Tax Working Group
Te Awheawhe Tāke

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1 November 2018

The Tax Working Group Secretariat
PO Box 3724
WELLINGTON 6140

submissions@taxworkinggroup.govt.nz

Submission – Future of Tax: Interim Report – Taxation of capital gains in respect of multi-rate Land PIEs

To The Tax Working Group

This submission is in relation to The Future of Tax: Interim Report ("The Report") from The Tax Working Group ("TWG") and also the subsequent discussion held with Land PIE entities on 8 October 2018 regarding the potential implementation of a tax on capital gains.

Based on the issues raised, we discuss the issues below that we consider are significant for Augusta Capital Limited's ("Augusta") multi-rate Land PIEs and the investors that invest in the PIEs.

By way of background Augusta is a specialist property fund manager and manages $1.85 billion of property assets across New Zealand and Australia. The portfolio includes 60 single asset vehicles, 1 listed PIE and 5 unlisted multi-rate PIEs. The remaining vehicle structures include a combination of limited partnerships and joint ventures.

Executive summary

We submit in respect of tax on capital gains that may potentially be imposed on both land held by multi-rate Land PIES and the shares/units held by investors in multi-rate Land PIEs.

Augusta consider that:

- The multi-rate PIE regime has been designed to ensure capital gains can be passed through to investors' tax free and any introduction of a tax on capital gains would significantly undermine the benefit of the PIE regime.

- There are already issues for a multi-rate Land PIE in respect of paying the tax and equalising an investor's interest based on the respective PIRs of each investor (discussed below).

- If a tax on capital gains was to be imposed it should only be imposed at one level and Augusta consider that level should be at the investor level for the following reasons:

    - Taxing the PIE on accruals method – Augusta consider either an unrealised movement in property values or using a deemed return to determine gains that are taxable would create significant cash flow issues to a multi-rate Land PIE, which is even more significant for single asset vehicles. The strain on cash flows could lead to issues with respect to banking covenants.

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- Taxing the PIE on a realisation basis – even on a realisation basis, it is unlikely an Augusta multi asset multi-rate Land PIE will return any capital as it will re-invest into new property assets. Further, there would be issues with determining potential future deferred tax liabilities due to the variable PIRs and it will be difficult to calculate and pay the tax due to different PIRs and the desirability to reinvest any proceeds.

- Taxing at the investor level - there is a reasonable level of secondary market activity in multi-rate Land PIEs. As such, taxing the investors at their level may be a simpler option and mean that gains on capital are taxed in a timelier manner.

- If only taxing at the investor level, there will need to be the ability to capture redemptions and capital distributions as taxable income, the impact on investor cost bases would need to be considered (discussed below). For Augusta the strategy of its multi-rate Land PIEs is to grow the portfolio and generally the only divestments are already likely to be on revenue account based on the current land provisions that taxes a number of land transactions already. As such, any tax changes in respect of redemptions and capital distributions should have minimal effect on the Augusta multi-rate Land PIEs.

- An investor only taxation will result in the loss of the 28% PIE tax rate cap for investors on sale of their investment in the PIE. There should be a special category of "income" for gains on the disposal or receipt of a capital distribution/redemption from multi-rate land PIEs to keep the cap at 28%.

We trust this assists in understanding the complexity in introducing a tax on capital gains for a multi-rate Land PIE and that you consider this when determining whether a tax on capital gains is recommended and how that might apply to multi-rate Land PIEs.

Please do contact me if you would like to discuss any aspects of our submission further [1]

Yours sincerely

[1]

Simon Woollams
Chief Financial Officer

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Taxing capital gains in respect of multi-rate Land PIES

1. Benefits of the PIE Regime

We note the PIE regime has a number of key benefits for multi-rate Land PIEs being:

- The ability to distribute untaxed gains (including capital gains) to investors without having to liquidate the entity;
- The ability to distribute other non-taxed income (like the depreciation shield);
- The redemption of shares/units in a multi-rate PIE is not taxable, whereas a secondary sale of shares/units in a PIE may be taxable if held on revenue account by the investor;
- The ability to pay tax at the marginal tax rates with a cap of 28%.

The introduction of a capital gains tax would diminish the benefits of a multi-rate Land PIE greatly where the only benefits may potentially be the top tax rate being 28% and the ability to distribute other non-taxed income (like the depreciation shield).

2. Current multi-rate Land PIE issues

Illiquid Assets

Investments in Land PIEs are relatively illiquid meaning that redemptions are unlikely to be permitted in a lot of circumstances, such is the case for the Augusta PIEs.

However, Augusta assist with providing a market place for secondary sales. The Augusta PIEs have restrictions on secondary sales, to ensure the PIE eligibility criteria is maintained and also to alleviate the practical issues when calculating and paying the PIE tax for an investor that has exited the PIE.

Adjusting investor interests to pay PIE tax

The calculation and payment of tax for a multi-rate Land PIE is also difficult. A PIE can adjust an investor's interest to pay the tax through redeeming shares/units, through distributions or request the investor pay the tax to the PIE. The only practical solution for a multi-rate Land PIE is to adjust the tax through distributions. Depending on the timing of distributions and calculation of tax liabilities, this can provide difficulties.

As an example, assuming the taxable income equals the distribution of 100, an investor on 0% PIR would receive the full 100, but an investor on 28% PIR would receive 72, as 28 would be held back to pay the tax. With changing PIRs and changing investors, the practical issues around adjusting the dividends escalate.

