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# TECHNICAL UPDATE



## DRAFT LEGISLATION INCREASES MIT WITHHOLDING TAX RATE FOR RESIDENTIAL AND AGRICULTURAL LAND, AND INCLUDES ADDITIONAL INTEGRITY RULES

The Federal Government has turned what was announced as an apparent tax concession for Managed Investment Trusts ('MIT') investing into affordable housing into a penalty for MIT's not investing in affordable housing. Over the last few months the Federal Government has been rolling out in a piecemeal fashion a number of proposed measures to limit the tax concessions for certain foreign investors, including draft legislation on improving the integrity of stapled structures and restrict concessions for foreign pension funds and sovereign wealth investors with non-portfolio investments. The Federal Government has added to this with the release of further exposure draft legislation that proposes to increase the MIT withholding tax from 15 per cent to 30 per cent for certain distributions from agricultural land and residential property. There is also a further exposure draft with additional integrity rules that will apply to stapled entities that access the infrastructure concession and/or transitional arrangements.

### BACKGROUND

The Government released a [Policy Measures Package](#) on 27 March 2018 with new integrity measures for stapled structures with the potential to impact commercial and financial outcomes for investors in Australian infrastructure and agricultural sectors, and not just those who invest in stapled arrangements. The [first stage of draft legislation](#) was released on 17 May 2018 as detailed in this previous [BDO Tax Technical Update](#). On 26 July 2018 the [second stage of draft legislation](#) was released reflecting feedback from consultation on the first stage of draft legislation and included the MIT agricultural land measure and the affordable housing measure. This was followed by additional [draft legislation](#) with integrity rules on 7 August 2018. The disjointed nature of this fragmented reform has contributed to confusion and short consultation times have further not allowed issues stemming from the proposed changes to be fully explored.

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## SECOND STAGE OF EXPOSURE DRAFT LEGISLATION

The [second stage of draft legislation](#) was released on 26 July 2018 and reflects feedback from public consultation on the first stage of draft legislation. It also includes measures to prevent foreign investors from accessing concessional 15 per cent MIT tax rates on agricultural land and changes to the treatment of residential housing held in a MIT announced as part of the affordable housing measures in the 2017/18 Federal Budget. The revised draft legislation creates four categories of non-concessional MIT income:

1. MIT cross staple arrangement income
2. MIT trading trust income
3. MIT agricultural income, and
4. MIT residential housing income.

The first two categories are largely unchanged from the first stage of draft legislation (including transitional measures—if applicable) however, the agricultural income and residential housing income provisions are new and are examined in more detail below.

### MIT RESIDENTIAL HOUSING INCOME

The [second stage of draft legislation](#) includes MIT residential housing income in the definition of non-concessional MIT income and proposes that a 30 per cent withholding tax rate apply to income of a MIT that is attributable to Australian residential housing instead of the 15 per cent rate that currently applies to most distributions by MITs to residents of 'exchange of information countries' (there is a list of 60 such countries). MIT residential housing income is defined as any assessable income of a MIT (whether received directly or indirectly) to the extent it is:

- a. attributable to an asset that is a dwelling;
- b. taxable Australian real property;
- c. and residential premises but not commercial residential premises.

MIT residential housing income includes all amounts of assessable income of a MIT attributable to such assets (such as rent, capital gains and licence fees). This means the 30 per cent withholding tax rate will apply for income from Australian residential premises. This will also apply to capital gains distributed through the MIT and attributable to the sale by the MIT of an interest in an entity where Australian residential premises make up more than 50 per cent of the assets of that entity. Amounts attributable to commercial residential premises (e.g. hotels and certain student accommodations in schools but not universities) will be carved out and continue to be subject to the 15 per cent withholding rate for residents of 'exchange of information countries'. In addition, amounts from assets used to "provide affordable housing" are also excluded from being MIT residential housing income and therefore will continue to be subject to the 15 per cent MIT rate for residents of 'exchange of information countries'.

For capital gains on affordable housing assets to qualify for the 15 per cent rate the dwelling must have been used to provide affordable housing for at least 3,650 days. The days must occur after 1 July 2017 but before the CGT event, and do not need to be consecutive<sup>1</sup>.

This measure was originally announced in the 2017/18 Federal Budget as a measure to "*encourage investment into affordable housing by enabling Managed Investment Trusts (MITs) to invest in affordable housing*". This appeared to be providing a concession for MIT's to invest in affordable housing. However, on 15 September 2017, Treasury released these measures in [draft legislation](#) as an 'integrity measure' to discourage MITs from holding residential premises other than affordable housing and commercial residential premises. What was originally announced as a concession suddenly evolved into more of a restriction that was punitive. MITs previously had a general 15 per cent rate on distributions to foreign residents in information exchange countries which included any non-trading income from investments in any type of residential housing but these MIT distributions are now penalised with a 30 per cent rate if they invest in residential housing other than affordable housing.

The MIT residential premises rule will apply from 1 July 2019, which is preferable to the start date of 1 July 2017 as announced in the 2017/18 budget. Transitional protection will be available for 10 years provided that the MIT held the relevant interest before 14 September 2017 and the amount received in relation to the residential premises is received by the MIT before 1 October 2027.

BDO notes that contrary to the first draft legislation released on 15 September 2017, the holding of residential housing will not result in a trust failing to qualify as a MIT which is a positive change. Instead, the consequence is a higher withholding tax rate.

