15 April 1999

Private & Confidential

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

Submission - A Platform For Consultation

We enclose a submission on behalf of Australian Growth Properties Limited ("AGP") in respect of Tax Reform. AGP has no objections to this submission being publicly released in its entirety.

If you have any queries in relation to this submission please contact any of the following people:

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We look forward to further dialogue with you on this important submission.

Yours sincerely
ERNST & YOUNG

Jock McCormack
Partner - Taxation

1.0 Executive Summary

Australian Growth Properties Limited ("AGP") is a property investment company which listed on the ASX in May 1997. Although AGP is structured as a company, it operates in a similar manner to listed property trusts. (Section 2.0)

AGP does not support the proposed reforms to the imputation system as set out in Chapter 15 of *A Platform for Consultation* unless appropriate mechanisms are established to ensure that vehicles such as AGP are not disadvantaged - for example transitional provisions and reorganisation relief. (Section 3.1)

AGP **does not** support the deferred company tax model as it would be complicated, confusing to shareholders, adversely affect the returns to non-resident shareholders (reducing overseas equity investment in Australia) and would adversely impact on the company's reported profits. It does not recognise existing tax preferences which generally arise from government economic policy initiatives. Nor does it allow companies to recoup the benefit of carried forward income tax losses. (Section 3.1)

AGP believes that in order to reduce costs of business restructures necessitated by the proposed taxation changes, it is critical that capital gains tax rollover relief be expanded and simplified, and that simple and comprehensive stamp duty exemptions are available. (Section 3.2)

AGP supports the concept of flow-through taxation of collective investment vehicles ("CIVs") outlined in Chapter 16 of *A Platform for Consultation* and that companies investing in property, equities and bonds should also be able to be treated as CIVs. It is submitted that tax preferences should flow-through CIVs to the ultimate shareholders. This should extend to all sub-trusts and companies. It should also extend to certain interests in entities which are not held 100%. (Section 3.4)

AGP has some concerns about the proposed consolidation regime. (Section 3.5)

AGP **does not** support the repeal of the current grouping provisions. It is submitted that the current grouping provisions should continue in parallel with the new consolidation regime. (Section 3.5)

2.0 Background

Australian Growth Properties Limited ("AGP") is a property investment company which listed on the ASX in May 1997. The company has total assets of over $460 million. It concentrates its activities in the Australian CBD office market, with emphasis on properties in Sydney. AGP owns a portfolio of commercial properties from which it derives rental and other related income, and is also currently developing a commercial site at 363 George Street, Sydney. These properties are held through wholly owned subsidiaries and wholly owned unit trusts. It also holds a strategic investment in a listed property trust (Global Property Fund) which itself owns a portfolio of properties. AGP currently both owns and manages its properties and investments.

Although AGP is structured as a company, it operates in a similar manner to listed property trusts, and is included in the Listed Property Trust Sector of the ASX. It is unique in that it is the only listed company included in this sector.

Similar to property trusts, AGP has a policy of paying its entire earnings as dividends to shareholders. Due to the benefit of past income tax losses carried forward, the dividends paid are unfranked. These carried forward losses arise in part out of depreciation allowances available in respect of the commercial properties held, and also due to the deduction of holding costs in respect of various properties.

A major shareholder in AGP is Trans Tasman Properties Limited ("TTP") - a company which is listed on the New Zealand Stock Exchange. The shares in AGP are owned through a wholly owned resident subsidiary. TTP owned 100% of AGP prior to AGP's flotation on the ASX, and was the owner when AGP's existing tax losses were incurred.

3.0 Submission

3.1 Redesigned Imputation System

AGP does not support the proposed reforms to the imputation system as set out in Chapter 15 of *A Platform for Consultation* unless appropriate mechanisms - for example safeguards, transitional provisions and (if necessary) reorganisation relief - are established to ensure that vehicles such as AGP are not disadvantaged. AGP supports the current imputation system of taxing company distributions. For the majority of dividends paid the current franking system works well. It is clearly understood by investors, and is relatively simple in most cases to administer.

