VICTORIAN DUTY REFORMS FOR ECONOMIC ENTITLEMENTS – THEY ARE NOT LIMITED TO PROPERTY DEVELOPMENT AGREEMENTS

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The *State Taxation Acts Amendment Act 2019* (Amendment Act) amends the *Duties Act 2000* (Duties Act) so as to broaden the types of transactions involving economic entitlements that will be subject to duty. These changes apply from 19 June 2019. Putting it most simply, under the new rules, a person said to receive an "economic entitlement" from 'relevant land' in Victoria will be deemed to have acquired a beneficial interest in the land and will be subject to duty on that acquisition.

The reforms are significant as they operate to impose duty on Property Development Agreements and similar structures between developers and land owners. These structures have been commonplace in Victoria and, until now, have been possible without adverse duty consequences.

While the reforms are principally targeted at Property Development Agreements, there is a risk that the provisions may apply more widely in practice. These risks are discussed below.

In this update we cover the following:

- What were the previous rules on economic entitlements?
- Why were reforms introduced?
- What type of land is covered by the amendments?
- What is an "economic entitlement"?
- When does transfer duty apply to an economic entitlement?
- Are there any thresholds?
- What percentage of the relevant land is deemed to be acquired?
- What value is used to determine the duty payable?
- What happens if the person that acquired an economic interest later acquires the relevant land?
- Are there any changes to the landholder duty provisions?
- Illustrative example
- Complex questions and issues in practice

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- State Revenue Office (SRO) guidance
- Concluding remarks

WHAT WERE THE PREVIOUS RULES ON ECONOMIC ENTITLEMENTS?

Victoria is the only Australian jurisdiction that imposes duty on transactions involving economic entitlements. Previously the rules related to 'landholder duty', meaning duty would only arise if:

- the land was owned by a 'landholder', such as a company or unit trust (but not an individual)
- the value of the land exceeded AUD1 million
- the "economic entitlement" related to more than a 50% interest in the economic benefits to be derived from the land.

WHY WERE REFORMS INTRODUCED?

In the case of *BPG Caulfield Village Pty Ltd v Commissioner of State Revenue* [2016] VSC 172, the Victorian Supreme Court held that the previous landholder duty provisions only applied where the economic benefits concerned related to more than 50% of all land that was held by the landholder. That is, the 50% threshold was not applied on a limited basis to the particular parcel of land from which the economic benefit was derived.

The Victorian Government was concerned that it was too easy for parties to structure their arrangements to ensure that the 50% threshold was not exceeded; meaning landholder duty did not apply. Most commonly, these structures took the form of Property Development Agreements by which a land owner would make its land available for development by a developer without transferring freehold title. Typically, the proceeds of development would then flow to the land owner and the developer pursuant to a defined payment 'waterfall'.

The amendments are intended to address these arrangements and similar structures by which rights are transferred which are economically equivalent to ownership. However, as discussed below, the provisions will not be limited to this one issue and will result in a significant broadening of the Victorian duty base.

WH

AT TYPE OF LAND IS COVERED BY THE AMENDMENTS?

The new rules will apply to 'relevant land' in Victoria. The definition is broad and may apply to land interests in Victoria that involve:

- a freehold interest
- a life estate
- a Crown Lease

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- a lease that includes a right or option to purchase the land (or a right of first refusal to purchase the land).

The above list is not exhaustive.

WHAT IS AN "ECONOMIC ENTITLEMENT"?

The definition of "economic entitlement" includes an entitlement:

> (i) to participate in the income, rents or profits derived from the relevant land
> (ii) to participate in the capital growth of the relevant land
> (iii) to participate in the proceeds of sale of the relevant land
> (iv) to receive any amount determined by reference to [the three points above]
> (v) to acquire any entitlement described in [the four points above].

The fourth point above is intended to capture amounts such as fees, interest or loan repayments that are calculated by reference to capital growth, sale proceeds, income, rents or profits.

This is significant as many arrangements connected with real estate development involve payments which are determined by reference to the actual or forecast proceeds of sale or development profit. For example, sales commissions, development management fees and other services arrangements are often calculated in this way. While the apparent intention of the reforms is to impose duty on rights which are economically equivalent to ownership, the legislation has not been drafted in this way and the implications are potentially significant.

The provisions make it clear that a person may acquire an economic entitlement when it is created or by taking a transfer of such entitlement (for example, as a consequence of an assignment).

WHEN DOES TRANSFER DUTY APPLY TO AN ECONOMIC ENTITLEMENT?

Under the amendments, a person who acquires an economic entitlement in relation to relevant land is deemed to have acquired beneficial ownership of the relevant land (in whole or in part as discussed further below).

Transfer duty is chargeable on that deemed acquisition accordingly.

