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11 October 2019
Australia 2019/28

Tax Insights

Changes to the taxation of stapled structures – ATO draft Law Companion Ruling LCR 2019/D2

Overview

Draft Law Companion Ruling LCR 2019/D2 (**the Draft Ruling**) was issued by the ATO on 26 June 2019 and explains the ATO's view of certain changes that were implemented by the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019* (**the Act**), enacted on 5 April 2019. Specifically the Draft Ruling considers the amendments in the Act relating to the use of stapled structures in the infrastructure, property, renewable energy and agriculture sectors. The ATO amended the Draft Ruling on 2 September 2019, as noted below.

All legislative references are to the *Taxation Administration Act 1953* (Cth) or the *Income Tax Assessment Act 1936* (Cth), as relevant, unless otherwise indicated.

Summary of the Act

From 1 July 2019, unless the transitional arrangements apply, the MIT concessional withholding tax rate of 15% for certain fund payments is replaced with a 30% withholding rate to the extent that the fund payment is attributable to 'non concessional MIT income' (**NCMI**).

Generally, an amount of a fund payment will be NCMI if it is attributable to any of the following (as defined):

- MIT cross staple arrangement income;
- MIT trading trust income;
- MIT agricultural income; or
- MIT residential housing income.

The 30% withholding rate applies to fund payments made by a MIT if the fund payment is made:

- on or after 1 July 2019; and
- it is for the 2019-20 income year or a later income year.

Other measures addressed by the Act include:

- the prevention of double gearing structures through changes to the thin capitalisation rules;
- proposed limitations on the foreign pension fund withholding tax exemption; and
- codification of the availability of the sovereign immunity tax exemption, as well as introducing specific limitations.

Overview of the Draft Ruling

The Draft Ruling covers key aspects of NCMI, with a particular focus on MIT cross staple arrangement income (**MIT CSA income**).

There are some interesting views expressed by the ATO in the Draft Ruling, including views in relation to:

- the cessation of transitional relief;
- the meaning of 'rent';
- the meaning of 'facility'; and
- the application of the eligible investment business rules in Division 6C.

Some of these views have potentially broader relevance outside of the operation of the MIT CSA income rules, going to the operation of Division 6C, on which little guidance has previously been available.

Each of the above are discussed in further detail below.

Transitional relief

Under the Act, transitional relief is available in respect of fund payments that are attributable to MIT CSA income where:

- the fund payments arise from cross staple arrangements covered by section 12-440, and
- the relevant entities have made a valid choice to apply the transitional provisions.

The choice must have been made by 30 June 2019 (or a later time at the Commissioner's discretion), and the approved form must have been given to the Commissioner within 60 days of making the choice.

Pursuant to section 12-440, broadly, the transitional rules can apply in relation to MIT CSA income that is attributable to a facility that existed or was sufficiently committed to prior to 27 March 2018. In addition, the following elements must be present:

- The cross staple arrangement must have been entered into before 27 March 2018, or it must be reasonable to conclude that such an arrangement would be entered into;
- All entities that are stapled entities in relation to the cross staple arrangement must exist before 27 March 2018.

If the transitional rules apply, the general MIT withholding rate of 15% may apply where all other relevant requirements of the MIT rules are satisfied (including that the recipient is a resident of an EOI country) from the later of 1 July 2019 or the facility's start date, for a period of seven years (with a hard stop date of 1 July 2031), or 15 years if the facility is an economic infrastructure facility (with a hard stop date of 1 July 2039).

Economic infrastructure facilities are subject to the concessional cross staple rent cap (**CCSRC**) integrity rule. The CCSRC integrity rule removes the benefit of transitional relief to the extent that the MIT CSA income for the relevant income year exceeds the CCSRC. The CCSRC varies depending on whether the lease and/or associated documents set out in writing, prior to 27 March 2018:

- the amount of annual rent under the lease for the first year of the lease that ends after 27 March 2018, or
- an objective method for determining the amount of annual rent under the lease.

If there is an objective method, the CCSRC is determined based on that method. If there is no objective method, the amount of the CCSRC is determined by reference to the amount of rent specified in the lease that was agreed to before 27 March 2018. Broadly speaking, this operates as follows:

- where an amount is specified for an income year, the amount corresponding to the relevant income year will constitute the CCSRC; and
- where an amount is not specified for the relevant income year, the CCSRC will be the amount from the most recent year of the lease for which an amount was so specified, indexed according to Subdivision 960-M of the ITAA 1997.

