NSW Urban Taskforce

State Taxation: Lifting the Burden

A submission to the Independent Pricing and Regulatory Tribunal's Review of State Taxation.

Prepared by **NSW Urban Taskforce** 23 November 2007

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The **NSW Urban Taskforce** is an industry organisation representing the development sector. Founded in 1999, the NSW Urban Taskforce represents companies involved in planning and development of the urban environment. Current members of the NSW Urban Taskforce include some of Australia's most prominent developers, construction companies, major infrastructure providers, planners, architects, financiers and lawyers involved in urban development.

1. Executive Summary

1.1 Urban renewal

The NSW Urban Taskforce passionately believes that public policy should support and encourage the renewal of our urban communities.

Regretfully, current taxation arrangements do not meet this goal.

Traditionally taxes have been levied most heavily on goods perceived by the community as 'bad things' to be discouraged. Hence the traditional view that cigarettes, alcohol and premium luxury goods should be more heavily burdened by taxation. Although it is no longer a common view today, society once also viewed imports as 'bad' and taxed them more heavily that domestically produced goods.

In property, today, the reverse is true. The:

- renewal and rebuilding of run – down, obsolete or underutilised property assets; and
- the construction of new homes or job generating industrial, retail or commercial premises,

is more heavily taxed than the structures or empty land they are replacing.

The price of new property assets includes costs embedded into in the form of state and local government taxes, charges and contributions.

A buyer of a typical new apartment developed on a former industrial site, without realising it, is paying more than they should because of section 94 contributions to local government, land tax, stamp duty, council rates, water, electricity and gas utility charges and, in some cases, State Government levies.

A buyer of a new in the greenfield development sites of Western Sydney also pays these charges together with a very high State Government infrastructure charge.

The NSW Urban Taskforce invites the Independent Pricing and Regulatory Tribunal to consider whether or not the current balance of taxation arrangements between new property and existing property assets is fair.

We submit that the development of new property assets is something that should be positively encouraged by taxation policy, and therefore some degree of tax relief (in terms of land tax, stamp duty and council rates) should be extended when property is acquired, held and sold as part of a process to redevelop the land as a new property asset.

<u>1.2 Land Rich Duty</u>

Land rich duty should only exist to the extent it is necessary to prevent people using unit trusts and corporations for the dominant purpose of avoiding stamp duty.

There is a whole range of unit trust and company ("entity") structures which are <u>unfairly</u> caught by the land rich duty provisions.

We say "unfairly" because these entities are, without question, established for the purposes of raising capital to undertake property development. Like listed unit trusts (which are exempt from land rich duty) and wholesale unit trusts (which are treated favourably) they are clearly not in existence for the purposes of avoiding stamp duty.

Land rich duty should not apply to an entity if:

- the entity has a large property portfolio; and
- the entity's shareholders/unit holders do not make personal use of the entity's land on any basis (other than a commercial one).

If the NSW Government accepts the above proposition, then there is a need to fundamentally re-write the land rich duty law.

In the event that a fundamental revision of the law is not occurred, it is possible to make some improvements to the current situation by incremental changes. However these changes will still leave a less than ideal situation which falls well short of the principles of efficiency and simplicity.

In the absence of wholesale reform, the following incremental changes that should be considered:

- The monetary threshold used to define a "land rich" entity should be set so as to avoid burdening entities that have relatively modest holdings of land: $10 million may be a more appropriate threshold.
- The monetary threshold in the definition of "land rich" should also be indexed to move in-line with land prices generally and to avoid bracket creep.
- The percentage of land held by an entity defined as land rich should be increased from 60 to 80 per cent.
- The definition of property used to calculate whether an entity is land rich should align to the commonly understood meaning of the word. The only assets that should be excluded are those that have been vested in the entity, on a non-commercial basis, for the purposes of avoiding the land rich duty provisions.
- In an environment where private unit trusts are a very common and ordinary investment vehicle, private unit trusts should not be treated less favourably than private companies or wholesale unit trusts.
- It should be sufficient that 50 per cent or more of the investors in a unit trust are qualifying investors in order for that trust to be defined as a wholesale trust.
- The definition of a "qualifying investor" should be broader, and should be defined to include sophisticated property investors more generally, rather than simply institutional investors.
- The current requirements for a tracing through to downstream entities in which the head entity has an economic interest of 20 per cent or more should be replaced with the *Corporations Act* definition of subsidiary.
- A current transaction should only be aggregated together with a previous transaction for the purposes of the land rich duty requirements if the reasons the transaction were processed as spate transactions was to avoid the imposition of the duty. If this is not

