PROPERTY COUNCIL of Australia

# TECHNICAL SUBMISSION ON CLEAN BUILDING MANAGED INVESTMENT TRUSTS

24 October 2012

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# 1. Executive Summary

The Federal Government has introduced the Tax Laws Amendment (Clean Building Managed Investment Trust) Bill 2012.

The overall policy intention behind this Bill is to provide a clear incentive for international investors to fund the construction of new green buildings.

The industry provided government and treasury with a submission to address concerns with the original draft bill (see attached submission).

The current Bill provides useful amendments that:

- ensure limited incidental activities will not taint a clean building's tax status;
- provide a more practical definition of "commenced construction" that excludes site works and excavation;
- ensure that clean income can pass through a head trust without tainting WHT eligibility;
- include a 180 day grace period to improve energy performance of a Clean Building that falls below the NABERS or Green Star energy ratings; and
- confirm NABERS ratings relate to base building performance.

However, the Bill can be significantly improved to operate in line with policy goals by:

- addressing two technical issues to ensure the Bill operates as intended;
- removing inconsistencies between the Bill and the Explanatory Memorandum; and
- adopting amendments to ensure the Bill will effectively incentivise the construction of new green buildings.

This submission is divided into four sections:

1) Fixing Technical Issues;
2) Removing Inconsistencies;
3) Policy Issues; and
4) Bill amendments.

The Submission recommends:

**Fixing Technical Issues**

The Bill should:

- provide a 25% safe harbour for income from "assets reasonably incidental to a clean building", in line with existing MIT rules.
- amend the clean building managed investment trust definition to ensure joint ventures and wholly owned subsidiaries are eligible for the 10% WHT rate.

**Removing Inconsistencies**

The submission recommends measures that would align the Bill and Explanatory Memorandum - at present they are inconsistent.

**Policy Issues**

In addition to the technical issues the Property Council urges the government to reconsider points made in its previous submission.

In short, the 10% WHT pathway should include:

- refurbishment and retrofit of existing structures in order to stop or forestall perverse environmental outcomes – for instance, the government's current approach encourages owners to demolish existing structures rather than refurbish them to a higher environmental performance standard;

- tracing of clean and non-clean income from within a single Clean Building Trust – this approach does not impact on expected tax revenue and will ensure clean buildings are not artificially excluded from the Clean MIT regime where they are comingled with building uses such as housing, student accommodation or other publicly beneficial infrastructure; and

- new eligible buildings that form an extension to existing structures – There is no revenue impact from this sensible measure.

# 2. Fixing Technical Issues

## 1. 5% Safe Harbour

**Issue**

The Bill provides for a clean building MIT to receive income from any assets reasonably incidental to clean buildings provided the income from those assets is less than 5% of the total income received from clean buildings.

**Problem**

A 5% limit on incidental income will unfairly penalise investors and is inconsistent with the MIT rules under Division 6C of the Income Tax Assessment Act.

The MIT rules allow trusts to effectively derive 25% of their income from a business reasonably incidental to the renting of land.

The clean MIT regime 5% safe harbour is substantially less than the 25% MIT safe harbour.

It is likely that trusts complying with the MIT safe harbour will earn more than 5% of income from a business reasonably incidental to a clean building.

**Solution**

Section 12-425 should be amended to provide a 25% safe harbour for income reasonably incidental to a clean building.

If incidental asset income falls within the 25% safe harbour, the trust is deemed to be a clean building MIT that satisfies the income requirements under 12-425(1)(c).

## 2. Joint Ventures and Wholly Owned Sub-Trusts

**Issue**

Many clean buildings are joint ventures and most assets are held in wholly owned sub-trusts of MITs.

**Problem**

As currently drafted, the Bill will unfairly exclude joint ventures and wholly owned sub-trusts from qualifying for a 10% withholding tax.

**Solution**

These problems are easily solved by amending the “meaning of clean building managed investment trust” in the Bill as follows:

Section 12-425 (1)(b) " it holds an interest in one or more *clean buildings (including the land on which the buildings are situated), directly or indirectly via a *wholly owned subsidiary; and”

The first change in red is to make it clear that joint ventures will qualify (ie. buildings not wholly owned by the trust).

The second change in red will allow a MIT to hold a clean building via a wholly owned sub trust without having to make that sub trust a MIT.

Unless joint ventures and owning assets via wholly owned sub trusts are directly included in the Bill, the intent of the Bill is unclear and investors will be unfairly penalised.

# 3. Removing Inconsistencies

The Managed Investment Trust Bill and Explanatory Memorandum are inconsistent.

The Bill and Explanatory Memorandum can be easily aligned by adopting the changes outlined below:

## 1. Commercial Construction Definition

### Basement Level

**Misalignment**

Paragraph 1.26 and 1.27 of the Explanatory Memorandum states that a building has commenced construction when the works on the lowest level of the building begins (excluding excavation and site preparation).