In situations where the above alternatives cannot apply, the CCSRC will be calculated in accordance with the '80/20' rule in subsection 12-444(2). In essence, under the '80/20' rule, transitional relief will be denied for current year MIT CSA income to the extent that the taxable income of the asset entity exceeds 80% of the project's total notional current year taxable income for the income year.

Cessation of transitional relief

The Draft Ruling[1] provides the following instances where the ATO believes that the transitional arrangements will cease to apply:

- when there are certain changes to the CSA;
- ceasing to have a CSA; or
- alterations to the facility, such that it ceases to be the original facility covered by the transitional rules.

[1] Paragraph 262

Importantly, the ATO confirms that a "mere renewal of a lease agreement covering the same facility and between the same parties would not, subject to the facts and circumstances, be expected to create a new cross staple arrangement". Similarly, "an ordinary exercise of an option to extend the arrangement without any material change would not be expected to cause transitional relief to cease to apply"[2]. The ATO also set out that "a mere rent review under an existing contract will not result in a new cross staple arrangement." [3]

On the other hand, "[c]ircumstances could exist in which an agreement has so fundamentally changed as to constitute a new cross staple arrangement ... These could include changes sufficient to result in a new contract." [4] The ATO's view is that the following characteristics could result in a new CSA, which would fall outside of the transitional relief:[5]

- introduction of assets and facilities not part of the existing facility, for example where they dramatically augment the earlier facility;
- amending the terms and conditions, such as altering the lease from a year-on-year lease to a long-term lease; and
- replacing parties, such that a change in the CSA results from a change in the stapled entities to the CSA.

As such, a great deal of care needs to be taken in making any amendments to a CSA, including extending a CSA, or in renewing a CSA, to seek to preserve the availability of transitional relief. In some cases it may be appropriate to obtain confirmation from the ATO via a private binding ruling.

Interestingly, the first version of the Draft Ruling suggested that a change in the ultimate economic ownership of the stapled entities during the transition period could result in the CSA transitional relief no longer being available.

In particular, the sixth bullet point of paragraph 263 of the Draft Ruling originally stated that an entity 'may cease to qualify' for the MIT CSA income transitional rules:

> *'where the external entities are replaced, or their participation interests are varied. For example, there is a change in ultimate economic ownership of the asset entities and operating entities'.*

Similarly, the third bullet point of paragraph 267 of the Draft Ruling stated that a '*change in the external entities holding those stapled entities'* could 'result in a new cross staple arrangement', and, as a result, transitional relief would no longer apply.

The ATO's revised position is that a change in external entities or a change in participation interests will not cause the cessation of transitional relief, other than where the change result in the arrangement no longer being a cross-staple arrangement (in which case the income should cease to be NCMI).

This is reflected in the latest version of the Draft Ruling on the ATO Legal Database, as at 2 September 2019, where paragraphs 263 and 267 have been amended to remove the references noted above in respect of changes to participation interests or external entities.

Exceptions to MIT CSA income

Under the Act, outside of the transitional rules, there are four circumstances in which an amount that is attributable to a cross staple arrangement will not be MIT CSA income:

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[2] Paragraph 266
[3] Paragraph 265
[4] Paragraph 264
[5] Paragraph 267

- **The third party rent exception**: where the income from a cross staple arrangement can be traced to an amount of third party rent from a land investment charged by an operating entity. To this end, a determination of what constitutes *rent* from land will prove critical;
- **The de minimis exception:** where the income for the previous income year from cross staple arrangements did not exceed 5% of the asset entity's assessable income (disregarding any net capital gains) for that previous income year. This test is applied on a trust-by-trust basis which can limit its availability;
- **The approved economic infrastructure exception:** where the income from a cross staple arrangement is attributable to rent from an approved economic infrastructure facility, or an approved improvement to an economic infrastructure facility; and
- **The capital gains exception:** where the income from a cross staple arrangement is attributable to a capital gain that arises because an operating entity acquires an asset from the asset entity.

While the Draft Ruling makes comments on each of these exceptions, we have focussed below on certain views expressed in the Draft Ruling in respect of the rent exception, and the meaning of rent more broadly.

Third party rent exception and the meaning of 'rent'

Under the third party rent exception, an amount included in the assessable income of a MIT that is attributable to a cross staple payment will not be MIT CSA income to the extent that it represents third party rent from land investment, being rent from investment in 'Division 6C land' derived from an entity that is not a stapled entity. In this regard Division 6C land refers to land as well as certain assets deemed to be land for the purposes of Division 6C (dealing with the taxation of "public trading trusts").

