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Tax Insights

Changes to the taxation of stapled structures and limitation of concessions for foreign investors

Overview

On 31 January 2017, the Australian Taxation Office released its updated draft *Privatisation and Infrastructure – Australian Federal Tax Framework* and Taxpayer Alert TA 2017/1. TA 2017/1 expresses concerns regarding certain arrangements which attempt to fragment integrated trading businesses in order to re-characterise trading income into more favourably taxed passive income. According to TA 2017/1, stapled structures were one mechanism being used in these arrangements.

Shortly after the release of TA 2017/1, a holistic examination of the re-characterisation of trading income derived through the use of stapled structures was announced by the Turnbull Government on 25 March 2017. Various public consultation and debate ensued, culminating in the introduction into Parliament of the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018* (the **Bill**) and associated Explanatory Memorandum (**EM**) on 20 September 2018.

Consistent with the name of the Bill, the EM states that the proposed changes are intended to improve the integrity of Australia's tax system for arrangements involving stapled structures by limiting access to tax concessions previously available to foreign investors acquiring interests in assets through Managed Investment Trusts (**MIT**). In essence, this is to be achieved by increasing the MIT withholding tax rate on fund payments to foreign investors from (typically) 15% to 30% where that 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 income that is any of the following (as defined):

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

Transitional rules can operate to preserve the availability of concessional MIT withholding tax rates as discussed further below.

Other measures addressed by the Bill include:

- The prevention of double gearing structures through proposed changes to Australia's 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.

As a whole, we expect that these proposed changes will have a significant impact not only on future expected after tax returns for foreign investors, but will also add to the compliance burden of a diverse range of stakeholders, including foreign investors and fund managers. Moreover, changes to the tax settings for foreign investors with seemingly retrospective effect (albeit subject to transitional rules) has the potential to increase sovereign risk perceptions.

It is worth noting that the Bill has been referred to the Senate Economics Legislation Committee which is due to deliver its report by 9 November 2018. We are aware of a number of industry bodies that have made submissions regarding the Bill.

All legislative references are to the *Taxation Administration Act 1953* (Cth) unless otherwise indicated.

Summary of application of non-concessional MIT income measures

Category	Application date	Application to capital gains on asset disposal by MIT	Application to capital gains on unit disposal by MIT	De minimis, third party rent and economic infrastructure exceptions
MIT cross staple arrangement income	Fund payment on or after 1 July 2019 (unless transitional rules apply)	No	No	Yes
MIT trading trust income		Yes	No	No
MIT agricultural income		Yes	Yes*	No
MIT residential housing income		Yes	Yes*	No

* Provided principal asset test is met.

Summary of application of other measures

Category	Application date
Thin capitalisation	Income years commencing on or after 1 July 2018 (no transitional rules)
Foreign pension fund withholding tax exemption	Payments on or after 1 July 2019 (unless transitional rules apply)
Sovereign immunity	2019-20 income year (unless transitional rules apply)

Summary of transitional rules

Measure	Date of acquisition or commitment	Transitional period ends
NCMI - MIT cross staple arrangement income	27 March 2018	1 July 2026 (or no later than 1 July 2031 if asset has not been put to use for the purpose of producing assessable income) – facility that is not an economic infrastructure facility 1 July 2034 (or no later than 1 July 2039 if asset has not been put to use for the purpose of producing assessable income) – facility that is an economic infrastructure facility
NCMI - MIT trading trust income	27 March 2018	1 July 2026
NCMI - MIT agricultural income	27 March 2018	1 July 2026
NCMI - MIT residential housing income	14 September 2017 or 20 September 2018 for student accommodation	1 October 2027
Foreign pension fund withholding tax exemption	27 March 2018 (at each of the pension fund and trust level, if relevant)	1 July 2026
Sovereign immunity	27 March 2018 (sovereign entities must have or have applied for a ruling)	2025-26 income year (or later time covered by ruling)

MIT cross staple arrangement income

The proposed new rules will apply to fund payments made by a withholding MIT from **1 July 2019**, subject to the application of transitional rules. Where the rules apply to a fund payment, MIT withholding tax will apply at 30%.

In general terms, a stapled structure refers to an arrangement where two or more entities that are commonly owned are contractually bound together, such that the membership interests held by an investor in the stapled entities cannot be bought or sold separately. Stapled structures first emerged in Australia in the late 1980s, and since that time, have become the preferred model in Australia for diversified property groups and infrastructure projects.