Chapter 15 of "A Platform for Consultation" states that the distinction between franked and unfranked dividends adds complexity at the shareholders level and at the company level. AGP does not accept this statement. In the majority of cases, dividends can either clearly be fully franked, or are unfranked. It is usually a fairly simple task for a company to determine its "required franking amount". After 12 years of the imputation regime, investors understand the implications of franked and unfranked distributions, and the reasons for such differences.

The current tax regime has a number of complicated anti-avoidance provisions to attack particular perceived misuses of the franking regime. Rather than re-designing the entire franking regime, AGP submits that a clear policy decision be made regarding the circumstances in which franking benefits can be utilised, and simplified anti-avoidance provisions be enacted to catch breaches of this policy, while not affecting genuine commercial activities.

AGP **does not** support the deferred company tax model as it would be complicated, confusing to shareholders, adversely affect the returns to non-resident shareholders (reducing overseas equity investment in Australia) and adversely impact on the company's reported profits. The effect of a deferred company tax regime would be to negate the effect of any tax initiatives that the government may wish to implement.

Any of the proposed regimes would penalise entities such as AGP which distribute substantially all of their accounting profit, and are entitled to taxation depreciation deductions during the period of ownership of its commercial properties. For accounting purposes, such properties held for investment purposes are not depreciated. As a result, there are substantial timing differences between accounting and taxable income. Any system which attempts to tax such distributions will result in double taxation. None of the options outlined in chapter 15 address the double taxation issue adequately. The refund of excess franking credits on liquidation will occur too late to benefit the shareholders who have borne the double taxation. The option to allow the double tax to be creditable against future company tax liability is a little better, but in AGP's case would also be of little benefit. Due to the nature of the temporary timing benefits, it will be many years before the timing benefits reverse (e.g. when the property is sold). The prepayment of tax on temporary tax preferences is not appropriate as it completely eradicates the tax policy reason for introducing the tax preference. The final option - to increase the cost base of the funded asset - also has the problem that it will be many years before the benefit can be utilised.

The effect of double tax is exacerbated by the non-allowance of DCT to be credited against future income tax payments. In this respect DCT is in the nature of a tax penalty, particularly where companies distribute all of their profits.

AGP also submits that transitional arrangements should be made for companies with carried forward taxation losses. If unfranked distributions arising out of taxation losses are subject to tax, this is effectively the imposition of retrospective taxation. The effect would be the same as denying the taxation losses. Transitional rules should exempt companies from the new proposed DCT or a RDWT regime in resect of untaxed distributions attributable to taxation losses.

3.2 Rollover Relief and Stamp duty exemptions to restructure

It is clear that whichever options for reform may be adopted, it will be necessary for companies to restructure their businesses in order to avoid punitive taxation treatments. This will necessarily involve substantial costs to business. AGP believes that in order to reduce such costs, it is critical that capital gains tax rollover relief be expanded and simplified, and that simple and comprehensive stamp duty exemptions are available for such restructures.

3.3 Uniform taxation treatment regardless of structure of business entity

Subject to our comments above, AGP supports the principle that investment income should be subject to the same overall level of taxation whether it is derived through a company or a trust.

3.4 Collective Investment Vehicles

AGP supports the concept of flow-through taxation of collective investment vehicles ("CIVs") outlined in Chapter 16 of *A Platform for Consultation*. Paragraph 16.3 states that most CIVs are established as unit trusts in Australia. However, based on the concept of consistent tax treatment of entities as outlined in *A New Tax System,* companies investing in property, equities and bonds should also be able to be treated as CIVs. In order to simplify the system, we recommend that entities which qualify as collective investment vehicles should have to elect for flow-through taxation.

