



TAX TREATY REFORM FOR COLLECTIVE INVESTMENT VEHICLES

An Australian REIT Perspective

The Voice of Leadership





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An Australian REIT Perspective

This paper introduces the Australian REIT and its key tax features.

The paper **points out** that **there is no coordinated treaty framework for the taxation of REIT distributions**, a situation which contrasts dramatically with the usual treatment of corporate distributions and debt returns.

The paper **argues the need to** overcome inconsistency across jurisdictions by **adding an Article to the OECD model tax treaty** that covers:

- **a suitable REIT definition;**
- the basis on which property **income distributions** from a REIT to foreign investors is exercised (i.e. assessment versus withholding tax);
- the basis on which **gains on disposal** of property by a REIT is exercised upon distribution of gain to foreign investors;
- the applicable **rates of withholding tax**; and,
- **limitation of benefits** articles (to prevent inappropriate access to treaty benefits by non-OECD member foreign investors).

Introduction

Unlike other jurisdictions, there is **no specific Australian legislative REIT regime**. Rather, there is a long history of the **use of Unit Trusts** as the preferred vehicle for holding securitised investments in real estate.

These trusts are governed by a comprehensive legislative framework covering corporate, regulatory and taxation systems, with many features common to our international trading partners.



Unit trusts are established as either **listed or unlisted**. Listed property trusts (LPTs) must comply with Stock Exchange Listing requirements where spread and trading requirements apply.

Vital Statistics

By world standards, **the Australian REIT market is mature and sophisticated**.

Australia represents about **15% of** the global REIT **market capitalisation** and currently is the **largest foreign investor in the US**. Westfield Group, a stapled entity listed on the Australian Stock Exchange is the largest constituent of the FTSE/NAREIT/EPRA Real Estate Index.

The value of **international property assets** held in Australian REITs by market capitalisation now exceeds **\$US30bn**. In 2005 alone, 75% of publicly raised funds were invested offshore.

The **global expansion** of Australian REITs has been **fuelled by** a combination of **demand and supply** factors.

First, **compulsory superannuation** contributions of 9% of wages have created a consistent and sizeable flow of funds, currently in excess of \$4bn/year.

Second, there has been an **increased investment weighting** towards property **by institutional investors**.

These two factors have combined to create a situation where it is estimated that there will be **\$300bn domestic supply deficit by 2014**. This means that over the next eight years there will be \$300bn that would otherwise be looking to invest in Australian property that will have to look elsewhere.

Finally, Australia's **ageing population** has a preference for annuity type products with capital stability and high yield.



Key Tax Features of Australian REITs

Unit Trusts formed in Australia **are** generally treated as **transparent** for Australian tax purposes. Australian **tax is usually not imposed on the income and gains of the trust** itself. Some trusts, characterised as 'trading' trusts, are subject to tax as companies.

A key attribute of Australian domestic tax law is that **trust distributions** to investors **retain their character** or tax attributes.

This means that where a distribution by an Australian REIT to a foreign investor includes income from **interest and/or dividends** those distributions are subject to **the withholding tax rates that apply to interest and dividends under an applicable treaty**. Under Australia's treaties interest normally attracts a 10% rate of withholding tax and dividends a 15% rate.

However, because most treaties do not specifically deal with other income, distributions of **rental income & capital gains** by Australian REITs to foreign investors are taxed at a rate of **up to 47%, being the top marginal rate for personal income**. **Importantly**, under current arrangements, **foreign investors are denied the capital gains tax benefits** that apply to domestic investors **in Australian REITs**.

Australian REITs investing globally are of course subject to the domestic and withholding taxes of the country in which they are investing.

However, these **foreign taxes cannot always flow through on a creditable basis to Australian REIT investors, foreign or domestic**. This compares unfavourably with companies where international headquarter regimes facilitate these flows.

When combined, foreign country, domestic and withholding taxes become an investment impediment in Australian REITs. Even more so if double tax issues arise.



Current Treaty Issues

There is an **urgent need to develop a rational and consistent framework for the taxation treatment of REITs under tax treaties.**

The OECD model tax treaty is the obvious starting point, but its application **is limited** by inconsistency and complexity **in five areas** when applied to REITs.

1. The **Permanent Establishment (PE) article** can operate in such a way that a foreign unitholder can have a PE in the source country.
2. Where there is no PE, the operation of **the Business Profits article** to income from 'internationally fiscally transparent entities' has limited scope for operation in cases where the income is exclusively passive investment income.
3. Double tax relief from **Real Property Income** may only be possible where the foreign unitholder has a clearly identifiable receipt of income from real property.
4. The general articles do not express a clear intent regarding **relief from double taxation**, where REITs and their investors are concerned.
5. It is not clear to what extent the **Limitation of Benefits articles** apply in the sector.

These examples highlight, more generally, the **absence of any coordinated treaty framework for the taxation of REIT distributions**, a situation which contrasts dramatically with the usual treatment of corporate distributions (subject to dividend withholding tax) and debt returns (subject to interest withholding tax).



A Way Forward

There is an urgent **need** to achieve **consistent treatment** of REITs **from an entity and investor perspective, across all treaties** worldwide. Little justification can be found in the expense and time devoted to understanding needlessly complex treaty interpretations.

Any solution must:

1. **promote capital market efficiency** by assisting to eliminate unnecessary complexity;
2. **enable** the free **flow of investment capital**; and,
3. **eliminate** the burden of **double taxation**, at either the Trust or investor level.

We believe the answer lies in the introduction of a specific article. The article should include the following features:

- **a suitable REIT definition**, taking account of both the unlisted and listed form of transparent entity;
- the basis on which the source country's **right to tax** property **income** distributions from a REIT to foreign investors is exercised (i.e. assessment versus withholding tax);
- the basis on which the source country's **right to tax gains** on disposal of property by REIT is exercised upon distribution of gain to foreign investors;
- the applicable **rates of withholding tax** (where tax is levied on a withholding basis), including withholding rates applicable to property income and capital gains and whether the same rates apply;
- **limitation of benefits** articles (to prevent inappropriate access to treaty benefits by non-OECD member foreign investors).

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