessment Act 1936* (ITAA 1936). Each such investment will need to be considered on its merits.

2.25 Factors that need to be considered to determine whether an investment in a dwelling is held for the purpose, or primarily for the purpose of deriving rent include:

- the trust’s investment strategy;
- the length of time the dwelling is intended to be held for, and any plan for disposal;
- any arrangements entered into or activities undertaken by the trustee (including in relation to the development of the property, its management, and other incidental activities);
- features of the dwelling affecting its suitability for rent by affordable housing tenants; and
- projected rental yields and capital growth to determine the purpose for holding the dwelling.

2.26 To satisfy the eligible investment business rules the MIT will generally need to hold dwellings used to provide affordable housing for significantly longer than a period of three or more years — the period before resident individuals will be eligible to receive the additional capital gains discount for affordable housing (see Chapter 1).

2.27 To satisfy the requirement of investing primarily for the purpose of deriving rent, the dwelling must typically be held for a minimum period. This varies, and needs to be considered taking into account the circumstances of the investment. For example, the Commissioner, in recent advice had regard to the nature of the investment, such that it ensured that the property would be held for the long-term and that the net rental yield would likely exceed the capital growth of the property over the 10 year rental period.

2.28 A trust will also be taken to be investing in the dwelling primarily for the purposes of deriving rent in any income year in which it satisfies the safe harbour test in section 102MB(2) of the ITAA 1936 (75 percent or more of income from rent and other requirements).

Consequential amendments

2.29 Two consequential amendments are made to ensure that the law operates as intended.

Trading trust rule for trusts seeking to be MITs

2.30 A trust is a MIT for an income year if it satisfies the MIT requirements in Subdivision 275-A of the ITAA 1997. One of these requirements is that the trust is not a trading trust for the income year.

2.31 Section 102N of the ITAA 1936 provides that a trust is a trading trust for an income year if the trustee (in the capacity of trustee of the trust), at any time during the income year, carried on a trading business or controlled or was able to control, directly or indirectly, the affairs or operations of another entity in respect of the carrying on by that other entity of a trading business.

2.32 Section 102M of the ITAA 1936 then provides that a trading business means a business that does not consist wholly of eligible investment business. Section 102M provides that eligible investment business means:

- investing in land for the purpose, or primarily for the purpose, of deriving rent; or
- investing or trading in certain equities, financial instruments and financial arrangements.

2.33 ~~Some of the activities that trusts can undertake concerning dwellings that are residential premises (but not commercial residential premises) and be a MIT would not otherwise be eligible investment business. An example is the construction of a dwelling, even if it is to be used to provide affordable housing for the purpose, or primarily for the purpose, of deriving rent.~~

2.34 While it is generally accepted that activities such as constructing a residential premises with the intention of using the premises to derive rent would be eligible investment business, to avoid any doubt Therefore an amendment is made so that, for the purpose of applying the trading trust test in subsection 275-10(4), investments in dwellings that are residential premises (but not commercial residential premises) are disregarded if at all times they satisfy the eligibility conditions (see paragraphs 2.22). [Schedule 1, item 3, subsection 275-10(4)]

Definition of public trading trust

2.35 Subsection 102T(16) of the ITAA 1936 has the effect that if a trust is a public trading trust then it cannot be a MIT.

2.36 A unit trust is a public trading trust if it satisfies the requirements set out in section 102R of the ITAA 1936. They are:

- it is a public unit trust in relation to the relevant year of income;
- it is a trading trust in relation to the relevant year of income; and
- it is a resident unit trust in relation to the relevant year of income or it was a public trading trust in relation to a year of income preceding the relevant year of income.

2.37 Under section 102M of the ITAA 1936 a trading trust is a trust that carries on business that is not wholly eligible investment business.

2.38 Most trusts that are MITs would satisfy the first and third conditions for being a public unit trust, meaning that the only reason they are not public trading trusts is because they are not trading trusts. ~~As noted in paragraph 2.22 some of the activities that trusts can undertake for dwellings that are residential premises (but not commercial residential premises) and be MITs do not come within the meaning of eligible investment business. Therefore a significant number of trusts that invested in affordable housing activities would ordinarily be public trading trusts, meaning that they could not be MITs.~~

2.39 While it is generally accepted that activities as noted in paragraph 2.22 when done with the intention of using the premises to derive rent would be eligible investment business, to avoid any doubt Therefore the definition of public trading trust is amended to ensure that in considering if a trust is a public trading trust, affordable housing activities as set out in the eligibility conditions for dwellings that are residential premises (but not commercial residential premises) that trusts can undertake and be MITs are disregarded. This includes constructing, altering, repairing and improving the dwelling and some other activities.
[Schedule 2, item 1, subsection 102R(5) of the ITAA 1936]