Alternative assets – a Federal Budget lost?

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In brief

A number of measures announced in the 2016-17 Federal Budget will directly impact the alternative asset industry. When these are considered as a whole, the Government's objectives for the sector are incomprehensible.

In detail

One of my fellow PwC partners, Jeremy Thorpe, described the 2016-17 Federal Budget as the 'instant coffee' Budget. It was not the 'espresso' that we would have liked, but it had enough caffeine to give the economy a little stimulus.

If that analogy were applied to Federal Budget tax reforms in the alternative asset industry, this would be described as the 'white-choco long black' Budget. We are getting an espresso but it has been watered down, and when considered as a whole, the objectives are almost irreconcilable.

We saw positive developments for the Australian fund management industry that are intended to stimulate the import of foreign capital (such as collective investment vehicles (CIVs) and asset-backed financing) at the same time as the passing of the attribution managed investment trust (AMIT) rules. However, foreign capital will simultaneously face a new unilateral diverted profits tax and hybrid mismatch rules. And while the clarification of the Foreign Investment Review Board announcements was welcome, those rules are hardly a positive for foreign capital.

The changes to remove tax concessions from investment in Australian superannuation are also not a positive development for a sector which relies so heavily on Australian superannuation as a source of capital.

The participants in the sector that considered below are:

- Australian funds – real estate investment trusts, Australian unlisted funds and, indirectly, Australian fund managers
- Foreign capital – foreign superannuation and pension funds, foreign asset managers, sovereign wealth funds, and
- Superannuation – Australian industry and retail superannuation funds.

Australian funds and fund managers

Australian fund managers did receive some welcome reforms in the announcement of the commencement dates for the new CIV measures and the asset-backed financing changes.

The asset-backed financing changes will allow fund managers to offer products in a tax efficient manner so as to access sources of capital that, for regulatory or other reasons, are restricted from deriving certain forms of income (for example, 'Islamic financing'). These investors rely on derivative instruments to gain exposure to certain asset classes. The changes will seek to align the tax treatment of these derivative instruments with the income earned from the underlying assets.

The CIV measures will result in a corporate flow-through investment vehicle from 1 July 2017 and a limited partnership flow-through investment vehicle from 1 July 2018. This expands the forms of limited liability investment vehicles, introducing vehicles that are more familiar to foreign investors. Eligibility for the CIV treatment is expected to follow the current managed investment trust (MIT) eligibility rules.

In a happy coincidence, the new AMIT rules were passed through the parliament on the day after the Budget. These rules also contained the repeal of Division 6B of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the repeal of rules that deemed a unit trust to be a 'public unit trust' where 20 per cent of the beneficial interests were held by a complying superannuation fund.

These changes are directed to attract foreign capital to invest in and through Australia. From an Australian alternative asset management perspective, it is hoped that this foreign capital will replace the declining Australian superannuation capital as a consequence of the policy changes mentioned above. However, this is before, the foreign capital has to consider the other changes in the Budget.

Foreign capital

Now, we don't think that the new international integrity rules in the Budget were introduced because foreign investors in alternative assets were not paying their fair share of Australian tax. The MIT rules, the Investment Manager Regime (IMR) and the new CIV rules are all directed at encouraging these investors to invest in Australia and particularly in alternative assets. Furthermore, a number of these investors enjoy exemptions enshrined in Australian domestic law (for example, exempt foreign superannuation funds are exempt from interest and dividend withholding tax (s 128B(3)(jb) ITAA 1936) or foreign policy (sovereign wealth funds)).

The two most pervasive international integrity measures that were announced included:

- a new diverted profits tax rule which applies a penalty tax of 40 per cent on profits transferred offshore to related parties with 'insufficient economic substance' that reduces the tax paid on profits generated by Australia by more than 20 per cent (for example, deductible expenditure in Australia, taxed at less than 24 per cent in the hands of the recipient), and
- a unilateral hybrid mismatch rule that looks to neutralise any tax benefit obtained through vehicles or financing instruments that are treated differently as between Australia and the counterpart foreign jurisdiction.

These rules mirror similarly enacted provisions in the United Kingdom (UK). However, unlike the UK, foreign superannuation funds and sovereign wealth funds have not been excluded from the diverted profits tax rule.

One might reasonably ask why should the foreign superannuation funds and sovereign wealth funds should be exempted from the diverted profits tax rules. However, if foreign countries were to apply similar rules to Australian outbound investments, Australia's superannuation funds could also be caught given the concessional tax rate on earnings (15 per cent or lower) enjoyed by these funds.

In analysing the consultation paper, *Implementing a diverted profits tax*, released by the Federal Government, it can be seen how foreign investors or foreign fund managers are likely to adapt to the new diverted profits tax rules.