The ATO's view is that 'rent' means 'payments made for periodic use of land under a lease of land'[6]. The concept of 'rent' is to be contrasted with the concept of a 'licence'. The long held ATO view is that payments in respect of land use under an agreement which is not a lease are properly characterised as 'licence' fees and not rent.[7]

In order for there to be a payment of 'rent', the arrangement between the operating entity and the third party from which the cross staple payment is sourced must therefore properly be characterised as a lease or sub-lease, rather than a licence.[8]

The ATO refers to the common law definitions of 'lease' and 'licence' respectively,[9] noting that at common law, a lease is an interest in land that confers on the grantee the right of exclusive possession over the land. By contrast, a licence is a personal, contractual right of the grantee against the grantor, effectively amounting to permission to do something that would otherwise be impermissible.

The following example from paragraphs 77 and 78 of the Draft Ruling reinforces the importance of 'exclusive possession' as a key factor in distinguishing between leases and licences:

> ***Example 3 – hotel operation and whether rent***
>
> *Hotel Trust and Hotel OpCo are stapled entities. Hotel Trust owns a building which it leases to Hotel OpCo to operate as a hotel. Hotel OpCo, in turn, grants temporary accommodation rights to third party customers to occupy one of the rooms in the hotel for payment calculated based on the number of nights of occupation. Although no other customer or guest can access the customer's room, Hotel OpCo retains the right to enter the room for a variety of purposes, including the servicing and cleaning of the room. Hotel OpCo covenants only to enter where there is a genuine need, and to minimise inconvenience to guests when entering the room.*

[6] Paragraph 52
[7] Paragraph 52
[8] Paragraph 54
[9] Paragraph 55

> *The third party customers of Hotel OpCo do not have exclusive possession of their rooms. On that basis, they are not common law tenants and amounts paid by guests to occupy the hotel are not rent. To the extent amounts paid by Hotel OpCo to Hotel Asset Trust are attributable to receipts from guests, the amounts will be MIT cross staple arrangement income and therefore NCMI.*

This distinction is generally accepted as being relevant to the application of the eligible investment business test in Division 6C, and the views of the ATO in this regard are uncontroversial, albeit there is probably little policy justification for distinguishing different legal forms of passive income from property in this way.

In terms of the calculation methodology for rent, the ATO sets out that while it may acceptable to calculate rent with 'an incidental turnover component', calculations based on 'a share of business profits' or 'otherwise entirely exposed to the risks of the business', are unlikely to be considered rent.[10] There is a lack of detailed legal analysis to support this conclusion and it seems somewhat inconsistent with the legal form approach adopted by the ATO in considering the distinction between rent and licence income. It is not clear when the ATO would consider turnover rent to be 'incidental' or why non-incidental turnover rent or profit based rent would not be rent, although the implication is that such rental arrangements may also not satisfy the eligible investment business requirements in Division 6C.

The ATO has also suggested that where a payment is made under the arrangement, and the payment is partly rent and partly for something else (for example, a licence), a 'reasonable basis of apportionment of income'[11] must be applied to identify the MIT CSA income component. This is illustrated by the following example from the Explanatory Memorandum (**EM**):

> ***Example 1.6: Amount attributable to cross staple arrangement***
>
> *Asset Trust owns commercial property (a specialist homewares shopping centre). It leases that commercial property to Op Co in consideration for an annual rental payment of $80,000. This arrangement is a cross staple arrangement entered into by Asset Trust (an asset entity) and Op Co (an operating entity) with a cross staple payment of $80,000.*
>
> *Op Co enters into sub-lease agreements with third party tenants for exclusive possession of retail spaces. Separately, it enters into licence arrangements with respect to common areas for the use of temporary advertising or promotional displays.*
>
> *Op Co derives:*
>
> - *$90,000 in third party rental income from its sub-leases (net of attributable expenses other than the cross-staple rent); and*
> - *$10,000 from its licence arrangements (net of attributable expenses other than the cross-staple rent).*
>
> *To determine the amount of income that is attributable to third party rental income, Op Co must reduce the third party rental income by part of the $80,000 cross staple payment on a proportionate basis.*
>
> *Therefore, because 90 per cent of Op Co's income is from third party rent, 90 per cent of the cross staple payment is attributable to that amount. Consequently, in relation to the cross staple payment of $80:*
>
> - *$72,000 (that is, $80,000 x 90 per cent) is attributable to third party rent and will not be MIT cross staple arrangement income; and*

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[10] Paragraph 83
[11] Paragraph 86

- *$8,000 will be MIT cross staple arrangement income.*

This is an unusual example, not expected to arise often in practice, as the relevant property would more likely be leased and licenced directly by the Asset Trust to third parties. It is noteworthy that in this case the licence income may qualify as part of a fund payment subject to 15% MIT withholding tax on the basis that the income is incidental to the investing in land for the purpose, or primarily for the purpose of deriving rent, in the context of the eligible investment business requirements in Division 6C.