The MIT withholding tax concessions were introduced to support the Australian funds management industry in attracting mobile foreign capital by lowering the withholding tax rate on distributions attributable to payments made to certain foreign investors in an Australian MIT that was operated or managed by an Australian fund manager.

According to the EM, the change to the MIT regime was a key reason driving the use of stapled structures in new ways and in new industries, facilitating the generation of "significant tax advantages for foreign investors that are not available to domestic investors". Highlighting the current extent of the use of stapled structures in the market, the EM also notes that there is significant potential for growth, with assets worth "hundreds of billions of dollars" remaining on States' balance sheets which could potentially be privatised into stapled structures in the future.

While TA 2017/1 included a carve out for "third party use of building businesses" (described as involving traditional real estate that the operating entity makes available for use (typically as a dwelling) by independent end-users), the Bill does not include any such exclusion and it is therefore clear that hotels, student accommodation and retirement villages subject to a cross staple arrangement will be impacted by the rules.

Gateway requirements: subsections 12-437(1) and (2)

As a preliminary matter, the proposed new rules require consideration of whether a MIT has an amount of *MIT cross staple arrangement income*. This requires a case-by-case factual analysis of amounts of assessable income received by a MIT during an income year. Broadly speaking, however, a MIT will *prima facie* have an amount of *MIT cross staple arrangement income* if:

- An amount is included in assessable income that is not excluded from being a fund payment of the MIT (typically, this will be income that is *not* a dividend, interest, royalty, non-taxable Australian property net capital gain or foreign sourced income – e.g. rental income);
- That amount of assessable income is attributable to an amount derived, received or made under an arrangement between an entity that carries on an *eligible investment business* (essentially a business to derive passive income) under Division 6C of the *Income Tax Assessment Act 1936* (**Division 6C**) (referred to as an **asset entity**) and an entity that derives trading income (referred to as an **operating entity**); and
- The arrangement is between an asset entity and an operating entity where the total direct and indirect common ownership percentage in each entity is 80% or more (referred to as a **cross staple arrangement**).

Importantly, the rules are intended to capture MITs that are both a direct party to a cross staple arrangement, as well as MITs that receive distributions of assessable income that are attributable to a cross staple arrangement entered into by a sub-trust (i.e. where the MIT is an indirect recipient of income under a cross staple arrangement). Where a MIT is an indirect recipient under a cross staple arrangement, an amount will still be attributable to a cross staple arrangement even where there are multiple tiers of flow through entities interposed between the MIT and the relevant asset entity.

As the rules only apply to *income under the cross staple arrangement*, a fund payment attributable to a capital gain on a disposal of an asset by the asset entity that is not attributable to a cross staple arrangement can still access the concessional 15% MIT withholding tax rate. There is also an exception for capital gains attributable to a cross staple arrangement in which an operating entity acquires an asset from the asset entity (see below).

Exceptions: subsections 12-437(3) – (7)

There are four specific exceptions where cross staple arrangement income will not be *MIT cross staple arrangement income*. Broadly, these are:

- **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– see below for further details; 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.

<u>Excepted MIT CSA income - The approved economic infrastructure exception</u>

Where approved by the Treasurer, cross staple rent from a land investment in an approved economic infrastructure facility is eligible for a 15% MIT withholding tax rate for a period of 15 years from the time when the asset (or improved asset) is first put to use (referred to as **excepted MIT CSA income**). Accordingly, whether an asset forms part of a facility will prove a critical consideration in determining whether any income derived in connection with that asset forms part of the approved economic infrastructure facility exception.

Whilst not defined in the Bill, according to the EM a **facility** is a collection of assets that are connected and together perform a particular function, with a number of relevant factors to consider being identified. The concept of a facility also applies in determining whether any income derived in connection with an asset is covered by the transitional rules (refer below).

Applications to the Treasurer in respect of a particular infrastructure facility, or an improvement to an infrastructure facility, can be made by an Australian government agency (other than the Commonwealth). The decision of the Treasurer may be subject to judicial review under section 39B of the *Judiciary Act 1903*.

<u>Excepted MIT CSA income - Transitional rules</u>

Transitional rules apply to certain existing facilities at the time of first announcement of the proposed measures (being 27 March 2018) or where a contract to acquire create or lease a facility was entered into as at that date. 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; and
- Each stapled entity must make a choice (refer below).

Where transitional treatment is available, it will continue to apply to the MIT concerned irrespective of whether new investors acquire an interest in the relevant stapled structure.