First, the rules only apply to Australian tax resident entities or foreign entities with a permanent establishment in Australia. The initial reaction of the foreign investor is therefore to ensure it does not

have a permanent establishment in Australia. If the flow-on consequence of that is that the foreign investor will maintain their capital invested in Australia but retains Australian fund managers, this is a boost for the Australian funds management industry. If the consequence is that the foreign capital is less likely to be deployed in Australia, this is a cost to the Australian economy.

The next criteria are that:

- It is reasonable to conclude that the transaction was designed to give rise to an 'effective tax mismatch', and
- The transaction has insufficient economic substance. Note that this test actually has nothing to do with economic substance, despite its name – it is simply a comparison between tax benefit and non-tax financial benefits.

An effective tax mismatch looks at the relative increase and reduction of tax liabilities of the parties. At para 24 of the consultation paper, the following statement is made:

"In determining the reduction in the tax liability, the circumstance of the reduction (for example, different tax rates, the provision of tax relief and the exclusion of an amount from tax) will be disregarded."

The inference from this statement is that the reason why the tax liability of the recipient is lower than reduction in the tax liability of the payer is irrelevant (other than for reasons such as tax losses).

This means the effective tax mismatch limb will be satisfied purely on a mathematical calculation. The character of the recipient and its status in its country of residence will be irrelevant. Clearly, every transaction between an Australian corporate taxpayer and an exempt foreign pension fund or sovereign wealth fund will give rise to an effective tax mismatch (if those entities have permanent establishments in Australia), as will transactions with tax residents of numerous countries.

The effective tax mismatch calculation anchors on relative 'tax liabilities'. There is no discussion in the consultation paper regarding situations where Australia provides flow-through taxation. For example, as a flow-through trust or a MIT (absent penalty provisions) is strictly not liable to tax in Australia, does this mean these entities may make payments that can never give rise to an effective tax mismatch?

The second 'insufficient economic substance' limb addresses whether:

"…it is reasonable to conclude based on the information available at the time to the ATO that the transaction(s) was designed to secure the tax reduction."

The consultation paper goes on to say that this involves a weighting of the non-tax financial benefits of the arrangement against the financial benefits of the tax reduction. If the non-tax financial benefits exceed the financial benefits of the tax reduction, the arrangement will have sufficient economic substance and the rule will not apply. In practice, this is difficult to prove and often will not be true for financing.

The factors that the Commissioner will consider in arriving at the reasonable conclusion, and their relative weighting, are unclear. However, it can be surmised from the introduction of this rule that the general anti-avoidance provisions are not sufficiently stringent to apply to these scenarios. Therefore, these provisions would have application where there is something less than an objective dominant purpose of achieving a tax benefit. Additionally, the consideration of the eight factors in s 177D(2) ITAA 1936 would not seem to be relevant to this enquiry.

In cases where the taxpayer by its very nature or its jurisdiction causes the effective tax mismatch, it will be difficult for the taxpayer to prove that non-tax financial benefits of 'the arrangement' outweigh the tax financial benefits. There may be no reasonable alternative postulates that the taxpayer could point to in order to disprove the insufficient economic substance test.

The consultation paper is only the first step in the release of the new diverted profits tax rule and it can be observed from its potential application to the alternative assets industry that some refinement is necessary.

Australian industry and retail superannuation funds

And then onto Australian superannuation funds. These funds are large investors in real estate and infrastructure.

The majority of the tax changes announced in the 2016-17 Federal Budget act as a disincentive to make contributions to all superannuation funds. These are as follows:

- reductions in the concessional contributions cap to $25,000 (from $30,000)
- lowering the income threshold for the 30% concessional contributions surcharge tax to $250,000 (from $300,000), and
- introducing a lifetime cap for non-concessional contributions of $500,000 (not assessable to the fund, nor deductible to that individual).

The purpose of these changes is to reduce the perception that superannuation is a tax preferred investment vehicle and to reinforce the now declared principle of superannuation, which is to provide income in retirement to substitute or supplement the aged pension. The objective is seemingly to provide tax concessions for an individual to achieve a superannuation balance that would provide for the same income in retirement as the aged pension, but no more than that.

While largely accepted by the economic community as being a boon for economic growth, the phased company tax reduction also acts as a deterrent to investing in superannuation. This is because the relative advantage of investing in superannuation compared to a company declines with a reduction in the corporate tax rate without a commensurate reduction in the taxation rates applicable to superannuation investment earnings. No reduction in taxation rates for superannuation earnings was announced.

The takeaway

When changes that are an overall negative to private sector investment in alternative assets are made against a commitment to 'jobs and growth' and amid a declining fiscal position, the ability to logically rationalise the changes becomes challenging. Private sector participants reduce the burden on the government sector to finance the construction of job-creating new infrastructure or new affordable housing. In a macro sense, this private sector participation has both the effect of creating new jobs and reducing the tax burden on the general population by shifting the financing of these investments to the private sector.

In spite of this, the Federal Government has released a series of measures intended to address specific issues without aligning these to a consistent objective for the alternative asset industry.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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