considered practicable, only transactions made in the last year (rather than the previous three years) should be included.

- A person should be treated as non-associated if the reason that their respective interests were acquired separately was for reasons other than to avoid land rich duty provisions.
- Interests acquired under an exempt acquisition should not be counted as interests for the purposes of determining whether a subsequent acquisition is dutiable.

A detailed explanation and justification for each of these proposals follows in this submission.

2. Land Rich Duty

Land rich duty arrangements were traditionally an anti-avoidance mechanism. The NSW Urban Taskforce recognises and accepts that some form of land rich duty may be required to ensure the integrity of the mainstream system of stamp duties on property purchases.

However, it has become apparent in recent years that the NSW Government regards the system of land rich duty as a significant source of revenue, rather than a mere anti-avoidance provision. If the scheme was genuinely about anti-avoidance, only a minimal amount of revenue would be raised. This is because persons seeking to avoid liability of stamp duty by using corporations or unit trusts as mere devices would see that there was no benefit, and would, therefore, not go to the trouble.

However, the changes made in the first half of this decade mean that the system of land rich duty now impacts on corporation and trustee arrangements that are clearly have not been adopted for the purposes of avoiding stamp duty. While the NSW Government has moved to abolish marketable securities duty, it has also broadened its land rich tax base, so that many more transactions are now caught than was previously the case.

The current arrangements for land rich duty are a major irritant for securing investment in property development in NSW and distorts investment raising activities by arbitrarily discriminating between different arrangements. These complex arrangements are difficult for taxpayers to understand and fail to meet the guiding principles articulated by the IPART in its discussion paper.

The NSW Urban Taskforce position can be summarised in this way: **land rich duty should only exist to the extent it is necessary to prevent people using unit trusts and corporations for the dominant purpose of avoiding stamp duty.**

Therefore the NSW Urban Taskforce believes there are fundamental problems with the structure of the current land rich duty provisions.

The current arrangements discriminate against different investment vehicles based on the identity of the investor. Our first preference would be for a system that instead focused on the nature of the investment held.

For example, a unit trusts that held a single property in which the majority unit holder was resident, rent-free, could readily be regarded as a stamp duty avoidance device.

There is a whole range of unit trust and company ("entity") structures which are unfairly caught by the land rich duty provisions.

We say "unfairly" because these entities are, without question, established for the purposes of raising capital to undertake property development. Like listed unit trusts (which are exempt from land rich duty) and wholesale unit trusts (which are treated favourably) they are clearly not in existence for the purposes of avoiding stamp duty.

Land rich duty should not apply to an entity if:

- the entity has a large property portfolio; and
- the entity's shareholders/unit holders do not make personal use of the entity's land on any basis (other than a commercial one).

In the event that the NSW Government/IPART do not accept this simple over-arching policy prescription, we have also taken the time to analyse the land rich duty system and make specific comments about various aspects of it. The comments suggest certain changes, but any reform that falls short of the fundamental re-think of land rich duty, in our opinion, is likely to fall short of what is required.

We have sought to apply the key guiding principles of efficiency and simplicity, as identified by IPART in its discussion paper.

3. Efficiency

3.1 Discriminatory treatment of private companies and unit trusts

The land rich duty creates a significant market distortion, and is inefficient in its application because it does not apply to publicly listed companies and unit trusts, but it does apply to private and wholesale unit trusts and private companies.