Importantly, the transitional rules also cover future expansions and enhancements where assets are added to an existing facility to improve or extend its functionality. However, if the new assets are a new facility in their own right, that new facility will not benefit from the transitional rules. As such, a determination of what constitutes a single facility or an improvement to a facility will prove critical.

In order to apply the transitional rules, an irrevocable choice must be made by the entities who are parties to the cross staple arrangement, in the approved form, no later than 30 June 2019 (or a later time at the Commissioner's discretion). The choice must subsequently be given to the Commissioner within 60 days.

If the transitional rules apply to a MIT, concessional MIT withholding tax rates remain available in respect of rent (also referred to as **excepted MIT CSA income**) for 7 years (for a facility that is a not an economic infrastructure facility) or 15 years (for a facility that is an economic infrastructure facility), commencing from the start date of the new rules (for existing assets) or when the asset is first put to use for the purpose of producing assessable income (for new assets). There is a hard stop date for the transitional rules of 30 June 2031 (for the 7-year transition) or 30 June 2039 (for the 15-year transition).

Excepted MIT CSA income - Integrity rules

Specific integrity rules apply if a MIT derives or receives excepted MIT CSA income.

If the facility that gives rise to the excepted MIT CSA income is not an economic infrastructure facility (and therefore benefits from the 7-year transitional rule), only the non-arm's length income rule will apply to the facility. That is, no additional specific integrity rule applies.

However, if the facility is an economic infrastructure facility (benefiting from either the approved economic infrastructure facility exception or 15 year transitional rule) both the existing non-arm's length income rule and the proposed concessional cross staple rent cap will apply. The proposed concessional cross staple rent cap has the effect of imposing a cap on the cross-staple rent that can access the concessional MIT rate of 15%.

Where an existing lease with an established rent method or fixed rent amount exists, the cap is either:

- The rent calculated under an objective rent calculation methodology that existed in the relevant cross staple lease, or any associated documents, before 27 March 2018; or
- If an objective rent calculation methodology is not specified but instead a fixed amount of rent is, the fixed amount previously charged (subject to an annual Consumer Price Index adjustment).

Where no existing lease with an established rent method or fixed amount exists, either because a new lease is entered into after 27 March 2018 or the rent had not been agreed to by the parties before 27 March 2018, a statutory concessional cross staple rent cap applies. The statutory concessional cross staple rent cap is determined using a statutory method statement. Broadly, this reflects the amount of rent that would be paid from the operating entity to the asset entity such that the asset entity would have a current year net (taxable) income position equal to 80% of the project's notional current taxable income. Importantly, this means that if the project's notional current taxable income is nil or negative, the concessional cross staple rent cap is nil. This is of particular relevance to large infrastructure projects which often have nil taxable income in their formative years.

If an operating company pays an amount of rent to an asset trust in excess of the concessional cross staple rent cap, the amount of that excess will be treated as NCMI and, to the extent it is reflected in a fund payment made to a foreign resident, is subject to MIT withholding at a rate of 30%.

Further, a priority rule applies to any deductions against assessable rent income of the relevant asset entity, such that any such deductions must be first applied against excepted MIT CSA income (subject to MIT withholding at a rate of 15%), and then against *MIT cross staple arrangement income* (subject to MIT withholding at a rate of 30%), rather than (for example) applying expenses on a pro-rata basis against each income category.

Specific deduction to an operating entity

Broadly, an operating entity is entitled to a specific deduction if the operating entity makes a payment of excepted MIT CSA income to an asset entity and each entity to the stapled arrangement has made a choice to apply the specific deduction. Where validly made, the effect of such a choice is that the operating entity will not be taken to have obtained a tax benefit in relation to the allowance of the deduction for the cross staple rent payment to the asset entity under Australia's general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936*, on the basis that the deduction is the result of a choice available under the tax legislation.

MIT trading trust income

This category of NCMI relates to certain income distributed to a MIT from a trust or partnership that carries on a trading business, but is *not* a public trading trust. Where the rules apply, 30% MIT withholding tax applies to fund payments attributable to such distributions.

The proposed rule effectively prevents MIT concessional withholding tax rates from applying to this category of NCMI despite the fact that the MIT may not control the affairs or operations of the investee for the purposes of Division 6C. Practically, this will require MITs (including fund managers) to ascertain and trace the receipt and distribution of trading trust income and potentially apply two MIT withholding tax rates to fund payments, and adopt appropriate expense allocation methodologies.

Transitional rules apply for 7 years to the extent that the MIT held interests in the investee entity before 27 March 2018. Where new interests are acquired or issued to the MIT, the availability of transitional concessions will be reduced accordingly. Practically, this may mean that different withholding tax treatments could apply to assessable distributions received by a MIT.