Meaning of 'facility'

As stated above, one of the requirements for the transitional rules to apply is that the MIT CSA income is attributable to a 'facility' that existed or was sufficiently committed to prior to 27 March 2018.

Of particular note are the ATO's views in relation to:

- the distinction between a 'facility' and chattels; and
- the distinction between enhancements to an existing facility, versus the creation of an entirely new facility.

These issues can impact on the extent of the application of the transitional rules, as well as the continued availability of the rules, as discussed below.

Chattels do not form part of the facility

In the Draft Ruling, the ATO has expressed the view that a 'facility' cannot include chattels,[12] noting that 'the facility does not include ancillary and peripheral assets, such as moveable property and items not characterised as fixtures'. The ATO provides an illustrative example at paragraph 167 of the Draft Ruling, as follows:

> *For example, a fire truck, which is self-evidently a chattel, would not be part of a fire station facility, even if the truck was based at the station and was necessary to perform the broader function that is the reason why the station was built.*

The ATO therefore seem to be of the view that although a 'facility' may include fixtures, it cannot include chattels and therefore payments cannot qualify under the transitional rules to the extent that they relate to such chattels, even where the relevant assets are deemed to be land for Division 6C purposes.[13] There is little basis in the legislation for taking this view, and indeed it seems contrary to the clear intention of the transitional rules as applying to "rent from land investment",[14] being rent for land or moveable property deemed to be land for the purposes of Division 6C.

On the views of the ATO therefore it would seem necessary to apportion rent in relation to chattels not forming part of the facility and treating such amounts as NCMI. Such an approach would involve significant compliance costs and is difficult to reconcile with the wording in section 12-440.

Enhancements to existing facility

Where an entity has satisfied the requirements for transitional relief under section 12-440, transitional relief will continue to apply to a facility where the facility is merely expanded or improved, so long as the facility remains identifiable.

However, the ATO is of the view that the transitional provisions will not apply to a facility where:[15]

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[12] Paragraph 165
[13] Pursuant to section 102MB, moveable property that is incidental to and relevant to the renting of land, customarily supplied or provided in connection with the renting of land and ancillary to the ownership and use of land is deemed to be land for the purposes of Division 6C.
[14] Refer to paragraph 12-440(3)(d)
[15] Paragraph 187

an expansion or improvement is made such that it constitutes a new and separate facility, or alters the existing facility so substantially that it ceases to have the identity of the relevant facility that was in existence or contemplated at the relevant time (before 27 March 2018).

The EM provides examples of what might constitute an enhancement or expansion of an existing facility. By way of illustration, Example 1.12 of the EM is as follows:

Example 1.12: Enhancement to an existing, non-income producing facility

In June 2017, stapled entities entered into a contract with the State Government to acquire and expand an existing un-tolled public highway.

The arrangement involved:

- *the asset entity acquiring a long term lease from the State Government over the highway; and*
- *the asset entity sub-leasing the highway to the operating entity which runs the toll road business.*

In July 2025, the expansion is completed and the toll road becomes operational and starts to earn assessable income.

The expansion is an enhancement to the existing facility because:

- *the expansion is functionally connected to the existing un-tolled road;*
- *the revenue stream generated from the enhancement to the road is not separately identifiable from the existing road; and*
- *the legal arrangements support this outcome.*

As at 27 March 2018, the facility (the un-tolled road) is an existing economic infrastructure facility that has never been used to produce assessable income.

As a result, the transitional period for the facility will:

- *commence on 1 July 2025; and*
- *cease on 1 July 2039 — as this is the earlier of the date listed in paragraph 12-440(4)(b) in Schedule 1 to the TAA 1953 and the end of the period of 15 years beginning on the day on which the toll road is first put to use for the purpose of producing assessable income.*

In the Draft Ruling,[16] the ATO provides a different example involving a toll road, where the construction of a depot constitutes 'a new and separate facility' that is not part of, or an extension of, the existing toll road facility. The example is as follows:

Example 5 – depot servicing a toll road

A depot is constructed after 27 March 2018 to hold equipment and to base staff so as to operate and maintain an existing stretch of toll road. The depot itself is not physically connected to the road in any way (that is, other than a connection via an un-tolled stretch of road) and is used from time to time to store equipment and provide a temporary base for maintenance staff.