It is appropriate and sensible that publicly listed companies and public unit trusts should continue to be exempt from the land rich duty because:

- a public listing is highly unlikely to have been adopted as a mere device to avoid stamp duty;
- many listed entities are not just limited to a single state – a state-based charge on the transfer of shares/unit entitlements will act as a major disincentive for those entities to invest in NSW;
- any tax would increase the cost of raising capital via a public listing and therefore reduce or remove the economic viability of projects dependant on this form of capital for their success.

However, the same issues can be applied to a whole range of unit trust and corporate structures that are not publicly listed, that is:

- many private unit trusts and companies have structures that are unlikely to have been created for the purpose of avoiding stamp duty;
- it is not efficient to limit private investment vehicles to one state – but the current system of inconsistent state-based land rich duties creates financial incentives to do just that;
- land rich duties do increase the cost of raising private capital and therefore reduce or remove the economic viability of projects dependant on this form of capital for their success.

Use of these structures is discouraged by the discriminatory tax treatment they receive under the land rich duty provisions.

3.2 When is an entity land rich

An entity is "land rich" is it satisfies two requirements. Firstly, if it has land holdings in NSW with an unencumbered value of $2,000,000 or more. Secondly, its land holdings anywhere in the world comprise 60 per cent or more of the unencumbered value of all its property.

In relation to the first requirement, given prices in the NSW property, $2 million is a relatively small amount. Many residential homes would now exceed $2 million in value and almost any parcel of commercial or industrial urban land will be captured within this limit. Furthermore, there has been no indexation of this amount – it has not been adjusted at all for many years.

The monetary threshold used to define a "land rich" entity should be set so as to avoid burdening entities that have relatively modest holdings of land: $10 million may be a more appropriate threshold.

If the land rich duty scheme is genuinely about anti-avoidance, rather than revenue raising, the government should not derive revenue ("bracket creep benefits") from land price inflation. For this reason, **the monetary threshold in the definition of "land rich" should also be indexed to move in-line with land prices generally and to avoid bracket creep.**

Furthermore, the previous test that an entity is not land rich unless land makes up at least 80 per cent of its assets should be reinstated. The 60 per cent threshold can result in entities which would not normally be regarded as "land rich" as being within the provisions and this was not the intention of the provisions. NSW would benefit from a higher percentage through the additional flexibility it would create for investors in property. **The percentage of property held by an entity defined as land rich should be increased from 60 to 80 per cent.**

In order to determine whether the land rich duty scheme applies to an entity, one must first indentify what assets are to be included, so as to work out whether or not more than 60 per cent of the entity's "property" are held as land.

Assets excluded from the definition include:

- cash, whether in Australian or other currency;
- money on deposit with any person, negotiable instruments or debt securities;
- loans that, according to their terms, are to be repaid on demand by the lender or within 12 months after the date of the loan; and
- land use entitlements.

The automatic exclusion of these assets regardless of the circumstances is arbitrary and outside the intended purpose of the provisions. Since when is cash not regarded as an asset? Since when are securities or negotiable instruments not regarded as assets?

The definition of property should align to the commonly understood meaning of the word. The only assets that should be excluded are those that are have been vested in the entity, on a non-commercial basis, for the purposes of avoiding the land rich duty provisions. The Commissioner already has a broad discretion to exclude any property if the landholder is unable to satisfy the Commissioner that the assets were not acquired for an avoidance purpose.

3.3 Trigger for duty

If an entity is 'land rich' the final requirement to trigger a liability to duty is a relevant acquisition, being the acquisition of a sufficient percentage interest in the land rich entity.

A relevant acquisition arises, broadly speaking, where a person acquires an interest of 50 per cent or more in a wholesale unit trust or a private company, but the trigger is 20 per cent or more for private unit trusts.

The introduction of the 20 per cent threshold for private unit trust schemes is a relatively recent and radical change from the previous provisions.

In an environment where private unit trusts are a very common and ordinary investment vehicle, private unit trusts should not be treated less favourably than private companies or wholesale unit trusts.