Consistent Treatment of Business entities

Under the current system, there is a difference between the taxation of distributions from property owning companies, and property trusts. Company distributions are received as dividends, whereas trust distributions retain their character (such as capital gains, interest income, and tax free or tax preferred income). In order to achieve consistent tax treatment of entities, where a company satisfies the definition of a CIV, it should be subject to the same tax treatment as an equivalent trust. As a result, amendments would be required to enable flow-through taxation of company CIV distributions to ensure that the income retains its character.

Definition of CIVs

The definition of Collective Investment Vehicles may need to be addressed. AGP supports the view in paragraph 16.13 that CIVs should be widely held vehicles delivering flow-through of annual profits to participants. The activities of a CIV should be primarily of an investment nature, rather than carrying on an active business.

Full Distributions of Income

Paragraph 16.15 states that "CIVs would be required to make full distributions of all income", and states that the penalty should be that non-distributed income should be subject to entity taxation, without the benefit of imputation credits. AGP submits that this is an overly onerous penalty. There are a number of circumstances where full distribution of income is not possible or practical. Investment trusts and companies seek to maintain a fairly constant distribution policy in terms of cents per share/unit, whereas accounting and taxation profits can vary from year to year. In such cases a "substantial distribution policy" should apply (e.g. if more than 90% is distributed. In addition, sometimes full distribution is not possible due to accounting rules and trust deed restrictions (e.g. distribution of capital gains). In relation to property investment companies, it is often necessary for cash to be applied for capital improvements to investments. A fairer regime would allow some form of carry forward/carry back of amounts distributed, or would provide that undistributed amounts were tax free when ultimately distributed to share/unit holders (i.e. distributions from tax paid retained earnings).

Widely Held Test

The definition proposed in paragraph 16.16-16.17 may be unnecessarily restrictive by requiring that 20 or fewer persons hold 75% or more of the entity. It is common with many of the property trusts and companies that a small number of institutions can often hold large parcels of shares/units, whereas numerous small investors only hold a relatively small percentage of the trust/company. Nevertheless, such entities can be regarded as being "widely held". The ASX has various listing rules which require a wide spread of investors. It is recommended that if a company is listed on the ASX, it automatically satisfies the "widely held" test. However, if this is not adopted the rules should allow CIVs to "look through" nominees and superannuation funds etc to determine the ultimate beneficial ownership of the entity.

Sub-Trusts and companies should also be treated as CIVs

It is common for listed property trusts and companies to own their underlying investments through a series of sub-trusts and subsidiary companies. Often a property trust will own an interest in a property as a joint venture with another party (either through a partnership or units in a sub-trust). In order for the CIV regime to be workable, the flow-through treatment should extend to all sub-trusts and companies. It should also extend to interests in entities which are not held 100%.

We recommend that if the parent entity is a CIV, all of its subsidiaries and investments should be treated as CIVs and the underlying tax losses of these entities should be respected. This would include investments in entities in which it may hold less than 100% interest.

It is recognised that the inclusion of non 100% entities may cause some complexity, especially where the other party in the joint venture is not a CIV. However, this could be alleviated by the CIV giving the sub-trust a CIV Investor Certificate, which would ensure that the portion of income relating to the CIV was excluded from the sub-trust/company's assessable income, and was taxed on a flow-through basis.

Treatment of Tax Preferences

It is submitted that tax preferences should flow-through CIVs to the ultimate shareholders. Tax preferences arise out of government policy to stimulate the economy in particular areas. Examples include the allowance of building depreciation allowances to stimulate economic activity. If these preferences do not flow-through to the ultimate investors, the effectiveness of policy initiatives will be jeopardised.

The flow-through of tax preferences preserves the concept of the CIV being equivalent to direct investment by the investor, and ensures that foreign investors are subject to the same level of tax as if they had invested in the asset directly.

3.5 Consolidation Regime

AGP has a number of recommendations and concerns regarding the introduction of a consolidation regime.

Questionable Compliance Savings

It would not be possible to simply use the accounting consolidated profits as a basis for the tax returns, as accounting rules include certain companies and income which would not be included for tax purposes (e.g. non-resident companies, non-wholly owned companies). As a result, it would be necessary to do a separate consolidation exercise for tax purposes. A consolidation regime would not necessarily result in compliance cost savings.