**This measure was originally announced in the 2017/18 Federal Budget as a measure to "*encourage investment into affordable housing by enabling Managed Investment Trusts to do so*".**

<sup>1</sup> Note - the circumstances in which a dwelling is used to provide affordable housing are set out in the [Treasury Laws Amendment \(Reducing Pressure on Housing Affordability Measures No. 2\) Bill 2018](#) which was introduced into the Senate on 19 March 2018 where to date it remains.

## MIT AGRICULTURAL INCOME

MIT agricultural income is proposed to be included in the definition of non-concessional MIT income subject to the MIT withholding at the 30 per cent corporate tax rate. It is defined as amounts of assessable income of a MIT that are attributable to an asset (whether or not held by the MIT) that is Australian agricultural land for rent. Importantly, this means that capital gains (derived directly or indirectly) are also included as MIT agricultural income and subject to withholding tax at the highest corporate tax rate of 30 per cent. In the explanatory memorandum (EM) 'Australian agricultural land for rent' is defined as an asset that is real property (including a lease of land) situated in Australia if the asset is used, or could reasonably be used, for carrying on a primary production business; and is held primarily for the purposes of deriving or receiving rent.

Example 1.12 of the EM 'Sale of indirect interests in agricultural land' addresses the possibility that the term 'could reasonably be used' means that the MIT agricultural income measures could apply to investors beyond the agricultural sector and capture large scale users of rural land even where the land is not currently being used for a primary production business. In this example capital gains arising from the disposal of a membership interest in a test entity and the assessable income of other entities ultimately attributable to such gains are MIT agricultural income as the assets of the test entity are principally Australian agricultural land for rent; and the entity holding the interest has a substantial interest in the underlying assets. This is an 'all or nothing' test where 100 per cent of a capital gain relating to membership interests will be taxed at the non-concessional withholding tax rate if the principal asset test is passed, even if only 51 per cent of the value of the underlying assets relates to agricultural land.

According to the transitional rules income or gains relating to assets acquired before 27 March 2018, and derived before 1 July 2026, will be taxed at the concessional 15 per cent withholding rate, however where MITs receive income or gains attributable to agricultural land held by another entity, the MIT will only be entitled to transitional relief if the MIT held 100 per cent of the other entity throughout the period. Therefore, MITs investing into joint ventures will not be eligible for the reduced withholding rate during the transitional period and will instead have a 30 per cent withholding from 1 July 2019 onwards. This punitive measure penalises foreign investors that have invested in joint ventures with Australian partners relative to those which have invested with 100 per cent foreign ownership.

## OTHER CHANGES

The thin capitalisation measures remain broadly the same as the first stage of the draft legislation except that an integrity measure has been introduced for the purposes of determining whether an investing entity has an interest of less than 10 per cent in another entity where the investing entity holds that investment via one or more interposed entities. As compared to the first stage of draft legislation there is also a revised concept of a sovereign entity group which no longer combines all sovereigns from the same country for the purposes of determining the level of participation interest. Rather sovereign entities of the same foreign government will be combined for the purposes of determining the participation interest, but sovereign entities from the same country but in relation to different governments within the same country will not be combined.

## ADDITIONAL INTEGRITY RULES

On 7 August 2018 additional [draft legislation](#) was released with additional integrity rules that will apply to stapled entities that access the infrastructure concession and/or transitional arrangements and build on a [proposals paper](#) released on 28 June 2018. The integrity rules will apply to stapled entities comprised of asset-owning managed investment trusts (MITs) and their stapled operating entities, where the stapled entity is permitted to continue under the transitional rules and/or approved economic infrastructure facility exception.

In line with the proposals paper, the integrity measures apply to all facilities that benefit under the transitional rules and/or approved economic infrastructure facility exception and will extend the current MIT non-arm's length income rule to require the asset-owning MITs to set their rent in respect of their land investment to the operating entity at market prices and introduce an additional concessional cross-staple rent cap. Any breach of the concessional cross-staple rent cap will result in withholding at 30 per cent (top corporate tax rate) to the extent that the rent cap was exceeded, while income below the cap continues to have access to the 15 per cent withholding rate. If the Australian Taxation Office (ATO) makes a determination to apply the non-arm's length income rule, then the trustee of the MIT will be liable to pay tax on the amount at 30 per cent (top corporate tax rate). The amount of the concessional cross-staple rent cap amount depends on whether an established method of determining rent is in place at 27 March 2018.

## BDO COMMENT

- ▶ It is regrettable that the Federal Government has not acknowledged that they have changed the emphasis of the 2017/18 budget announcement on affordable housing from 'encouraging' and 'enabling' MITs to investing in affordable housing, which is now described in the exposure draft explanatory materials as "MITs would be prevented from investing in residential premises unless they are commercial residential premises or affordable housing".
- ▶ The broad application of the agricultural measures has punitive consequences for foreign investors in agricultural land and the transitional rules on capital gains and indirect investments are particularly onerous. The inclusion of MIT residential housing income as non-concessional MIT income will create an additional barrier or disincentive for foreign institutional investors to invest in large scale 'build to rent' residential real estate projects that are required to increase housing supply in Australia.

- ▶ Contact BDO for assistance with reviewing the current status of ongoing and planned projects - current investments will need to revisit existing structures to determine the impact of the changes on after tax returns and proposed new investments should factor in the new changes when assessing the financial and commercial impact for investors
- ▶ It is expected that the Government will aim to have the measures introduced into Parliament before the conclusion of the 2018 Spring sittings on 6 December 2018, therefore affected taxpayers should anticipate ATO guidance on the compliance and administrative impacts that will arise as a result of the implementation of these changes.



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