However, the Bill states that the construction of the building is taken to have commenced at the time the works on the lowest level (including any basement level) of the building commence.

The Bill is confusing when read in conjunction with 1.27.

The Explanatory Memorandum has a clearer explanation of "commenced construction".

**Solution**

**To reduce confusion, the Bill should delete the words "including any basement level".**

### Excavation

**Misalignment**

Paragraph 1.27 of the Explanatory Memorandum states that any works preparing the site for construction and works undertaken below the lowest level of the proposed building do not represent the commencement of construction for the purposes of this measure. This includes any excavation, environmental remediation or site stabilisation works.

However, as noted above, the Bill does not refer to preparing the site for construction.

**Solution**

**The Bill should specifically state that commencement of construction does not include "any works preparing the site for construction and works undertaken below the lowest level of the proposed building."**

## Error in Explanatory Memorandum

**Misalignment**

Paragraph 1.28 of the Explanatory Memorandum states: “Therefore, buildings such as those built on top of previous foundations or on top of shared car parking facilities will be considered to have commenced construction until works on the lowest level of the building commences”.

However, government has previously stated that pre-existing foundations and facilities are not meant to evidence the commencement of construction.

Paragraph 1.28 of the Explanatory Memorandum is incorrect.

**Solution**

**The Explanatory Memorandum should insert the word “not” after the word “will” at paragraph 1.28.**

# 4. Policy Issues

The Bill currently penalises investors that provide social amenities or mixed use developments mandated under government planning rules.

The regime also unnecessarily excludes clean building MITs if managers can't quarantine the clean assets into a separate trust.

The Bill does not consistently provide a clear incentive for building owners to invest in the construction of new green buildings.

Instead, many clean buildings and green developments will be ineligible for a 10% WHT incentive because:

1) Refurbishments and green retrofits are excluded from the regime, which perversely encourages owners to demolish existing buildings;

2) Student accommodation and residential accommodation are excluded from the regime even where construction is mandated under development planning rules;

3) Extensions are excluded from the regime even though 90% of all shopping centre developments involve extensions.

Attached at four below is a list of activities impacted by the legislation.

## 1. Refurbishment and Green Retrofit

The Bill specifically excludes refurbishment and retrofit of existing buildings.

The Bill discourages investment in green retrofit of existing buildings by only providing the incentive to entirely new constructions.

The current approach will perversely encourage owners to demolish existing structures and waste the building's embodied energy.

The approach is also inconsistent with other laws including GST which treats existing buildings as new where they are substantially renovated.

Each refurbishment or retrofit will create an entirely new building because the structure must meet the regime's new environmental standard to be eligible for the incentive.

**The Bill should allow refurbishment and retrofit of existing structures to stop perverse environmental outcomes.**

## 2. Tracing Clean and Non-Clean income

The Bill forces managers to quarantine all Clean Building assets in a Clean Building MIT in order to access the 10% WHT incentive.

Government wants to isolate clean and non-clean income into separate trusts.

This is unnecessary and creates significant problems for managers. Quarantining Clean Buildings can distort the structuring of investments and causes MITs to fall out of the regime for perverse reasons:

1) it forces managers to restructure existing MITs to quarantine assets, involving significant compliance costs and red tape;

2) it may not be feasible to restructure the MIT and this will effectively exclude the MIT from competing for patient capital to finance clean buildings in the future;

3) restructuring can increase tax burdens including CGT liabilities;

4) mixed use developments can cause a MIT to fall out of the regime if it includes non-clean assets such as student accommodation, residential accommodation or social amenities (eg: libraries).

   Inclusion of non-clean assets in a development is often mandated by Government and this requirement will effectively exclude the MIT from the regime through no fault of the manager.

   The list of activities at four below, are all excluded from the regime and will disqualify a Clean Building MIT.

These problems can be easily fixed by allowing fund managers to tag income from clean and non-clean sources within the one trust.

This approach is consistent with tried and tested tax conventions and would eliminate most of the issues highlighted in the Property Council submission by allowing mixed use trusts.

Taxpayers can use tagging rules to identify non-clean income without distorting investment and there will be no impact on the tax take.

**The Bill should allow tracing of clean and non-clean income from within a single Clean Building Trust.**

## 3. Extensions

As currently drafted extensions to existing buildings are ineligible for the 10% WHT rate.

90% of today's investment in shopping centres take the form of extensions to the existing structures.

An extension is a new building attached to an old building and should be included in the regime.

Tagging of income can be used to ensure that only the new extension on an existing building receives the WHT incentive. This approach will ensure there is no impact to the tax take.