The provisions state that it does not matter whether the person acquiring the economic entitlement was a party to the arrangement. This is intended to address circumstances where a parent company may be party to an agreement with a land owner, but negotiates for the economic entitlements to be paid to a subsidiary that is not a party to the transaction.

Further, a person can acquire an economic entitlement indirectly through another person.

To avoid double duty, duty will not apply to the acquisition of an economic entitlement through a transaction that is already subject to duty. For example, if a person acquires an economic interest through the acquisition of a freehold interest in land, duty will only apply to the acquisition of the freehold interest.

Note that, unlike under the previous rules, the imposition of duty is not limited to the landholder duty provisions. Rather, the amendments expand the transfer duty provisions. This means that the imposition of duty on economic

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entitlements will no longer be limited to circumstances where the relevant land is owned by a landholding company or trust. The amendments will ensure that transfer duty applies regardless of who owns the relevant land.

ARE THERE ANY THRESHOLDS?

The new provisions will only apply if the value of the relevant land exceeds AUD1 million.

Further, duty will be phased in at a concessional rate where the value of the relevant land is between AUD1 million and AUD2 million. Full duty will apply where the value of the relevant land exceeds AUD2 million.

The 50% interest threshold that previously applied in a landholder duty context is no longer relevant.

WHAT PERCENTAGE OF THE RELEVANT LAND IS DEEMED TO BE ACQUIRED?

Generally speaking, if the arrangement makes it clear that the economic entitlement is limited to a specific percentage; the person receiving the entitlement will be deemed to acquire the same percentage as a beneficial interest in the relevant land.

However, the person will instead be deemed to acquire a 100% interest in the relevant land if:

- the arrangement does not specify that the economic entitlement acquired is limited to a certain percentage
- in addition to the specified percentage, the person (or an associated person) will receive another entitlement or payment
- the person (or an associated person) will receive two or more different types of economic entitlements.

If a person is deemed to acquire a 100% beneficial interest, the Commissioner has the discretion to determine that the person has acquired a lesser percentage if the Commissioner is satisfied that it is appropriate to do so in the circumstances.

WHAT VALUE IS USED TO DETERMINE THE DUTY PAYABLE?

If transfer duty is applicable, it will be calculated based on the unencumbered value of the relevant land at the time the economic entitlement is acquired.

WHAT HAPPENS IF THE PERSON THAT ACQUIRED AN ECONOMIC INTEREST LATER ACQUIRES THE RELEVANT LAND?

If a person that has acquired and paid duty on an economic entitlement later takes a transfer of the relevant land, the duty that would otherwise be payable on that transfer will be reduced by the amount of duty previously paid on the acquisition of the economic entitlement.

ARE THERE ANY CHANGES TO THE LANDHOLDER DUTY PROVISIONS?

The previous provisions relating to economic entitlements will be repealed for the most part.

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The definition of the term 'landholding' will be expanded to include a beneficial interest in land arising from the acquisition of an economic entitlement.

Consequently, if a unit trust or company has an economic entitlement (and therefore a beneficial interest in land in Victoria), this will be taken into account when determining whether the entity is a 'landholder' for the purposes of the landholder duty provisions.

The acquisition of a 'relevant interest' in a landholder (20% for unit trusts and 50% for companies) will trigger the landholder duty provisions in the usual fashion.

The one previous economic entitlement provision that will not be repealed relates to circumstances where a person has an entitlement to the dividends or income of a private landholder. This relates to the holding of an economic entitlement in the landholder itself (rather than the relevant land) and will be retained in the landholder duty provisions.

ILLUSTRATIVE EXAMPLE

Land Co owns land in Victoria valued at AUD5 million which would be ideal for a residential development.

Dev Co enters into a Property Development Agreement with Land Co in respect of the development of the land. 100 residential apartments will be constructed. The arrangement is as follows:

- Land Co will be paid AUD5 million as a Development Rights Fee.
- Dev Co will undertake the development on the land at its own cost and risk.
- On completion, Land Co will sell all 100 residential apartments. As a practical matter, Dev Co will arrange this on behalf of Land Co and collect the proceeds of sale.
- Dev Co will be paid a GST exclusive fee calculated as 100% of the GST exclusive sale proceeds.
- Land Co will be entitled to retain an amount equal to the GST payable on the sales (note that as a practical matter, purchasers will withhold and remit the GST directly to the ATO).
- Land Co will pay Dev Co an amount for GST in addition to the GST exclusive fee.

The issues that will need to be considered include the following:

- Has Dev Co acquired an economic entitlement? The answer would be yes, as Dev Co will receive a fee calculated by reference to the proceeds of sale.
- When did Dev Co acquire the entitlement? This will need to be considered carefully. Dev Co will want to acquire the entitlement prior to the development of the land, so as to minimise the land value subject to duty. This may be an issue if Dev Co's entitlement is contingent on certain events occurring.
- What percentage interest has been acquired? It is likely Dev Co will be taken to have acquired a 100% beneficial interest in the land, given Dev Co will be entitled to 100% of the GST exclusive sale proceeds. However, it may be arguable the percentage is lower given Dev Co will not be entitled to the GST component of the sale proceeds.