4. Simplicity

There is a significant disparity between all state and territory jurisdictions regarding the application of the land rich duty. It takes a great deal of effort, even for the most skilled of legal advisors, to correctly advise developers on their compliance with land rich duty provisions when their entities are operating in several States.

Even when an entity is operating just in NSW, the rules are not simple and, to some extent, counter-intuitive.

4.1 Wholesale unit trusts

A wholesale unit trust is not publicly listed, but it is treated more favourably than a private unit trust. A person can acquire up to 50 per cent interest in the property of a wholesale unit trust before the land rich duty provisions apply, but an interest as low as 20 per cent will be enough to trigger the provisions for a private unit trust.

A wholesale trust is defined to be one where at least 80 per cent of units in a trust must be held by a "qualifying investor". This expression is then defined to include what the NSW Government presumably believes are legitimate wholesale investors:

- a trustee of a complying superannuation fund that has not less than 300 members;
- a trustee of a complying approved deposit fund that has not less than 300 members;
- a trustee of a pooled superannuation trust;
- a trustee of a public unit trust;
- a life company if its holding of the units in the unit trust scheme is an investment of a statutory fund;
- a custodian for a trustee, or a trustee for a life company, referred to in any of the preceding paragraphs in its capacity as such a custodian or trustee;
- a trustee of another wholesale unit trust scheme;
- a custodian or trustee for an investor directed portfolio service, if the IDPS has not less than 300 clients or investors, none of whom (individually or together with any associated person) is beneficially entitled to more than 20% of the property to which the service relates;
- an entity responsible for a managed investment scheme;

These classes of a qualifying investor do not necessarily reflect the funds management industry view of what constitutes a wholesale investor. But even if you disregard this point, why should the involvement of these particular groups as 80 per cent of the unit holders of trust deliver a better tax outcome than if these particular groups were 70 per cent? Whatever percentage is set will be arbitrary. However, if the goal is to prevent stamp duty avoidance, rather than revenue raising, a lower percentage should be possible. As it is also a requirement that no single investor holds 50 per cent or more of the units, a trust effectively under the control of one investor is already excluded. **It should be sufficient that 50 per cent or more of the investors in a unit trust are qualifying investors in order for that trust to be defined as a wholesale trust.**

If a high net worth individual invests in a public unit trust, which in turn invests in a wholesale trust, the land rich duty provisions will not apply. However if too many such individuals invest directly into a wholesale trust, suddenly land rich duty provisions do apply. This is neither simple, nor efficient.

The definition of a "qualifying investor" should be broader, and should be defined to include sophisticated property investors more generally, rather than simply institutional investors.

4.2 Tracing of assets

The land rich duty provisions also mean that, in addition to any interest in land or other property that an entity holds in its own right, it is also taken to hold an interest in land or other property held by certain downstream entities.

Traditionally, tracing focussed on the interests of subsidiaries, which generally required an economic interest in the downstream entity of more than 50 per cent. However, this requirement has changed and the law now provides for tracing through to downstream entities in which the head entity has an economic interest of 20 per cent or more.

In order for an entity to be a linked entity of a unit trust or a private company (the principal entity), the principal entity must be entitled to receive not less than 20 per cent of the unencumbered value of the property of the underlying entity if all the persons in the chain (other than the principal entity) were to be wound up.

For example: A company (the head company) has a 20 per cent interest in company B which in turn has a 20 per cent interest in company C. As the head company would not be entitled to 20 per cent or more of the unencumbered value of all the property of company C, company C will not be a linked entity of the head company (even though company C is a linked entity of company B). The head company would only be entitled to 4 per cent of the unencumbered value of property of company C.

The provisions preclude tracing through any public unit trust scheme, wholesale unit trust scheme or a company whose shares are listed on the ASX or an exchange of the World Federation of Exchanges.

Special rules apply for tracing interests through discretionary trusts. In general terms, any beneficiary in whose favour capital of the trust may be applied (whether following the exercise of a discretion or on default) is taken to own or be entitled to 100 per cent of the property the subject of the trust.