3. Tax on capital gains

We submit that no tax on capital gains is imposed on a multi-rate Land PIE or the investors holding investments in the multi-rate land PIEs. We consider a tax on capital gains, if imposed, will disadvantage all investors and depending on the level at which the tax on the gain is imposed, this could severely impact the PIE and investors.

Notwithstanding this, we have considered the issues below that might arise for a multi-rate Land PIE if a tax on capital gains is imposed.

3.1. Double Taxation

We note imposing a tax on capital gains at both the PIE level and the investor level will likely give rise to double taxation in a lot of circumstances, the level depending on the extent to which tax is reflected in the exit unit price.

As redemptions would be extremely difficult for a lot of multi-rate Land PIEs, it is likely there would be a significant amount of double taxation if capital gains were taxable at the PIE level and then on secondary sales by the investors, depending on the extent to which tax is reflected in the unit/share price.

We note a partnership type option of adjusting cost base for investors was considered in the Report, however undertaking such calculations would be extremely difficult and costly to administer and if the only benefit was the 5% difference in tax rate, the costs of administering the regime would likely whittle that benefit away. We recommend that any regime imposed does not increase the compliance burden for multi-rate Land PIE.

We discuss below the issue of imposing tax on capital gains at the relevant levels below.

3.2. Tax at PIE level

Tax on an accrual basis

Taxing unrealised gains at the PIE level either based on an unrealised movement basis or using a deemed return would create significant cash flow issues to the multi-rate Land PIE the tax, which is even more significant for single asset vehicles where it's only.

As investor interests have to be adjusted to pay the PIE tax it is likely dividend distributions would need to be made to equalise the tax liability. The unrealised movements could fluctuate throughout the year which could make it extremely difficult to ensure enough tax was withheld on respective distributions to cover the tax liability.

Further, there will be a strain on cash flows as a result of having to pay the distributions and tax liability which could lead to issues with respect to banking covenants and as such jeopardise the PIE structure.

Tax on realised gains

If the realised gains on the disposal of buildings are taxed, there may be substantial delays in any income being derived from the disposal of property, as long term hold multi-rate Land PIEs would rarely undertake a sale, but an unrealised tax liability will continue to build up in the PIE and determining that liability would be difficult given the different PIRs that could exist at any one time.

We note rollover relief was discussed in the Report. If rollover relief was allowed for multi-rate Land PIEs that reinvest the proceeds, the tax may never be payable and the future tax liability may continue to increase further.

The potential deferred tax liability will have a large impact if the PIE allows redemptions in determining the value of redemption. A conservative approach would be to consider the DTL at 28% no matter the investors PIR. If a blended rate is used, the issue arises for 0% PIR investors that may have a tax liability of 28%

themselves when income is attributed them. If no DTL is allocated throughout on redemptions, then on a last investor standing basis a 0% PIR investor would be significantly disadvantaged.

We note that if investors are not taxed on their secondary sales of units/shares, this will incentivise investors to exit before the sale of assets, but we consider it will be up to investors that are buying the interest in the PIE to determine their potential tax liability in the future if the assets were disposed.

Taxing the capital gains at the PIE level will significantly increase the already complex issue of adjusting the investor's interest and paying the tax. The PIE would have to potentially pay a significant dividend to all investors upon realising a capital gain to equalise the investor's position and ensure the correct tax is paid for each investor.

3.3. Tax at investor level

We consider taxing investors on their secondary sales and not taxing the gain on disposal in a multi-rate Land PIE would appear to be a simpler option than having to determine the tax outcomes at the PIE level. Secondary sales are allowed and facilitated by Augusta in respect of its multi rate PIEs as it needs to ensure the PIE eligibility criteria is still met. There is a reasonable frequency to secondary sales which means taxable income on a capital gain is likely to arise more frequently than if taxed at the PIE level.

We note you would need to consider how to deal with redemptions and distributions from multi-rate Land PIEs as currently they are not taxable to investors. We note Augusta does not generally allow redemptions unless the PIE was being wound up so the taxation on redemptions would have minimal affect.

Further, Augusta's intention for its multi-rate Land PIEs is to grow and long term hold its properties, and any disposals are likely to be reinvested as opposed to being distributed. As such, the distribution of capital gains is not likely to affect Augusta's multi-rate Land PIEs.

Potential options to deal with redemptions and capital distributions could be that distributions of capital gains are not allowed. Alternatively the capital gain distributions could be taxable to the investor or the cost base of the investor (as maintained by the investor and not the PIE) is adjusted for the capital distribution for multi-rate Land PIEs. Redemptions could be treated in the same manner as a secondary sale by the investor and as such taxable or redemptions are only allowed on wind up of the fund at which point the redemption is taxable.

Special tax rate cap

If a tax on capital gains was to be imposed, we consider that the tax rate on any secondary sales, taxable redemptions or taxable capital distributions should be capped at the top PIE rate of 28% as opposed to the top marginal tax rate of 33%, to ensure the PIE regime status is maintained for the investor no matter the activity that the investor undertakes in respect of the ordinary income and tax on the capital gains.

3.4. Widely held investment vehicle

We note that a PIE by its very nature is a widely held investment vehicle that is designed to have no single person control the PIE and we consider this should be taken into account when determining how the issues raised above should be legislated if a tax on capital gains were to be implemented. Particular regard to anti-avoidance mechanisms should be considered seeing no single investor can influence the multi-rate Land PIE.