MIT agricultural income

The Bill alters the scope of the measures announced on 27 March 2018, which had flagged that investments in agricultural land would no longer qualify as eligible investment business, meaning that, in addition to the removal of concessional MIT withholding tax rates, a public unit trust investing in agricultural land would be taxed in a similar way to a company (i.e. "flow-through" treatment would not be available). As loss of flow-through treatment would have adversely impacted local investors, the change in approach adopted in the Bill is welcomed, although remains difficult to justify as an integrity measure.

Under the Bill, distributions of MIT agricultural income will be subject to 30% MIT withholding tax from 1 July 2019, subject to 7-year transitional rules. MIT agricultural income is defined as assessable income attributable to an asset that is land (including chattels deemed to be land for Division 6C purposes) that is used, or could reasonably be used, for carrying on a primary production business and that is held primarily for the purposes of deriving or receiving rent. As such, MIT agricultural income may also include net capital gains included in the assessable income of a MIT attributable to the disposal of land.

While the MIT agricultural income definition is broad and has the potential to capture certain greenfield sites, the EM notes that the definition should not apply once a site has been rezoned such that a primary production business is no longer permitted.

An economic infrastructure facility is deemed to be an asset separate from the land and not agricultural land for the purposes of these rules.

Transitional rules can apply for 7 years where the relevant asset was held before 27 March 2018, or a contract for the acquisition or lease of the asset had been entered into before that date. Where the MIT receives distributions of MIT agricultural income from a sub-trust, the transitional rules can apply for interests held by the MIT before 27 March 2018. Where new interests are acquired or issued to the MIT, the availability of transitional concessions will be reduced accordingly.

Capital gains on the disposal of membership interests by a MIT will also be MIT agricultural income subject to 30% MIT withholding tax where a modified principal asset test is met – broadly, the market value of the membership interest is mainly attributable to agricultural land for rent.

MIT residential housing income

Following consultation, the Bill refines the policy announced by the former Treasury on 14 September 2017 which would have treated investments in residential housing (other than qualifying affordable housing) as not constituting *eligible investment business*, with the consequence that a public unit trust investing in relevant residential housing would be taxed in a similar way to a company (i.e. *flow-through* treatment would not be available).

Under the Bill, distributions of MIT residential housing income will be subject to 30% MIT withholding tax from 1 July 2019, subject to the application of transitional rules. MIT residential housing income is defined as assessable income attributable to a residential dwelling asset, being residential premises (other than commercial residential premises under the GST rules) or premises used primarily to provide accommodation for students (other than in connection with a school). As such, MIT residential housing income includes capital gains on disposal of residential dwelling assets (other than qualifying affordable housing).

Transitional rules can apply until 30 September 2027 where the relevant facility that consists of or contains the residential dwelling asset was held before the relevant transition date (refer below), or a contract for the acquisition, creation or lease of the asset had been entered into before that date. Where the MIT receives distributions of MIT residential housing income from a sub-trust, the transitional rules can apply for interests held by the MIT before the transition date. Where new interests are acquired or issued to the MIT, the availability of transitional concessions will be reduced accordingly.

The transition date is generally 14 September 2017, with a 20 September 2018 transition date for student accommodation.

The Bill expands the scope of the measure as compared to the previously released exposure draft legislation by capturing all university student accommodation (even where the dwellings constitute commercial residential premises). This is acknowledged in the Bill through the availability of transitional relief for investments in student accommodation prior to the release of the Bill on 20 September 2018.

Capital gains on the disposal of membership interests will also be MIT residential housing income subject to 30% MIT withholding tax where the market value of the membership interest is mainly attributable to residential dwelling assets.

It is expected that a number of groups will make submissions to the Senate Economics Legislation Committee advocating for concessional MIT withholding tax rates to remain available for residential housing to support the current momentum in development of a build-to-rent asset class in Australia. Arguments could also be made for the exclusion of investments in student accommodation and retirement living, given the importance of the international education industry to Australia's economy and the housing and care demands of an aging population.

Thin capitalisation rules

The proposed rules will apply retrospectively for income years starting on or after **1 July 2018**, and are not subject to transitional rules.