The NSW Urban Taskforce suggests that these provisions are extremely difficult to work with, and that a more conventional approach should be taken, such as in the regime that applies, in this respect, in the Australian Capital Territory and Tasmania. Here, in addition to any interest in land or other property that it may hold in its own right, an entity is taken to hold an interest in land and other property held by its "subsidiary".

The value of the land or other property that an entity is taken to hold by virtue of its interest in a subsidiary is that portion which the entity would be entitled to on a winding up of the subsidiary and every other subsidiary in the ownership chain.

In other words, an entity is only attributed with an interest in the land and other property of a downstream entity to the extent that the upstream entity would be entitled to that property on a winding up of the downstream entity.

A private company (Company A) is a subsidiary of another private company (Company B) if the Company A is a subsidiary of Company B within the meaning of the *Corporations Act 2001* (Cth).

The Corporations Act concept of subsidiary also covers control, as well as voting and ownership interests held in a downstream entity.

A private company is a subsidiary of a unit trust scheme if the trustees of the scheme, in their capacity as trustees of the scheme, have a majority interest in the private company. A 'majority interest' means an interest of more than 50 per cent.

A unit trust scheme is the subsidiary of a private corporation if the corporation has a majority interest in the scheme.

The current requirements for a tracing through to downstream entities in which the head entity has an economic interest of 20 per cent or more should be replaced with the *Corporations Act* definition of subsidiary.

4.3 Trigger for duty

If an entity is 'land rich' the final requirement to trigger a liability to duty is a "relevant acquisition", is the acquisition of a sufficient percentage interest in the land rich entity.

A "relevant acquisition" can arise in the following ways.

- a person acquires a "significant interest";
- a person acquires an interest that, when taken together with other interests held by that person or an associated person, amounts to a "significant interest";
- a person acquires an interest that, when taken together with other interests acquired by the person or other persons under substantially one arrangement between the acquirers, amounts to a "significant interest"; or
- a person who has a "significant interest" in a land holder, whether alone or on an associate inclusive basis, acquires a further interest in the land holder.

For the purposes of determining whether an acquisition has given rise to a relevant acquisition the provisions aggregate transactions which have occurred within the preceding three years.

These provisions are exceedingly complex to apply when a person has gradually acquired interests in a particular "land rich" entity over a period of time. At some point their acquisition program can unwittingly take them over the "significant interest" threshold. As always with this scheme, the threshold is not intuitive, it's arbitrary, and unwitting non-compliance with the law is a very real possibility.

A current transaction should only be aggregated together with a previous transaction for the purposes of the land rich duty requirements if the reasons the transaction were processed as spate transactions was to avoid the imposition of the duty. If this is not considered practicable, only transactions made in the last year (rather than the previous three years) should be included.

4.4 Associates

Determining whether a person has made a "relevant acquisition" is considered on an associate-inclusive basis, which means that the interests of a person together with any interest held by that person or their associate are aggregated for the purposes of working out whether a relevant acquisition has occurred.

The test for determining who someone's associates are is extremely wide. The Commissioner has a discretion to treat associated persons or entities as non-associated if he is satisfied that their respective interests were acquired and will be used independently and not for any common purpose (i.e. not acting in concert). **However, a person should be treated as non-associated if the reason that their respective interests were acquired separately was for reasons other than to avoid land rich duty provision.**

4.5 Exempt acquisitions

Interests acquired under an exempt acquisition are still counted as interests for the purposes of determining whether a subsequent acquisition is dutiable. This approach cannot be justified.

For example, if the acquisition of a significant interest is exempt because the land was acquired as a distribution from a deceased estate, the acquisition of a further interest (not being itself a significant interest) eg by acquiring the interests from other beneficiaries, would result in duty, including in relation to the exempt acquisition. In calculating duty on the subsequent acquisition, a reduction should be made in respect of the interest acquired by the exempt acquisition.

Interests acquired under an exempt acquisition should not be counted as interests for the purposes of determining whether a subsequent acquisition is dutiable.

5. Further information

The NSW Urban Taskforce is available to further discuss the issues outlined in this paper.

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