**The Bill should allow extensions of existing structures to receive the 10% WHT incentive.**

## 4. Examples: Activities impacted by the Bill

| ACTIVITY | ALLOWABLE |
|---|---|
| A five star retail development that includes affordable housing under NRAS – The National Rental Assistance Scheme. | X |
| A five star Green Star development that includes student accommodation (as a condition of development consent). | X |
| A mixed use regional urban renewal project (developed with Landcom in NSW). | X |
| Developments in trusts that also include libraries or aquatic facilities. | X |
| A six star Green Star shopping centre extension that is attached to an existing centre (even if the old centre is upgraded to six stars). | X |
| Demolishing a building – thereby shedding its embodied energy - rather than refurbishing it. | ✓ |

# 5. Bill Amendments

Below are the recommended amendments to the Bill and EM that will:

1) rectify technical problems that prevent the Bill from operating as intended;

2) amend inconsistent paragraphs within the Bill and EM to clarify the operation of the regime; and

3) adopt measures that more effectively incentivise the construction of new green buildings.

## 1. Technical Issues

**The following amendments should be made to the relevant sections of the Tax Laws Amendment (Clean Building Managed Investment Trust) Bill 2012 (specific industry changes to the current Bill are in red):**

Replace section 12-425 (1) and (2) with:

**12-425 Meaning of *clean building managed investment trust***

(1) A trust is a ***clean building managed investment trust*** in relation to an income year if during the income year:

(a) it is a *managed investment trust in relation to the income year; and

(b) it holds an interest in one or more *clean buildings (including the land on which the buildings are situated), directly or indirectly via a *wholly owned subsidiary; and

(c) subject to subsection (2), it does not derive assessable income from any *taxable Australian property (other than from the clean buildings or assets that are reasonably incidental to those buildings).

*25% safe harbour for certain income reasonably incidental to a clean building*

(2) A trust is taken to satisfy subsection (1)(c) if the assessable income of the trust that is derived from assets that are reasonably incidental to *clean buildings is not greater than 25% of the assessable income of the trust that is derived from clean buildings.

## 2. Inconsistencies with the Bill and EM

In section 12-430(2) delete the words "(including any basement level)" wherever appearing and insert at the end:

"Any works preparing the site for construction, any excavation, environmental remediation or site stabilisation works and works undertaken below the lowest level of the proposed building do not represent the commencement of construction."

Insert the word "not" after "facilities will" in Paragraph 1.28 of the Explanatory Memorandum:

"Therefore, buildings such as those built on top of previous foundations or on top of shared car parking facilities will not be considered to have commenced construction until works on the lowest level of the building commences".

## 3. Policy Issues

**Please note that some of these amendments alter the recommendations in 1 and 2 above. To the extent of any conflict, these amendments below supersede subsection amendments made above.**

Replace 12-375 in Schedule 1:

"A managed investment trust is a clean building managed investment trust if it is a managed investment trust that holds one or more clean buildings or an interest in one or more *clean buildings (including the land on which the buildings are situated), directly or indirectly via a *wholly owned subsidiary."

Amend section 12-425 after sub para (a) to replace the subparagraphs with:

Replace section 12-425 (1) and (2) with:

**12-425 Meaning of *clean building managed investment trust***

(1) A trust is a ***clean building managed investment trust*** in relation to an income year if during the income year:

(a) it is a *managed investment trust in relation to the income year; and

(b) it traces an amount of assessable income from clean buildings held by the trust; or

(c) it holds an interest in one or more *clean buildings (including the land on which the buildings are situated), directly or indirectly via a *wholly owned subsidiary; and

(d) some or all of the assessable income of the MIT includes a distribution that is referrable to the assessable income from a *clean building; and

(2) for clarity, the clean building managed investment trust can hold income producing taxable Australian property (including for example public amenities, non-commercial housing and student accommodation), taxed at their relevant WHT rates in the Taxation Administration Act 1953."

Amend section 12-430 (3)(a):

"3 A building or part of a building satisfies the requirements in this subsection if:

a) the building or part of a building is a commercial building (including a retrofit or extension of a commercial building) that is any of the following (or is a combination of any of the following):

(i) an office building;

(ii) a hotel for use wholly or mainly to provide short-term accommodation for travellers;

(iii) a shopping centre; or "

Amend the EM to confirm:

- Clean MITS can trace clean and non-clean income from within a clean building MIT;
- Clean MITs can receive any non-clean income (taxed at the appropriate WHT rate);
- Clean MITs can hold any non-clean buildings (taxed at the appropriate WHT rate);
- A new clean building includes extensions and retrofits of existing structures that meet the energy hurdles;
- Eligible sections of a mixed use development should receive the 10% WHT rate.
- All clean buildings can receive the 10% WHT irrespective of any incidental assets.