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COMPLEX QUESTIONS AND ISSUES IN PRACTICE

In a vanilla scenario such as that described in the illustrative example above, the application of the new transfer duty rules seems relatively straight forward. However, the broadness of the provisions is a major concern. There is a high risk of unintended consequences and potential double duty scenarios. The following is a list of issues that we consider are uncertain at this time.

- Will the provisions apply to retirement villages?

Retirement village contracts are notoriously complex and vary widely across the industry. In some instances, residents will be entitled to a share of any capital gain when their unit is resold to the next resident. Further, operators may be entitled to fees based on sale proceeds for a unit. There is a risk that residents and operators may be deemed to receive an "economic entitlement", triggering a liability to duty, which is likely not intended.

- Will the provisions apply to renewable energy projects?

Wind and solar farm operators typically enter into hedging contracts which involve payments based on income received from electricity sales into the national energy market at the prevailing spot price. Could such arrangements be seen as involving a right to participate in the 'income or profits' derived from the relevant land on which the farm is located? The better view is that such income and profits are derived from the electricity sales and not the land.

- If there are multiple parties involved, will each be liable for duty?

As noted above, a person does not need to be party to an arrangement to be taken to have acquired a beneficial interest in the relevant land. If a parent company enters into a Property Development Agreement that gives rise to an economic entitlement, but directs payment to a subsidiary, will both the parent company and the subsidiary be taken to have acquired an economic entitlement? The legislation does expressly limit the application of duty to the subsidiary in this scenario.

- Which party is liable in the context of a joint venture?

A development project may be undertaken by an unincorporated joint venture comprising two or more parties. A Property Development Agreement may confer 100% of the economic entitlements from relevant land to the JV participants, but it may not specify their individual interests in those economic entitlements. Will each JV participant be liable for duty based on 100% of the land value?

- If land that is subject to a Property Development Agreement is sold to a third party, does the existence of an economic entitlement reduce the value of the land for duty purposes?

Duty is generally calculated on a transfer of land based on the higher of the consideration and the unencumbered market value of the land (meaning the existence of the Property Development Agreement would generally be ignored in determining the land value). If duty is paid on the economic entitlement conferred under the Agreement, it is arguable the value of the land should be decreased to reflect the existence of that entitlement.

- If duty is paid on an economic entitlement, but a project does not proceed and no payments are received, is a duty refund available?

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Parties enter Property Development Agreements in good faith expecting that they will proceed to completion. However, projects do fail or may not proceed for a variety of reasons. If duty has been paid on an expected economic entitlement, it is arguable that a duty refund should be available if that entitlement is not realised.

- Will financiers be caught if they are entitled to loan repayments as a part of a 'payments waterfall' under a Property Development Agreement?

Payment waterfalls will typically provide for secured creditors to be paid from the proceeds of sale ahead of most other parties. While such payments may be paid from the sale proceeds, the better view is that this should not of itself mean that the creditors have obtained an economic entitlement (particularly if the loan repayment and interest amounts are not calculated by reference to the sale proceeds).

- Will Mezzanine Financing, 'Fund Through' arrangements and 'Property Linked Notes' be caught?

In some property financing arrangements, the lender may be entitled to interest, 'bullet payments' or other amounts that are calculated by reference to the sale proceeds or profits derived by the land owner in connection with a particular project. Such arrangements would seem likely to involve an 'economic entitlement' as defined. Similar, issues may arise with respect to 'fund through' arrangements if they are not carefully structured.

The above list is not exhaustive and there will be many additional issues to work through in practice.

STATE REVENUE OFFICE (SRO) GUIDANCE

The SRO has released some public guidance on its website, which is available here.

While such guidance is very welcome, it does not address all of the complex issues we have set out above. Further, unlike ATO public rulings, guidance provided by the SRO is not legally binding.

The guidance confirms that fees paid to service providers, such as real estate agents and professional advisers, will not generally be regarded as an "economic entitlement", even if the fees are calculated by reference to capital growth or proceeds of sale. However, it is not expected that this approach will apply to fees paid to developers (albeit they are also providing a service to the landowner).

CON

CLUDING REMARKS

Parties that are considering entering into Property Development Agreements, or other arrangements involving land in Victoria, should carefully consider whether the new provisions may apply.
Specifically, the parties should carefully consider any proposed payment arrangements to determine whether an economic entitlement arises. If duty will be applicable, care should be taken to ensure that it is only paid once and on the lowest value possible.

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