Broadly, Australia's thin capitalisation rules seek to prevent multinational groups from obtaining excessive Australian debt deductions by limiting such deductions by reference to the entity's *maximum allowable debt* determined under the rules (including, broadly, a 60% gearing *safe harbour*). The EM states that foreign investors are "increasingly entering into double gearing structures that allow them to convert more of their active business income to interest income that is subject to interest withholding tax of 10% or less in certain circumstances". While the measures are aimed at removing the tax benefits associated with such structures, they can apply much more broadly.

Essentially, a double gearing structure is one where a non-controlling foreign investor in an Australian flow-through entity (e.g. a trust or partnership) that has issued debt up to the safe harbour limit establishes its own holding entity that also issues debt up to the safe harbour limit. Currently Australia's thin capitalisation rules only operate to *group* a trust or partnership with another entity if, broadly, the other entity holds an interest of 50% or more in the trust or partnership or otherwise has a sufficient level of influence. This meant that by using a double gearing structure, investors could effectively achieve gearing levels of greater than the safe harbour limit of 60%.

In short, a key change to the thin capitalisation rules is that the associate entity threshold has been lowered from 50% to 10%.

Under the proposed rules, grouping will apply where an entity holds an interest of 10% or more in a trust or partnership, or where the interest is less than 10% but it is "reasonable to conclude" that a "principal purpose" of the holding arrangement was to avoid grouping. In these cases the overall effective gearing will therefore be limited to 60% under the safe harbour.

As the rules apply in all cases where an entity holds an interest of 10% or more, it is easy to imagine situations where an investor will be subject to the grouping rules but will not be in a position to obtain information from the investee trust in order to calculate its safe harbour amount. This practical issue will need to be addressed from an administrative perspective.

The thin capitalisation rules also provided for a higher maximum allowable debt based on the arm's length debt amount. In determining the arm's length debt amount, the new rules clarify that the debt to equity ratios of any entities' in which the entity has a direct or indirect interest is a factor that must also be taken into account, to the extent the interest is relevant and material to the considerations of an independent lender or borrower. This measure is also intended to prevent effective double gearing utilising the arm's length debt test.

Limitations on the foreign pension fund withholding tax exemption

The proposed rules will apply to income that is derived by a foreign pension fund on or after **1 July 2019**, subject to transitional rules. Broadly, a withholding tax exemption for dividends and interests can currently apply to foreign pension funds that are exempt from income tax in their home country, *irrespective of whether the income is associated with a non-portfolio interest in the paying entity*.

Under the proposed new rules, the withholding tax exemption will be limited to foreign pension funds that are exempt from income tax in their home country where the foreign pension fund:

- Holds a portfolio like investment only (i.e. less than 10%); and
- Broadly, does not have influence (either directly or indirectly) over the entity's operational decisions.

While some guidance is provided in the Bill and the EM in relation to the assessment of relevant influence, including clarifying that certain *step in* rights as a lender can be ignored for these purposes, the influence test is likely to give rise to a significant level of uncertainty in some cases.

Interest and dividends (including non-share dividends) paid to foreign pension funds with a non-portfolio like investment will not be exempt from withholding tax.

A 7 year transitional rule applies (i.e. until 1 July 2026) to income in respect of assets acquired directly or indirectly by a relevant foreign pension fund on or before 27 March 2018.

Sovereign immunity tax exemption

The proposed rules will apply to the **2019-20 income year** and subsequent income years, subject to transitional rules.

Under the new rules, a legislative framework for the existing administrative tax concession for foreign governments (including sovereign wealth funds) will be created. Broadly, under the proposed framework, a covered sovereign entity will be exempt from income tax and withholding tax where the sovereign entity:

- Holds a portfolio like investment only (i.e. less than 10%);
- Derives income or capital gains on an investment in shares or non-share equity in an Australian company, units in a MIT or in a debt interest; and
- No member of the sovereign entity group has influence (either directly or indirectly) over operational decisions of the Australian company or MIT.

A sovereign entity that is not eligible for the sovereign immunity tax exemption will be liable to pay income tax on its taxable income at 30% and will be subject to withholding tax.

For investments held on or before 27 March 2018 where the sovereign entity had also applied for a private ruling on or before 27 March 2018 in relation to the investment, a transitional rule generally applies to income and capital gains for 7 years (i.e. until the 2025-26 income year), provided that the Commissioner grants the ruling prior to 1 July 2026. Where the ruling applies for a period ending after the 2025-26 income year, the transitional rules will apply until that later date.

Effectively at the end of the transitional period the sovereign entity is deemed to dispose of the investment and re-acquire it for the greater of its market value or its cost base, for the purposes of determining a gain or loss on a future disposal (i.e. the cost can be stepped up to market value).

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