Exiting the Group

AGP also has concerns regarding the complexities which will arise if a company is sold outside the group. In particular, it is important that a company leaving a consolidated group does not continue to be liable for taxes of the group.

Repeal of Current Grouping Provisions

AGP **does not** support the repeal of the current grouping provisions. The result of repealing the grouping provisions will, in effect, force groups to elect to consolidate. The consolidation regime should be made attractive enough, without forcing taxpayers to conform. Depending on which option is adopted in relation to taking losses into the consolidated group, taxpayers with losses could be severely disadvantaged by the repeal of the current grouping provisions. It is submitted that the current grouping provisions should continue in parallel with the new consolidation regime.

Treatment of Losses

A Platform for Consultation indicates that losses within a consolidated group would be pooled and that a company or trust entering into a consolidated group would bring its carried forward losses into the consolidated group. AGP supports the proposition of pooling of losses, however, it has some concerns about some of the options for bringing losses into the consolidated regime.

AGP supports the option that all prior year losses should be brought within the consolidated group (paragraph 26.87).

Option 1 - AGP does not support this option as it would mean that losses which were incurred before entering the consolidated group would be forfeited completely. At present such losses are quarantined, but are able to be utilised by the company itself.

Option 2 - AGP supports a modified form of Option 2 which would simply allow prior year losses into the consolidated group if either the continuity of ownership test up to the point of consolidation, or the same business test in the year that the loss was incurred and at the point just before entry into the consolidation regime. As a result, any losses which had already been forfeited (such as a cessation of business) would not be allowed into the consolidated group. Such a test would be simple and would create certainty. AGP does not support any yearly "cap" on the amount of the loss which would be able to be "pooled" on the basis that it would create uncertainty, and would leave companies worse off than under the current regime. The statement in paragraph 26.95 that *"Even with the cap, this option is more generous than the current law which does not allow transfer of SBT losses"* is not correct. It is currently possible to transfer SBT losses, as long as the receiving company also satisfies the same business test.

Option 3 - AGP does not support any further limitation on losses, such as adding a requirement that the losses would have been able to be used within a short period of time. This is contrary to the current legislative scheme which allows unlimited carry forward of losses.

Option 4 - AGP rejects the suggestion that a proportion of losses should be allowed into the group based on the group's percentage ownership at the time that the loss was incurred. This would be a significant departure from the current concept that losses will be allowed where there is a change of ownership, providing the company carries on the same business.

Option 5 - AGP supports the view that losses which do not currently satisfy the loss transfer rules should be quarantined within the entity which incurred the loss. However, the entity would still be part of the consolidated regime, so that any future losses would be pooled against other income of the group. While this option would be slightly more complex to administer, it would probably result in a much fairer result.

Option 6 - AGP does not support leaving loss companies outside the group. If the existing loss transfer rules were repealed, such loss companies would have to generate sufficient income of their own to recoup the losses. This would seriously disadvantage groups which are currently able to transfer losses.

Entities included in Consolidation Regime

AGP supports the view that it is critical that trusts are included in the consolidation regime.

3.6 Non-Resident Investment Funds

AGP supports the concept of Non-Resident Investment Funds ("NRIFs") as outlined in paragraph 30.38, but believes that NRIFs should exist in addition to flow-through treatment for CIVs. It also believes that the "widely held" requirement should not be applied to NRIFs. Instead, the sole requirement should be that the only shareholders in NRIFs are non-residents of Australia, and the sole investments of NRIFs are interests in CIVs.

It is common for non-resident public companies to establish an Australian resident entity to hold investments in various Australian companies and trusts. These investments may be in Australian resident CIVs. In the absence of a NRIF regime, the benefit of the CIV flow-through taxation would be lost, as Australian resident intermediate holding entities would be subject to the DCT/DWT regime.