The depot is built to provide support to ensure satisfaction of obligations of Operating Entity under its licence in relation to the delivery of the services provided by the toll road. The depot does not give rise to a revenue stream, other than to support the revenue stream generated by the toll road. Asset Trust charges rent to Operating Entity pursuant to a lease calculated by reference to the total value of assets that are the subject of the cross staple arrangement (which includes the value of the depot). The depot is conveniently located for access to the toll road. The existing toll road and the depot are subject to the same regulatory regime in the

[16] Paragraphs 188 to 191

sense that the depot is reasonably required for Operating Entity to meet its obligations to maintain the toll road.

Given the factors mentioned in paragraph 1.118 of the Explanatory Memorandum, the depot is considered to be a facility in and of itself and not an enhancement to the existing toll road facility for the following reasons:

- *the depot is neither functionally, not physically integrated into a broader facility*
- *services provided from the depot maintain a facility, being the toll road*
- *the advantageous geographical location is not relevant in the context of a facility to maintain a facility, and*
- *the contractual arrangement between Asset Entity and Operating Entity is not relevant in identifying the revenue stream.*

Hence, the depot is a new and separate facility to maintain a facility, not part of, or an extension of the toll road, to the extent that the toll road constitutes a facility in its own right.

The differences in outcomes in these two examples highlight the very specific enquiry that is required to identify enhancements to existing facilities and the potential need to seek guidance in a number of cases where a common sense view may be that an enhancement is involved given the degree of functional and physical connection.

In another example, the ATO highlights that vacant land on which a proposed expansion to a shopping centre is planned, cannot form part of a facility, although may do so once the expansion has been completed.[17] In such a case apportionment of rental to the facility would be expected.[18]

The application of the trading trust rules in Division 6C

Pursuant to Division 6C, a public unit trust may be treated in a similar way to a company for income tax purposes (referred to as a public trading trust), where it does not wholly carry on eligible investment business. One category of eligible investment business is investing in land for the purpose, or primarily for the purpose, of deriving rent.

In the Draft Ruling the ATO include some guidance on the term investing in land for the purpose, or primarily for the purpose, of deriving rent, noting:

"13. The purpose must be determined having regard to all the relevant facts and circumstances. In determining whether the trustee is investing in land for the purpose, or primarily for the purpose, of deriving rent, regard should be had to several factors including the following:

- *the trust's investment strategy*
- *the length of time the interest in land is held for, and any strategy for its disposal*
- *the actions taken by the trustee to make the land available for leasing by prospective tenants*
- *the terms of the lease(s)*
- *any other arrangements entered into or activities undertaken by the trustee (including in relation to any development of the land, its management, and other incidental activities)*
- *features of the land affecting its suitability for long-term rental or its potential for profit on sale, and*
- *projected rental yield and capital growth.*

14. No one factor is determinative and all the relevant facts and circumstances must be weighed to determine whether the primary purpose test is satisfied. …"

[17] Paragraphs 192 to 194
[18] Paragraphs 228 and 229

Perhaps surprisingly given that Division 6C was enacted more than 30 years ago, these comments seem to be the only public ruling guidance issued by the ATO to date in relation to the primary purpose test.

The ATO also comment on the potential for investments in affordable housing to qualify as eligible investment business noting that, as the rental return on the residential dwelling asset may be below the market rate, it "may be more difficult to demonstrate that the projected rental yield for the property will significantly outweigh the projected capital growth"[19]. In this case the ATO considers that the trustee entering into a long-term arrangement with an eligible community housing provider to exclusively manages the tenancy of the residential dwelling asset would be relevant in determining whether the below-market rental yield is consistent with the requisite purpose.

Status of the Draft Ruling and next steps

The consultation period for public comments on the Draft Ruling ended on 23 August 2019. The ATO is currently reviewing the feedback received, and will proceed to issue a finalised ruling in due course. The ATO has proposed that the finalised ruling will be backdated to have effect from 1 July 2019.

The finalised version of the ruling will be a binding public ruling. A public ruling is binding on the Commissioner if it applies to a taxpayer and the taxpayer relies on it by acting, or omitting to act, in accordance with it.[20]

Whilst awaiting the finalised ruling, we recommend that taxpayers review their existing cross staple arrangements and generally seek advice before varying any existing cross staple arrangements or undertaking activities aimed at enhancing or otherwise changing an existing facility, to consider whether such variations or changes may jeopardise the availability of transitional relief or create a risk that the ATO may seek to deny the application of the transitional rules going forward.

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[19] Paragraph 15
[20] As per section 357-60 and PSLA 2008/3